Witness CCS-4
Exhibit CCS-4

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

	)	**Docket No. 98-2035-04**
In the Matter of the Application	)	
of PacifiCorp and ScottishPower plc	)	**PRE-FILED DIRECT TESTIMONY OF**
for an Order Approving the Issuance	)	**NEIL H. TALBOT**
of PacifiCorp Common Stock	)	**FOR THE**
	)	**COMMITTEE OF CONSUMER SERVICES**

June 18, 1999

TABLE OF CONTENTS

1. Introduction and Qualifications

Q. PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.

A. My name is Neil H. Talbot. I am self-employed as an economic and financial consultant specializing in the electricity industry. My business address is 81 Grand Street, New York, New York 10013.

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

A. I am a member of a consulting team assembled by Synapse Energy Economics. The team has been retained by the Committee of Consumer Services, State of Utah Department of Commerce, on whose behalf I am testifying.

Q. PLEASE OUTLINE YOUR QUALIFICATIONS.

A. I have masters degrees in economics and finance from Cambridge University, England, and Boston College, respectively. From 1968 to 1994 I was employed as an economist with The Economist Intelligence Unit of London, Arthur D. Little, Inc. of Cambridge, Mass., and Tellus Institute, Boston. Since 1995 I have been self-employed as an independent consultant. My resume is attached as Exhibit CCS-4.1 (NHT).

Q. HAVE YOU TESTIFIED IN OTHER MERGER PROCEEDINGS?

A. Yes. I have testified in some six merger proceedings in various states including Utah and Washington. In 1989 I testified before the Utah Commission on the merger of Utah Power & Light Company into PacifiCorp. In that proceeding, I addressed the merged company's financial situation and cost of capital, and the appropriate treatment of UP&L's Energy Balancing Account. In 1996 I testified before the Washington Commission on the merger of Puget Sound Power & Light Company and Washington Energy Company. My focus was on financial impacts of the merger and I developed and applied a corporate financial model to the utilities. The other merger proceedings on which I have testified include the take-over of Long Island Lighting Company by the Long Island Power Authority; the proposed acquisition of Kansas Gas & Electric by Kansas Power & Light/ KPL Gas Service; and the proposed take-over of Public Service Co. of New Hampshire by Northeast Utilities. Regarding the proposed hostile take-over of UNITIL Corp. by Eastern Utilities Associates, I testified that the financial condition of EUA made the acquisition risky from a ratepayer standpoint, an opinion that was accepted by the New Hampshire PUC, which turned down the acquisition.

Q. WHAT ISSUES WILL YOU ADDRESS IN YOUR TESTIMONY?

A. I will address financial and corporate concerns raised by the proposed acquisition of PacifiCorp by ScottishPower.

Q. HOW DOES YOUR TESTIMONY RELATE TO THAT OF THE OTHER WITNESSES FOR THE COMMITTEE OF CONSUMER SERVICES?

A. My testimony complements that of Mr. Bruce Biewald and Mr. Paul

Chernick. We all support the recommendation proposed by Mr. Dan Gimble of the Committee of Consumer Services.

2. Summary of Testimony

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. With regard to financial issues, I first address PacifiCorp's financial outlook on a stand-alone basis. Second, I review the financial track record of ScottishPower in the U.K. Third, I consider ScottishPower's reasons for seeking to acquire PacifiCorp. Finally, I consider the financial outlook for PacifiCorp under a ScottishPower regime and contrast it with the outlook for PacifiCorp on a stand-alone basis. With regard to corporate issues, I will address corporate structure and corporate cost allocation, and some of the difficulties that will be encountered in trying to monitor and regulate a utility that is part of a complex international corporate structure.

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

A. First, I conclude that the financial situation of PacifiCorp as a stand-alone utility serving electricity markets in the Pacific Northwest and Intermountain regions is fundamentally sound. I don't believe there is any dispute about this conclusion. It is certainly true that PacifiCorp stumbled financially during 1998 after it embarked on an unsuccessful diversification strategy. While PacifiCorp's management problems harmed the Company's stockholders more than its ratepayers, the latter may have been affected by financial weakness, management distraction, and operating cost increases. However, PacifiCorp's management has put that episode behind it and is now renewing its focus on its core western electricity business, its associated wholesale electricity business, and the business of Powercor, its regulated Australian distribution utility. The simple financial test from a customer standpoint is that PacifiCorp's cost of capital is low and its rates, already among the lowest in the country, have been further reduced by 12% by the Utah Public Service Commission. As a regulated electric utility, the outlook is for PacifiCorp to continue to provide low-cost service to customers. Furthermore, with a low-cost generation mix, no nuclear power commitments, a strategically placed transmission network and a growing customer base, PacifiCorp is well positioned to benefit from any future changes in the western electricity market.

Q. PLEASE TURN TO SCOTTISHPOWER'S SITUATION.

A. The financial track record of ScottishPower in the U.K. in the 1990s has to be assessed in the context of privatization, incentive regulation and increasing competition. ScottishPower was formed as an investor-owned utility when the electricity industry was privatized by the Electricity Act of 1989. Unlike the utilities in England and Wales, ScottishPower was allowed to remain vertically integrated. A liberal regulatory framework was introduced for distribution utilities: rates were permitted to increase annually according to a formula and there were regulatory reviews only every five years. Within this framework, electricity companies achieved considerable gains in efficiency and made high profits. However, the record suggests that ScottishPower did not share any more of the gains with ratepayers than other companies did. The same appears to be true of Manweb, the subsidiary ScottishPower acquired in 1995.

Q. WHY IS SCOTTISHPOWER SEEKING TO ACQUIRE PACIFICORP?

A. ScottishPower has been described as the most acquisitive utility in the U.K. It has embarked on a multi-utility acquisition strategy in which it is seeking to acquire electric and other utilities in the U.K. and overseas. In furtherance of this strategy, it acquired Manweb in 1995 and Southern Water in 1996. Its initial objective is to increase profits by increasing the operating efficiency of the acquired company, thereby maintaining a high rate of profit and dividend growth for the ScottishPower group. Its more fundamental objective, however, appears to be to use the utility as a base for expansion into mostly unregulated businesses. It seems that the proposed acquisition of PacifiCorp is intended to fit into this corporate strategy of ScottishPower. It is part of a reversal of the earlier trend of acquisitions of U.K. utilities by U.S. utilities seeking to cash in on the high profits permitted by the U.K. electricity regulator. The reverse trend of acquisitions reflects the impending decline of profitability of U.K. utilities as regulation is tightened, and the prospects for deregulation in the U.S.

Q. WHAT IS THE OUTLOOK FOR PACIFICORP'S RETAIL CUSTOMERS UNDER A SCOTTISHPOWER REGIME AND HOW DOES IT CONTRAST WITH THE OUTLOOK UNDER PACIFICORP ON A STAND-ALONE BASIS?

A. In my opinion, a ScottishPower acquisition would bring financial costs, risks and uncertainties to PacifiCorp and its customers that are not offset by a possible improvement in PacifiCorp's operating efficiency.

No doubt, ScottishPower will attempt to improve PacifiCorp's operating efficiency, but it has refused to provide customers or regulators with any rate guarantees. PacifiCorp itself has already embarked on a program of efficiency improvements and it is not clear that ScottishPower will significantly improve the efficiency outlook. By refusing to provide any rate guarantees, ScottishPower appears to be attempting to retain prospective cost savings in order to maintain its high dividend growth. The operation of “regulatory lag” can allow a utility to delay the re-setting of rates to reflect efficiency gains for a period of approximately three years.

Q. WHAT RISKS TO RATEPAYERS WOULD RESULT FROM THE PROPOSED ACQUISITION?

A. It is indisputable that a corporate strategy of expansion and diversification brings risks. Even when such a strategy succeeds, there is some degree of risk resulting from the attendant uncertainty. When such a strategy fails, as it did in the case of PacifiCorp in 1998, there is obviously considerable risk. Ratepayers as well as investors may suffer. There is a risk that the cost of capital to PacifiCorp as a subsidiary of ScottishPower could rise in the future as a result of uncertainty or, in the case of missteps, financial weakness. And there is also a risk of management distraction and operating cost increases.

Q. SCOTTISHPOWER HAS CLAIMED THAT PACIFICORP’S COST OF CAPITAL WOULD *DECLINE*. WHY DO YOU DISAGREE?

A. ScottishPower has argued that the cost of capital to PacifiCorp would decline because ScottishPower is in a financially stronger situation than PacifiCorp today, and would create a larger utility system after the merger. This argument does not withstand scrutiny. First, the size factor is irrelevant when PacifiCorp on a stand-alone basis is already one of the larger utilities in the U.S. Second, it seems certain that as PacifiCorp’s back-to-basics strategy begins to show results, any lingering concerns of the financial community about PacifiCorp’s 1997-1998 diversification strategy will be laid to rest. Under a ScottishPower regime , there would be greater financial risk in a renewed acquisition strategy which might or might not be successful.

Q. CAN PACIFICORP BE PROTECTED FROM THE FINANCIAL

VICISSITUDES OF SCOTTISHPOWER?

A. No, not completely. Expansion using PacifiCorp as a platform could bring risk directly to PacifiCorp. And continued expansion by the ScottishPower group could bring increased debt or financial distress to the parent company, could distract management, and could affect such features of PacifiCorp management as dividend policy and the availability of capital for core operations.

Q. PLEASE SUMMARIZE YOUR CONCERNS ON CORPORATE ISSUES.

A. Additional corporate costs would be incurred at the ScottishPower plc holding company or the ScottishPower U.K. levels. ScottishPower would seek to allocate these costs and a portion of its existing corporate costs to PacifiCorp. ScottishPower already has a cost allocation problem with Southern Water, where its allocation formulas had to be overridden by a cap on the subsidiary's total corporate costs. It appears a similar type of cap would be necessary for PacifiCorp. It would seem to be unwise to create a situation where a parent company is unable to apply a standard allocation method that is universally acceptable among its subsidiaries.

Q. WILL STATE REGULATION OF PACIFICORP BECOME MORE DIFFICULT?

A. Yes. The more complex corporate management and financial structure will add to the burdens of state regulation and make it more difficult for regulators to monitor corporate costs and financial issues that affect PacifiCorp.

Q. WHAT IS YOUR RECOMMENDATION TO THE COMMISSION?

I support Mr. Gimble's recommendation that the merger application be rejected. From a financial and corporate standpoint, absent a constructive rate proposal by the Applicants or other convincing showing of benefits, the merger brings financial risks and corporate cost allocation problems without having any significant gain to ratepayers.

