

-BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH-

IN THE MATTER OF THE APPLICATION OF)DOCKET NO. 98-2035-04
PACIFICORP AND SCOTTISH POWER PLC)UTAH DIVISION OF PUBLIC UTILITIES
FOR AN ORDER APPROVING THE)EXHIBIT NO. DPU 2.0
ISSUANCE OF PACIFICORP COMMON STOCK)

DIRECT TESTIMONY OF MARY H. CLEVELAND

FOR THE

DIVISION OF PUBLIC UTILITIES

DEPARTMENT OF COMMERCE

STATE OF UTAH

June 18, 1999

1

I. QUALIFICATIONS

2 **Q. PLEASE STATE YOUR NAME FOR THE RECORD.**

3 **A.** Mary H. Cleveland.

4 **Q. BY WHOM ARE YOU EMPLOYED AND WHAT IS YOUR BUSINESS ADDRESS?**

5 **A.** I am employed by the Utah Department of Commerce, Division of Public Utilities
6 (Division). My business address is 160 East 300 South, Suite 400, Salt Lake City, Utah,
7 84114.

8 **Q. WHAT IS YOUR POSITION?**

9 **A.** Utility Regulatory Analyst.

10 **Q. BRIEFLY DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL**
11 **BACKGROUND.**

12 **A.** I hold a Bachelor of Business Administration, as well as a Master of Business
13 Administration, from the University of Missouri-Kansas City. In addition I have regularly
14 attended the National Association of Regulatory Utility Commissioners (NARUC) Staff
15 Subcommittee on Accounts meetings and have served on the NARUC Securities and
16 Exchange Commission (SEC) Subcommittee. I have participated extensively in PacifiCorp's

1 Integrated Resource Planning process. I also participated in the IndeGO Pricing Work Group
2 and served as a non-member representative on the IndeGO Steering Committee.

3 I have approximately eighteen years of utility regulatory experience, both as a
4 consultant and as an employee of state regulatory agencies. I have participated in regulatory
5 proceedings in the states of Alaska, Arizona, Connecticut, Kansas, Missouri, New Mexico,
6 Ohio, Utah and Wisconsin. I have also testified before the Kansas Supreme Court.

7 I am a licensed Certified Public Accountant in the state of Kansas and I am a member
8 of the Institute of Certified Public Accountants. Further details regarding my background
9 are provided in Exhibit No. DPU 2.1.

10 II. PURPOSE OF TESTIMONY

11 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

12 A. My testimony will address the following areas as they relate to the proposed
13 transaction between ScottishPower and PacifiCorp (Applicants): 1) corporate cost
14 allocations; 2) affiliate transactions; and 3) access to books and records. For each of these
15 areas I shall discuss issues and/or concerns arising from the proposed transaction which
16 could potentially impact the Division's ability to carry out its statutory responsibilities with
17 respect to the regulation of PacifiCorp and recommend conditions which the Division
18 believes will serve to mitigate those issues and concerns.

1 **Q. IN GENERAL WHAT IS THE OVERALL RISK YOU ARE ATTEMPTING TO**
2 **MITIGATE?**

3 **A.** In a recent joint paper, “Regulatory Issues Associated with Multi-Utilities” (May
4 1998), by the Directors General of Electricity Supply, Gas Supply, Telecommunications and
5 Water Services; the Director General of Electricity Supply (Northern Ireland) and the
6 Director General of Gas (Northern Ireland), the concerns which arose in connection with the
7 proposed PacifiCorp acquisition of Eastern Electricity (The Energy Group) were
8 summarized:

9 “In competitive markets, if a company runs into financial difficulties,
10 the customers can move elsewhere. But customers of monopoly
11 utilities have no such facility. Regulators need, therefor, to be
12 satisfied that monopoly utility license holders have the appropriated
13 financial and managerial resources to finance their activities and meet
14 their license and statutory obligations. Where the monopoly utility is
15 part of a larger group, whether or not a multi-utility, there is a risk
16 that decisions will not be taken solely in the interests of the regulated
17 company and its customers, but will be influenced by the wider
18 ambitions of the group. There is a risk that a licensee will be denied
19 the resources to meet its obligations.”

20 The question before the Monopolies and Mergers Commission in this instance was whether
21 the existing license requirements, taken together with the existing powers of the regulator,
22 were sufficient to meet these concerns. The tables have now turned with PacifiCorp
23 becoming acquired, but the question remains the same. As regulators we need to impose
24 requirements on this new entity to ensure that we have sufficient powers to protect the public
25 interest.

1 **Q. HOW DID YOU IDENTIFY THE ISSUES AND CONCERNS YOU ARE ABOUT TO**
2 **ADDRESS?**

3 **A.** I reviewed the application filed by PacifiCorp and ScottishPower filed on December
4 31, 1998, as well as the supporting testimonies subsequently filed on February 26, 1999. I
5 issued a series of data requests seeking information about ScottishPower as well as the
6 transaction and reviewed data requests issued by other parties to this proceeding. I reviewed
7 ScottishPower's annual reports, filings before the Securities and Exchange Commission
8 (SEC) as well as other publicly available data. I might add that we were generally precluded
9 from reviewing ScottishPower's future budgetary information and plans as they were
10 considered to be highly sensitive and proprietary.

11 Additionally, I gained a knowledge of the regulatory environment in which
12 ScottishPower operates by reviewing consultation papers published by the United Kingdom
13 (U.K.) regulator, the Office of Electricity Regulation (OFFER). I also examined filings made
14 by ScottishPower before OFFER.

15 **III. CORPORATE STRUCTURE / COST ALLOCATIONS**

16 **Q. DOES CORPORATE STRUCTURE PLAY AN IMPORTANT ROLE IN THE**
17 **ALLOCATION PROCESS?**

18 **A.** Yes, the corporate structure will determine to a large degree how individual members
19 of the corporate group interrelate with each other and the extent to which they transact

1 business among themselves. As such it will influence the number of entities within the group
2 who's costs are allocated among other members of the group as well as the extent and
3 complexity of affiliate transactions.

