BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UE 170

In the Matter of PACIFIC POWER & LIGHT, d/b/a PacifiCorp Reconsideration of Order No. 05-1050.	**REPLY BRIEF OF PACIFICORP**

PacifiCorp respectfully submits the following reply to the Post-Hearing Response Briefs of Citizens' Utility Board (CUB), Industrial Customers of Northwest Utilities (ICNU) and Utility Reform Project and Nancy Newell (URP) (collectively "Intervenors").

I. Inapplicability of SB 408 to this Case.

1. Citing the Attorney General's December 27, 2005 opinion on SB 408, CUB and ICNU argue that, in addition to establishing an automatic adjustment clause, SB 408 mandated an immediate change to the Commission's ratemaking authority and practices with respect to utility taxation. CUB and ICNU trace the source of that mandate to the addition to ORS 757.210 of the word "fair" and a sentence that states "The Commission may not authorize a rate or schedule of rates that is not fair, just and reasonable," and section 2(1)(f) of SB 408's preamble.

While the Attorney General's opinion did look to these sections of SB 408 and others in defining the general policy of the bill, the opinion does not support the proposition that SB 408's policy functions separately and independently of the automatic adjustment clause. Instead, the Attorney General's opinion makes clear that the policy is effectuated through the tax report and the automatic adjustment clause: "To achieve the general policy of aligning taxes collected with taxes paid, section 3 of chapter 845 establishes tax-related reporting and rate adjustment procedures for regulated utilities subject to the law." Op Atty Gen at 13.

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2. Intervenors argue that the Commission's ratemaking authority was changed by the amendments to ORS 757.210, but they have cited no legislative history in support of this interpretation—which is certainly not clear from the text of the legislation—and have asked the Commission to disregard PacifiCorp's citation of contrary legislative history on the basis that Order 05-1050 ("the Rate Order") already found that no such legislative history exists. *See* ICNU Post-Hearing Brief at 5, citing Rate Order at 17. In granting reconsideration, however, the Commission stated that: "Since we issued the [Rate] Order, the Department of Justice has compiled the legislative history of SB 408 for use in AR 499, a rulemaking docket opened to implement the new law. *Clearly, this history is of use to PacifiCorp, intervenors and us in determining the meaning of SB 408.*" Order 05-1254 at 2 (Dec. 19, 2005) (emphasis added).

3. Intervenors respond to the legislative history that SB 408 was not directed at changing the Commission's ratemaking authority by arguing that the legislative history refers only to the ratemaking "process," not the standards to be applied in the process. Viewed in full, however, it is clear that legislative references to the ratemaking process include the substantive aspects of the ratemaking process, as well as its procedural aspects:

> "[I]'m going to close with one quick paragraph here which is probably the laymen's version of what we're talking about here. Power is a rate regulated monopoly in Oregon. During the ratemaking process utilities detail their costs to the Public Utility Commission. One of these items is taxes paid. SB 408C does not change the original ratemaking process. SB 408 does not change the way utilities file taxes. The bill does not alter any tax credits or charitable contributions. What SB 408 does is to outline the process for rate adjustments to be made to balance the amount of taxes collected out of your pocket and the amount actually paid to government." (Statement of Rep. Brian Boquist, July 30, 2005, carrying SB 408 on House floor).

4. Also viewed in full, the legislative history of SB 408 is clear that the amendments to ORS 757.210 were designed to provide a "*Hope* off-ramp" to ensure constitutional application of SB 408, not to change the Commission's ratemaking authority with respect to

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utility taxes. For example, Deputy Attorney General Peter Shepherd testified that the Attorney General's office interpreted the new "fair, just and reasonable" provision in ORS 757.210 as providing an earnings test off-ramp:

> "ICNU's version [of the bill] does not contain the same provision [for an earnings test 'off-ramp'] as the Utilities' Version and the DOJ Alternative. ICNU's version does prohibit the establishment of a rate that is 'not fair, just and reasonable.' If the Assembly adopted ICNU's version and a facial challenge to its constitutionality were to arise, we would assert that this provision has the same legal effect as the more explicit provisions in the 'Utilities version' and in the 'DOJ Alternative.'" Written Testimony of Deputy Attorney General Peter Shepherd re SB 408B (June 30, 2005).

