Exhibit No.___(SCH-1T)
Docket Nos. UE-061546/UE-060817
Witness: Samuel C. Hadaway

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. PACIFICORP dba Pacific Power & Light Company, Respondent.	Docket No. UE-061546
In the Matter of the Petition of PACIFICORP dba 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

PACIFICORP

REBUTTAL TESTIMONY
OF
SAMUEL C. HADAWAY

March 2007

1 **Introduction and Purpose of Testimony**

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

3 A. My name is Samuel C. Hadaway. My business address is FINANCO, Inc., 3520

4 Executive Center Drive, Austin, Texas 78731.

5 **Q. On whose behalf are you testifying?**

6 A. I am testifying on behalf of PacifiCorp (the Company).

7 **Q. Have you appeared as a witness on behalf of PacifiCorp in previous**

8 **regulatory proceedings?**

9 A. Yes, I have appeared as a cost of capital witness on behalf of PacifiCorp in a

10 number of state regulatory proceedings, including cases before the Washington

11 Utilities and Transportation Commission.

12 **Q. Please state your educational background and describe your professional**

13 **training and experience.**

14 A. I have a Bachelor's degree in economics from Southern Methodist University, as

15 well as MBA and Ph.D. degrees in finance from the University of Texas at Austin

16 (UT Austin). I serve as an adjunct professor in the McCombs School of Business

17 at UT Austin. I have taught economics and finance courses, and I have conducted

18 research and directed graduate students writing in these areas. I was previously

19 Director of the Economic Research Division at the Public Utility Commission of

20 Texas, where I supervised the Commission's finance, economics, and accounting

21 staff, and served as the Commission's chief financial witness in electric and

22 telephone rate cases. I have taught courses at various utility conferences on cost

23 of capital, capital structure, utility financial condition, cost allocation and rate

1 design issues. I have made presentations before the New York Society of
2 Security Analysts, the National Rate of Return Analysts Forum, and various other
3 professional and legislative groups. I have served as a vice president and on the
4 board of directors of the Financial Management Association. A list of my
5 publications and testimony I have given before various regulatory bodies and in
6 state and federal courts is contained in my resume, which is attached as Exhibit
7 No.___(SCH -2).

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

9 A. The purpose of my rebuttal testimony is to respond to the recommendations of
10 Commission Staff witness Kenneth L. Elgin and Industrial Customers of the
11 Northwest Utilities (ICNU) witness Michael P. Gorman concerning cost of capital
12 impacts associated with implementation of PacifiCorp's requested Power Cost
13 Adjustment Mechanism (PCAM). I will demonstrate that their proposed rate of
14 return reductions are unnecessary and inappropriate because they are inconsistent
15 with the treatment of other companies in Washington, inconsistent with the
16 regulatory treatment of the comparable electric utilities that were used to estimate
17 the rate of return, and inconsistent with sound regulatory policy.

18 Mr. Elgin's capital structure adjustment is specifically inconsistent with
19 Commitment No. 18 from the Commission's Order in Docket UE-051090
20 involving PacifiCorp's acquisition by MidAmerican Energy Holdings Company
21 (MEHC). Commitment No. 18 specifies that, for PacifiCorp to avoid dividend
22 restrictions, it must maintain certain minimum equity ratios through 2011—all of
23 which are higher than Mr. Elgin's 42 percent equity ratio recommendation. The

1 Company would thus be precluded from paying dividends if the increased
2 leverage upon which Mr. Elgin's adjustment is based were implemented. In this
3 light, Mr. Elgin's proposal appears to be yet another effort to impose his theory of
4 double leverage, which the Commission soundly rejected in PacifiCorp's previous
5 Washington rate case, Docket UE-050684 (the 2005 Case). Similarly, Mr.
6 Gorman's proposed income tax adjustment based on MEHC's interest deductions
7 resembles the consolidated tax savings adjustment proposed by ICNU in the 2005
8 Case, which the Commission determined to incorporate virtually the same
9 concepts as the rejected double leverage adjustment.