4 **Q. WHAT CORPORATE STRUCTURE IS PROPOSED FOR THE MERGED**
5 **COMPANIES?**

6 **A.** The proposed corporate structure for the merged companies has been and continues
7 to be a moving target. To date, to the best of my knowledge, there have been three proposed
8 corporate structures. Originally, as filed pursuant to the Agreement and Plan of Merger
9 entered into by ScottishPower plc, NA General Partnership, and PacifiCorp, dated December
10 6, 1998 (Merger Agreement), PacifiCorp was to have been a subsidiary of ScottishPower
11 along with Manweb, Scottish Telecom and Southern Water. However, to address concerns
12 of the U.K. Director General of Electricity Supply (DGES), ScottishPower agreed to
13 establish a holding company for the ScottishPower group. The establishment of the holding
14 company is reflected in the Amended and Restated Agreement and Plan of Merger entered
15 into by New ScottishPower plc, ScottishPower plc, NA General Partnership, and PacifiCorp,
16 dated February 23, 1999 (Amended Merger Agreement). Under the Amended Merger
17 Agreement, PacifiCorp would be a subsidiary of the holding company. The Amended
18 Merger Agreement also established a Service Company. Subsequently on May 14, 1999,
19 yet another proposed corporate structure was provided to the Wyoming Consumer Advocate

1 Staff, as part of a letter of commitment by ScottishPower, plc witness Robert Green. Under
2 this proposal there would be two holding companies, a United States registered holding
3 company; as well as the U.K. holding company. According to ScottishPower plc witness
4 Robert Green a United States registered holding company would facilitate further
5 acquisitions by ScottishPower plc in the United States (Response to CAS interrogatory
6 7.204).

7 As proposed the merger will create a registered holding company. Thus, ultimately
8 the Security and Exchange Commission (SEC) will approve a corporate structure under the
9 Public Utilities Holding Company Act of 1935 (PUHCA). However, ScottishPower has
10 taken the position that the merger does not have to be approved by the SEC under PUHCA.
11 Following completion of the merger, however, ScottishPower plans to register as a holding
12 company as required under Section 5 of the PUHCA. PUHCA requirements are addressed
13 by Division witness Artie Powell

14 Therefore, the final corporate structure is unknown at this time. This is a significant
15 issue since, as I mentioned previously, the corporate structure can impact the number of
16 corporate allocations. The more complex the corporate allocations, the more difficult it may
17 become to maintain an audit trail regarding those allocations.

1 **Q. HAS SCOTTISHPOWER PROPOSED A METHODOLOGY FOR ALLOCATING**
2 **CORPORATE COSTS?**

3 A. No. Originally ScottishPower committed to provide an analysis of its proposed
4 allocation of corporate costs within three months of the completion of the transaction (Direct
5 Testimony of Robert D. Green, February 26, 1999, page 10, lines 1 - 2). However,
6 ScottishPower has now committed to file a draft proposed cost allocation methodology no
7 later than June 18, 1999. This commitment is contained in Term 21 of the proposed
8 Stipulation among PacifiCorp (“PacifiCorp”), ScottishPower plc (ScottishPower) and the
9 Consumer Advocate Staff of the Wyoming Public Service Commission (CAS), which reads
10 as follows:

11 “No later than June 18, 1999, ScottishPower/PacifiCorp shall provide the
12 CAS and other jurisdictional state rate regulators a proposed methodology for
13 the allocation of corporate and affiliate investments, expenses, and overheads
14 and a statement of where each of the ScottishPower principal corporate
15 departments will sit in the corporate structure. This document would
16 constitute a draft of what is to be filed regarding cost allocations with the
17 Securities and Exchange Commission. No later than October 15, 1999,
18 PacifiCorp/Scottish Power shall schedule a conference/meeting with state and
19 other interested regulators to discuss the proposed corporate and affiliate cost
20 allocation methodology”

21 ScottishPower has verbally made a similar commitment to the Division.

1 **Q. HOW DOES SCOTTISHPOWER CURRENTLY ALLOCATE CORPORATE COSTS**
2 **TO ITS SUBSIDIARIES?**

3 **A.** In response to a data request ScottishPower stated that it currently allocates costs to
4 its subsidiaries by applying a range of allocation bases that include assessment of workload,
5 usage statistics and net assets (Response to DPU interrogatory S1.6). In subsequent
6 conversations with ScottishPower it was implied that net assets were used to allocate
7 corporate overheads which were not attributable on a usage basis, although this may have
8 only applied to Southern Water which is regulated by the Office of Water Services
9 (OFWAT).

10 Subsequently, in reviewing a recent OFFER Consultation Paper, “Review of Public
11 Electricity Suppliers 1996 - 2000: Distribution Price Control Review” (May 1999), I became
12 aware of an accounting guideline known as CSC 194, introduced before privatization, that
13 sets out guidance on cost allocations. Per CSC 194, corporate overheads which by their
14 nature are not assignable on a usage basis should be assigned on salaries and net assets,
15 **measured on a current cost basis.** I have placed emphasis “on a current cost basis” since
16 PacifiCorp’s net assets are measured on a historical cost basis for regulatory purposes.

17 However, in its May 1999 Consultation Paper, OFFER, noting that the application
18 of CSC 194 results in approximately 90% of corporate overheads being assigned to the
19 Distribution function and questioning whether this is a reasonable reflection of the usage of
20 corporate assets and staff, has proposed a new methodology for allocating corporate

1 overheads. The proposed methodology would allocate corporate overheads based on four
2 measures: 1) turnover (e.g. revenues); 2) historic cost operating profit; 3) employee numbers;
3 and 4) historic cost net assets; giving equal weight to each. Comments on this proposal are
4 due to OFFER by July 2, 1999. So, as is the corporate structure a moving target, the
5 methodology for allocating corporate overheads employed by the U.K. regulator has likewise
6 become a moving target.

