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May 1, 2006

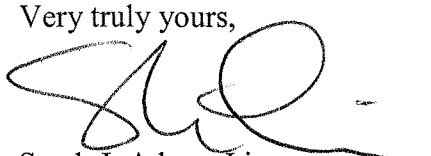
VIA ELECTRONIC FILING

PUC Filing Center
Public Utility Commission of Oregon
PO Box 2148
Salem, OR 97308-2148

Re: In the Matter of PACIFIC POWER & LIGHT (d/b/a PacifiCorp) Reconsideration of Order No. 05-1050
Docket UE 170 (RECON)

Enclosed for filing is an original and 6 copies of PacifiCorp's Post-Hearing Opening Brief in the above-referenced matter. A copy of this filing was served on all parties to this proceeding as indicated on the attached certificate of service.

Very truly yours,



Sarah J. Adams Lien

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cc: Service List

BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UE 170 (RECON)

In the Matter of

PACIFIC POWER & LIGHT
(d/b/a PacifiCorp)

Reconsideration of Order No. 05-1050.

PACIFICORP'S POST-HEARING OPENING BRIEF

I. INTRODUCTION

In Order No. 05-150 (the "Rate Order"), the Commission's selective attribution of PacifiCorp Holdings, Inc.'s ("PHI") interest-related tax deduction to reduce PacifiCorp's tax expense was inconsistent with the Commission's existing rules and standards, was not authorized by Senate Bill 408 ("SB 408"), and is not supported by the facts. For all of these reasons, the Commission should vacate the adjustment and permit PacifiCorp to recoup its lost revenues associated with this adjustment back to October 28, 2005, the date of the deferred accounting application in this case. Barring this, the Commission should reduce the adjustment to $660,000 based on necessary corrections and updates to its calculations, and should permit PacifiCorp to recover the difference between the original adjustment and the modified adjustment since October 28, 2005.

Administrative Law Judge Kathryn Logan has directed the parties to address the reconsideration and rehearing issues in the following order:

1. Was the Commission required to apply or prohibited from applying SB 408 to this docket?
2. Assume that the Commission could apply SB 408 or "its principles" to this docket. How should SB 408 or "its principles" be applied?
3. Did the $16.07 million tax adjustment result in rates violative of ORS 756.040?

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4. What is the appropriate remedy if the Commission should determine to modify the revenue requirement from the original order?

II. ARGUMENT

A. Was the Commission Required to or Prohibited from Applying SB 408 in This Docket?

1. The Commission Erred in Applying SB 408 in This Case.

Prior to the Rate Order, the Commission's historical practice has been to calculate utility taxes for ratemaking purposes based on a stand-alone methodology. *See* Rate Order at 13, 17-18 (acknowledging that past precedent had "always" been to calculate the tax expense on a stand-alone basis). In the Rate Order, the Commission abruptly departed from both its precedent and administrative rules,[1] stating that "[t]he legislative intent behind SB 408 is clear—we are to depart from historic practice and consider taxes paid by a utility or its parent when setting rates." Rate Order at 18.

Contrary to this ruling, SB 408 does not and should not apply to this case because: (1) SB 408 does not require or authorize an immediate change to calculation of taxes in rates,

[1] *See* OAR 860-027-0048(3)(g) and (4)(h), which require tax expenses "for both ratemaking purposes and regulatory reporting" to be calculated on a "standalone basis." In the Rate Order, the Commission summarily dismissed PacifiCorp's argument that the Stand-Alone Rule expressly requires a stand-alone approach to tax expense in ratemaking, stating that the Stand-Alone Rule is "an accounting rule, which requires an energy utility to keep its books of account on a stand-alone basis," and as such has no effect on how a utility calculates its taxes for ratemaking purposes. Rate Order at 18. The Commission's interpretation of its rule ignores the general rules of statutory construction, which maintain that courts should construe a provision according to its plain meaning and give effect to all language in a provision if possible. *See* ORS 174.010. The Stand-Alone Rule expressly requires utility tax expense to be calculated for "ratemaking purposes" on a stand-alone basis. There is no support in the rule for the Commission's position that "for ratemaking purposes" in this context actually means "for accounting purposes." Indeed, the Commission's orders routinely distinguish between the two functions, permitting a utility to treat a cost in one manner for accounting purposes while reserving the Commission's authority to address the matter differently for "ratemaking purposes." Additionally, the express purpose of the rule—to prevent cross-subsidization between regulated and unregulated functions—cannot be realized if the rule is construed only to apply to a utility's accounting, not to its rates. *Re Affiliated Transactions for Energy Utils.*, Order No. 03-691 (AR 459), 2003 WL 23305011 at *1 (OPUC Dec. 1, 2003).

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but rather only authorizes a true-up mechanism; (2) SB 408 applies only to taxes after 2006, and here the Commission applied it to a case with a rate effective date in 2005; (3) the Commission has not yet adopted standards and rules for SB 408, and thus its application in this case is premature; and (4) in order to apply SB 408 in this case, the Commission has to forecast tax expense under SB 408, which it cannot or should not do.

2. SB 408 Does Not Require or Authorize an Immediate Change to Calculation of Taxes in Base Rates, but Only Authorizes a True-up Mechanism.

