DRAFT ALTERNATE FOR ENERGY DIVISION

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Item 73a ID#3588

ENERGY DIVISION **RESOLUTION E-3866**

August 19, 2004

R E S O L U T I O N

Resolution E-3866. The Commission certifies to the Securities and Exchange Commission (SEC) that the California Public Utilities Commission (Commission) has the resources and authority to safeguard the interests of California customers of PacifiCorp, an indirect utility subsidiary of ScottishPower plc (ScottishPower), a holding company registered with the SEC under the Public Utility Holding Company Act of 1935, as amended (PUHCA or the Act), 15 U.S.C. §§ 79a, et seq. pursuant to the conditions imposed.

SEC Letter Dated March 11, 2004

SUMMARY

The Commission certifies to the SEC that the Commission has the ability to protect PacifiCorp customers if the SEC grants the expanded financing authority requested by ScottishPower.

This Resolution informs the SEC that the Commission has the ability to protect PacifiCorp's California customers from the potential adverse consequences related to the SEC's increasing the authorization for ScottishPower's and its subsidiaries'[1](Applicants) investment in exempt wholesale generators (EWGs) and

[1] The UK subsidiaries are Scottish Power NA 1 Limited, Scottish Power NA 2 Limited, Scottish Power UK Holdings Limited (SPUK Holdings), Scottish Power UK plc (SPUK), headquartered in Glasgow, Scotland UK. The US subsidiaries are PacifiCorp Holdings, Inc. (PHI), PacifiCorp, a utility subsidiary, and PacifiCorp Group Holdings Company (PGHC) - a non-utility Holding Company, all headquartered in Portland Oregon. PHI's non-utility subsidiaries are: PPM Energy Inc.; Pacific Klamath Energy Inc.; PacifiCorp Financial Services, Inc.; Energy West Mining Company, Glenrock Coal Company; Investment Mining Company; Pacific Mineral, Inc.; PacifiCorp Environmental Remediation Company; PacifiCorp Investment Management, Inc.; PACE Group, Inc.; Enstor, Inc.; Arlington Wind LLC; and Heartland Wind LLC, all located in Portland, Oregon.

foreign utility companies (FUCOs) from the current $4.68 billion to $12.5 billion because:

- The Commission has broad power to regulate PacifiCorp based on the California Constitution, the Public Utilities Code and conditions imposed by Commission decisions pursuant to section 854 of the Public Utilities Code related to the merger of PacifiCorp and ScottishPower.
- Although ScottishPower is not a "public utility", based on section 701 of the Public Utilities Code the Commission has jurisdiction over ScottishPower to enforce the conditions imposed by Commission decisions pursuant to Public Utilities Code section 854 related to the merger of PacifiCorp and ScottishPower.
- PacifiCorp and ScottishPower have agreed to additional conditions upon their merger, and will file a petition to modify Commission Decision (D.) 99-06-049 to include the following:
    - PacifiCorp agrees that effective as of the date of this Resolution, it will not make any distribution to ScottishPower that will reduce PacifiCorp's common equity capital below 40 percent of PacifiCorp's total capital without Commission approval. The Commission Staff and PacifiCorp may reexamine this minimum common equity percentage as financial conditions or accounting standards change, and may request that it be adjusted.
    - ScottishPower and PacifiCorp agree that in future Commission proceedings they will not seek a higher cost of capital than PacifiCorp would have been authorized on its own. Specifically, no capital financing costs (either debt or equity) should increase by virtue of PacifiCorp's merger with ScottishPower.
- PacifiCorp recognizes the holding in *Pacific Gas and Elec. Co. v. People of the State of California* (9th Cir. 2003) 350 F.3d 932 as the current state of the law with respect to the Commission's jurisdiction pursuant to PU Code § 851 in the event of a bankruptcy of ScottishPower or PacifiCorp. As to this third condition, we note that the merger conditions approved in D.99-06-049 (Mimeo at 18-19) already contain the following condition: "If PacifiCorp sells or transfers its California distribution system, ScottishPower and PacifiCorp agree that PacifiCorp will first apply for an order of the Commission authorizing such sale in accordance with Public Utilities Code Section 851."

