The Role of the Corporate Finance Expert in Debt-Equity Litigation: Lessons From *ScottishPower* (Part 2)

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The ScottishPower case illustrates the role that financial experts may play in documenting debt-equity related issues and litigation.

Numerous articles have examined the issue of when and under what circumstances related party debt may be considered valid debt for tax purposes. This two-part article proposes, based on the authors' experience consulting on debt-equity controversy matters, that given enhanced political and societal focus on tax motivated structures, a good faith attempt to create a relationship between borrowing and lending entities similar to that between unrelated third-party debtors and creditors may not be sufficient to avoid challenge by the IRS or state tax authorities. Part one of this article examined the role that financial experts play in documenting debt-equity related issues, and in litigation. Part two of this article will illustrate the Part one discussion by using the work the authors performed and trial testimony that was provided in *NA General Partnership (ScottishPower)*.[1]

Overview of *ScottishPower*

ScottishPower's acquisition of PacifiCorp was announced on 12/7/98. On 11/29/99, ScottishPower and PacifiCorp completed the merger with PacifiCorp's

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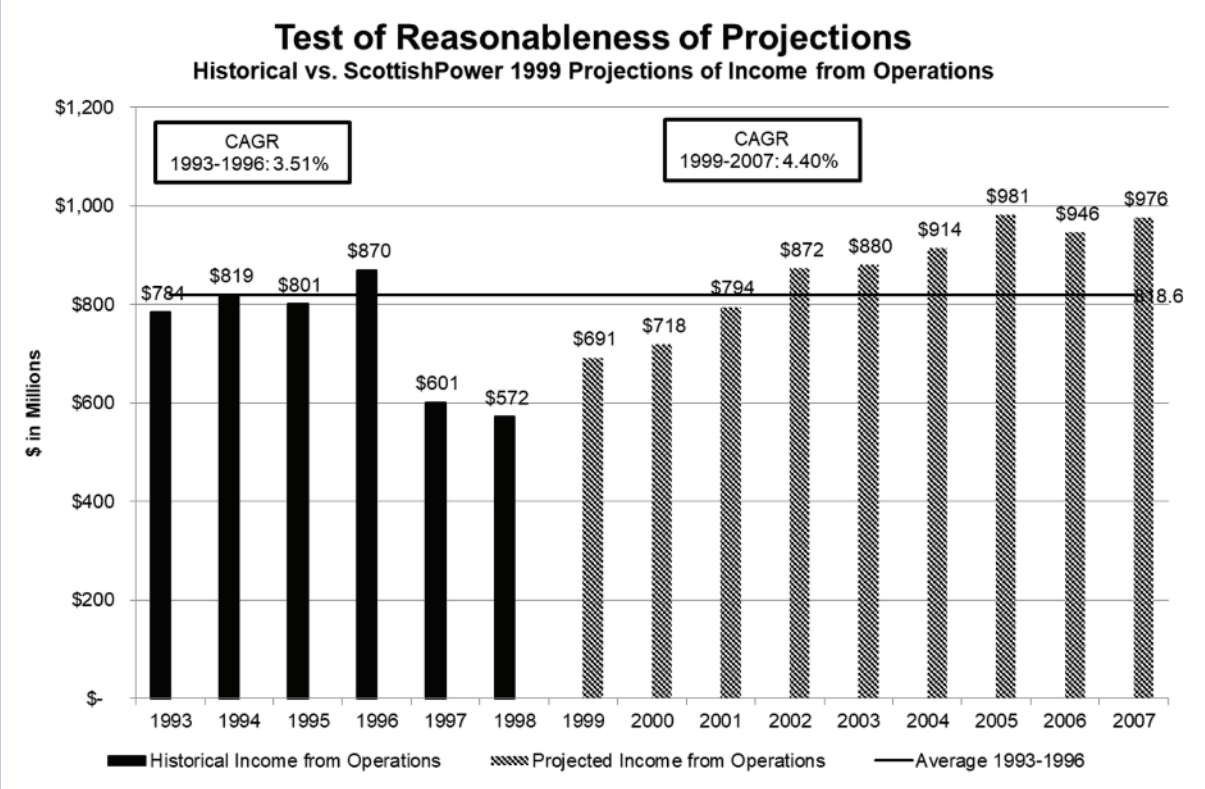
EXHIBIT 1

ScottishPower's Acquisition Model



shareholders receiving 2.32 ScottishPower common shares for each PacifiCorp share held. The deal, at the 11/29/99 closing price of ScottishPower common shares, valued PacifiCorp's common equity at approximately $6.5 billion. As a result of the acquisition, PacifiCorp became a direct subsidiary of NA General Partnership (NAGP), a partnership organized under the laws of Delaware, and an indirect subsidiary of ScottishPower. Pursuant to the transaction, NAGP became the obligor on an intercompany loan secured by NAGP's common equity ownership in PacifiCorp. The intercompany debt totaled $4 billion of fixed rate notes and an $897 million floating rate note.

The IRS disputed whether the intercompany loans were debt or an equity capital contribution for federal tax purposes, and thus whether the petitioner was entitled to interest deductions. As noted in Part one, counsel for the petitioner hired multiple experts to analyze various case issues, including a utility expert, a corporate finance expert, an investment banking expert, and a credit rating expert. The analyses performed by these experts, most of which are explained in detail below, provide an illustration of how the general economic methods discussed in Part one were applied to one specific set of facts and circumstances. It is not an exhaustive list of the analyses that should be performed for all transactions or in all tax controversy and litigation proceedings.

Testing the Reasonableness of ScottishPower's Financial Projections for PacifiCorp

The financial projections that formed the basis of an analysis of NAGP's intercompany debt were highly detailed, created by an experienced transaction team, and used as the basis for a $6.5 billion investment. However, a concern existed prior to trial that they would be challenged as overly optimistic (given the company's subsequent underperformance) or incomplete.

Therefore, the petitioner's financial expert performed several analyses to test the reasonableness of the projections, beginning by comparing the historical performance of PacifiCorp to the performance projected by ScottishPower's deal team, with particular focus on Earnings Before Interest and Taxes (EBIT) and Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Note, the specific metrics analyzed by a financial expert may vary from case to case depending on the industry and the information available.

