

Exhibit No. ___ (PJG-5T)
Docket No. UE-051090
MEHC Acquisition of PacifiCorp
Witness: Patrick J. Goodman

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**IN THE MATTER OF THE JOINT)
APPLICATION OF MIDAMERICAN)
ENERGY HOLDINGS COMPANY AND)
PACIFICORP DBA PACIFICORP POWER &)
LIGHT COMPANY FOR AN ORDER)
AUTHORIZING PROPOSED)
TRANSACTION)**

Docket No. UE-051090

Rebuttal Testimony of Patrick J. Goodman

December 2005

1 **Introduction**

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

3 A. My name is Patrick J. Goodman. My business address is 666 Grand Avenue,
4 Suite 2900, Des Moines, Iowa 50309.

5 **Q. Are you the same Patrick J. Goodman that previously submitted prepared**
6 **direct and revised direct testimony in this docket?**

7 A. Yes, I am.

8 **Q. What is the purpose of your rebuttal testimony?**

9 A. The purpose of my rebuttal testimony is to respond to the direct testimony of
10 Mr. Kenneth L. Elgin of the Commission Staff (“Staff”), Mr. Stephen G. Hill and
11 Mr. James R. Dittmer representing Public Counsel, and Mr. Ken Canon and
12 Mr. Michael P. Gorman representing the Industrial Customers of Northwest
13 Utilities (“ICNU”).

14 **Q. Please identify the topics that are addressed in your rebuttal testimony.**

15 A. My rebuttal testimony addresses several topics discussed in the direct testimony
16 of the witnesses I have just mentioned. In some instances these witnesses have
17 included similar discussions in their direct testimonies. In order to more
18 efficiently address these common discussions, I have organized my rebuttal to
19 respond to these comments as shown in the table below rather than respond to
20 each witness individually and unnecessarily lengthening this reply.

Discussion	Elgin	Hill	Dittmer	Canon	Gorman
Credit Quality	Pages 14-15, 34-35	Pages 8-12	Page 5		Pages 3-14
Double Leverage	Pages 13-26 & 38-46	Pages 23-26	Pages 32-38		Page 16
Acquisition Premium	Pages 26-33			Page 6	Pages 17-19
Ring Fencing	Pages 38-41	Pages 5-7 & 13-23			
Cost of PacifiCorp debt			Page 8	Page 16	Pages 20-22
Money Pooling			Page 11		

2

3 **Response to Credit Quality Concerns**

4 **Q. Please summarize the discussions of the various witnesses with regard to**
5 **credit quality.**

6 A. Fundamentally the concerns of the various witnesses are that MidAmerican
7 Energy Holdings Company (“MEHC”) allegedly employs too much financial
8 leverage and has a lower credit rating than Scottish Power, and that these factors
9 are bound to eventually be detrimental to PacifiCorp’s credit quality and/or
10 require ratepayers to provide financial cross-subsidization.

11 **Q. What is your response to the allegation that MEHC employs too much**
12 **financial leverage?**

13 A. MEHC is very careful and prudent regarding the amount of leverage it employs; it
14 does not over-employ leverage.

15 **Q. Please explain.**

16 A. MEHC is an investment grade company. When compared to other energy
17 companies, MEHC’s BBB- unsecured credit rating is approximately equal to the
18 average credit rating for the industry. Further, Standard & Poor’s reports that it
19 does not believe that the average BBB rating for the industry as a whole will

1 deviate from the current levels.¹ Thus, while ScottishPower does currently have a
2 higher unsecured bond rating than MEHC, that does not detract from the fact that
3 MEHC is an investment grade credit and is on positive outlook at Standard &
4 Poor's and Moody's Investors Service indicating its rating is more likely to go up
5 than to go down.

6 **Q. Please describe the basis for MEHC's credit standing.**

7 A. As is noted by several of the witnesses, a bond rating is composed of the amount
8 of business risk the firm faces and the amount of financial risk that the firm
9 chooses to employ. As these witnesses have also noted, the lower the business
10 risk, the higher the financial risk that can safely be employed and still leave the
11 firm investment grade. (See Hill pages 8-10, Elgin, pages 14-15.)

12 MEHC is an investment grade company for good reasons. Consider
13 Exhibit No. ___(PJG-6). This exhibit contains recent credit reports for MEHC
14 published by Standard & Poor's, Moody's Investors Service and Fitch Ratings.²
15 A review of these documents will indicate that MEHC is an investment grade
16 credit primarily for three reasons: stable cash flows, use of non-recourse debt,
17 and its relationship with Berkshire Hathaway.

18 **Q. Please explain the impact of stable cash flows on MEHC's credit standing.**

19 A. All the rating agencies comment on the stability of the company's cash flows,
20 which lowers the firm's business risk and, in turn, can be used to fund debt
21 service.

¹ "U.S. Utility Upgrades Beat Downgrades In Second Quarter, But Negative Watch List Grew," *Standard & Poor's Ratings Direct*, July, 28, 2005.

² Mr. Gorman has included portions of the Standard & Poor's and Moody's Investors Service reports as is Exhibit No. ___(MPG-3). The full reports are included in my exhibit for the purpose of completing the record and for ease of reference.