BACKGROUND

The Commission approved ScottishPower's merger with PacifiCorp in 1999.

PacifiCorp is a public utility organized in the state of Oregon and providing electric service in California and the states of Oregon, Idaho, Utah, Washington, and Wyoming. D. 99-06-049, as amended by D.99-10-059, approved with conditions the joint request of PacifiCorp and ScottishPower for an exemption from the requirements of PU Code § 854 for the merger of an indirect, wholly-owned subsidiary of ScottishPower with and into PacifiCorp and ScottishPower's subsequent exercise of control over PacifiCorp. At that time, PacifiCorp provided electric service to 41,273 retail customers in its California service territory, which represented only 3.3% of its retail customers system-wide and 2% of its retail electricity sales system-wide. (D.99-06-049, Findings of Fact No. 3, Mimeo at 16-17).

The SEC granted ScottishPower financing authority to invest in FUCOs and EWGs up to $4.68 billion on December 6, 2000.

After its acquisition of PacifiCorp on November 29, 1999, ScottishPower registered with the SEC under PUHCA as a holding company. By order dated December 6, 2000 (Financing Order), the SEC authorized ScottishPower and certain of its subsidiaries to engage in various financing transactions through March 31, 2004 (Current Authorization Period). The Financing Order for the Current Authorization Period was for various external financings and internal credit support arrangements. As relevant here, the FUCO and EWG authorization limit was $4.68 billion during the Current Authorization Period.

ScottishPower now requests substantially expanded financing authority from the SEC up to $12.5 billion.

In its pending application to the SEC (Application), ScottishPower now requests authorization to increase ScottishPower's existing financing authority for investments in EWGs and FUCOs to $12.5 billion, an increase of $7.82 billion, and to establish a new authorization period of April 1, 2004 through March 31, 2007 (Authorization Period).

The Application also requests authority for $8.0 billion of external financing and $2.0 billion of short-term financing limits in addition to $8.0 billion in guarantees and loans, and authority for PacifiCorp to issue $1.5 billion in commercial paper and promissory notes as part of the short-term debt limit. According to ScottishPower, it is committed to

maintain PacifiCorp's credit ratings[2] at investment grade. The Application may be viewed on the Office of Public Utility Regulation's website at: http://www.sec.gov/divisions/investment/opur/filing.htm.

The SEC solicits States' certification for the Applicants' additional authority.

On March 13, 2004, the President of the Commission received a letter dated March 11, 2004 from the Assistant Director of the SEC (SEC Letter) soliciting the views of the Commission regarding the Application for additional financing authority to invest in EWGs and FUCOs. The SEC sent a similar letter to state commissions in Idaho, Oregon, Washington, Utah, and Wyoming for their consideration.

Among other regulations, PUHCA limits the amount of investment by holding companies in EWGs and FUCOs. Because ScottishPower's request exceeds the safe harbor investment limits under PUHCA, SEC rules require that ScottishPower must affirmatively demonstrate that its use of financing proceeds to invest in EWGs and FUCOs will not have an "adverse impact" on any utility subsidiary or the ability of the state commissions to protect utility customers. Pursuant to Rule 53 under PUHCA, a holding company's "aggregate investment" in EWGs and FUCOs may not exceed 50% of the system's consolidated retained earnings. (17 C.F.R. § 250.53(a)(1)). Accordingly, as stated in the SEC Letter, "Rule 53(c) under the Act requires that Scottish Power affirmatively demonstrate that its use of financing proceeds to invest in EWGs and FUCOs will not have an "adverse impact on any utility subsidiary [of ScottishPower] or its customers, or on the ability of the State Commissions to protect such subsidiary or customers." (17 CFR § 250.53(c)).

We are not aware that any other state commission has responded to the SEC Letter.

The SEC has given interim approval pending completion of the record.

On April 1, 2004, in Release No. 35-27831, 2004 SEC LEXIS 766 (Apri1 1, 2004) (Interim Decision), the SEC gave ScottishPower interim approval to enter into external financings, credit support arrangements, and other proposals, but reserved jurisdiction over whether to allow ScottishPower to increase its aggregate investment by up to $12.5

[2] PacifiCorp's senior secured debt has a credit rating of "A3" and "A"; unsecured debt has a rating of "Baa1" and "BBB+"; preferred stock has a rating of "Baa3" and "BBB"; and commercial paper has a rating of P-2 and "A2" and "P2" by Moody's and Standard and Poor's (S&P), respectively.

billion in EWGs and FUCOs pending completion of the record. Id. at *39-40. The Interim Decision states that the SEC did not receive any requests for a hearing. Id. at *3.

