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Via Electronic Filing and U.S. Mail

Oregon Public Utility Commission
Attention: Filing Center
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Re: UM 1271

Attention Filing Center:

Enclosed for filing in the captioned docket are an original and five copies:

DIRECT TESTIMONY AND EXHIBITS OF RANDY DAHLGREN AND JAY TINKER (PGE/100 POLICY) AND JIM PIRO AND BOB TAMLYN (PGE/200-201 ACCOUNTING AND TAX ISSUES)

These documents are being filed by electronic mail with the Filing Center.

An extra copy of this cover letter is enclosed. Please date stamp the extra copy and return it to me in the envelope provided.

Thank you in advance for your assistance.

Sincerely,

INARA K. SCOTT

IKS:jbf
enclosure

CC: UM 1271 SERVICE LIST

CERTIFICATE OF SERVICE

I hereby certify that I have this day caused the **DIRECT TESTIMONY AND EXHIBITS OF RANDY DAHLGREN AND JAY TINKER (PGE/100 POLICY); JIM PIRO AND BOB TAMLYN (PGE/200 – 201 ACCOUNTING AND TAX ISSUES)** to be served by electronic mail to those parties whose email addresses appear on the attached service list, and by First Class US Mail, postage prepaid and properly addressed, to those parties on the attached service list who have not waived paper service.

Dated at Portland, Oregon, this 6th day of December 2006.

INARA K. SCOTT

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UM 1271

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I. Introduction

Q. Please state your names and positions with PGE.

A. My name is Randy Dahlgren. I am Director of Regulatory Policy and Affairs at PGE.

My name is Jay Tinker. I am a Project Manager for PGE. My areas of responsibility include revenue requirement analyses and other regulatory analyses.

Our qualifications appear at the end of this testimony.

Q. What is the purpose of your testimony?

A. We discuss the regulatory principles and policy in place at the time of the purchase of the LM6000 turbine and associated transformer, which include the:

- Benefits and burdens alignment
- Prohibition of cross-subsidization

We also address PGE's expectations concerning non-utility property, the earnings impact of crediting the tax loss associated with the sale of the turbine to customers, which was not foreseeable at the time of purchase, and the unusual nature of the event (i.e., the manner in which Senate Bill 408 will operate to give to customers a tax benefit associated with a non-utility asset to customers).

II. Regulatory Principles and Policies

Q. What was the guiding regulatory principle in place when PGE purchased the LM6000 turbine and transformer?

A. PGE purchased the LM6000 turbine and associated transformer ("turbine") in 2001. The overarching regulatory principle in place at that time was that of aligning the benefits customers receive with the burdens they bear. Under Oregon's application of this principle, the Commission based PGE’s prices on the cost of utility property used or expenses incurred to serve retail customers within our service territory. Commission policy excluded from retail electric prices the cost of any and all non-utility property and expenses and, conversely, any profits or losses arising from non-utility property or activities.

Interwoven with the principle of aligning benefits and burdens for ratemaking purposes is the regulatory policy of prohibiting cross-subsidization. Cross-subsidization occurs when a utility uses revenues from one product's sales to help cover the costs of another product. Cross-subsidization may occur if the utility uses revenues from sales to one class of customers to subsidize prices charged to another class of customers. It may also occur if utility service prices are based on costs related to service to non-utility customers, or conversely, if non-utility revenues or profits reduce utility prices even though those prices exclude the underlying non-utility costs.

Q. What Commission practices supported these regulatory principles?

A. In 2001, PGE maintained specific accounts separate from utility accounts, as discussed in PGE Exhibit 200, to shield utility customers from non-utility investments and expenses. These easily identifiable amounts did not appear in PGE’s revenue requirement requests or results of operations reporting. The Commission also restricted PGE from issuing debt for non-utility purposes, and similarly prohibited PGE from extending credit on its books to any affiliate, or otherwise subsidizing affiliate operations without Commission approval. Therefore, of necessity, PGE could make non-utility investments and expenditures only through retained earnings. These practices continue today.

Q. Did PGE apply this regulatory principle to the accounting of the purchase of the turbine?

A. Yes. PGE acquired the turbine with retained earnings, and at all times maintained the investment and any related expenses in non-utility accounts. PGE did not request to include either investment or expenses related to the turbine in PGE's revenue requirement in any rate proceeding nor reflected its costs in results of operation reporting since its acquisition.