- 1 • Standard & Poor’s states that MEHC’s ratings “... reflect the
2 company’s ability to meet its financial obligations from dividend
3 distributions from its diverse portfolio of energy assets.”
4
5 • Moody’s Investors Service states that the “Diversified geographic
6 and business operations provide a varied cash flow stream” and
7 “... the long-term debt rating of MEHC is supported by the quality
8 of cash flows from its regulated and non-regulated platforms.
9 Regulated subsidiaries ... provide for lower business risk and more
10 stable cash flows.”
11
12 • Fitch Ratings comments “(t)he ratings reflect the relative
13 predictable cash flow and solid standalone credit profiles of
14 MidAmerican Energy Holdings Co.’s (MEHC) five regulated
15 subsidiaries... .”
16

17 **Q. Please describe MEHC's use of non-recourse debt.**

18 A. Considerable amounts of the debt on MEHC’s consolidated balance sheet are
19 called “non-recourse debt” to MEHC. If the rating agencies believe the servicing
20 of this debt is being handled satisfactorily by the subsidiaries that issued the
21 obligations, then the determination of MEHC’s creditworthiness reflects this. In
22 addition, portions of MEHC’s subordinated debt is structured such that the rating
23 agencies grant equity treatment for a portion of this subordinated obligation. For
24 instance:

- 25 • Standard & Poor’s comments that “(t)he company’s
26 creditworthiness is ultimately derived from the total quality of the
27 residual distributions from (its) subsidiaries. Standard & Poor’s
28 has made this analytical judgment based on MEHC’s extensive use
29 of nonrecourse project financing, limited interdependency among
30 the individual business units, and the perception that MEHC would
31 abandon equity investments when the economics of the stand-alone
32 business unit so dictate.” Standard & Poor’s goes on to state that
33 due to the structure of significant portions of MEHC’s
34 subordinated debt, up to 40% of some portions of this debt are
35 treated as equity and 100% of other portions are treated as equity.
36
37 • Moody’s Investors Service states that a “(l)arge bulk of (MEHC’s)
38 debt ... consists of non-recourse debt and also includes \$1.5 billion

1 of trust preferred securities issued to Berkshire Hathaway, which
2 are subordinate to senior debt, have deferral provisions and are
3 non-transferable by Berkshire.” The rating agency goes on to state
4 “(w)e also view the existing substantial investment by the majority
5 owner in the form of parent company subordinated debt to be
6 predominately equity-like given the unique characteristics of this
7 instrument. The interest on the instrument is deferrable at
8 MEHC’s option for up to five years, and the ownership of the
9 subordinated debt cannot be transferred.”

10
11 While Fitch Ratings does not comment on this feature of MEHC’s
12 financial structure, its recognition is implicit in the BBB credit rating that it gives
13 the company.

14 It is difficult to separate out all the adjustments rating agencies make to
15 MEHC’s financial statements in the course of their credit review. Thus, while the
16 adjustments mentioned above are made to grant equity credit to portions of
17 MEHC’s debt, there may be other adjustments, some undisclosed, that are made
18 by the rating agencies to MEHC financials to reflect obligations such as leases,
19 pensions, capitalized interest, inventory methods, non-recurring items and
20 possibly other issues. As a result, the final total debt to total capital ratios
21 published by the rating agencies can be difficult to interpret.

22 **Q. How does the relationship with Berkshire Hathaway affect MEHC?**

23 A. MEHC’s relationship with Berkshire Hathaway is a positive for the company’s
24 creditworthiness and the rating agencies acknowledge their comfort with the
25 relationship between Berkshire Hathaway and MEHC in their reports.

- 26 • Standard & Poor’s comments “...the financial resources of
27 Berkshire Hathaway provide some flexibility, which is
28 incorporated in the rating.”
- 29 • Moody’s Investors Service states that MEHC’s “(o)wnership and
30 business organizational structure provides (a) degree of financial
31

1 and operational flexibility.” The report goes on to state “Moody’s
2 views the increased investment by majority owner Berkshire
3 Hathaway to be a favorable indication of the company’s continuing
4 commitment to MEHC and the energy sector.”
5

- 6 • Fitch Ratings comments “(t)he ratings reflect ... the considerable
7 support provided by the company’s principal shareholder,
8 Berkshire Hathaway Inc.” The report further identifies the
9 financial interest of Berkshire Hathaway as a “Key Credit
10 Strength” for MEHC.
11

12 The clear conclusion of the rating agencies after their diligent review of
13 MEHC’s financial structure is that the company has (1) diversified and stable cash
14 flows, (2) that large amounts of the leverage on MEHC’s consolidated balance
15 sheet are satisfactorily serviced by the primarily investment grade subsidiaries
16 that issued the debt and that portions of MEHC’s own debt are actually treated as
17 equity due to the deferral provisions of the debt service and the non-transferability
18 of the securities by Berkshire Hathaway, and (3) MEHC’s association with
19 Berkshire Hathaway is unanimously noted as a strong positive influence on
20 MEHC’s creditworthiness. MEHC’s balance sheet is simply not over-leveraged
21 for the business risk it has and the company has an investment grade credit rating.

