

BEFORE THE PUBLIC SERVICE COMMISSION
OF UTAH

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In The Matter Of The Application)
of PacifiCorp And Scottish Power plc)
For An Order Approving the Issuance)
of PacifiCorp Common Stock)
_____)

Docket No. 98-2035-04

SCOTTISH POWER

REBUTTAL TESTIMONY OF GRAHAM L. MORRIS

JULY 16, 1999

INTRODUCTION

Q. Please state your name.

A. My name is Graham L. Morris. I am testifying on behalf of ScottishPower in lieu of Robert D. Green, who is leaving ScottishPower to pursue other opportunities. My educational background and experience is attached as Exhibit SP _ (GLM-1). Mr. Green had previously filed Direct Testimony in this proceeding, which I hereby adopt.

Q. Please summarize your rebuttal testimony in this proceeding.

A. My rebuttal testimony addresses many of the issues raised by the Division of Public Utilities (“DPU”) concerning ratemaking and cost allocation issues, financial impacts of the transaction, and access to books and records, and addresses the DPU’s corresponding proposed conditions. My testimony also responds to testimony submitted by witnesses on behalf of the Committee of Consumer Services (“CCS”), Large Customer Group (“LCG”), Utah Industrial Energy Consumers (“UIEC”), Emery County (“Emery County”), Utah Department of Community and Economic Development (“DCED”) and Nucor Steel (“Nucor”). Included in my testimony are the following points:

Inclusion of Cost Savings in Rates: The corporate cost savings to which we are committed, and the other savings which we expect to achieve, will lead over time to prices for customers that are lower than they would have been without the transaction. ScottishPower commits to ensuring that cost savings resulting from the transaction are reflected in a timely fashion in the results of operations for Utah and can be captured for customers in future rate proceedings. A rate cap or rate freeze is not necessary in this case to establish that there are net positive benefits for Utah customers that will result from this merger. Any rate condition would pre-judge the outcome of many issues that are properly considered by the ratemaking process.

Corporate Structure: My testimony clarifies the basis for the new

ScottishPower/PacifiCorp corporate structure after the transaction, and describes how the DPU's proposed Conditions address the corporate structure issues.

Cost Allocations: To provide assurances about our commitment to make available our proposed methodology for allocating corporate overheads, we agreed with the DPU to file a proposal earlier, rather than waiting until after the transaction is complete. We fulfilled our commitment by filing our proposal on June 18; a copy is included as Exhibit SP _ (GLM-2) to this testimony.

Transaction Costs: We confirm our commitment to record costs of the transaction below the line. My testimony also clarifies the ratemaking treatment of certain post-merger transition costs.

Financial Impacts of the Transaction: We are confident that the transaction will have a positive impact on PacifiCorp's financial strength. In any event, PacifiCorp's Utah customers will be protected if any adverse financial impacts arise through existing Commission authority, certain conditions proposed by the DPU, and by our Direct Testimony, Mr. Alan Richardson's Supplemental Testimony, and the commitments in this Rebuttal Testimony.

Access to Books and Records: The proposed conditions which we would agree to include a number of provisions to ensure that the Commission will have the necessary access to books and records for it to perform its regulatory oversight role. These adopt and extend the commitments proposed in Mr. Green's Direct Testimony.

Cost Savings and Their Inclusion in Rates

Q. Some witnesses have questioned the basis and magnitude of cost savings that ScottishPower has outlined and how those savings would be incorporated into rates. How do you respond?

A. First, as noted in Mr. Green's Direct Testimony, the \$10 million of guaranteed, annual corporate cost reductions, and the other cost savings we expect to achieve, will lead to rates that are lower than they otherwise would be without the transaction. Second, the investment which ScottishPower will be making in PacifiCorp's system to improve service quality will not increase overall costs, since the investment will constitute a re-direction of existing budgeted expenditures, as described in Mr. Richardson's Supplemental Testimony. Third, ScottishPower is not proposing to recover the transaction costs from Utah customers, but rather will bear these costs itself. Based on these three factors, a net positive benefit has been demonstrated even before accounting for the other benefits of the transaction. Through general rate cases, the Commission has the necessary tools to ensure that the cost savings achieved by ScottishPower will be reflected in rates. It must be stressed that nothing about this transaction will affect the ratemaking authority of the Public Service Commission ("PSC") with respect to PacifiCorp.

Q. Some witnesses have been critical of ScottishPower's inability to quantify cost savings and how the transaction will impact rates. How do you respond?