See also Statement of Rep. Bob Ackerman, July 30, 2005 (noting that legislative counsel's conclusion that SB 408 was constitutional was based on SB 408's provision that rates must be fair, just and reasonable); Statement of Rep. Brian Boquist, July 30, 2005 (referring to "fair, just and reasonable" as language that addressed constitutional concerns about symmetry).

5. Intervenors argue that the Commission was free to depart from its stand-alone tax rule in this case in response to the passage of SB 408. However, an agency action that repeals or amends an existing rule without following the procedures of the Oregon Administrative Procedures Act ("APA") is invalid and therefore ineffective to repeal or amend the existing rule. *Burke v. Children's Services Div.*, 288 Or 533, 538, 607 P2d 141 (1980). This is true whether the existing rule was promulgated formally in rules or informally through contested case precedent. *Id.* at 537-38 (any agency statement or directive that prescribes generally applicable practice or policy, whether formally promulgated through a rulemaking or informally promulgated through a contested case order, constitutes a rule); *see also* ORS 183.310(9) (defining "rule").

The Commission's stand-alone rule is embodied in its formal rules as well as in its contested case precedents. *See* OAR 860-027-0048(3)(g) & (4)(h); Rate Order at 13, 17-18

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(acknowledging that past precedent had "always" been to calculate the tax expense on a stand-alone basis); *see also In re Util. Reform Project*, Order No. 03-214, App. A at 2 (OPUC Apr. 10, 2003) (ratemaking on a standalone basis is "[c]onsistent with long-standing OPUC policy," which "'protect[s] [utility] customers, competitors, and the public generally'" (citation omitted)); *Re Or. Exch. Carrier Ass'n*, Order No. 93-325, 1993 WL 117620, at *6 (OPUC Mar. 12, 1993) (allocating tax liabilities resulting from nonregulated operations to ratepayers "is contrary to the Commission's statutory obligation to prevent subsidization by the ratepayers of unregulated activities").

Because the Commission did not validly repeal or amend its stand-alone tax rule, the rule remains "an existing statement of practice or policy, binding on the agency" and was binding in this case. *Burke*, 288 Or at 537.

6. CUB also argues that the Commission was free to depart from the stand-alone rule because SB 408 directly conflicts with it. CUB argues that, in light of this purported conflict, the Commission could announce and apply a new policy in the Rate Order without first adhering to the requirements of the APA. *See* CUB Post-Hearing Brief at 5-6 (citing *City of West Linn v. LCDC*, 200 Or App 269, 275, 113 P3d 935 (2005) (stating that court will declare rule invalid if rule affirmatively authorizes actions that violate a statute)).

CUB's arguments ignore Oregon law to the contrary. Under Oregon law, the Commission's stand-alone rule applies to general rate cases until the rule is repealed pursuant to the rulemaking procedures mandated by the APA. *Burke*, 288 Or at 538 ("[A] rule may be declared by a court to be invalid * * *. In the absence of such a declaration, however, it remains an effective statement of existing practice or policy, binding on the agency, until repealed according to procedures required by the Administrative Procedures Act."); *id.* at 542 (repeal itself is a rulemaking action that must follow the prescriptions of the APA); *Harsh Investment Corp. v. State Housing Div.*, 88 Or App 151, 157, 744 P2d 588 (1987) (agency must follow its rules until they are properly amended or repealed). In the

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face of directly conflicting legislation, "an agency remains bound by the practices and policies declared by its rules * * * unless and until the existing rules are judicially declared invalid or are changed by the agency *pursuant to formal rulemaking procedures.*" *Vier v. SOSCF*, 159 Or App 369, 374-76, 977 P2d 425 (1999) (emphasis added).[1]

Thus, SB 408 did not automatically invalidate the Commission's stand-alone rule or relieve the Commission of its duty to adhere to the requirements of the APA. Even if SB 408 directly conflicted with the stand-alone rule as intervenors argue, the legislation would not automatically repeal or amend the stand-alone rule and would not excuse the Commission's obligation to comply with the mandates of the Oregon APA.

In any event, SB 408 does not conflict with the stand-alone rule because SB 408 did not change the Commission's ratemaking authority or process. *See* sections I.1-4 supra at 1-3. SB 408 provides a true-up mechanism in the form of an automatic adjustment clause and the stand-alone rule pertains to ratemaking. Each can be applied to reach a reasoned outcome in separate venues (*i.e.,* automatic adjustment clause proceedings and rate cases, respectively) without undermining the policies of the other.