The Commission's conclusion that SB 408 required it to immediately change its approach to calculating taxes in base rates is not supported by the language of SB 408. The Commission based its conclusion on the addition of the word "fair" to the "just and reasonable" standard in ORS 757.210(1)(a). Relying on section 2(1)(f) in SB 408's preamble, providing that taxes in rates should reflect taxes paid to be considered "fair, just and reasonable," the Commission concluded that SB 408's change to ORS 757.210 required immediate adoption of a new, undefined actual-taxes-paid standard in rate cases.

The Commission's interpretation of SB 408 was incorrect. First, as the Commission acknowledges in the Rate Order, the addition of the word "fair" to the pre-existing "just and reasonable" standard did nothing other than exactly conform the language of ORS 757.210 to the Commission's pre-existing rate standard. Rate Order at 17 ("[W]e have always been required to establish fair and reasonable rates."); *see also In re PacifiCorp*, Order No. 05-1202 at 2-3 (citing numerous orders and statutes (before and after the passage of SB 408) that require the Commission to set rates that are "fair, just and reasonable"; observing that the "fair, just and reasonable standard" is "commonly referred to as the 'just and reasonable standard,'" such that the express inclusion or omission of the word "fair" is insignificant).

Second, the Commission incorrectly relied on section 2(1)(f) of SB 408's preamble as the basis for its conclusion that SB 408 mandated an immediate change to the calculation of taxes in base rates. *See* Rate Order at 17 ("In interpreting this language [section 2(1)(f)], we

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believe we are required to consider taxes paid to governmental units when setting rates for PacifiCorp in this docket."). A legislative finding in a preamble cannot create rights or obligations not otherwise found in the statute. *Sunshine Dairy v. Peterson*, 183 Or 305, 193 P2d 543 (1948).

Third, the Commission improperly focused on only one section of the preamble, instead of reading the findings as a whole. ORS 174.010; *Curly's Dairy, Inc. v. State Dept. of Agriculture*, 244 Or 15, 21, 415 P2d 740 (1966) (improper to read one statement in findings in vacuum, without guidance of statute as whole). The Commission disregarded the legislative findings, which expressly acknowledge the current ratemaking practice of setting the tax expense in rates on a stand-alone basis—without in any way suggesting that this practice be discontinued—and the fact that ratemaking process can result in taxes being collected in rates that are not paid. *See* SB 408 § 2(1)(c), (e) ("The Public Utility Commission permits a utility to include costs for taxes that assume the utility is not part of an affiliated group of corporations for tax purposes"; "[T]he ratemaking process may result in collecting taxes from ratepayers that are not paid to units of government."). When the sections of the preamble are read together as required, it is clear that they simply provide the justification for the automatic adjustment clause contained in SB 408, rather than impliedly mandating an immediate change in the calculation of tax expense in base rates.

Fourth, the legislative history of SB 408 (which had not been compiled at the time of the Rate Order) contains no support for the Rate Order's finding that the inclusion of the word "fair" in ORS 757.210 required an immediate change in the Commission's standard for calculation of tax expense in base rates. Indeed, the legislative history demonstrates the exact opposite. Representative Brian Boquist carried SB 408 on the House floor and unequivocally stated that the bill did "not change the original ratemaking process." Statement of Rep. Brian Boquist, House of Representatives Chamber Session, July 30, 2005.

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The proponents of SB 408 campaigned for its passage on the basis that it adopted only an automatic adjustment clause and did not change utility ratemaking or tax policy:

> "[T]here have been serious misrepresentations about SB 408-C. Yet the effect of the bill is very straightforward: utilities will have to report how much they have collected in taxes and they will have to report how much they paid in taxes. If there's a difference between the two amounts of more than $100,000, there will have to be a true up. That's it. Nothing in utility ratemaking is changed. Nothing in tax policy is changed.
>
> "* * * * *
>
> "The bill could have fundamentally changed tax policy or ratemaking. The bill could have done many things that could be labeled extreme. But SB 408-C is very moderate in its approach * * *"

Statement of CUB/ICNU regarding SB 408, Exhibit PPL/1704.

The legislative history of SB 408 also reveals the real reason for the addition of the word "fair" to ORS 757.210: to ensure that SB 408 was read in conjunction with ORS 756.040, which protects utilities against rate reductions that violate the *Hope* standard. *See* Statement of Deputy Attorney General Peter Shepherd, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("[The] PUC cannot allow the adjustment if it would result in a rate which is not fair, just and reasonable, as the terms of the total rate. So, that there would be an upward limitation, as well as a downward limitation."); s*ee also* Statement of Rep. Tom Butler, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("fair, just and reasonable" language "attempts to make [the adjustment] both symmetrical, as well as nonconfiscatory and in that regard completely constitutional"); Statement of Rep. Tom Butler, House Chamber Session, July 30, 2005 ("The bill's current proponents contend that the trigger to stop the downward spiral was that the rates must be fair, just and equitable—fair, just and reasonable."); Statement of Rep. Robert Ackerman, House Chamber Session, July 30, 2005 ("I conclude that the 'fair,

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just and reasonable' standard and the limited use of the automatic adjustment clause satisfies constitutional requirements. Now that is from our Legislative Council."); Written testimony of Deputy Attorney General Peter Shepherd, SB 408 Work Session, House State and Federal Affairs Committee, June 30, 2005 (describing "fair, just and reasonable" language as providing protection against *Hope* violation). The Attorney General's opinion has confirmed the applicability of ORS 756.040 to SB 408, consistent with this legislative history. Op Atty Gen at 16 (Dec. 17, 2005).