As shown in Exhibits 1 and 2, PacifiCorp's financial results had declined

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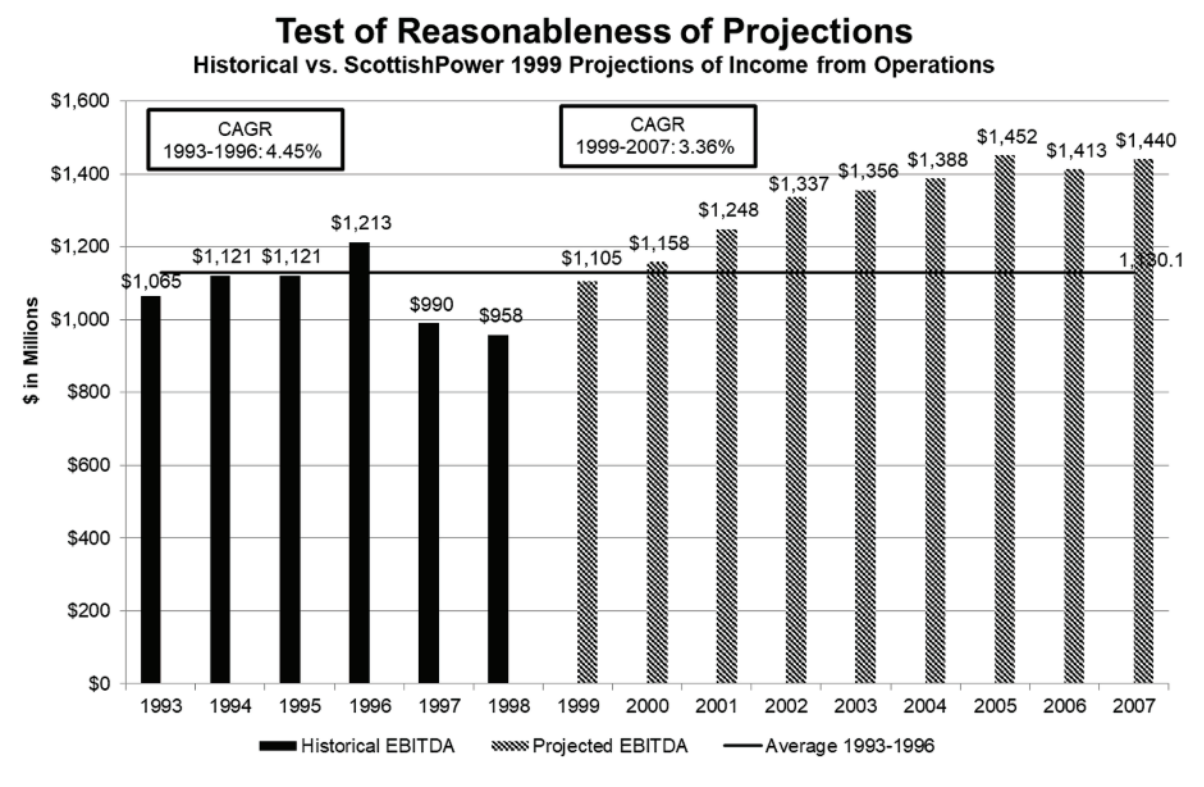
[1] TCM 2012-172.

EXHIBIT 2

ScottishPower's Acquisition Model



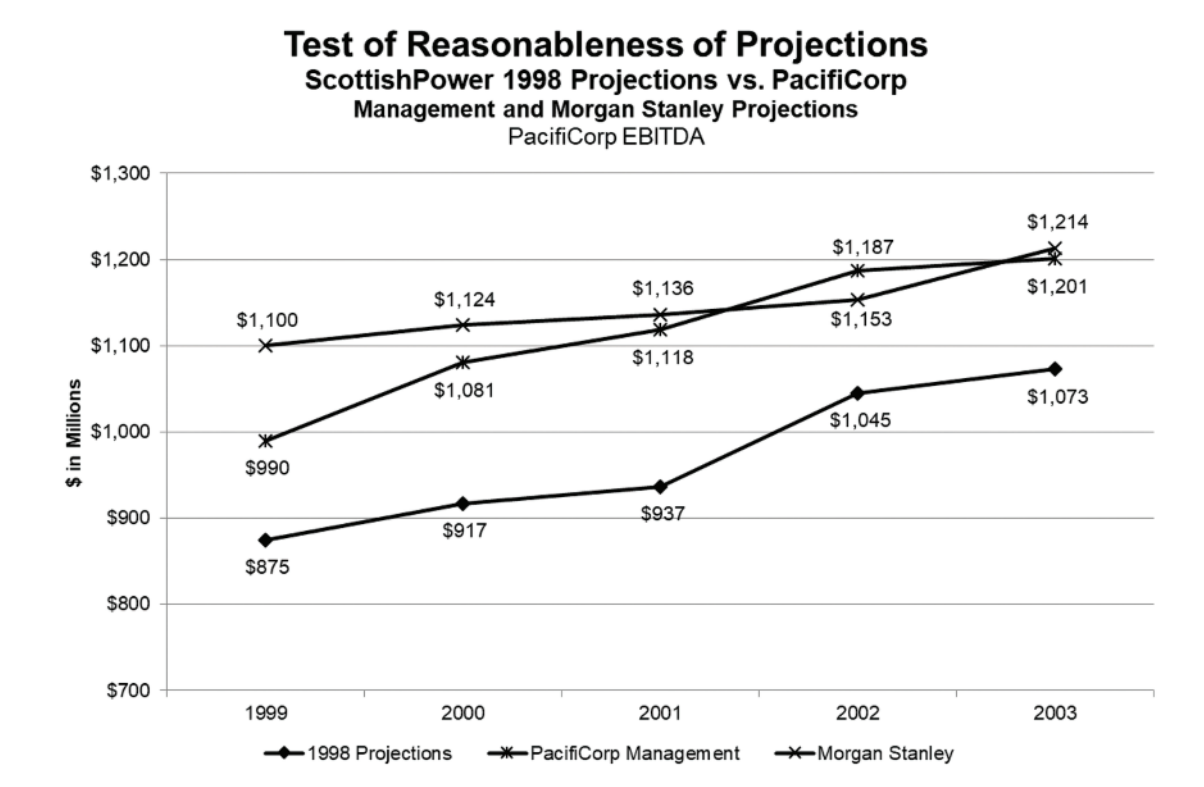
dramatically in 1997 and 1998 due to a number of one-time charges and correctable operational issues. The petitioner's financial expert drew the court's attention to the fact that the growth of income from operations and EBITDA projected in ScottishPower's acquisition model were consistent with longer-term historical trends (i.e., prior to 1997). As shown in Exhibits 1 and 2 (which were presented in court), from 1993 to 1996, PacifiCorp's income from operations grew at a compounded annual growth rate (CAGR) of 3.5% while EBITDA grew at 4.5% over the same period. During the projection period, the income from operations and EBITDA were projected to grow at CAGRs of 4.4% and 3.4%, respectively. Thus, the petitioner's financial expert argued that the projections were generally in line with PacifiCorp's long-term averages.

