Case UE-170
PPL Exhibit 317
Witness: Bruce Williams

BEFORE THE PUBLIC UTILITY COMMISSION
OF THE STATE OF OREGON

PACIFICORP

Supplemental Testimony of Bruce Williams

October 2005

Q. Are you the same Bruce Williams who previously filed direct, rebuttal and sur-surrebuttal testimony in this proceeding?

A. Yes.

Q. What are the purposes of your supplemental testimony?

A. My testimony demonstrates that the Commission's disallowance of $26.63 million, on an Oregon-allocated and grossed-up basis, in Order No. 05-1050 (the "Order") will result in a significantly negative impact on the return on equity the Company would have any reasonable expectation of earning. These results demonstrate that the Commission's tax adjustment in this case leads to rates which fall below the "fair, just and reasonable" rate standard required by SB 408. Further, I will explain the risk of a downgrade in the Company's credit rating as a result of the Order. Lastly, I provide new evidence of the benefit of PacifiCorp's affiliation with ScottishPower, demonstrating conclusively that the required benefits and burdens test for the tax adjustment cannot be satisfied in this case.

Q. Have you considered the impact the Order will have on PacifiCorp's financial position?

A. Yes. The impact on PacifiCorp is significantly negative for several reasons. First, the Company will have no reasonable opportunity to earn the authorized 10% return on equity that was stipulated to and approved in the Order. Based on Oregon normalized results of operations for the test period of 12 months ending December 31, 2006, the Company's projected return on equity will be 8.4%; that is, 160 basis points lower than the approved 10%, based on the $16.07 million tax expense adjustment. That disparity is due to the fact that in arriving at the tax adjustment, the Commission essentially assumed that the Company will not have that tax expense, which as explained by Larry Martin in his Supplemental Testimony, is erroneous. The Company's actual results for calendar year 2006 will not have the benefit of the $16.07 million interest deduction assumed by the Commission. The Company has chronically under-earned over the past few years as it has faced increasing costs and investment needs. For instance, the semi-annual report for the year ended March 31, 2005 showed its unadjusted Oregon return on equity to be 7.07%, and its adjusted return on equity to be 6.895%. The Commission's Order ensures that this ultimately unsustainable pattern of underearning could continue under the rates in effect pursuant to the Order, as the authorized return on equity is now effectively 8.4%.

Q. Is a reduced return on equity the only impact of the tax expense disallowance?

A. No. In addition to the impact on return on equity, the disallowance also negatively impacts key financial ratios underlying PacifiCorp's credit rating. Without the disallowance, PacifiCorp's ratios were already sufficiently borderline between its current 'A-' credit rating by Standard & Poor's and a BBB rating that it has been necessary to rely upon the benefit from ScottishPower ownership in order to avoid a downgrade. As the table below illustrates, however, the negative change in those ratios heightens the risk of a downgrade as PacifiCorp moves further down the scale of BBB ratios. The table below compares the key financial ratios that result from the Order to the S&P benchmarks.

	S&P Guideline for A Rating Category*	Oregon Normalized Result**	Pass/Fail ‘A’ Guideline?	S&P Guideline For BBB Category*	Indicative Rating
FFO/ Interest	4.5x – 3.8x	3.6x	Fail	3.8x - 2.8x	high BBB
FFO/ Total Debt	30% - 22%	17%	Fail	22% - 15%	low BBB
Debt/ Capitalization	42% - 50%	56%	Fail	50% - 60%	mid BBB

*for Business Position 5 (i.e. PacifiCorp)
**includes S&P adjustments for imputed debt

What this comparison shows is that based on the metrics used by Standard & Poor’s in establishing credit rating for a company such as PacifiCorp, a mid-BBB to weak-BBB rating would likely be given.

In that context, it is important to note that being just barely within the S&P guidelines’ ranges is not a preferred position, since it does not leave the Company acceptable “headroom” in the event of unusual and significant occurrences, such as the power cost upswing of 2000-2001. It is best to be positioned such that anomalous events do not cause a change in credit rating due to the metrics moving outside the guidelines. Inadequate headroom exposes customers to increased risk of the adverse consequences of a credit rating downgrade.