A. ScottishPower is committed to reflecting a \$10 million net reduction in corporate costs in PacifiCorp's annual cost of service at the end of the third year following completion of the transaction. Moreover, as stated in Mr. MacRitchie's Rebuttal Testimony, we will commit to filing a transition plan with the Commission no later than six months after the closing date of the transaction. This filing will include anticipated time lines, actions necessary to implement the transition plan and the proposed benefits (including anticipated cost savings), the estimated associated capital and expense expenditures and anticipated workforce changes. Mr. MacRitchie's Rebuttal Testimony provides a more complete description of the transition plan. Implementing this plan will provide cost

savings more quickly and with greater certainty than PacifiCorp could have achieved on its own.

Q. What will be the base from which the \$10 million in corporate cost savings will be measured?

A. The achievement of the \$10 million guaranteed savings will be measured from PacifiCorp's 1999 actual corporate costs, with an inflation escalation, and normalized and adjusted so as to reflect only those costs that would be included in rates. The \$10 million savings will also incorporate an inflation escalation. This commitment is similar to that proposed in DPU condition 3.

Q. How do you respond to the suggestion of LCG witness Anderson that the \$10 million annual corporate savings commitment is "inconsequential"? (Anderson, p. 12).

A. This \$10 million in savings is guaranteed and recurring, and therefore has a net present value of approximately \$100 million. If the actual amount of PacifiCorp corporate savings exceeds \$10 million on an annual basis, the higher amount of actual savings will be used. The commitment is to achieve these savings in above-the-line activities; any savings achieved in areas not allowed for ratemaking purposes will not count toward the \$10 million figure. These annual savings will be tracked for Utah customers in the semi-annual financial reports provided to the Commission and can be captured in rate proceedings thereafter.

Q. How will cost savings lead to rates that are lower than they otherwise would be without the transaction?

A. In order to improve PacifiCorp's financial performance, ScottishPower will be striving to earn a reasonable rate of return in each of the jurisdictions in which PacifiCorp operates. If PacifiCorp is underearning, the cost savings which ScottishPower is able to achieve will result in a need for rate relief of a smaller magnitude. On the other hand, to the

extent that cost savings allow PacifiCorp to exceed a reasonable return, a reduction in rates may be warranted. In either event, the cost savings will be captured in rates and lead to prices lower than they otherwise would be.

Q. Some witnesses have advocated rate conditions as part of the merger approval. DPU witness Alt advocates a 3-year rate cap, and CCS witness Gimble advocates either a rate reduction or a rate cap to lock in savings from the merger. Nucor witness Goins proposes an immediate base rate reduction for non-special contract customers and a post-reduction 5-year rate freeze for all customers. (Alt, p. 9), (Gimble, p.30), (Goins, p. 15). How do you respond?

A. ScottishPower fundamentally disagrees with any rate cap or rate reduction conditions. A general rate case, not a merger proceeding, is the proper process in which to incorporate in rates cost savings that have been achieved, and for the Commission to evaluate at the same time a whole host of other legitimate issues and considerations. Any rate condition would pre-judge the outcome of many issues that are properly considered by the ratemaking process. Normal ratemaking procedures are sufficient to flow-through merger benefits to Utah customers. Mr. Richardson addresses this issue in greater detail in his testimony.

Corporate Structure

Please discuss DPU witness Cleveland's questions about the new corporate structure, her recommendation relating to Commission approval of the sale or divestiture of assets, and DPU witness Artie Powell's concerns regarding the implications of the Public Utility Holding Company Act, or PUHCA, and the consequences of oversight by the Securities and Exchange Commission ("SEC"), on cost allocation issues. (Cleveland, pp. 5, 26), (Artie Powell, pp. 14-18).

Corporate Structure

Our June 18 cost allocation filing, attached as Exhibit SP _ (GLM-2) to this testimony, clarifies the new corporate structure, with a new holding company as a parent and without a new separate entity to provide corporate services. The new holding company was approved at the ScottishPower stockholder meeting on June 15. This corporate structure best assists the Commission in monitoring transactions and cost allocations between PacifiCorp and ScottishPower UK plc and ScottishPower plc (Holdco).