7 This is problematic since PacifiCorp will reallocate to its subsidiaries corporate
8 overheads allocated from ScottishPower. PacifiCorp currently allocates corporate overheads
9 on the basis of three factors: 1) operating expenses, 2) number of employees and 3) historic
10 cost net assets; giving equal weight to each. PacifiCorp's allocation methodology differs
11 significantly from OFFER's current methodology and in some respect from OFFER's newly
12 proposed methodology. The use of two different allocation methodologies will result in the
13 allocation by PacifiCorp to its subsidiaries differing amounts of ScottishPower's corporate
14 overheads than ScottishPower's allocation methodology actually attributed to the
15 PacifiCorp subsidiaries.

16 **Q. DO YOU KNOW WHEN OFFER WILL DECIDE ON THE ALLOCATION**
17 **METHODOLOGY?**

18 **A.** Not precisely, however, since the Distribution rates to which the proposed allocation
19 methodology applies are scheduled to go into effect in April 2000, I would suspect that a

1 decision would be made prior to April 2000. I would also suspect that ScottishPower may
2 have a vested interest in having the same cost allocation methodology adopted by both
3 OFFER and the U.S. regulators. Therefore, I would not be surprised if the proposed cost
4 allocation that ScottishPower has committed to file on June 18, 1999, is similar to that
5 proposed by OFFER.

6 **Q. SHOULD THE UTAH COMMISSION APPROVE A COST ALLOCATION**
7 **METHODOLOGY IN THIS PROCEEDING?**

8 **A.** No, to do so at this time would premature. At this time the corporate structure, which
9 can impact the number of and complexity of cost allocations, is unknown. The Division has
10 not had an opportunity to examine the corporate costs which ScottishPower currently
11 allocates to its subsidiaries, nor will we have access to ScottishPower's books and records
12 until the merger is consummated. Furthermore, the establishment of a cost allocation
13 methodology is only necessary when and if the merger is consummated. Currently the
14 proposed transaction is in the approval process. However, the Utah Commission should
15 require ScottishPower/PacifiCorp to file a proposed cost allocation methodology for its
16 approval within 30 days following completion of the merger.

17 Although the establishment of a cost allocation methodology is a moot issue at this
18 time, the principles governing any cost allocation methodology are not. These principles
19 should constitute a merger condition.

1 **Q. WHAT ARE THE PRINCIPLES?**

2 **A.** The Utah Commission should require that a benefit to PacifiCorp be shown for any
3 costs allocated to it from ScottishPower.

4 Cost allocations should be based on generally accepted accounting standards, that is,
5 that in general, direct costs should be charged to specific PacifiCorp subsidiaries wherever
6 possible and shared or indirect costs should be allocated based upon the primary cost-driving
7 factors.

8 Corporate executives' costs are the most difficult to allocate fairly since they do not
9 routinely provide the same services on a consistent basis. Therefore, the Utah Commission
10 should require timekeeping and project management systems adequate to support the
11 allocation of such costs. This condition was ordered by the Utah Commission in the Utah
12 Power & Light and PacifiCorp merger, Docket No. 87-035-27.

13 An audit trail should be maintained such that all costs allocated can be specifically
14 identified along with their origination and adequately supported. Failure to adequately
15 support any allocated cost may result in denial of its recovery in rates.

16 Costs which would have been denied recovery in rates had they been incurred by
17 PacifiCorp regulated electric operations should likewise be denied recovery whether they
18 are allocated directly or indirectly through subsidiaries in the ScottishPower group. This is
19 consistent with the Utah Commission's order in Mountain Fuel Supply (Docket No. 93-057-
20 01):

1 “We find that donations, dues, lobbying expenses and political
2 contributions that are disallowed for cost recovery when funded
3 directly by Mountain Fuel are not recoverable when included in
4 affiliate charges.”

5 Finally, any corporate cost allocation methodology and subsequent changes thereto
6 must be approved by the Utah Commission. ScottishPower will assume the risk for the Utah
7 Commission approval and adoption of cost allocation methodologies which differ from
8 those adopted by OFFER or any other U.S. regulatory jurisdiction. A similar condition was
9 ordered by the Utah Commission in the Utah Power & Light and PacifiCorp merger, Docket
10 No. 87-035-27.

11 **Q. DOES SCOTTISHPOWER CURRENTLY HAVE IN PLACE TIME REPORTING**
12 **OR PROJECT MANAGEMENT SYSTEMS ADEQUATE TO SUPPORT THE**
13 **ALLOCATION OF EXECUTIVES’ COSTS?**

14 **A.** No. ScottishPower classifies these costs as corporate overhead and allocates them
15 along with all other corporate overhead costs (Response to DPU interrogative S7.17)

16 **Q. HOW DOES PACIFICORP CURRENTLY TRACK EXECUTIVES’ TIME?**

17 **A.** Each executive completes a profile designating the percentage of time he or she
18 expects to spend on various projects. These percentages are then used to allocate the
19 executive’s cost to those projects. Executives do not fill out time sheets. Profiles are

1 updated annually, as new projects are added, or when the percentage of time an executive
2 spends on certain projects significantly changes.

3 The Division has examined these executive profiles by reference to the executive's
4 expense accounts and travel itineraries. The Oregon staff performed a detail audit of
5 executives' time by examining appointment calendars etc.