According to the Interim Decision, the $12.5 billion request represents current EWG/FUCO investments of $2.47 billion, plus an additional 320% of consolidated retained earnings, totaling approximately 420% of ScottishPower system's consolidated retained earnings. 2004 SEC LEXIS 766, at *38 and n.18.

NOTICE

This Draft Alternate Resolution was mailed on May 20, 2004 to PacifiCorp and interested persons or organizations for public review and comment and will be placed on the Commission's Agenda on June 9, 2004.

PROTESTS

There are no protests to the certification request by the SEC to the Commission.

DISCUSSION

The Energy Division reviewed the Application filed with the SEC, the SEC Letter, PacifiCorp's letter dated April 30, 2004, and other related matters, including various files and decisions of the Commission. On May 6, 2004, Energy Division issued Draft Resolution E-3866, stating that the Commission declined to certify to the SEC that the Commission has the ability to protect PacifiCorp customers if the SEC grants the expanded EWG and FUCO financing authority to ScottishPower because:

- The $12.5 billion authority requested is more than four times ScottishPower's consolidated retained earnings as of September 30, 2003.
- Investments in EWGs and FUCOs generally cost several hundred millions of dollars and if two or three investments are woefully unprofitable, ScottishPower's retained earnings could be wiped out in a short time, particularly in light of the historical risk and instability of EWG and FUCO investments.
- There is a risk that should ScottishPower file for bankruptcy in the future the Commission would be unable to shield PacifiCorp customers from risk to PacifiCorp's assets.
- ScottishPower's additional debt may also result in a higher cost of debt to PacifiCorp.

After Draft Resolution E-3866 was mailed, on May 12, 2004, Energy Division staff met with representatives of PacifiCorp. PacifiCorp submitted comments dated May 14, 2004, a copy of which is attached hereto as Exhibit A. In its May 14, 2004 comments, PacifiCorp agreed to certain commitments which address the concerns Energy Division had raised in declining to issue the certification. On May 18, 2004, 2004, PacifiCorp submitted supplemental comments, a copy of which is attached hereto as Exhibit B, which modify one of the commitments proposed in the May 14, 2004 comments.

The Commission has broad powers to protect the interests of California ratepayers.

The California Constitution provides that the Commission may fix rates, establish rules, examine records, issue subpoenas, administer oaths, take testimony, punish for contempt, and prescribe a uniform system of accounts for all public utilities subject to its jurisdiction. Cal. Const. Art. 12, § 6. In addition to its Constitutional powers, the PU Code grants the Commission broad regulatory authority. Section 701 grants the Commission the authority to "supervise and regulate every public utility in the State and do … all things … which are necessary and convenient in the exercise of such power and jurisdiction." This authority includes the power to review and audit the books and records of PacifiCorp and its subsidiaries and affiliates with respect to their transactions with PacifiCorp.

Section 587 requires annual reporting to the Commission of significant transactions between PacifiCorp and its subsidiaries or affiliates, and § 314 provides Commission staff with access to all of PacifiCorp's books and records and those of its subsidiaries and affiliates with respect to any transactions between PacifiCorp and any affiliate or subsidiary on any matter that might adversely affect ratepayers. Further, the provisions of §§ 816-830 and § 851 grant the Commission the power to regulate and supervise PacifiCorp's issuance of securities, the encumbering of utility property within the state, and its assumption or guaranteeing of any liability with respect to securities of any other person. Section 701.5 specifically limits a public utility's authority to issue securities and pledge utility assets or credit on behalf of an affiliate. Finally, §§ 798, 827, 2100-2107, 2108-2110, 2113 and 2114 provide extensive enforcement authority and penalties for violations of California's public utility laws and Commission orders, including laws and orders regarding transactions with affiliates.