7. Intervenors also argue that the Commission can apply SB 408 in this case without first promulgating rules interpreting SB 408. *See* CUB Post-Hearing Brief at 7; ICNU Post-Hearing Brief at 12; URP Post-Hearing Brief at 3. Intervenors premise these arguments on misstatements regarding the key cases, *Forelaws on Board v. Energy Facility Siting Council*, 306 Or 205, 760 P2d 212 (1988) and *Trebesch v. Employment Div.*, 300 Or 264, 710 P2d 136 (1985).

Oregon law requires rulemaking prior to implementation of new legislation when: (1) the legislature intended the agency to conduct prior rulemaking, or (2) prior rulemaking is

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[1] CUB also suggests that the cases cited in PacifiCorp's Opening Post-Hearing Brief rely on provisions of the APA that do not apply to the Commission. *See* CUB Post-Hearing Brief at 6. This is not true. Each of the cases PacifiCorp cites interpret sections of the APA that apply to the Commission.

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necessary to ensure uniform application of the law. *See Forelaws*, 306 Or at 214-15 (holding that prior rulemaking was not required because legislature did not charge the agency with broad policymaking authority and agency did not have substantive rulemaking authority with respect to the statute at issue); *Trebesch*, 300 Or 264 (holding that prior rulemaking is required if necessary to ensure uniform application of law; stating that whether requirement exists is determined through an analysis of the specific statutory scheme at issue). Oregon law recognizes a "strong inference" that the legislature intends for agencies to undertake prior rulemaking when, as in the case of SB 408, statutes delegate broad policymaking authority. *Forelaws*, 306 Or at 214.[2]

Rulemaking is required to implement SB 408 because the legislature delegated the broadest policymaking authority to the Commission, the Commission's enabling statutes provide it with substantive rulemaking authority by which it can establish uniform policies and the Commission has already commenced an SB 408 rulemaking. *See* Formal Opinion Letter from Attorney General Hardy Meyers to Lee Beyer, Chair, Oregon Public Utility Commission re Oregon Laws 2005, Chapter 845, p. 9-11 (Dec. 27, 2005) ("Op Atty Gen") (concluding that legislature delegated to the Commission the authority to define the policy term "properly attributed"); *see also Springfield Education Ass'n v. School Dist. No. 19*, 290 Or 217, 230 (1980) (a delegative term leaves to the agency a policy choice that is "legislative" in nature); *see also In re Adoption of Permanent Rules*, AR 499, CUB Opening Brief at 4 (OPUC Oct. 28, 2005) ("[L]ike terms such as 'fair' or 'unreasonable,' 'properly

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[2] The Court explained:

> "Because the rulemaking proceedings established by the APA, by permitting wider public participation than ordinarily found in the context of a contested case, are particularly appropriate for exercising policymaking authority, the existence of such authority permits a strong inference of legislative intent that the agency exercise its policymaking in rulemaking proceedings rather than in the course of deciding contested cases." *Id.*

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attributed' delegates to the Commission the responsibility to complete the general policy by determining what attribution is 'proper.'").

8. ICNU also argues erroneously that the need for prior rulemaking is excused by the fact that a delegative term appears in only one section of the legislation. Specifically, ICNU argues that the Commission need not determine the meaning of "properly attributed" before it applies SB 408 to this rate case, because "properly attributed" appears in section 3 of SB 408 only, and the Commission can apply sections 2 and 5 of SB 408 to this rate case.

ICNU's argument ignores the significance of the term "properly attributed" to the general policy of the legislation. It makes no sense that the Commission would consider actual taxes paid and "properly attributed" to the utility when computing automatic adjustment clauses under section 3 of SB 408, but consider actual taxes paid without any assessment of proper attribution when setting rates in a general rate case.[3] The Attorney General specifically recognized the integral nature of the term "properly attributed" to the legislation's broad goals, stating:

> "The context [of the delegative term] includes the legislative findings and declarations made in chapter 845. Paragraph 2(1)(f) * * * states that '[u]tility rates that include amounts for taxes should reflect the taxes that are paid to units of government to be considered fair, just and reasonable.' *The expression 'properly attributed' is part of the machinery by which the Assembly's goal is to be achieved* * * *." Op Atty Gen at 8.