6 **Q. SCOTTISHPOWER HAS COMMITTED TO A NET \$10 MILLION REDUCTION**
7 **IN CORPORATE COSTS THREE YEARS SUBSEQUENT TO THE COMPLETION**
8 **OF THE MERGER. WHAT IS THE BASIS FOR THIS REDUCTION?**

9 **A.** The net \$10 million reduction assumes a \$15 million savings being achieved in
10 PacifiCorp's corporate costs due to the elimination of duplicate functions arising as a result
11 of the merger and a \$5 million increase in Scottish Power's corporate costs recognizing there
12 will be some increase to the remaining function after duplication has been eliminated. This
13 was based on a high level analysis of various corporate functions. No detail analysis of
14 where the savings will actually be achieved has been made. Such an analysis will be done
15 as part of the transition plan.

16 **Q. WHAT IS THE BASE FROM WHICH SCOTTISHPOWER PROPOSES THE \$10**
17 **MILLION SAVINGS IS TO BE MEASURED?**

18 **A.** Per ScottishPower, the base from which the corporate duplication savings will be

1 deducted is the 1999 actual regulated corporate costs (Response to Division interrogatory
2 S14.15).

3 **Q. DOES THE DIVISION FIND THIS BASE TO BE ACCEPTABLE?**

4 **A.** No. Not all actual costs charged to regulated operations are allowed for ratemaking
5 purposes. Examples would include the executive Long Term Incentive Plan (LTIP); any
6 incentive compensation based on the achievement of financial goals; the totality of
7 extraordinary expenses, some of which would be deferred and amortized over a number of
8 years. Thus, using a base of 1999 actual charges from which to measure the net \$10 million
9 savings does not guarantee that such savings will be recognized by ratepayers. To the extent
10 reductions were achieved in costs not allowed for ratemaking, stockholders would benefit,
11 not ratepayers. The use of actual costs charged to regulated operations as a base for
12 measuring the achievement of the \$10 million guaranteed savings does not translate into a
13 corresponding benefit for ratepayers.

14 **Q. FROM WHAT BASE SHOULD THE \$10 MILLION SAVING BE MEASURED?**

15 **A.** The achievement of the \$10 million guaranteed savings should be measured from
16 PacifiCorp's 1999 actual corporate costs, normalized and adjusted so as to reflect only those
17 costs that would be included in rates. Any costs related to the ScottishPower merger should

1 also be excluded. Absent the merger these costs would not have been incurred. Therefore
2 they are not reflective of PacifiCorp's corporate operating costs prior to the merger. The
3 inclusion of merger related costs will increase the base from which the savings are measured
4 and since they are non-reoccurring will increase the savings reported. Reported merger
5 savings should only be attributable to increased efficiencies. Additionally, ScottishPower
6 witness Robert D. Green has testified that "the \$10 million in annual savings to which we
7 are committed will not be affected by currency exchange risk". (Rebuttal Testimony of
8 Robert D. Green, Before the Public Utility Commission of Oregon, June 2, 1999, pg. 4). The
9 Division likewise concurs, that currency exchange risk should not enter into the calculation
10 of the guaranteed \$10 million annual savings.

11 **Q. HASN'T PACIFICORP RECORDED ALL MERGER RELATED COSTS BELOW**
12 **THE LINE?**

13 **A.** No, PacifiCorp only committed to record "transaction" costs below the line. There
14 are several categories of personnel costs, which although related to and would not be
15 incurred absent the merger, are not considered to be "transaction" costs by PacifiCorp. These
16 include costs associated with: 1) the PacifiCorp Executive Severance Plan (the Executive
17 Plan); 2) payments to directors; 3) retention and bonus incentives and 4) the recognition pool.

18 The Executive Severance Plan provides for the payment of enhanced severance
19 benefits if, during the 24-month protection period following the completion of the merger,

1 a participant (A) is terminated by PacifiCorp “without cause” or (B) resigns within two
2 months after a “material alteration in position”. A “material alteration in position” means
3 the occurrence of any of the following: (1) a change in reporting relationship to a lower level;
4 (2) a material reduction in the scope of duties and responsibilities; (3) a material reduction
5 in authority; (4) a material reduction in compensation; or (5) relocation of the participant’s
6 work location to an office more than 100 miles from the participant’s office or more than 60
7 miles from the participant’s home. Mr. O’Brien is eligible for enhanced severance benefits
8 if he resigns for any reason no earlier than 12 month and no later than 14 months after the
9 merger.

10 Executives who qualify for enhanced payment of severance benefits under the
11 Executive Plan will receive:

- 12 (A) severance pay in an amount equal to two and one-half times (three times for
13 Mr. O’Brien) the Executive’s “annual cash compensation”;
- 14 (B) an additional payment to compensate the Executive for the effect of any
15 excise tax if change-in-control benefit payments would result in the
16 imposition of such excise tax under section 4999 of the Internal Revenue
17 Code;
- 18 (C) continuation of subsidized health insurance for the Executive, spouse and
19 qualified dependants from 6 to 24 months depending on length of service;
20 and

1 (D) a minimum of 12 months of executive officer outplacement services.

2 There are 27 executives covered by the Executive Plan. It is our understanding that the
3 potential maximum cost for severance pay alone is approximately \$17 million.

4 Included among the executives covered by the Executive Plan are Messrs. O'Brien,
5 Steinberg, Bohling and Topham. The estimated amount of change in control severance
6 benefit for each of these executives (calculated based on compensation as of March 1, 1999
7 and without regard to any additional payment to compensate for the effect of any excise tax)
8 are as follows: Mr. O'Brien - \$1,832,400; Mr. Steinberg - \$1,199,500; Mr. Bohling -
9 \$1,129,500 and Mr. Topham - \$1,129,500 (Scottish Power Circular to Shareholders, p.96).

10 Promptly following completion of the merger each non-executive director on
11 PacifiCorp's Board will receive a special payment of \$50,000 in recognition of his or her
12 years of service and contributions. The decision to make these payments was made after the
13 Merger Agreement was executed.

14 Additionally, a very small number of employees have retention agreements that
15 payout if they are employed on the date the merger is consummated. Even if the merger is
16 not consummated these employees will receive one-half of the payout. This program could
17 cost up to \$7 million.

