

BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH

In the matter of the Application of
PacifiCorp and ScottishPower plc for an
Order Approving the Issuance of
PacifiCorp Common Stock

Docket No. 98-2035-04

DIRECT TESTIMONY

OF

J. ROBERT MALKO

ON BEHALF OF EMERY COUNTY

June 9, 1999

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2 **DIRECT TESTIMONY OF J. ROBERT MALKO**
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4 **I. INTRODUCTION AND WITNESS QUALIFICATION**
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6 Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

7 A. My name is J. Robert Malko. I am a Professor of Finance for the College of
8 Business at Utah State University located in Logan, Utah. My business consulting
9 address is 245 North Alta Street, Salt Lake City, Utah 84103.
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11 Q. WOULD YOU PLEASE DESCRIBE YOUR QUALIFICATIONS?

12 A. Yes. I received my Bachelor's degree, cum laude, in economics and mathematics
13 from Loyola College in Baltimore, Maryland. I received my Master's and
14 Doctorate degrees in economics from the Krannert Graduate School
of 15 Management at Purdue University on Lafayette, Indiana. I have taken
graduate
16 courses in business finance at the University of Wisconsin at Madison and
17 accounting courses at Illinois State University in Normal, Illinois. I was also a
18 Visiting Scholar in industrial engineering at Stanford University in Palo Alto,
19 California.
20

21 At Utah State University, I teach the following undergraduate level and graduate
22 level courses: Principles of Corporate Finance, Investments, Case Studies in

23 Finance, and Managerial Economics. Besides my current position with Utah
1 State University, I have been on the faculties at Illinois Wesleyan University and
2 Illinois State University. I have also presented guest lectures concerning energy
3 utility issues at the University of Wisconsin at Madison, Stanford University,
4 Michigan State University, University of California-Berkeley, and University of
5 Utah.

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7 I served during the period, 1975-1977, as the Chief Economist for the Public
8 Service Commission of Wisconsin (PSCW). During this time, I also serves as
9 Chair and Vice Chair of the National Association of Regulatory Utility
10 Commissioners (NARUC) Staff Subcommittee on Economics. From 1977 to
11 1981, I was Project Manager and then Program Manager for the Electric Utility
12 Rate Design Study. This study was prepared for NARUC and housed at the
13 Electric Power Research Institute (EPRI) in Palo Alto, California. From 1981 to
14 1986, I returned to the position of Chief Economist with the PSCW. In 1981-
15 1982, I was the Senior Staff Advisor to the NARUC Ad Hoc Committee in
16 Utility Diversification. I assisted the committee in the preparation and publication
17 of its “Final Report” in 1982. I also served as the Vice Chair of the NARUC Staff
18 Subcommittee on Economics and Finance during the time period, 1981-1986.

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20 I have written or co-authored approximately 150 articles on energy utility
21 economic and finance issues. During 1994 and 1995, I co-edited two books
22 entitled Electric Utilities Moving Into the 21st Century and Reinventing Electric

23 Utility Regulation published by Public Utilities Reports, Inc. During 1999, I
1 co-edited another book entitled Customer Choice: Finding Value In Retail Electricity
2 Markets, published by Public Utilities Reports, Inc. I have also address several
3 national conferences. I am a member of the American Finance Association, the
4 American Economic Association, the Financial Management Association, and the
5 Council on Economic Regulation. I am a past President of the Society of Utility and
6 Regulatory Financial Analysts (SURFA), and I serve on its Advisory Council. I am a
7 past Chair of the Transportation and Public Utilities Group of the American
8 Economic Association, and I have served on its Executive Committee. I am a
9 member of the Advisory Council of the Center for Public Utilities at New Mexico
10 State University, and I serve on the board of Directors at the National Regulatory
11 Research Institute (NRRI), located at Ohio State University.

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13 I have testified on behalf of state regulatory commissions, state offices of consumer
14 counsel, energy utilities, and customer groups before the following regulatory
15 agencies: the Arizona Corporation Commission, the Connecticut Public Utilities
16 Control Authority, the Federal Energy Regulatory Commission, the Hawaii Public
17 Utilities Commission, the Illinois Commerce Commission, the Maryland Public
18 Service Commission, the Nevada Public Service Commission, the New Hampshire
19 Public Utilities Commission, the New York Public Service Commission, the
20 Pennsylvania Public Utility Commission, the Public Service Commission of the

21 District of Columbia, the Public Service Commission of Wisconsin, the Utah Public
22 Service Commission, and the Virginia State Corporate Commission.