10 **Recommendations of the Parties**

11 **Q. What are the parties' rate of return recommendations?**

12 A. The Company is requesting the same 10.2 percent rate of return on equity (ROE)
13 and capital structure that the Commission established in the 2005 Case, and the
14 updated costs of debt and preferred stock described by Company Vice President
15 and Treasurer Bruce N. Williams. While Mr. Elgin accepts the Company's cost
16 rates for debt, preferred, and common equity, he recommends reducing the
17 Company's equity ratio by 4 percentage points if a PCAM is adopted. His
18 recommendation has the effect of reducing the overall rate of return (ROR) from
19 the Company's requested 8.06 percent to 7.90 percent. While Mr. Gorman
20 accepts the Company's proposed capital structure and cost rates for debt and
21 preferred stock, he recommends a 30 basis point reduction to ROE if a PCAM is
22 adopted. The effect of his recommendation is to reduce the overall ROR to 7.92
23 percent.

1 **Q. Are Mr. Elgin's and Mr. Gorman's recommendations consistent with the**
2 **Commission's treatment of PCAM/rate of return issues in past cases?**
3 A. No. While the Commission in previous decisions has consistently connected risk
4 reduction associated with cost recovery mechanisms with the allowed rate of
5 return, it has not imposed a capital structure adjustment of the magnitude
6 suggested by Mr. Elgin or a one-sided ROE reduction like Mr. Gorman proposes.
7 The Commission's treatment is consistent with the fundamental rate of
8 return principles stated in *Hope* and *Bluefield*[1]: The allowed rate of return should
9 reflect the risks that shareholders bear. To the extent that a PCAM or other
10 mechanism reduces a given utility's risks to less than the corresponding risks of
11 other similarly situated enterprises, the subject utility's allowed rate of return
12 should reflect the lower risks. Conversely, to the extent that a given utility's risks
13 are the same or higher than those of other similarly situated companies, that
14 utility's rate of return should reflect those circumstances. The Commission has
15 consistently found that a sharing of risks between customers and shareholders is
16 appropriate. The one-sided approaches offered by Messrs. Elgin and Gorman do
17 not reflect the fundamental risk-return principle upon which the Commission has
18 relied.
19 **Q. What are the cases in which the Commission addressed this issue?**
20 A. Although the Commission had dealt with cost recovery mechanisms in several
21 earlier cases, in 2002 it approved Settlement Stipulations that contained the risk

[1] *Federal Power Commission v. Hope Natural Gas Company*, 320 US 591, 603 (1944) and *Bluefield Water Works & Imp. Co. v. West Virginia Public Service Commission*, 262 US 679, 693 (1923).

1 sharing principle and its connection to the allowed rate of return. The
2 Commission has stated that whether a cost of capital reduction is necessary
3 depends on the design of the particular power cost recovery mechanism, and that
4 it will make this determination "as part of the overall analysis of how the
5 mechanism shifts risks between investors and ratepayers." (Order 04 in
6 PacifiCorp's 2005 Case.)
7 In Avista Corporation, Docket UE-011595 (June 18, 2002), the
8 Commission adopted a Stipulation that authorized Avista to implement an Energy
9 Recovery Mechanism (ERM). In the Staff's Memorandum Explaining the
10 Settlement Stipulation, Staff explained that the ERM included "an appropriate
11 sharing of risk between shareholders and ratepayers" and that the ERM
12 accomplished goals of "imposing sufficient risk on the Company to justify the
13 existing return on equity…."
14 Similarly, the Commission approved the unopposed Settlement Stipulation
15 in Puget Sound Energy, Inc., Dockets UE-011570 and UG-011571 (June 20,
16 2002). That Stipulation provided for a return on equity of 11.0 percent in
17 combination with a power cost adjustment. The parties agreed that "a power cost
18 adjustment mechanism (PCAM) which properly shares the risk of power cost
19 variations between customers and shareholders is appropriate and will be
20 implemented as part of the General Rate Case."
21 More recently, in Avista Corporation, Dockets UE-050482 and UG-
22 050483 (December 21, 2005), and UE-060181 (June 16, 2006), the Commission
23 approved modifications to Avista's ERM and maintained Avista's 10.4 percent

