Exhibit No. ___T (KLE-1T)
Docket No. UE-051090
Witness: Kenneth L. Elgin

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

IN THE MATTER OF THE JOINT APPLICATION OF MIDAMERICAN ENERGY HOLDING COMPANY AND PACIFICORP DBA PACIFIC POWER & LIGHT COMPANY FOR AN ORDER AUTHORIZING PROPOSED TRANSACTION	**DOCKET NO. UE-051090**

TESTIMONY OF

Kenneth L. Elgin

STAFF OF
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

November 18, 2005

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Kenneth L. Elgin. My business address is Chandler Plaza Building, 1300 South Evergreen Park Drive SW, Olympia, Washington, 98504-7250.

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

A. I am employed by the Regulatory Services Division of the Washington Utilities and Transportation Commission as the Case Strategist.

Q. Have you prepared an exhibit describing your education and relevant employment experience in public utility regulation?

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

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

A. Yes, they are Exhibit Nos. ___ (KLE-3) through ___ (KLE-8).

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

A. I present the Staff analysis of the proposed acquisition of PacifiCorp, d/b/a Pacific Power & Light Company ("PacifiCorp"), by MidAmerican Energy Holding Company ("MEHC") (collectively, "Joint Applicants"). I have reviewed the Joint Application submitted by MEHC and PacifiCorp, their direct testimony and exhibits, and their responses to data requests in this docket and dockets in other states where similar applications are pending. My analysis focuses on the financial impact of the acquisition on PacifiCorp's cost of capital. I also comment on the specific public interest benefits alleged by the Joint Applicants.

II. SUMMARY

Q. Please summarize your analysis of the Joint Application in which MEHC seeks to purchase PacifiCorp.

A. Scottish Power asserts that it no longer wants to own PacifiCorp's regulated utility operations. It has found a willing buyer in MEHC. *Ex. ___ (JAJ-1T), page 8.* However, the buyer proposes to purchase the utility, own it as part of MEHC's holding company structure, and finance the operations of the utility with significant leverage. This is a financial transaction that provides benefits only to the shareholders of MEHC and Scottish Power, and to PacifiCorp's managers.

The transaction will not result in significant changes in PacifiCorp's operations. As Mr. Abel states, "PacifiCorp will operate very much like it does today." *Exhibit No. ___ (GEA-1T) page 23, line 23.* Thus, the transaction is not a traditional merger where utilities and their operations are combined to produce lower costs and other savings for the public.

The transaction's benefits to ratepayers are nominal at best. Each of the ratepayer benefits alleged by the Joint Applicants is an existing public service obligation of PacifiCorp or the continuation of a commitment already made by Scottish Power. Indeed, the transaction could harm ratepayers if the Commission does not react appropriately, as Staff recommends.

Q. Please summarize your recommendation.

A. The Commission has previously applied a "no harm to the public interest" standard in evaluating transactions that change the ownership of a utility. The Joint Application meets the "no harm" standard, assuming the Commission continues to apply that standard, but only with the following condition: immediately after the transaction is completed, the Commission must re-open PacifiCorp's pending general rate case, Docket No. UE-050864, for the limited purpose of determining the impact of the acquisition on PacifiCorp's cost of capital for ratemaking purposes.

Q. Please summarize why this condition is necessary.

A. Following its sale from Scottish Power to MEHC, PacifiCorp will be part of the MEHC holding company structure. The issue then becomes how MEHC capitalizes itself, and whether this new ownership arrangement affects PacifiCorp's cost of capital for ratemaking purposes. Staff's recommended condition for approval is essential to hold ratepayers harmless from any impact on PacifiCorp's cost of capital due to MEHC's ownership.

Q. Why should the Commission be concerned about PacifiCorp's revenue requirement under MEHC's ownership?

A. The Commission should be concerned because MEHC will carry significantly more debt on its balance sheet to fund its consolidated operations than PacifiCorp will carry on its balance sheet to fund its utility operations. MEHC will control PacifiCorp's capitalization. MEHC's equity investment in PacifiCorp will be, in part, borrowed money.

The relevant question is whether rates should support a return on equity for MEHC's investment in PacifiCorp or, instead, a return on debt to reflect the leverage that actually appears on MEHC's consolidated financial statements. Much of my testimony focuses on this "double leverage" issue and the recovery of the $1.2 billion acquisition premium for MEHC shareholders through double leverage.

Q. Are there other issues the Commission should consider in its evaluation of the Joint Application?

A. Yes. The Joint Applicants propose "ring-fencing" provisions that are designed to protect PacifiCorp as a "stand-alone" entity. However, these ring-fencing provisions do not fully protect PacifiCorp against the ongoing financial risk to PacifiCorp and its ratepayers of being part of MEHC's holding company structure. Full "ring fencing" protection can only be obtained by publicly traded public service companies. If the objective is "no harm to the public interest," and to regulate PacifiCorp as if it were a "stand-alone" utility, then it is reasonable to question whether this transaction is in the public interest.

This transaction also does nothing to ameliorate the complexities of regulating a public service company operating in six states, while at the same time being part of a holding company structure. Despite assurances by the Joint Applicants that regulatory commissions will have access to corporate books and records, the ability of the Commission to regulate PacifiCorp will continue to be complicated. Moreover, the Joint Applicants' assurances do nothing to reduce the current burdens on the Commission, Staff and other parties to determine appropriate rates.

III. DISCUSSION

A. Nature of the Transaction

Q. Please describe the transaction proposed by MEHC and PacifiCorp.

A. MEHC proposes to acquire Scottish Power's equity investment in PacifiCorp for a purchase price of $5.1 billion. MEHC will also assume all of PacifiCorp's outstanding debt obligations, which at the time of the application was approximately $4.3 billion. The total transaction is valued at approximately $9.4 billion. *Joint Application at 6*.