In addition to its Constitutional and statutory authority, when the Commission granted the application of ScottishPower and PacifiCorp for an exemption from the merger requirements in PU Code § 854, the approval was subject to certain enumerated conditions, including:

- ScottishPower and PacifiCorp agree that in their management and operation of PacifiCorp in the state of California they will comply with the Commission's rules and regulations regarding public utilities and their affiliates.

- To determine the reasonableness of allocation factors used by ScottishPower to assign costs to PacifiCorp and amounts subject to allocation or direct charges, the Commission may audit the accounts of ScottishPower and its affiliates, which are the bases for charges to PacifiCorp. ScottishPower and PacifiCorp agree to cooperate fully with such Commission audits.

- ScottishPower and PacifiCorp will provide the Commission access to all books of account, documents, and data of ScottishPower or its affiliates that pertain to transactions between PacifiCorp and ScottishPower or its affiliates.

- PacifiCorp will maintain its own accounting system, separate from ScottishPower's accounting system. PacifiCorp financial books and records will be kept in the United States.

- ScottishPower and PacifiCorp will make their officers and employees, and those of their affiliates, available to appear and testify, as necessary or required in Commission proceedings, in connection with future transactions between PacifiCorp and ScottishPower or its affiliates, and will bear the associated costs.

- If PacifiCorp sells or transfers its California distribution system, ScottishPower and PacifiCorp agree that PacifiCorp will first apply for an order of the Commission authorizing such sale in accordance with Public Utilities Code Section 851."[3]

(D.99-06-049, Mimeo at 18-19). In addition to the principal conditions imposed by the Commission, ScottishPower agreed with the Office of Ratepayer Advocates to certain

[3] PacifiCorp represented at the meeting of May 12, 2004 that it does not presently intend to sell its California distribution system.

performance standards and conditions in the following areas: (1) Customer Service, (2) Regulatory Oversight, (3) Commitment to the Environment, (4) Commitment to Communities, and (5) Commitment to Employees. These are included as Appendix A to D.99-06-049. In D.99-10-059, D.99-06-049 was modified to add two additional conditions to the merger.

After the merger, PacifiCorp filed an application for an exemption from the requirements of PU Code § 854(a), which applies to mergers and other forms of reorganization that result in a change of control of a public utility. This application requested the transfer of all of the common stock of PacifiCorp from NA General Partnership; a Nevada partnership indirectly controlled by ScottishPower, to a newly formed Delaware holding company, PacifiCorp Holdings, Inc. (PHI), which is also an indirect subsidiary of ScottishPower. D.01-12-013 granted this application, and noted that the conditions previously imposed by the Commission remained in effect. D.01-12-013, Mimeo at 14-16. PacifiCorp also was required to file a resolution agreeing to accept and abide by the conditions of D.99-06-049 and D.99-10-059 and to provide notice to the Commission prior to any transfer to PHI of any non-regulated business now held by PacifiCorp Group Holdings Company. Id. This resolution was filed on December 27, 2001.

Although ScottishPower is not a public utility, based on section 701 of the Public Utilities Code the Commission has jurisdiction over ScottishPower to enforce the conditions imposed related to the merger pursuant to section 854. (PG&E Corp. v. Public Utilities Commission (2004) 118 Cal. App. 4th 1174, 1197-1201 (Commission has limited jurisdiction over holding companies to enforce conditions imposed by the Commission concerning dealings between holding companies and regulated public utilities.)

PacifiCorp continues to serve approximately 41,000 customers in Northern California. There are no OIIs or adjudicatory proceedings pending against PacifiCorp.

Additional commitments by ScottishPower and PacifiCorp in their May 14, 2004 comments enhance the Commission's ability to protect ratepayers in the event of the bankruptcy of a ScottishPower holding company.

In Draft Resolution E-3866, Energy Division expressed reservation that the powers enumerated above may not protect PacifiCorp's utility assets and California customers from adverse consequences of unprofitable investments in EWGs and FUCOs. The increased financing authority could lead to a highly leveraged holding company since the amount of external financing of $8.0 billion could be in long-term debt, which is currently at 47% ($8.3 billion) of total capitalization of $18.0 billion. Moreover, it is public knowledge that many energy merchant companies are disposing of their foreign and US investments in EWGs, an indication of the instability and risk associated with

EWG and FUCO investments. One potential adverse consequence is a bankruptcy filing in the UK or the United States. Although PacifiCorp asserts that the SEC's ring fencing requirements for holding companies will insulate PacifiCorp from the adverse consequences of a bankruptcy, we have no examples of ring fencing provisions have been applied in practice and enforced by the SEC.