3. PacifiCorp's Financial Outlook on a Stand-Alone Basis

Summary of PacifiCorp's Current Situation

Q. PLEASE SUMMARIZE PACIFICORP'S CURRENT BUSINESS AND FINANCIAL SITUATION.

A. PacifiCorp is primarily a regulated and integrated electric utility serving customers in five states – Oregon, Utah, Washington, Idaho and Wyoming. PacifiCorp is selling the distribution assets that serve its small Montana and California service territories. PacifiCorp does business as Utah Power in Utah and Pacific Power in other western states.

Q. PLEASE DESCRIBE THE COMPANY'S DIVERSIFIED ACTIVITIES.

A. Prior to mid-1998, PacifiCorp had embarked on an ambitious acquisition program. It raised funds for that program by selling its subsidiary Pacific Telecom, Inc. (PTI) for $1.5 billion in cash in December 1997. It also sold its independent power venture, Pacific Generation Co. The acquisition program culminating in the Company making successive bids to acquire The Energy Group, a British utility and energy company with operations in the U.K., U.S. and Australia. The acquisition was blocked by a U.K. government antitrust review and eventually PacifiCorp's final bid was topped by a successful Texas Utilities' bid for The Energy Group in April 1998. During 1998, PacifiCorp also suffered losses in electricity trading in the eastern U.S. through PacifiCorp Power Marketing. In October it decided to exit that business, closing the operation down and selling TPC Corporation through which it had natural gas interests. Finally, PacifiCorp suffered from reduced margins on its wholesale market sales in the West in 1998 owing to adverse hydro-electric power conditions and increased purchased power costs.

Q. WHAT REMAINS OF PACIFICORP'S DIVERSIFIED ACTIVITIES AT THIS POINT?

After the resignation of PacifiCorp's former CEO in August 1998 and a fundamental review of its alternatives, the Company decided on a "back to basics" strategy in October. PacifiCorp would pull back from its diversification strategy and concentrate on its regulated western U.S. electricity business and its associated wholesale market business. It would, however retain its Australian distribution utility subsidiary, Powercor.

DOES PACIFICORP'S INVOLVEMENT IN OTHER BUSINESSES STILL INCREASE ITS LEVEL OF BUSINESS RISK?

A. No. While there is a residual concern in the investment community regarding the risks of these businesses, it is clear that PacifiCorp is exiting these businesses. PacifiCorp's continued ownership of the Australian utility Powercor, and its participation in the competitive wholesale power markets that are growing in the western U.S., do not significantly affect this assessment.

Q. HOW WOULD YOU CHARACTERIZE PACIFICORP AT THE PRESENT TIME?

A. PacifiCorp is and will continue to be a vertically-integrated electric utility. Changes in PacifiCorp's business that could occur over time as a result of the evolution of the U.S. electric utility industry include increasing sales of generation in competitive markets including competitive retail markets to the extent they are deregulated. For the time being, however, PacifiCorp will remain essentially a traditional regulated electric utility.

Q. HOW WOULD YOU CHARACTERIZE PACIFICORP'S FINANCIAL SITUATION AT THE PRESENT TIME?

A. PacifiCorp is recovering from a period of relatively low earnings, both in its diversified activities and in parts of its regulated business. However, flush with cash freed up from its intended purpose as a war chest to use in the acquisition of The Energy Group, and with a reasonable proportion of debt in its capital structure, PacifiCorp is in a strong financial position.

PacifiCorp's Cost of Capital

PLEASE EXPLAIN THE SIGNIFICANCE OF PACIFICORP'S COST OF CAPITAL IN THIS PROCEEDING.

A. In assessing a regulated utility's financial situation, the bottom line for customers is the utility's cost of capital. The reason is of course that the utility's rates are set at a level that is intended to recover this cost. The Utah Commission recently determined that PacifiCorp's cost of capital is 8.84% on rate base, using a hypothetical capital structure based on that of a group of comparable utilities with single-A bond ratings. The cost of equity capital to PacifiCorp was set at 10.5% and the weighted average rate of 8.84% was calculated as follows:

Component	Weight	Cost Rate	Cost Contribution
Debt	46.7%	7.518%	3.51
Preferred Stock	5.7%	5.794%	0.33
Common Equity	47.6%	10.5%	5.00
		100.0%	8.84%

IN YOUR OPINION, IS THIS A REASONABLY LOW COST LEVEL?

Yes. It reflects relatively low rates for all three components of long term capital. The Utah Division of Public Utilities found that "PacifiCorp's actual capital structure is close to the recommended hypothetical one and the embedded costs of the Company's long-term debt and preferred stock are near the average (for the group of comparable single-A utilities)."[1] The average cost rate of 8.84% is below the U.S. electric utility composite of 9.0% earned on net plant (Electric Utility Week, March 8, 1999). Essentially, the Utah Commission's finding is that PacifiCorp fits the financial profile of a sound single-A utility.

PacifiCorp's Financial Prospects

WHAT IS THE FINANCIAL OUTLOOK FOR PACIFICORP ON A STAND-ALONE BASIS?

The financial outlook for PacifiCorp is good, with low risk for investors.

Q. PLEASE EXPLAIN THIS VIEW.

Investment risk is usually divided into two parts: business risk and financial risk. Business risk is the inherent risk of the underlying business, in this case the risk of the Company's vertically-integrated electric utility business. Financial risk is the additional risk to investors resulting from debt and other fixed financial commitments. The higher the level of these commitments, the greater the risk for both stockholders (whose claims are residual) and bondholders (who have a smaller equity cushion).

WHAT IS PACIFICORP'S LEVEL OF BUSINESS RISK?

PacifiCorp is correctly regarded by the financial community as having a low level of business risk. There are several reasons for this: PacifiCorp has a low-cost

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[1] Public Service Commission of Utah *Report and Order* issued March 4, 1999 in Docket No. 97-035-01, p. 47.

generation mix; it does not have any exposure to nuclear power risks; it has a strategically located transmission network; and its service territory has a growing economy and customer base.

WHAT IS PACIFICORP'S FINANCIAL RISK PROFILE?

As regards financial risk, PacifiCorp's situation is sound. It has a well-balanced capital structure. The availability of the proceeds of the sales of unrelated businesses is also a favorable feature.

BEFORE IT MADE THE DECISION TO MERGE WITH SCOTTISHPOWER, PACIFICORP WAS PLANNING A STOCK BUY-BACK. HOW WOULD THE BUY-BACK HAVE AFFECTED THE COMPANY'S STAND-ALONE BALANCE SHEET?

On the assets side of the Company's balance sheet, the sale of unrelated businesses has resulted in the accumulation of a large amount of cash. As of December 31, 1998, PacifiCorp recorded $583 million of cash and cash equivalents on its balance sheet. The money came from the sale of assets and was intended as a war chest for the Company to use in its acquisition of The Energy Group. When that plan fell through, and the Company decided to abandon its acquisition strategy, the cash became an under-performing asset on which low returns were being earned. The Company planned to use that cash to reduce its capitalization on the liabilities-and-capital side of its balance sheet. And the assets remaining on the assets side of the balance would be expected to perform better than cash. The Company had and still has an opportunity to buy back equity and redeem debt in the proportions that it chooses in order to fine tune its capital structure as well as reduce its overall capitalization. However, as I note later in my testimony, PacifiCorp's plan to focus on the buy-back of stock, thereby reducing the amount of equity on the balance sheet, raised concerns at the rating agencies because of a perceived increase in risk to bondholders.

4. Financial Track Record of ScottishPower in the U.K.

HOW DO SCOTTISHPOWER'S RATES COMPARE WITH THOSE OF OTHER BRITISH UTILITIES?

A. As shown by Mr. Biewald, the rates of ScottishPower and its subsidiary Manweb do not appear to be any lower than those of other British utilities, in fact the opposite may be true.

Q. HOW HAVE THE *INVESTORS* OF SCOTTISHPOWER FARED, COMPARED WITH THOSE OF OTHER BRITISH UTILITIES?

ScottishPower's investors appear to have fared relatively well compared with those of other British utilities, as measured by rate of return on capital employed. This view is based on information I have reviewed from the Centre for the Study of Regulated Industries, University of Bath School of Management, to which I was referred by the Office of Electricity Regulation. Manweb has also performed very well by U.S. standards, but has fallen short of its peers in Britain in recent years. Financial returns are compared in the following table:

Comparative Returns of British Public Electricity Suppliers

	1990/91	1996/97	1997/98
ScottishPower	22%	30%	29%
Manweb	15%	20%	19%
Average PES	19%	23%	25%

Notes: Average PES is the simple average for the 14 companies reported – 12 regional electricity companies (RECs) in England & Wales, plus ScottishPower and Scottish Hydro. Capital is measured at historical cost.

Source: Centre for the Study of Regulated Industries (CRI), *The UK Electricity Industry Financial and Operating Review, 1997/98.*

ScottishPower's own financial report gives an average 26% return on equity company-wide during the five-year period 1994-1998 (years ended March). (*Group Activities: Investing for Growth*, November 1998)

WHAT CONCLUSION DO YOU DRAW FROM THIS FINANCIAL DATA?

One would expect superior corporate performance to be reflected in lower rates for customers or higher profits for investors or some combination thereof. In the case of ScottishPower, it appears that *if* the company did indeed achieve greater efficiency gains than its peers, the gains were reflected in higher profits for investors, not lower rates for customers, during the past five or ten years.

5. The Role of PacifiCorp in ScottishPower's Corporate Strategy

ScottishPower's Corporate Strategy

Q. HOW WOULD YOU DESCRIBE SCOTTISHPOWER'S CORPORATE STRATEGY?

A. ScottishPower describes itself as a "multi-utility," by which it means a company which is primarily focused on ownership and operation of a variety of utility businesses – electric, gas, water and telecom. It has been described by Warburg Dillon Read as the most acquisitive utility in the U.K. In 1992, it decided on a multi-utility acquisition strategy in which it is seeking to acquire electric and other utilities in the U.K. and overseas. This strategy got into high gear with the acquisition of Manweb, a regional electricity company (REC) in 1995 and Southern Water in 1996. Its fastest-growing subsidiary is Scottish Telecom.

Q. WHAT IS THE BREAKDOWN OF SCOTTISHPOWER'S CURRENT BUSINESSES?

A. As measured by assets and contribution to corporate income, the breakdown of ScottishPower's businesses today, prior to the PacifiCorp acquisition, is shown in the following table:

Breakdown of ScottishPower Turnover (Revenue) by Business

(percentages as of March 1998)

Energy & Power (including Manweb)	74%
Southern Water	13%
Other (including Scottish Telecom)	13%

Source: Adapted from Warburg Dillon Read report on

ScottishPower, September 1998, p. 43.