According to the application, MEHC will obtain the funds for the purchase of PacifiCorp's equity from two sources: 1) $3.4 billion in equity from MEHC's primary owner, Berkshire Hathaway ("Berkshire"); and 2) the issuance of additional unsecured debt of $1.7 billion. Once the transaction closes, PacifiCorp will be part of the holding company structure of MEHC.

B. Standard for Evaluating the Transaction

Q. Did you review the relevant statutes and rules governing Commission approval of the proposed transaction?

A. Yes. I reviewed the same statutes and rule identified by the Joint Applicants: Chapter 80.12 RCW and WAC 480-143-170.

Q. The Joint Applicants conclude that the Commission's standard for review under these provisions is a "no harm" standard. *Joint Application at 16.* Did you locate the "no harm to the public interest" standard in the text of any of the statutes or rule you reviewed?

A. No. Chapter 80.12 RCW is the Commission's transfer of property statute. It does not contain a standard for evaluating such transfers. It states only that Commission approval of the sale is required.

A standard for approval is contained in WAC 480-143-170, which states that the Commission "shall deny the application" if the proposed transaction "is not consistent with the public interest." However, this is not necessarily a "no harm" standard. Under this language the Commission could require a showing of positive benefits to ratepayers.

Q. Where does the "no harm" standard come from?

A. The Commission applied a "no harm to the public interest" standard in the prior uncontested acquisition of PacifiCorp by Scottish Power. In its Order in that case, the Commission stated: "[i]n our view, Applicants' initial burden is satisfied if they at least demonstrate no harm to the public interest." *Docket No. UE-981627, Pacific/Scottish Power, Third Supplemental Order at 2-*3 *(October 14, 1999)*.

I believe the Commission should have discretion to require MEHC to show that its acquisition of PacifiCorp produces benefits for ratepayers. After all, my analysis shows that the sale will produce tangible benefits for Scottish Power shareholders, MEHC shareholders, and PacifiCorp executives. It would be fair for the Commission to require that ratepayers realize tangible benefits as well.

C. Staff's Analysis of the Ratepayer Benefits of the Transaction

Q. Have you reviewed the Joint Applicants' assertions regarding the benefits of the acquisition and other public interest considerations?

A. Yes. The Joint Applicants outline these alleged benefits and public interest considerations on pages 17-20 of the Joint Application. The public interest considerations they list include:

- Investment in new electrical plant and MEHC's long-term desire to continue to invest in new electric facilities;
- Acquiring a diverse portfolio of new resources;
- Use of collaboratives for regulatory processes;
- Environmental stewardship;
- Emphasis on safety; and
- Positive relationships with other regional interests on energy issues.

The specific benefits identified by MEHC include:

- Investments in emissions control technology and reductions in certain specific emissions, and affirmation of prior commitments for renewable energy resources;
- Specific investments in new transmission facilities and various upgrades to current facilities;
- A ten basis point reduction for the next five year period in PacifiCorp's cost of debt;
- Specific service quality and performance guarantees;
- Reduction in corporate overhead costs;

- Uniform application of prior ScottishPower commitments, and most favored nation clause so that all states are similarly situated with respect to any new commitments.

The Joint Applicants do not specify any benefits from the acquisition that typically arise when utilities combine operations, such as reduced costs, eliminating duplicative roles or positions, or other synergies.

Q. Do these alleged "benefits" and public interest considerations truly constitute benefits of the transaction?

A. No. Each of the "benefits" and public interest considerations cited by the Joint Applicants are either: 1) PacifiCorp's existing obligations under current Washington rules and statutes, irrespective of ownership; or 2) they continue existing commitments of Scottish Power. In other words, MEHC is offering little that could be construed as new tangible benefits that are not currently in place or anything else that could not be achieved under Scottish Power ownership.

Q. The Joint Applicants assert that "… the chief benefit from the acquisition is MEHC's willingness and ability to deploy capital to meet PacifiCorp's infrastructure needs." ***Joint Application at 20.*** **Is this assertion**

representative of your point that the Joint Applicants offer nothing new in the way of material ratepayer and public benefits?

A. Yes. Investment in necessary utility infrastructure is already a current requirement for PacifiCorp, and any other utility for that matter, operating under Chapter 80.28 RCW.

Q. MEHC states that one of the benefits of the acquisition is a 10 basis point reduction in the cost of PacifiCorp's long-term debt for a period of five years. ***Joint Application at 19.*** **Is that a significant benefit?**

A. No. This benefit is too insignificant for the Commission to measure in any meaningful way. Consequently, this is an inadequate measure for evaluating whether there are benefits of the transaction.

Q. Does MEHC anticipate any benefits from joint operations of PacifiCorp with other utilities owned by MEHC?

A. No. As Mr. Able testifies, "PacifiCorp will operate very much like it does today; it will not be merged with other platforms such as [MidAmerican Energy Company]." *Exhibit No. ___ (GEA-1T), pages 24-25*. This testimony is an explicit recognition by MEHC that PacifiCorp will continue to operate as a stand-alone business, with no significant operational benefits through a combination with any other business unit.

Q. The Joint Applicants assert that one of the benefits of the transaction is the reduction in corporate overhead costs of approximately $6 million per year or $30 million over the next five year period following the transaction. ***Joint Application at 19.*** **What is Staff's position regarding this asserted benefit?**

A. First, the premise of the claim is disputed. The system wide cross-charges (overhead) from Scottish Power is currently a contested issue in PacifiCorp's pending general rate case, where Staff states that the appropriate amount is $11.6 million, rather than $15 million, as presented by Mr. Specketer. *Exhibit No. ___ (TBS-3), page 1.* Therefore, the reduction in corporate overhead costs is only about $2 million annually. Washington's share of that amount is about $160,000, which is immaterial in the context of a transaction that exceeds $9 billion to complete.