The tax expense disallowance may have an additional adverse impact on the Company’s risk profile as a result of the underearning it causes. With less earnings, the Company will have less income tax expense, leading to further downward pressure on rates. Further rate reductions in turn may increase the Company's business risk.

Q. What would be the consequence of a credit rating downgrade?

A. There would be two primary impacts, both negative: higher cost of debt for the Company, and reduced access to borrowed capital, at a time when PacifiCorp will need to invest approximately one billion dollars per year for the next several years. The significant impact for the Company's customers would be higher rates due to the higher cost of capital, but there are additional impacts as well, such as reduced access to long-term markets for power purchases and sales, and more onerous collateral requirements related to such transactions. Those more onerous collateral requirements, which are potentially very substantial, can in turn put constraints on the Company's ability to make investments in facilities for customers. The costs of these impacts, especially in light of wholesale power market cost increases, could far exceed the amount of the tax adjustment.

Q. Have you received any indications that the Order will negatively impact the Company's credit rating?

A. Yes. Following issuance of the Order, Standard & Poor's published a note on October 7, 2005, regarding the Order's tax disallowance, stating that "the ruling is adverse for credit quality." Exhibit PPL/318 at 1. The note warned that in the future there could be an adverse ratings action due to the disallowance. Whether an adverse ratings action occurs will be dependent on a number of factors, including the provisions of the permanent rules to be adopted for implementation of SB 408.

Q. Have institutions other than Standard & Poor's expressed concern regarding the impact of the Order?

A. Yes. Consistent with the concern reflected in the S&P note, representatives of Barclay's Bank, JP Morgan and BNP Paribas, all of whom have substantial financial commitments to PacifiCorp, have expressed to me concerns not only about the magnitude of the dollar impact from the disallowance, but also its very nature, in that it flows to ratepayers the tax benefits of non-regulated affiliates. That is, such an adjustment will tend to negatively impact the risk profile of the Company in that the performance of nonregulated affiliates may now impact the Company's rate of return.

Q. If the Commission were to apply a benefits and burdens test in considering whether to make an adjustment for consolidated tax filing benefits, is there new evidence relevant to that issue?

A. Yes. On September 20, 2005, Standard & Poor's issued a credit note assigning preliminary ratings to PacifiCorp's first mortgage bonds and senior unsecured obligations under a recently filed registration statement. The note states that "the current 'A-' corporate credit rating on PacifiCorp is based on ScottishPower's consolidated credit profile, whose solid financial performance has compensated for its weaker U.S. utility." Exhibit PPL/319. Similarly, the October 7 note by S&P pointed out that "[c]ritical to understanding" its decision not to take rating action in the short term as a result of the Order "is the fact that PacifiCorp's current 'A-' corporate credit rating (CCR) is based on the consolidated credit quality of Scottish Power." This is additional reaffirmation of my prior testimony that PacifiCorp is benefited, not burdened, by its relationship with ScottishPower, and that with the absence of a negative credit impact from that relationship, there is no basis for the disallowance imposed by the Commission.

Q. Does this conclude your supplemental testimony?

A. Yes, it does.

BEFORE THE PUBLIC UTILITY COMMISSION
OF THE STATE OF OREGON

PACIFICORP

UE 170

GENERAL RATE CASE

SUPPLEMENTAL TESTIMONY AND EXHIBITS

October 2005

Case UE-170
PPL Exhibit 317
Witness: Bruce Williams

BEFORE THE PUBLIC UTILITY COMMISSION
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October 2005

PPL/318
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Credit FAQ: PacifiCorp's Rate Case Ruling

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Quick Links
Frequently Asked Questions

PacifiCorp (A-/Watch Neg/A-2) received a disappointing ruling from the Oregon Public Utilities Commission (OPUC) on Sept. 28, 2005, that cut in half the $52.5 million retail rate increase negotiated as part of a stipulated settlement with various parties, including staff. The decision authorized just $25.9 million, or a retail rate increase of about 3.2%, which became effective Oct. 4, 2005.

The $26 million disallowance reflects adjustments the OPUC made in the amount of income taxes that PacifiCorp may collect in its retail electric rates related to recently enacted legislation, Senate Bill (SB) 408. Oregon constitutes about 30% of PacifiCorp's retail market. While the ruling is adverse for credit quality, no near-term rating action is foreseen at this time as Scottish Power supports PacifiCorp's ratings. Longer-term, there could be an adverse ratings action, depending on factors that are discussed in detail below.

