BEFORE THE WASHINGTON UTILITIES & TRANSPORTATION COMMISSION

PACIFICORP-MIDAMERICAN MERGER

DOCKET NOS. UE-051090

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ON BEHALF OF

PUBLIC COUNSEL

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subsidization of the unregulated parent (MEHC) by the ratepayers of the regulated entity (PacifiCorp).

Q. Please explain what you mean by financial cross-subsidization and why this Commission should be concerned.

A. Cross-subsidization of a parent company's unregulated operations by its regulated subsidiary operations can occur in many forms. For example, the unregulated firm could provide services to the utility at above-market rates or, conversely, the utility could provide services to its unregulated affiliates at rates below that which would prevail in an arms-length transaction.

Financial cross-subsidization occurs when the capital structure of the utility operation provides financial strength to the holding company, which, in turn, allows the parent to capitalize its consolidated operations with more debt and less equity (i.e., more cheaply) than they would otherwise be able to do. In other words, the utility (and, thereby, utility ratepayers) shoulders some of the financial risk of the unregulated affiliates by allowing the holding company to be capitalized in a manner which would not prevail in a stand-alone situation.

One way that MEHC can maintain a stronger financial profile and offset the increased risks of its unregulated operations, is to set rates with a high common equity ratio for its regulated utility operations while simultaneously financing its unregulated operations with a higher percentage of debt capital than would otherwise be possible. That is the essence of financial cross-subsidization. The tangible result of that action is a common equity ratio for PacifiCorp that is ~~below~~ higher than that of MEHC.

Q. Can the bond rating of a regulated subsidiary be constrained by a financially weaker parent company?

A. Yes, according to publications by the rating agencies. Standard & Poor's, for example, is