Q. LOOKING FORWARD, WHERE IS SCOTTISHPOWER'S STRATEGY HEADED?

A. ScottishPower's strategy can be summarized in a two-dimensional chart with territorial expansion on one axis and type of business on the other:

1 <u>Chart: ScottishPower Multi-Utility Expansion Strategy</u>

Scotland	Electricity (Scottish Power)	Telecom, Gas
England	Electricity (Manweb)	Water (Southern Water), Gas
West. U.S.	Electricity (PacifiCorp)	?
Australia	Electricity (Powercor)	?
?	?	?

<u>Source</u>: Adapted from Warburg Dillon Read report on ScottishPower, September 1998, page 10.

WHAT ARE SCOTTISHPOWER'S OBJECTIVES IN EACH ACQUISITION?

It appears that ScottishPower's objectives are similar to those of other companies that seek to expand their businesses by acquisition. The financial objective is usually to "create value" which means to increase the value of the corporation to shareholders. In some cases value is increased as a result of corporate synergies, as in the case of mergers of businesses that can be operated more efficiently together than separately. In other cases, including the present one, the argument is that better management will unlock shareholder value by turning an "under-performing" asset into one that is fully performing from a financial standpoint. This has been called "sweating the asset base" in ScottishPower's "'cash is king' culture" by the London investment house Warburg Dillon Read. One of the principal features of this strategy is that it is intended to maintain a momentum of financial growth as measured by earnings, dividends or stock price. This strategy may involve balance-sheet engineering and tax reduction measures designed to increase stockholder returns.

Decline in ScottishPower's Profit Outlook in the U.K.

Q. ABSENT ACQUISITIONS, WOULD SCOTTISHPOWER LOSE ITS FINANCIAL MOMENTUM?

A. Yes, it appears that it will be difficult for ScottishPower to maintain its financial momentum. Warburg Dillon Read in a September 1998 report on ScottishPower was forecasting a significant slow-down in momentum prior to the PacifiCorp announcement in December 1998:

	Past 3 Years	Next 3 Years
Dividends per Share	15.0%	10.5%
Earnings per Share	8.4%	-0.8%

Source: Adapted from Warburg Dillon Read report on ScottishPower, September 1998, p. 43.

Q. WHAT ARE THE FACTORS THAT ACCOUNT FOR THIS EXPECTED SLOW-DOWN IN SCOTTISHPOWER GROWTH?

A. The principal factor is the expectation that the price caps on ScottishPower's regulated electricity and water businesses in the U.K. will be reduced by Offer, the Office of Electricity Regulation, and Ofwat, the water utility regulator, in the upcoming five-year pricing reviews that will be effective in 2000.

Q. ARE THERE OTHER FACTORS THAT MAY CONTRIBUTE TO THE EXPECTED SLOW-DOWN?

A. Yes. ScottishPower appears to have attempted to sustain a high rate of dividend growth by increasing its earnings payout and by increasing the share of debt in its capital structure, what could be called "balance sheet engineering." By increasing dividends faster than earnings during the past four years – 13.2% per year versus 7.4% per year -- it has increased its payout ratio from 40% to 50%, admittedly still not a high ratio. It has also increased its "gearing" – the ratio of net debt to net capital – from zero in 1994 to 114% in 1998. (In U.S. terms, the 114% ratio in 1998 is a debt:assets ratio of 53-54%, somewhat high by U.S. standards.) Obviously, these past trends are not sustainable indefinitely because the company would become financially stretched.

Q. WHAT IS SCOTTISHPOWER'S COMMITMENT WITH RESPECT TO DIVIDEND GROWTH AT THIS POINT?

A. In its May 6, 1999, document entitled *The Scheme of Arrangement*, ScottishPower makes the following statement:

> New ScottishPower is committed to ScottishPower's stated aim of achieving 7% to 8% *real* dividend growth per annum until *at least* the UK regulatory reviews which take effect in the year 2000, whilst maintaining a prudent level of dividend cover. It is New ScottishPower's current aim to deliver real dividend growth thereafter and this will be re-examined once the outcome of these regulatory reviews is known. (emphasis added)

Q. WHY IS IT IMPORTANT FOR SCOTTISHPOWER TO TRY TO MAINTAIN ITS FINANCIAL MOMENTUM?

A. Warburg Dillon Read noted in its September 1998 report (page 4) that:

> ScottishPower's share price performance since 1995 has been dominated by perceptions of its acquisitive multi-utility strategy. Underperformance in 1996 was a result of negative sentiment surrounding the Southern Water acquisition. Subsequently, the underperformance has been clawed back, as the market has begun to appreciate the merits of the multi-utility strategy, including Scottish Telecom.

This suggests that the financial community is hoping for and expecting a successful continuation of the ScottishPower expansion strategy.

Q. HAVE OTHER ANALYSTS TAKEN THIS APPROACH TO SCOTTISHPOWER'S FINANCIAL OUTLOOK?

A. Yes. Bankers Trust/ Alex Brown is quite explicit about this.

> Without an acquisition, ScottishPower's earnings will stagnate until 2003 when the Scottish interconnector upgrade comes fully online. By acquiring PacifiCorp, ScottishPower can enhance earnings by 10% (before goodwill) and give EPS (earnings per share) growth to fill the gap between now and 2003." (Report on ScottishPower, 2/19/99)

As noted elsewhere in my testimony, the Bankers Trust/ Alex Brown report also believes that "the central challenge facing ScottishPower in this deal is to navigate seven sets of US regulators without giving away the efficiency upside."

Q. DOES THIS PUSH FOR FINANCIAL GROWTH ENTAIL RISK?

A. Yes. There is a risk that the financial imperative can outweigh more prudent financial and business considerations.

Q. DO ANY OTHER RECENT STEPS INDICATE HOW SCOTTISHPOWER MAY TRY TO MAINTAIN OR REGAIN ITS

FINANCIAL MOMENTUM?

A. Yes. ScottishPower is considering new ways in which it can utilize its investment in Scottish Telecom. It has already used Scottish Telecom as a platform for expansion and further acquisitions including Demon Internet, the U.K.'s largest internet service provider, in April 1998. Panmure Gordon expects that "further expansion is likely to follow." (Report on ScottishPower, 9/30/98) Warburg Dillon Read noted in its September 1998 that "Recent market speculation has focused on the future ownership of Scottish Telecom" and predicted that ScottishPower would float a minority stake in Scottish Telecom. On February 16, 1999, ScottishPower issued a press release that announced the appointment of a new managing director for ScottishTelecom and included the following rather opaque statement:

> Scottish Telecom has grown rapidly since its launch in 1994. ScottishPower has recently appointed Goldman Sachs to explore the options open to optimise value for ScottishPower shareholders from its investment in Scottish Telecom. The review is at a preliminary stage and an announcement will be made if and when appropriate.

The point I am making is that ScottishPower's financial strategy requires it to make major decisions about its various subsidiaries from time to time that are driven primarily by financial growth considerations. *The (Manchester) Guardian* reported the day after the ScottishPower news release that:

> ScottishPower is keen to emulate National Grid, which recently sold a third of its 74 per cent stake in its publicly-quoted telecoms arm, Energis, for more than pounds 1 billion. ScottishPower, like National Grid, could use cash to support an ambitious overseas expansion programme which includes the

agreed all-share bid for PacifiCorp.

(National Grid is the other U.K. company that is currently making a bid to acquire a U.S. utility, in its case New England Electric System.)

Unregulated Businesses Offer Higher Profit Prospects

Q. WILL SCOTTISHPOWER REMAIN PRIMARILY FOCUSED ON REGULATED UTILITY BUSINESS?

A. No. There is every indication that ScottishPower will become increasingly dependent on faster-growing unregulated businesses, of which Scottish Telecom is the leading example. This conclusion is unaffected by the possibility that ScottishPower will perhaps sell part of its interest in Scottish Telecom. Merrill Lynch has predicted that the share of ScottishPower profits derived from its unregulated businesses will rise from 24% in the year ended March 1999 to 33% in the year ended March 2002. (Merrill Lynch report on ScottishPower, 10/2/98) HSBC Securities had a similar expectation:

Operating Profits	1999	2001	Profit Growth Rate
(millions of pounds)			
Generation Wholesale	134	206	24%/yr
Energy Supply	30	62	44%/yr
Developing Businesses	22	65	72%/yr
Unregulated total	186	333	33.8%/yr
Regulated	622	579	-3.5%/yr
Total Operating Profits	808	912	6.2%/yr
Percentage Unregulated	23%	36%	

Source: HSBC Securities, *ScottishPower: Value Added*, May 1998, p.9.

Q. THOSE REPORTS WERE WRITTEN BEFORE THE ANNOUNCEMENT OF THE PACIFICORP ACQUISITION. HOW WOULD THIS ACQUISITION AFFECT THE PICTURE?

A. The acquisition of PacifiCorp would, of course, increase the regulated portion of ScottishPower's portfolio, at least initially.

Q. HOW WOULD THE ACQUISITION OF PACIFICORP FIT INTO SCOTTISHPOWER'S STRATEGY?

A. If, as the financial analysts suggest, the way to look at the ScottishPower strategy is in terms of *growth*, ScottishPower will try to turn PacifiCorp into a growth business or a platform for growth, in the way that telephone companies have grown into "telecom" companies in the U.S. In a nutshell, I think that ScottishPower's growth ambitions could break through the financial constraints that are inherent in a strictly-defined "multi-utility" strategy. The chart describing ScottishPower's acquisition strategy needs to be extended along the "type-of-business" access to include an increasing amount of unregulated business.

Q. PLEASE EXPLAIN.

A. ScottishPower's financial imperative is likely to lead to a two-stage approach to PacifiCorp. I believe that ScottishPower's primary near-term objective will be to increase the profitability of PacifiCorp by cutting costs or trying to leverage PacifiCorp's profits. However, as is evident in the U.K., there are likely to be limits to the profit growth of the regulated utility business. Longer term, ScottishPower is likely to "create (shareholder) value" in other ways by proposing incentive regulation, deregulation of electricity generation and supply, partial sale of PacifiCorp, and not least, using PacifiCorp as a platform for further acquisitions or expansion in the U.S. or Australia.