Frequently Asked Questions

What is SB 408?

SB 408 addresses concerns that Oregon utilities may be collecting income tax expenses in retail electric and natural gas rates that are not ultimately paid by either the utility or its affiliate (such as a parent) to taxing authorities. A utility's federal and state income taxes are considered an operating expense for ratemaking purposes. In Oregon, as in many other states, retail rates are set at levels designed to cover operating expenses, including income taxes, over an agreed upon test period. But differences frequently arise between amounts that an electric or gas utility collects that are attributable to its stand-alone tax obligations and amounts that the consolidated company actually pays in taxes. Such differences arise for a number of reasons. For example, a utility's positive stand-alone tax obligation could be properly combined with the generation of income as well as losses within the parent company's federal tax return. Tax payments reflect all the combined income and loss positions of the consolidated entity.

The essence of SB 408 is that it overturns the precedent of calculating utility taxes on a stand-alone basis and instead requires the OPUC to track taxes collected by utilities in rates and compare this amount against taxes ultimately paid by the utility or the consolidated corporation to state, federal and local governments. The legislation authorizes the establishment of a mechanism that automatically flows back to retail ratepayers any differences in income taxes collected versus income taxes actually paid by the filing company that are attributable to regulated operations.

The genesis of SB 408, which passed by a significant margin in the Oregon Legislature, has to do with issues surrounding Enron's ownership of Portland General Electric (PGE; BBB/Stable/--). Consumer advocates have charged that while the utility collected millions of dollars in retail rates for PGE's estimated tax obligations, offsetting losses in other Enron operations resulted in its paying no federal or state income taxes for several years. As a result, PacifiCorp has found itself drawn into a sensitive policy issue that has generated widespread concern throughout the state.

How does SB 408 affect PacifiCorp and Scottish Power?

SB 408 applies to investor-owned electric and natural gas utilities that are regulated by the OPUC and serve more than 50,000 customers. Other utilities that are potentially affected are PGE, Northwest Natural Gas (A+/Stable/A-1), Avista (BB+/Stable/B-1) and PacifiCorp.

While all four of these investor-owed utilities will be required to file tax information, those most vulnerable to actual income tax-based adjustments appear to be PGE and PacifiCorp. PacifiCorp's potential SB 408 tax adjustments stem principally from:

- The ability of its U.S. holding company to deduct interest expenses on its federal and state income tax filings, which it pays to Scottish Power in association with its acquisition indebtedness; and
- The U.S. holding company's ability to utilize tax deductions from PacifiCorp's non-regulated affiliates.

Scottish Power purchased PacifiCorp in 1999. Subsequent to the acquisition, Scottish Power created PacifiCorp Holdings Inc. (PHI), a non-operating, indirect, wholly owned subsidiary. PHI is the parent of PacifiCorp and of Scottish Power's three other U.S. subsidiaries, including PPM Energy.

The interest that PHI pays to Scottish Power that is associated with an inter-company loan is deductible on the consolidated tax returns that PHI files on behalf of PacifiCorp and the other three subsidiaries. At fiscal year end March 31, 2005, PHI reflected an inter-company loan balance of about $2.4 billion, and PHI paid to Scottish Power approximately $160 million in related interest. This constituted a direct offset to PHI's consolidated tax liability, and thus reduced the consolidated group's taxable income. SB 408 will likely mean that until Scottish Power sells PacifiCorp, the utility could face future retail rate deductions induced by the automatic adjustment mechanism, unless PHI debt is reduced.

How is the automatic tax adjustment mechanism

expected to work?

SB 408 applies to income taxes collected from ratepayers and paid to governments beginning Jan. 1, 2006. The legislation specifies that beginning in 2005, utilities must file an annual tax report on October 15. For the three preceding fiscal years, the report must provide: A) the amount of taxes paid by the utility, or the consolidated entity's income taxes paid that are "attributable" to regulated operations; and B) the amount of taxes authorized for collection in the utility's retail rates. The lesser of item A is then compared to item B, and if the difference is at least $100,000, an adjustment is triggered.