Fifth, the Commission's construction of SB 408 undermines SB 408's express directives, which allow tax adjustments through an automatic adjustment clause, subject to various safeguards and limitations. Automatic adjustment clause rate changes under section 3 of SB 408 are not applicable to small energy utilities or water utilities, require adjustments to the computation of "taxes" and "taxes paid" to retain certain tax incentives for investors, and provide a safety net against normalization violations and material adverse impacts. The fact that these safeguards and limitations expressly apply only to an automatic adjustment clause rate change under section 3 of the bill, and not to a change to base rates under section 5, is additional evidence that the legislature never contemplated that the Commission would make base rate changes under section 5.

3. SB 408 Only Applies to Taxes After 2006, and in This Case, the Commission Applied It to a Case with a Rate Effective Date in 2005.

By its terms, SB 408's automatic adjustment clause applies only to taxes collected in rates and taxes paid after January 1, 2006. *See* SB 408 § 4(2). Information on 2006 taxes collected and paid will not be available until 2007. For this reason, parties to the SB 408 rulemaking, AR 499, all agreed that the SB 408 tax reports filed in 2005 and 2006—which contain pre-2006 data—"are for the sole purpose of determining whether there is a trigger for the automatic adjustment clause, not to support a rate change." *See* ICNU Exh. 600, Department of Justice letter to AR 499 participants (Oct. 7, 2005). The result of this

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consensus interpretation is that the automatic adjustment clauses mandated by SB 408 will not result in rate changes until after the 2007 tax report, more than two years after the date of the Rate Order. The two-year-plus lag between the rate adjustment in this case and the commencement of rate adjustments under SB 408's automatic adjustment clause confirms the premature and unjustified application of SB 408 in this case.

Because the Rate Order adjusted pre-2006 rates based on pre-2006 data, the Rate Order violates section 4(2) of SB 408. Intervenors may argue that section 4 technically applies only to an automatic adjustment clause rate change under section 3 of SB 408 and is inapplicable to a general rate change allegedly authorized under section 5. Such an argument has broad potential implications, however, because it suggests that none of the other express limitations of SB 408 would apply to a general rate change under section 5, including protection against normalization violations and inapplicability to water utilities and small energy utilities. Even if the Commission accepts this argument and concludes that it has essentially limitless authority under section 5 of SB 408 to apply an actual-taxes standard to any utility at any time in any manner, it should defer to the clear statement of legislative policy embedded in section 4 that rate changes under SB 408 not occur until after 2006 tax data becomes available.

4. The Commission Cannot Apply SB 408 or Its Principles in General Rate Cases Until It Adopts Application Standards.

The Commission's application of SB 408 in this case was unlawful because it predated the adoption of standards and rules for SB 408's application. SB 408 is not a self-implementing piece of legislation, as has been made clear by the complexity and length of the AR 499 rulemaking process, now moving into its ninth month. This fact was also an express finding of the Attorney General's opinion on SB 408, in its conclusion that the term "properly attributed" is a delegative term. *See* Op Atty Gen at 8 (Dec. 17, 2005). A delegative term is an incomplete expression of legislative policy that the agency is authorized

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to complete. *Id.* at 4. The Commission has not yet defined "properly attributed." Without this definition, the proper scope of attribution to a utility of tax benefits from unregulated entities in the utility's consolidated group under SB 408—the precise issue in this case—remains unknown.

Until the Commission adopts SB 408 application standards, it cannot apply SB 408 or its principles in a general rate case. *Trebesch v. Employment Division*, 300 Or 264, 270, 710 P2d 136 (1985) (prior rulemaking required before policymaking term in statute is applied in a contested case hearing); *Megdal v. Board of Dental Examiners*, 288 Or 293, 304-16, 605 P2d 273 (1980) (implied legislative intent that terms delegating policymaking discretion be explained by rule, not by contested case hearing); *Sun Ray Drive-In Dairy, Inc. v. Or. Liquor Contr. Comm'n*, 16 Or App 63, 70, 517 P2d 289 (1973) ("A legislative delegation of power in broad statutory language * * * places upon the administrative agency a responsibility to establish standards by which the law is to be applied" before applying that statute.); *Forelaws on Board v. Energy Facility Siting Council*, 306 Or 205, 214, 760 P2d 212 (1988) (statutes that give an agency broad authority to set policies create "a strong inference of legislative intent that the agency exercise its policymaking in rulemaking proceedings rather than in the course of deciding contested cases").

In the Rate Order, the Commission "agree[d] with PacifiCorp that [it] must follow [its] own rules." Rate Order at 18. This means that the Commission cannot jettison its historical stand-alone rule[2] until it completes the SB 408 rulemaking to define its new approach to reflecting utility tax expenses in rates, including the meaning of the delegative term "properly attributed."