Second, if PacifiCorp is not earning its fair rate of return, then a reduction in corporate overhead charges is one of the first steps ratepayers could reasonably expect Scottish Power to undertake in order to improve the financial performance of PacifiCorp. In other words, a reduction in corporate overhead charges does not support a claim that the transaction results in a benefit to ratepayers.

Q. What conclusion is appropriate to draw from the benefits listed by the Joint Applicants?

A. Ratepayers will realize no significant benefits from this transaction.

D. Staff's Analysis of the Investor Benefits of the Transaction

Q. Did Staff analyze the benefits of the transaction to investors?

A. Yes.

Q. What did that analysis show?

A. The analysis shows that MEHC will be able to reap substantial financial benefits from this transaction.

1. Key Terms: "Leverage," "Double Leverage" and "Acquisition Premium"

Q. Three of the terms you use later in your testimony are "leverage," "double leverage" and "acquisition premium." Before you proceed with your

financial analysis, please explain what "leverage" means in terms of financial policy.

A. "Leverage" is the opportunity of any business enterprise to issue debt to finance the long-lived assets necessary to deliver a service or product. By financing assets with debt in lieu of equity, financial leverage enables a firm to magnify earned returns for shareholders. Earned returns are increased because lower cost fixed debt obligations are substituted for higher cost equity capital. In so doing, the business is able to increase net income for shareholders, and lever the earned returns on the remaining smaller equity investment.

The key objective for financial managers is to find the lowest overall cost of capital, which implies the maximum amount of debt, in order to maximize the return to shareholders.

Q. Please give an example of a highly leveraged company.

A. Any firm with low business risk is an ideal candidate for being a highly leveraged company. Business risk is determined principally by the variability of cash flows. Utilities generally fall into the category of low business risk. Indeed, any business that can stabilize its cash flow is able to issue additional debt, lower its overall cost of capital, and maximize the return to shareholders.

Q. Please define "double leverage."

A. Double leverage arises when a business, such as MEHC, is organized as a holding company, and both the holding company and the operating company, here PacifiCorp, can issue debt. Since MEHC controls the amount of equity in PacifiCorp, MEHC can issue debt and record the proceeds on PacifiCorp's books as equity. Therefore, MEHC can enhance its return on equity twice from leverage: once on the book equity of the operating company, PacifiCorp, and then again on book equity at the holding company level.

Q. Please give an example of how MEHC uses double leverage.

A. MEHC's current financial statements provide an example. As I explain in more detail later, MEHC is currently capitalized with roughly 79% debt and 21% equity, but MEHC's operating companies have significantly different capital structures. For example, the books of Northern Natural Gas Company show capitalization ratios of 40% debt and 60% equity; Kern River Gas Transmission Company shows capitalization ratios of 60% debt and 40%

equity; and MidAmerican Energy shows capitalization ratios of 46% debt and 54% equity.

Because MEHC is the source of the equity for these operating companies, and MEHC is able to issue debt to fund its equity investment in these operating companies, MEHC is able to realize a significant financial reward from the holding company ownership structure.

Q. Do MEHC's capitalization ratios with the acquisition of PacifiCorp also show the effects of double leverage?

A. Yes. Mr. Goodman's own calculation shows a post-transaction debt ratio for MEHC of 71% and an equity ratio of 29% (Exhibit No. ___T (PJG-1T), page 5, Table 1), yet PacifiCorp's equity ratio is only 43%. *Exhibit No. ___ (KLE-4), page 2.*

Q. Using that example comparing MEHC's capitalization ratios to those of PacifiCorp, please explain how MEHC can use double leverage to its benefit.

A. Since MEHC would only have 29% of its total consolidated capitalization provided by equity, the remaining debt on its consolidated balance sheet is funding the equity investment in the operating companies, which would include PacifiCorp if the transaction is completed. If regulators set rates to provide a return on equity and associated income taxes to support PacifiCorp's equity, while MEHC's cost of that equity is much lower because it is funded by MEHC with debt, MEHC will be able to realize a high return on its actual equity investment. As I stated previously, the question is whether rates should support a return on equity and associated income taxes, when the actual cost to the owners of PacifiCorp is a function of MEHC's cost of debt.

Q. Please explain the term "acquisition premium".

A. The term "acquisition premium" describes a sale of any asset for more than its net book value. In this case, it is the difference between the $5.1 billion net purchase price paid by MEHC to Scottish Power and PacifiCorp's net book equity at the time of closing. At the time of closing, PacifiCorp's estimated net book value will be $3.9 billion. Consequently, the acquisition premium will be approximately $1.2 billion. *Exhibit No. ____ (PJG-1T), page 11, line 10.*

Q. How is an acquisition premium treated for ratemaking purposes?

A. Typically, an acquisition premium is not included in the calculation of rate base and, therefore, it is not recognized in the rate setting process. This is the treatment proposed by the Joint Applicants. *Exhibit No. ___ (BEG-2), page 8.*

2. *Financial analysis of the transaction*

Q. Please describe the financial analysis you performed to evaluate the proposed acquisition of PacifiCorp by MEHC.

A. I began with a review of MEHC's financial statements in order to analyze the assets, liabilities, and income of MEHC before the acquisition. I then compared those results with the *pro forma* financial statements that will result if the transaction is consummated. I also analyzed the intangible assets, *e.g*. acquisition premiums, on MEHC's balance sheet and whether MEHC will realize a return on those intangibles following the transaction.

a. Balance sheet comparison

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

A. Yes. Exhibit No. ___ (KLE-3) shows MEHC's consolidated balance sheet and income statement for the twelve months ended March 31, 2005. The balance sheet (page 1) comes from MEHC's regular quarterly filing with the Securities and Exchange Commission (SEC). The income statement (page 2) was produced by MEHC from its annual and quarterly SEC filings in response to a Staff data request.