In the event of bankruptcy – whether caused by the failure of EWG and FUCO or otherwise – the Commission's ability to protect PacifiCorp's utility assets and customers will depend on the particular fact situation presented, and the applicable law, neither of which can be anticipated at this time. However, PacifiCorp agrees that *Pacific Gas and Elec. Co. v. People of the State of California*, 350 F.3d 932 (9th Cir. 2003) is the current state of the law with respect to the Commission's jurisdiction pursuant to PU Code § 851 in the event of a bankruptcy of ScottishPower or PacifiCorp. Moreover, the merger conditions approved in D.99-06-049 (Mimeo at pp. 18-19) already contain the following condition: "If PacifiCorp sells or transfers its California distribution system, ScottishPower and PacifiCorp agree that PacifiCorp will first apply for an order of the Commission authorizing such sale in accordance with Public Utilities Code Section 851."

Additional commitments by ScottishPower and PacifiCorp in their May 14 and 18, 2004 comments enhance the Commission's ability to protect ratepayers from increased utility financing costs as a result of high leveraging of the holding company.

Draft Resolution E-3866 also expressed concern that the increased debt obligations or a downgrade of ScottishPower's credit ratings may have adverse consequences on PacifiCorp's cost of borrowing money. To address this concern, ScottishPower and PacifiCorp agree that: (1) PacifiCorp agrees that effective as of the date of this Resolution, it will not make any distribution to ScottishPower that will reduce PacifiCorp's common equity capital below 40 percent of PacifiCorp's total capital without Commission approval; and (2) in future Commission proceedings ScottishPower and PacifiCorp will not seek a higher cost of capital than that which PacifiCorp would have been authorized on its own and specifically that no capital financing costs (either debt or equity) should increase by virtue of PacifiCorp's merger with ScottishPower.

The Commission may revise or withdraw this certification prospectively as to future acquisitions.

Although ScottishPower has requested up to $12.5 billion of financing authority, at present it has used only $2.67 billion of its current $4.68 billion authority. PUHCA

allows the Commission, upon the filing of a notice, to revise or withdraw the requested certification prospectively as to any future acquisition. (15 U.S.C. § 79z-5b(a)(2)). Accordingly, if the Commission becomes concerned regarding ScottishPower's aggregate or incremental use of its EWG or FUCO financing authority, the Commission may prospectively withdraw its certification for any future acquisition.

COMMENTS

Draft Resolution E-3866 was mailed on May 6, 2004 to PacifiCorp and interested persons or organizations for public review and comment and placed on the Commission's Agenda on June 9, 2004 in compliance with PU Code § 311(g)(1), which provides that a resolution be served on all interested persons and organizations (parties) and subject to at least 30 days public review and comment prior to a vote of the Commission. The 30-day period was not waived or reduced. Pursuant to Commission Rule of Practice and Procedure 77.6(d), an alternate resolution may be served less than 30 days, but at least 14 days, before the Commission meeting at which the proposed decision is scheduled to be considered. Accordingly, comments for this alternate resolution are due on June 2, 2004. No comments were received.

FINDINGS

1. On March 5, 2004, the SEC noticed the Application of ScottishPower, a foreign registered holding company with the SEC under PUHCA, 15 U.S.C. § 79a, et seq., and its direct and indirect subsidiaries for additional financing and acquisition authority.

2. ScottishPower's Application to the SEC includes a request for additional authority to increase investment in EWGs and FUCOs from $4.68 billion to $12.5 billion.

3. On March 13, 2004, the Commission received a letter from the SEC regarding ScottishPower's Application. The letter requests a certification from the Commission that it has the ability and resources to protect the California ratepayers of PacifiCorp, an indirect utility subsidiary of ScottishPower,

4. On April 1, 2004, the SEC provided its interim approval of ScottishPower's Application but reserved jurisdiction over whether to allow ScottishPower to increase its aggregate investment up to $12.5 billion in EWGs and FUCOs pending completion of the review.

