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August 14, 2006

VIA ELECTRONIC FILING

PUC Filing Center
Public Utility Commission of Oregon
PO Box 2148
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Re: Docket AR 499

Enclosed for filing in the above-referenced docket is an original and six copies of PacifiCorp's Reply Comments on Interim Order and Draft Rules. A copy of this filing has been served on all parties to this proceeding as indicated on the attached certificate of service.

Very truly yours,

Katherine A. McDowell

Enclosures
cc: Service List

BEFORE THE PUBLIC UTILITY COMMISSION OF OREGON

AR 499

In the Matter of the Adoption of Permanent Rules to Implement SB 408, Relating to Matching Utility Taxes Paid with Taxes Collected	**PACIFICORP'S REPLY COMMENTS ON INTERIM ORDER AND DRAFT RULES**

I. Introduction

PacifiCorp respectfully submits the following Reply Comments on the Commission's Interim Order in this docket, *In re: Adoption of Permanent Rules to Implement SB 408*, Order 06-400 (July 14, 2006) (the "Interim Order") and the AR 499 draft rules.

PacifiCorp stated three principles in its Opening Comments: tax benefits unrelated to regulated operations should not be imputed to the utility, the apportionment method should be applied consistently with general regulatory and tax principles and state taxes should be based upon taxes paid by the unitary group of which the utility is a member.

With respect to the first principle, PacifiCorp's position is that the apportionment method has significant legal, policy and practical infirmities. PacifiCorp opposes the adoption of this or any other properly attributed approach that takes tax attributes that belong to unrelated companies and imputes them to the utility. PacifiCorp expressly reserves its objections to the apportionment method, many of which were outlined in PacifiCorp's Opening Comments. PacifiCorp's proposals on implementation of the apportionment method should not be interpreted as a waiver of these objections.

PacifiCorp's latter two principles address how to mitigate some of the worst problems associated with the apportionment method, assuming the Commission adopts it. There was a high level of consensus on these principles in the Opening Comments, leading to the filing of Joint Comments concurrently with the filing of these Reply Comments. PacifiCorp submits these Reply Comments as a supplement to the Joint Comments to raise and clarify

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a number of additional points. PacifiCorp intends to submit rule revisions consistent with these Reply Comments by Thursday, August 17, 2006.

II. Mechanics of Apportionment Method Calculation.

PacifiCorp faces significant implementation challenges with respect to the apportionment method because PacifiCorp is a multi-state utility with a very large affiliated group that includes other regulated companies. Additionally, PacifiCorp faces reporting challenges associated with its mid-year ownership change and the need to obtain non-public information necessary for apportionment from its former owners. PacifiCorp has therefore focused on the mechanics of the apportionment method, taking the principles upon which there is general agreement and making them work as a part of a verifiable and straightforward calculation. Exhibit A sets forth these calculations, the steps of which are discussed below.

A. Federal Calculation

<u>Step 1: Calculate the Adjusted Federal Consolidated Tax</u>

- *Use Federal Taxes Before Credits from Federal Return.* The federal tax return specifically reports taxes before credits and PacifiCorp proposes to use this number to avoid allocation of the production tax credits (PTCs) held by the affiliated group. While this may also exclude other federal tax credits, none are as significant as the renewable energy PTCs from a monetary or policy standpoint. Tax credits are designed to promote specific policies, such as renewable energy investment. In the case of the PTC, the underlying federal tax policy is fully aligned with the policy of the State of Oregon. By using federal tax before credits, the Commission can apply the apportionment method without interfering with these policies through allocation of tax credits to Oregon utility customers. Without this step, PTCs could be shifted from ratepayers in one jurisdiction who bear the cost of the renewable resource to ratepayers in Oregon who bear none of the costs of the resource. While this

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proposal was not included in the Joint Comments, PacifiCorp believes that there is a high degree of consensus around it.