Under Oregon law, an agency is bound by its established rules and policies until it changes them pursuant to procedures required by the Oregon Administrative Procedures Act

[2] *See supra* note 1.

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(the "APA"). *Burke v. Children's Serv. Div.*, 288 Or 533, 538, 607 P2d 141 (1980) (agency rules are binding on an agency until repealed according to the procedures required by the APA); *Vier ex rel Torry v. State Office for Serv. to Children and Families*, 159 Or App 369, 374-75, 977 P2d 425 (1999) (once an agency has adopted policy through a rulemaking, it must use rulemaking to refine that rule); *Harsh Inv. Corp. v. State*, 88 Or App 151, 157, 744 P2d 588 (1988) ("Whether or not an agency is *required* to adopt rules, when it has authority to adopt them and does so, it must follow them."). *See also Attorney General's Administrative Law Manual* at 9 (2004).

> "Once an agency has adopted a rule, the agency is bound to follow its terms. Moreover, an agency policy or practice that meets the definition of a rule but is not in the form of a written rule or has not been promulgated according to the APA is, nevertheless, binding on the agency until it is declared invalid by a court or until it is amended or repealed by the agency in accordance with proper rulemaking procedures."

Id. (footnotes omitted).

Even if SB 408 had expressly directed the Commission to change its approach to setting tax expense in base rates, the Commission would still be bound by the practices and policies declared by its rules until it changed the existing rules pursuant to the procedures required by the APA. *Vier ex rel Torry*, 159 Or App at 374-75 ("[A]n agency remains bound by the practices and policies declared by its rules, even in the face of newly enacted legislation changing the agency's responsibilities, unless and until existing practices and rules are judicially declared invalid or are changed by the agency pursuant to formal rulemaking procedures."); *City of Klamath Falls v. Environmental Quality Comm'n*, 318 Or 532, 545 870 P2d 825 (1994) (agency authority "may be circumscribed by the agency's own regulations").

Application of SB 408 in this case, before the promulgation of implementation rules, was impermissible guesswork on the part of the Commission. It was also prejudicial to PacifiCorp because, among other things, it has decreased cash flows and earnings and caused

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a rating agency downgrade—matters that cannot easily be remedied if it turns out the Commission's guesswork was wrong.

5. To Apply SB 408 in This Case, the Commission Had to Forecast Tax Expense Under SB 408, Which It Cannot or Should Not Do.

The premise of SB 408, which is that a backward-looking automatic adjustment clause is the means by which actual taxes and taxes in rates are trued up and aligned, is inconsistent with the Commission's decision here forecasting such an adjustment in base rates. The plain language of SB 408 requires the Commission to adjust rates to align "taxes collected" with "taxes paid" based on historical, not forecasted, data. The backward-looking nature of SB 408 adjustments is particularly apparent from the definition of "taxes paid," a term that appears throughout the Act. Section 3(13)(f) of SB 408 defines "taxes paid" as follows:

> "'Taxes paid' means amounts *received* by units of government from the utility or from the affiliated group of which the utility is a member, whichever is applicable, adjusted as follows:
>
> "(A) Increased by the amount of tax savings *realized* as a result of charitable contribution deductions *allowed* because of charitable contributions made by the utility;
>
> "(B) Increased by the amount of tax savings *realized* as a result of tax credits associated with investment by the utility in the regulated operations of the utility, to the extent the expenditures giving rise to the tax credits and tax savings resulting from the tax credits have not been taken into account by the commission in the utility's last general ratemaking proceeding; and
>
> "(C) Adjusted by deferred taxes related to the regulated operations of the utility." (Emphasis added.)

If the legislature had intended the Commission to base adjustments on forward-looking estimates, as opposed to actual historical data, it would not have directed the Commission to determine "taxes paid" by looking at amounts "received" by the government, adjusted for tax savings "realized." It would have been a simple matter for the legislature to

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say "taxes that will be paid," "rates that will be collected," "amounts that will be received," and "tax savings that will be realized," but it did not. Likewise, if the legislature had intended the Commission to base adjustments on forward-looking estimates, it would not have required utilities to report actual tax payments. *See* SB 408 § 3(1)(a) (requiring utilities to report tax payments for the prior three years "without regard to the tax year for which the taxes were paid"); *id.* § 3(13)(f) (defining "taxes paid" as "amounts *received* by units of government" (emphasis added)).

Even if the Commission had discretion to use forecasted data under SB 408 in a rate case, as a policy matter it should refrain from doing so given the associated complexities, inaccuracies, and potential for selective and unfair application. The participants in AR 499, which include utilities, customer groups, and Staff, agreed that, whether or not SB 408 allows the Commission to use forecasted data for the automatic adjustment clause, as a policy matter the Commission should base SB 408 adjustments on historical data only. *See* ICNU Exh. 600. The same policy concerns that informed this consensus position apply to the use of forecasted data to make an SB 408 adjustment in a general rate case and militate against such a practice. This is especially true because the presence of the automatic adjustment clause makes such rate case estimates fundamentally unnecessary to effectuate the policy of SB 408.