Asset Transfers and Divestiture

ScottishPower disagrees with condition 10 because it is unnecessary in light of condition 9. Condition 9 provides for reporting to the Commission prior to the construction, purchase, acquisition, sale, transfer or disposition of utility and non-utility assets, all as currently provided for in the Commission's rules as set forth in Utah Admin. Code § R746-401. Condition 10 seeks to impose a pre-approval process which is an extension of the current situation and is unnecessary and cumbersome. ScottishPower agrees to comply with current regulations regarding this issue which sufficiently provide the Commission with the information it needs to regulate the utility.

PUHCA and SEC Related Issues

ScottishPower would agree to additional reporting and consultation requirements, as proposed in conditions 22-26, with some exceptions. The principal exceptions are: (1) for condition 22, the detailed report should be provided as soon as possible after the approval of the merger; (2) for condition 23, PacifiCorp will maintain separate debt, but not preferred stock as this will be eliminated pursuant to the merger agreement; (3) for condition 24, we believe this is unnecessary because this issue is addressed by Utah Code Ann. § 54-4-31; and (4) for condition 25, ScottishPower would not assert in any future

Utah proceeding that the Commission's jurisdiction over affiliated interest transactions is preempted. ScottishPower agrees with condition 26 related to providing the Commission with a copy of any SEC filed lobbying reports.

Some witnesses have raised concerns that the proposed corporate structure would enable

ScottishPower to diversify into other potentially riskier endeavors. Are there adequate safeguards to address this potential risk?

- A. Yes. Most importantly, the DPU already has at its disposal sufficient authority to monitor PacifiCorp's activities. Utah Admin. Code § R746-401, as described above, provides for reporting to the Commission a variety of dispositions of company assets. Utah Code Ann. §§ 54-4-28 through 54-4-31 also provide safeguards regarding mergers, acquisitions and the issuance of securities. ScottishPower would readily comply with these provisions. The DPU in condition 5 has also suggested that any diversified holding and investments (e.g., non-utility business or foreign utilities) of ScottishPower and PacifiCorp be held in company(ies) separate from PacifiCorp, with ring-fence provisions for each of these diversified activities. We would agree to this, provided that existing holdings may remain and that affiliates of PacifiCorp are not prohibited from holding investments. In total, these items provide the Commission with sufficient regulatory oversight to mitigate any potential diversification risk.

Cost Allocation Issues

Some witnesses have raised concerns about the allocation of corporate costs to PacifiCorp and

affiliate relationships. (Talbot, pp. 42-45), (Cleveland, pp. 10, 21-24). What is

ScottishPower proposing with respect to these issues?

- A. We had originally proposed to wait until after the transaction to provide our corporate cost allocation proposals. However, to eliminate any uncertainty in this area, and to provide assurances about our commitment to make this proposed methodology available,

we accelerated to June 18 the filing date for our proposal. This filing includes our proposal on the treatment of affiliate transactions, corporate cost allocation methodology, and a statement of where each of the ScottishPower principal corporate departments will sit in the new corporate structure.

On the issue of corporate cost allocations, our June 18 filing addresses many of the concerns raised by DPU witness Cleveland in her testimony. On the issue of affiliate transactions, both our June 18 filing and our commitment to comply with DPU condition 7, PacifiCorp's Transfer Pricing Policy, as it relates to transactions with PacifiCorp, should adequately address concerns regarding the perceived risk of cross-subsidization to and from other members of the ScottishPower group. It should also be noted that our June 18 filing contains a written procedure which proposes a process for coordination and conflict resolution between and among U.S. and U.K. regulators concerning cost allocation and affiliate transaction issues.

Based on these commitments, conditions 2 and 8 need to be modified. Condition 8 (1), (2) and (3) are acceptable as they relate to PacifiCorp and notifying the Commission prior to starting or stopping affiliate transactions with PacifiCorp. Condition 8(4) is unnecessary relating to creating or expanding business ventures as it is covered in condition 6, which relates to Commission notification by ScottishPower/PacifiCorp of the public announcement of the acquisition of regulated or non-regulated business representing 5% or more of the market capitalization of ScottishPower. Condition 8(5) is unnecessary because of the statutory provisions in Utah Code Ann. §§ 54-4-28 through 54-4-31 dealing with the mergers, acquisitions, and the issuance of securities.

Q. Do you agree with the last sentence of condition 2, and condition 46, particularly the recommendation that ScottishPower bear the risk of the inability of state regulators to agree to allocation methodologies?

