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August 14, 2006

Sent Via email and U.S. Mail

Oregon Public Utility Commission
Attn: Filing Center
550 Capitol St. NE, #215
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Re: **DOCKET AR 499: Avista Corporation's Response Comments on Interim Order**

Enclosed please find Avista Corporation's Response Comments on Interim Order No. 06-400 entered July 14, 2006 in the above-referenced docket.

Please direct any questions to Ron McKenzie at (509) 495-4320.

Sincerely,

Kelly Norwood
Vice President State and Federal Regulation

Enclosure

C: AR 499 Service List

SUBMITTED: August 14, 2006

BEFORE THE PUBLIC UITLITY COMMISSION
OF OREGON

In the Matter of the Adoption of Permanent Rules implementing SB 408 Relating to Utility Taxes	)))	AR 499

AVISTA CORPORATION'S RESPONSE COMMENTS
ON INTERIM ORDER NO. 06-400 ENTERED JULY 14, 2006

On July 14, 2006 the Commission issued an Interim Order addressing proposed rules on "properly attributed" and issued preliminary decisions on related issues. Parties submitted opening comments on the Interim Order on July 31, 2006. An additional workshop was held on August 8, 2006. Avista now submits its response comments addressing issues raised in the opening comments and discussed at the last workshop. Avista's response comments follow the agenda outline presented at the last workshop.

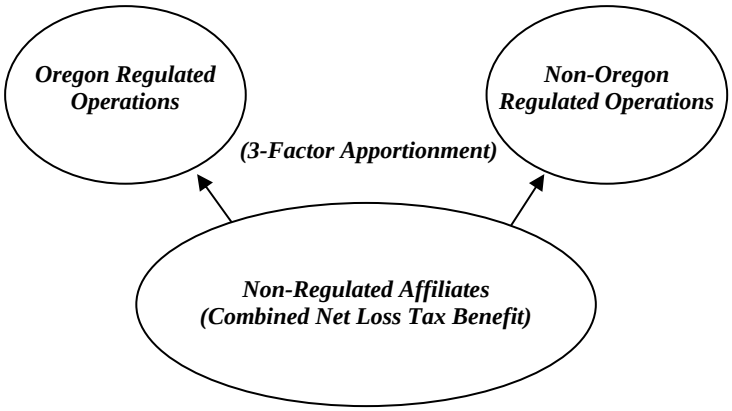
I. NORMALIZATION

The July 25, 2006 version of the draft rules determine the amount of federal income taxes properly attributed to Oregon regulated operations by multiplying the total amount of federal income taxes paid by the taxpayer times the three-factor apportionment ratio of property, payroll, and sales. The properly attributed amount is then compared to the total amount of taxes paid and to the Oregon stand-alone amount. The lesser of these three values is then adjusted for charitable contributions, tax credits and deferred taxes and the result is compared to taxes collected to determine if a SB 408 rate adjustment is required. It is expected that the properly attributed amount using the apportionment methodology will always be less than the total taxes paid amount, since the properly attributed amount is an allocated portion of the total taxes paid amount.

If the Oregon stand-alone amount is the "lesser of " amount of federal income taxes paid, then the amount gets adjusted for Oregon deferred taxes and there would not be a normalization violation. If the properly attributed amount is the "lesser of " amount of federal income taxes paid, a normalization violation would occur since the sum of the tax benefits related to accelerated tax depreciation from Oregon regulated operations and from non-Oregon regulated operations is apportioned to Oregon. Oregon would receive a portion of its own and a portion of non-Oregon tax benefits related to accelerated tax depreciation. The adjustment for Oregon deferred taxes would not properly match the tax benefits related to the accelerated tax depreciation apportioned to Oregon. Hence, in Avista's case Oregon ratepayers would receive a portion of accelerated tax depreciation tax benefits from other regulated jurisdictions not offset by a like amount of deferred taxes, and a normalization violation would occur.

Avista has two proposals to avoid the normalization problem.

A. Preferred Proposal. Avista recommends adoption of the preferred proposal, but has provided the alternative proposal which was also discussed at the August 8th workshop, and seemed to have some level of support among the parties at the workshop. The preferred proposal avoids a normalization violation by not apportioning federal income taxes associated with regulated operations among the regulatory jurisdictions in which the utility operates. Oregon and non-Oregon regulated operations would be treated as separate entities. The separate regulated entities would then receive an apportionment of any reduction in federal taxes paid due to a net loss of the combined group of non-regulated affiliates. No apportionment from non-regulated to regulated would occur if the combined group of non-regulated affiliates has positive taxable income. The diagram below illustrates this proposal:



The three-factor apportionment ratio of property, payroll, and sales would be used to apportion the federal income tax benefit of the combined net loss from non-regulated affiliates to regulated operations in Oregon. Non-Oregon regulated operations would also receive an apportioned share of the federal income tax benefit of the combined net loss from non-regulated affiliates. The properly attributed amount of federal income taxes for Oregon regulated operations would be the Oregon stand-alone amount reduced by the amount of tax benefit from the combined net loss of non-regulated affiliates apportioned to Oregon regulated operations. Avista believes that this proposal would actually provide greater benefits to customers than what was intended by Senate Bill 408.[1] If taxes paid have been reduced by a net non-regulated affiliate loss, then Oregon and non-Oregon regulated operations receive their apportioned share of the tax effect of such loss. This approach avoids a normalization violation and treats regulated operations in all jurisdictions the same.

