Exhibit No.___(MPG-1T)
Docket Nos. UE-061546/UE-060817
Witness: Michael Gorman

BEFORE THE

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. PACIFICORP d/b/a PACIFIC POWER & LIGHT COMPANY Respondent.	)	**Docket No. UE-061546**
In the Matter of the Petition of PACIFIC POWER & LIGHT COMPANY For an Accounting Order Approving Deferral of Certain Costs Related to the MidAmerican Energy Holdings Company Transition.	)	**Docket No. UE-060817**

DIRECT TESTIMONY OF

MICHAEL P. GORMAN

ON BEHALF OF

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

February 16, 2007

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q. WHAT IS YOUR OCCUPATION?

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

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A. These are set forth in Exhibit No.___(MPG-2).

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

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

Q. WHAT IS THE SUBJECT OF YOUR TESTIMONY?

A. I will comment on the appropriateness of adjusting PacifiCorp's authorized return on equity to reflect the operating risk reductions if the Company's Power Cost Adjustment Mechanism ("PCAM") is approved.

Second, I recommend an adjustment to the Company's income tax expense recovery in retail rates. My proposed tax adjustment will limit the recovery of income tax expense to an amount that will be paid to government taxing authorities

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS.

A. My recommendations are summarized as follows:

1. If the Company's PCAM is approved, I recommend PacifiCorp's 10.2% current authorized return on equity be reduced by 0.3%, down to an authorized return of 9.9%. This would reduce PacifiCorp's Washington jurisdictional retail revenue requirement by $1.2 million.

2. I recommend PacifiCorp's Washington retail jurisdictional revenue requirement be reduced by $3.0 million to reflect an adjustment to its income tax expense to an amount equal to the tax expense likely paid to government taxing authorities.

I. RETURN ON EQUITY ADJUSTMENT

Q. HAS THE COMPANY PROPOSED TO ADJUST ITS AUTHORIZED RETURN ON EQUITY OF 10.2% TO REFLECT THE IMPACT OF THE PCAM IN THIS PROCEEDING?

A. No. PacifiCorp's witness Andrea Kelly states that the Company is not re-litigating the cost of equity in this proceeding, and does not assess the potential impact on its return on equity if its PCAM is approved. She states that until the Company's PCAM is approved by the Washington Utilities and Transportation Commission ("WUTC" or the "Commission"), it would be speculative to estimate the potential impact to its return on equity. She recommends the return on equity reflected in a PCAM should be considered in PacifiCorp's next rate filing – not this proceeding. Exhibit No.___(ALK-1) at 11.

Q. IS IT APPROPRIATE TO ADJUST PACIFICORP'S AUTHORIZED RETURN ON EQUITY OF 10.2% TO REFLECT THE RISK REDUCTION IF THE PROPOSED PCAM IS APPROVED IN THIS PROCEEDING?

A. Yes. In PacifiCorp's last rate filing, the 10.2% return on equity was awarded without a PCAM. A PCAM will not only reduce PacifiCorp's risk, but will increase rate volatility risk to customers. Hence, it is cost justified to reduce PacifiCorp's authorized return on equity to reflect its risk reduction and to compensate customers for taking a proportion of PacifiCorp's power cost volatility risk.

Q. WHAT RETURN ON EQUITY ADJUSTMENT DO YOU BELIEVE WOULD BE REASONABLE IF PACIFICORP'S PCAM IS APPROVED?

A. If a PCAM is approved, I recommend reducing its authorized return on equity by 0.3%. My proposed equity return adjustment is based on an assessment of reduced capital cost recovery risk demanded by the market. I proxied a fair return reduction using the three-year average yield spread between 'A' rated utility bonds and 'Baa' utility bonds. A utility with a credit rating of 'A' has a greater probability of full recovery of its debt service cost than a utility with a 'Baa' rating. As shown on my Exhibit No.___(MPG-3), the ten and five-year average spread between 'A' and 'Baa' utility bond yields has been approximately 0.3%. Thus, if the PCAM is approved, a fair and reasonable adjustment to PacifiCorp's 10.2% return on equity would be to reduce the authorized return on equity by 0.3% to 9.9%.