Q. Did the separation of non-utility investments and expenses from retail electric ratemaking include the tax effects of those investments and expenses in 2001?

A. Yes. The Commission set rates in UE 115 on a stand-alone utility basis for tax purposes. This means that neither the expenses nor revenue stream from non-utility investments and activities affected the income opportunity and related tax expense assumed in the ratemaking process. Senate Bill 408 (SB 408) now requires that the tax effects of non-utility expenses and investments affect ratemaking if those tax effects lower the taxes that the utility otherwise would pay. Thus, SB 408 changes one side of the guiding regulatory principle under which PGE made this non-utility investment. This deferral concerns our request that the Commission restore the regulatory principle under which we made this investment by permitting into ratemaking only so much of the investment cost as is necessary to prevent a windfall gain to customers and unpreventable loss to PGE from this old decision.

Q. Has the Commission expressed concern in the past with providing customers with tax benefits for which they have not paid the associated costs?

A. Yes. Appendix A to Commission Order 03-214 (April 10, 2003) states:

> **"**If PGE's rates were set in a manner that captured some of Enron's tax losses, PGE's rates would also have needed to reflect the expenses that created those tax savings, and customers would be worse off. Staff's counsel advised that it would be difficult for the OPUC to justify picking and choosing which of Enron's revenues and expenses—including tax savings—to include for purposes of setting Oregon customers' rates. Moreover, such an approach may lead to confiscatory rates.

Q. Was this longstanding Commission policy?

A. Yes. Prior to the enactment of SB 408, the tax policy of the Commission was that utility prices should not reflect the benefit of tax savings for any risks also not reflected in those prices.

Q. What were PGE's expectations of the financial treatment of the turbine when it purchased the turbine in 2001?

A. Based on the regulatory principles described above, and its decision to classify the turbine as a non-utility expense, PGE expected that neither gains nor losses associated with the turbine would affect PGE electric prices.

Q. How does PGE propose to address the impact of SB 408?

A. We are applying for this deferral to enable the company to neutralize the tax effect of the loss associated with the sale of the turbine, in the event this tax effect is included in PGE's prices for retail electric service.

Q. What will happen if deferral is not granted?

A. As Messrs. Piro and Tamlyn testify, the tax loss generated by the sale of the turbine will lower PGE's retail electric prices by approximately $4.8 million dollars, due to the application of SB 408. As described above, neither the initial cost nor any of the expenses related to the turbine were reflected in PGE's rates. Thus, in the interest of fairness and in keeping with PGE's reasonable investment-backed expectations at the time the turbine was purchased, we request a deferral of this same amount.

Q. Is the $4.8 million deferred amount requested based on an identifiable utility revenue or expense, as required by ORS 757.259?

A. Yes. As explained by Messrs. Piro and Tamlyn and provided in PGE's Application for Deferred Accounting, the Commission can use either of two alternatives to determine the deferred amount. First, the Commission could defer the revenue decrease that would otherwise occur as SB 408 reduced retail electric prices based on this non-utility tax loss. Alternatively, the Commission could defer only so much of the initial non-utility turbine cost as necessary to balance the tax loss benefit. In either case, the deferral represents the effect of a specific item: the tax effect of the sale of a non-utility asset.

Q. Under what statutory requirement is PGE seeking this deferral?

A. As explained in PGE's Application for Deferred Accounting, PGE seeks this deferral to appropriately match the costs included in retail ratemaking with the tax effects used to reduce retail rates due to the application of SB 408. Thus, the deferral is filed under ORS 757.259(2)(e). This deferral will allow the Commission to set rates that better match the costs of the turbine with the SB 408 effect of including tax benefits in retail electric rates.

Q. Are there any other regulatory statutes that support the granting of this deferral?

A. Yes, the Commission has broad authority under ORS 757.040 to balance the interests of utility investors and consumers in establishing fair and reasonable rates. Under that same statute, the Commission has a responsibility to ensure that fair and reasonable rates "provide adequate revenue...for the operating expenses of the utility..." If, under SB 408, utilities' prices include reductions related to the tax effects of non-utility expenses, utilities' prices also should include the non-utility costs underlying those tax effects, at least to the extent of the tax losses. PGE does not seek a gain here; we seek only neutrality.

Q. Has the Commission expressed a willingness to consider unique circumstances caused by the application of SB 408 as they arise?