9. Intervenors' suggestion that the Commission can apply some of the express mandates of SB 408 in this docket while disregarding others (particularly the safeguards and limitations in sections 3 and 4) is also contrary to Oregon administrative law. Any generally

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[3] An interpretation that applies an actual-taxes-paid principle to general rate cases but disregards the significance of "properly attributed" in that context would be particularly perverse, considering the fact that section 3 does not apply to water, telecommunications and certain small electric and gas utilities, but section 5 applies to all utilities.

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applicable directive or statement (*i.e.*, rule) that implements a statute must do so consistent with the statute's specific mandates. *Planned Parenthood Ass'n v. Dep't of Human Res.*, 297 Or 562, 573-74, 687 P2d 785 (1984) (declaring invalid a rule that failed to consider the factors that the enabling legislation required the agency to consider). Thus, the Commission does not have the discretion to implement SB 408 in a way that is inconsistent with the statute's express mandates, which include: (1) actual taxes paid may not exceed taxes paid and properly attributed to the utility; (2) taxes properly attributed to an unregulated affiliate may not be allocated to the utility; and (3) taxes paid must be adjusted to account for certain charitable contributions, tax credits and accelerated depreciation, and must include refunds and settlement payments. SB 408 § 3(6), (7) & (13); *see also* Op Atty Gen at 2 ("specific limits [of the legislation] include a cap on the maximum amount of taxes paid that the Commission may properly attribute to regulated operations of the public utilities"). Consequently, even if the Commission could announce a rule implementing SB 408 in a contested case order without first formally promulgating administrative rules or defining "properly attributed," a rule that disregarded the express mandates of the legislation would nevertheless be invalid. The application of SB 408 in the Rate Order failed to conform to express requirements of the law.[4] Accordingly, the Rate Order constituted an invalid ad hoc application of the statute.

10. Intervenors' arguments that PacifiCorp knew about potential and actual changes in rate setting policy early in the case do not remedy the flaws in the Rate Order. *See* CUB Post-Hearing Brief at 6-7 (arguing that all parties were apprised of changes in rate-setting policy contained in SB 408 throughout the first phase of UE 170). The fact that various versions of a bill are being considered in the legislature does not provide notice of a new

[4] *See* PacifiCorp Post-Hearing Opening Brief at 6 (*e.g.*, exempting small energy utilities or water utilities from automatic adjustment clause rate changes, requiring adjustments to the computation of "taxes" and "taxes paid" to retain certain tax incentives for investors and provide a safety net against normalization violations).

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legal standard to parties appearing before an agency to which some version of that bill might apply if it is passed by the legislature and signed into law by the Governor. Moreover, even if the existence of a bill could provide notice, it does not effectuate a repeal or amendment to an agency's existing rules. As discussed above, the Commission's stand-alone policy constituted an administrative rule. The only valid mechanism by which to repeal or amend an administrative rule is through the procedures outlined in the APA.

11. CUB's argument that the temporary OAR 860-22-0039 (the "Temporary Rule") provides requisite notice of a new ratemaking standard is also flawed. *See* CUB Post-Hearing Brief at 7. The Temporary Rule was promulgated for the express purpose of providing Oregon utilities with the information necessary to file the tax reports due under SB 408 on October 15, 2005. *In re Adoption of Temporary Rules*, AR 498, Order No. 05-991 at 1 (OPUC Sept. 15, 2005) (stating that purpose of Temporary Rule was to establish the filing requirements for the tax reports). It did not purport to establish the legal standards applicable to SB 408. *Id.* ("All issues relating to implementation of [SB 408], including details regarding the automatic adjustment clause, will be further reviewed in a permanent rulemaking, docketed at AR 499. * * * None of the decisions made in this temporary rule should be considered as precedent for our findings in the permanent rulemaking."). Nor did the Temporary Rule purport to amend or repeal the stand-alone rule. *Id.*

In any event, the Temporary Rule expired on March 14, 2006. An expired rule cannot provide the basis for a decision and cannot effectuate the repeal or amendment of permanent rule. Because, the Temporary Rule expired in March 2006, it neither establishes the legal standards necessary to implement SB 408 in this docket nor repeals or amends the stand-alone rule.