- *Adjust for Normalization by Adding Non-Oregon Regulated Deferred Taxes and the Imputed Tax Benefit of Depreciation on Disallowed Capital Costs.* The clearest way to avoid normalization issues in implementing SB 408 is to preclude allocation of tax benefits from unrelated companies in the affiliated group to the utility except as required by ORS 757.268(12). If the Commission adheres to a loss allocation methodology, however, the next best way to avoid normalization issues is the approach PacifiCorp recommended in its Opening Comments. This approach proposed removing all PacifiCorp non-Oregon regulated utility operations and all non-Oregon regulated entities from the allocation exercise, along with the imputed tax benefit of tax depreciation on Oregon disallowed capital costs, if any, in the calculation of current taxes. Another possible way to minimize normalization issues is to add back all deferred taxes associated with PacifiCorp non-Oregon regulated utility operations and all other regulated entities in the affiliated group, as proposed in the Joint Comments, as well as the imputed tax benefit of tax depreciation on Oregon disallowed capital costs. With the proviso that it may not be a full cure for the normalization issues the apportionment method raises, PacifiCorp supports this approach.
- *Adjust for Symmetry by Adding Unregulated Deferred Taxes and the Imputed Tax Benefit of Charitable Contributions.* It is poor public policy to allocate to utility customers tax benefits from losses resulting from timing differences, especially when the asymmetry of SB 408 means that customers will never bear any tax liability when such losses reverse. It is also poor public policy to allocate tax benefits associated with charitable contributions to Oregon customers, because it creates a disincentive for such contributions. The addition of unregulated deferred taxes (a proposal CUB

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made earlier in this docket and one that now Avista also advocates), and the imputed tax benefit of all charitable contributions to taxes paid is necessary to avoid these problematic results.

Step 2: Apportion Taxes to Total Utility Regulated Operations.

- *Calculate Gross Plant, Wages & Salaries and Sales Factors for Affiliated Group and for Total Utility Using Federal and State Tax Returns, Workpapers and Supporting Schedules.* Property, payroll and sales can be derived and verified from data in the federal and state tax returns, workpapers and supporting schedules for gross owned and rented plant, wages and salaries and sales.
- *Derive and Apply Apportionment Percentage to Determine Total Utility Allocated Tax.* Compare property, payroll and sales of affiliated group and utility on an equally weighted basis to derive apportionment percentage. Apply this percentage to determine what portion of affiliated group taxes to allocate to utility on a total company basis.

Step 3: Apply Properly Attributed Floor

- *Calculate Floor Based on Total Utility Federal Stand-alone Tax Less Total Affiliate Group Losses.* This step limits losses potentially available for allocation to the utility to the sum of the tax effects of all losses in the affiliated group. The point of this floor is to prevent the double counting of losses that can otherwise occur under the apportionment method. Compare this floor to the amount derived from Step 2 and select the greater of the two amounts.

Step 4: Apportion Taxes to Oregon Utility Regulated Operations and Add Deferred Taxes.

- *Calculate Gross Plant, Wages & Salaries and Sales Factors for Oregon Regulated Operations From Results of Operations Report.* Property, payroll and sales allocated to Oregon for regulatory purposes can be derived and verified from data in the utility's Results of Operations Report for the time period corresponding with that of

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the tax return(s) used in Steps 1-3. The Joint Comments support use of factors that reflect property, payroll and sales allocated to Oregon for regulatory purposes.

- *Derive and Apply Apportionment Percentage to Determine Oregon Allocated Tax.* Compare property, payroll and sales of total utility regulated operations and Oregon regulated operations on an equally weighted basis to derive apportionment percentage. Apply this percentage to determine what portion of total utility taxes to allocate to Oregon regulated operations.
- *Add Deferred Taxes for Oregon Regulated Operations.* To further address normalization concerns, add deferred taxes for Oregon regulated operations, as required by ORS 757.268(13)(f)(C). The other add-backs required by ORS 757.268(13)(f), tax credits and charitable contributions, were covered in Step 1 of the calculation.

B. State Calculation

Step 1: Calculate the Adjusted State Unitary Tax.

- *Use Tax Return from Utility Unitary Group to Determine Taxes Paid.* As set forth in the Joint Comments, there is general consensus that the properly attributed calculation for state taxes paid should use the tax return of the unitary group of which the utility is a member and not look to other tax returns filed by members of the utility's federal consolidated group.
- *Use State Taxes Before Credits of Utility Unitary Group.* Similar to the federal approach, PacifiCorp proposes to use state taxes before credits. This approach precludes allocation of Business Energy Tax Credits to utility customers, a proposal supported by the same strong policy rationale as the proposal to eliminate PTCs from the federal tax calculation.

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- *Adjust for Symmetry by Adding Unregulated Deferred Taxes and the Imputed Tax Benefit of Charitable Contributions.* This is the same adjustment proposed for the federal tax calculation.
- *For a Multi-State Utility, Derive and Apply Adjusted Oregon Tax Rate.* PacifiCorp pays taxes at a higher rate in Oregon than the blended system rate reflected in its rates. Thus, Oregon customers are already receiving the benefit that other states do not have a state income tax and, all other things being equal, PacifiCorp would pay more in Oregon state income taxes than it collects in rates, which is the foundation of the law. However, as a part of its effort to make constructive and workable comments on implementation of the apportionment method, the Company has proposed to adjust the amount of Oregon income taxes paid by the unitary group by a ratio equal to the effective tax rate from the utility's last rate case divided by the Oregon statutory tax rate. Use of this "bumping" ratio is more straightforward than the alternative of deriving state taxes paid for a multi-state utility on a state-by-state basis, and the approach is supported by the Joint Comments.