SB 408 appears to apply the adjustment symmetrically, allowing for the possibility of an increase in retail rates due to higher tax obligations of the stand-alone utility. But a concern from a credit perspective is that the OPUC may suspend the adjuster if it is found to have a materially adverse effect on ratepayers. This suggests that in its application, the mechanism would more commonly be used to reduce retail rates rather than to pass through rate increases to consumers. Many of the details of the mechanism are left to the OPUC.

When will the details of the mechanism be finalized?

The OPUC issued interim rules on Sept. 15 to enable the Oct. 15 filings. These rules have proved difficult to decipher and have sparked significant concern of the utilities, because there is a potential for unintended consequences. For example, the temporary rules seem to apply a tax adjustment even in cases where the consolidated tax payments far exceed the amount of taxes collected and paid by the utility. Troubling for the pending MidAmerican Energy Holdings Co. (MEHC) acquisition of PacifiCorp is interim rule language that would allow the OPUC to allocate the tax benefits of losses at unregulated affiliates owned by Berkshire Hathaway to Oregon ratepayers in the form of a rate reduction.

Permanent rules are expected to be in place by mid-January 2006. The content of these permanent rules will be critical for credit quality--open-ended rules that introduce a wide set of circumstances in which a rate reduction could be required will increase regulatory risk and potentially increase the variability of regulated cash flows. Also unknown is when the tax trigger should begin. It is PacifiCorp's position (and that of some intervenors) that filings made in 2005 and 2006 are to be used for information purposes only, and that only in late 2007 should the filings be used trigger an actual adjustment. But until permanent rules are in place, it is difficult to determine how the details will work.

How is it that SB 408 formed the basis of reductions in PacifiCorp's rate case?

Treatment of taxes was a contested issue in PacifiCorp's general rate case, and no stipulations were reached with parties on this issue. While the case was pending before the OPUC, SB 408 was passed on an emergency basis, which means the bill became effective when the state's governor signed it on Sept. 2, 2005. The Industrial Customers of Northwest Utilities (ICNU) argued that SB 408 should be considered in the context of PacifiCorp's general rate case decision. The OPUC agreed.

Because it was not expected that the OPUC would apply the principles of SB 408 until after permanent rules were adopted for taxes paid after Jan. 1, 2006, the ruling was a surprise. The OPUC appears to have predicated its authority to apply SB 408 to the general rate case on the fact that PacifiCorp's retail rates are based on a forward 2006 test year, and therefore some portion of the authorized rate increase is to cover expected 2006 expenses, including income taxes. The OPUC noted in its decision that it is not "bound to maintain our practice of stand-alone calculations, particularly when a new statute comes into play." In reducing the settlement by half, the OPUC did not formally apply an adjustment mechanism but followed a methodology presented by the Citizen's Utility Board, a ratepayer advocate. More balanced rules proposed by staff were rejected.

What are the immediate credit implications for PacifiCorp?

In the short run, Standard & Poor's is taking no rating action. Critical to understanding this decision is the fact that PacifiCorp's current 'A-' corporate credit rating (CCR) is based on the consolidated credit quality of Scottish Power. Thus, a rating action, if it were to occur, would reflect the impact of the OPUC rate case decision and the future risks of SB 408 on the consolidated operations.

PacifiCorp represents about 45% of Scottish Power's operating profit, with the Oregon market being the second-largest service area behind Utah. Scottish Power produced about £1.2 billion (or $2.2 billion) of funds from operations (FFO) in fiscal 2005 (ending March 31), so the pre-tax $26 million disallowance represents about 1% of consolidated cash flows. Thus, the immediate consequences of the rate case are nominal from the consolidated perspective. Key consolidated cash flow ratios for fiscal 2005 were appropriate for the rating, with funds from operation (FFO) interest coverage of about 4.0x and adjusted FFO to total debt of 20%.

What are the longer-term credit implications?

In the long run, the credit implications are more complex, and will be a function of a number of unknowns. For example, until permanent rules are in place, it is difficult to assess the full impact of SB 408 on future utility financial performance. In addition, PacifiCorp has vigorously disputed OPUC's application of SB 408 to the rate case proceeding, calling the OPUC decision premature, ill advised, and possibly illegal. If the company takes legal action regarding the rate case and prevails, it could recoup the rate reductions, though not for some time, and SB 408 will continue to apply to future revenues earned by the utility. Also, while the legislation applies only to Oregon, there is potential for this issue to become a policy concern in other states, especially in Utah, which is PacifiCorp's largest market, accounting for 40% of the company's retail electric revenues. On Oct. 6, 2005 the Committee of Consumer Services issued a letter calling on the Utah Public Service Commission to investigate consolidated tax issues.