Q. IS THIS OPINION SUPPORTED BY FINANCIAL ANALYSTS?

A. Yes. According to stockbrokers Panmure Gordon & Co., "under ScottishPower's (acquisition) criteria any international acquisition has to both add value itself as well as create future growth opportunities." (Report on ScottishPower, 9/30/98) WestLB Panmure, in a report dated 11/5/98, says: "For ScottishPower the utility business is not just about cost cutting, it is about growth… Its strategy is to sell as many additional utility services as it can to both its existing customers as well as new ones." I would reiterate that the new services, like those ScottishPower is diversifying into in the U.K., are likely to be unregulated services including sale of electrical appliances, unregulated gas supply and unregulated electricity supply (as an ESP or energy service provider in the deregulated retail energy markets in the U.S.), unregulated telecom services, etc. Morgan Stanley Dean Witter, in its 9/23/98 report on ScottishPower considering the prospect of a U.S. utility acquisition by ScottishPower, says the following under the heading "Multi-utility evolves into international utility":

> We believe that the logic of a multi-utility company is only justified if it can be shown that:
>
> _ synergy benefits are created, such that cost-cutting achieved by the multi-utility is at least in line, if not superior, to that achieved by pure regulated utilities; and
>
> _ synergy benefits are created through increased top-line sales, so that *growth in market share by the multi-utility, in areas such as competitive gas and electricity markets, is seen to be faster and more profitable than that of pure regulated utilities*. (emphasis added)

HSBC, in a December 1988 report titled *ScottishPower…prospects for gold in the Wild West*, characterizes the company's strategy as follows:

> ScottishPower enhances value by acquiring under performing assets; engineering the balance sheet to maximize financial efficiency; sweating the asset base; and using the customer base to sell a multi-utility product. The deregulating US market is the logical next step for this strategy.

Warburg Dillon Read says simply "Acquisition of a US utility provides a new platform for growth. ScottishPower's scope to grow in its 'home' markets of UK and Continental Europe is limited…" (December 1998 report on the merger, p.7)

Q. WILL THE TERM "MULTI-UTILITY" STILL FIT SCOTTISHPOWER IF ITS ACQUISITION PROGRAM SUCCEEDS?

A. No. ScottishPower's likely expansion into unregulated businesses, and the deregulation of electricity generation and energy supply will increasingly change the nature of the company. It will become a multi-utility-based company or what has been termed a "hyper-utility."

Q. PLEASE SUMMARIZE YOUR VIEWS ON THE ROLE OF PACIFICORP IN SCOTTISHPOWER'S ACQUISITION STRATEGY.

A. My fundamental view is that ScottishPower is viewing PacifiCorp as something different from a traditional utility operation. On the one hand, the utility business has been ScottishPower's base of operations in the U.K., and it was apparently able to squeeze high profits out of it during the 1990s. Now that the phase of high profit growth appears to be ending in the U.K., ScottishPower is looking for ways to maintain the growth of profitability. The acquisition of a company such as PacifiCorp is likely based on a view of the target company as a *utility platform*. They would hope to *both* repeat their experience of cost cutting, balance sheet engineering, etc., with U.K. regulated utilities *and* use the financial and managerial capability, name recognition, and customer base of the utility business to expand into mostly unregulated businesses, as they are doing in the U.K. with Scottish Telecom, electrical appliance retailing and unregulated energy supply.

Implications for PacifiCorp Investors

Q. WHAT KIND OF U.S. INVESTOR WOULD INVEST IN SCOTTISHPOWER STOCK?

A. Currently, at the height of an investment boom, perhaps even a bubble, in U.S. financial markets, investors who normally would be more cautious are being increasingly attracted to growth-oriented stocks. Internet stocks are the extreme example. However, when this boom ends, as every boom must sooner or later, investors will likely return to more traditional investment patterns. Income-oriented, risk-averse investors will tend to shift to bonds, utility stocks such as PacifiCorp would be on a stand-alone basis, and other relatively safe investments. Those investors who remain more growth-oriented and less risk-averse, will continue to be more interested in growth situations. If ScottishPower continues to be growth-oriented – with the perception of its stock influenced more by its acquisition strategy than its steady utility earnings growth – its stock will increasingly be more attractive to growth-oriented investors. If, however, ScottishPower suffers setbacks in its acquisition strategy, as PacifiCorp did with *its* acquisition strategy last year, it may also at some time in the future revert to a “back-to-basics” strategy.

Q. HOW MANY OF PACIFICORP’S STOCKHOLDERS RESIDE IN THE STATES SERVED BY THE COMPANY?

A. According to the Company, 33,817 PacifiCorp stockholders reside in the five states that will continue to be served by PacifiCorp. They represent 32% of the Company’s holders of common and preferred stock, and their holdings represent 10% of the total stock outstanding. (Response to CCS Data Request, Attachment Response 9.44)

Q. HOW DO YOU THINK CURRENT PACIFICORP INVESTORS WILL BE AFFECTED BY THE MERGER?

A. PacifiCorp's stockholders appear to be underwhelmed by the prospect of the merger, judging by the fact that PacifiCorp stock is languishing in the bottom half of its twelve-month price range. Although PacifiCorp's stockholders were offered a 21% premium over the value of their PacifiCorp stock, based on the relative valuations of PacifiCorp and ScottishPower stock at the time, stockholders in target companies usually fare even better. Assuming the merger goes through, I suspect that over time income-oriented U.S. investors will shift away from ScottishPower stock, to the extent they have not already done so after PacifiCorp ran into financial difficulties last year. Although offering the *expectation* of higher returns, investment in a growth-oriented company always comes with greater risk. Its attraction lies more in future returns than in current ones, and the future is inherently uncertain. Not only is a utility-based or hyper-utility company inherently more risky than a pure utility company, but there is the currency risk issue to be taken into account.

Q. PLEASE EXPLAIN THE CURRENCY RISK ISSUE FOR U.S. INVESTORS.

A. PacifiCorp shareholders will receive ScottishPower stock in the form of American Depositary Shares (ADS's) traded on the New York Stock Exchange. Each ADS will represent, as it does now, four shares of ScottishPower common stock. The value, dividends, and earnings underlying these ADS's will be those of ScottishPower, the majority of which will originate from the U.K. Thus, in addition to the impact on its investors of the value of Australian dollars because of

PacifiCorp's ownership of Powercor, ScottishPower's U.S. investors will be affected by the value of the British pound in terms of U.S. dollars. The pound has dropped about 4% since the merger was announced, from $1.665 to about $1.60, but it is still a strong currency although not as strong as the U.S. dollar. The only thing one can say with any generality about floating exchange rates like those between the British pound and the U.S. dollar is that they go up and down. This adds a new dimension of variability to an investment in PacifiCorp by anybody who is primarily concerned about income in U.S. dollars. This results in somewhat more risk for a traditional U.S. utility investor.

The Significance of the Acquisition Premium

Q. PLEASE EXPLAIN HOW THIS MERGER IS BEING CHARACTERIZED FROM AN ACCOUNTING STANDPOINT.

A. The purchase method of accounting is being used. In this case, where there is an exchange of stock, rather than a cash payment, the price being paid depends upon the relative prices of the stocks of the acquiring company and the target company.

HOW LARGE IS THE ACQUISITION PREMIUM THAT SCOTTISHPOWER IS PAYING FOR PACIFICORP STOCK?

A. Because the acquisition is by means of an issuance and exchange of ScottishPower stock for PacifiCorp stock, the premium depends on the relative market prices of the stocks. At the time of the merger announcement, the premium was $1.3 billion.

Q. DOES THE ACQUISITION PREMIUM BEING PAID BY SCOTTISHPOWER FOR PACIFICORP'S STOCK AFFECT SCOTTISHPOWER'S FINANCIAL SITUATION?

A. Yes. The acquisition adjustment or premium puts extra pressure on

ScottishPower to make a success of the acquisition. First, it reflects the reality that ScottishPower is in fact paying a premium for PacifiCorp's stock, *i.e.*, it is paying more than the *market* value of that stock prior to the merger, let alone the *book* value. (The market to book ratio of PacifiCorp stock at year end 1998 was about 1.4.) The acquisition adjustment is recorded as an "asset" on ScottishPower's books and has to be depreciated over a number of years. This means that ScottishPower's *reported* earnings are reduced during that period. This is not a real drain on cash flow, and in that sense should not matter to the financial community, which is in theory supposed to focus more on cash than on reported earnings. However, reported earnings figures carry weight with investors. For example, dividend payout is standardly calculated as the percentage of reported earnings that is paid out to stockholders and the higher that percentage, the smaller the amount of earnings that is apparently being plowed back into the business. In any event, the net result is that ScottishPower will be under pressure to overcome the reduction in reported earnings per share that results from the acquisition.

Q. HOW DOES SCOTTISHPOWER BELIEVE THE ACQUISITION ADJUSTMENT SHOULD BE RECOVERED?

A. ScottishPower is not requesting recovery of the premium in PacifiCorp rates. However, ScottishPower believes that merging companies should ideally be given the opportunity to recover the premium. It complains about the regulatory treatment of mergers and acquisitions in the U.K. "(T)he regulatory community in the United Kingdom may have the effect of eroding too quickly the shareholder benefits arising from mergers and acquisitions. This results in the customer gaining the great majority of the present value of future cost savings." In the U.S., I would point out, there is typically a sharing of quantified merger benefits between the companies and their customers. In the present case, since there are no quantified net benefits, ScottishPower could not very well ask for recovery of a portion of the acquisition premium. This leaves the premium to be amortized against ScottishPower profits.

Financial Implications of the Merger for PacifiCorp

YOU HAVE POINTED OUT THAT SCOTTISHPOWER MUST TRY TO CREATE VALUE OR UNLOCK VALUE FOR ITS STOCKHOLDERS FROM THE ACQUISITION OF PACIFICORP. HOW COULD IT DO THIS?

Partly, there is an element of timing. ScottishPower has been actively looking for a U.S. utility to acquire. It entered into discussions with at least two utilities, Florida Progress and Cinergy, during the past year and finally settled on PacifiCorp. It saw value in PacifiCorp that the financial markets had not yet seen; it anticipated –correctly, I believe -- that PacifiCorp's' back-to-basics strategy was likely to be successful financially. ScottishPower has stated that it believes it can operate PacifiCorp in the future more efficiently than PacifiCorp's existing management could on its own. At least, recognizing that PacifiCorp is already planning to improve efficiency as part of its back-to-basics strategy, ScottishPower states that it will bring about efficiency gains more quickly and more certainly than PacifiCorp's management could on a stand-alone basis. In any event, one of ScottishPower's primary objectives is to benefit from profit increases resulting from improvements in the operating efficiency of PacifiCorp, whether or not they were caused by the acquisition.