22 **Q. How do you respond to the concerns expressed by some witnesses about the**
23 **relationship between Berkshire Hathaway and MEHC and their suggestion**
24 **that Berkshire Hathaway can’t be relied upon to support MEHC?**

25 A. There were two comments made in the testimony of Mr. Gorman. (See Gorman,
26 pages 9-13.) First, Mr. Gorman states that the relationship between MEHC and
27 Berkshire Hathaway in terms of financial support is not contractual and therefore
28 cannot be counted on and, second, that the relationship depends on Mr. Warren
29 Buffett continuing to lead Berkshire Hathaway.

1 In discussing his first comment, Mr. Gorman states that it would be
2 “speculative and inappropriate” to count on the promises of Mr. Buffett and
3 Berkshire Hathaway. Standard & Poor’s disagrees. Standard and Poor’s report
4 clearly addresses this issue by stating that “(i)ndeed, MEHC’s and Berkshire
5 Hathaway’s managements have told Standard & Poor’s that if the need arises, these
6 securities would be restructured before any default.” Exhibit No. ___(PJG-6), Page
7 2 of 10. Clearly Standard & Poor’s sought and received assurances that Berkshire
8 Hathaway intends to stand by MEHC. While Mr. Gorman may consider the
9 promise of Berkshire Hathaway “speculative and inappropriate,” Standard & Poor’s
10 is publishing reports informing clients that it is comfortable with the commitment of
11 Berkshire Hathaway.

12 Mr. Gorman’s second comment is that if Mr. Buffett retires, the direction
13 of Berkshire Hathaway would be in question. In a regulatory world that generally
14 relies on the known and measurable in making decisions, Mr. Gorman’s comment
15 is unusual. Mr. Buffett is in good health, he has indicated no desire to leave his
16 position at Berkshire Hathaway, and the board of directors of Berkshire Hathaway
17 has already addressed the succession issue. What is known and measurable is that
18 Mr. Buffett intends to continue to manage Berkshire Hathaway and continue to
19 support MEHC’s investments in the energy sector. If there is any regulatory
20 concern here, it is Mr. Gorman’s suggestion that “speculation” is a basis upon
21 which a regulatory authority should act rather than on what is known and
22 measurable.

1 **Q. Is there tangible evidence to support the position that PacifiCorp’s**
2 **creditworthiness will be improved by a relationship with MEHC?**

3 A. Yes. At the time of the announcement that MEHC proposed to purchase
4 PacifiCorp from Scottish Power, Moody’s Investors Service affirmed the
5 PacifiCorp rating and stated that:

6 “...the acquisition of PacifiCorp by MEHC may have long-
7 term positive benefits, particularly given the size of the capital
8 investment program, (however) new near-term regulatory
9 challenges may surface as the merger-related approval process in
10 each of the six states could affect the timing and the outcome of a
11 number of important rate cases that are underway. ... This near-
12 term concern is balanced against the longer-term benefits to
13 PacifiCorp’s bondholders of ownership by MEHC, which is 80.5%
14 owned by Berkshire Hathaway, and considers MEHC’s successful
15 track record in operating other regulated utility businesses as well
16 as Moody’s belief that the potential new owners are likely to take a
17 long-term view towards enhancing returns at PacifiCorp.” See
18 Exhibit No. ___(PJG-7), Pages 2-3.

19
20 Fitch Ratings also commented on the acquisition announcement by
21 affirming PacifiCorp’s unsecured debt rating (A-), and declared PacifiCorp’s
22 ratings outlook to be stable. Fitch Ratings mentioned that while it believes
23 regulation is a primary risk for PacifiCorp, it believes there has been progress in
24 this area and that such progress will continue. Fitch Ratings also noted that
25 MEHC has the financial capability to provide equity financing for PacifiCorp’s
26 ongoing capital expenditure program. See Exhibit No. ___(PJG-7), Page 4.

27 After the announcement of the proposed acquisition, Standard & Poor’s
28 placed PacifiCorp’s credit rating on CreditWatch with negative implications.
29 Standard & Poor’s explained that its current unsecured credit rating for
30 PacifiCorp, BBB+, reflected Scottish Power’s consolidated credit profile and that

1 the CreditWatch is based on PacifiCorp's weaker stand-alone metrics. Standard
2 & Poor's also expressed its intention to assess other factors as the transaction
3 proceeds, including the structure of the financing of the acquisition, MEHC's
4 resulting consolidated creditworthiness, the benefits of any ring-fencing
5 mechanisms that MEHC structures around PacifiCorp, PacifiCorp's stand-alone
6 metrics, MEHC's history of strong operations and regulatory management, and
7 any necessary support for PacifiCorp's sizable capital expenditure program. See
8 Exhibit No. ____ (PJG-7), Pages 5-6.