A. Yes. In its Interim Order in AR 499 (Order No. 06-400) the Commissioners stated that they "acknowledge the general concerns raised by utilities" (regarding earnings tests and "double whammy") and that they "will consider the tax effect when evaluating issues in other dockets…"

III. Unforeseeable Nature of the Event

Q. Does PGE consider the manner in which SB 408 will operate to credit the tax loss associated with the turbine to utility prices an unusual event that could not have been reasonably foreseen?

A. Yes. As described above, the manner in which SB 408 operates directly contradicts a number of basic and well-settled regulatory principles. This is a highly unusual event that could not have been foreseen.

Q. Could PGE have anticipated the impact of SB 408 on the treatment of the tax loss associated with the sale of the turbine?

A. No. When we purchased the turbine in 2001, neither the Commission nor PGE could have foreseen SB 408 or its impact on the basic regulatory principles described above.

Q. Can this event be considered stochastic?

A. No. A stochastic risk is one that is "quantifiable, can be represented by a known statistical distribution, and its impacts can be simulated in advance. In other words, the event is one that can be foreseen with some reasonable degree of probability." (UM 1071, Staff Comments) The enactment of SB 408 was not a stochastic event. It was not modeled in rates and, as discussed above, it was a completely unforeseeable event.

Q. Has PGE been compensated for the additional business risk SB 408 creates?

A. No. PGE's compensation for risk is contained in its allowed rate of return set by the Commission. The Commission last set PGE's allowed rate of return in August 2001 for rates starting October 2001 - many years before SB 408 became law.

IV. Earnings Test

Q. What are PGE's the anticipated earnings for 2006?

A. PGE has not performed an earning test for 2006 because the year is not over. In addition, an earning test is not required until the amortization phase. The amount for which we would expect to request amortization is $4.8 million dollars, as discussed in Exhibit 200 Piro-Tamlyn. However, actual 2005 results and actual results through the third quarter of 2006 are instructive.

Q. What was PGE's 2005 actual weighted average return on capital and what has been PGE's experience thus far this year?

A. Our 2005 return was 6.80% versus our allowed return of 9.08%. As stated in our 2006 3rd Quarter SEC filing, our year-to-date earnings of $31 million are substantially below the corresponding 2005 figure of $73 million. Thus, we do not expect the deferral of $4.8 million to produce regulated earnings in excess of PGE's authorized ROE for 2006.

V. Qualifications

Q. Mr. Dahlgren, please state your qualifications.

A. I received a Bachelor of Science degree from Oregon State University in Electrical Engineering. In addition, I have taken courses from other universities in the areas of engineering economics, systems analysis, and business administration. I also attended the 1980 Public Utilities Executives' Course at the University of Idaho.

I joined PGE in 1973 shortly after graduation and subsequently have been involved in the areas of load research, load and revenue forecasting, price analyses and design, and class cost-of-service analyses. I was appointed Rate Engineer in January 1977 and have held various management positions in the regulatory area since 1978. I entered my present position as Director of Regulatory Policy and Affairs in 2001.

Q. Mr. Tinker, please state your educational background and experience.

A. I received a Bachelor of Science degree in Finance and Economics from Portland State University in 1993 and a Master of Science degree in Economics from Portland State University in 1995. In 1999, I obtained the Chartered Financial Analyst (CFA) designation. I have worked in the Rates and Regulatory Affairs department since joining PGE in 1996.

Q. Does this conclude your testimony?

A. Yes.

I. Introduction and Summary

Q. Please state your name and position.

A. My name is Jim Piro. I am Executive Vice President of Finance, Chief Financial Officer, and Treasurer of PGE.

My name is Bob Tamlyn. I am Tax Director for PGE.

Our qualifications appear at the end of this testimony.

Q. What is the purpose of your testimony?

A. The purpose of this testimony is to explain the accounting and tax issues associated with the purchase and sale of the LM6000 turbine and the associated transformer that are the subject of this deferral.

II. The LM6000

Q. Can you describe the turbine and transformer that are the subject of this deferral?

A. The turbine is an LM6000 Gas Turbine Generator ("LM6000" or "turbine"), manufactured by General Electric for PGE. The transformer was purchased from Waukesha Electric Systems for use with the turbine.