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

A. MEHC's current debt ratio is approximately 79%. *Exhibit No. ___ (KLE-3), page 1*. This demonstrates that MEHC currently employs significant financial leverage in its consolidated operations.

Q. Is there a problem with MEHC being capitalized with almost 80% debt?

A. Yes. This extensive use of debt by the holding company, MEHC, coupled with the more modest use of debt by the operating companies under it, creates the "double leverage" effect that I described earlier. The direct result of double leverage provides MEHC shareholders a high return on the book equity of MEHC. Furthermore, MEHC's use of debt provides shareholders a return on the intangible assets on its balance sheet. I will discuss the intangibles issue later.

Q. Please explain how MEHC can benefit from this "double leverage."

A. As I explained earlier, by employing a highly leveraged capital structure, MEHC is able to use debt to finance the equity investment in its operating companies. The Commission sets rates to recover PacifiCorp's revenue requirements based upon a capital structure that presumes both a cost component for a reasonable level of equity investment and associated income taxes. However, the actual cost of a portion of that equity is the net of tax cost of debt to MEHC, not the pre-tax cost of equity. The effect is a mismatch between the assumed cost of ownership provided by regulators and the actual costs of ownership incurred by MEHC. This mismatch benefits MEHC's shareholders. MEHC's consolidated return increases proportionally since it is earning a higher equity return on the lower cost debt MEHC uses to fund its equity investment in its operating companies.

More simply put, MEHC is rewarded since it gets both the higher equity return and associated income taxes on funds it provided at the net of tax cost of debt.

Q. Could ratepayers be harmed by the significant leverage MEHC will have compared to PacifiCorp, if the Commission approves the acquisition?

A. Yes. If this issue is not addressed properly in the rate setting process, double leverage can harm ratepayers. MEHC has a strong financial incentive to issue as much debt as possible, and, in turn, propose significantly greater amounts of equity in utility capitalization ratios for ratemaking purposes. The Commission must take this double leverage effect into account when determining an appropriate capital structure for the utility for ratemaking purposes.

Q. Please describe how double leverage is reflected on MEHC's financial statements and PacifiCorp's financial statements.

A. According to Mr. Goodman, MEHC had a debt ratio of 77.1% and an equity ratio of 22.3%, as of March 31, 2005. *Exhibit No. ___T (PJG-1T), page 5, Table 1*. By comparison, PacifiCorp's equity ratio is 43% and its debt ratio is 55%. *Exhibit No. ____ (KLE-4), page 2*. Once the transaction is consummated, only about 29% of the book equity on PacifiCorp's balance sheet is actual equity on MEHC's balance sheet. *Exhibit No. ___ (PJG-1T), page 5, Table 1.*

Q. Do these figures for MEHC approximate the total amount of leverage employed by MEHC during the period?

A. Yes. My calculations show that, as of March 31, 2005, MEHC had 79% debt and 21% equity. *Exhibit No. ___ (KLE-5)*. My figures are slightly different than the Joint Applicants' calculation because mine include the current portion of long-term debt.

However, regardless of this small difference, the high degree of leverage on MEHC's balance sheet is clear. Both exhibits show that MEHC's debt ratio is significantly higher than PacifiCorp's, which creates the double leverage effect.

Q. What was MEHC's return on equity from continuing operations during the twelve months ending March 31, 2005?

A. The return on equity was 17%. *Exhibit No. ___ (KLE-5), page 2, line 6*.

Q. What does this 17% equity return reveal?

A. This high rate of return reveals rather dramatically the effects of financial leverage on MEHC's current consolidated book equity. From a purely theoretical perspective, this is precisely what one would expect from any firm that uses significant financial leverage on its balance sheet: Financial leverage magnifies earned returns on book equity.

Q. You have explained MEHC's current financial statements. Once MEHC acquires PacifiCorp, will this issue of divergent capital structures between PacifiCorp's regulated utility operations and the parent still remain?

A. Yes. However, MEHC's consolidated balance sheet will improve after it acquires PacifiCorp because the financing plan calls for MEHC's principle owner, Berkshire, to finance its acquisition in PacifiCorp's equity with both equity and debt. As stated in the application, MEHC will fund part of the purchase price with $3.6 billion of equity from Berkshire. Therefore, following the transaction, the degree of double leverage on MEHC's balance sheet will decrease.

Q. Have you prepared an exhibit to show the financial ratios and capitalization amounts that will occur under the proposed financing plan for MEHC's acquisition of PacifiCorp?

A. Yes. Exhibit No. ___ (KLE-6) contains the *pro forma* balance sheet amounts of debt and equity. This exhibit shows a similar opportunity after MEHC's purchase of PacifiCorp for MEHC's shareholders to realize high returns due to double leverage. MEHC's equity and debt ratios will improve to 28% and 72%, respectively. However, PacifiCorp will continue to show on its books a higher equity ratio and a lower debt ratio than MEHC.

Q. How did you calculate the *pro forma* amounts in Exhibit No. ___ (KLE-6)?

A. First, the exhibit shows the $5,100,000,000 purchase price for PacifiCorp's book equity. To generate this cash, MEHC will receive $3,419,700,000 in new equity from Berkshire (line 19), and MEHC will issue an additional $1,709,800,000 in long-term unsecured debt (line 12). Line 11 of the exhibit also shows $3,629,000,000 in PacifiCorp's outstanding debt consolidated into MEHC.

