BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

AR 499

In the Matter of the Adoption of Permanent Rules to Implement SB 408, Relating to Utility Taxes	STAFF'S RESPONSE COMMENTS

Comments on Determining "Properly Attributed"

In Opening Comments, ICNU and NWIGU recommended six principles that should guide the rules implementing SB 408. Staff first addresses principles 2 and 3:

2. Tax benefits supported by utility revenues belong to ratepayers;

3. In determining the utility income tax expense to be borne by customers, the OPUC must allocate to the Oregon utility some portion of the tax losses of unregulated businesses within the consolidated tax group;

ICNU and NWIGU use the second principle to support the position that the 3(12)(a) cap should reflect tax benefits related to interest deductions and tax credits outside the regulated operations of the utility. The third principle supports their proposal to allocate losses of individual affiliates among the utility and other members of the subgroup with positive taxable income.

We believe that both these principles are overly broad. A more reasonable principle is a matching of the benefits and burdens. A test in this regard is to ascertain whether there is a burden on utility customers related to the tax items that produce the tax benefits or tax losses. For example, simply because a utility sends dividends to a parent company, and the parent company in turn has debt expense, does not mean there is a burden on utility customers. If the utility has been ring-fenced such that the utility is neither responsible for the debt nor at risk in the event of default, and the ring fencing is sufficient to protect the financial integrity of the utility, customers should not receive the tax benefits of that debt. On the other hand, if there is a factual showing that customers

are affected in some manner by the parent's debt (e.g., through higher cost of capital), the Commission should consider an adjustment in a general rate proceeding to hold customers harmless. Based on this benefits and burdens matching principle, the tax benefits from losses of affiliates should not flow to utility customers, unless the Commission has established that customers bear a burden related to the costs of those affiliates.

The fourth principle proposed by ICNU and NWIGU is that "Ratepayers are not first in line to pay the consolidated income tax, and should pay only their proportionate share of each dollar of the consolidated income tax." That is, the utility and all affiliates with a positive taxable income should be allocated proportionate shares of the total amount of taxes paid to units of government. Staff's comments at 2-3 indicated that although an argument can be made that this method is equitable, stronger regulatory policy reasons support an attribution approach that starts with the tax liability from the utility's regulated operations. The DOJ Opinion at 12-17 concluded that the law does not require an attribution of taxes paid that uses a proportionate share approach. Given that opinion, staff questions why customers should receive any share of the tax benefits from affiliate losses, except when the consolidated group's tax liability is lower than the utility's liability, or the utility's positive taxable income otherwise enables affiliate losses or other tax savings to be recognized. The 3(12)(b) cap requires the former exception, and PacifiCorp's "with and without" approach for properly attributed should capture the latter.

CUB's proposal for determining the properly attributed amount would allocate interest-related tax deductions in the utility's chain of ownership, based on a proportionate share of positive taxable income (adjusted for the effect of accelerated depreciation) of the utility and other affiliates. It would also allocate the benefits from the negative tax liability of affiliates, but only if the utility's earnings were above its authorized ROE. The purpose of this test is to "reduce the impact of the feedback loop

on an under-earning utility, as well as to reduce the frequency and magnitude of non-utility affiliate tax loss attributions to the regulated utility." Staff recognizes CUB's attempt to craft a compromise proposal, but we believe the earnings test creates an artificial threshold for allocating tax benefits from affiliate losses. In our view, it is either appropriate to mechanically—that is, without a case by case assessment of benefits and burdens—pass through those tax benefits to utility customers or it isn't; that shouldn't be determined by an earnings review.

Staff supports PacifiCorp's "with and without" approach along with other adjustments as needed to reflect Commission ratemaking decisions on income taxes. However, we acknowledge that reviewing the "pro forma" tax return (without the utility) will require a significant degree of verification and judgment. In addition, we disagree with the company's statement that "There is no question that an interpretation of properly attributed that adopts a selective or proportional loss allocation approach beyond that actually required by SB 408 will result in the immediate deterioration of the credit ratings of any Oregon utility in a large consolidated group." It is not a certainty that another approach for properly attributed would result in a ratings downgrade, particularly if the Commission adopts a process that would prevent an SB 408 rate adjustment if it were found to violate ORS 756.040.

While staff appreciates the hard work and creative thinking the participants in AR 499 have done over the past several months, none of the straw proposals for properly attributed can bridge the gap between two mutually exclusive principles from which it appears the Commission must choose:

> (a) A factual benefits and burdens test; or
>
> (b) A principle that a share of tax savings related to debt and losses outside the utility should flow automatically to utility customers.

Staff does not see a middle ground between these two options. Either customers receive those benefits through a perfunctory allocation in the properly attributed

calculation, or, in staff's opinion, they should receive such benefits when the Commission has found that customers bear the associated burden.

Comments on Other Issues

Each of the utilities proposes an earnings test whereby SB 408 refunds or surcharges would be made only to the extent the utility earns its authorized rate of return. PGE states that the end result of the rates must be fair and reasonable, and any rate adjustment under the automatic adjustment clause would move the utility's actual return farther away from its required return. (PGE Comments at 8-9, 16-18) Staff believes that by making an adjustment to income taxes as required by SB 408, the Commission is not determining the utility's overall revenue requirement and return, any more than it does in passing through changes in purchased gas costs or electric power costs. (Staff Comments at 5-6) While staff agrees with PGE that nothing in SB 408 prohibits the Commission from using an earnings test, ORS 756.040 would not necessarily be violated if the rules do not require one.

The fact that staff opposes adding a provision for an earnings test to the Commission's rules does not mean that staff also opposes some type of case by case earnings review to ensure the Commission is setting rates that are consistent with ORS 756.040. Staff is simply opposed to a formulaic approach to measure compliance with the statute. If a utility believes its rates are confiscatory because of an SB 408 adjustment, it can present a case to the Commission to show that its revenues, as a result of the SB 408 automatic adjustment clause, do not allow it a reasonable opportunity to cover prudent expenses and to earn a fair return on rate base. If the utility convinces the Commission that its rates are too low, the Commission can raise them.

Staff also has addressed PGE's proposal to use actual costs for calculating the ratios to use in determining "taxes collected." (PGE Comments at 10-15; Staff Comments at 7-8) Whether using actual data would provide results that are fairer or is

sound regulatory policy is irrelevant. We do not believe the Commission has that discretion under section 3(13)(e).

In the same manner, PGE's proposal to defer the tax benefits associated with investments and expenses that have been disallowed or otherwise not included in customer rates, for later recovery from customers, may represent proper regulatory policy. (PGE Comments at 19-20) But staff does not recommend the Commission make adjustments beyond those the legislature expressly designated in section 3(13)(f) of the law. (Staff comments at 6-7) Instead, this matching of benefits and burdens should be a change for the legislature to consider.

DATED this 19th day of May 2006.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that on May 19, 2006, I served the foregoing upon the parties in this proceeding hereto by electronic mail and sending a true, exact and full copy by regular mail, postage prepaid or by shuttle mail/hand deliver to the parties accepting paper service.

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