18 In addition PacifiCorp has established an employee recognition pool in the amount
19 of \$8.5 million. Payments made to employees from the recognition pool may be merger
20 related. To date \$2.9 million has been awarded from the recognition pool. The \$2.9 million

1 was recorded on PacifiCorp's books in 1998.

2 **Q. ARE THERE ANY OTHER COSTS RELATED TO THE MERGER WHICH WILL**
3 **BE INCURRED BY PACIFICORP?**

4 **A.** Yes. The ScottishPower Circular to Shareholders identifies two additional costs to
5 be bourn by PacifiCorp: 1) the stamp duty reserve tax and 2) special cash payments to
6 PacifiCorp Preferred Shareholders.

7 PacifiCorp's obligation with respect to the stamp duty tax is described on page 10 of
8 the ScottishPower Circular to Shareholders:

9 "Stamp duty reserve tax of an amount equal to 1.5% of the issue price
10 of New Shares issued in the Merger in the form of New ADSs will be
11 payable. Based on the market price for the ScottishPower Shares on
12 27 April 1999 (being the latest practicable date prior to the
13 publication of this document), and on the assumption that all New
14 Shares issued in the Merger are issued in the form of New ADSs,
15 stamp duty reserve tax of approximately £54.64 million would be
16 payable. Any such tax will be paid by PacifiCorp."

17 Special cash payments are to be made to PacifiCorp Preferred Shareholders for voting
18 in favor of the Merger as well as in favor of increasing the amount of unsecured indebtedness
19 which PacifiCorp may issue. Per the ScottishPower Shareholders Circular:

20 "If the Merger is approved at the PacifiCorp annual meeting and all
21 regulatory approvals for the Merger required under the Merger
22 Agreement have been obtained. PacifiCorp will make a special cash
23 payment of \$1.00 per share (\$.025 per share for the \$1.16, \$1.18 and
24 \$1.28 series) to each PacifiCorp Preferred Shareholder on the
25 PacifiCorp Record Date that voted in favour of the Merger. These

1 special cash payments will be paid out of PacifiCorp's general funds,
2 promptly after receipt of the last regulatory approval for the Merger
3 but prior to the Merger . . .
4

5 Under the articles of incorporation of PacifiCorp, the amount of
6 unsecured debt that PacifiCorp may issue is limited to 30%, of the
7 total secured indebtedness of PacifiCorp, its capital and surplus.
8 PacifiCorp is seeking consent of the PacifiCorp Preferred
9 Shareholders to increase the amount of unsecured indebtedness which
10 PacifiCorp may issue from time to time. PacifiCorp believes that the
11 unsecured debt consent is key to meeting the objectives of flexibility
12 and favourable cost structure and therefore if the unsecured debt
13 consent is approved, PacifiCorp will make a special cash payment in
14 the amount of \$1.00 per share (\$.025 per share for \$1.16, \$1.18 and
15 \$1.28 series) to each PacifiCorp Preferred Shareholder on the
16 PacifiCorp Record Date that voted in favour of the unsecured debt
17 consent. If the unsecured debt consent is approved, special cash
18 payments will be paid out of PacifiCorp's general funds, promptly
19 after the PacifiCorp annual meeting. . .

20 The special cash payments referred to above, in aggregate, would not
21 exceed approximately \$5 million.

22 In addition, certain dealer solicitation fees will be payable by
23 PacifiCorp in relation to the resolutions referred to above which, in
24 aggregate, would not exceed \$4 million."

25 Additionally based on the proposed transaction's structure approximately \$268.2
26 million of PacifiCorp's credit facilities supporting tax exempt debt issuances will be in
27 default requiring PacifiCorp to refinance. ScottishPower believes that \$45 million could be
28 "easily amended" prior to closing, thereby reducing PacifiCorp's refinancing requirements.

1 **Q. IS IT THE DIVISION'S POSITION THAT THESE OTHER MERGER COSTS**
2 **SHOULD BE RECORDED BELOW THE LINE?**

3 **A.** Yes. But for the merger, PacifiCorp would not have incurred these costs. PacifiCorp
4 has indicated that the employee recognition pool may be an exception, but it was established
5 by PacifiCorp's Board in conjunction with the Board's decision to proceed with the
6 ScottishPower transaction and therefore at the onset appears to be merger related. The
7 Division plans to examine the employee recognition pool further in conjunction with its audit
8 of PacifiCorp's 1998 results of operations with particular emphasis on the \$2.9 million
9 employee recognition expenditure included in the 1998 results. The Division considers all
10 of the other costs to be merger related.

11 As testified to by Division witness Artie Powell, stockholders are receiving the
12 "premium". Therefore, stockholders should bear the associated merger costs. As a
13 conditional of this merger, all merger related costs should be recorded below the line.

14 **Q. DO YOU HAVE ANY CONCERNS REGARDING THE PROPOSED CORPORATE**
15 **STRUCTURE?**

16 **A.** Yes, the most recently proposed corporate structure would create a U.S. registered
17 holding company to facilitate further acquisitions by ScottishPower in the United States.
18 This potential diversification creates more risk.

19 Utility ratepayers have no choice but to take service from the monopoly utility. The

1 Division believes ratepayers should not be compelled to be partners in an enterprise over
2 which they have no control. Subsidiary activities and operations should be as far removed
3 as possible from the regulated utility enterprise and sufficient safeguards and controls put in
4 place to assure that ratepayers do not inadvertently bear any risks associated with
5 diversification. Therefore, any diversified holdings and investments (e.g., non-utility
6 business or foreign utilities) of ScottishPower and PacifiCorp should not be held by
7 PacifiCorp, the entity for utility operations.