II. Incorrect Application of SB 408 in this Case.

1. ICNU claims that the Commission was not required to support the tax adjustment in this case with substantial evidence that the adjustment would align taxes collected with

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taxes paid. *See* ICNU Post-Hearing Brief at 20. This is contrary to the Attorney General's opinion which states that "faithful execution of the basic policy choice" expressed by the Assembly in SB 408 depends on a comparison between these amounts. Op Atty Gen at 18. ICNU also claims that CUB and ICNU provided this evidence. This misstates the record which focused exclusively on the selective allocation of one consolidated group tax attribute, without consideration of offsetting tax attributes or PacifiCorp's total tax liability. The Commission acknowledged in its Rate Order that its adjustment was "not precise," but was "the best [it could] do under present circumstances," "because there [is] no way to predict the actual tax payment of PacifiCorp (or its affiliate group) for each year." Rate Order at 19.

2. On the one hand, CUB claims that the Commission has addressed the administrative law concerns outlined above by granting reconsideration and permitting PacifiCorp to introduce new evidence. *See* CUB Post-Hearing Brief at 6-7. On the other hand, CUB and ICNU object to PacifiCorp's evidence on the proper application of SB 408 in this case as violative of the rule against single issue ratemaking. *Id.* at 8-10; ICNU Post-Hearing Brief at 14-18. This argument presents a classic Catch 22: intervenors argue that this case is controlled by SB 408, even though it was enacted after the record closed in this case and even though it is a "single issue" ratemaking statute, but that PacifiCorp is forbidden by single-issue ratemaking principles from presenting new evidence about the operation of SB 408 in this case and the appropriateness of the tax adjustment—notwithstanding the Commission's order specifically allowing reconsideration on this issue.

The intervenors' single issue ratemaking objection demonstrates the problems associated with applying SB 408 retroactively to this case and most logically leads to an outcome where SB 408 is not applied. If the Commission decides that SB 408 does apply to this case, however, it cannot fairly refuse to hear PacifiCorp's new evidence on the basis that it updates tax expense in the case, but not other costs.

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3. ICNU and CUB ask the Commission to reject PacifiCorp's argument that the change in its ownership eliminates the factual basis of the tax adjustment, claiming that PacifiCorp has not sufficiently proven what its tax liability will be under its new ownership. CUB Post-Hearing Brief at 10; ICNU Post-Hearing Brief at 18-19. PacifiCorp has, however, presented undisputed evidence that the PHI tax deduction is gone and will not be replicated, including: (1) the uniqueness of the PHI tax structure (Tr. 73); (2) the non-existence of such a tax structure under PacifiCorp's new ownership (*id.*); (3) PacifiCorp's membership in the Berkshire Hathaway consolidated tax group, which pays taxes far beyond the level of PacifiCorp's standalone liability (Tr. 35); and (4) the non-existence of debt at the immediate holding company level and the fact of no net debt in the consolidated group. PPL/1304, Martin/3-4.

In ordering the tax adjustment, the Commission found that "[t]he effect of [PHI's interest] deduction is to eliminate or substantially reduce the consolidated group's taxable income, resulting in PacifiCorp collecting more money from ratepayers than the consolidated group pays in taxes to governmental units." Rate Order at 14. PacifiCorp's evidence on the elimination and non-replication of the PHI tax deduction and the magnitude of its future consolidated tax payments is sufficient to remove theoretical and factual support for the tax adjustment, which should result in resetting PacifiCorp's tax liability at its full stand-alone level.

4. CUB also argues that elimination of the tax adjustment on the basis of MEHC ownership is inconsistent with the requirement that MEHC ownership provide a net benefit to customers. CUB Post-Hearing Brief at 11. MEHC's elimination and non-replication of what ICNU refers to as the "PHI tax minimization structure" produces a significant and lasting benefit to customers, however, because it helps effectuate SB 408's basic policy seeking alignment of taxes collected and taxes paid and addresses underlying concerns about overly-leveraged holding company structures.