Next, the petitioner's financial expert compared the ScottishPower projections to several other different sets of projections generated by various parties around the time of the transaction. The purpose of this analysis was to determine whether the projections used by the buyer materially differed from other contemporaneous projections. The petitioner's financial expert determined that the ScottishPower projections reflected expected improved performance similar to other contemporaneous projections, indicating that the market also thought a turnaround in PacifiCorp's operating performance was feasible. For example, as shown in Exhibit 3, which was presented in court, ScottishPower's management forecasted PacifiCorp's income from operations to increase from $874.9 million in 1999 to $1,073 million in 2003. PacifiCorp's management forecasted income from operations to increase from $989.8 million in 1999 to $1,200.7 million in 2003, while Morgan Stanley forecasted income from operations to improve from $1,100 million in 1999 to $1,213.6 million in 2003. ScottishPower's forecast of PacifiCorp's income from operations was generally lower than the other projections, indicating it was reasonable.

Similarly, ScottishPower's management forecasted that PacifiCorp's EBITDA would increase from $1,360.1 million in 1999 to $1,584.3 million in 2003. PacifiCorp's management forecasted EBITDA to improve from $1,429 million in 1999 to $1,666.2 million in 2003, while Morgan Stanley forecasted PacifiCorp's EBITDA to increase from $1,577 million in 1999 to $1,760.6 million in 2003. As was the case for income from operations, the petitioner's financial expert used the chart shown in Exhibit 4 to illustrate to the court that the ScottishPower projections for PacifiCorp were more conservative than other contemporaneous projections prepared by knowledgeable market participants.

EXHIBIT 3

ScottishPower's Management Forecast



While helpful to the petitioner's case, note that there were certain limitations in these projections. Specifically, that they were prepared some time before the transaction closed, and that the PacifiCorp management projections were prepared by the same team that had overseen the company's drop-off in performance and were ultimately used to market the company to interested buyers.

The petitioner's financial expert also reviewed other industry analyst reports to determine whether the ScottishPower projections were consistent with the expectations of third-party analysts. Similar to the comparisons discussed previously, the petitioner's financial expert determined that the ScottishPower projections were consistent with industry analyst forecasts.

When analyzing debt vs. equity issues, one would ideally like to compare several financial metrics important to lenders, as forecasted by the company (or the buyer), to the same metrics presented in industry analyst reports. However, that is not always possible. Industry analysts covering PacifiCorp primarily focused on earnings per share forecasts, and therefore the petitioner's financial expert was able to use only net income as a point of reference. While not directly relevant to lenders, net income can serve as an indicator of the overall health of a business in the absence of other metrics. As displayed in Exhibit 5, in the period 1999 - 2001 the net income as forecasted by ScottishPower were more conservative than industry analysts', and were in line with industry analyst forecasts for 2002.[2]

Testing the reasonableness of a set of projections involves more than quantitative processes such as the examples shown in Exhibits 1-5. Qualitative information is also important, such as, reviewing the state of the industry in which the company operates; the company's strategy and business outlook; management's experience; the depth and quality of due diligence and planning engaged in when creating financial forecasts and business plans; and (if possible) analyzing the historical ability of the management team to achieve its forecasts.

In the case of ScottishPower, the petitioner's financial expert researched the views of major market participants regarding PacifiCorp's business operations and outlook. At the time of the transaction, Moody's stated the following:

> PacifiCorp's domestic operations are among the most competitive in the country and benefits significantly from low-sulfur coal mines, which

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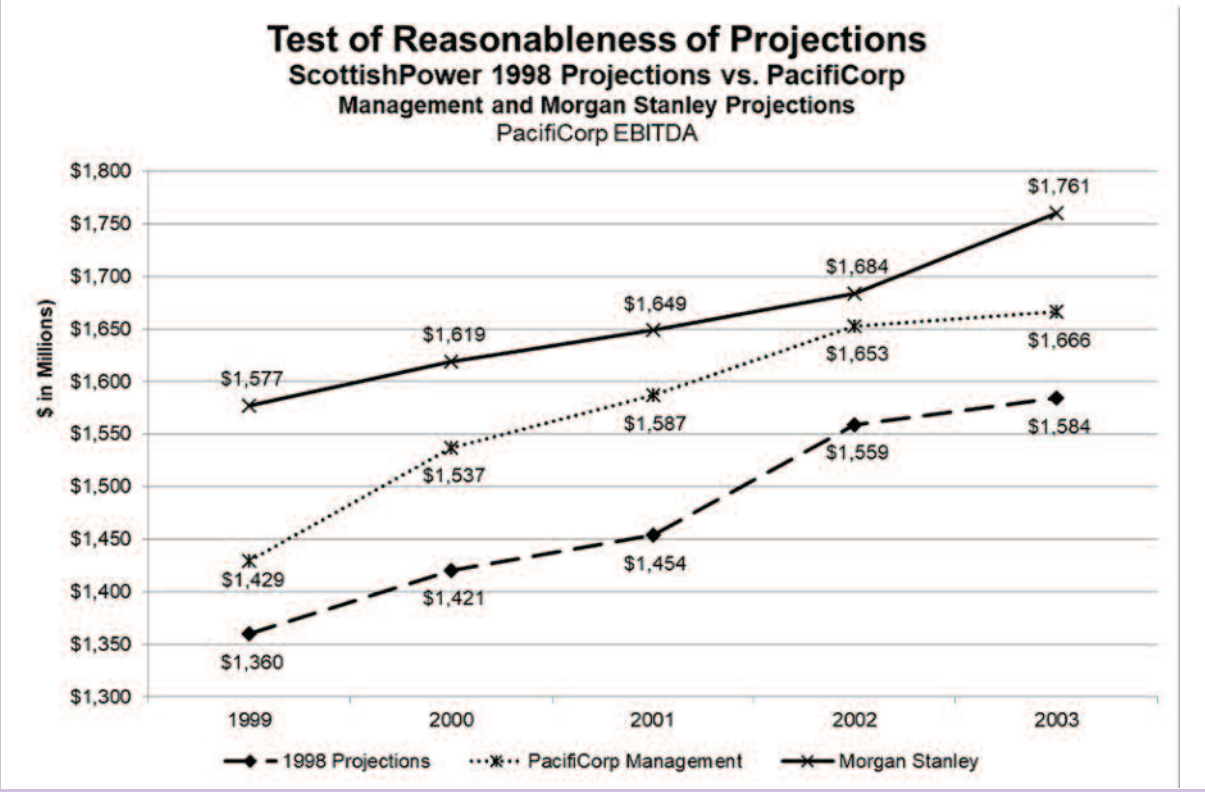
[2] Morgan Stanley's industry analyst was the only analyst that projected figures for 2001 and 2002. However, both the 1998 Projections and the 1999 Projections were either lower than or in-line with Morgan Stanley's industry analyst estimate for those years.