9 While Moody's and Fitch Ratings have concluded that the proposed
10 acquisition will be either a positive credit event or have no negative implications
11 for PacifiCorp, Standard & Poor's is monitoring PacifiCorp's on-going financial
12 results, rate case outcomes, application of Senate Bill 408 in Oregon, and the
13 transaction structures before finalizing their review. My direct testimony
14 discusses MEHC's intention to ring-fence PacifiCorp, and states that PacifiCorp
15 will continue to have its own debt rating, and my belief that PacifiCorp's cost of
16 debt will benefit from an association with Berkshire Hathaway. That testimony
17 also contained a table (reproduced below, updated to November 2005 and revised
18 to include PacifiCorp's unsecured credit ratings) showing that all of MEHC's
19 regulated utility subsidiaries, all of which are ring-fenced, have unsecured credit
20 ratings equal to or above those of PacifiCorp.

Table 1 Senior Unsecured Credit Ratings – November 2005			
	Standard & Poor's	Moody's Investors Service	Fitch Ratings
Berkshire Hathaway	AAA	Aaa	AAA
MidAmerican Energy Holdings Company	BBB-	Baa3	BBB
MidAmerican Energy Company	A-	A3	A-
Northern Natural Gas Company	A-	A3	A-
Kern River Gas Transmission Co.	A-	A3	A-
Northern Electric Distribution Ltd	BBB+	A3	A-
Yorkshire Electric Distribution plc	BBB+	A3	A-
PacifiCorp	BBB+	Baa1	A-

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Furthermore, the Joint Application states that MEHC has committed to finance the acquisition, should it be approved, in a manner that maintains or improves MEHC's current investment grade credit rating (Joint Application, page 18 and Appendix 5 to the Joint Application, page 22). In my direct testimony, I discussed the fact that, after announcement of the transaction, Standard & Poor's placed MEHC's corporate rating and senior unsecured rating on CreditWatch with positive implications, Moody's affirmed MEHC's senior unsecured rating and noted a positive outlook for MEHC, and Fitch Ratings affirmed MEHC's senior unsecured rating with a stable outlook. Overall, these statements by the rating agencies imply improving credit quality at MEHC and compliance with the financing commitments mentioned in the Joint Application.

1 **Q. Are there any examples where MEHC has acquired a company and assisted**
2 **the acquired company in improving its creditworthiness?**

3 A. Yes. In early 2002, Northern Natural Gas Company (“Northern”) was owned by
4 Enron and, due to that entity’s bankruptcy, Northern was rated CC by Standard &
5 Poor’s and B2 by Moody’s Investors Service, both credit ratings well below
6 investment grade. In February 2002, Dynegy Inc. announced its intention to
7 purchase Northern and by late July 2002, Standard & Poor’s had issued Northern
8 a credit rating of B+ and Moody’s Investors Service rating remained unchanged.
9 These credit ratings incorporated Dynegy Inc.’s credit quality at that time and
10 resulted in an improved rating from Standard & Poor’s, but Northern remained
11 below investment grade. In July 2002, MEHC announced its intention to
12 purchase Northern and, by August 2002, Standard & Poor’s had raised Northern’s
13 credit rating to BBB- and Moody’s Investors Service had raised its rating to Baa2,
14 both investment grade ratings. At that time, Standard & Poor’s indicated
15 Northern’s rating would remain on CreditWatch with positive implications due to
16 the expectation that MEHC would structure Northern as a ring-fenced,
17 bankruptcy-remote entity whose rating could achieve a level above MEHC,
18 similar to how MEHC had structured other subsidiaries. Standard & Poor’s stated
19 that it expected MEHC to reduce the leverage at Northern, which would also
20 support a higher credit rating. In September 2002, after structuring Northern as a
21 ring fenced, bankruptcy-remote entity and infusing \$150 million of equity into
22 Northern’s capital structure, Standard & Poor’s raised Northern’s credit rating to
23 A- and after further improvement in the business operations and financial results,

1 Moody's Investors Service issued a rating of A3 in 2005. Northern's credit rating
2 has remained at that level since that time.

3 A similar example is MEHC's acquisition of Kern River Gas Transmission
4 Company ("Kern River"). At the time of the acquisition in March 2002, Kern
5 River carried a credit rating of A- from Standard & Poor's and A2 from Moody's
6 Investors Service. However, it was undertaking a significant pipeline expansion
7 project that, under the terms of its existing indentures, required an investment
8 grade entity other than Kern River to provide completion guarantees. The
9 Williams Companies, Kern River's former parent, was experiencing significant
10 financial problems and by July 2002 had fallen to below investment grade. Thus,
11 MEHC was able to step in and, as an investment grade company, provide the
12 necessary completion guarantees. MEHC subsequently infused over \$300 million
13 of equity into Kern River and it continues to enjoy an A-/A3 investment grade
14 credit rating today.

15 While MEHC has never needed to make infusions of capital into
16 MidAmerican Energy Company ("MEC"), as noted in my revised direct
17 testimony, despite extensive capital expansion projects, MEC has gradually
18 improved its equity ratio under MEHC's ownership from 48%, as of
19 December 31, 1998 to approximately 53%, as of December 31, 2004.³

20 As a further example of the favorable impact of MEHC ownership,
21 PacifiCorp recently renegotiated its \$800 million revolving credit facility in order
22 to take advantage of a strong market for such facilities. This facility was
23 successfully re-negotiated and, not only did nearly all the invited banks that

³ The entity that is now named MEHC purchased MEC in March of 1999.