Under this proposal, paragraph (3)(a) of the rules would read as follows:

> (a) The amount of federal income taxes paid to units of government that is properly attributed to the regulated operations of a utility is the stand-alone amount for the utility reduced by the product of the following two figures:

[1] Senate Bill 408 specifies that the only time that Oregon utility customers would pay less taxes than the amount determined based on the "income generated by the regulated operations of the utility," is if the total taxes paid by the affiliated group is a lower number. The language of Senate Bill 408 includes no provision for an apportionment, sharing, or allocation of tax benefits.

(A) The total amount of federal income tax benefit from the combined net loss of non-regulated affiliates, if any; and

(B) The average of the ratios calculated for the utility's property, payroll and sales, as defined in ORS 314.650 through 314.675, using amounts for regulated operations of the utility in Oregon in the numerator and amounts for regulated operations in all jurisdictions in the denominator.

B. Alternative Proposal. An alternative proposal to avoid the normalization problem is to start with the consolidated federal income tax liability amount before tax credits, then add back the tax effect of charitable contributions for the taxpayer and make an adjustment for all deferred taxes. The three-factor apportionment ratio of property, payroll, and sales would be used to apportion the resulting consolidated amount of federal income tax to determine the amount properly attributed to regulated operations in Oregon. If this properly attributed amount is the "lesser of" amount when compared to the total amount of taxes paid by the taxpayer and to the Oregon stand-alone amount, then the adjustments for charitable contributions, tax credits and deferred taxes in paragraph (2)(o) of the proposed rule would not be made, since these adjustments were made upfront before the apportionment occurred. This approach also avoids a normalization violation and treats regulated operations in all jurisdictions the same. Avista believes this alternative proposal also would provide greater benefits to Oregon customers than what was intended by Senate Bill 408, for the reasons that were explained earlier.

Under this proposal, paragraph (3)(a) of the rules would read as follows:

(a) The amount of federal income taxes paid to units of government that is properly attributed to the regulated operations of a utility is the product of the following two figures:

(A) The total amount of federal income taxes paid by the taxpayer before tax credits and adjusted for all charitable contributions and all deferred taxes; and

(B) The average of the ratios calculated for the utility's property, payroll and sales, as defined in ORS 314.650 through 314.675, using amounts for regulated operations of the utility in Oregon in the numerator and amounts for the taxpayer in the denominator.

Avista does not believe that the rules should be ambiguous about avoiding a normalization violation. A specific methodology needs to be set forth that avoids a violation. Avista has suggested two methodologies that solve the normalization problem.

With respect to obtaining a Private Letter Ruling (PLR) from the Internal Revenue Service (IRS) regarding normalization, Avista does not object to circulating its draft to other parties prior to it submission to the IRS. Avista believes, however, that the deadline for submitting the PLR should be extended until December 31, 2006, in order to allow for the submission of the 2005 tax reports on October 15, 2006, and additional process associated with the review of the draft PLR's.

II. SITUS (AND ALTERNATIVES)

The majority of the parties agree that the situs basis of determining the allocation factors for apportionment percentages is not appropriate. An example was given at the workshop that demonstrated that a tax refund would result simply because a production facility serving Oregon customers was located in another state. A concern was raised that the situs basis method of determining the apportionment factors could affect decisions regarding where future facilities are built. The appropriate numbers to use are the plant, payroll and sales that are used for ratemaking purposes in determining the apportionment factors, and Avista is supportive of this method.

III. STATE AND LOCAL TAXES

Local income tax is not an issue for Avista, as it does not operate in Multnomah County. Avista does, however, have a concern about Oregon state income tax. A three-factor (property, payroll, and sales with a double weighting of sales) is used to compute the portion of federal taxable income for the unitary group that is considered taxable income in Oregon for state

income tax. An Oregon utility can have positive taxable income for Oregon state income tax with the associated positive taxes paid, but have more or less income on a stand-alone basis. The Oregon stand-alone amount of taxable income may, in fact, be zero, or even a loss due to accelerated tax depreciation and purchased gas costs that are expensed for tax purposes and deferred for accounting and ratemaking. While the proposed rules call for adjustments for deferred taxes, in Avista's case there are no deferred state income taxes for regulatory purposes. Hence, Avista will pay Oregon state income tax related to its Oregon gas operations that may have to be refunded to customers due to a fictitious stand-alone tax calculation that has nothing to do with how state income tax payments are determined in the state of Oregon.