EXHIBIT 4

ScottishPower's projections for PacifiCorp



> are located next to its generation facilities.[3]
>
> The combination of a low-cost generation portfolio and an extensive transmission network allows PacifiCorp considerable access to several markets throughout the West.[4]

Furthermore, stock analysts had a positive view of ScottishPowers' acquisition of PacifiCorp:

> We are positive on the PacifiCorp deal. PacifiCorp was purchased cheaply and its extreme inefficiency means that there is potential for dramatic cost-savings. Any doubts should be calmed by ScottishPower's cost-savings and acquisition record.[5]
>
> We think PPW [PacifiCorp] has the ability to reduce costs significantly going forward."[6]

Quotes, like the above, were compiled and presented in the petitioner's financial expert's report to demonstrate the positive consensus regarding PacifiCorp's core business and that the prospects for ScottishPower's acquisition were promising.

The petitioner's financial expert was also able to demonstrate that ScottishPower's management had a proven track record of successfully managing acquisitions to meet their deal projections. As a first step, the petitioner's financial expert turned to the market once again to see how industry analysts covering ScottishPower viewed the company's acquisition history. At the time of the transaction, industry analysts stated the following:

> ScottishPower, a financially strong partner, has a good track record in improving all aspects of the core utility business [two recent ScottishPower acquisitions] and plans to incorporate these skill sets into the PacifiCorp organization and regulatory process.[7]
>
> Given ScottishPower's track record at taking costs out of Manweb and Southern Water, and the high cost base year of 1998, there seems the scope for ScottishPower to improve the returns from PacifiCorp, before any rate increases are considered.[8]

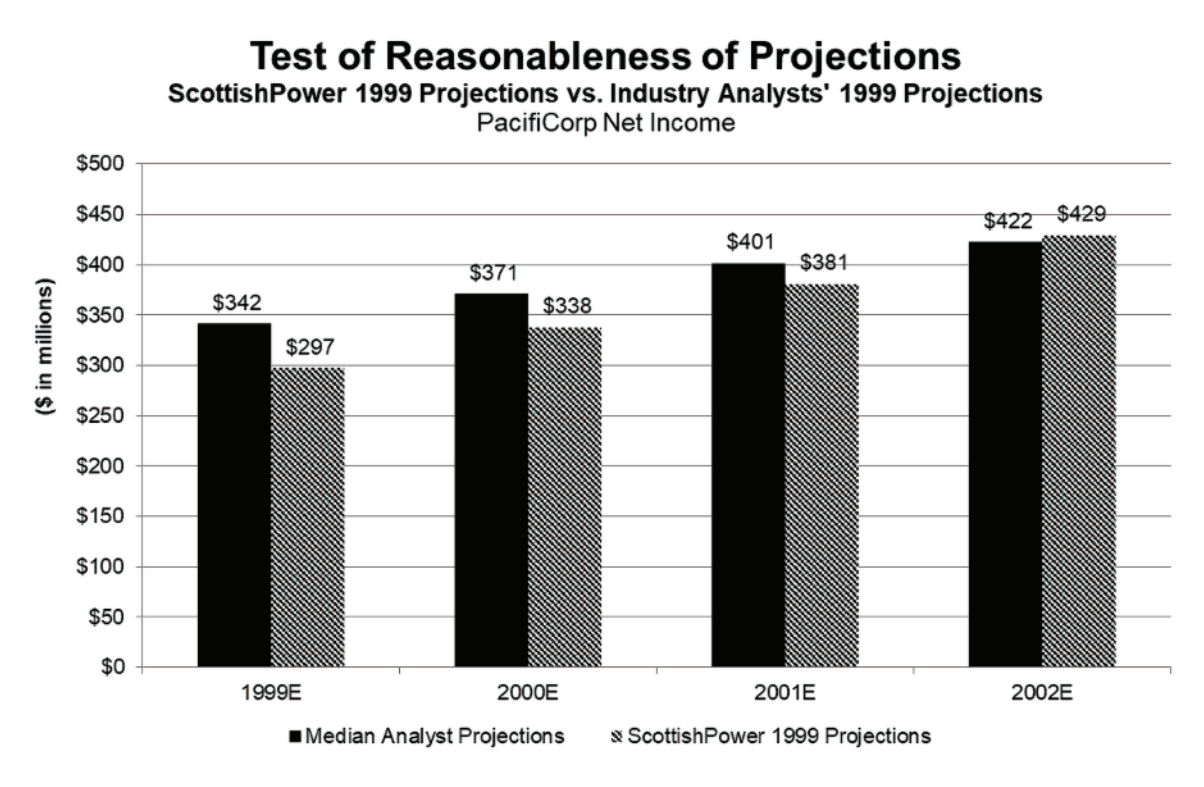
Furthermore, the petitioner's financial expert was able to point to the specific success stories in the ScottishPower's prior acquisitions of Manweb and Southern Water. Exhibit 6 (presented in court) summarizes ScottishPower's actual vs. budgeted performance as well as the actual vs. plan of Manweb and Southern Water. It demonstrates ScottishPower's ability to achieve its financial plans.