1 ROE, but required testimony in Avista's next General Rate Case on the cost of
2 capital impact of an ERM.
3 In Puget Sound Energy's General Rate Case, Dockets UE-060266 and UG
4 060267 (January 8, 2007), the Commission denied the company's proposal to
5 eliminate its $20 million deadband and established an ROE of 10.4 percent.
6 Within this context, Mr. Gorman's proposal to reduce PacifiCorp's ROE
7 by 30 basis points, to only 9.9 percent, is unnecessary and inappropriate. As
8 explained by Company witness Mark Widmer, the Company's proposed PCAM is
9 entirely consistent with the risk sharing mechanisms the Commission has
10 approved in prior cases involving utilities with ROEs currently set at 10.4 percent.
11 Considering the Commission's statement in PacifiCorp's 2005 Case that whether a
12 reduction in the cost of capital is necessary depends upon "the design of a sharing
13 mechanism" and the similarity between PacifiCorp's proposed PCAM and
14 existing mechanisms in Washington, a cost of capital adjustment is not
15 warranted.[2]

16 **Rebuttal of Staff Witness Kenneth L. Elgin**

17 **Q. What is the basis for Mr. Elgin's proposed capital structure adjustment?**

18 A. Mr. Elgin summarizes his analysis on pages 4 and 5. His basic thesis is that
19 PacifiCorp's overall rate of return should be reduced if a PCAM is adopted. He
20 proposes to accomplish this result by reducing the Company's equity ratio, for
21 regulatory purposes, from 46 percent as set by the Commission in the 2005 Case

[2] The overall rate of return currently allowed for Avista is 9.11 percent and for Puget Sound Energy 8.40 percent. These compare to PacifiCorp's requested 8.06 percent, Mr. Elgin's 7.90 percent and Mr. Gorman's 7.92 percent.

1 to 42 percent. As noted previously, this equity reduction has the effect of
2 reducing the overall ROR from 8.06 percent to 7.90 percent.
3 **Q. How does Mr. Elgin justify his proposed adjustment?**
4 A. He first summarizes his views on the Commission's past decisions on PCAMs.
5 Oddly, he focuses only on cases from the 1980's and early 1990's. He fails to
6 mention any of the recent cases that I discussed above. His conclusion is that
7 "[w]hile the Commission may not have implemented its policy perfectly by
8 requiring an explicit reduction in the cost of capital each and every time it has
9 been asked to approve a power cost adjustment mechanism, the Commission has
10 been consistent in its pursuit of reduction to the utility's cost of capital related to
11 such mechanisms." (Elgin testimony, page 9, lines 7-10.)
12 **Q. Is Mr. Elgin's view consistent with the Commission's risk sharing principle**
13 **and its application of that principle in recent cases?**
14 A. No. What he describes as the Commission's policy appears to be his personal
15 view of what he would like the Commission's policy to be. As I will demonstrate,
16 Mr. Elgin's views are extreme. They are not consistent with what the
17 Commission has done in recent cases; they are not consistent with the treatment
18 of fuel and purchased power adjustment mechanisms employed by other
19 regulators; and they are not consistent with reasonable regulatory policy.
20 Additionally, the financial analysis that Mr. Elgin offers in support of his position
21 is much too narrow. The one financial metric that he provides is obsolete and is
22 no longer used by the rating agencies, and the conclusions he draws from his
23 analysis are incorrect. I will show that, in fact, if Mr. Elgin's capital structure

1 adjustment were generally applied to PacifiCorp, it would lead to a downgrade of
2 the Company's bonds and to an increase in the cost of capital rather than a
3 decrease as Mr. Elgin recommends.