B. Assume That the Commission Could Apply SB 408 or "Its Principles" to This Docket. How Should SB 408 or "Its Principles" Be Applied?

1. The Commission's Application of SB 408 (or Its Principles) Must Be Supported by Substantial Evidence Demonstrating That It Is Necessary to Align Taxes Collected with Taxes Actually Received by Government.

As articulated in the Attorney General's opinion, "the general policy of [SB 408] is to more closely align taxes collected by a regulated utility from its ratepayers with taxes received by units of government." Op Atty Gen at 2 (Dec. 27, 2005). The Attorney General's opinion also made clear that the Commission's discretion in interpreting SB 408 is

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not "unfettered," but is bounded by the need to effectuate the policy of aligning paid taxes with taxes collected. *Id.* at 11-12. Thus, the Commission has no authority under SB 408 to make a tax adjustment unless substantial evidence exists to demonstrate that it is necessary to align taxes collected with actual taxes paid. *See* ORS 183.482(8)(c) ("The court shall set aside or remand the order if it finds that the order is not supported by substantial evidence in the record."). For this reason, the Commission may not selectively attribute unregulated tax benefits to the utility under SB 408 in a manner inconsistent with the complete picture of how the utility or its consolidated group actually pays taxes. *See Younger v. City of Portland*, 305 Or 346, 360, 752 P2d 262 (1988) (substantial evidence standard requires a review of the evidence as a whole, not just specific evidence in isolation).

The record in this case is insufficient to meet this standard. The Commission concluded that the "PHI tax benefit is a constant that SB 408 requires to be passed on to customers," but did not support this ruling with the required factual determination, supported by substantial evidence, that lowering rates by the amount of the PHI tax benefit was necessary to align taxes collected and taxes paid. Rate Order at 19. Such a ruling would need to define and identify "taxes collected," "taxes paid," and taxes "properly attributed" to the utility, and consider actual taxes paid at PHI, including SB 408-recognized add-backs for tax settlement payments, deferred tax offsets, and charitable contributions.

Without such findings, SB 408 cannot be invoked as the authority for the adjustment. This is especially true given the evidence that PacifiCorp had significant taxes-paid add-backs that fully or partially offset the PHI tax deduction. Looking to Fiscal Year ("FY") 2005, for example, PHI's tax settlement payments to the IRS absorbed a significant portion of the PHI tax benefit ($70 million of the $160 million, or almost 50%). PPL/1303, Martin/3. Additionally, PacifiCorp had Oregon deferred taxes of $44 million. *Id.* The Commission recently reported that, "[u]nder the Temporary Rules, [it] observed the following about taxes paid and taxes collected for 2004: PacifiCorp: 'Taxes paid exceeded taxes collected in rates

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by $8,183,784. * * *'" Notice of Proposed Rulemaking, AR 499, Fiscal and Economic Impact, Including Statement of Cost of Compliance (Apr. 10, 2006).

The Commission impliedly acknowledged the lack of substantial evidence for its adjustment, confessing that the tax adjustment was "not precise" and was "the best [the Commission could] do under present circumstances," and that "it was not possible to know what PacifiCorp (or its affiliated group) will pay [in taxes] each year." Rate Order at 19. SB 408 does not authorize one-off tax adjustments in this manner divorced from substantial evidence about how the adjustment will align rates with actual taxes paid. Without the requisite record, the Commission could not make the SB 408 adjustment in this case.

2. The Evidence Presented Shows That, in Calendar Year 2006, PacifiCorp's New Affiliated Group Will Pay to Units of Government Far More Than PacifiCorp's Stand-Alone Tax Expense.

On reconsideration, PacifiCorp conclusively demonstrated that the PHI tax benefit will not lower PacifiCorp's 2006 actual taxes paid for several reasons, the most important being that PHI ceased to be PacifiCorp's holding company on March 21, 2006, when MidAmerican Energy Holdings Company ("MEHC") purchased PacifiCorp. PPL/1703, Larson/3. PacifiCorp's new consolidated tax group, Berkshire Hathaway, will pay far more in taxes for 2006 (and beyond) than PacifiCorp will collect on a stand-alone basis. PPL/1304, Martin/4. As a part of Berkshire Hathaway's projected $3 billion tax return, PacifiCorp expects to pay to the government every tax dollar collected from Oregon customers in 2006. Tr. at 35. Because of this change of circumstance, PacifiCorp's tax liability calculated on a stand-alone basis is now clearly the most accurate estimate of actual taxes PacifiCorp will pay in 2006.