Moreover, the petitioner's financial expert emphasized that ScottishPower conducted significant merger due diligence to support its assumptions regarding PacifiCorp's business. As shown in Exhibit 7, ScottishPower was advised by nine different advisors throughout the acquisition process.

In summary, the ScottishPower projections were a detailed financial model

EXHIBIT 5

ScottishPower's forecast of net income



that included projections of PacifiCorp's financial performance for the ten years following the acquisition and had been prepared by ScottishPower's corporate development team. The significant number of analysts that reviewed and used the ScottishPower projections gave credibility to them. Additional due diligence underpinning the projections had been prepared by investment bankers, accountants, and other advisors. ScottishPower used the projections to justify a multi-billion-dollar investment decision.

With hindsight, however, it was clear that PacifiCorp underachieved these projections for several reasons that were not known or knowable at the time of the transaction. Anticipating that the projections might be challenged due to this underperformance, the petitioner's financial expert conducted numerous reasonableness tests. Each of these tests could, on their own, have been rebutted due to their shortcomings, as noted above. However, combined, they presented overwhelming evidence indicating that the ScottishPower projections represented the best judgment of informed participants at the time, and thus could be relied on to determine whether the intercompany loan should be considered debt or equity from an economic perspective.

When testing a different set of projections associated with a deals or tax controversy matter, the facts and circumstances and availability of information will dictate which analyses should be performed. Those analyses will, inevitably, vary from those which were performed for ScottishPower. However, ScottishPower provides good examples of analyses that may be undertaken, and of how thorough, in-depth quantitative and qualitative analyses can help establish the economic bona fides of a challenged transaction.

ScottishPower: The Ability to Pay its Debts

Having established the reasonableness of the ScottishPower projections, the petitioner's financial expert utilized them to analyze NAGP's ability to pay its debts as they became due. Cash flows generated by PacifiCorp beyond that required to fund operations were assumed to first go to service PacifiCorp's existing debt

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3 Moody's Investors Service, September 1999.

4 *Id*.

5 SG Equity Research Analyst Report, "Groundbreaking US deal & telecoms growth brings value – regulatory fears in the price," 5/28/99.

6 CIBC Oppenheimer Analyst Report, "Energy Group Bid Increases; Higher Bid Limited EPS Prospects," 3/4/98.

7 Moody's Investor Service Analyst Report, "Moody's Confirms Security Ratings of PacifiCorp and its Subsidiaries," 12/8/98.

8 Deutsche Bank Analyst Report, "ScottishPower-US: Awaiting Cost Control and Rate Reviews," 2/3/00.

EXHIBIT 6

ScottishPower's prior acquisitions

	Year ended 31 March								
	1996			1997			1998		
	Budget £m	Actual £m	Var £m	Budget £m	Actual £m	Var £m	Budget £m	Actual £m	Var £m
Sales	2,266	2,271	0.2%	3,041	2,940	(3%)	3,239	3,126	(4%)
Operating Profit	473	478	1%	674	682	1%	785	785	-
Operating Profit %	21%	21%		22%	23%		24%	25%	
Operating Profit Analysis:									
Generation Wholesale	139	145	4%	146	158	8%	158	153	(3%)
Power Systems & Energy Supp	263	261	(1%)	277	280	1%	283	276	(3%)
Manweb	80	81	1%	133	139	4%	132	139	5%
Southern Water	-	-	-	136	136	-	233	244	5%
ScottishTelecom	(3)	(3)	-	-	-	-	8	7	(14%)
Other	(6)	(6)	-	(18)	(31)	(42%)	(29)	(34)	(15%)
Total	473	478	1%	674	682	1%	785	785	-

EXHIBIT 7

ScottishPower's advisors

Advisor Name	Due Diligence Topics
PricewaterhouseCoopers	Finance, Tax, Pensions, Employees, Regulation, Power Marketing, Mining, and Borrowing Power Limits
Deloitte & Touche	Working Capital Adequacy
Ernst & Young	NAGP Tax Structure
Morgan Stanley	Financial analysis and Fairness Opinion
Dames & Moore and Milbank, Tweed, Hadley & McCloy	Environmental issues
Freshfields	Merger structure and UK regulatory issues
Baker & McKenzie	Due diligence of Australian Operations
HSBC	Market perception of the Merger
Warburg Dillon Reed	Market perception of the Merger

and preferred stock obligations. Residual amounts were available for common stock dividends to be paid by PacifiCorp to NAGP. NAGP could then use these dividends to make interest and principal payments on the intercompany debt.

To calculate NAGP's cash flows available to make interest and principal repayments on its intercompany debt, the petitioner's financial expert first calculated PacifiCorp's projected debt free cash flow (DFCF), as explained in Part one, for the years of the projection period. DFCF was reduced by the after-tax interest expense on PacifiCorp's existing debt, mandatory payments to preferred equity holders, and required principal repayments on PacifiCorp's third-party debt. This resulted in the cash flow available for interest and principal repayments on NAGP's intercompany debt.[9]

Based on this analysis, the petitioner's financial expert concluded that NAGP was projected to be able to pay the interest and principal on the intercompany debt as it became due.

In addition to performing an analysis of NAGP's ability to pay its debt under the "base case" scenario, the petitioner's financial expert performed a sensitivity analysis to determine the margin of safety a third-party lender to NAGP would have had against adverse changes in PacifiCorp's business. Specifically, he performed a "break-even interest rate" analysis. This break-even interest rate is the highest rate at which a company could make interest payments on its debt out of the free cash flow it generates. Comparing a break-even interest rate with the actual interest informs a lender as to a company's margin for error in achieving its projections. It also indicates a company's ability to refinance its debts, potentially at a higher rate of interest. NAGP's break-even interest rate was shown to be in the mid-teens, significantly higher than the actual intercompany interest rate of 7.3%, thus demonstrating a margin of safety.

