Pacific Power |
Rocky Mountain Power |
PacifiCorp Energy
825 NE Multnomah, Suite 1900 LCT
Portland, Oregon 97232

December 12, 2008

VIA ELECTRONIC FILING
AND OVERNIGHT DELIVERY

Washington Utilities and Transportation Commission Staff
P.O. Box 40128
1300 S. Evergreen Park Dr. S.W.
Olympia, WA 98504-0128
Attn: Ken Elgin

and

Office of Attorney General
900 Fourth Avenue, Suite 2000
Seattle, WA 98164-1012
Attn: Simon ffitch

Re: Washington Docket No. UE-051090 Compliance Filing

PacifiCorp hereby submits an original and two (2) copies of the attachment in compliance with the Commission's Order in this case issued on February 22, 2006 and amended on March 10, 2006. The Order approved the Stipulation supporting MEHC's acquisition of PacifiCorp from ScottishPower.

Commitment Wa21 of the Stipulation provides that PacifiCorp will provide to Staff and Public Counsel, on an informational basis, credit rating agency news releases and final reports regarding PacifiCorp when such reports are known to PacifiCorp and are available to the public.

Therefore, in compliance with Commitment Wa21 of the Stipulation, please find the attached report related to PacifiCorp.

Very truly yours,

Bruce Williams
Vice President and Treasurer

Enclosure

The McGraw·Hill Companies

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RESEARCH

Summary:

PacifiCorp

Publication date: 24-Nov-2008
Primary Credit Analyst: Anne Selting, San Francisco (1) 415-371-5009; anne_selting@standardandpoors.com

Credit Rating: A-/Watch Neg/A-1

Rationale

The 'A-' corporate credit rating (CCR) on PacifiCorp reflects its 'excellent' business profile, evidenced by a diverse and growing service territory, and an 'aggressive' financial profile that reflects a large capital program and the need to shore up its cash flow metrics. While the ring-fenced utility's credit metrics are more consistent on a standalone basis with a 'BBB' category rating, the ratings benefit from the implicit and explicit support available to MEHC (the direct owner of PacifiCorp) from its parent, Berkshire Hathaway (AAA/Stable/A-1+). Berkshire has a $3.5 billion equity commitment agreement with MEHC through 2011 that MEHC can unilaterally call upon to support the ratings of MEHC or its regulated subsidiaries, including PacifiCorp. We view this agreement from a 'AAA' rated entity to greatly reduce the likelihood of a default at the utility or its parent. As a result, the ratings assigned to PacifiCorp are higher than would be warranted without this agreement.

The CreditWatch listing reflects MEHC's announcement in September that it seeks to acquire Constellation Energy Group (BBB/Watch Dev) for $4.7 billion. The transaction requires shareholder and regulatory approvals, which are not expected before January and late spring or early summer 2009, respectively. Standard & Poor's Ratings Services views the acquisition as imposing substantially greater business risks on MEHC. Heretofore, the company has built its operations through acquisitions, but these have been solidly investment-grade companies in the regulated energy and electric sector. While the Constellation sale includes utility Baltimore Gas & Electric, this business is dwarfed by a large merchant and trading business that define the company. Constellation earned about earned 85% of its net income in 2007 from unregulated activities in 2007. In recent months Constellation's liquidity position and a general crisis of confidence amongst counterparties jeopardized Constellation's existence and led to it enter into the merger agreement with MEHC.

While Constellation has announced efforts to exit businesses and de-risk its trading operations, as it currently stands, the acquisition creates downward pressure on MEHC's ratings due to heightened risks to the business and financial profile. While PacifiCorp has in place structural protections that insulate it from MEHC, the credit quality of the parent is not completely divorced from that of the subsidiaries. Moreover, with the potential increase in MEHC's scale with the acquisition, the contingent equity commitment may no longer be adequate in size, tenor, and terms to accommodate the needs of regulated subsidiaries such as PacifiCorp. As result, the MEHC acquisition could have rating impacts on its subsidiaries, even those that are properly ring-fenced.