23

1 Exhibit JRM-1 provides additional information concerning my education and
2 profession background.

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4 Q. BY WHOM ARE EMPLOYED TO PRESENT THIS TESTIMONY?

5 A. I am employed as a financial consultant by Emery County to present testimony in this
6 proceeding. PacifiCorp property comprised approximately 75% of the total of all
7 centrally and locally assessed property in Emery County in 1998. Moreover,
8 PacifiCorp property represented the largest centrally assessed single company
9 property in Utah during 1996. Exhibit JRM-2 presents specific
10 quantitative information prepared by the Utah State Tax Commission concerning
11 these assessed property relationships. Emery County is concerned about potential
12 net harm associated with the proposed merger between PacifiCorp and
13 ScottishPower.

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15 Q. WHAT ARE THE PRIMARY PURPOSES OF YOUR DIRECT TESTIMONY IN
16 THIS PROCEEDING?

17 A. The primary purposes of my direct testimony in this proceeding are:

18 (1) to describe the financial framework used to value PacifiCorp;

19 (2) to comment on the accounting method that will be used for this merger

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transaction; and

(3) to make specific recommendations to the Public Service Commission of Utah.

II. FINANCIAL FRAMEWORK FOR VALUATION

Q. PLEASE SUMMARIZE THE SPECIFIC CONDITIONS CONCERNING THE CONVERSION OF OUTSTANDING COMMON STOCK OF PACIFICORP IN THIS MERGER?

A. According to the direct testimony (page 2, lines 14-19) of Mr. Robert D. Green of ScottishPower in this proceeding:

“ScottishPower proposes to merge with PacifiCorp by acquiring all of the outstanding common stock of PacifiCorp. Under the terms of the agreement, each PacifiCorp share will be exchanged tax-free for 0.58 American Depositary Receipts or 2.32 ordinary shares of ScottishPower. Before allowance for any buyback, this will give ScottishPower shareholders approximately 64% and current PacifiCorp shareholders approximately 36% ownership in the combined group.”

Conditions concerning the conversion of PacifiCorp common stock in the merger are also discussed on page 57 of the PacifiCorp Proxy Statement.

Q. WHAT IS THE FINANCIAL BASIS FOR THE CONDITIONS OF THE

19 CONVERSION OF OUTSTANDING COMMON STOCK OF PACIFICORP IN
20 THE MERGER?

21 A. The primary financial basis for conditions of the conversion of outstanding common
22 stock of PacifiCorp in the merger is the opinion of its financial advisor, Salomon
23 Smith Barney, and the opinion of ScottishPower’s financial advisor, Morgan Stanley.

1 Q. PLEASE SUMMARIZE THE FINANCIAL METHODS USED BY THESE
2 FINANCIAL ADVISORS FOR FINANCIAL OPINIONS AND VALUATION.

3 A. Based on information provided in pages 40-46 of the PacifiCorp Proxy Statement,
4 Salomon Smith Barney used the following financial analyses/approaches concerning
5 the financial valuation of PacifiCorp common stock and ScottishPower ordinary
6 shares: discounted cash flow analysis, public market valuation analysis, sum-of-the-
7 parts valuation analysis, valuation comparison contribution analysis, and pro forma
8 analysis of the merger.

9 Based on information provided on pages 46-54 of PacifiCorp Proxy Statement,
10 Morgan Stanley used the following financial analyses/approaches concerning the
11 financial valuation of PacifiCorp common stock and ScottishPower ordinary shares:
12 historical common stock performance, comparative stock price performance, trading
13 ratio analysis, comparable public company analysis, discounted cash flow analysis,
14 analysis of selected precedent transactions, contribution analysis, pro forma analysis
15 of the merger, and business line analysis.

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17 **III. ACCOUNTING METHOD FOR MERGER TRANSACTION**

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19 Q. WHAT IS THE ACCOUNTING METHOD THAT WILL BE UTILIZED FOR THE
20 MERGER TRANSACTION?