4 **Q. Please describe Mr. Elgin's PCAM analysis.**

5 A. His entire financial analysis is focused on the evaluation of a single financial
6 metric—the pre-tax interest coverage ratio. He calculates interest coverage ratios
7 under various Company and Staff power supply cost scenarios and concludes that
8 the Company's financial condition would be adequate with the equity ratio
9 reduced from 46 percent to 42 percent.

10 **Q. What is wrong with Mr. Elgin's analysis?**

11 A. His analysis is problematic from both policy and technical perspectives. At the
12 policy level, his conclusion that PacifiCorp's equity ratio should be reduced from
13 46 percent to 42 percent is not appropriate and the resulting loss of the Company's
14 existing bond rating is not a desirable outcome for either the Company or its
15 customers. His recommendation also directly contradicts the Commission's order
16 in Docket UE-051090 and would, if implemented, create a violation of the
17 commitments adopted by the Commission in granting regulatory approval of the
18 MEHC acquisition.

19 A detailed review of his analysis also reveals a number of unreasonable
20 assumptions and conclusions as well as outright technical errors. For instance, his
21 singular focus on the pre-tax interest coverage ratio is much too narrow and his
22 conclusion from the analysis is improper. He states: "A 2.50 coverage ratio still
23 satisfies S&P's criteria for a "BBB" bond rating, which is an investment grade

1 rating." (Elgin direct testimony, page 17, lines 12-13). This conclusion is
2 incorrect on a technical basis because Standard and Poor's (S&P) has not used the
3 interest coverage ratio in its rating criteria since 2004. In addition, S&P has never
4 relied exclusively on one metric in the rating process. Further, from a policy
5 perspective, it would be entirely inappropriate to establish a bond rating target
6 that is lower than the Company's existing single-"A" rating.

7 **Q. What are S&P's current published benchmarks?**

8 A. S&P publishes benchmarks for three financial metrics:
9 1) Funds from operations (FFO) to total debt;
10 2) FFO interest coverage; and
11 3) Total debt to total capital.

12 **Q. What benchmarks would you use to analyze Mr. Elgin's recommendation?**

13 A. I would use the three benchmarks currently published by S&P.

14 **Q. Using these measures, what do you conclude about Mr. Elgin's**
15 **recommendation?**

16 A. His recommendation would lead to a significant weakening of the Company's
17 financial integrity and if generally applied to PacifiCorp, a likely bond
18 downgrading. In Exhibit No.___(SCH-3), I have prepared an analysis of
19 Mr. Elgin's position. On page 1 of that exhibit, I show the results of his
20 recommendation to reduce the Company's equity ratio to 42 percent, with no
21 adverse power costs. As the data show, the three S&P benchmarks would place
22 the Company in the triple-"B" to double-"B" category.

1 **Q. What are the results if the Company experiences adverse power costs?**

2 A. These outcomes are reflected in pages 2-4 of Exhibit No.___(SCH-3). With
3 $5 million of adverse power costs (and Mr. Elgin's sharing mechanism), two of
4 the three S&P ratios are weakened further and, most strikingly, the Company's
5 ROE falls 130 basis points to 8.90 percent. These trends continue as additional
6 adverse power costs are considered. If $10 million of adverse power costs are
7 incurred, the S&P ratios drop to the weak triple-"B"/double-"B" category and
8 ROE would drop to 8.18 percent. With $25 million of adverse power costs, the
9 Company's ROE would drop to 7.74 percent and the remaining credit metrics
10 would place the Company in a seriously threatened financial position.

11 **Q. Your results for the Company assuming adverse power costs of $10 million**
12 **and $25 million are different than the results shown by Mr. Elgin on pages 11**
13 **and 12 of his Exhibit No. ___ (KLE-3). Please explain why.**

14 A. The most important difference is that my analysis focuses on the three financial
15 ratios currently used by S&P, while Mr. Elgin's analysis is based on one ratio that
16 is outdated and obsolete. Furthermore, there are two technical errors in
17 Mr. Elgin's analysis that should be corrected. First, he does not consider off
18 balance sheet (OBS) debt in any of his calculations. Rating agencies and financial
19 analysts consider long-term purchased power agreements to be debt-like and will
20 impute debt and related interest to the utility's financial statements based on the
21 fixed payments the utility is required to make under such agreements. For
22 example, S&P will adjust PacifiCorp's published results and add debt and interest
23 resulting from purchased power agreements when assessing PacifiCorp's

1 creditworthiness. It does so in order to obtain a more accurate assessment of the
2 financial commitments and fixed payments that the Company has.