PacifiCorp serves 1.7 million customers in portions of six western states: Utah, Oregon, Wyoming, Washington, Idaho, and California. The company operates as Pacific Power in Oregon, Washington, and California, and as Rocky Mountain Power in

Utah, Wyoming, and Idaho. The company's two largest markets, Utah and Oregon, comprise about 70% of the company's retail electric operating revenues. As of Sept. 30, 2008, the utility's stand-alone debt, including current maturities and preferred stock, was approximately $5.2 billion. Consolidated long-term debt at MEHC (which includes PacifiCorp's debt) was more than $20 billion as of the same date.

Supportive rate case outcomes continue to be key to maintaining and improving upon the company's financial performance. When MEHC purchased PacifiCorp in 2006 from ScottishPower, the utility had consistently been unable to earn its authorized ROE, which varies by jurisdiction but ranges from 10.0%-10.6%.

Management has focused on improving its returns, with some success. ROEs are higher but are still below authorized, as regulatory lag remains an issue for the company, particularly given the absence of adjusters in some of its largest markets and its large capital program, with expenditures year to date about $1.1 billion. The company currently has active rate cases in Wyoming (a $34 million request, or a 7% rate increase), Utah (a revised $115 million request, which will be adjusted based on commission direction in a filing expected in December), and Idaho (a $6 million request, or a 6% request).

In September the company purchased for $308 million the Chehalis plant, a 520 MW combined-cycle plant that will now have to be authorized for recovery in current or future rate cases in all but California. The investment will be part of the Washington and Oregon 2009 general rate cases and is part of pending cases in Wyoming and Utah, which has pre-approved the purchase.

While falling commodity costs should provide a small measure of relief in managing power costs in states without adjusters, this issue and the expectation for persisting regulatory lag continue to be significant credit concerns. The company has been able to 1) institute a power cost adjuster in Wyoming (which will revert to a process that relies on a forward power cost forecast in 2011 under a settlement reached in January 2008; 2) implement a forward price forecast methodology in Oregon (referred to as the transition adjustment mechanism) in which new rates for fuel and purchased power go into effect every January based on forecast power prices (however, shortfalls in revenue to cover these costs are not eligible for deferral); and 3) apply for approval to establish an adjuster in Idaho. But prospects for attaining adjusters in Washington and Utah appear dim in the near term. In Washington, PacifiCorp's last rate case settlement prevents it from seeking one until its next rate case, and in Utah the company expects to request an adjuster in its next rate case but has been rebuffed in its prior requests.

The challenge to mitigate lag appears to be particularly acute for PacifiCorp's largest market, Utah, in which the company earlier this year received a rate case outcome awarding it just $36 million of its original $100 million request. (The request was originally for $161 million, but the Utah Public Service Commission, or UPSC, directed the company to change its test period, which reduced the company's request.)

As a result of a petition for reconsideration, the UPSC in October increased its original award $3 million to $39 million, after the company announced it would consider service cuts based on the USPC's ruling. A new case is pending, and was filed for $161 million last July (notably while the original case was still pending before the commission). The request in this newest case was revised in August to $115 million and the UPSC in October ordered the company to re-file its request, using a 12-month test year ending December 2009, rather than a test year ending June 2009. While moving the test year out should favorably increase the number of projects that can be included in the rate base, the company's ability to receive approval to recover both sizable upticks in commodity costs and spending for capital investment in this state is uncertain.

Hydro relicensing efforts for a portion of the company's 1,158 MW of hydro generation began in 2004 and are for the most part behind the company. We expect that the costs will be recovered in retail electric rates. Through negotiations and settlements PacifiCorp has been largely successful in extending its licenses, which is beneficial for credit given the low cost and flexibility of hydro resources. The most contentious license is associated with the 169 MW Klamath Falls facilities, which is the subject of a non-binding agreement in principle that sets a framework for a path toward removal of the dams no earlier than 2020. The agreement is expected to be finalized in mid-2009 and would institute a maximum 2% surcharge on PacifiCorp's California and Oregon customers to generate over time up to $200 million for dam removal, with an additional $250 million raised by the state of California through a bond issuance. PacifiCorp would also not have liability for the actual removal, an obligation that will be assumed by a third party. The agreement requires federal and state legislation to implement.