PLEASE DISCUSS SCOTTISHPOWER'S NEAR-TERM GOALS FOR PACIFICORP IN TERMS OF RATE OF RETURN REGULATION.

Dealing with the near term, I would leave to one side the likelihood that at some point in time ScottishPower will use PacifiCorp as a platform for expansion into other businesses in the U.S. Initially, it seems clear that ScottishPower's financial objective will be to benefit from a reduction in PacifiCorp's costs and an increase in its profitability, in an attempt to maintain a high rate of earnings and dividend growth for the ScottishPower group. ScottishPower has acknowledged this to a limited degree by articulating the goal of bringing PacifiCorp's earnings up to the level allowed by regulators. This in itself is a somewhat ambiguous objective, because the cost of capital today is significantly lower than it was at the time of the rate cases in most of the states served by PacifiCorp.

BY HOW MUCH HAS THE COST OF CAPITAL DECLINED SINCE THE LAST RATE CASES IN PACIFICORP'S VARIOUS JURISDICTIONS?

PacifiCorp's allowed rate of return, prior to the recent Utah rate decision, was approximately 11.36% on a weighted average basis, as shown in the following table, which excludes the Montana and California distribution assets.

State	Rate Base	Percent of Rate Base	Allowed Return on Equity
Idaho	$0.2b.	3%	13.40%
Oregon	$2.5b.	38%	10.00%
Utah	$2.3b.	35%	12.10%
Washington	$0.7b.	11%	

13.25%

Wyoming	$0.9b.	13%

<u>11.50</u>

Weighted Average	11.36%

<u>Source</u>: Based on PacifiCorp's Investor/ Analyst Presentation, New York, October 28, 1998. Rate base data are for 12/31/97. ROEs are updated to reduce Oregon allowed ROE of 15.8% set in 1984 to the 10.0% alternative form of regulation (AFOR) benchmark in May 1998.

The most recent estimate of PacifiCorp's cost of common equity is the Utah Commission's finding of 10.5%, nearly one percentage point below PacifiCorp's average allowed level before the recent Utah Power rate case, and more than two percentage points below the level before the Oregon Commission set a 10% benchmark in May 1998. At the time ScottishPower was evaluating the merger and agreeing on the terms in late 1998, the Utah order had not been issued. The average ROE allowed and actually earned by U.S. electric utilities is about 10-11% which, given the high market-to-book ratios of utility stocks, does not seem to be too low. (For the 17 western utilities covered by Value Line, the average market-to-book ratio at year-end 1998 was 168%.)

Q. HOW DOES THIS DECLINE IN ALLOWED ROE AFFECT SCOTTISHPOWER'S STRATEGY?

A. There is less upward potential for regulated ROE than there previously appeared to be. Further, if it is planning to match its past U.K. performance, or sustain its corporate financial performance by acquisition, ScottishPower would have to achieve higher rates of return than would currently be allowed in the U.S.. Alternatively, it would have to leverage allowed returns by balance sheet engineering to create a more efficient capital structure or lower effective tax rate, or some other means.

PLEASE PROVIDE INFORMATION TO SUPPORT THIS VIEW.

During the 1990s, ScottishPower's stockholders have benefited from a high rate of return on their investment, including increases in dividends and earnings that are far higher than those of U.S. electric utilities. Return on equity has averaged 26% during the five-year period 1994 to 1998. Earnings per share and especially dividends per share have grown rapidly.

	Growth Rate 1994-1998
Earnings per Share	7.4%
Dividends per Share	13.2%

Source: ScottishPower, *Investing for Growth*, Nov. 1998.

Q. HOW DOES FINANCIAL PERFORMANCE OF U.S. UTILITIES COMPARE WITH THAT OF SCOTTISHPOWER?

A. As noted earlier, the average ROE actually earned by U.S. utilities is approximately 11% (composite 10.8% for 1998 according to Electric Utility Week, March 8, 1999), less than half that achieved by ScottishPower over the last five years. As regards dividend and earnings growth, the comparison is even more striking. For the 17 western U.S. utilities covered by Value Line, the average growth rates of earnings and dividends over the last five years and Value Line's expectations regarding growth rates in the future are as follows:

	Past Five	Expected Years
	1995/97 to 2001/03	
Earnings per Share	2.2%	3.0%
Dividends per Share	-0.6%	2.4%

Source: Value Line, Feb. 19, 1999. Simple averages of all meaningful estimates. Past Five Years Earnings per Share exclude Public Service Co. of New Mexico which had 29%/year earnings growth. With PSNM, the average would be 4.0%.

GIVEN THESE DISPARITIES, DO YOU BELIEVE THAT PACIFICORP'S FINANCIAL MANAGEMENT UNDER SCOTTISHPOWER IS LIKELY TO RESULT IN LOWER RATES FOR CUSTOMERS?

No. In my opinion, it is likely that ScottishPower will be disappointed by PacifiCorp's earnings and dividends prospects under business-as-usual regulation. If ScottishPower wants to increase the contribution of PacifiCorp to its profit growth, it will find it difficult to do so without changes in the regulatory framework, such as incentive regulation or deregulation, or leveraging PacifiCorp profits in some way.

HOW MIGHT SCOTTISHPOWER TRY TO CREATE ADDITIONAL SHAREHOLDER VALUE IN THE NEAR TERM?

A. As I note elsewhere in my testimony, there are other ways in which ScottishPower might try to realize its financial imperatives by or through PacifiCorp. There is scope for balance sheet engineering to create a more efficient capital structure and reduced tax rate.

Q. WHAT MIGHT THE ALTERNATIVES BE IN THE LONGER TERM?

A. In the longer term, other ways include incentive regulation or deregulation. It is clear that PacifiCorp is positioned to do well in a deregulated electricity generation market in the West. PacifiCorp's low-cost generation mix and strategically located transmission network will be very valuable assets in an increasingly deregulated and competitive market. Other ways in which ScottishPower could benefit financially would be to use PacifiCorp as a platform for growth into other markets, many of which are likely to be deregulated. Sale or partial sale or spin-off of some or all of PacifiCorp's generating assets or transmission assets could be very profitable at some point. ScottishPower has acknowledged that in the longer term, it "intends to investigate opportunities relating to multi-utility service provision." (Response to Wyoming Industrial Energy Consumers, Request No. 14.) ScottishPower has also stated its preference for creating a new holding company because it would facilitate acquisition of new businesses. This could bring financial risks to PacifiCorp, increase its cost of capital, reduce the allocation of capital to PacifiCorp, and over-extend or distract management. A strategy of this nature involves risk, even if it is eventually successful. If it runs into difficulties, the level of risk would of course be greater.

Q. HAVE FINANCIAL ANALYSTS COMMENTED ON THE DIFFERENT OUTLOOK FOR UTILITY REGULATION AND PROFITS IN THE U.K. AND U.S.?

A. Yes. It has been noted that the tide of Transatlantic mergers and acquisitions has turned. During the 1990s, while U.K. electric utilities have been outperforming those in the U.S., there have been a number of acquisitions of U.K. companies by U.S. companies. Now, financial analysts believe that the time may be ripe for a reversal of this trend. The expected decline in profit growth in the U.K. contrasts with prospects for increasing returns in the U.S. Merrill Lynch, in a June 1998 report entitled *Transatlantic Consolidation: The Empire Strikes Back*, describes the evolving situation in the U.S. as follow:

> Regulation has hitherto been based on cost-recovery-plus-return-on-invested-capital, but is now moving towards U.K.-style price cap mechanisms. The (U.S. electric utility) industry is also slowly moving to a similar type of *structure* to the U.K. The competitive generation and supply sectors will become

> more and more separated from regionalized wires businesses subject to regulation. This should help U.K. predators focus on acquisitions that fit.

It is a moot point whether PacifiCorp fits this deregulation scenario. What seems clear, though, is that this type of thinking affects British companies looking for higher returns, and they can be expected to push for deregulation. ScottishPower has stated its preference for price-cap regulation over strict rate of return regulation. Deregulation of generation and supply also offers clear advantages for PacifiCorp, but not for its customers who enjoy low rates from its regulated rate base.

6. The Outlook for PacifiCorp's Financial Situation and Regulation With and Without the Merger

WHAT IS THE FINANCIAL OUTLOOK FOR UTAH POWER & LIGHT ON A PACIFICORP STAND-ALONE BASIS?

Utah Power and its customers should continue to enjoy the benefits of low cost of capital and some of the lowest electric rates in the country. Utah Power's rates were already among the lowest in the country before the recent rate case. They were reduced by a further 12% by the Utah Commission in March of this year, reflecting a reduction in the authorized rate of return on common equity from 12.1% to 10.5%, a change in the interjurisdictional allocation method, and other adjustments.

ABSENT THE MERGER, WILL PACIFICORP'S EFFICIENCY IMPROVE?

Yes. Nobody disputes the fact that PacifiCorp has already embarked on a program to enhance efficiency as part of its back-to-basics strategy.

Moreover, I anticipate that PacifiCorp will be under increasing financial pressure to bring about improvements in the way it does business. There are several sources of pressure. First, the electricity market is becoming more competitive. There will be pressure on PacifiCorp to respond to the needs of customers who face competitive alternatives in the marketplace. Second, PacifiCorp's stockholders, through the board of directors, can be expected to exert considerable pressure on the Company. They are already dismayed at the poor financial results of the last year, and they will also want to be assured that PacifiCorp retains the competitive edge that it already has as a low-cost producer. Third, it is reasonable to expect that regulatory pressure on the company will be maintained.

WOULD PACIFICORP'S RATEPAYERS IN UTAH STAND TO BENEFIT FROM THE FINANCIAL CONSEQUENCES OF THE ACQUISITION?

A. No. On the contrary, I believe there are financial risks that are more likely to increase than reduce rates over time. "Creation of value" for stockholders is not the same as benefits for ratepayers. Mr. Biewald has testified on the cost savings issue, and I will not address that issue further here.

TURNING TO COST OF CAPITAL, COULD SCOTTISHPOWER MANAGEMENT ACHIEVE A LOWER LEVEL OF CAPITAL COSTS FOR PACIFICORP?

A. No. It would be difficult for ScottishPower to achieve a lower weighted average cost rate without increasing the proportion of debt in the capital structure. However, this would increase investors' level of financial risk. It would probably be unwise to do this at a time when the electricity industry is experiencing structural changes and it would reduce the Company's degree of financial flexibility. Indeed, ScottishPower has said that its intention would be to slightly strengthen PacifiCorp's capital structure by bringing the common equity ratio up a bit, to 47%, which is the average for the comparable group of single-A rated companies.