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5. CUB objects to PacifiCorp's specific updates and corrections to the tax adjustment, claiming they are not supported by the record. *Id.* at 11-12. Specifically, CUB claims that its use of a three-year average to determine the allocation factor is more representative of test year expense than PacifiCorp's most recent tax information, FY 2005. CUB's gross profits allocation factor was based upon PacifiCorp's 2001-03 tax information. *See* CUB/102, Jenks/1. Not only is this tax information more remote in time than PacifiCorp's 2005 tax information, CUB's average includes years in which PacifiCorp was impacted by the energy crisis and years in which the PHI debt amount was much higher. *See* PPL/1301, Martin/7 (PHI debt is now less than one-half of original size). CUB's tax data is therefore less representative of the 2006 test year than PacifiCorp's FY 2005 tax data. If the Commission makes a tax adjustment in this case, it should use PacifiCorp's proposed allocation factor based upon FY 2005 relative taxable income.

III. Violation of ORS 756.040 in this Case.

1. CUB inappropriately dismisses PacifiCorp's concerns regarding unfair and unreasonable rates as "an attempt to make a federal case out of UE 170 (literally)." CUB Post-Hearing Brief at 14; *see also* ICNU Post-Hearing Brief at 21, n. 4 (arguing that the question posed is whether the rates are unconstitutional, not whether they violate the ORS 765.040 and 757.210 standard). Intervenors' arguments address only US Supreme Court case law on confiscatory rates—they do not even cite ORS 756.040 (except to claim it is not relevant). *See* CUB Post-Hearing Brief at 14-15; ICNU Post-Hearing Brief at 21-24. Intervenors' exclusive focus on federal law demonstrates their misunderstanding of the issues. The issues, as defined by the Commission, are whether the Rate Order produced rates "that fail to comport with ORS 756.040" or "are unconstitutional." *See* Order 05-1254 at 3 (OPUC Dec. 19, 2005). As the evidence and argument presented by PacifiCorp demonstrates, the rate adjustment in this case violates Oregon's statutory rate standard

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(which has a broader scope than the constitutional law standard) and raises serious constitutional concerns. *See* PacifiCorp Opening Post-Hearing Brief at 18-20.

2. As a jumping-off point for CUB's discussion of federal case law, CUB erroneously criticizes PacifiCorp for misquoting *Duquesne Light Co. v. Barash*, 488 US 299, 109 S Ct 609, 102 L Ed 2d 646 (1989). *See* CUB Post-Hearing Brief at 14. PacifiCorp's citation was to the Attorney General's opinion on SB 408, which observed that an asymmetrical approach to ratemaking raises serious constitutional concerns, especially in light of *Duquesne Light*. *See* Op Atty Gen at 16 n. 4 ("a 'State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions'" (quoting *Duquesne Light*, 488 US at 315)[5]).

Whether these concerns are implicated does not hinge on whether the state purports to apply a single methodology, but rather on the overall effect of the state's approach to ratemaking. That is, if the ratemaking approach allows for different tests and bases its choice of test on which test will result in the lowest rates given the particular facts, such a ratemaking approach would in fact use different methodologies, opportunistically switching back and forth between them on the basis of which methodology will provide the lowest rates given the facts presented. This is precisely what SB 408 does when it directs the Commission to set the tax expense in rates based on the lowest of: (a) the utility's standalone tax expense, (b) the consolidated tax expense, or (c) some other measure. *See* SB 408 § 3(6) & (12). And, this is precisely the asymmetric opportunism that the U.S. Supreme Court warned against in Duquesne Light. *See also Verizon Communications, Inc. v. FCC*, 535 US 467, 527, 122 S Ct 1646, 152 L Ed 2d 701 (2002) (noting confiscatory rate

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[5] *Duquesne* upheld a Pennsylvania statute barring rate recovery of certain prudent capital investments because the overall impact of the rate orders was not constitutionally objectionable. The rate orders provided for returns on common equity of 16 percent and overall returns of 11 to 12 percent. 488 US at 312.

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concerns raised by "opportunistic changes in rate setting methodologies"); Commission Recommendation to Legislature on Utility Income Taxes at 3 (Mar. 22, 2005) (tax adjustments must follow benefits and burdens standard and be symmetrical to satisfy federal case law).

3. Intervenors also argue that the Commission should not consider PacifiCorp's disallowed tax expense when considering whether the overall rates resulting from the Rate Order violate the statutory standard. CUB Post-Hearing Brief at 15 (arguing that including tax expense in calculation of ROE is equivalent to including expense that was disallowed because it was imprudent); ICNU Post-Hearing Brief at 23. However, the point is that the Rate Order did not conclude that PacifiCorp's tax expense is imprudent. Rather, the Order based the adjustment on an erroneous and unsupported factual finding that PacifiCorp would not incur this expense. *See* Rate Order at 19 (finding that PHI interest deduction is a constant that must be passed on to customers).