1 participated in the previous line of credit participate in the new facility, the term
2 of the facility was also extended, interest costs were reduced, and PacifiCorp was
3 able to obtain consents from the entire bank group to allow MEHC to purchase
4 PacifiCorp. (This consent was required because a change in control triggers a
5 consent requirement.) Based on my discussions with Mr. Bruce Williams, the
6 PacifiCorp Treasurer, the banks expressed positive comments regarding the
7 change in control and felt that MEHC would be a better parent for PacifiCorp.

8 In summary, there is considerable evidence that rating agencies and
9 lenders look favorably upon the proposed acquisition. MEHC has every
10 expectation that over the long term, with just, fair and reasonable regulatory
11 outcomes, PacifiCorp's creditworthiness will improve.

12 **Q. Mr. Gorman alleges that MEHC does not have a credit agreement that will**
13 **allow it to post adequate collateral to cover wholesale marketing and trading**
14 **activities in the event MEHC falls below investment grade. (Gorman, page 7)**
15 **Is this a legitimate concern?**

16 A. No. Mr. Gorman fails to recognize that MEHC is not an operating electric utility.
17 MEHC does not engage in any wholesale marketing and trading activity. MEC is
18 the operating utility and that entity has more than adequate credit facilities in
19 place and, as noted in Table 1 above, is rated A-. Furthermore, Mr. Gorman fails
20 to note that his own Exhibit No. ___(MPG-1T) addresses this issue. Therein,
21 Standard & Poor's states:

22 "Compared with other developers, MEHC's business risk is
23 low, due to its limited exposure to the electricity trading and
24 marketing function and other unregulated ventures in comparison
25 with its exposure to the purely regulated delivery businesses that

1 lack commodity risk. ...MEHC has adequate liquidity and access
2 to capital to meet ongoing financial obligations. MEHC maintains
3 revolving, unsecured credit facilities of \$100 million, which it is in
4 the process of expanding to \$400 million, to support liquidity
5 needs and LOCs. As of December 31, 2004, there were no
6 borrowings, but \$70 million of capacity was taken with LOCs.
7 Total unrestricted cash at the parent and subsidiaries was \$828.2
8 million as of June 30, 2005, which is sufficient, given MEHC's
9 stable distribution profile and limited equity commitments." (Note:
10 The acronym "LOC" stands for Letter of Credit. An LOC is a
11 promise by a bank or consortium of banks to extend short-term
12 loans.)
13

14 **Q. Mr. Gorman further claims that MEHC has significant capital obligations to
15 meet that put its credit rating at risk. (Gorman, page 8) Is this a concern?**

16 A. No. Mr. Gorman's own exhibit once again answers his own question. Exhibit
17 No. ___(MPG-1T), which he quotes on page 8 of his testimony, clearly states that
18 "MEHC has adequate cash on hand to fund these maturities."

19 **Q. Mr. Gorman suggests that the cost of MEHC's subordinated debt, issued to
20 Berkshire Hathaway, is high at 11%. (Gorman, page 6) Is Mr. Gorman
21 correct in his suggestion?**

22 A. No. Unfortunately, Mr. Gorman does not have the full story surrounding the
23 financing Berkshire Hathaway has provided. As part of previous acquisitions,
24 MEHC has issued 11% trust preferred securities and zero coupon, non-voting,
25 convertible trust preferred securities. I should add that MEHC has never paid a
26 dividend on its common stock since Berkshire Hathaway became an investor.
27 Thus Berkshire Hathaway's return on its investment in MEHC has been limited to
28 the amounts it has received on the 11% trust preferred securities, which are only a
29 part of its investment in MEHC. Additionally, the trust preferred securities are
30 amortizing and are scheduled to be completely repaid by 2012.

1 **Q. Mr. Hill suggests that the use of a normal capitalization at PacifiCorp, for**
2 **ratemaking purposes, will allow MEHC to capitalize its mix of regulated and**
3 **unregulated companies more inexpensively than it otherwise would be able to**
4 **do. He terms this “financial cross-subsidization.” (Hill, page 4) Is this a**
5 **valid concern and, if so, is there any evidence this is taking place?**

6 A. No, it is not a valid concern. It is MEHC’s desire to maintain an unsecured credit
7 rating of A- at its regulated subsidiaries. That is certainly the intention of MEHC
8 for PacifiCorp as well. If the financial cross-subsidization Mr. Hill is concerned
9 about were taking place, some subsidiaries would have to carry uneconomic bond
10 ratings of double-A or higher in order to “subsidize” other subsidiaries that would
11 carry bond ratings just above default status. As Table 1 above indicates, MEHC
12 is uniform in its treatment of its regulated utility subsidiaries: they are all in the
13 neighborhood of single A. In MEHC’s opinion, bond ratings higher than that
14 would require ratepayers to pay amounts to meet unnecessarily high coverage
15 ratios and the return on an excessively equity thick capital structures. The
16 evidence simply does not support Mr. Hill’s concern.

17 **Response to Double Leverage Concerns**

18 **Q. In your opinion is a discussion of double leverage appropriate in this**
19 **proceeding?**

20 A. No it is not. How the acquisition is structured has nothing to do with whether
21 MEHC and PacifiCorp have met the statutory thresholds to earn the
22 Commission’s approval of the proposed acquisition. Double leverage discussions
23 are best left for future general revenue requirement determinations.