Q. SCOTTISHPOWER HAS CLAIMED THAT PACIFICORP'S COST OF CAPITAL WOULD *DECLINE* AS A RESULT OF THE MERGER. WHY DO YOU DISAGREE?

ScottishPower has argued that the cost of capital to PacifiCorp would decline because ScottishPower is in a financially stronger situation than PacifiCorp today, and would create a larger utility system after the merger. This argument does not withstand scrutiny. First, ScottishPower has not presented any estimate of the cost reduction. "No additional analyses or studies that quantify the impact of the transaction on PacifiCorp's financial strength have been undertaken. No such studies could be undertaken that could precisely quantify this effect." (response to CCS Data Request No. 9.40) Second, the size factor is irrelevant when PacifiCorp on a stand-alone basis is already one of the larger utilities in the U.S., the 25th as measured by capitalization, 24th by installed capacity and 6th by sales, according to Warburg Dillon Read. (Dec. 1998 report on the merger, p.19) Third, it seems very likely that when PacifiCorp's back-to-basics strategy begins to show results, any lingering concerns of the financial community about PacifiCorp's 1997-1998 diversification strategy will be laid to rest. It is interesting to note that when Moody's Investors Service changed its outlook from stable to negative on October 23, 1998, when PacifiCorp announced its new strategy, a Moody's vice president expressed concern about the planned stock buyback. He said: "Although refocusing activities at the U.S. utility reduces overall business risk, the increase in leverage resulting from the stock buyback reduces financial flexibility and puts downward pressure on ratings." (Electric Utility Week, Nov. 2, 1998) With the merger, the stock buyback has been put on hold. However, it is now ScottishPower that is considering a stock buyback at the parent company level. Moody's put ScottishPower under review for a downgrade Nov. 3, 1998, put it under review for a further downgrade and cut ScottishPower's long-term senior debt rating from Aa2 to Aa3 on December 7, citing the outlook for lower U.K. regulated earnings and "the perceived likelihood of a substantial U.S. acquisition that could weaken debt protection measures." (Electric Utility Week, Dec. 14, 1998) Fourth, in my opinion there would be greater financial risk in the long run from a renewed ScottishPower acquisition strategy, which might or might not be successful.

ASSUME FOR THE SAKE OF ARGUMENT THAT THE MERGER WERE TO RESULT IN AN UPGRADING OF PACIFICORP'S BONDS. WOULD THAT BENEFIT PACIFICORP CUSTOMERS?

If PacifiCorp's debt rating were upgraded, it would mean that the Company could issue new bonds at slightly more favorable interest rates. This would affect the new bonds issued in the next few months, perhaps a year. I believe that after that period one cannot predict that PacifiCorp's borrowing costs would be lower as a result of the merger, because I do not believe that PacifiCorp will be stronger financially as a result of the merger in the longer run. Meanwhile, if borrowing costs were indeed lower during the next year or so, PacifiCorp's embedded cost of debt would be slightly lower at its next rate case. This would be a second-order effect, because it would only reflect interest rates on debt issued during a period of up to a year.

Q. HOW SIGNIFICANT WOULD THAT EFFECT BE?

A. Assuming, for the sake of argument, that PacifiCorp debt could be upgraded by one full grade, from single-A to double-A – an optimistic assumption – the decline in interest rate might be 20 basis points or 0.2 percentage points. For each $100 million of PacifiCorp long-term debt issued, the reduction in annual cost of debt would be $200,000. From information contained in PacifiCorp's SEC Form 10-K for 1998, it appears that the Company expects to raise about $150 million during 2000. (Capital spending of $479 million plus refunding of $170 million of maturing debt, less operating cash flow of about $500 million.) A hypothetical reduction of $300,000 in annual debt costs would be insignificant when one considers that PacifiCorp's annual cost of debt is approximately $235,000,000 (PacifiCorp's 1998 FERC Form 1, p. 117) and retail revenues are currently around $2,200,000,000.

Q. IS THE *AVAILABILITY* OF CAPITAL TO PACIFICORP LIMITED?

A. No. PacifiCorp reported to the SEC that as of December 31, 1998, it had unused borrowing capability of $2.5 billion based on its credit agreements. Furthermore, the excess cash that PacifiCorp has amassed from the sale of businesses creates a source of capital that can be used to optimize its capital structure and retain a reasonable cash reserve. Recently, for example, PacifiCorp has entered into a sale of its interest in Centralia.

Q. ASSUME FOR THE SAKE OF ARGUMENT THAT SCOTTISHPOWER *DOES* SUCCEED IN BRINGING INCREMENTALLY MORE EFFICIENT MANAGEMENT TO PACIFICORP, NET OF THE COST. WILL THIS BENEFIT CUSTOMERS?

A. By refusing to make any significant rate guarantees, I believe that ScottishPower has signaled its intention to retain for as long as possible any efficiency gains in the form of profits rather than flowing them through to customers in lower rates.

HOW WOULD THIS APPROACH TO INCREASING PACIFICORP'S PROFITABILITY ENABLE SCOTTISHPOWER TO ACHIEVE ITS FINANCIAL OBJECTIVES?

A key financial objective of ScottishPower is to maintain dividend growth. It currently targets dividend growth of 7-8% in real terms through at least 2000. It would be a shock to ScottishPower's stockholders to have that dividend growth prospect notched down substantially.

PLEASE EXPLAIN THE IMPORTANCE OF DIVIDEND GROWTH.

A. Dividend decisions are among the most important decisions made by any corporation. This is not difficult to understand; the dividend payout is after all the only regular payment by a company to its stockholders. The standard discounted cash flow (DCF) method of valuing a stock is based on the current dividend yield and the expected growth rate of dividends in the future. There is always a situation of information asymmetry between a company and the financial community; the company knows many things about its business that others do not. In these circumstances, a dividend announcement is often seen as a signal about a company's prospects. A cut in dividend, or in prospective dividend growth, leads to a re-assessment of a company's prospects by the financial community.

Q. IN LIGHT OF YOUR EARLIER DISCUSSION OF DIVIDENDS AND EARNINGS GROWTH TRENDS IN THE U.S. AND U.K., HOW COULD PACIFICORP SUSTAIN ITS RELATIVE HIGH RATE OF DIVIDEND GROWTH THROUGH PACIFICORP?

A. I believe that the only way it could do so would be to squeeze as much profit as it could out of PacifiCorp during the next few years.

Q. IS THE FINANCIAL COMMUNITY EXPECTING SCOTTISHPOWER

TO ADOPT AN APPROACH OF THIS KIND?

A. Yes. One of the main themes in the financial community's assessment of the merger is the conflict between the interests of ScottishPower stockholders and PacifiCorp ratepayers. This conflict has been bluntly stated as follows:

> ScottishPower can only create value from this deal if it can cut costs at PacifiCorp and keep the benefits away from the multitude of US regulators … The central challenge facing ScottishPower in this deal is to navigate seven sets of US regulators without giving away the efficiency upside. Already Utah and Oregon (PacifiCorp's two biggest states) are making unhelpful noises about getting something for customers out of the merger. (Bankers Trust/ Alex Brown 2/19/99)

Q. TO SUMMARIZE, IS IT YOUR OPINION THAT SCOTTISHPOWER'S FINANCIAL GOALS WILL INCREASE THE PRESSURE FOR HIGHER RATES FOR PACIFICORP CUSTOMERS?

A. Yes. I believe the considerations I have described above will result in PacifiCorp becoming a more financially driven utility. Further, the financial risks of its acquisition strategy will tend to increase PacifiCorp's rates.

Q. CAN PACIFICORP BE PROTECTED FROM THE FINANCIAL VICISSITUDES OF SCOTTISHPOWER?

A. No, not entirely. Expansion using PacifiCorp as a platform could bring risk directly to PacifiCorp. And continued expansion by the ScottishPower group through other subsidiaries of a parent company could bring increased debt or financial distress to the parent company, could distract management, and could affect such features of PacifiCorp management as dividend policy and the availability of capital for core operations. These eventualities may seem remote at the present time, when the financial community in the U.S. and U.K. is bullish and mergers and acquisitions are commonplace. When financial markets are buoyant, expansion and diversification tend to look good, but if there is financial turbulence the financial community's assessment of ScottishPower's situation could deteriorate. It is interesting that even today the stock of ScottishPower and PacifiCorp are under some pressure.

New ScottishPower's Proposed Corporate Structure

Q. PLEASE DESCRIBE THE PROPOSED ACQUISITION.

A. The proposed acquisition essentially takes the form of an exchange of shares rather than a cash purchase. PacifiCorp will become an operating subsidiary of a U.K. corporation. The headquarters of the group will be in Glasgow, Scotland, and PacifiCorp's headquarters will remain in Portland, reporting to Glasgow.

WHAT WILL THE NEW SCOTTISHPOWER CORPORATE STRUCTURE BE?

A. Various alternatives have been discussed. Initially, the idea was to make PacifiCorp a direct subsidiary of ScottishPower. It seems reasonably clear at this point, however, that ScottishPower will create a holding company called ScottishPower plc (also called New Scottish Power or Holdco) that will own *both* ScottishPower U.K. and, through subsidiaries in the U.K. and a partnership in Nevada, PacifiCorp.

When I refer to "ScottishPower" in my testimony, I am using the name in a non-legalistic sense to apply to the entity that owns and manages PacifiCorp. My assumption is that ScottishPower *management* will continue to be located in Glasgow, whatever corporate structure is created from a formal or legal standpoint. When necessary to be more precise, I will refer to ScottishPower plc to refer to the new holding company and ScottishPower U.K. to refer to ScottishPower's British operation and overall corporate management.

Q. HOW DOES THE PROPOSED CORPORATE STRUCTURE AFFECT REGULATORY CONCERNS?

A. The structure has been devised in part to address the concerns of the Office of Electricity Regulation (Offer). The equivalent U.S. concerns include the need to ensure that electricity supply is adequately funded and managed and will remain reliable, the appropriate pricing of affiliate transactions, and facilitation of competition. Those concerns are addressed in part by what is called "ring-fencing" in the U.K. and is similar to corporate or functional separation of business segments coupled with affiliate codes of conduct, etc. The creation of a holding company of which PacifiCorp is a separate subsidiary responds in part to these concerns.