Most importantly, Scottish Power is in the process of selling PacifiCorp. As a result, PacifiCorp's ratings are on CreditWatch with negative implications, reflecting PacifiCorp's weak credit metrics, which would not support its current CCR were it rated on a stand-alone basis. The OPUC decision will reduce after-tax cash flows by about $16 million. And absent any changes in PHI's debt and tax arrangements, stand-alone performance will be weaker than forecast. These impacts could be ephemeral, if it is completed. However, the extent to which SB 408 may impact PacifiCorp following the sale to MEHC is also uncertain and is dependent on the permanent decision. For example, given the broad nature of Berkshire's businesses, it is likely that loss-making companies will exist in any given year, which under the temporary rules could result in rate reductions to Oregon customers.

What effect could this have on the sale of PacifiCorp to MEHC?

While the parties have made no public statements in this regard, it is clear that the legislation could influence whether MEHC proceeds with the sale because the permanent rules have the potential to affect the future profitability of PacifiCorp. MEHC's offer was made before SB 408 was passed and, since then, it has closely followed the developments. After the temporary rules were announced, MEHC met with multiple parties, including the state governor. The company's public statements have expressed significant concern about the interim rules. Standard & Poor's is monitoring the situation and will comment further as conditions warrant.

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October 2005

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Research:

Return to Regular Format

Research Update: PacifiCorp's First Mortgage Bonds Assigned 'A-' Preliminary Rating

Publication date: 20-Sep-2005
Primary Credit Analyst(s): Anne Selting, San Francisco (1) 415-371-5009; anne_selting@standardandpoors.com

Credit Rating: A-/Watch Neg/A-2

Rationale

On Sept. 20, 2005, Standard & Poor's Ratings Services assigned its 'A-' preliminary rating to PacifiCorp's first mortgage bonds and its 'BBB+' rating to senior unsecured obligations under a mixed shelf registration filed by the company on Sept. 6, 2005. The filing permits the issuance of up to $700 million in senior secured and unsecured debt.

The 'A-' corporate credit rating on PacifiCorp reflects the consolidated credit quality of the utility's parent, ScottishPower PLC (A-/Stable/A-2). Ratings of PacifiCorp remain on CreditWatch with negative implications following the May 2005 announcement that the Oregon-based utility is to be sold to MidAmerican Energy Holdings Inc. (MEHC; BBB-/Watch Pos/--) for $9.4 billion, including $5.1 billion in cash, and the assumption of $4.3 billion in net debt and preferred stock. The purchase will be effectuated by the purchase of the outstanding shares of common stock of the utility, which is currently held by PacifiCorp Holdings Inc. (PHI; A-/CW Developing). PHI is the indirect holding company for ScottishPower's U.S. interests, which, in addition to PacifiCorp, include PPM Energy Inc., Pacific Klamath Energy, and PacifiCorp Group Holdings (PGHC).

PacifiCorp is a vertically integrated electric utility that serves about 1.6 million customers in portions of Utah, Oregon, Wyoming, Washington, Idaho, and California. Utah and Oregon accounted for about 70% of retail electric revenues in fiscal 2005 (ended March 31). The company is regulated by the state utility commissions in each of these states. PacifiCorp's satisfactory business profile score of '5' (on a 10-point scale, where '1' is the strongest) reflects a predominately coal-fired generation fleet that provided about 80% of energy requirements in fiscal 2005, low retail electric rates relative to other investor-owned utilities in the western U.S., and a regulatory profile that has been improving, although the utility lacks a fuel and purchased power adjustment mechanism in any of the jurisdictions it serves. However, persistently poor financial performance caused by a variety of factors, including the California power crisis, historic disallowances for purchased power, regulatory lag, issues with plant performance, and large capital expenditures prompted ScottishPower to sell PacifiCorp, which it acquired in 1999.