1 **Q. Please summarize the discussions of the various witnesses with regard to**
2 **double leverage.**

3 A. The witnesses claim that PacifiCorp should not be able to recover income taxes in
4 its retail revenue requirement that are alleged to not be paid to state and federal
5 taxing authorities. It is alleged that recovery of such taxes will lead to
6 inappropriate earnings at the holding company level.

7 **Q. Does who owns a utility company necessarily have any impact on the rate of**
8 **return required by investors?**

9 A. No. Assume two identical electric utility companies with identical capital
10 structures. Assume the common shares of Company A are owned by the general
11 public and the common shares of Company B are owned by a holding company.
12 If both companies are identical, then their risks would be identical and the
13 required rate of return to attract capital would also be identical. In the landmark
14 *Bluefield Water Works* case, the United States Supreme Court ruled that:

15 “A public utility is entitled to such rates as will permit it to
16 earn a return upon the value of the property which it employs for
17 the convenience of the public equal to that generally being made at
18 the same time and in the same general part of the country on
19 investments in other business undertakings which are attended by
20 corresponding risks and uncertainties, but it has no constitutional
21 right to profits such as are realized or anticipated in highly
22 profitable enterprises or speculative ventures. The return ...
23 should be reasonably sufficient to assure confidence in the
24 financial soundness of the utility, and should be adequate, under
25 efficient and economical management, to maintain and support its
26 credit, and enable it to raise the money necessary for the proper
27 discharge of its public duties.” [*Bluefield Water Works and*
28 *Improvement Co. v. Public Service Comm’n.* 262 U.S. 679, 692
29 (1923)]
30

1 The Supreme Court recognizes here that (1) a regulated firm cannot
2 remain financially sound unless the return it is allowed an opportunity to earn on
3 the value of its property is at least equal to the cost of capital, and (2) an
4 appropriate allowed rate of return should be sufficient under efficient and
5 economical management to maintain and support the utility's credit and to attract
6 the necessary capital. Neither of these standards can be met if the regulatory
7 authority does not allow the operating utility an opportunity to earn a return on its
8 investment equal to the return investors expect to earn on other investments of the
9 same risk.

10 **Q. If MEHC's proposed acquisition of PacifiCorp is approved, how will MEHC**
11 **structure the transaction?**

12 A. As discussed in my revised direct testimony, the common stock of PacifiCorp
13 would be owned by an entity to be called PPW Holdings LLC. This company
14 would have no debt, and it would be a subsidiary of MEHC.

15 **Q. Is it absolutely inevitable that a holding company will earn a rate of return**
16 **higher than that allowed by a subsidiary operating utility?**

17 A. No. The implicit assumption of those raising this issue is that the operating utility
18 can earn its allowed rate of return. That is not a foregone conclusion.
19 Additionally, the holding company has different financial and business risks than
20 the operating utility company and whether it earns a higher or lower return should
21 not impact the operating utility.

1 **Q. From a theoretical point of view, if a holding company did earn a return**
2 **higher than the return the regulated operating utility was allowed the**
3 **opportunity to earn, can that be justified?**

4 A. Yes. Many of the parties in this proceeding have argued that additional leverage
5 leads to additional risk. That principle is true and it is apparent in different credit
6 quality ratings. However, as risk increases, so does the market-required rate of
7 return. Thus the holding company, if it employs additional leverage, has higher
8 risks, lower credit ratings, and a higher required rate of return.

9 **Q. What treatment has been suggested by the parties in this proceeding if the**
10 **transaction is approved and MEHC consummates the acquisition in the**
11 **manner anticipated?**

12 A. The parties advocate that PacifiCorp should not be permitted to recover income
13 tax expense in its retail revenue requirements to the extent that such income taxes
14 are not actually paid to state and federal taxing authorities. (Gorman, page 19;
15 Elgin, page 17; Hill, page 33) The parties allege that if PacifiCorp is allowed to
16 retain such taxes, MEHC may earn a rate of return on its investment in PacifiCorp
17 higher than what the Commission intended to allow.

18 **Q. Does MEHC object to such a requirement for the approval of this**
19 **acquisition?**

20 A. Yes. Such a condition, which is actually a rate adjustment, should be considered
21 only in a rate case where a full record can be developed. In our view, such a
22 proposal violates the basic requirements of the *Bluefield* case. The proposal
23 suggested by the parties would not allow either the operating utility subsidiary or

1 the holding company parent a fair opportunity to earn its market-required cost of
2 capital.

3 Anticipating such an attempt in a future ratemaking proceeding, MEHC
4 included in its Joint Application the commitment that it would not seek recovery
5 of the acquisition adjustment arising from this transaction unless the Commission
6 ruled that it was appropriate to reach up to the holding company level to obtain
7 benefits arising at the holding company (the leverage) without also recognizing
8 the holding company costs (recovery of the acquisition adjustment and the higher
9 cost of capital). Under such circumstances, MEHC has asked that it be allowed
10 the opportunity to seek recovery of the acquisition premium.