Accordingly, MEHC's *pro forma* amount of debt and equity will increase to $16,884,559,000 and $6,513,400,000, respectively. MEHC's *pro forma* debt ratio is 72% and the *pro forma* equity ratio is 28%. Again, my *pro forma* calculations differ slightly from those presented by Mr. Goodman in Exhibit No. ___ (PJG-1T), page 5, Table 1, for the same reason I discussed earlier in my testimony.

The bottom line is that both Staff and Joint Applicants' *pro forma* calculations show improved capitalization ratios from including PacifiCorp into MEHC's consolidated balance sheet, assuming the proposed plan to fund the acquisition is carried out.

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

A. I estimate that the pro forma return on equity for MEHC is about 14%. *Exhibit No. ___ (KLE-5), page 2, line 23*. This calculation includes estimates of both the additional interest expense associated with the new debt MEHC will issue to pay for the acquisition, and an adjustment to normalize PacifiCorp's operations.

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

A. The reduction in MEHC's earned return on book equity from 17% to 14% is caused primarily by the magnitude of Berkshire's equity investment in PacifiCorp and the financial assumptions of including PacifiCorp's normalized operations in MEHC's consolidated operations. Nevertheless, this data shows that MEHC will earn about 14% on its consolidated book equity once the transaction is complete, which is still a very healthy return.

Q. If the transaction is completed, what will be the effect on MEHC's assets and its underlying equity investment in those assets?

A. After the transaction is completed, MEHC's *pro forma* balance sheet will show new book equity investment of $6,513,377,000, compared to $3,093,677,000 before the transaction. *Exhibit No.____(PJG-1T), page 5, Table 1.*

b. Acquisition premiums on MEHC's books

Q. What other features of MEHC's consolidated financial statements should the Commission consider in this docket?

A. Pre-acquisition, MEHC books show an asset in the amount of $4,285,132,000 for "Goodwill." This is an intangible asset that exceeds MEHC's current book equity of $3,093,677,000 by $1,191,455,000. *Exhibit No. ___ (KLE-3), lines 9 and 36*. After the transaction is completed, MEHC's *pro forma* balance sheet will show Goodwill of approximately $5,450,332,000. In other words, the financial statements of MEHC show that its consolidated operating income provides a return to MEHC for its equity investment in Goodwill both before and after the acquisition of PacifiCorp.

Q. For purposes of financial reporting, has MEHC provided any notice to shareholders about this large amount of Goodwill on its balance sheet?

A. Yes. The footnotes to MEHC's financial statements, Exhibit No. ___ (PJG-4), pages 53-54 and 66, explain the critical accounting policies surrounding SFAS No. 142, "Goodwill and Other Intangible Assets" and how the fair value of these assets is recognized on MEHC's balance sheet. It also explains that Goodwill is not amortized, and it is regularly reviewed by MEHC's auditors to determine whether MEHC can continue to carry it on its books.

Q. What comprises this $4.3 billion in Goodwill currently on MEHC's books?

A. This $4.3 billion is an intangible asset comprised primarily of acquisition premiums associated with prior purchases of the operating companies by MEHC. Exhibit No. ___ (PJG-4), pages 69-70 is a footnote to MEHC's financial statements explaining the recognition of Goodwill due to recent MEHC acquisitions of Kern River and Northern Natural Gas, two operating companies within the holding company structure. The footnotes do not explicitly state the amounts of the acquisition premium paid for these companies.

Q. Why is this asset on MEHC's balance sheet an important factor for the Commission to consider in this transaction?

A. MEHC is proposing to pay Scottish Power $5.1 billion, which exceeds PacifiCorp's net book value by $1.2 billion. As I explained earlier, this $1.2 billion is the acquisition premium. If the Commission approves the Joint Application and the transaction is completed, then MEHC will record the $1.2 billion on its books, increasing the amount of Goodwill on MEHC's balance sheet. MEHC plans to continue to carry that amount on its books, unless otherwise impaired.

As an intangible asset, Goodwill does not produce the underlying value and services of MEHC's operating companies. If an intangible asset is impaired, it would be removed from the balance sheet. Under a worst case scenario, assuming that these intangible assets are impaired and written off MEHC's books, the debt ratio for MEHC would exceed 100%.

Q. What could cause an intangible asset to be impaired and no longer carried on MEHC's balance sheet?

A. The biggest factor would be the consolidated net operating income of MEHC going forward. Any event that would materially affect the earnings of an operating company might cause the auditors to question the continued recognition of the asset.

Q. What is the relationship between double leverage and the Goodwill on MEHC's financial statements once the transaction is closed?

A. Double leverage is the mechanism that provides MEHC a return on the intangible assets, *e.g.*, the acquisition premium, which it will record on its books as Goodwill following the transaction. Double leverage is the means for MEHC to realize a return on the $1.2 billion in excess of book value that it will pay to acquire PacifiCorp.

Q. Is there any information in MEHC's current financial statements with respect to *tangible* assets and how these assets are financed?

A. Yes. Exhibit No. ___ (KLE-3), page 1, line 8, shows a MEHC balance sheet item for a category of assets entitled, "Properties, plants and equipment, net." These entries represent the "real" long-lived assets of MEHC. *See MEHC's Critical Accounting Policies in Exhibit No. ___ (PJG-4), page 53.* For regulatory purposes these assets represent the core components of any rate base calculation. MEHC's balance sheet shows a net amount of $11,679,031,000 classified to these accounts at March 31, 2005. MEHC's total debt for the period is $11,545,759,000. *Exhibit No. ___ (KLE-5), line 13.*

Q. What other aspects of MEHC's consolidated balance sheet are noteworthy in the context of your discussion on Goodwill and acquisition premiums?