Q. HOW WOULD THE NEW CORPORATE STRUCTURE AFFECT PACIFICORP'S FINANCIAL SITUATION AND SOURCES OF CAPITAL?

A. It is not clear at this point what the *financial* ramifications of the new corporate structure will be. Where will equity or debt be issued and held, where will taxes be paid, etc.? Further, will there be a service company in the ScottishPower group or will corporate management services be performed by ScottishPower U.K.? These issues, some of which have not been finally determined as far as I know, could affect the financial situation and state regulation of PacifiCorp. I will show that it is essential for U.S. regulators to be able to monitor and take into account the financial and tax situation of the parent company and possibly the whole group in order to effectively regulate PacifiCorp's financial situation, capital structure and rate of return.

Affiliate Transactions and the Allocation of Corporate Costs

WILL THE NEW MANAGEMENT STRUCTURE RESULT IN INCREASED CORPORATE COSTS?

Yes. There is no dispute that the new corporate structure will add new layers of corporate costs at the parent company, ScottishPower U.K. or possibly corporate service company levels. "Corporate costs will be allocated from both ScottishPower plc (the HoldCo) and from ScottishPower UK plc. The HoldCo structure is only a recent development and, as such, decisions on where corporate functions reside have yet to be made." (response to Utah DPU Merger Data Request S8.10) The only question is whether and how any cost savings at the PacifiCorp level are netted against these additional costs. In any event, there is the problem of a new level of corporate costs to be accounted for and allocated to PacifiCorp. It is not clear what amount of corporate costs is involved. (An initial data response was erroneous.) The total amount of ScottishPower corporate management costs could be somewhere in the range of $50-100 million.

HAS IT BEEN DETERMINED HOW THOSE COSTS WILL BE ALLOCATED TO PACIFICORP?

No. The problem of allocating ScottishPower corporate costs has already resulted in some inconsistencies in the U.K. Apparently the method applied to Manweb – what could be called the "standard" method -- would, if applied to Southern Water, have significantly increased the level of corporate costs. Accordingly, a deal was done with the regulator, Ofwat, to cap or fix Southern Water's corporate costs including the ScottishPower allocation at a level "consistent with" Southern Water's previous level of corporate costs.

IS IT PROPOSED TO APPLY THE STANDARD METHOD TO PACIFICORP?

A. No. The standard method, which apparently relies significantly on the proportions of assets of subsidiary operations, would have resulted in PacifiCorp bearing more than half of ScottishPower's corporate cost allocation. Accordingly, some new allocation method needs to be devised, but none has yet been devised. Meanwhile, a limit has been proposed according to which there would be a small net reduction of $10 million in PacifiCorp corporate costs including the ScottishPower allocation.

Q. DOES THIS CAP RESOLVE THE ISSUE?

A. No, not entirely. I believe there is a continuing problem if ScottishPower cannot recover the full amount of corporate costs in the rates of its operating subsidiaries. ScottishPower stockholders, who would have to bear the costs that are not recovered, can be expected to take this into account in determining the value of ScottishPower's stock. And sooner or later I would expect the issue to come up again, maybe at the time of ScottishPower's next acquisition. At some point, ScottishPower might create a service company which would contract with PacifiCorp to provide certain services. To the extent that such services included what is now covered by corporate management services, this would make it more difficult to figure out the total cost allocation to PacifiCorp.

Q. DOES THE ADDITION OF ANOTHER LAYER OF MANAGEMENT TO THE EXISTING MANAGEMENT STRUCTURE OF PACIFICORP RAISE POTENTIAL MANAGEMENT PROBLEMS?

A. Yes. Coordination between countries and over a long distance will represent a challenge. Warburg Dillon Read notes that management depth will be vital:

> (the integration of PacifiCorp) will be made more difficult by the extent of PacifiCorp's operations in five U.S. states and the physical distance from ScottishPower's head office. Conversely, (ScottishPower) management will need to ensure that the management of the UK core businesses remains focused on delivering results at a time when both regulatory and competitive pressures are expanding. (Dec. 1998 report on the merger, p.32)

There is always the danger that management resources will be stretched too thin. Among the reasons Bankers Trust/ Alex Brown believes that "this particular acquisition is more risky than (Manweb and Southern Water)" is the management challenge:

> The key operational manager responsible for implementation at both Manweb and Southern Water, Mr. Mike Kinski, has left the group to be Chief Executive of Stagecoach plc. Mr. Alan Richardson, the ScottishPower executive charged with being the new CEO of PacifiCorp, while clearly having a track record, faces a daunting task of relocating to the north west of the USA in order to aggressively cut costs and boost efficiency. (Bankers Trust/ Alex Brown report on the merger, p. 3)

Of course, the hope and intention is that the new management structure will strengthen PacifiCorp management. But there is the potential downside of management friction and duplication when an overseas management that is operating in a different national context with different regulation, different work practices, etc., is introduced. Strong personalities can find it difficult to share power. Differences in management philosophies and corporate cultures can lead to tensions. These differences are more likely to occur between managements which have had different histories of regulation, labor relations, etc., in different countries. Many PacifiCorp corporate functions will remain in Portland. The principal conduit through which Glasgow will assert its authority over Portland management on a continuing basis will be a group of Scottish executives relocated to Portland.

Q. DOES THE ACQUISITION RAISE AFFILIATE TRANSACTION CONCERNS?

A. Yes. Admittedly, the remoteness of PacifiCorp from the rest of ScottishPower's existing operations suggests that there will initially be little scope for affiliate transactions. However, affiliate relationships may grow over time. Initially, the primary affiliate concerns relate to the corporate cost allocation problem. The Applicants acknowledge that "the insertion of a HoldCo will probably expand the scope of affiliated interest activities because certain corporate activities will probably remain, and be allocated from, ScottishPower UK plc." (response to Utah DPU Merger Data Request S8.11) These affiliate activities could take a further affiliate form if ScottishPower chose to create a service company and contract with PacifiCorp for the provision of management services.

Financial Concerns Arising From Parent Company Capital Structure

IF THE ACQUISITION TAKES PLACE, HOW WOULD THE FINANCIAL STRUCTURE OF SCOTTISHPOWER AFFECT PACIFICORP'S CAPITAL STRUCTURE?

The effect would be that PacifiCorp would become a wholly-owned operating subsidiary of a ScottishPower holding company. PacifiCorp's stock, in other words, would be owned by ScottishPower. This means that the cost of debt and the capital structure of ScottishPower could have a significant effect on PacifiCorp.

PLEASE EXPLAIN.

According to ScottishPower, “The entities ScottishPower plc (the holding company), ScottishPower UK plc and PacifiCorp may issue debt, as required, to external parties following the completion of the transaction so as to fund the business in the course of carrying out their operations. The enlarged group will seek funding at the best rates possible.” (response to UIEC Merger Data Request No. 6, Q. 91) This departs from the usual situation of holding companies in the U.S. Usually, debt is issued only at the subsidiary or operating company level, *e.g.*, first mortgage bonds backed by the assets of the operating utility. To the extent that ScottishPower finances its holdings of PacifiCorp stock by a mix of debt and equity as opposed to 100% common equity, it would be leveraging its ownership of PacifiCorp and indirectly affecting the capital structure and cost of capital to PacifiCorp. It seems essential to me that U.S. state regulators should be able to monitor the financial situation of the parent company and perhaps the whole group in order to determine that the financial policies of the company are reasonable, the level of financial risk is not excessive, and the cost of capital is appropriate.

Q. PLEASE EXPLAIN WHY THIS SHOULD BE A MATTER OF CONCERN TO THIS COMMISSION.

There are two related reasons. First, with PacifiCorp no longer a stand-alone utility, it becomes necessary for the Commission to review the capital structure of the parent company, and possibly the group, in order to satisfy itself that it is reasonable.

WHAT IS A “REASONABLE” CAPITAL STRUCTURE?

A reasonable capital structure is one that is within the optimal range in the sense of achieving an appropriate balance between the amount of debt and the amount of equity. Debt typically has a lower cost rate and debt interest costs provide a shield against corporate income taxes. Equity strengthens the balance sheet by providing a cushion against earnings variations and increasing a company's financial flexibility. While a good deal of judgement has to be exercised by a company and its financial advisors in these matters, PacifiCorp's capital structure is probably very close to optimal for a regulated utility. In the recent rate case, the Utah Commission took comfort from the fact that PacifiCorp's financial profile is similar to that of other single-A rated utilities.

HOW WOULD THIS CHANGE IF PACIFICORP WERE A SUBSIDIARY OF SCOTTISHPOWER?

With PacifiCorp stock owned by ScottishPower, the true capital structure of PacifiCorp could no longer be determined without taking into account the types of ScottishPower securities that finance ScottishPower's ownership of PacifiCorp common equity.

COULD YOU GIVE AN EXAMPLE?

Yes, a hypothetical example would be as follows. Suppose that in the next rate case the Commission determines that PacifiCorp's debt-equity ratio is 50-50 and is reasonable. That would be the end of the matter if PacifiCorp were a stand-alone company. With ScottishPower ownership of PacifiCorp's equity, however, the PacifiCorp equity could be financed in part by debt at the parent company level. Suppose that ScottishPower plc, the holding company, has a 20-80 debt-equity ratio. The true capital structure of PacifiCorp, direct and indirect, is 60% debt and only 40% equity.

AGAIN, WHY SHOULD THIS BE OF CONCERN TO THE COMMISSION?

There are two reasons. First, the ScottishPower group would be taking on greater risk than U.S. regulators such as this Commission might regard as reasonable. In these circumstances, for example, a downturn in earnings or a failed venture by the group could result in financial distress to the parent company and reduce the capital available to PacifiCorp.

WHAT IS THE OTHER REASON?

The other reason is that the double-leverage structure could effectively serve to siphon off a financial subsidy from PacifiCorp to the parent company. There are two ways in which this could work, both related mostly to taxes.

PLEASE EXPLAIN.

According to ScottishPower, the corporate structure to which PacifiCorp is held as an indirect subsidiary of an owned partnership "is for corporate income tax and foreign tax credit management purposes." (response to UIEC Data Request No. 6 (Question 88). PacifiCorp's allowed rate of return on equity in state jurisdictions is grossed up for corporate income taxes. It is divided by (1-t) where "t" is the tax rate. For example, with an income tax rate of 40% or 0.40, an equity return of 12% has to be grossed up to 20% in the revenue requirement calculation, which is what customers have to pay (12/(1-.40) = 20). Assume hypothetically that

ScottishPower's holding of PacifiCorp stock is backed 20-80 by debt and equity respectively. The 20% debt component has a cost rate that does *not* have to be grossed up for income taxes. Put differently, the debt interest provides an income tax shield. However, the cost savings from this tax shield goes to the parent company and is not reflected as an offset to the revenue requirement of PacifiCorp. In other words, PacifiCorp is subjected to the financial risk resulting from greater leverage, but the benefit of greater leverage is captured by the parent company. I compare these situations illustratively in the following table. I also add a difference in effective tax rates between the subsidiary and the parent, and show how this too results in discrepancy between regulated returns, which are supposed to be cost-based, and the actual capital costs and tax costs incurred by ScottishPower.