3 Second, Mr. Elgin determines Net Operating Income (NOI) and then
4 subtracts the impact of adverse power costs to arrive at his estimates of interest
5 coverage and ROE. His NOI value is determined by multiplying a "Pre-PCAM
6 ROR" by the Washington State rate base. In this calculation, Mr. Elgin
7 mistakenly used a Pre-PCAM ROR of 8.06 percent. He should have used his own
8 ROR of only 7.90 percent.

9 **Q. What are the impacts of correcting the two technical errors in Mr. Elgin's**
10 **coverage analysis?**

11 A. In Exhibit No.___(SCH-4), I have rerun the analysis from Mr. Elgin's Exhibit
12 KLE-3, pages 11 and 12. When OBS debt and Staff's Pre-PCAM ROR of 7.90
13 percent are used, his results change significantly. Rather than an interest coverage
14 ratio of 2.50 times and an ROE of 8.12 percent as shown on page 11 of Exhibit
15 No. ___ (KLE-3) ($25 million adverse power cost case), the revised data show a
16 coverage ratio of 2.25 times and an ROE of only 7.74 percent. Likewise, the new
17 data that correspond to page 12 of Exhibit No. ___ (KLE-3) ($10 million adverse
18 power cost case) show a coverage ratio of 2.32 times and an ROE of 8.18 percent.
19 While I disagree with Mr. Elgin's narrow, one-metric approach, these calculations
20 show that if he had done his own analysis correctly he would have shown weaker
21 financial results.

1 **Rebuttal of ICNU Witness Michael P. Gorman**

2 **Q. What are your principal disagreements with Mr. Gorman's**
3 **recommendations?**

4 A. I disagree with his reduction to PacifiCorp's ROE and I disagree with his use of
5 MEHC's capital structure to reduce PacifiCorp's income tax allowance.

6 **Q. Please explain why you disagree with Mr. Gorman's proposed ROE**
7 **adjustment.**

8 A. I disagree with his ROE reduction for two reasons:

9 1) The proposed PCAM includes a specific risk sharing mechanism between
10 customers and shareholders that the Commission has approved in past cases
11 without further adjustment to rate of return;

12 2) Virtually all of the companies (14 out of 17) used to estimate PacifiCorp's
13 ROE have fuel and purchased power cost recovery mechanisms. Therefore, any
14 risk reduction for shareholders that results from PCAMs is already included in the
15 current 10.2 percent ROE. Mr. Gorman's attempt to further reduce ROE is a
16 double counting of that risk reduction.

17 **Q. In the 2005 Case, did Mr. Gorman use a comparable group to estimate**
18 **ROE?**

19 A. Yes. Both Mr. Gorman for ICNU and Mr. Rothschild for Staff adopted the 17-
20 company group that I used to estimate ROE.

21 **Q. How many of the companies in that comparable group have fuel and**
22 **purchased power cost recovery mechanisms?**

23 A. In Exhibit No.___(SCH-5), I present a survey of the comparable companies' fuel

1 and purchased power cost recovery mechanisms. Fourteen of the seventeen
2 companies used to estimate ROE in the 2005 case have such cost recovery
3 mechanisms.