A. ScottishPower agrees that it bears the risk relating to the possibility that the Commission may adopt an allocation methodology that differs from those adopted by OFFER and OFWAT. However, relating to the differences in allocations between the states, allocation issues should be resolved during PITA group discussions which must start with the expectation that a mutually agreeable solution can be reached by all parties. This will aid the resolution of all issues. If ScottishPower bears all of the risk, then there is no incentive for any party to try to reach a reasonable solution with other state staff members. This may, in turn, put at risk the financial viability of the company.

Costs of the Transaction Will Not be Recovered from Customers

Q. Some witnesses have expressed concern over the treatment of transaction costs. LCG witness Anderson states that ScottishPower has reserved the option of attempting to recover transaction costs from customers. (Anderson, p. 39). CCS witness Talbot and UIEC witness Brubaker also imply that ScottishPower will be under pressure to overcome the impact of the premium on earnings. (Talbot, p. 26-27), (Brubaker, pp. 2, 24-25). How do you respond?

A. A detailed breakdown of costs, and proposed ratemaking treatment, is included in my testimony as Exhibit SP _ (GLM-3), which is responsive to the DPU's condition 4 concerning merger-related costs. ScottishPower has committed to excluding transaction costs for the purpose of setting rates in Utah. ScottishPower will also disregard for ratemaking purposes any premium paid for PacifiCorp stock and will set rates based upon original, not revalued, costs, as provided in condition 28. Having excluded these items from the calculations, we then expect to earn a reasonable rate of return from the regulated business, which will generate sufficient funds to provide for capital and operating expenditures and provide shareholders with a reasonable return on their investment. ScottishPower shareholders would expect to recover any premium associated

with the merger through the earning of a reasonable return on their investment in PacifiCorp.

Q. Are the costs of the executive severance plan part of the transaction costs that will be excluded for ratemaking purposes?

A. With respect to existing executive severance packages, we would propose to include them above-the-line for ratemaking purposes because they will result in lower salary costs going forward. We also propose to include the bonus pool as recoverable, to the extent these costs are not related to the merger. With respect to enhanced severance and the merger-related portion of the bonus pool, such costs will be accounted for below-the-line. In any event, our treatment of severance payments and bonus incentives is subject to review in any general rate proceeding.

Q. How will certain transition costs, as illustrated in Mr. Anderson's testimony be treated for ratemaking purposes? (Anderson, pp. 41-45).

A. ScottishPower should be able to recover transition costs since they will deliver offsetting savings of a greater magnitude going forward. The transition plan will demonstrate this where applicable.

Financial Impacts of the Transaction

Some witnesses have raised the issue that the transaction creates additional financial risk for PacifiCorp. For example, CCS witness Talbot mentions the risks to PacifiCorp arising from the "financial vicissitudes" of ScottishPower. (Talbot, p. 6). How can these concerns be addressed?

A. There is no evidence to support a claim that this transaction imposes increased risk on PacifiCorp. The most important point here is that the Commission retains its authority in rate proceedings to protect PacifiCorp's Utah customers from any adverse impacts. We would agree to the DPU's condition 21 related to capital structure. Through the use of a

hypothetical capital structure, the cost of equity, for example, has traditionally been set by reference to U.S. companies comparable to PacifiCorp. This practice insulates customers from external risks. Also, the operations of ScottishPower in the U.K. will not have any impact on our U.S. operations. The regulators in the U.K., like regulators in the U.S., must set rates at a level that is adequate to permit us to finance the expenditures necessary to maintain our operations and provide safe and adequate utility service. The capital spending to which we have committed in our U.K. operations will be recovered in rates set by our U.K. regulators, and will have no financial effect on PacifiCorp. Moreover, any "continued expansion by the ScottishPower group" (Talbot, p. 6) will not adversely affect PacifiCorp customers. ScottishPower's history shows a consistent record of successful acquisitions based on a defined strategy, focused planning up to and beyond completion of the transaction, and the establishment of clear plans and accountabilities following the acquisition.

Please describe the proposal for PacifiCorp to be authorized to increase its debt to \$5 billion, as referenced in Mr. Anderson's testimony. (Anderson, pp. 52-53).

- A. The proposal to increase PacifiCorp's debt is not merger-related. The requirement to obtain consent from preferred shareholders is not dependent on the merger being approved. As stated in the Proxy Statement at page 136, the reason for seeking consent is that the increase in the unsecured debt facility is "key to meeting the objectives of flexibility and favorable cost structure" required to "operate effectively in the new competitive environment."

Please comment on DPU witness Burrup's recommendation (DPU condition 18) that asset revaluation resulting from the merger should not be used as a basis to increase property taxes or other taxes or existing contract costs for ratemaking purposes. (Burrup, p.11).