II. INCOME TAX EXPENSE ADJUSTMENT

Q. ARE YOU PROPOSING AN ADJUSTMENT TO PACIFICORP'S ESTIMATED AMOUNT OF INCOME TAX EXPENSE RECOVERY IN RETAIL RATES?

A. Yes. I recommend adjusting PacifiCorp's income tax expense to reflect the debt interest offset to PacifiCorp's taxable income on the debt capital used by MidAmerican Energy Holding Company ("MEHC") to fund its investment in PacifiCorp's common stock. PacifiCorp consolidates its taxable income with MEHC and Berkshire Hathaway and other affiliates. Therefore, to the extent MEHC has relied on debt to fund its investments in PacifiCorp, that debt interest will offset the taxable income on PacifiCorp's stand-alone equity income, and thus, reduce the income tax payable to government taxing units on PacifiCorp's earnings.

There are further complications to PacifiCorp's consolidated income tax expense because PacifiCorp consolidates its taxable income with Berkshire Hathaway and all of its affiliates, not just MEHC. However, in order to estimate an amount of income tax expense that should be recovered from retail ratepayers, my adjustment is limited to reducing PacifiCorp's income tax expense to reflect only the capital supporting MEHC's investment in PacifiCorp's common equity. Moving further up the affiliate corporate structure significantly complicates the issue and I did not perform that adjustment.

Q. IF PACIFICORP'S COMMON STOCK WERE OWNED BY PUBLIC SHAREHOLDERS INSTEAD OF MEHC, WOULD IT STILL BE APPROPRIATE TO REFLECT THE CAPITAL SUPPORTING THE PUBLIC'S INVESTMENT IN PACIFICORP'S COMMON STOCK IN ESTABLISHING ITS WASHINGTON JURISDICTIONAL RECOVERABLE INCOME TAX EXPENSE?

A. No. If PacifiCorp was owned by public shareholders, then its income tax expense would not be consolidated with the owners of its stock. In that instance, PacifiCorp's taxable income, based on traditional ratemaking formulas, would be a reasonable estimate of the amount of income tax expense that would ultimately be paid to government taxing units. However, since PacifiCorp is not owned by public shareholders, but rather is controlled by MEHC and files consolidated tax returns with MEHC, then MEHC's parent capital structure and tax deductible interest on the capital supporting its equity investment in PacifiCorp will impact the amount of income tax expense on PacifiCorp's earnings that will be paid to government taxing authorities.

Q. DOES MEHC OWN PACIFICORP DIRECTLY?

A. No. MEHC owns PacifiCorp's common equity through PPW Holdings LLC ("PPW"), a special purpose entity. PPW is 100% common equity financed and does not issue debt or equity capital on its own. Rather, it gets all of its capital from MEHC. The PPW setup provides ring fence protection to PacifiCorp. However, since MEHC funded its investment in PPW, and subsequently its acquisition of PacifiCorp's common equity with its own capitalization, the debt portion of that capital creates interest deductions that can reduce the income tax payable on PacifiCorp's taxable income.

Q. ARE YOU PROPOSING TO USE OPERATING LOSSES AT OTHER AFFILIATE COMPANIES TO REDUCE THE AMOUNT OF PACIFICORP INCOME TAX RECOVERABLE FROM UTILITY RATEPAYERS?

A. No. My proposed adjustment does not reduce income tax collections from PacifiCorp's retail ratepayers based on operating losses at other affiliate companies. Rather, my income tax adjustments simply reflect the capitalization mix chosen by MEHC to support its investment in PacifiCorp. Hence, this income tax adjustment reflects the amount of deductible interest related to MEHC's capital supporting its investment in PacifiCorp's common equity. It in no way reflects operating losses or capitalization decisions for any other MEHC or Berkshire Hathaway investment other than PacifiCorp.