While advocating for an actual tax standard, intervenors have urged the Commission to disregard PacifiCorp's evidence on reconsideration of its projected 2006 tax liability, updated to include changes associated with MEHC's purchase of PacifiCorp. The

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Commission should reject the position of the intervenors and consider this evidence for the following reasons:

- The change in PacifiCorp ownership is an undisputed, permanent change, different in kind from the usual known and measurable cost- or revenue-related change in a rate case.
- The change in PacifiCorp ownership was authorized by and is a result of an intervening Commission order. *See In re MEHC*, Order No. 06-082, *amended by* Order No. 06-121 (2006).
- The basis of the Rate Order was that the PHI tax benefit was a "constant" that SB 408 required be passed on to customers. Rate Order at 19. The change in PacifiCorp ownership eliminating the PHI tax benefit negates a fundamental premise of the Rate Order.
- Similarly, the Rate Order was expressly designed to limit the amounts that will flow through the automatic adjustment clause associated with the PHI tax benefit. *Id.* With the change in ownership and the elimination of the PHI tax benefit, this rationale for reducing PacifiCorp's rates is no longer valid.
- According to Industrial Customers of Northwest Utilities ("ICNU") witness James Selecky, the PHI tax benefit from what he called the "PHI tax miniminization structure" came from an inter-company loan. ICNU/200, Selecky/17, Tr. 72. Mr. Selecky testified that the PHI structure was a "unique," "one-of-a-kind" structure that he had never seen replicated elsewhere. ICNU/211, Selecky/6, Tr. 73. Mr. Selecky acknowledged that there was no equivalent tax structure in place under PacifiCorp's new ownership. *Id.*
- PacifiCorp's new ownership structure is materially different from its old structure. PacifiCorp's new immediate parent company, PPW Holdings LLC,

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has no debt. PPL/1304, Martin/3. PPW Holdings LLC was capitalized with $5.1 billion of equity issued to MEHC; MEHC in turn issued $5.1 billion of equity to its shareholders, $5.07 billion of which was issued to Berkshire Hathaway. Berkshire Hathaway provided all of its capital from cash and cash equivalents. *Id.* at 4.

- In his testimony, Mr. Selecky's only basis for suggesting that PacifiCorp's ownership change will not affect PacifiCorp's 2006 actual taxes paid was his argument that MEHC has debt levels equivalent to PHI's. Tr. 67-68. On cross-examination, however, Mr. Selecky admitted that the relevant analysis would be debt levels in the Berkshire Hathaway group because it, and not MEHC, was the consolidated taxpayer. Tr. 68-69. Mr. Selecky explained that "you'd have to follow the MEHC capital structure in through the Berkshire total consolidated return," and that "you got to look at the total" consolidated tax return, not just MEHC. Tr. 70-71.
- Mr. Selecky acknowledged that if equity exceeded debt in the Berkshire Hathaway group, it would be a "significant change" from the PHI situation. Tr. 70. In fact, Berkshire Hathaway's latest published audited financial filing, its 10K for 2005, shows cash and cash equivalents of approximately $45 billion and notes and others borrowings of approximately $(14) billion. PPL/1304, Martin/4. Interest, dividend, and other investment income was approximately $5 billion while interest expense was less than $1 billion. *Id.* Thus, unlike PHI, Berkshire Hathaway has no net debt. *Id.*

For all of these reasons, it is clear that PacifiCorp's ownership change is relevant evidence that the Commission should consider in reviewing the proper application of SB 408 to this case. The ownership change ensures that PacifiCorp, through its new consolidated group, will pay its stand-alone taxes to units of government in 2006. Now that concerns

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about the PHI tax benefit lowering PacifiCorp's actual taxes paid are moot, PacifiCorp's tax expense in rates should be restored to its full stand-alone level. *See In re PacifiCorp*, Docket No. UE-050684 at 58-59 (Apr. 17, 2006) (rejecting ICNU's PHI-related tax adjustment on the basis that PacifiCorp's change in corporate ownership rendered the tax adjustment moot.)

3. At Most, the Commission Should Have Disallowed Only $0.66 Million of PacifiCorp's Tax Expense.

For all of the reasons outlined above, PacifiCorp does not believe that any tax adjustment in this case is warranted. If the Commission persists in applying such an adjustment, however, under SB 408 it must use the most accurate and up-to-date information possible to ensure that the adjustment comes as close as possible to projecting actual taxes that PacifiCorp will pay in 2006. *See Potomac Electric Power Co. v. Public Service Comm'n*, 380 A2d 126, 139 (DC App 1977) (finding reversible error when commission refused to take proper cognizance of certain known changes that occurred after the originally proposed test period). PacifiCorp has demonstrated the need for several corrections and updates to the Commission's original adjustment on this basis.

First, the Commission should use relative taxable income as the allocation factor for determining PacifiCorp's share of any PHI tax benefit. Based on PHI's most recent tax return, FY 2005, this allocation percentage should be 50%. PPL/1304, Martin/5; PPL/1305. The Rate Order incorrectly allocated the tax benefit using PacifiCorp's estimated contribution to the "gross profits" of the PHI consolidated group for FY 2005, which was 91.5%. Rate Order at 14. The Rate Order implies that taxable income is the appropriate allocation factor, however, because it justifies the use of a gross profits approach as a closer surrogate to taxable income than the assets approach suggested by ICNU. *Id.* at 18. Use of relative taxable income is consistent with the Commission's Temporary Rule for tax reports under SB 408, which allocated based on tax liability. OAR 860-022-0039(2)(d)(B). Tax liability is the product of taxable income and the applicable tax rate.