A. The amount of equity of MEHC's three principle operating companies, Northern Natural Gas Company, Kern River Transmission Company, and MidAmerican Energy Company, exceeds the consolidated book equity of MEHC. From a Joint Applicant response to a data request, I reviewed the stockholder equity balances for these three companies as of December 31, 2004: Northern Natural Gas Company total equity was $1,168,433,680; Kern River Transmission Company total equity was $716,543,803; and MidAmerican Energy total equity was $1,527,468,000. The total for these three companies is $3,412,445,583, compared to MEHC's stockholder equity of only $2,971,159,000 for the same period.

Q. What conclusions are appropriate to draw from this data and the data you discussed earlier concerning MEHC's tangible and intangible assets?

A. It is appropriate to conclude both that MEHC finances its operations with a significant amount of debt and that MEHC's current equity investment in its operating companies is also financed with debt. Moreover, the data show that MEHC's current equity investment is in Goodwill, an intangible asset.

Q. Following the acquisition, will MEHC continue to realize a return on its investment in Goodwill?

A. Yes. The double leverage issue remains: MEHC will remain financed principally with debt, and the consolidated net operating income will support MEHC's consolidated book equity, which includes its investment in Goodwill. Following the transaction, the Goodwill on MEHC's books will include the acquisition premium it paid for PacifiCorp. *Exhibit No. ___ (BEG-2), page 8*. Double leverage, as before, is the means for MEHC to recover its total investment in PacifiCorp, including the acquisition premium.

Q. Why is recovery of the acquisition premium an important consideration for the Commission in this docket?

A. As I explained earlier, utilities are generally not permitted to recover an acquisition premium. If public service commissions include acquisition premiums in rate base calculations, there is an incentive to artificially inflate rate base, *i.e.*, "pyramiding," through successive acquisitions of public service companies at prices above book value.

On the other hand, commissions permit recovery of acquisition premiums when the utility can show ratepayer benefits from the transaction that justify paying more than book value for the assets. That rationale does not apply in this case because ratepayer benefits are negligible or non-existent.

Consequently, without double leverage, MEHC has no other means to provide a return to shareholders for their *total* investment in the operating companies, including the acquisition premium. MEHC shareholders will pay over $5.1 billion for PacifiCorp, and they will expect a full return on their total investment.

The central question is how to hold ratepayers harmless from the impacts of this purely financial transaction where there are no significant benefits to offset MEHC's cost of acquiring PacifiCorp. Staff's recommended condition for approval protects ratepayers by ensuring that rates reflect the Commission's decision on this central issue.

Q. Earlier you referred to Exhibit No. ___ (PJG-4), pages 53-54 and 66, and the footnote to MEHC's balance sheet regarding SAFS 142 for Goodwill and other Intangible assets. What is the importance of this footnote?

A. It clearly explains a major justification for MEHC to acquire PacifiCorp. If PacifiCorp's cost of capital is determined on a stand-alone basis irrespective of MEHC's financial leverage and its costs to obtain funds to finance the operating companies it owns, MEHC will realize a full return on its investment in PacifiCorp, including the acquisition premium. Otherwise, MEHC would not be able to carry the acquisition premium as Goodwill on its books.

A double leverage adjustment removes MEHC's ability to earn a return on its acquisition premiums. This explains why MEHC says it will propose to directly recover the acquisition premium if any other party proposes a double leverage adjustment in a rate case. *See Exhibit No. __ (GEA-1T), page 13; Exhibit No. ___ (BEG-2), page 8; and Exhibit No. ___ (JPG-1T), page 8.*

c. Other issues

Q. Do you have any other concerns with the acquisition in the context of the *pro forma* capital structure and ratios in your exhibits?

A. Yes. All of the *pro forma* calculations assume that the proposed plan to finance the purchase of PacifiCorp will endure. There is nothing preventing MEHC from varying from its proposed financing plan, such as by issuing additional debt after the acquisition.

For example, MEHC could issue additional debt to fund the $1.0 billion of infrastructure investments identified as imminent for PacifiCorp's operations and record this on PacifiCorp's books as equity. This will further exacerbate the double leverage problem I discussed above.

Q. Is the financial structure of this transaction fair to ratepayers?

A. No. It is not fair to ratepayers to regulate PacifiCorp as a stand alone company, while the stable cash flows of the utility operations support the debt of MEHC, and provide a return for the acquisition premiums paid by MEHC to acquire utility assets.

Q. Do you have any experience in the context of capital structure and the ratemaking consequences of this determination for a utility?

A. Yes. I have considerable experience in the area of rate of return and capital structure. Recently, the Commission has seen significant testimony advocating the need for increased equity ratios for rate making purposes. Indeed, in the pending general rate case, PacifiCorp advocates that rates should support a common equity ratio of 49.5%.

In this case, the Commission is presented with an application for MEHC to purchase PacifiCorp and make it part of MEHC. MEHC's equity ratio upon closing is expected to be only 28%. It makes little sense. How can MEHC, with its aggressive capital structure and significant investments in intangibles, obtain an investment grade corporate credit rating, yet a public service company with a similar balance sheet would carry a junk bond rating?

Q. Do you have an opinion about the underlying rationale for this purchase of PacifiCorp by MEHC, and Berkshire's interest in pursuing utilities?

A. Yes. In my opinion, this transaction is driven by the current macro-economic environment in general, and factors unique to Berkshire in particular.