The CreditWatch with negative implications status reflects that the current 'A-' corporate credit rating on PacifiCorp is based on ScottishPower's consolidated credit profile, whose solid financial performance has compensated for its weaker U.S. utility, which constitutes about 45% of cash flows. On a stand-alone basis, PacifiCorp's debt leverage and cash coverage ratios are solidly in the 'BBB' category. For the first quarter ending June 30, 2005, funds from operations (FFO) to interest and FFO to total adjusted debt was 3.3x and 16.3%, respectively. Standalone debt to total capitalization was 58.9%, adjusted for PacifiCorp's purchased power obligations. Thus, how the acquisition is structured will materially affect PacifiCorp's ratings if the transaction closes. In regulatory filings, MEHC has stated its intent to create a limited liability company, PPW Holdings LLC, which will be a direct subsidiary of MEHC. MEHC has indicated that no new debt will be issued at PPW, and that existing utility debt of $3.9 billion and $86.3 million in preferred stock (both as of June 30) will reside at PacifiCorp.

PacifiCorp's cash flows have been volatile for an investor-owned utility, but have stabilized somewhat in recent years, with FFO reaching $805 million in fiscal 2005, in line with fiscal 2004. But due to steady increases in debt driven largely by rising capital expenditures, financial metrics deteriorated slightly in fiscal 2005 relative to fiscal 2004, but are significantly improved over performance from fiscals 2001 through 2003. In the first quarter of fiscal 2006, PacifiCorp issued $300 million in first mortgage bonds to pay down the utility's commercial paper balances. This increased leverage was partially offset by an equity contribution of $125 million from PHI made on June 30, 2005, as discussed further in the short-term ratings section below.

Capital expenditures are a substantial challenge for the utility, and largely account for the utility's negative free operating cash flow position of $141 million at year-end fiscal 2005, when capital expenditures totaled $852 million. The company estimates that for the next five years, more than $1 billion will be needed each year for new plant construction, emissions and environmental compliance, and investment in infrastructure, particularly in Utah, where retail customer growth is forecast to be about 3% per annum.

The transaction does face some regulatory risk; the Federal Energy Regulatory Commission and all six state commissions must approve the sale. However, the companies will not require Securities and Exchange Commission approval, which could have been a meaningful hurdle, because the Energy Policy Act of 2005 repealed the Public Utilities Holding Company Act (PUHCA) in August. ScottishPower shareholders approved the sale in July 2005.

PacifiCorp has asked the six commissions to rule by February 2006 to enable the transaction to close by the end of PacifiCorp's fiscal year ending March 31, 2006. The terms of the purchase provide that the sale must be completed by May 2006; however, if all conditions are satisfied except the regulatory approvals, either the buyer or seller may extend the purchase agreement until February 2007.

Short-term rating factors

The short term rating on ScottishPower, Scottish Power U.K. PLC, and PacifiCorp is 'A-2'. ScottishPower's consolidated liquidity is good, owing to a steady, predictable net cash flow stream produced by regulated businesses, minimal debt maturities over the next few years, and good credit facility capacity. Cash and other short-term deposits, which amounted to about £1.75 billion ($3.2 billion) at March 31, 2005, are held in a variety of quickly accessible funds. Full capacity exists under a $1 billion revolving credit facility, split between a $625 million facility and a $375 million facility, both due in 2008. ScottishPower U.K. maintains a $2 billion Euro-commercial paper program, which is undrawn.

PacifiCorp provides for its own liquidity needs. Its cash and cash equivalent position was $168 million as of June 30, down from the $199 million as of year-end fiscal 2005. In addition, it has an $800 million commercial paper program that is backstopped by a currently undrawn revolving credit agreement that terminates in May 2007. Short-term debt balances totaled $314 million as of the same date. Regulatory authorities limit PacifiCorp from issuing more than $1.5 billion in short-term debt.

Additional cash will be provided in the coming year in the form of planned equity contributions from PHI. The purchase agreement specifies that ScottishPower via PHI make a common equity contribution to PacifiCorp in quarterly amounts that total $500 million per year for fiscal 2006, rising to $526 million in fiscal 2007. (The latter year amount will be refunded to PHI in terms of an increased sale price to ScottishPower if the transaction closes.) Net of dividends from the utility, which are capped in the acquisition agreement, in fiscal 2006 PHI/ScottishPower cash equity contributions to PacifiCorp will be roughly $285.2 million. In contrast, in fiscal 2005, PacifiCorp's dividends paid to PHI totaled about $195 million, and no equity investments were made.