8 Additionally, ScottishPower/PacifiCorp should be required to notify the Utah
9 Commission subsequent to ScottishPower plc's Board approval and as soon as practicable
10 following any public announcement of and acquisition of a regulated or non-regulated
11 business representing 5% or more of the market capitalization of ScottishPower plc.

12 **IV. AFFILIATE TRANSACTIONS**

13 **Q. HOW WILL THE PROPOSED CORPORATE STRUCTURE AFFECT THE**
14 **COMMISSION'S ABILITY TO REGULATE AFFILIATED TRANSACTIONS?**

15 **A.** Subsequent to the merger, contracts for goods and services among affiliated
16 companies as well as the allocation of common overhead costs will be governed under
17 PUHCA. The SEC, under PUHCA has a standard of pricing affiliated transactions "at cost".
18 There is some question as to whether the SEC, under PUHCA, would have the authority to

1 pre-empt state regulatory authority over the pricing of affiliated transactions in a registered
2 holding company system. In Ohio Power Co. v. FERC, 954 F.2d 779 (D.C. Cir.), cert.
3 denied, 113 S. Ct. 483 (1992) (Ohio Power), the court asserted precedence of the SEC's "at
4 cost" rules over the Federal Energy Regulatory Commission's (FERC) use of lower of cost
5 or market pricing for coal received by a utility subsidiary from its affiliated coal company.
6 The utility subsidiary was forced to pay for the coal "at cost", which was 30% over market
7 coal prices. Although this case has never been tested, it raises the issue as to whether the
8 SEC's "at cost" standard can prevent state regulators from exercising authority over the
9 pricing of affiliate transactions in a registered holding company system. Therefore, as a
10 condition of this merger, ScottishPower/PacifiCorp should not assert in any future Utah
11 proceeding that the provisions of the Public Utility Holding Company Act of 1935 or the
12 related Ohio Power v FERC case preempt the Utah Public Service Commission's
13 jurisdiction over affiliated interest transactions and will explicitly waive any such defense
14 in those proceedings.

15 **Q. WHAT OTHER ISSUES ARE RAISED BY AFFILIATE TRANSACTIONS?**

16 **A.** Affiliate transactions have the potential to result in cross-subsidization of affiliates
17 by the regulated utility. In the U.S., PUHCA prevents affiliates from charging prices above
18 "cost" to other entities within the registered holding company's group, however, there may
19 be instances where the "cost" of an affiliate good or service exceeds what the utility would

1 pay in the market for the same good or service. In these instances the utility's payment of
2 "cost" would result in a subsidy to the affiliate. To prevent the potential for cross-
3 subsidization all goods and services provided either directly or indirectly by affiliates within
4 the ScottishPower group should be priced at the lower of cost or market, where cost may
5 include a return on investment no greater than the most recently authorized utility rate of
6 return. The Utah Commission has made its policy in this area quite clear:

7 "Our policy, stated in our Order in the prior rate case, 89-057-15, and
8 elsewhere, is that affiliate billings should not include a rate of return
9 greater than we authorize for the utility. Otherwise, transactions with
10 affiliates would be a means of increasing return beyond that allowed,
11 and ratepayers, other things being equal, would pay more for utility
12 service than we have found just and reasonable. We have
13 consistently ordered revisions where necessary to reduce the rate of
14 return component of affiliate billings to that authorized for the
15 utility." (Order in Docket No. 93-057-01, pgs. 69-70).
16

17 It is unclear whether conditions similar to the PUHCA "cost" restriction or the lower
18 of cost or market criteria apply equally in the U.K. to services provided members of the
19 wider group of companies of which the utility is a part. OFFER's May 1999 Consultation
20 Paper states:

21 "Certain PESs have structured themselves in such a way that services
22 used by the distribution business are provided outside the distribution
23 business but within the wider group of companies of which
24 distribution is a part. Examples of this include the provision of
25 transport fleets and non-operational property. Typically, the charge
26 for the provision of the service includes an element of profit. Many
27 of the businesses making recharges have little or no trade outside the
28 group. An effect of this appears to be an increase in distribution

1 business costs and the transfer of profits from the regulated business
2 to elsewhere in the group. OFFER's consultants are removing the
3 margins from recharges from other companies in the group, except
4 where those companies presently carry out a significant element of
5 their trade externally to the group, presently assumed to be 50 per
6 cent or more."

7 Thus, it would appear as if in the U.K. services received from affiliates who provide at least
8 50% of their trade externally to the group are not necessarily priced at the lower of cost or
9 market, or even at "cost" for that matter.

10 This could be problematic, particularly if these affiliates provide services at the
11 corporate level, the costs of which are reallocated to ScottishPower subsidiaries. It may
12 even violate the requirements of PUHCA. Perhaps this is why there has been much debate
13 as to whether PUHCA requirements would extend to ScottishPower's U.K. subsidiaries.

14 **Q. DOES PACIFICORP HAVE A POLICY REGARDING THE PRICING OF GOODS**
15 **AND SERVICES PROVIDED BY THE UTILITY TO ITS SUBSIDIARIES AND**
16 **AFFILIATES?**

17 **A.** Yes, as a condition of the Utah Power / PacifiCorp merger, PacifiCorp was required
18 to file for Commission approval a Transfer Pricing Policy. The Transfer Pricing Policy as
19 approved by the Utah Commission is attached as DPU Exhibit 2.2. Under this policy goods
20 and services provided by the utility are to be priced at a rate which covers all associated
21 costs, including a return on investment no greater than the most recently authorized utility

1 rate of return. This condition should also apply to ScottishPower.

2 **Q. DOES PACIFICORP HAVE A POLICY REGARDING THE TRANSFER OF**
3 **ASSETS AMONG AFFILIATES?**

4 **A.** Yes. Utility assets transferred to affiliates are priced at the greater of fair market
5 value or net depreciated book value. Assets acquired by Electric Operations from affiliated
6 companies are transferred at the lesser of fair market value or the net depreciated book value.
7 This policy was established in PacifiCorp's Transfer Pricing Policy as a condition of the Utah
8 Power / PacifiCorp merger. This condition should also apply to ScottishPower.