The solution to the problem is to define the properly attributed amount as also being the stand-alone amount, and not do a "lesser of" calculation for Oregon state income tax. The taxes paid amount reflects what is actually paid. The taxes paid amount is apportioned between regulated and non-regulated using the 3-factor apportionment pursuant to paragraph (3)(b) of the proposed rule. The resultant amount of Oregon state income tax paid attributable to Oregon regulated operations should be considered as both the properly attributed amount and the stand-alone amount.

IV. DOUBLE COUNTING OF LOSSES

The double counting of losses issue has to do with affiliates with a loss receiving a positive amount of taxes paid apportioned to them under the apportionment method of the proposed rule. The result is that more than 100% of the loss amount is allocated to the remaining gain entities, including Oregon regulated operations. Avista's preferred proposal for determining the properly attributed amount of taxes paid solves this problem. Under Avista's preferred proposal, explained under the "NORMALIZATION" section of these comments, loss affiliates

receive no apportionment of taxes paid. If there is a net loss for the combined group of affiliates, the tax effect of the net loss is apportioned to the regulated Oregon and regulated non-Oregon utility operations. If Avista's approach is not adopted, Avista is supportive of capping the amount of federal income tax benefit from a loss as has been explained by Northwest Natural. One issue where most, if not all, of the parties agree is that there should be no apportionment made in determining properly attributed taxes paid if all of the entities in the consolidated group have positive tax liabilities. Avista concurs.

V. CALCULATION OF 3(12)(a) CAP

This issue has to do with the "with and without" amount being defined as the stand-alone amount of taxes paid for Oregon regulated utility operations. PacifiCorp has explained that the "with and without" amount could be larger or smaller than the stand-alone amount. Avista's opening comments explained that if there is any "with and without" benefit, it should not be given to just the Oregon jurisdiction; rather, it should be shared among all regulatory jurisdictions in which the utility operates. To do otherwise gives a preferential treatment to the Oregon jurisdiction. Avista is supportive of eliminating the "with and without" calculation and allow stand-alone to be calculated based on the revenues and expenses of the regulated operations.

VI. JOINT COMMENTS

In reviewing the draft Joint Comments that are to be filed, Avista does not concur with Item 1 which provides that an adjustment be made for deferred federal income tax for just non-Oregon regulated entities prior to applying the apportionment factor. The adjustment should include deferred federal income taxes for all entities, including regulated Oregon operations, regulated non-Oregon operations and non-regulated affiliates. To exclude Oregon regulated

operations from the upfront deferred tax adjustment will create a mismatch. Only a portion of Oregon regulated accelerated tax benefits will be apportioned to Oregon regulated operations. The deferred tax adjustment for Oregon regulated operations, which is a 100% Oregon regulated amount, won't match the apportioned amount of Oregon regulated accelerated tax benefits. The exclusion of deferred taxes of non-regulated affiliates from the upfront adjustment results in a one-way taking of tax benefits due to the "lesser of" provisions of the proposed rules.

Avista concurs with Item 2 regarding the use of three-factor ratios based on amounts used for setting rates rather than situs amounts.

Avista is not certain that Item 3 concerning state income tax covers Avista's situation. While the explanation to Item 3(A)(4) says that the Commission has determined that 100 percent of Oregon taxes should be allocated by rule to Oregon, a portion of the determination of Oregon state income tax paid is due to Avista owning Coyote Springs 2, a natural gas fired, electric generating plant in Oregon. Avista believes that the regulated portion of the properly attributed taxes paid amount should be defined as also being the stand-alone amount, and that no "lesser of" comparison be made. The amount that is actually paid to the Oregon Department of Revenue is based on an apportioned amount of the taxable income of the unitary group. A stand-alone calculation is entirely fictitious and has no bearing on what is paid. The stand-alone amount could be zero or negative, and in Avista's case, there are no deferred state income taxes for regulatory purposes to add back to the stand-alone amount.

Item 4 deals with Multnomah County Business Income Tax. Avista does not operate in Multnomah County and does not pay this tax. Item 5 addresses a floor for the properly attributed amount. Avista concurs with the floor calculation for federal income tax, but believes the floor is unworkable for state income tax due to the methodology employed by the Department of

Revenue in determining the amount of taxable income for state income tax. Avista concurs with Item 6 defining the stand-alone basis for determining the cap. Avista also concurs with a filing date of December 31, 2006 for filing a Private Letter Ruling with the Internal Revenue Service as set forth in Item 7.

RESPECTFULLY SUBMITTED this 14th day August, 2006.

AVISTA CORPORATION

By: Kelly Norwood

Kelly Norwood
Vice President, State and Federal Regulation

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served Avista Corporation's Response Comments on Interim Order in Docket AR 499, upon the parties listed below by sending a copy via electronic mail and U.S. Mail.

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I declare under penalty of perjury that the foregoing is true and correct.
Dated at Spokane, Washington this 14th. day of August 2006.

Patty Olsness