The types of sensitivity analyses deployed will vary from case to case, de-

EXHIBIT 8

NAGP's equity value

Step 1: Valuation of PacifiCorp's Operations

PacifiCorp Enterprise Value
less: PacifiCorp Debt
less: PacifiCorp Preferred
add: PacifiCorp Cash
= **PacifiCorp Equity Value**

Step 2: Valuation of NAGP

NAGP Enterprise Value
less: Intercompany Debt
= **NAGP Equity Value**

EXHIBIT 9

PacifiCorp's Cost of Equity

	As of November 29, 1999
Risk-Free Rate	6.7%
Beta	0.52%
Risk Premium	8.0%
Size Premium	0.2%
Cost of Equity	11.0%

pending on the circumstances. While not necessarily required to show that intercompany debts can be repaid, they add comfort by illustrating the magnitude by which actual future performance could vary from projected performance and still allow for debt service. Given that some variances from expectations are a virtual certainty, sensitivity analyses may help illustrate that reasonably foreseeable performance variances could be absorbed.

ScottishPower: Equity Cushion

The petitioner's financial expert performed two separate analyses to assess NAGP's equity cushion: a market-based approach, which used the value of PacifiCorp's assets as established by the transaction as its starting point, and a discounted cash flow valuation. As mentioned above, NAGP's sole material asset was its 100% common equity interest in PacifiCorp. Therefore, the petitioner's financial expert assessed NAGP's equity value following the process outlined in Exhibit 8.

Market-Based Valuation Analysis

For the market-based valuation analysis of PacifiCorp, the petitioner's financial expert examined the value of NAGP and PacifiCorp as implied by ScottishPower's acquisition of PacifiCorp, specifically value given by ScottishPower to PacifiCorp shareholders of which the indebtedness assumed by NAGP was only one part. This provides a good approximation of NAGP's beginning enterprise value, as NAGP held all of PacifiCorp's common equity interests following the transaction's close. Subtracting the intercompany debt, which totaled approximately $4.9 billion, gives a fair market value (FMV) of NAGP's equity of approximately $1.6 billion as of the closing date.

This analysis shows that even accounting for the additional intercompany debt issued, NAGP had significant equity value as of the valuation date. Naturally, performing this type of market-based valuation will depend on a recent valuation event, such as a transaction. However, when these data exist they can be helpful in demonstrating a borrower's equity cushion without the need to resort to a formal valuation analysis.

Discounted Cash Flow Valuation Analysis

The petitioner's financial expert in the ScottishPower case also performed a discounted cash flow valuation (DCF) analysis to obtain another indication of NAGP's equity cushion. This was done primarily to address the possibility that the IRS's experts might argue that the price paid for PacifiCorp was based on overly optimistic assumptions, and was therefore inflated and an unreliable indicator of equity cushion. As discussed in Part one, the DCF is a valuation method that discounts an estimated a stream of future cash flows back to the valuation date. A terminal value, which accounts for periods extending beyond the time horizon that is actually projected, is also typically included. Note that the DCF and other cash-flow based analyses are generally preferred methods used by lenders to assess the company's ability to repay its debts[10] and its equity cushion.[11]

The petitioner's financial expert first determined PacifiCorp's projected debt-free cash flows, which were then discounted back to the valuation date using a weighted average cost of capital (WACC). As described in Part one, WACC is calculated by multiplying the cost of equity by the percentage of capitalization that is equity and adding it to the after-tax cost of debt multiplied by the percentage of capitalization that is debt.

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[9] Note that in some cases, not all cash is available to repay the principal of the company's debt. Typically, businesses need a certain minimum level of cash to be able to maintain the operations of the business, including funding working capital needs. In the case of ScottishPower, the petitioner's financial expert determined that PacifiCorp needed a minimum cash balance of $25 million after analyzing the company's historical cash balances, working capital needs, and business profile.

[10] Rouse, Bell, and Graham, *Banker's Lending Techniques*, Third Edition. Global Professional Publishing, 2011, p. 103.

[11] *Id*. at p. 123.

EXHIBIT 10

PacifiCorp's WACC Calculation, As of November 29, 1999

	Market Cap Prior to Announcement	Implied Equity Value
Percent Equity	55.2%	56.6%
Percent Debt	44.8%	43.4%
Cost of Equity	11.0%	11.0%
Cost of Debt	7.5%	7.5%
Tax Rate	38.0%	38.0%
WCC	**8.1%**	**8.2%**

EXHIBIT 11

PacifiCorp's Common Equity

($ Million)	Valuation as of November 29, 1999
PV of Cash Flows	$ 4,454
PV of Terminal Value	7,580
Total Enterprise Value (PacifiCorp)	**12,034**
– PacifiCorp Interest Bearing Debt	(4,624)
– PacifiCorp Preferred	(241)
– PacifiCorp Preferred Interest in Debenture	(341)
– PacifiCorp Excess Cash	120)
Total Enterprise Value (NAGP)	**6,948**
– Intercompany Debt	(4,000)
NAGP Equity Value	**$ 2,948**

In determining the risk-free rate component of PacifiCorp's cost of equity as of the transaction announcement date and the transaction close date, the petitioner's financial expert used the 20-year U.S. Treasury constant maturity bond yield, which was 6.7% as of 11/29/99. The beta for PacifiCorp was obtained from the Barra Beta Book for Companies[12] and the equity risk premium from Ibbotson Associates' Stocks, Bonds, Bills and Inflation (SBBI) Yearbook.

The petitioner's financial expert also applied a size premium based on PacifiCorp's market capitalization prior to its acquisition by ScottishPower. This size premium was also sourced from the SBBI Yearbook. As summarized in Exhibit 9, PacifiCorp's cost of equity as of the close date was approximately 11%.

To determine the cost of debt for PacifiCorp, the petitioner's financial expert analyzed the average effective interest rate on PacifiCorp's existing, outstanding debt and found it ranged from 7% to 7.4% in the two years prior to the close date. Conservatively, the petitioner's financial expert elected to use a cost of debt of 7.5%.