Future maturities of $289 million in fiscal 2006 are in line with historic obligations. Affiliate transaction rules restrict PacifiCorp from lending to any of PHI's subsidiaries or U.K. affiliates.

Ratings List

PacifiCorp	
Corp credit rating	A-/Watch Neg/A-2
Ratings assigned	
First mortgage bonds	A-/Watch Neg
Senior unsecured obligations	BBB+/Watch Neg

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search.

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Case UE-170
PPL Exhibit 1303
Witness: Larry O. Martin

BEFORE THE PUBLIC UTILITY COMMISSION
OF THE STATE OF OREGON

PACIFICORP

Supplemental Testimony of Larry O. Martin

Tax

October 2005

Q. Are you the same Larry Martin who previously filed rebuttal testimony and sursurrebuttal testimony in this proceeding?

A. Yes.

Q. What are the purposes of your testimony?

A. My previous testimony explained why a consolidated tax adjustment based upon PHI's interest deduction was unfounded and inappropriate in this case. While my position on this basic point has not changed, because the Commission has decided to invoke SB 408 in this case to make a tax adjustment, my supplemental testimony provides additional, necessary facts upon which any such adjustment must be based if the Commission were to decide to retain such an adjustment. I demonstrate that the Commission's disallowance of $26.63 million, on an Oregon-allocated and grossed-up basis, was inaccurately calculated, failed to take into account known and measurable changes, and relied on the faulty premise that the adjustment is consistent with Senate Bill 408. Specifically, I show that the adjustment, when calculated with an appropriate allocation factor and considering known and measurable changes in the calendar year 2006 (CY06) test year, should be approximately $1.4 million on an Oregon-allocated basis, which is approximately $2.3 million on a grossed-up basis. Further, the Commission failed to consider significant aspects of Senate Bill 408 in making its adjustment.

Q. Please explain your statement that the disallowance was based on an inaccurate calculation.

A. In Order 05-1050 (the"Rate Order"), the Commission calculated the adjustment by apportioning to PacifiCorp a percentage of the fiscal year 2005 (FY05) PacifiCorp

Holdings, Inc. ("PHI") interest deduction based on PacifiCorp's contribution of "gross profits" to the PHI affiliated group. As the Commission notes in the Rate Order, however, taxes are based upon net taxable income, not gross profits. Gross profits, which exclude expenses and deductions, are not a rational method of apportionment. As I stated in my sur-surrebuttal testimony, and as intimated by the Commission in its order, relative taxable income is a more rational apportionment factor.

Q. What was PacifiCorp's contribution to the PHI group's taxable income in FY05?

A. PHI is now in the process of finalizing its FY05 federal tax return, which must be filed by December 15, 2005. Based upon the near-final return, PacifiCorp contributed 49% of PHI's group taxable income in FY05.

Q. Was this relative taxable income percentage available earlier?

A. No. Because it was not, I had originally estimated a higher percentage, 61.5%, and offered testimony on this percentage at hearing. CUB objected to this testimony and, to facilitate settlement and avoid an extension of the suspension period, PacifiCorp agreed to withdraw my testimony on the estimate of the percentage. At the time of this agreement, however, PacifiCorp was not aware that the Commission would make a tax adjustment based on SB 408 or its "principles" using gross profits as an allocation factor, and imply that relative taxable income was the appropriate allocation factor. Nor was the Company aware that the Commission would on its own add more than $10 million to the tax adjustment CUB actually proposed in the case (*see* Transcript of UE 170 hearing at 167; Cross-examination of Bob Jenks;

Oregon allocated revenue requirement impact of CUB adjustment is $14.8 million; CUB not proposing to tax-adjust or gross-up this amount to a larger adjustment). Because of these developments, PacifiCorp has sought rehearing to ensure that the tax adjustment, if it is retained by the Commission notwithstanding PacifiCorp's arguments in its Application for Rehearing and Reconsideration, is at least calculated accurately. PHI has now nearly finalized its FY05 tax return and based upon the most recent information available, PacifiCorp's relative taxable income percentage, approximately 49%, was lower than originally estimated.