<u>Step 2: Apportion State Taxes to Total Utility Regulated Operations</u>.

- *Calculate Gross Plant, Wages & Salaries and Sales Factors for Unitary Group and for Total Utility.* This step and the next follow the mechanics outlined for the federal calculation above.
- *Derive and Apply Apportionment Percentage to Determine Total Utility Allocated State Tax.*

<u>Step 3: Apply Properly Attributed Floor</u>

- *Calculate Floor Based on Total Utility Oregon Stand-alone Tax Less Total Unitary Group Losses.* Compare this floor to the amount derived from Step 2 and select the greater of the two amounts.

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<u>Step 4: Apportion Taxes to Oregon Utility Regulated Operations and Add Deferred Taxes</u>.

- *Calculate Gross Plant, Wages & Salaries and Sales Factors for Oregon Regulated Operations From Results of Operations Report.* These are the same factors used to allocate total utility federal taxes to Oregon.
- *Derive and Apply Apportionment Percentage to Determine Oregon Allocated State Tax.* This step follows the mechanics of the federal calculation outlined above.
- *Add Oregon Deferred Taxes for Oregon Regulated Operations.* Add Oregon deferred taxes for Oregon regulated operations, as required by ORS 757.268(13)(f)(C). The other add-backs required by ORS 757.268(13)(f), tax credits and charitable contributions, were covered in Step 1 of the calculation.

C. Local Calculation.

The only local income tax for Oregon utilities is the Multnomah County Business Income Tax (MCBIT). MCBIT is collected on a gross income basis. Based upon this fact and the fact that the amount of MCBIT taxes paid is relatively small, the Joint Comments contain a proposal to apportion MCBIT based upon gross income.

Under this approach, the utility would calculate the apportionment percentage based upon total unitary group Multnomah County gross income and the utility's Multnomah County gross income. This apportionment percentage would be applied to total MCBIT paid to determine the amount of local taxes paid properly attributed to the utility.

III. Technical Corrections to Proposed Rules

A. <u>Pre-tax Interest</u>. OAR 860-022-0041(2)(g) defines pre-tax income as net revenues before income taxes and interest expense, as determined by the Commission in a general rate proceeding. The exclusion of interest expense from pre-tax income was a simplifying assumption proposed on the basis that it was inconsequential. PacifiCorp has reviewed this issue more closely and concluded that the exclusion of interest expense from pre-tax income materially

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impacts the tax expense levels reflected in its utility operating income calculation. Therefore, PacifiCorp proposes to restore interest expense in the calculation of pre-tax income by deleting the words "and interest expense" from OAR 860-022-0041(2)(g).

B. Effective Tax Rate. Reflecting the language of SB 408, OAR 860-022-0041(2)(n)(A)(iii) indicates that the effective rate used to determine taxes collected in rates should be the rate as set forth in the most recent Commission proceeding establishing a tax rate. The rule then goes on to define the effective tax rate as the ratio of total income tax expense in revenue requirement to pre-tax income. This definition goes beyond the language of SB 408 and may be inconsistent with it by requiring the effective tax rate to be calculated in a specific manner, which may or may not be how the rate was actually set in the utility's last rate case. For these reasons, PacifiCorp submits that the effective tax rate definition should be deleted from OAR 860-022-0041(2)(n)(A)(iii).

C. Double Whammy. In its Opening Comments, PacifiCorp proposed to allow utilities to mitigate negative impacts of the mismatch in the SB 408 true-up (which compares actual taxes paid to an estimate of taxes collected) through a potential adjustment in the properly attributed calculation. The proposal would permit a utility to apply to add the tax effect of expenses between rate cases to the properly attributed amount up to the level set by the ORS 757.268(12) cap. In the Interim Order, the Commission acknowledged the legitimacy of the utility's concerns on this issue, but expressed a competing concern about interfering with the operation of the automatic adjustment clause (AAC). PacifiCorp submits that its proposal balances these concerns by allowing the Commission to compensate for the double whammy impact in the properly attributed calculation, but only to the extent of the "headroom" between the properly attributed calculation and the

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section 12 caps. In this way, the proposal cannot interfere with the operation of the AAC required by ORS 757.268(12). Given the relatively narrow scope of this proposal, PacifiCorp requests that the Commission reconsider its general rejection of proposals to address the double whammy and adopt this proposal.