Next, the petitioner's financial expert calculated PacifiCorp's WACC. Using the methodology described above, the petitioner's financial expert calculated a WACC for PacifiCorp to be 8.2% as of 11/29/99.[13]

While the ScottishPower Projections did not extend beyond year-end 2007, the financial expert determined that PacifiCorp was a viable going concern entity and, therefore, its cash flows will not cease at the end of that year. To account for cash flows in years beyond 2007, the petitioner's financial expert calculated a terminal value utilizing a perpetuity growth rate. The method applied, known as the Gordon Growth Model, calculates a terminal value by taking the cash flows in the final projected year, growing them by one year at the projected terminal growth rate, and dividing that cash flow figure by the cost of capital less the projected terminal growth rate. The result represents the present value of all the cash flows following the final projected year.

Terminal growth rates are often subject to challenge, as terminal values typically make up a large percentage of a company's computed value and are sensitive to growth rate assumptions. To estimate the terminal growth rate, the petitioner's financial expert reviewed the Energy Information Administration's Annual Energy Outlook including Supplemental Tables, for 1998 and 1999 (the EIA Outlook). These publications projected electricity demand and real price growth to the year 2020 for the Northwestern U.S. where PacifiCorp operated. In the EIA Outlook for 1998, the annual growth in electricity demand and real prices in the Northwestern U.S. was projected to be 1.2% and negative 1%, respectively, for the period 2007 – 2020.

To convert these real growth rates into nominal growth rates, the petitioner's financial expert used an inflation rate of 3.1%, which was the historical inflation rate of the U.S., and an expected inflation rate of 2.5%, which was the expected inflation rate used in the ScottishPower projections. As a result, the petitioner's financial expert calculated nominal growth rates for the period 2007 – 2020 of 3.4% and 4%. Given this range, the petitioner's financial expert used a terminal growth rate of 3.5% in his DCF valuation.

Discounting PacifiCorp's 1999 – 2007 DFCF and terminal value back to 11/29/99, derived an enterprise value for PacifiCorp of approximately $12 bil-

lion as of that date. As shown in Exhibit 11, subtracting PacifiCorp's existing interest bearing debt and preferred securities and adding excess cash gives FMV of common equity for PacifiCorp of $7 billion. Again, the petitioner's finance expert subtracted the value of the intercompany debt to derive FMV of equity for NAGP of $2.9 billion.

The petitioner's financial expert noted that the equity value of NAGP derived from these DCF analyses was higher than that derived from the market-based valuation analysis. This was unsurprising. It is in accordance with the economic logic that ScottishPower would pay less than what it believed the present value of PacifiCorp's cash flows to be worth. Therefore, the value actually paid for PacifiCorp was lower than the "intrinsic" value of the company as determined through other methodologies.

The petitioner's financial expert's ultimate conclusion regarding NAGP's equity cushion was the following: "The significant positive equity value at NAGP demonstrated in these valuation analyses would be seen as a margin of safety, or equity cushion, for lenders and other potential investors in NAGP."[14]

ScottishPower: Capital Adequacy

Analysis from the Perspective of a Leveraged Buyout

To provide context for the debt taken on by NAGP, the petitioner's financial expert analyzed debt leverage in the context of acquisitions. As noted in the petitioner's financial expert's report, there is no simple standard for what constitutes "too much debt" for a company. Appropriate leverage and interest coverage ratios depend on the nature of the business being considered, the stability of the firm's cash flows, regulatory environment, opportunities for improvements in operations, and numerous other factors.

It is a widely accepted concept in finance that the total risk borne by a company is made up of two elements: operating risk and financial risk. Companies with high levels of operating risk, such as those operating in highly uncertain environments or in cyclical and volatile industries, cannot safely take on high levels of finance risk. Conversely, companies with low levels of operating risk can bear the risk of significant leverage. Consider, for example, the following:

> The total systematic risk of the firm's equity thus has two parts: business risk and financial risk. The first part (the business risk) depends on the firm's assets and operations and is not affected by capital structure. Given the firm's business risk (and its cost of debt), the second part (the financial risk) is completely determined by financial policy.[15]
>
> Firms with high business risk therefore tend toward less highly leveraged capital structures, and firms with low business risk tend toward more highly leverage capital structures.[16]

Given the balance between business and financial risk, it is unsurprising that candidates for highly leveraged acquisitions are typically mature firms in stable industries with strong cash flows, as these firms have low operational risk, and provide lenders with reasonable assurance that debts can be repaid or refinanced.

Consider, for example, the following characteristics of a strong LBO candidate:

- Strong Cash Flow Generation.
- Leading and Defensible Market Positions.
- Growth Opportunities.
- Efficiency Enhancement Opportunities.
- Low Capex [capital expenditures] Requirements.
- Strong Asset Base.
- Proven Management Team.[17]

The petitioner's financial expert noted that PacifiCorp met the majority of the requirements of a successful leveraged acquisition candidate, particularly given the demonstrated expertise of ScottishPower in cutting costs and improving service quality. Indeed, it is well known that cost cutting is a major factor in many highly leveraged transactions. For example, consider the following:

> In both the early 1980's and after 1992, LBOs have earned superior returns to investors in all stages…The most important reason is the improvement in operations, reducing cost and increasing cash flows. This is achieved by bringing in management with experience and competence in the operations of the company.[18]

The finance literature supports the reasonableness of a leveraged transaction such as PacifiCorp's acquisition by ScottishPower through NAGP. The success of LBOs in general, and PacifiCorp's suitability as an LBO candidate in particular, indicate that ScottishPower's incorporation of additional leverage into NAGP/PacifiCorp's capital structure was consistent with financial and economic principles.

The petitioner's financial expert performed several different analyses that examined the capital adequacy of NAGP. First, he analyzed the post-acquisition capitalization of NAGP, PacifiCorp and NAGP/PacifiCorp based on the purchase consideration received by PacifiCorp shareholders as of the acquisition close date. The petitioner's financial expert analyzed the total debt-to-capitalization ratio of NAGP and concluded that NAGP's total debt-to-capitalization ratio was forecasted to improve due to the cash flow generation capability of PacifiCorp. This forecasted improvement in NAGP's total debt-to-capitalization was in anticipation of NAGP's ability to pay down its debt with its free cash flow.