21 A. According to the direct testimony (page 3, lines 4-11) of Mr. Robert D. Green of
22 ScottishPower in this proceeding:

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1 “The transaction will be accomplished through a share-for-share exchange for all of
2 the issued and outstanding shares of PacifiCorp common stock in a transaction in
3 which all outstanding debts obligations of PacifiCorp will remain. This form of
4 transaction is required to be accounted for using the “purchase” method of accounting.
5 The purchase method of accounting requires all assets and liabilities of PacifiCorp to
6 be valued at fair market value at the time of closing of the transaction. After
7 assigning fair market values to all identifiable assets and liabilities, any unallocated
8 portion of the purchase price is recorded as goodwill.”

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10 Additional information concerning the use of the purchase method of accounting for
11 this merger is presented on page 78 of the PacifiCorp Proxy Statement.

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13 Q. UNDER THE PROPOSED PURCHASE METHOD OF ACCOUNTING, DOES
14 SCOTTISHPOWER PLAN TO MAKE ACCOUNTING CHANGES
15 CONCERNING ASSETS OF PACIFICORP?

16 A. Yes. Using the purchase method of accounting, U.S. GAAP, and U.K. GAAP,
17 ScottishPower plans to make accounting changes concerning the assets of

PacifiCorp.

18 Some of the proposed accounting changes are specified in the following list.

19 First, assets of PacifiCorp will be valued at fair market value at the time of the
20 closing of the transaction. Second, there will be a re-allocation of assets between
21 tangible assets and intangible assets including goodwill. Third, other intangible
assets, 22 such as trademarks, operating licenses, and customer lists, could be assigned
23 quantitative values.

1 Additional information concerning accounting changes to assets of PacifiCorp is
2 presented on pages 84-100 of the PacifiCorp Proxy Statement.

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4 Q. DO YOU BELIEVE THAT THE PROPOSED PURCHASE METHOD OF
5 ACCOUNTING SHOULD SIGNIFICANTLY IMPACT THE TRADITIONAL
6 COST ACCOUNTING METHOD USED IN THE RATE BASE-RATE OF
7 RETURN REGULATORY FRAMEWORK APPLIED TO PACIFICORP BY THE
8 UTAH PUBLIC SERVICE COMMISSION?

9 A. No. The traditional regulatory accounting framework uses a different costing
10 foundation and financial premises as compared to the purchase method of
accounting.

11

12 Q. ARE THESE PROPOSED ACCOUNTING CHANGES CONCERNING ASSETS
13 OF PACIFICORP REASONABLE FOR VALUING AND ASSESSING
14 PROPERTY?

15 A. Based on the information presented in the PacifiCorp Proxy Statement and

16 practices and policies at the Utah State Tax Commission, I believe that some of the
17 proposed accounting changes concerning assets of PacifiCorp are unreasonable for
18 valuing property in Utah. Specifically, part of the unallocated portion of the
19 purchase price could certainly be attributable to enhancements to tangible assets
20 as opposed to intangible assets, including goodwill. Moreover, valuation of
21 property issues concerning: (1) the assignment of assets to intangible assets versus
22 enhancement to tangible assets and (2) the assignment of assets to specific types
23 of intangible assets are in the jurisdiction of the Utah State Tax Commission.

1 Exhibit JRM-3 presents a copy of recent (1998) legislation concerning the definition
2 of intangible property in Utah. Please note that goodwill is not defined as intangible
3 property in this legislation.
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5 **IV. RECOMMENDATIONS**

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7 **Q. DO YOU HAVE ANY RECOMMENDATIONS CONCERNING THIS MERGER**
8 **CASE AND THE VALUING AND ASSESSING OF PACIFICORP PROPERTY?**

9 **A.** Yes. I recommend that the Public Service Commission of Utah *defer* rulings or
10 findings relating to this merger that concern valuation and assessment issues of
11 PacifiCorp property, including the allocation between enhancement to tangible assets
12 versus intangible assets and the allocation to specific types of intangible assets, to the
13 jurisdiction of the Utah State Tax Commission.
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15 **Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

16 A. Yes.

Emery County
Exhibit: JRM-1
PSCU Docket No. 98-2035-04
Witness: J. Robert Malko

Emery County
Exhibit: JRM-2
PSCU Docket No. 98-2035-04
Witness: J. Robert Malko

Emery County
Exhibit: JRM-3
PSCU Docket No. 98-2035-04
Witness: J. Robert Malko