D. Normalization. In addition to the steps in the apportionment method calculation designed to address normalization and the extension of the PLR submission date included in the Joint Comments, PacifiCorp proposes to add a sentence to OAR 860-022-0041(9)(f) that would allow utilities to adjust their compliance filings as necessary to minimize normalization risks.

E. ORS 756.040 Challenges. PacifiCorp requests restoration of rule language from earlier rule drafts proposed by Staff that set a 120-day timeline for resolution of claims that the AAC results in rates that violate the Commission's fair, just and reasonable standard. There was nothing in the Interim Order that stated or implied that a defined procedure for such a challenge was inappropriate. This process provides important procedural protections to underearning utilities like PacifiCorp. PacifiCorp requests that the following language be restored in OAR 860-022-0041(11):

> "Within 120 days following any such filing, the Commission will hold a hearing and make a determination of whether a rate adjustment under the automatic adjustment clause would result in the claimed violation. In the event of a filing under this section, the applicable rate adjustment will not be implemented until the Commission makes its determination. If the Commission decides against termination of the automatic adjustment clause, interest will accrue according to subsection 9(e) of this rule on the final amount of rate adjustment."

IV. Response to ICNU

ICNU's Opening Comments failed to recognize and constructively address the implementation challenges created by the Interim Order. First, ICNU's position that the Commission should define the sales factor more broadly than generally accepted in tax law

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(*i.e.*, by including dividend income in sales) undermines the Commission's stated intention that the apportionment method be straightforward to calculate and rely on information already developed for filing tax returns.

Second, ICNU proposes an overbroad approach to the interpretation of ORS 757.268(12)(a) which would allow it to argue for reductions to taxes paid to reflect the inclusion of interest deductions on parent debt. This is inconsistent with the Joint Comments, which propose that ORS 757.268(12)(a) be defined as the utility's stand-alone tax liability. The apportionment method allocates all tax attributes, including interest deductions, among members of the affiliated group. There is no legal or policy justification for a definition of section 12(a) that would allow additional allocation of the tax benefits of parent interest deductions.

Third, ICNU objects to the provisions in OAR 860-022-0041(11) which allow utilities to challenge the AAC if it produces rates that violate ORS 765.040. The Attorney General's opinion on SB 408 made clear that the automatic adjustment clause was limited by ORS 756.040. The provisions of Section 11 of the rule allow a procedure to guard against a violation of ORS 756.040. These provisions should not be eliminated as proposed by ICNU; on the contrary, they should be made more specific as suggested by PacifiCorp in Section III(E) above.

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V. Conclusion

For all of the reasons stated above, in PacifiCorp's Opening Comments and in the Joint Comments, PacifiCorp respectfully requests adoption of its positions and proposals on SB 408 implementation.

DATED: August 14, 2006.

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in Docket AR 499 on the following named person(s) on the date indicated below by email and first-class mail addressed to said person(s) at his or her last-known address(es) indicated below.

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DATED: August 14, 2006.

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Federal, State, and Local Apportionment Method Calculations

FEDERAL CALCULATION

Step 1

	Adjusted Federal Consolidated Tax
Federal Consolidated Tax Before Credits	3,500
Addback: Deferred Tax on Non-Oregon Regulated Entities	1,500
Addback: Deferred Tax on PacifiCorp Non-Oregon Regulated Operations	500
Addback: Deferred Tax on Non-Regulated Affiliated Entities	500
Addback: Imputed Tax Benefit of Charitable Contributions	2
Addback: Imputed Tax Benefit of Depreciation on Disallowed Capital Costs	3
Adjusted Federal Consolidated Tax Before Credits	**6,005**

Step 2

	PacifiCorp Total Regulated Operations	Consolidated Federal Taxpayer	Factor Gross	Factor Weighting	Net
Total Gross Owned and Rented Property	16,000	300,000	5.33%	X 0.3333	1.78%
Total Wages and Salaries	500	8,000	6.25%	X 0.3333	2.08%
Total Sales and Other Receipts	3,000	80,000	3.75%	X 0.3333	1.25%
Apportionment Percentage - Total PacifiCorp Regulated Operations					**5.11%**
Adjusted Federal Consolidated Tax Before Credits					6,005
Properly Attributed Current Federal Tax - Total PacifiCorp Regulated Operations					**307**