9 **Q. DO YOU HAVE ANY INDICATION THAT SCOTTISHPOWER INTENDS TO**
10 **DIVEST ANY OF PACIFICORP'S UTILITY ACTIVITIES OR FUNCTIONS?**

11 **A.** ScottishPower has no current plans to divest any of PacifiCorp's utility activities or
12 functions. However, this does not mean that divestiture of utility activities or functions will
13 never occur. In its prepared response to the Department of Trade & Industry (DTI) on the
14 future of gas and electric operations, ScottishPower stated:

15 " . . . greater unbundling of transmission and distribution activities,
16 such as metering and connections, . . . is welcome. This will enable
17 the more efficient players to succeed and, in so doing, deliver lower
18 prices and improved services to consumers . . . the regulator should
19 encourage the development of separate competitive business serving
20 the regulated core monopolies at market rates." (Response to the DTI
21 Consultation Paper on the Future of Gas and Electric Regulation,

1 Nov. 16, 1998, pg. 3)

2 After its hostile take-over of Manweb, ScottishPower transferred Manweb's second-tier (e.g.
3 wholesale) sales to ScottishPower. Suppose a similar decision was made, transferring
4 PacifiCorp's wholesale sales function to its non-regulated subsidiary PacifiCorp Power
5 Marketing (PPM). Restrictions are necessary to assure that integral functions are not
6 reorganized into independent profit centers for the benefit of stockholders at the possible
7 detriment of ratepayers.

8 **Q. WHAT CONDITIONS SHOULD THE COMMISSION IMPOSE TO ASSURE THAT**
9 **RATEPAYERS ARE NOT HARMED BY DIVESTITURE OF INTEGRAL UTILITY**
10 **FUNCTIONS?**

11 **A.** The Applicants should be required to provide notification of and file for Commission
12 approval of the divestiture, spin-off, or sale of any integral utility assets or functions. My
13 legal counsel, Michael Ginsberg, has advised me that legal precedent for this requirement
14 was established by the Wexpro decision.

1 **Q. SHOULD ANY OTHER CONDITIONS BE PLACED ON AFFILIATED**
2 **TRANSACTIONS?**

3 **A.** Yes. The following conditions were implemented in the PacifiCorp / Utah Power
4 merger and should apply equally to the ScottishPower transaction.

5 A. The Merged Company shall notify the Commission, and provide sufficient
6 information and documentation to the Commission, prior to the implementation of
7 plans (1) to form an affiliate entity for the purpose of transacting business with the
8 electric divisions of PacifiCorp, (2) to commence new business transactions between
9 an existing affiliate and the electric utility divisions of PacifiCorp, (3) to dissolve an
10 affiliate which has transacted any substantial business with such divisions, (4) to
11 enter into new business ventures or expand existing ones, or (5) to merge combine,
12 transfer stock or assets of any part or all of the Merged Company.

13 B. ScottishPower shall file an annual affiliated interest report.

14 C. The Merged Company shall provide notification of all asset transfers to or from
15 PacifiCorp, its affiliates, or subsidiaries in accordance with current PSC rules (see in
16 particular PSC R746-401).

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V. ACCESS TO BOOKS AND RECORDS

B. WHAT CONCERNS DOES THE DIVISION HAVE REGARDING ACCESS TO RELEVANT DOCUMENTS AND RESPONSIBLE INDIVIDUALS?

A. ScottishPower witness Robert D. Green stated in his testimony, that “ScottishPower and PacifiCorp will provide the Commission access to all books of account, as well as all documents, data and records of their affiliated interest, which pertain to any transactions between PacifiCorp and its affiliated interests.” However, ScottishPower has not stated to what extent the Utah Commission and Division will have access to relevant materials in the possession of the holding company(s), their subsidiaries, or to officers and employees.

PacifiCorp’s corporate functions reside in the operating company. Thus, all corporate costs are readily available for our review and examination, as these costs are recorded as part of electric operations and allocated out to PacifiCorp’s subsidiaries. Additionally we are able to interview corporate officers and employees regarding corporate expenditures and allocations as needed. The proposed merger will necessitate the need to audit transactions between PacifiCorp and its parent company, ScottishPower; and possibly subsidiaries of ScottishPower. Not only will this involve the examination of an additional set(s) of books and records, but books and records which are located outside of the U.S. and are not recorded according to U.S. Generally Accepted Accounting Principles (GAAP).

Additionally, we have become cognizant of documents which we routinely examine in our reviews of PacifiCorp, that will not be readily made available in the U.K. For

1 example, the outside auditors workpapers in the U.K. are not made available. Thus, it will
2 be necessary to establish agreed upon procedures by which Division staff can have access to
3 documentation supporting the purpose and/or circumstances attributable to costs charged
4 to PacifiCorp.

5 **Q. WHAT CONDITIONS DO YOU RECOMMEND TO ADDRESS THE ISSUE OF**
6 **ACCESS TO BOOKS AND RECORDS?**

7 **A.** Consistent with the Utah Commission's order In the Matter of the Investigation of
8 the Creation of a Holding Company (Questar) by Mountain Fuel Supply Company (Docket
9 No. 84-057-10), the holding company(s) and subsidiaries' employees, officials, directors, or
10 agents shall be available to testify before the Utah Commission to provide information
11 relevant to matters within the jurisdiction of the Utah Commission.