4 **Q. Has Mr. Gorman been consistent in recommending similar rate of return**
5 **reductions in other cases in which PCAMs were requested?**

6 A. No. In Portland General Electric's (PGE) recent General Rate Case in Oregon
7 (Docket UE 180), Mr. Gorman offered rate of return testimony on behalf of ICNU
8 and the Citizens' Utility Board (CUB). In that testimony, he did not mention or
9 make any adjustment for PGE's requested power cost recovery mechanism. As in
10 PacifiCorp's 2005 Case in Washington, Mr. Gorman recommended that PGE be
11 allowed an ROE below 10 percent, but that recommendation was not based on
12 any downward adjustment for a cost recovery mechanism. Similarly, in January
13 2007, in Aquila's General Rate Case in Missouri (Case No. 2007-0004), Mr.
14 Gorman recommended a 10.0 percent ROE, but again with no mention of Aquila's
15 request for a fuel and power cost recovery mechanism. In this light, his 30 basis
16 point reduction to PacifiCorp's 10.2 percent ROE appears to be Mr. Gorman's way
17 of getting back to the lower ROEs he generally recommends.

18 **Q. Is Mr. Gorman's 30 basis point adjustment based on any analysis related to**
19 **the existence or lack of a fuel and purchased power cost adjustment**
20 **mechanism?**

21 A. No. Mr. Gorman simply assumes that the bond yield spread between "A" and
22 "BBB" rated utilities is representative of the equity risk of a PCAM. However, he
23 provides no analysis whatsoever to support this contention. While his yield

1 spread "analysis" correctly measures the recent "A"/"BBB" spread for utility
2 bonds, it has nothing to do with the value of a PCAM, its structure, or any other
3 mutual risk sharing mechanism that may ultimately result. Mr. Gorman's 30 basis
4 point reduction to PacifiCorp's ROE should not be adopted.

5 **Q. At page 2, Mr. Gorman says that a reduction to ROE is "cost justified" to**
6 **"compensate customers" for bearing a portion of PacifiCorp's power cost**
7 **volatility risk. How do you respond to this statement?**

8 A. This statement sums up the misdirected nature of ICNU's position. Utility
9 customers do not invest capital and they do not receive "compensation" for being
10 customers. Customers receive utility service and ideally pay only the fair and
11 reasonable cost of that service. When customers simply pay the prudently
12 incurred cost of fuel and purchased power, neither they nor shareholders are
13 "compensated" or overcharged.

14 **Q. Please explain why you disagree with Mr. Gorman's proposed use of**
15 **MEHC's capital structure to adjust PacifiCorp's income tax allowance.**

16 A. I disagree with Mr. Gorman's income tax deductions based on MEHC's debt
17 because such deductions are an inappropriate attempt to reapply double leverage
18 concepts the Commission rejected in the 2005 Case.

19 **Q. Please explain.**

20 A. The concept of double leverage can be confusing and it is easily misunderstood.
21 What Mr. Gorman has done in his Exhibit No.___(MPG-4) is complex but can be
22 summarized as follows:

23 1) Mr. Gorman starts with the MEHC parent-only capitalization shown

1 on Exhibit No.___(MPG-5), page 2. This shows a book value capital
2 structure of 34.31 percent debt and 65.69 percent equity.
3 2) Mr. Gorman assumes that the MEHC parent-only capital structure
4 implies that the underlying composition of PacifiCorp's equity is 34.31
5 percent debt and 65.69 percent equity. With this assumption Mr.
6 Gorman has leveraged up PacifiCorp's capital structure by replacing
7 34.31 percent of PacifiCorp's equity with debt priced at MEHC's
8 parent cost of 6.25 percent.
9 3) Mr. Gorman then imputes additional interest to PacifiCorp's income
10 tax calculation with the following calculation.
11 a. 34.31 percent of PacifiCorp's 46 percent equity capital is
12 assumed to be parent company debt; i.e. 34.31 percent times 46
13 percent equals an additional 15.7826 percent debt.
14 b. The additional debt is assumed to carry MEHC's embedded
15 cost of 6.25 percent; so the weighted cost of this imputed debt
16 is 15.7826 percent times 6.25 percent or 0.9864 percent.
17 c. The weighted cost of the imputed debt is multiplied by ICNU's
18 proposed rate base for PacifiCorp to impute the amount of
19 additional interest to add to the income tax calculation. Thus
20 0.9864 percent times ICNU's rate base for PacifiCorp of
21 $554,460,866 equals imputed interest expense of $5,469,271.
22 (See Exhibit No.___(MPG-4), Page 3 of 3, Lines 8 through 12
23 and footnote 1.)