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Second, PacifiCorp has submitted evidence that the interest rate on the PHI debt was reduced as of September 22, 2005 from 6.75% to 4.98%. This lowered PHI's interest payments from $160 million annually (the amount assumed in the Rate Order) to $136 million, or approximately $34 million per quarter. PPL/1304, Martin/2, 8.

Third, PacifiCorp has submitted evidence that ScottishPower has paid taxes at a 30% rate under the UK Finance Act of 2005 on all interest payments it received from PHI, offsetting a significant portion of the PHI tax benefit assumed in the Rate Order. PPL/1303, Martin/4. While the Rate Order concluded that the PHI interest deduction reduced the tax liability of PacifiCorp's corporate family by 37.95%, the actual net reduction was only 7.95% because of ScottishPower's UK tax liability. *Id.* This reduces the tax adjustment by $40.8 million annually, or approximately $10.3 million a quarter.

Fourth, as discussed above, PHI ceased to exist as PacifiCorp's parent as of March 21, 2006. If the tax adjustment is not eliminated on this basis, it should be reduced to one-fourth of the test year total.

Combining these adjustments by using actual calendar year 2006 interest rates, offsets for tax liability associated with the interest, and considering the first quarter interest payment only would result in an adjustment of approximately $0.40 million on an Oregon-allocated basis, which is approximately $0.66 million on a grossed-up basis. These figures are derived as follows: ((PHI interest deduction based on first quarter payment only * combined U.S. effective tax rate) - (PHI interest deduction based on first quarter payment only * UK tax rate)) * percentage of PHI group taxable income from PacifiCorp * Oregon allocation factor on an SNP basis * tax gross-up factor = adjustment to revenue requirement. In numeric form, the calculation is as follows: (($34.357m * 37.95%) - ($34.357m * 30%)) * 50.3095% * 28.8723% = $0.40m * 1.657 = $0.66m. PPL/1304, Martin/9-10.

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C. Did the $16.07 Million Tax Adjustment Result in Rates Violative of ORS 756.040?

The rate adjustment in this case violates SB 408's "Fair, Just and Reasonable" standard. The adjustment violates the requirements set forth in ORS 756.040(1) of "fair and reasonable" rates. As interpreted by the Attorney General, ORS 756.040 "limits utilities' exposure to rate reductions" under SB 408, regardless of how the Commission applies the bill. Op Atty Gen at 16-17. The inquiry focuses on the total effect of the rate order, rather than the ratemaking method used. *Id.* at 16 n 4 (quoting *Duquesne Light Company v. Barasch*, 488 US 299, 307, 109 S Ct 609, 102 L Ed 2d 646 (1989)). However, an asymmetrical approach to ratemaking raises "serious constitutional concerns." *Id.* These heightened constitutional concerns are present here, given the fact that the tax adjustment in this case unquestionably violates the ratemaking matching principle. *See* Tr. 84-86 (Mr. Selecky's testimony acknowledging that the matching principle, providing the benefits of the expense or investment to the party who bore the costs or risks, is a "general theme of ratemaking," and admitting that the adjustment in this case is contrary to that principle).

As a result of the Rate Order, PacifiCorp will have no reasonable opportunity to earn the stipulated and approved return on equity ("ROE") of 10%. PPL/317, Williams/2. The tax adjustment reduces PacifiCorp's ROE by 160 basis points to 8.4%, just barely above the weighted average cost of capital set in this case. The reduced ROE results from the fact that the Rate Order imputes a reduction in PacifiCorp tax expense of $16.07 million that is inconsistent with the fact that PacifiCorp will incur its full stand-alone tax expense in 2006. PPL/324, Williams/3.

An 8.4% ROE is far below the US industry average of 11.3% for the 12 months ending September 30, 2005. *Id.* Thus, an effective ROE of 8.4% is not commensurate with returns on investment in other enterprises having corresponding risk. *Southern Bell Tel. & Tel. Co. v. Louisiana Public Service Comm'n*, 239 La 175, 227-28, 118 So 2d 372 (1960) (a

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utility was entitled to a return on its rate base and its equity capital comparable to that realized by other utilities).

Such a return, 160 basis points lower than the lowest ROE recommendation in the case (by ICNU/CUB and Staff), is confiscatory and in violation of constitutional and statutory requirements. *See Southern Bell Tel. & Tel. Co. v. Public Service Comm'n*, 202 Tenn 465, 482, 302 SW 2d 640 (1957) ("the rates prescribed by the Commission do not produce the rate of return on the adjusted net investment rate base which the Commission itself found was necessary.").

PacifiCorp's recent financial results provide no headroom for it to absorb the aberrantly low effective ROE set in this case. PacifiCorp's most recent semi-annual earnings report showed its unadjusted ROE to be 7.07% and its adjusted ROE to be 6.895%. PPL/317, Williams/3. These results place PacifiCorp 45th out of 48 utilities listed with measurable returns in a January 2006 Regulatory Research Associates ranking of industry equity returns. *Id.* PacifiCorp's financial ratios for the last five years compared to the industry average and to the reference group it uses for cost-of-capital purposes demonstrate that PacifiCorp has significantly under performed in every year relative to both comparators. Exhibit PPL/320.