12 The Utah Commission should establish procedures by which the Public Service
13 Commission and Division staffs, or their authorized agents can obtain needed access to
14 subsidiary books and records, other relevant documents, data and records. Failure to provide
15 adequate supporting documentation of costs may result in those costs being denied rate
16 recovery. Requests by the Utah Commission, the Division, or their authorized agents shall
17 be deemed presumptively valid, material and relevant, with the burden falling to
18 ScottishPower/PacifiCorp to prove otherwise. ScottishPower/PacifiCorp shall reserve the
19 right to challenge any such request before the Utah Commission and shall have the burden

1 of demonstrating that any such request is not valid, material or relevant. In addition,
2 ScottishPower shall pay for the expense incurred by Utah regulatory personnel in accessing
3 corporate records and personnel located outside of the state of Utah.

4 **VII. SUMMARY OF CONDITIONS**

5 **Q. WOULD YOU PLEASE PROVIDE A SUMMARY OF THE MERGER CONDITIONS**
6 **YOU ARE PROPOSING.**

7 **A.** The merger conditions I am proposing are:

- 8 1) Within 30 days of the completion of the merger ScottishPower/PacifiCorp shall file
9 a proposed cost allocation methodology with the Utah Public Service Commission
10 for its approval.
- 11 2) Cost allocation methodologies shall comply with the following principles:
- 12 a) For all costs allocated to PacifiCorp from the ScottishPower group,
13 ScottishPower must demonstrate a benefit to PacifiCorp.
- 14 b) Cost allocations should be based on generally accepted accounting standards,
15 that is, that in general, direct costs should be charged to specific PacifiCorp
16 subsidiaries wherever possible and shared or indirect costs should be
17 allocated based upon the primary cost-driving factors.
- 18 c) ScottishPower should have in place timekeeping and project management

- 1 systems adequate to support the allocation of executives' costs.
- 2 d) An audit trail be maintained such that all costs allocated can be specifically
3 identified along with their origination and adequately supported. Failure to
4 adequately support any allocated cost may result in denial of its recovery in
5 rates.
- 6 e) Costs which would have been denied recovery in rates had they been incurred
7 by PacifiCorp regulated electric operations will likewise be denied recovery
8 whether they are allocated directly or indirectly through subsidiaries in the
9 ScottishPower group.
- 10 f) Any corporate cost allocation methodology and subsequent changes thereto
11 must be approved by the Utah Commission.
- 12 3) ScottishPower will assume the risk for the Utah Commission approval and adoption
13 of corporate cost allocation methodologies which differ from those adopted by
14 OFFER or any other U.S. regulatory jurisdiction.
- 15 4) The achievement of the \$10 million guaranteed savings should be measured from
16 PacifiCorp's 1999 actual corporate costs, normalized and adjusted so as to reflect
17 only those costs that would be included in rates. Any costs related to the
18 ScottishPower merger should also be excluded.
- 19 5) Any diversified holdings and investments (e.g., non-utility business or foreign
20 utilities) of ScottishPower and PacifiCorp shall not be held by PacifiCorp, the entity

- 1 for utility operations.
- 2 6) ScottishPower/PacifiCorp should be required to notify the Utah Commission
3 subsequent to ScottishPower plc's Board approval and as soon as practicable
4 following any public announcement of and acquisition of a regulated or nonregulated
5 business representing 5% or more of the market capitalization of ScottishPower plc.
- 6 7) ScottishPower/PacifiCorp should not assert in any future Utah proceeding that the
7 provisions of the Public Utility Holding Company Act of 1935 or the related Ohio
8 Power v FERC case preempt the Utah Public Service Commission's jurisdiction over
9 affiliated interest transactions and will explicitly waive any such defense in those
10 proceedings.
- 11 8) ScottishPower should be required to comply with PacifiCorp's Transfer Pricing
12 Policy. (Exhibit No. DPU 2.2).
- 13 9) The Applicants should be required to provide notification of and file for Commission
14 approval of the divestiture, spin-off, or sale of any integral utility assets or functions.
- 15 10) The Merged Company shall notify the Commission, and provide sufficient
16 information and documentation to the Commission, prior to the implementation of
17 plans (1) to form an affiliate entity for the purpose of transacting business with the
18 electric divisions of PacifiCorp, (2) to commence new business transactions between
19 an existing affiliate and the electric utility divisions of PacifiCorp, (3) to dissolve an
20 affiliate which has transacted any substantial business with such divisions, (4) to

- 1 enter into new business ventures or expand existing ones, or (5) to merge combine,
2 transfer stock or assets of any part or all of the Merged Company.
- 3 11) ScottishPower shall file an affiliated interest report annually.
- 4 12) The Merged Company shall provide notification of all asset transfers to or from
5 PacifiCorp, its affiliates, or subsidiaries in accordance with current PSC rules (see in
6 particular PSC R746-401).
- 7 13) Establish agreed upon procedures by which Division staff can have access to
8 documentation supporting the purpose and/or circumstances attributable to costs
9 charged to PacifiCorp.
- 10 14) The holding company(s) and subsidiaries' employees, officials, directors, or agents
11 should be available to testify before the Utah Commission to provide information
12 relevant to matters within the jurisdiction of the Utah Commission.
- 13 15) The Utah Commission should establish procedures by which the Public Service
14 Commission and Division staffs, or their authorized agents can obtain needed access
15 to subsidiary books and records, other relevant documents, data and records. Failure
16 to provide adequate supporting documentation of costs may result in those costs
17 being denied rate recovery. Requests by the Utah Commission, the Division, or their
18 authorized agents shall be deemed presumptively valid, material and relevant, with
19 the burden falling to ScottishPower/PacifiCorp to prove otherwise.
20 ScottishPower/PacifiCorp shall reserve the right to challenge any such request before

1 the Utah Commission and shall have the burden of demonstrating that any such
2 request is not valid, material or relevant. In addition, ScottishPower shall pay for the
3 expense incurred by Utah regulatory personnel in accessing corporate records and
4 personnel located outside of the state of Utah.

5 16) All merger related costs incurred by PacifiCorp and ScottishPower shall be recorded
6 below the line.

7 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

8 Yes.