Senate Bill (SB) 408 is not expected to have any adverse impact on PacifiCorp in 2008 or 2009. (SB 408 requires electric and gas utilities in Oregon to file a report annually with the Oregon Public Utilities Commission, or OPUC, that compares income taxes actually paid to income taxes collected in rates. It requires a rebate for over-collections and a surcharge for shortfalls, potentially introducing large cash flow swings in company results.) Based on estimated federal, state, and local taxes paid in 2006 (which are reported to the OPUC in October 2007 and trued up in rates in 2008), the OPUC authorized PacifiCorp to begin collecting from ratepayers in June 2008 some $27 million in taxes paid but uncollected in retail electric

rates. The charge will end in June 2009. Furthermore, the company's October 2008 filing reflected a modest overpayment of $4 million, which is not expected to have a significant impact on 2009 results.

More material for the company is its prospects for improving its financial profile. Leverage remains high for its rating category at 54%. The company issued $800 million in long-term debt in July 2008, which resulted in total borrowing increasing by $586 million (net of maturities but including short-term debt increases). However, leverage did benefit from a $200 million equity contribution of MEHC in May. These equity investments will be key to maintaining a credit-friendly capital profile if the company realizes its proposed capital program. We expect that PacifiCorp will not be in a position to make distributions to its parent while it is executing its capital program.

Cash flow metrics as of Sept. 30, 2008, continue to be weak for the rating. And year end numbers are not expected to meaningfully improve, relative to 2007. Operating revenue was up about 6% year to date to $3.4 billion, due largely to $68 million in rate increases approved by regulators. Revenues were up despite sales dropping modestly, mostly because of a mild winter. Notably, customer growth continues in the utility's service territory, but is slowing. Despite stronger operating revenue, net income was flat. Primary drivers are higher fuel costs (up 20% relative to 2007, with gross margin unchanged from last year) and larger interest expense caused by increased borrowing.

While cash flows for the nine months ending Sept. 30, 2008, were stronger relative to 2007, this is solely attributable to the accelerated depreciation the company is benefiting from under the economic stimulus package approved by Congress earlier this year. As a result, the company was able to reflect a $228 million add back to cash flows. Absent this, funds from operations ($892 million including the deferred tax add back) would have been lower than the same period in 2007 ($681 million for the nine months ended Sept. 30, 2008, versus $694 million for 2007).

The company appears to be on track to spend the $2 billion in 2008 that it has forecast. For the nine months ended Sept. 30, the company invested $1.1 billion in infrastructure ($1.4 billion including the Chehalis acquisition). As with all utilities, PacifiCorp may need to reexamine some of its near-term capital spending in light of the credit crisis, which has significantly re-priced the cost of debt in recent months.

Short-term credit factors

The company's liquidity position is very strong. PacifiCorp's 'A-1' short-term rating considers the equity commitment of MEHC's ultimate parent, Berkshire Hathaway, to which it has strong ties. Without these ties, the short-term rating on the company would be 'A-2'. Berkshire Hathaway's extremely strong liquidity position is assumed to be available to PacifiCorp via MEHC in the unlikely event that PacifiCorp could not repay its commercial paper (CP) or other short-term obligations. Explicit support exists in the form of a $3.5 billion equity commitment agreement between Berkshire Hathaway and MEHC that could be called upon to support the liquidity requirements of MEHC's regulated subsidiaries, including PacifiCorp. However, because Berkshire has up to 180 days to provide contingent equity at the request of MEHC's board, strong internal liquidity is also required to support the short-term rating.

PacifiCorp cash and cash equivalents totaled $69 million as of Sept. 30, 2008. In addition, the company has $1.395 billion in unsecured revolving credit structured in two separate agreements: an $800 million line expiring July 2013 and a $700 million line extending through the end of October 2012. While these facilities total $1.5 billion, in September 2008 the bankruptcy of Lehman Brothers Bank FSB reduced capacity on the two agreements to a total of $105 million. Liquidity remains ample, however, and the single largest exposure to any banks as a percentage of total commitments is 15%, which is manageable. Net of $155 million in short-term borrowing, CP issuance, and letters of credit, the utility had $1.24 billion available to it under credit agreements as of Sept. 30. Regulators limit PacifiCorp to having no more than $1.5 billion in debt outstanding.

In September 2008, due to the significant reduction in its market liquidity, PacifiCorp acquired $216 million of its insured variable-rate pollution control bonds. These bonds are a small component of the company's overall debt profile, and PacifiCorp can utilize its ample liquidity facility to hold the obligations until market conditions support the company placing the debt back with investors.

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