1 d. Mr. Gorman calculates that his imputed interest expense would
2 reduce income taxes by $1,914,245 (Exhibit No.___(MPG-4,
3 Page 1 of 3, Line 22) and lower PacifiCorp's revenue
4 requirement by $3,079,254. (Exhibit No.___(MPG-4, Page 2 of
5 3, Line 9.)

6 What Mr. Gorman has done is employ MEHC debt to apply interest to an indirect
7 subsidiary's cost of service in order to impute an interest deduction to that
8 subsidiary's income tax calculation. The assumption of additional leverage to the
9 subsidiary was done without imputing a compensating increase in the subsidiary's
10 cost of equity as a result of the imputed additional leverage or without any other
11 allocation of parent company costs incurred by that parent in order to obtain the
12 alleged tax benefits. This is squarely contrary to the Commission's order in the
13 2005 Case.

14 **Q. Please explain why Mr. Gorman's use of double leverage conflicts with the**
15 **Commission's order in the 2005 Case.**

16 A. The Commission's Order 04 spoke directly to this specific point. The
17 Commission stated:

18 The ring fencing provisions required by our final order in Docket
19 UE-051090 insulate PacifiCorp and its customers from risks and
20 financial distress at the MEHC level. In addition, conditions
21 affecting the flow of dividends from PacifiCorp to MEHC serve to
22 constrain the ability of MEHC to manipulate the capital structure
23 of PacifiCorp. Staff describes the ring fencing provisions as "state
24 of the art.

25 Nonetheless, after having insulated PacifiCorp and its customers
26 from the risks of leveraged financing at the parent, Staff and Public
27 Counsel seek to secure for customers the cost and tax benefits of
28 that financing. The Company's expert witness argues this may
29 violate the familiar principle in utility law that financial benefits

1 should follow burden of risks. We agree. If the risks and costs of
2 activities at the parent-level are born exclusively by shareholders-
3 because customers are insulated from them by the ring fence-then
4 it is fair and appropriate for the shareholders, and not the
5 customers, to receive the benefits that result from those activities.
6 In circumstances that do not include adequate ring fencing
7 protections, the analysis could well be different. But in
8 circumstances that do include a "state-of-the-art" ring fence, as
9 here, we are not persuaded it would be equitable to insulate
10 customers from the burden of the risks and costs borne at the
11 parent-level while allowing customers to capture the benefits of
12 those same parent company activities. Without the proposed
13 double leverage adjustments, customers are held harmless from the
14 consequences of the acquisition-they pay a return on capital that is
15 no higher than they would have paid if PacifiCorp were a stand-
16 alone utility. Reducing potential harm to customers by activities at
17 the parent-level is the objective of the ring fence and also an
18 appropriate objective for our determination of a reasonable and
19 sufficient cost of capital for PacifiCorp. (Washington Utilities and
20 Transportation Commission v. PacifiCorp, Dockets UE-050684
21 and UE-050412, Order 04, April 17, 2006, ¶¶ 284-85.)

22 Thus the Commission has clearly ruled that if customers of a utility subsidiary are
23 insulated from the costs incurred by the subsidiary's parent, then those customers
24 should not share in any benefits that derive from the costs incurred by the parent
25 entity.

26 Q. **Mr. Gorman purports to share benefits of MEHC's capital structure with**
27 **customers. Is there an appropriate adjustment contained in Mr. Gorman's**
28 **exhibits under which customers would bear the associated costs from the**
29 **parent in order for his adjustment to be consistent with the Commission's**
30 **benefits and burdens ratemaking precedent?**

31 A. No, there is not. I would direct the Commission to Company witness Evans who
32 has supplied further rebuttal testimony on the appropriate amount of income taxes

1 to include in rates.

2 **Q. Does this conclude your testimony?**

3 A. Yes, it does.