Q. Is PacifiCorp's contribution to the PHI group's taxable income expected to increase in CY06?

A. No. It is expected to decrease based upon projected revenue increases for nonregulated affiliates within the PHI consolidated group and potential corporate restructuring. Furthermore, assuming regulatory approval in each of PacifiCorp's jurisdictions of the pending joint application by MidAmerican Energy Holdings Company ("MEHC") and PacifiCorp for approval of MEHC's acquisition of PacifiCorp, PacifiCorp will no longer contribute any income to the PHI affiliated group.

Q. The Commission's Rate Order indicates that the PHI interest deduction is a "constant" that SB 408 requires the Commission to pass on to customers. Is this true?

A. No. Over the past several years, the interest deduction has decreased significantly. In 2006, it is expected to decrease even further.

Q. Which known and measurable changes in CY06 should the Commission's Rate Order reflect?

A. First, the Commission's Rate Order should account for a change in the PHI debt structure, which occurred on September 22, 2005, and which will decrease PHI's interest deduction in the test year. This change decreased the level of interest that PHI will pay in CY06 to $122 million, which is significantly less than the $160 million assumed by the Commission in the calculation of the disallowance.

Second, the Rate Order also failed to consider the offsetting effect of ScottishPower's tax payments in CY06. The Rate Order concluded that the PHI interest deduction will decrease the CY06 tax liability of PacifiCorp's corporate family by 37.95%. This is not true. In fact, the PHI interest deduction will decrease the CY06 tax liability of PacifiCorp's corporate family by only 7.95%. As a result of the passage of the UK Finance Act of 2005, ScottishPower now pays taxes at a rate of 30% on the PHI interest payments. Thus, ScottishPower will pay taxes at a rate of 30% in CY06 on any PHI interest payments it receives.

Q. Why should the Commission consider ScottishPower's tax payments?

A. ScottishPower's tax payments are actual tax payments on the PHI interest. Furthermore, ScottishPower is PHI's only shareholder and therefore PacifiCorp's ultimate shareholder. The notion that underlies the disallowance—*i.e.,* that PHI or the PHI group receives an economic windfall benefit from the PHI tax deduction—is unfounded. Not only does PHI suffer a burden that creates the deduction (it makes the interest payment), ScottishPower pays tax on the income it receives from PHI. Thus, the alleged economic benefit to the PHI group of the interest deduction cannot be more than the difference between the PHI tax savings and the ScottishPower tax burden.

Q. You state that the Commission's adjustment, when calculated with a correct allocation factor and considering known and measurable changes in the CY06 test year, would be $2.3 million on an Oregon-allocated and grossed-up basis. How exactly did you calculate this figure?

A. The figure is derived as follows: ((PHI interest deduction * combined U.S. effective tax rate) – (PHI interest payment * UK tax rate)) * Percentage of PHI group taxable income from PacifiCorp * Oregon allocation factor on an SNP basis * tax gross-up factor = adjustment to revenue requirement. In numeric form, the calculation is as follows: (($122m * 37.95%) – ($122m* 30%)) * 49.4862% * 28.8723% = 1.386m * 1.657 = $2.296 million.

Q. You also say that the Commission's reliance on Senate Bill 408 is faulty. Please explain.

A. The Commission's adjustment fails to consider facts relevant to a Senate Bill 408 analysis, which, if considered, would have decreased the adjustment considerably. For instance, calculations under SB 408 of actual taxes paid are to include tax payments to units of government without regard to the tax year for which those payments were made. The Rate Order fails to do this because it does not consider tax settlement payments that PacifiCorp's affiliated group made to units of government in FY05 (for years other than FY05), which totaled in excess of $70 million.

Senate Bill 408 also directs the Commission to compare taxes collected in rates with cash tax payments, increased by the amount of tax savings from

PacifiCorp's charitable contributions and by the amount of tax savings associated with PacifiCorp's investments in utility operations to the extent those expenditures were not included in rates, and adjusted by deferred taxes related to PacifiCorp's regulated operations. The Rate Order fails to do this because it does not consider any of these effects, including adjustment for the tax savings of over $435,000 and deferred taxes of over $44 million related to PacifiCorp's regulated operations in Oregon.

Q. Does this conclude your supplemental testimony?

A. Yes, it does.

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