Q. When was the LM6000 purchased, and by whom?

A. In May 2001, PGE entered into a contract to purchase the LM6000 for a proposed Port of Morrow gas generating project. The turbine was expected to be completed in September 2001. A sales price of $16.8 million was to be paid in installments as described in the contract. PGE entered into a separate contract for the purchase of the transformer, with an initial cost of $414,800.

Q. Why was the LM6000 purchased?

A. Prices in the wholesale power markets at the time justified the investment in the turbine as a "merchant" or non-utility plant. After PGE had committed to the purchase, wholesale prices fell, making the plant uneconomic.

In June 2001, PGE decided not to proceed with the Port of Morrow project. Although the project was cancelled, PGE decided to go ahead and have the turbine built, with the intention of reselling it.

PGE transferred the turbine purchase costs, other costs associated with the turbine (such as storage and property taxes) and cash for the final payment on the turbine to the Portland General Resource Group, Inc. (PGRD), a subsidiary of PGE created expressly for the purpose of holding the turbine. The transformer remained at PGE.

Q. When you say PGE purchased the LM6000 and transformer, does that mean that PGE included this investment in the retail electric prices it proposed for Commission approval?

A. No. The costs associated with the LM6000 and transformer has always been recorded in non-utility accounts. Specifically, the payments for the turbine have been recorded in FERC accounts 121, non-utility property (while at PGE), and 123.1, investment in subsidiary companies (once moved to PGRD). The payment for the transformer was recorded in FERC account 121, and remained there until it was sold.

Q. Did PGE incur any debt to fund the purchase of the turbine or transformer?

A. No. Both purchases were funded from shareholders' equity.

Q. Please explain how SB 408 applies to the tax loss created by the sale of the non-utility turbine investment.

A. In simple terms, SB 408 compares "taxes paid" with "taxes collected" (as those terms are defined by the statute). Pursuant to Commission rules, "taxes collected" is based on a forecast of the utility's tax liability based primarily on data from the utility's most recent rate case. "Taxes collected" does not include non-utility forecasts, because rate cases explicitly exclude such activities. "Taxes paid," on the other hand, is based on actual tax payments to government authorities, which include taxes for both utility and non-utility activities. Thus, SB 408 compares two very different values.

The amount of taxes paid and properly attributed is the lowest of three values: 1) the utility's stand alone tax liability, which excludes non-utility activities; 2) the total taxes paid to government authorities by the utility or a consolidated taxpaying entity; or 3) an apportioned amount of the total taxes paid by a consolidated entity.

Thus, when non-utility activities <u>increase</u> total taxes paid, they will be excluded from the calculation under the "lesser of" comparison. Where those non-utility activities <u>decrease</u> total taxes paid, they will flow through the calculation to lower retail utility prices.

Exhibit 201 demonstrates the asymmetrical application of SB 408 through a simplified example. In the example, we assume that the utility's actual financial results mirror rate case projections, in order to eliminate a "double whammy" type of effect. We then depict a situation in which there is a non-utility asset sale that results in a gain, and a non-utility asset sale that results in a loss. In the first case, SB 408's "lowest of" cap would eliminate the increased tax liability resulting from non-utility activity by calculating "taxes paid" based on the utility's stand alone tax liability. In the second case, the non-utility loss results in a decrease in taxes paid, based on the "lowest of" test.[1]

Q. Can you quantify the amount by which the application of SB 408 will lower retail rates, based solely on the sale of the turbine and transformer?

A. At the time we purchased the LM6000, PGRD recorded the cost basis of the asset, plus certain capitalized costs (e.g. property taxes and storage fees). For accounting purposes PGRD was required to periodically write down the value of the asset to its market value, which declined over the years. This generated a difference between the tax basis of the LM6000 (the purchase price plus capitalized costs), and the book value.

In July 2006, PGRD sold the turbine for $6.1 million, while its tax basis was $18.1 million. The difference between those two values created a $12.0 million tax loss, which will be recognized in the consolidated 2006 tax return of PGE and subsidiaries. This will decrease 2006 income taxes by approximately $4.8 million. PGE's 2006 quarterly estimated federal and state tax payment reflect this $4.8 million tax benefit.

The transformer was purchased for $415,000 and with capitalized costs had a tax basis of $471,000. It was also sold in July 2006 for $136,000, generating a tax loss of $335,000 and a tax benefit of approximately $130,000.