Q. What macro-economic factors are driving this transaction, in your opinion?

A. The principle factors are: low transaction costs, low real long-term interest rates, expectations for low inflation and, in my opinion the most significant factor, investors' reduced equity risk premiums. Other factors are the current global glut of cash and technology that enables capital to flow freely between markets throughout the world.

All of these macro-economic factors have resulted in a very low cost of capital for investors. Utility equities have benefited greatly from this environment.

Q. How do these macro-economic factors apply to this particular transaction?

A. The principle owner of MEHC, Berkshire, as of December 31, 2004, had over $47 billion in cash on its balance sheet. It is looking to invest this cash, rather than return it to shareholders. Consequently, this transaction should be viewed in the context of Berkshire's opportunity cost of holding excess cash. In today's markets, this opportunity cost is extremely low.

In essence, Berkshire is purchasing a utility and employing leverage through MEHC to generate a return on the book value of the assets, and a return on the acquisition premium it agreed to pay for the equity interest in PacifiCorp.

Further complicating the equation is that utilities are currently being provided equity returns that exceed investor requirements. These high utility equity returns create a further incentive for transactions such as this to take place. As I show in my Exhibit No. ___ (KLE-5), page 2, this transaction is a conduit for Berkshire to acquire utilities through MEHC, and achieve high returns on these investments through double leverage. Ultimately, these high returns for MEHC also increase Berkshire's earned returns.

Q. Have other financial analysts reached this same conclusion?

A. Yes. One portfolio manager, Mr. Tim O'Brien of Evergreen Utility and Telecommunications Fund in Boston, succinctly summarized the transaction as follows:

> (Berkshire) has $25 billion in cash assets earning a 3% return, which is depressing Berkshire's return on equity. A regulated public utility, even a weak one like PacifiCorp, can earn 8% to 9%, return on income. Put a little parent leverage on that and you can get returns up in the low teens. It's unexciting, but certainly a big improvement."[1]

Q. Does Berkshire have any alternative use for its $47 billion in cash?

A. Yes. Berkshire could return the cash to its shareholders in the form of dividends or a share repurchase. Investors today have no tax advantage to deferring the receipt of cash in hopes of realizing future capital gains. If Berkshire shareholders want utility stocks in their portfolios, they can purchase utility shares directly with the cash that Berkshire is holding.

Q. Does Scottish Power have any alternative way to dispose of PacifiCorp?

A. Yes. If Scottish Power's goal is to be relieved of its obligations as the owner of PacifiCorp and to have PacifiCorp regulated as a stand alone entity, then Scottish Power could sell its PacifiCorp shares on the open market.

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[1] *Yahooo! Finance., TheDeal.com, "MidAmerican grabs PacifiCorp," Wednesday May 25, 6:00 am ET, Claire Poole in Houston.*

PacifiCorp would then be a publicly traded, stand-alone utility. This puts everyone back to where they were before the purchase by Scottish Power.

3. Regulatory response to double leverage

Q. Are there ways to protect ratepayers from the financial leverage problem you have identified, if the Commission authorizes the transaction?

A. Yes. There are two different ways to protect ratepayers from double leverage. The first method is to adjust the ratemaking capital structure for the effect of MEHC's leverage. The double leverage adjustment recalculates PacifiCorp's cost of capital. It recognizes the fact that the new owners employ additional leverage at the holding company level to fund the equity investment in the operating companies. The adjustment applies MEHC's cost of debt to the equity in PacifiCorp's capital structure and takes the tax advantages of the debt for the benefit of ratepayers. In essence, this approach accepts the capital structure of the holding company and compensates ratepayers for this additional risk by passing through to them the capital cost savings that result from the higher leverage.

Q. What is the other way to protect ratepayers from the additional financial leverage used by MEHC?

A. 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 "ring fencing" theory advocated by the Joint Applicants in this proceeding. The ring fencing 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 No. ___ (BEG-2), pages 2 and 4.* The Joint Application contains similar ring fencing provisions to shield MEHC's other operating companies from the parent and from one another. *Id.*

Q. Has this "ring fencing" theory been discussed in the regulatory arena as a way to protect ratepayers from the effects of double leverage?

A. Yes. Exhibit No. ___ (KLE-8) is an article from <u>Public Utilities Fortnightly</u> describing the double leverage issue in the context of a private equity acquisition of a utility under a leveraged buy-out.

Page 6 of the exhibit (page 29 of the issue) discusses the ring fencing theory of regulation within a holding company structure, and whether this theory can protect ratepayers. Under this theory, the Commission ignores the owner's leverage by estimating the return on equity and capital structure of a proxy group of stand-alone utilities, and applies that finding to the operating company. Proponents of this theory argue that there is no harm to ratepayers by using this method.

Q. Will ring fencing in fact protect ratepayers from harm if MEHC's purchase of PacifiCorp is consummated?

A. It's unclear. These provisions are MEHC's best efforts to ensure that PacifiCorp continues as a separate bankruptcy risk from the parent and other operating companies. However, the future is uncertain and there are risks to ratepayers due to the relationship between MEHC and PacifiCorp, and MEHC's decision to finance with significant leverage. My review of the literature on ring fencing that MEHC provided during discovery suggests that there are no "fool proof" provisions. If MEHC were forced into bankruptcy, there are no assurances that PacifiCorp would remain unaffected.

Only a separate, stand-alone, publicly traded utility can guarantee the complete isolation of bankruptcy risk for a utility. Because MEHC would still control the ring fenced subsidiary, PacifiCorp, there will always be some possibility that the parent's bankruptcy or other financial distress will adversely affect the ability of the utility to operate, and attract capital and other resources.

Q. Please explain Staff's position regarding the other safeguards and assurances Joint Applicants plan for Washington customers if the transaction is approved?