11 **Q. Mr. Elgin suggests that there are two ways to avoid the double leverage**
12 **conundrum: the regulated utility must either be a stand alone, publicly**
13 **owned entity or, alternatively, if structured as a subsidiary of a holding**
14 **company, the subsidiary must be ring fenced tightly enough to protect it**
15 **from any bankruptcy of the holding company parent. (Elgin, pages 38-40).**
16 **Do you have any response to his comments?**

17 A. I believe MEHC can meet Mr. Elgin's conditions. While Mr. Elgin expresses
18 skepticism that a ring fencing structure can be structured tight enough to protect a
19 subsidiary from the bankruptcy of a parent (Elgin, page 40), the evidence shows
20 that such can be done. In Oregon, Portland General Electric was ring fenced by
21 Enron to protect it from Enron's bankruptcy. The ring fencing has been
22 successful and today, as Enron continues to struggle through its bankruptcy,

1 Portland General Electric remains investment grade. I will discuss ring fencing in
2 more detail later in my testimony.

3 **Q. Do you have any comments with regard to the double leverage calculations**
4 **made by Mr. Elgin, (Elgin, pages 41-42), Mr. Dittmer (Dittmer, pages 34-35)**
5 **and Mr. Hill (Hill, pages 24-25)?**

6 A. Mr. Elgin and Mr. Dittmer attempt to calculate the approximate adjustment to a
7 utility's revenue requirement to remove revenue that is intended to represent the
8 amount of taxes that the consolidated entity allegedly will not pay due to the
9 deductibility of interest on leverage employed by a parent in a holding company
10 structure.

11 In a double leverage calculation for a simple holding company structure
12 that includes only a parent and a single utility subsidiary, the weighted average
13 cost of capital for the parent company equals the cost of equity for the subsidiary.
14 Mr. Elgin's Exhibit No. ___(KLE-7) does not appear to satisfy that condition.

15 On the other hand, Mr. Hill's illustrative double leverage example
16 recognizes the link between the weighted average cost of capital of the parent and
17 the cost of equity of the subsidiary. Finally, Mr. Dittmer's calculation does not
18 employ a double leverage capital structure calculation and merely appears to
19 assume that the utility subsidiary is allowed to earn its required cost of capital.

20 **Response to Ring Fencing Concerns**

21 **Q. Public Counsel witness Hill's testimony discusses his concerns surrounding**
22 **whether ring fencing will adequately protect PacifiCorp. Do you have**
23 **anything to add regarding this issue?**

1 A. My Exhibit No. ___(PJG-8) contains documents establishing the ring-fencing
2 provision related to NNGC Acquisition, LLC, the entity created to ring fence
3 MEHC’s acquisition of Northern. This provision, which will be used for PPW
4 Holdings LLC, has been found by rating agencies to provide adequate ring
5 fencing to allow stand-alone ratings of the applicable ring-fenced subsidiaries.

6 To reflect this, Commitment 11 in Mr. Gale’s Exhibit No. ___(BEG-10)
7 will be amended to read as follows:

8 “Any diversified holdings and investments (e.g., non-utility
9 business or foreign utilities) of MEHC following approval of the
10 transaction will not be held by PacifiCorp or a subsidiary of
11 PacifiCorp. Ring-fencing provisions for PPW Holdings LLC will
12 be the same as those in effect for NNGC Acquisition, LLC.
13 MEHC and PacifiCorp will notify the Commission of any changes
14 in the ring-fencing provisions. This condition will not prohibit
15 MEHC or its affiliates other than PacifiCorp from holding
16 diversified businesses.”
17

18 **Q. Please describe the position of the parties with regard to ring fencing of**
19 **PacifiCorp.**

20 A. My impression is that all the parties agree that ring fencing is desirable. The
21 relevant discussion is merely how to assemble the structure. Mr. Hill outlines
22 several provisions he feels are necessary and Mr. Elgin implies several provisions
23 through inclusion of his Exhibit No. ___(KLE-8). (I do not wish to infer too
24 much from Mr. Elgin submitting his Exhibit No. ___(KLE-8), but I assume if he
25 disagreed with the recommendations contained in the exhibit, he would have said
26 so in his direct testimony.)

27 **Q. Has MEHC addressed the ring-fencing concerns identified by Mr. Hill and**
28 **Mr. Elgin?**

1 A. Yes, I believe the use of the NNGC Acquisition, LLC ring-fencing provisions for
2 PPW Holdings LLC and the commitments in Exhibit No. ___(BEG-10)
3 applicable to PacifiCorp address their concerns.

4 **Q. With regard to the calculation of PacifiCorp's equity ratio before a**
5 **distribution can be made by PacifiCorp, Mr. Gorman (Gorman, pages 13-14)**
6 **and Mr. Hill (Hill, page 6) suggest the inclusion of short-term debt in the**
7 **calculation. Are you agreeable to this?**

8 A. No. MEHC's intent here is to utilize PacifiCorp's long-term capitalization to
9 calculate the capital structure of PacifiCorp to meet the distribution test. As a
10 matter of principle, MEHC does not finance long-term assets (i.e., rate base) using
11 short-term sources of funds. MEHC therefore does not believe the inclusion of
12 short-term debt in a regulatory capital structure calculation is appropriate.
13 Rating agency's calculations of leverage ratios reflect adjustments that would not
14 be used for ratemaking purposes and, frankly, may not be disclosed by the
15 agency. Therefore, MEHC believes the concept of adhering to PacifiCorp's long-
16 term sources of capital for this calculation is the appropriate policy to pursue for
17 this commitment.