In addition to the immediate impact of the Rate Order resulting in underearnings, the tax expense adjustment has also led to a deterioration of PacifiCorp's credit rating. On January 31, 2006, Fitch Ratings ("Fitch") lowered PacifiCorp's credit rating on senior unsecured debt to "BBB+" from "A-," expressly noting "the unfavorable final order issued September 2005 by the Oregon commission in PPW's general rate case." PPL/317, Williams/6. Fitch continued that "the Oregon Public Utilities Commission's September 2005 order incorporating recently enacted tax legislation (Senate Bill 408) in PPW's Oregon GRC is a serious matter for concern in Fitch's view." PPL/321 at 1-2.

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Other credit rating agencies have expressed similar concerns about the Rate Order and the application of SB 408. Shortly after the Rate Order was issued, Standard & Poors ("S&P") published a note stating that "the ruling is adverse for credit quality," and warned about future rating action related to the disallowance. Exh. PPL/322 at 1. More recently, S&P described the "difficult regulatory environment" created in Oregon by SB 408. PPL/325. Moody's has warned that the outcome of rehearing in this case is an issue that could affect future credit quality. Exh. PPL/327. In early March, Fitch reiterated its concerns that a key credit concern for PacifiCorp is the adverse tax ruling in this case associated with SB 408. PPL/326. Concerns regarding the impact of the Rate Order on PacifiCorp have also been raised by Barclay's Bank, JP Morgan, and BNP Paribas, all of which have substantial financial commitments to PacifiCorp. PPL/317, Williams/7.

All of this evidence demonstrates that, in Oregon, a regulatory environment in which PacifiCorp's ROE has been held to levels that are consistently on the low end of the industry average ranges, the Commission does not have the ability to aggressively impute away PacifiCorp's tax expense without immediately running afoul of ORS 756.040. *See* Op Atty Gen at 16 n 4 (whether the rate satisfies ORS 756.040 depends on what a fair rate of return is given the risks of a particular rate-setting system).

D. What Is the Appropriate Remedy If the Commission Should Determine to Modify the Revenue Requirement from the Original Order?

The Commission should grant PacifiCorp's request for deferred accounting and permit PacifiCorp to recoup its lost revenues associated with the tax adjustment. Concurrently with the filing of its Reconsideration Application in this case, PacifiCorp filed an application for deferred accounting, docketed as UM 1229. PacifiCorp filed this application to permit the Commission to grant PacifiCorp recovery of its lost revenues if the tax adjustment was vacated or modified on rehearing.

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The suspension period in this case made rates effective in early October 2005. By granting reconsideration and seeking additional evidence on SB 408 in this case, the Commission has effectively extended the rate suspension period on this issue. Although PacifiCorp agrees that a rehearing process is necessary in this case, it should not come at PacifiCorp's expense. Granting deferred accounting is required to allow the Commission to address SB 408 application in this case in a manner that is full, orderly, and revenue neutral to PacifiCorp. *See In re PacifiCorp*, Docket No. UE 170, Staff's Post-Hearing Reply Brief at 6 (Aug. 12, 2005) (arguing that Commission should establish deferred account for PacifiCorp's tax expense so that it can address SB 408 in an orderly manner).

The revenues associated with the tax adjustment are material, amounting to approximately $500,000 a week since September 28, 2005. PPL/1702, Larson/6. PacifiCorp has no ability to recoup the lost tax revenues in 2005 through the automatic adjustment clause and would need to wait approximately two years before it could hope to recoup its lost revenues for 2006. *Id.*

Deferred accounting is necessary to properly match costs borne by and benefits received by ratepayers as required by ORS 757.259. The use of identifiable tax expenses, calculated on a stand-alone basis—which as noted above is the most accurate estimate for PacifiCorp's 2006 actual tax expense—produces an appropriate match between costs borne by and benefits received by customers, because customers will be charged rates based on the stand-alone costs PacifiCorp will incur in providing its regulated service.

The magnitude of the non-recovery associated with the denial of deferred accounting could affect PacifiCorp's credit rating, which has already suffered as a result of the Rate Order. Therefore, the Commission should exercise its broad discretion under ORS 757.259(2) to authorize a deferred account in this instance to provide PacifiCorp full recovery of its lost revenues. *See In re Investigation into Deferred Accounting*, Docket No. UM 1147, Order No. 05-1070 at 7 (Commission should look at the facts of each case and

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allow deferred accounting if statutory requirements are satisfied and type and magnitude of event warrant deferred accounting).

III. CONCLUSION

For all of the reasons outlined above and in PacifiCorp's testimony and exhibits, the Commission should vacate or significantly reduce the tax adjustment contained in the Rate Order.

DATED: May 1, 2006.

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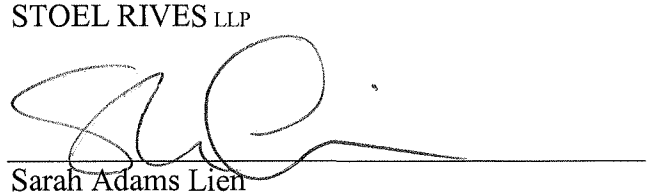

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in Docket UE 170 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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