A. For all other elements of the transaction, Staff is relying on the assertions of the Joint Applicants that they will treat all jurisdictions similarly.

Q. How should the Commission protect ratepayers?

A. If the Commission approves the application, and the transaction is consummated, the Commission should then re-open PacifiCorp's pending general rate case in order to determine whether and how rates should be adjusted to protect ratepayers. This re-opened proceeding would include consideration of a double leverage adjustment and the Joint Applicants' position that they will seek recovery of the acquisition premium if a double leverage adjustment is proposed.

Q. Have you prepared an exhibit to show the potential magnitude of a double leverage adjustment?

A. Yes. My Exhibit No. ___ (KLE-7) illustrates the relative magnitude of such an adjustment. The first step is to estimate the cost of debt for the additional $1,709,000,000 debt that MEHC will issue to acquire PacifiCorp's equity. Then, the expected interest cost to MEHC of this new debt replaces the cost of equity at the proportional difference between MEHC's consolidated equity ratio and PacifiCorp's equity ratio.

Q. What do you estimate MEHC's marginal cost of long-term debt is today?

A. I estimate it to be 6.00%. This is based upon the current yield of twenty-year Treasury bonds at 4.75%, with a reasonable spread for MEHC's current corporate rating.

Q. Please continue your discussion of the exhibit.

A. The top half of the exhibit contains Staff's recommendation in Docket No. UE-050864 for PacifiCorp's weighted average cost of capital. The bottom half of the page adjusts PacifiCorp's ratemaking equity ratio for MEHC's estimated marginal cost of debt, and uses that cost rate in lieu of common equity costs.

The result is that the overall rate of return is reduced from 7.40% to 6.52%. The calculation also needs to adjust the interest expense so that the new weighted cost of debt is included in the *pro forma* cost of debt calculation. This ensures that the tax effects of the additional leverage are recognized in the calculation of PacifiCorp's revenue requirements.

Q. Did you estimate the impact this double leverage adjustment would have on PacifiCorp's revenue requirements in Washington?

A. Yes. I asked Mr. Thomas Schooley of Commission Staff to run my double leverage adjustment through the results of operations statement he sponsors in the current PacifiCorp general rate case. The result is that the double leverage adjustment reduces Washington revenue requirements by an additional $10 million.

Q. Are there any other observations you would like to discuss with respect to the double leverage issue and the recovery of the acquisition premium by MEHC for its shareholders?

A. Yes. I made a simple calculation to determine the return requirements for the acquisition premium and Washington's share of that amount.

The acquisition premium is $1.2 billion. Assuming that investors require a 9% return on this investment, MEHC's return requirement on the acquisition premium is $108 million annually. I did not amortize the

Goodwill because it is necessary to calculate only the return on capital. Since Washington is about 8.5% of PacifiCorp's rate base, Washington's share of the acquisition premium return requirement is about $9.2 million annually.

Q. What conclusion is appropriate to reach from this calculation?

A. This calculation of investors return requirements for the acquisition premium supports my testimony regarding how double leverage will be used to provide a return to MEHC shareholders for their total investment in PacifiCorp, including the acquisition premium.

Q. Do you have any final comments about the financial implications of the proposed acquisition?

A. Yes. This double leverage issue is not a new issue for the Commission. It is a variant of the capital structure issue that has been part of the rate setting process since the earliest days of economic regulation in this country. The Commission regularly determines an appropriate capital structure for ratemaking purposes. The issue is how much equity is reasonable to balance the competing interests of safety and cost.

This case involves a holding company scenario. As always, the further the utility ratemaking capital structure diverges from the actual capital structure of the holding company, the greater the impact the divergent leverage will have upon earned returns from ownership of utility stock within the holding company structure. At today's tax rates, every $1.00 of return necessary to compensate common equity owners for their investment requires $1.54 in revenue requirements. Conversely, every $1.00 of return necessary to compensate bondholders for their investment requires only $0.65 in revenue requirements. The difference is $0.89.

This simple calculation explains why Staff recommends that the Commission determine whether rates should provide equity returns and associated income taxes when the cost to MEHC for its equity investment in PacifiCorp is something else, if the transaction is completed.

This is the critical inquiry. The effect of Joint Applicants' proposal is to turn the notion of historical cost rate base regulation on its head. It simply is misleading for MEHC to assert that it will not seek to recover the acquisition premium from ratepayers. *Exhibit No. ___ (GEA-1T) page 13, lines 1-16.* The double leverage employed by MEHC compensates shareholders for the total investment in PacifiCorp, including the acquisition premium.

Q. Please summarize Staff's recommendation for this application by MEHC to acquire PacifiCorp.

A. The Commission should find that MEHC's proposal to acquire PacifiCorp provides no benefits to ratepayers. Following the transaction, there will be little if any change in PacifiCorp's operations. The Commission should be mindful of the incentives this application provides to MEHC as the controller of PacifiCorp's equity ratio, and the impact of double leverage on MEHC's recovery of the acquisition premium.

If the Commission chooses to apply the "no harm" standard so that the transaction may proceed, it should also adopt Staff's recommendation to re-examine capital structure in the pending rate case if, and when, the acquisition closes. To do otherwise, would immediately harm ratepayers.

This double leverage capital structure issue will be contentious. Joint Applicants are on record that they will seek recovery of the acquisition premium if a double leverage adjustment is proposed. I have made a case for the public interest benefit of publicly traded utilities. I also believe that I have adequately explained a reasonable scenario for both the current owner of PacifiCorp to unwind this case for the benefit of both ratepayers and shareholders.

Q. Does that complete your direct testimony?

A. Yes.