Q. IN THIS COMPARISON, PLEASE DESCRIBE YOUR PACIFICORP STAND-ALONE CASE.

A. The PacifiCorp stand-alone case is the familiar one used to determine cost-of-capital revenue requirements in a rate case. I assume 50-50 debt and equity, an effective tax rate of 40%, and cost rates for debt and equity of 8% and 12% respectively:

			Gross-of-TaxCost
Component	% of Capital	Cost Rate	Cost Rate
Contrib.			

Debt	50%	8%	8%	4.0
Equity	50%	12%	20%	<u>10.0</u>
Weighted average cost of capital:				14.0%

Ratepayers pay the full 14.0% and the Company receives 12% on equity after tax.

Q. HOW DOES THE SITUATION CHANGE IF PACIFICORP BECOMES A SUBSIDIARY OF A FOREIGN COMPANY?

A. The 20% earned on equity before tax, which would previously have accrued to the before-tax equity positions of various investors, accrues as before-tax earnings to the parent company in the U.K.

Q. HOW DO DEBT ISSUANCE AND TAX SAVINGS AT THE PARENT COMPANY LEVEL AFFECT THE SITUATION?

A. Two new factors can enter into the picture. First, the parent capital structure may not be 100% equity but could for example be only 80% equity, and the remaining 20% debt with an interest rate of 8%. The debt interest is tax-deductible and reduces earnings by 0.8% on the PacifiCorp investment (20% X 50% X 8%). Second, if the parent can reduce the effective tax rate below 40% to say 35%, depending on the terms of double-taxation agreements between the two countries, it stands to further improve its position.

Q. WHAT WOULD BE THE NET COST RATE TO THE PARENT?

A. The 20 percentage points received by the parent from the subsidiary would be reduced by 0.8 percentage points representing the debt interest cost, leaving 19.2 percentage points taxable. At an effective 35% tax rate, tax would be 6.72 percentage points (19.2 X 35%).

Q. WOULD THE PARENT COMPANY BENEFIT AT THE EXPENSE OF RATEPAYERS?

A. Yes. The parent would retain 13.28 percentage points after tax (20 – 6.72). This would be a return on equity 1.28 percentage points above the 12% cost of equity.

Q. IN YOUR OPINION, WHAT WOULD BE THE FAIR WAY TO CALCULATE COST OF CAPITAL TO PACIFICORP IN THESE CIRCUMSTANCES?

A. I believe it would be fair in this illustrative example to calculate the capital structure and tax rate on a combined parent-subsidiary basis, using combined 60% debt, 40% equity and an effective tax rate of 35%, as follows:

Component	% of Capital	Cost Rate	Gross-of-Tax Cost Rate	Cost Contrib.
Debt	60%	8%	8%	4.8
Equity	40%	12%	18.46%	7.38
Weighted average cost of capital:				12.18%

Q. WHAT WOULD BE THE SAVINGS FOR RATEPAYERS?

A. In this illustrative example, the revenue requirement savings would be based on a reduction in the gross-of-tax rate of return on rate base of 1.82 percentage points (14 – 12.18). For a combined PacifiCorp equity base of approximately $6 billion in the five western states, the revenue requirement reduction in this illustrative example would be $109.2 million per year (6 billion X 1.82%).

Q. HAS SCOTTISHPOWER ADDRESSED THIS ISSUE?

A. No. It has not raised the possibility of flowing through to ratepayers any tax or cost-of-capital savings related to the new corporate structure. In answers to a number of data responses, it appears to be defining rather narrowly the areas of ScottishPower's business that it regards as appropriate for scrutiny by U.S. state regulators.

Q. YOU HAVE DESCRIBED POTENTIAL COST SAVINGS AT THE PARENT COMPANY LEVEL THAT SHOULD BE FLOWED THROUGH TO CUSTOMERS. IS THERE ANY DOWNSIDE TO THE ISSUANCE OF DEBT AT THE PARENT COMPANY LEVEL?

A. Yes. As I noted earlier, the issuance of debt at another corporate level increases the leverage of the group and, other things being equal, could increase the cost of both debt and equity capital to the parent company and possibly the subsidiary too. This is not a matter of solely theoretical interest. It would arise if the parent company were to issue debt and it may arise in the near term if the parent company effects a stock buy-back.

HOW DOES THE MERGER AFFECT THE USE OF PACIFICORP'S EXCESS CASH?

In PacifiCorp's financial planning last year, the excess cash was going to be used for a stock buyback. This was regarded as desirable to create a more efficient capital structure, although it raised concerns with bond rating agencies. With the merger, the buyback has been put on hold. ScottishPower, meanwhile, has announced that it plans a stock buyback of pounds 500 million (about $800 million) in order to create a more efficient capital structure *for ScottishPower*. Although, according to ScottishPower, the PacifiCorp cash is not to be used for this purpose, the use of cash to buy back stock would reduce the equity ratio of the ScottishPower group, leaving the group capital structure more highly leveraged. The buyback has been characterized by some financial analysts as part of a ScottishPower plan to create a more efficient capital structure. However, it raises the very issues of tax rates, cost of capital and financial risk that I am discussing here. These should be subject to state review in the U.S. and should be taken into account in determining PacifiCorp's capital structure and cost of capital.

Loss of Local Control

IS THE LOSS OF LOCAL CONTROL AN ISSUE THAT SHOULD CONCERN THE COMMISSION?

A. Yes. I believe that loss of local control is important because it underlies some of the concerns that I have addressed, related to the role of PacifiCorp in ScottishPower's corporate strategy. With the acquisition, PacifiCorp's western electric utility business would be more like a pawn in a larger financial game, rather than being the primary focus of PacifiCorp management. Of course, local control is no guarantee that management will remain focused. Under PacifiCorp's stand-alone management in 1997-1998, a failed expansion strategy created risks for PacifiCorp's western electric utility business. However, at this juncture local control would be associated with management retaining an appropriate focus.

7. Conclusions

Q. TO SUMMARIZE, WHAT IS THE OUTLOOK FOR PACIFICORP'S RETAIL CUSTOMERS UNDER A SCOTTISHPOWER REGIME AND HOW DOES IT CONTRAST WITH THE OUTLOOK UNDER PACIFICORP ON A STAND-ALONE BASIS?

A. In my opinion, a ScottishPower acquisition would bring financial risks and uncertainties to PacifiCorp and its customers. ScottishPower has embarked on an aggressive strategy of expansion and acquisition. It is clear to the financial community that this strategy is leading increasingly in the direction of unregulated businesses. The profitability of unregulated businesses can be greater than that of regulated businesses, but greater risk always accompanies the hope of higher returns. The core regulated utility business of PacifiCorp could be jeopardized by the financial risks and uncertainties that ScottishPower is likely to bring. ScottishPower has not provided any tangible economic benefits for customers to offset these risks and uncertainties, merely the vague prospect of rate relief as a result of possible cost savings in the future.

Q. **PLEASE SUMMARIZE THE FINANCIAL RISKS TO RATEPAYERS THAT WOULD RESULT FROM THE PROPOSED ACQUISITION?**

A. There is a risk that the cost of capital to PacifiCorp could rise or the capital available to PacifiCorp might be limited if ScottishPower continues to pursue an acquisition strategy. The ironic feature of this acquisition is that the ambitions of ScottishPower's management today are quite similar to those of PacifiCorp's management in 1997 and early 1998 when it embarked on a roller-coaster acquisition strategy which turned out to be unsuccessful. Here is how PacifiCorp described its "Strategic Rationale" for the acquisition of The Energy Group in February 1998:

- Large step toward becoming a premier global energy company
- Presents growth opportunities on three continents as retail competition accelerates
- Unlock significant revenue and cost benefits across the business
- Sharpens strategic focus through sale of non-core assets

From: PacifiCorp Analyst/Investor Presentation, New York, February 3, 1998.

After it turned out only eight months later that the strategic focus had not been sharpened enough, and PacifiCorp had lost a lot of money, the story was quite different with hindsight:

- Weaknesses of PacifiCorp
  - Poor earnings track record in recent years …
  - Preoccupation with “transforming” transaction
  - Too many underperforming businesses distracting and detracting from the core business
- Conclusions
  - PacifiCorp needed a new cogent, clear, achievable and fully focused strategy
- The Western Strategy
  - Our chosen strategy is to focus on .. our “western” electric business …
  - Implement a cost reduction program …
- Why we chose the “Western” strategy:
  - Most achievable
  - Lowest risk/most predictable financial results
  - Focuses on what we do best
  - Most acceptable to our shareholders
  - With focus, should bring the most value
- Implementing the strategy
  - Focus on being a western U.S. electricity company – eliminate external distractions
  - Reduce risk in western wholesale business

From: PacifiCorp Investor/Analyst Presentation, New York, October 28, 1998.

Q. WHAT ARE YOUR CONCLUDING COMMENTS, IN LIGHT OF THESE “BEFORE” AND “AFTER” QUOTES?

A. I believe that PacifiCorp's present strategy is sound and low-cost from a financial standpoint, for the reasons outlined by the Company in its October 1998 presentation and discussed in my testimony. Regarding the ScottishPower alternative, my point is that an aggressive diversification strategy is inherently risky. There is no knowing in advance how it is going to work out. There is always the risk that a corporate management will overreach itself. It seems to me likely, in the present case, that ScottishPower will be disappointed by the slow growth of earnings at PacifiCorp. It will try to squeeze more profits out of PacifiCorp and will be tempted to use PacifiCorp as a platform for expansion into more profitable businesses which would be inherently more risky. Quite possibly, it will divest itself of PacifiCorp in the future, as some U.S. companies are now considering divesting themselves of U.K. utilities whose earnings are turning out to be disappointing.

Q. ARE THERE ANY BENEFITS THAT WOULD COMPENSATE PACIFICORP'S CUSTOMERS FOR THE ADDITIONAL RISK?

A. No. My overall assessment is that ScottishPower has not made its case with respect to net benefits. Other witnesses will address the benefits claims. My contribution has been to show that the financial features, contrary to PacifiCorp's claims, will result in costs and risks, not benefits, for customers. I support Mr. Gimble's recommendation that the acquisition be rejected.