Q. WHAT IS YOUR PROPOSED ADJUSTMENT TO PACIFICORP'S TAXABLE INCOME?

A. As developed on the attached Exhibit No.___(MPG-4), I recommend reducing PacifiCorp's Washington jurisdictional federal income tax expense recoveries by $3.0 million.

Q. HOW DID YOU DEVELOP YOUR PROPOSED INCOME TAX ADJUSTMENT FOR PACIFICORP?

A. I replicated PacifiCorp's Washington jurisdictional operating revenue for return before a price change on my Exhibit No.___(MPG-4). I adjusted the income tax expense at its current revenue to reflect MEHC's interest on the debt supporting its PacifiCorp equity investment.

On page 2 of Exhibit No.___(MPG-4), I reflect this adjusted operating income to determine an operating income deficiency at current rates. I grossed this operating income deficiency up to the relevant tax factor to derive an adjusted operating revenue adjustment.

The difference between my estimated revenue deficiency reflecting this income tax expense adjustment and the Company's proposed revenue requirement increase results in a $3 million reduction to the Company's claimed revenue deficiency. This reduced revenue requirement is attributable to this income tax expense adjustment.

Q. PLEASE EXPLAIN HOW YOU ESTIMATED THE TAX EXPENSE REVENUE REQUIREMENT ADJUSTMENT.

A. The amount of MEHC debt interest expense supporting its PacifiCorp equity investment is based on MEHC's parent company capitalization mix of debt and equity. In response to ICNU Data Request No. 5.2, PacifiCorp indicated that MEHC's parent capitalization mix at September 30, 2006 was 34.3% debt, and 65.7% common equity.[1/] This was parent company capital only, and excluded significant subsidiary debt, including PacifiCorp's stand-alone debt. Hence, PacifiCorp's common equity is supported by MEHC's capital consisting of 34.3% debt and 65.7% common equity. In that same data response, PacifiCorp indicated MEHC's embedded cost of debt was 6.25% at September 30, 2006.

As shown on page 3 of Exhibit No.___(MPG-4), using these parameters, I estimated the amount of debt interest expense incurred by MEHC in the capital supporting its investment in PacifiCorp's common equity to be $5 million. I included this $5 million of debt interest in the income tax calculation for PacifiCorp. This resulted in a reduction to the income tax expense at current rates. At current rates, PacifiCorp estimated an income tax expense of approximately $2.5 million. With this adjustment, the income tax expense increased by about $650,000. This increased the rate of return at

[1/] Exh. No.___(MPG-5) at 2.

current rates from 5.547% estimated by PacifiCorp, up to 5.80% with this income tax adjustment. Then, on page 2 of this exhibit I recalculated PacifiCorp's revenue deficiency using a 5.8% return on rate base at current rates, rather than the Company's 5.547%. This reduced the claimed revenue deficiency by $3 million. Thus, adjusting the income tax expense to reflect the amount of tax likely to be paid to government taxing units as a result of interest expense deductions lowers PacifiCorp's revenue requirement by approximately $3 million.

Q. IS IT REASONABLE TO LIMIT PACIFICORP'S INCOME TAX EXPENSE RECOVERY TO ONLY THE AMOUNT OF EXPENSE THAT ULTIMATELY WILL BE PAID TO GOVERNMENT TAXING AUTHORITIES?

A. Yes. PacifiCorp should only be permitted to recover operating expenses that provide benefits to customers. As such, PacifiCorp should only be allowed to recover income tax expense from customers that is likely to actually be paid to government taxing units. Because of MEHC's capitalization mix and consolidated tax return, a certain amount of PacifiCorp's taxable income will be reduced by debt interest on capital relied on by MEHC to fund its investment in PacifiCorp. This will reduce the taxes paid to government taxing units on PacifiCorp's taxable income. As such, PacifiCorp should only be allowed to recover through rates the income tax expense that would ultimately be paid to government taxing authorities.