- A. We agree with Emery County witness Malko, who recommends that the Commission

defer rulings or findings relating to the merger that concern valuation and assessment issues of PacifiCorp property, to the jurisdiction of the Utah State Tax Commission. (Malko, p. 10). PacifiCorp has always participated in Tax Commission proceedings which affect the company with the object of keeping property and other taxes as low as possible. Property and other taxes may arise for a variety of reasons and it will be difficult to determine whether such taxes are attributable to the merger. Once the Tax Commission has ruled, however, ScottishPower would expect a potential adjustment to be reflected in rates, as PacifiCorp has always done in the past.

Q. Please respond to Mr. Brubaker's proposed condition that "special contract customers should be permitted, at their option, to renew existing contracts on terms no less favorable to the customer than the terms of the current special contracts . . ." (Brubaker, p. 5).

A. The Commission has established a Task Force to examine the special contract issue. PacifiCorp has participated in this process and will add its resources to the Task Force. Prior to completion of the transaction and until the Commission's Task Force has finished its work, however, the discussion regarding special contracts is premature and should not be an issue in this docket.

Q. Please address DCED witness Winder's concern that any transfers of money or other assets from PacifiCorp to the new holding company or any affiliates may pose a risk of detrimentally impacting PacifiCorp plant, equipment and infrastructure. (Winder, pp. 7-8).

A. Existing Commission rules and procedures relating to asset transfers and affiliate transactions provide sufficient assurance that the assets of the Utah Division of PacifiCorp will not be adversely impacted by the transaction. The loan note from the partnership to the new holding company, which Mr. Winder mentions, was established in

consideration for the transfer of ownership of PacifiCorp and does not involve the actual transfer of funds. This arrangement will have no impact on PacifiCorp's Utah operations.

Q. Has the DPU raised other issues related to the financial aspects of the transaction?

A. Yes. The DPU has proposed conditions related to intra-company loans, payment of dividends, foreign currency and exchange risk, and capital structure. Regarding these issues, ScottishPower proposes the following:

The existing Umbrella Loan Agreement between PacifiCorp and its affiliates would continue to govern the terms for loans between PacifiCorp and its affiliates, and could be extended to include ScottishPower UK plc as an affiliate. (Compare, DPU condition 16).

Regarding dividend payments, PacifiCorp would continue to comply with the provisions of Utah Code Ann. § 54-4-27. (Compare, DPU condition 17).

ScottishPower would also follow FASB 52, for the purpose of U.S. financial reporting, to mitigate the effects of foreign currency and exchange risk. (Compare, DPU condition 20).

We propose that a hypothetical capital structure using a group of A-rated electric utilities comparable to PacifiCorp be used to determine the correct cost of capital for ratemaking purposes in Utah. (Compare, DPU condition 21).

Access to Books and Records

Q. Some witnesses have raised the issue of adequate access to books and records. (Cleveland, pp. 28-30), (Chernick, p. 17, fn. 13). How will ScottishPower ensure the Commission has sufficient oversight in this area?

A. As an initial matter, ScottishPower is committed to comply with the Commission's existing rules and requirements in this area. Additionally, we would agree to other conditions that would provide the Commission with reasonable and sufficient access to

books and records. We would make available holding company personnel to provide information relevant to matters within the jurisdiction of the Commission. We would also agree to establish with the DPU procedures for providing access to documents related to costs charged to PacifiCorp. ScottishPower would also pay for reasonable expenses incurred by Utah regulatory personnel in accessing corporate records and personnel located outside of Utah, provided such expenses would be recoverable for ratemaking purposes. These commitments are in addition to those made in my Direct Testimony and are similar to the DPU's conditions 11-13. Regarding the filing of general and financial reports, as proposed in condition 19, ScottishPower would provide information as it relates to PacifiCorp, with the exception of (g), which requires further clarification, and (i.), which would be available for DPU inspection. Taken in total, these ScottishPower commitments provide adequate assurance to the Commission that its regulatory oversight will not be diminished after the transaction.

- Q. In your opinion, will the ScottishPower/PacifiCorp merger provide a net benefit to PacifiCorp's Utah customers?
- A. Yes. ScottishPower's proposal in connection with appropriate conditions discussed above demonstrates a net positive benefit for PacifiCorp's ratepayers in Utah.
- Q. Does this conclude your rebuttal testimony, Mr. Morris?
- A. Yes, it does.