Step 3

	Properly Attributed Federal Tax Cap
Total PacifiCorp Regulated Operations Federal Standalone Tax Liability	250
Less: Imputed Negative Tax Liability from the Sum Total of All Loss Companies in the Federal Consolidated Group	(50)
Properly Attributed Federal Tax Cap for Total PacifiCorp Regulated Operations	**200**

Step 4

	PacifiCorp Oregon Regulated Operations	PacifiCorp Total Regulated Operations	Factor Gross	Factor Weighting	Net
Total Gross Owned and Rented Property	4,500	16,000	28.13%	X 0.3333	9.38%
Total Wages and Salaries	200	500	40.00%	X 0.3333	13.33%
Total Sales and Other Receipts	1,000	3,000	33.33%	X 0.3333	11.11%
Apportionment Percentage - PacifiCorp Oregon Regulated Operations					**33.82%**
Properly Attributed Current Federal Tax - Total PacifiCorp Regulated Operations***					307
Properly Attributed Federal Tax - PacifiCorp Oregon Regulated Operations					**104**
Federal Deferred Tax for Oregon Regulated Operations Only					100
Properly Attributed Federal Tax					**204**

*** Properly Attributed Current Federal Tax - Total PacifiCorp Regulated Operations for this calculation is the greater of the Properly Attributed Current Federal Tax - Total PacifiCorp Regulated Operations as calculated in Step 2, or the Properly Attributed Federal Tax Cap for Total PacifiCorp Regulated Operations as calculated in Step 3.

STATE CALCULATION

Step 1

	Adjusted Oregon Unitary Tax
State Effective Tax Rate Used in Setting Rates	4.84%
Oregon Statutory Tax Rate	6.60%
Adjusted Oregon Statutory Tax Rate	**73.33%**
Oregon Unitary Tax Before Credits	125
Adjusted Oregon Unitary Tax Before Credits	**92**

Step 2

	PacifiCorp Total Regulated Operations	Oregon Unitary Taxpayer	Factor Gross	Factor Weighting	Net
Total Gross Owned and Rented Property	16,000	50,000	32.00%	X 0.3333	10.67%
Total Wages and Salaries	500	1,500	33.33%	X 0.3333	11.11%
Total Sales and Other Receipts	3,000	9,000	33.33%	X 0.3333	11.11%
Apportionment Percentage - Total PacifiCorp Regulated Operations					**32.89%**
Adjusted Oregon Unitary Tax Before Credits					92
Properly Attributed Current State Tax					**30**

Step 3

	Properly Attributed State Tax Cap
Total PacifiCorp Regulated Operations Oregon Standalone Tax Liability	25
Less: Imputed Negative Tax Liability from the Sum Total of All Loss Companies in the Oregon Unitary Group	(5)
Properly Attributed State Tax Cap for Total PacifiCorp Regulated Operations	**20**

Step 4

	PacifiCorp Oregon Regulated Operations	PacifiCorp Total Regulated Operations	Factor Gross	Factor Weighting	Net
Total Gross Owned and Rented Property	4,500	16,000	28.13%	X 0.3333	9.38%
Total Wages and Salaries	200	500	40.00%	X 0.3333	13.33%
Total Sales and Other Receipts	1,000	3,000	33.33%	X 0.3333	11.11%
Oregon Apportionment Percentage					**33.82%**
Properly Attributed Current State Tax - Total PacifiCorp Regulated Operations***					30
Properly Attributed Current State Tax					**10**
Oregon Deferred Tax for Oregon Regulated Operations Only					25
Properly Attributed State Tax					**35**

*** Properly Attributed Current State Tax - Total PacifiCorp Regulated Operations for this calculation is the greater of the Properly Attributed Current State Tax - Total PacifiCorp Regulated Operations as calculated in Step 2, or the Properly Attributed State Tax Cap for Total PacifiCorp Regulated Operations as calculated in Step 3.

LOCAL CALCULATION

	Properly Attributed Local Tax
Multnomah County Gross Income - PacifiCorp Regulated Operations	110
Total Multnomah County Business Gross Income	125
Multnomah County Apportionment Percentage	**88.00%**
Total Multnomah County Business Income Tax	10
Properly Attributed Local Tax	**9**

TOTAL

Total Properly Attributed Federal Tax	204
Total Properly Attributed State Tax	35
Total Properly Attributed Federal and State Taxes Paid	**239**
Properly Attributed Local Taxes Paid	**9**

Exhibit A