The petitioner's financial expert also examined merger and acquisition activity

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12 Barra Beta Books for Companies is a well-known database that provides risk analysis statistics, including beta, from global and single country models and is published by MSCI.

13 The need to perform valuation at multiple dates and calculate WACC using different capital structures varies depending on the case, and should be taken into consideration by the financial expert.

14 Expert Report of Professor Israel Shaked 4/8/11, p. 43.

15 Ross, Westerfield, and Jordan, *Fundamentals of Corporate Finance*, Seventh Edition (MacGraw-Hill Irwin, 2006) p. 547.

16 *Gitman*, *Principles of Management Finance*, Seventh Edition (Harper Collins College Publishers, 1994) p. 456.

17 Rosenbaum and Pearl, *Investment Banking: Valuation, Leveraged Buyouts and Mergers & Acquisitions*, (John Wiley & Sons, 2009) p. 168.

18 Weston and Weaver, *Mergers and Acquisition*, (McGraw-Hill, 2001) p. 188.

EXHIBIT 12

All Electric Utility Companies Included in the S&P 500 at the Time of Acquisition

Company	Debt Issued	Debt Repaid	Net
American Electric Power	$ 4,263	$ (1,786)	$ 2,477
American Corp	652	(571)	81
Baltimore Gas & Electric	1,756	(1,283)	473
Carolina Power & Light	606	(425)	181
Central & South West Corp	977	(827)	150
Cinergy Corp	1,716	(1,274)	442
Consolidated Edison Inc	1,708	(1,605)	103
Dominion Resources	17.039	(14,373)	2,666
DTE Energy Inc	1,278	(999)	279
Duke Energy Corp	7,600	(3,072)	4,528
Edison International	11,761	(5,332)	6,429
Energy Corp	5,447	(5,099)	348
FirstEnergy Corp	955	(1,988)	(1,033)
FPL Group Inc	1,994	(2,028)	(34)
George Pacific Corp	1,247	(1,793)	(546)
Niagara Mohawk Power	3,361	(1,314)	2,047
North States Power	1,450	(526)	924
PECO Energy Inc	4,345	(2,468)	1,877
PG&E Corp	386	(3,311)	(2,925)
PP&L Resources Inc	3,476	(2,149)	1,327
Public Service Enterprises	2,453	(1,933)	520
Southern Company	10,405	(4,903)	5,502
Texas Utility Company Unicom Corp	8,283	(5,311)	2,972
Unicom Corp	4,480	(3,124)	1,356
Total	**97,638**	**$(67,494)**	**$30,144**
Number of Companies with Issurances Exceeding			**20**
Number of Companies with Repayments Exceeding Issurances			**4**

around the time of ScottishPower's acquisition of PacifiCorp to determine whether leveraged transactions occurred in the marketplace, and, if so, at what leverage levels. The ability of other utilities to place large quantities of debt and complete highly leverage transactions would be a strong indication that the transaction structure and debt incurred by NAGP pursuant to the acquisition was reasonable.

The selection criteria for this analysis was the following: the target company was based in the U.S., the total deal value was greater than $1 billion, all-stock deals were excluded, and at least 50% of the deal value was funded through debt assumptions or new debt issuances. It was important to note that of the 22 transactions identified, five were funded entirely through debt, and 13 had debt equal to 75% or more of the total transaction value. This was presented as evidence that large, highly leveraged transactions were completed in the utility industry around the time of the acquisition.

The petitioner's financial expert also analyzed debt issuances for electric utilities to determine whether the issuance and refinancing of large amount of debt was typical in the industry. In 1998, ScottishPower was a component of the S&P 500. Therefore, the petitioner's financial expert elected to use, as his sample, all electric utility companies (other than PacifiCorp) included in the S&P 500 at the time of the acquisition. The petitioner's financial expert compared the cash these companies received from

debt issuances with cash used for debt repayments in the three-year period ended 12/31/99.

As shown in Exhibit 12, not only were other major utility companies refinancing their debts during the period in which ScottishPower acquired PacifiCorp, they were also issuing more debt than they were repaying, and thereby increasing their leverage.

As noted previously, based on the ScottishPower projections, NAGP was projected to pay its debts as they became due. However, even if NAGP was for some unforeseen reason unable to do so, this market evidence suggests that the intercompany debt could have been refinanced.

The Role of Additional Financial Experts

As mentioned above, additional financial experts are commonplace in a debt-equity litigation. This article provided an in-depth analysis of the role of the corporate finance expert, one of three financial experts who testified on behalf of the petitioner in ScottishPower . The other experts who testified included a credit rating expert and an investment banking expert. The credit rating expert is generally involved in assigning a credit rating to the issuing company and the intercompany loan itself. Assigning a credit rating to the issuer and possibly to the issue, helps determine whether the interest rate of the intercompany loan is at market rate. Additionally, the credit rating expert may perform a ratio analysis that also helps determine whether the subject company was adequately capitalized.

The investment banking expert is typically hired to opine on whether debt securities with characteristics similar to the intercompany loan in question could be placed in the open market. This expert helps explain whether there was demand, at the time of the issuance, for a third-party loan with characteristics similar to the intercompany loan in question. Both the credit rating expert and the investment banking expert can play an important role in determining whether an intercompany loan is qualified as debt.

Conclusion

Expert finance and economic analysis plays a critical role in the substantiation of related party obligations as debt for U.S. tax purposes, whether it is in the context of a transaction or in a court room. The key issues which a financial expert generally examines are: the subject company's ability to pay its debts as they become due, equity cushion, and capital adequacy. These economic factors are complex, and often form the basis for challenges by tax authorities and contested in tax courts. Therefore, it is essential for a taxpayer, when implementing or defending a related party arrangement, to consider how that arrangement could be defended in court, should it come to that point. This article has demonstrated an effective defense to a debt-equity challenge. However, each situation will differ. Thus, we suggest that, particularly in highly visible or controversial transactions, a company involve advisors (legal, financial, and otherwise) who are experienced in supporting these arrangements in Exam, Appeals, and at trial. ●