Q. DOES YOUR PROPOSED INCOME TAX ADJUSTMENT IMPACT PACIFICORP'S DEFERRED INCOME TAX USED IN THE RATEMAKING FORMULA?

A. No. Deferred income taxes are based on the depreciation timing differences between book depreciation rates and tax depreciation rates. In effect, if tax depreciation rates are higher or lower than the book depreciation rates, and retail rates are based on book depreciation rates, then the Company will record deferred tax.

My proposed income tax adjustment will not change this relationship, nor will it impact the Company's deferred taxes or deferred tax balance. In fact, in developing my tax expense adjustment, I did not adjust the deferred tax as shown on my Exhibit No.___(MPG-4), page 1, line 6.

Rather, my income tax adjustment is based on the income tax related to PacifiCorp's approved return on common equity or pre-tax net income. This pre-tax net income is after revenues are reduced to fully recover book depreciation expense and all other operating expenses except current income tax. Hence, there will be no impact on PacifiCorp's deferred tax expense or accumulated deferred tax balance caused by my proposed income tax expense adjustment.

Q. DOES YOUR PROPOSED INCOME TAX ADJUSTMENT SATISFY A BENEFIT BURDEN TEST?

A. Yes. My proposed income tax adjustment should not benefit or burden either investors or ratepayers. From the investors' standpoint, the Company will be allowed to fully recover all income tax expense that will ultimately be paid to taxing authorities. As such, it will fully recover all of its debt interest obligations supporting utility rate base, and will be provided an opportunity to earn its after-tax authorized return on equity on equity capital supporting utility rate base. What the utility will not be allowed to recover is income tax expense collections that will not ultimately be paid to taxing authorities.

On the other hand, customers will be asked to shoulder the burden of compensating PacifiCorp for all income tax expense it will incur and ultimately will pay to taxing authorities, but will benefit from receiving utility service.

As such, investors will fully recover income tax expense that will be paid to government taxing authorities, and will be fully compensated at the approved after-tax return on equity.

Q. BUT WOULDN'T IT REDUCE PACIFICORP'S EARNED RATE OF RETURN ON EQUITY IF PACIFICORP MADE TAX PAYMENTS TO AFFILIATE COMPANIES BASED ON PACIFICORP'S STAND-ALONE TAXABLE INCOME, RATHER THAN THE ACTUAL INCOME TAX EXPENSE THAT WILL ULTIMATELY BE PAID TO TAXING AUTHORITIES WHEN PACIFICORP'S TAXABLE INCOME IS ADJUSTED BY THE MEHC DEBT INTEREST DEDUCTIONS?

A. That's certainly a possibility, however, ultimately the shareholders of PacifiCorp will retain income tax payments from PacifiCorp to either MEHC or Berkshire Hathaway, that are not paid to government taxing authorities. Hence, the after-tax cash equivalent of PacifiCorp's authorized return on equity will be retained by PacifiCorp and/or its affiliates.

For example, to the extent PacifiCorp makes income tax expense payments to an affiliate company, and that affiliate pays less than 100% of that tax expense payment to government taxing authorities, then the difference between the cash paid by PacifiCorp to an affiliate, and the affiliate's tax payment to government taxing units, will be retained in PacifiCorp's affiliate corporate structure. This retained income tax payment compensates the affiliates' corporate structure and ultimately its public shareholders. If PacifiCorp's affiliates choose this cash flow management structure, then PacifiCorp may not earn its approved rate of return, but the investment structure that controls PacifiCorp will retain the cash equivalent of PacifiCorp earning its authorized return on equity.

In other words, the cash is retained in the PacifiCorp, MEHC, and Berkshire Hathaway corporate structure. Hence, investors will be fairly compensated for PacifiCorp's low regulated utility investment risk. Customers should not be obligated to pay anything above this amount of fair compensation.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.