For SB 408 purposes, this decrease in PGE's total consolidated tax liability will flow through the calculation of PGE's total taxes paid, and ultimately result in a rate credit to

[1] We did not attempt to address the manner in which an apportionment calculation might further impact the final amount of taxes paid.

customers of approximately $4.8 million. Again, "taxes collected" pursuant to SB 408 is unaffected by the sale of the turbine at a loss.

Q. Who bears the burden of this $4.8 million retail price reduction?

A. PGE's shareholders. Any rate credit generated by the comparison between "taxes collected" and "taxes paid" will decrease PGE's retained earnings. More specifically, imposing a rate credit for the tax benefit of the sale of the turbine and transformer would transfer cash to customers in the form of a credit on their bill. This rate credit decreases shareholders' equity in the company. That equity equates to cash that could otherwise be paid in dividends to shareholders.

Q. In the deferral application, PGE requested deferred accounting treatment of "a potential refund/expense associated with SB 408." Can you please explain these two accounting methods?

A. PGE described the proposed deferral in two ways. Under alternative one, we requested deferral of the revenue refund associated with a rate adjustment under SB 408 generated by the tax effect of the sale of the LM6000 and the transformer. We proposed to debit this amount to FERC Account 229 (Accumulated Provision for Rate Refunds), crediting FERC account 449.1, Provision for Rate Refunds. Second, PGE proposed to defer the tax effect of the loss on the sale of the LM6000 and the transformer as a utility expense. For this alternative, we proposed to record a debit for Deferred Amounts in FERC Account 182.3 (Regulatory Assets) crediting FERC Account 407.4 (Regulatory Credits).

IV. Qualifications

Q. Mr. Piro, please describe your educational background and experience.

A. My name is James P. Piro. I received a Bachelor of Science degree from Oregon State University in Civil Engineering in 1974 with an emphasis in Structural Engineering. In addition, I have taken graduate courses in engineering, accounting, economics, and rate making. I am a registered Professional Engineer in Civil Engineering in the State of California (Registration No. 28174). I joined Portland General Electric in 1980 and have held various positions in Generation Engineering, Economic Regulation, Financial Analysis and Forecasting, Power Contracts, Economic Analysis, Planning Support, Analysis and Forecasting, and Business Development. I was elected Vice President of Business Development in 1998 and then became Chief Financial Officer and Treasurer on November 1, 2000. I was then named Senior Vice President, Finance, Chief Financial Officer and Treasurer on May 1, 2001, and entered my current position as Executive Vice President, Finance, Chief Financial Officer and Treasurer effective July 25, 2002.

Q. Mr. Tamlyn, would you please review your qualifications?

A. I am a graduate of Portland State University receiving a Bachelor's degree in Political Science in 1974. I also have a Masters of Taxation degree from Portland State University, received in 1996 and have been a certified public accountant since 1979. I am a member of the American Institute of CPAs as well as the Oregon Society of CPAs and a director for the Portland chapter of Tax Executives Institute.

I worked for the Portland Oregon based CPA firm of Fellner & Kuhn, PC from 1976 to 1987, advising clients on various accounting and tax matters. Subsequent to that I worked in various tax capacities at PacifiCorp, NERCO, PacifiCorp Financial Services and Standard Insurance Company.

I have been the tax director at PGE from March 2005 until the present time.

Q. Mr. Piro, Mr. Tamlyn, does this conclude your testimony?

A. Yes.

Example of Asymmetry of SB 408 Taxes Collected versus Taxes Paid

		Non-Utility Asset Sale Gain			**Non-Utility Asset Sale Loss**		
	Rate Case	Utility Actuals	Non-Utiltity Activity	Consolidated	Utility Actuals	Non-Utiltity Activity	Consolidated
Revenue (or Rev Req)	1,750	1,750		1,750	1,750		1,750
Pre-Tax Expenses	1,000	1,000	(200)	800	1,000	200	1,200
Income Taxes @ 40%	300	300	80	380	300	(80)	220
Operating Income	450	450	120	570	450	(120)	330

Taxes Collected	300	Taxes Collected	300
Taxes Paid - Consolidated	380	Taxes Paid - Consolidated	220
Taxes Paid - Stand Alone	300	Taxes Paid - Stand Alone	300
Taxes Paid - Lesser Of	300	Taxes Paid - Lesser Of	220
SB 408 Adj. (Tx Coll - Tx Pd)	0	SB 408 Adj. (Tx Coll - Tx Pd)	80