5. We are not aware that any other state commission has responded to the SEC Letter.

6. The responses of other state commissions may prompt further action of the Commission to protect the interests of PacifiCorp's California ratepayers.

7. In comments and supplemental comments dated May 14 and May 18, 2004 respectively, PacifiCorp represented and agreed that: (1) effective as of the date of this Resolution, it will not make any distribution to ScottishPower that will reduce PacifiCorp's common equity capital below 40 percent of PacifiCorp's total capital without Commission approval. (The Commission Staff and PacifiCorp may reexamine this minimum common equity percentage as financial conditions or accounting standards change, and may request that it be adjusted); (2) in future Commission proceedings, ScottishPower and PacifiCorp will not seek a higher cost of capital than that which PacifiCorp would have been authorized on its own and specifically that no capital financing costs (either debt or equity) should increase by virtue of PacifiCorp's merger with ScottishPower; and (3) the holding in *Pacific Gas and Elec. Co. v. People of the State of California*, 350 F.3d 932 (9th Cir. 2003) is the current state of the law with respect to the Commission's jurisdiction pursuant to PU Code § 851 in the event of a bankruptcy of ScottishPower or PacifiCorp.

8. The merger conditions approved in D.99-06-049 (Mimeo at 18-19) already contain the following condition: "If PacifiCorp sells or transfers its California distribution system, ScottishPower and PacifiCorp agree that PacifiCorp will first apply for an order of the Commission authorizing such sale in accordance with Public Utilities Code Section 851."

9. The Commission has broad power under California law to protect the interests of PacifiCorp California ratepayers as indicated herein. Although ScottishPower is not a public utility, the Commission has jurisdiction over ScottishPower to impose and enforce conditions related to its merger with PacifiCorp, a regulated utility.

10. The Commission has the ability and resources to protect the interests of PacifiCorp California ratepayers.

THEREFORE IT IS ORDERED THAT:

1. The Commission certifies to the SEC that it has the ability and resources to protect the interests of PacifiCorp's California ratepayers under the broad

authority granted by the California Constitution, the California Public Utilities Code, including sections 701 and 854 and the conditions imposed on ScottishPower and PacifiCorp related to their merger pursuant to Commission decisions.

2. PacifiCorp shall provide to the Commission the final order of the SEC on the ScottishPower Application not later than 15 days after it is issued. In addition, PacifiCorp shall provide to the Commission the response of each state commission to the SEC's certification request not later than 20 days after it is issued by each state.

3. PacifiCorp shall immediately advise the Commission in writing of any financing by ScottishPower for the purposes of acquisition or funding of the operations of any EWG or FUCO.

4. Within 30 days of the effective date of this Resolution, PacifiCorp will file a petition to modify D.99-06-049, Ordering Paragraph 2, to include the following additional conditions to the Commission's approval of the merger of ScottishPower and PacifiCorp: 1) effective as of the date of this Resolution, PacifiCorp will not make any distribution to ScottishPower that will reduce PacifiCorp's common equity capital below 40 percent of PacifiCorp's total capital without Commission approval (The Commission Staff and PacifiCorp may reexamine this minimum common equity percentage as financial conditions or accounting standards change, and may request that it be adjusted); (2) in future Commission proceedings, ScottishPower and PacifiCorp will not seek a higher cost of capital than that which PacifiCorp would have been authorized on its own and specifically that no capital financing costs (either debt or equity) should increase by virtue of PacifiCorp's merger with ScottishPower; and (3) the holding in *Pacific Gas and Elec. Co. v. People of the State of California*, 350 F.3d 932 (9th Cir. 2003) is the current state of the law with respect to the Commission's jurisdiction pursuant to PU Code § 851 in the event of a bankruptcy of ScottishPower or PacifiCorp.

5. The Commission reserves the right to order its own independent audit or review of any financing and service arrangements between PacifiCorp and its direct or indirect subsidiaries and affiliates at the expense of PacifiCorp.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on August 19, 2004, the following Commissioners voting favorably thereon:

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WILLIAM R. AHERN
Executive Director