18 **Response to Cost of Incremental PacifiCorp Debt Issuances**

19 **Q. Please describe the position of the parties with regard to the commitment by**
20 **MEHC and PacifiCorp that, over the five year period following the approval**
21 **of this proposed acquisition, PacifiCorp will be able to issue incremental**
22 **long-term debt at a spread 10 basis points below that of similarly rated peers.**

1 A. The concerns raised by Mr. Dittmer (Dittmer, page 8), Mr. Canon (Canon,
2 page 16) and Mr. Gorman (Gorman, page 20-22) are whether the spread can be
3 accurately quantified and whether PacifiCorp's overall cost of capital will rise as
4 a result of the proposed acquisition.

5 **Q. Are these concerns well founded?**

6 A. No. With regard to the concern over the accuracy of the quantification of the
7 spread, the burden of proof rests with MEHC and PacifiCorp on this issue in the
8 appropriate regulatory proceeding. If a party to such proceeding is not convinced,
9 based on the evidence presented by MEHC and PacifiCorp, that a 10 basis point
10 or greater reduction has been achieved in the incremental cost of PacifiCorp's
11 long-term debt, as compared to PacifiCorp's similarly rated peers, then that party
12 can take the position in the proceeding that the cost of the respective issuances by
13 PacifiCorp for ratemaking purposes should be reduced by up to a maximum of ten
14 basis points from the cost that PacifiCorp reports over the remainder of the five
15 year commitment period. If the Commission concurs, then it can order that
16 adjustment. The risk of failure to provide sufficient evidence rests with MEHC
17 and PacifiCorp. No other party shoulders the company's burden to substantiate
18 its claim.

19 **Q. Mr. Canon also suggests that this commitment will be difficult to enforce. Do**
20 **you have any rebuttal to this claim?**

21 A. I am unaware of any obstacles to the enforcement of this commitment. The
22 commitment is certainly public and, I assume, will become part of the
23 Commission's order in this docket if the transaction is approved. In any event,

1 MEHC and PacifiCorp would consider themselves bound by the commitment if
2 the proposed acquisition is approved. If the Commission rules that MEHC and
3 PacifiCorp have not carried their burden of proof in a future proceeding where the
4 company's allowed rate of return is determined, then the Commission can simply
5 order an adjustment to the cost of PacifiCorp's incremental long-term debt in the
6 determination of any revenue requirement effective for the five year period
7 subsequent to the closing of the proposed acquisition. Enforcement would seem
8 to be quite straight forward.

9 **Q. What response do you have to the allegation that the measure should be**
10 **PacifiCorp's overall cost of capital, not the incremental cost of long-term**
11 **debt?**

12 A. Stating the measure in terms of overall cost of capital effectively requires MEHC
13 to guarantee a specific bond rating for PacifiCorp, something MEHC cannot do.
14 That would require not only efficient and economical utility management, it also
15 would require that the regulatory authority grant the utility an opportunity to earn
16 a fair rate of return. MEHC has made an asymmetric commitment in the ring-
17 fencing structure it will apply to PacifiCorp that if PPW Holdings LLC cannot
18 meet certain credit metrics, MEHC will need to keep PacifiCorp an investment
19 grade utility before any distributions to MEHC would be permitted. That
20 commitment carries with it the risk that the regulatory authority will not employ a
21 double leverage adjustment without allowing PacifiCorp the opportunity to
22 request compensating recovery of the acquisition adjustment. It also carries the
23 risk, as Mr. Elgin's Exhibit No. ___(KLE-8) states, that "... negative regulatory

1 impact can come from other sources: a serendipitous change of rulemaking
2 framework on the timing of recovery of fuels, the pricing of fuel inputs, the
3 willingness to extend rate freeze agreements or engage in prospective rate
4 stabilization discussions.”

5 Thus a desire to keep PacifiCorp’s cost of capital unaffected or to lower it
6 is a collaborative effort in applying the regulatory compact. MEHC will deploy
7 efficient and effective management in return for the regulatory authority’s
8 allowance of an opportunity to earn a fair, just and reasonable rate of return.

9 **Conclusion**

10 **Q. Do you have any concluding comments?**

11 A. Yes. PacifiCorp is currently owned by an entity that has publicly stated that it
12 wishes to divest itself of its investment in PacifiCorp. The Commission has
13 before it a decision to allow a financially strong, proven manager of utility assets
14 that is willing to commit capital to the business to acquire PacifiCorp or,
15 alternatively, it can wait for the next willing buyer, if any. MEHC takes pride in
16 its commitment to regulatory integrity. I believe MEHC is an appropriate
17 acquirer for PacifiCorp and will be an excellent partner for the state of
18 Washington into the future.

19 **Q. Does this conclude your rebuttal testimony?**

20 A. Yes, it does.