CUB would have the Commission assess whether the rates that result from this erroneous and unsupported finding are "fair and reasonable" by first assuming that the finding was correct and then calculating the effect on rates. As PacifiCorp has demonstrated, the PHI interest deduction is not a constant, and PacifiCorp will in fact incur its stand-alone tax expense. In light of these facts, the Rate Order resulted in rates that reduced PacifiCorp's ROE to 8.4%, just barely above the weighted average cost of capital set in this case. *See* PacifiCorp Post-Hearing Opening Brief at 18-19.

4. CUB's argument that an 8.4% effective ROE is fair and reasonable because it is within 250 basis points of the 10% ROE to which the parties stipulated, misconstrues the legal standard. *See* CUB Post-Hearing Brief at 15. ORS 756.040 requires the Commission to set rates that are "fair and reasonable," which means that the rates must:

> [P]rovide adequate revenue both for operating expenses of the public utility or telecommunications utility and for capital costs of the utility, with a return to the equity holder that is:

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> (a) Commensurate with the return on investments in other enterprises having corresponding risks; and
>
> (b) Sufficient to ensure confidence in the financial integrity of the utility, allowing the utility to maintain its credit and attract capital.

PacifiCorp has demonstrated that an effective ROE of 8.4% is far below the U.S. industry average and is not commensurate with returns on investment in other enterprises having commensurate risk. *See* PacifiCorp Post-Hearing Opening Brief at 18-20.

5. Like CUB, ICNU fails to rebut PacifiCorp's evidence that the effective ROE is not commensurate with returns on investment in other enterprises having commensurate risk. ICNU instead argues that an 8.4% ROE is fair and reasonable because it is "at the low end of the range of the ROE analysis performed by ICNU, CUB, and Staff" and is "within the range of reasonable results for three of [Staff's] four discounted cash flow models presented." ICNU Post-Hearing Brief at 23. ICNU's arguments are misleading. An 8.4% return is over 100 basis points lower than the lowest ROE recommendation in the case by any party (including Staff, ICNU and CUB). Nor does Staff's discounted cash flow analysis provide any support for the view that 8.4% is fair and reasonable. Staff did not recommend an ROE of 8.4%. Rather, Staff recommended an ROE of 9.5%.

6. ICNU argues that the Rate Order must have been fair and reasonable because MEHC did not react to the Order by withdrawing its application for approval to acquire PacifiCorp. ICNU Post-Hearing Brief at 24. ICNU's argument ignores the existence of this proceeding. *See* PPL/324, Williams/2 (testifying that "PacifiCorp and MEHC do not share [ICNU witness] Mr. Selecky's apparent view that it is a forgone conclusion that the tax adjustment adopted in the Rate Order will stand.").

7. ICNU attempts to dilute the significance of the impact of the Rate Order on PacifiCorp's ability to maintain its credit and attract capital by arguing that the Fitch downgrade was based on other factors. See ICNU Post-Hearing Brief at 24. However,

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Fitch identified specifically the Rate Order's SB 408 adjustment as a "key" concern and a "serious matter for concern." PPL/326, Williams/1; PPL/321, Williams/1-2. The other agencies have also expressed serious concern regarding the effect of SB 408 adjustments, and the Rate Order in particular, on PacifiCorp's financial integrity. PPL/324, Williams/5; *see also* PPL/318-23, PPL/325-28. Moreover, the credit action by Fitch was taken in light of this reconsideration proceeding. *See* PPL/321, Williams/2 (specifically noting that the Commission granted rehearing). Fitch and other credit agencies have indicated that they will take further negative action if the Commission affirms the Rate Order. *See id.*; PPL/327, Williams/1 (regulatory and legislative issues in Oregon which could impact future credit quality include the rehearing in this case). Thus, the evidence demonstrates that the SB 408 tax adjustment, if affirmed, will cause the financial community to lose confidence in PacifiCorp's financial integrity and undermine PacifiCorp's ability to maintain its credit and attract capital.

IV. The Commission Should Eliminate the Tax Adjustment and Allow Deferred Accounting.

1. The appropriate remedy in this case is to eliminate the tax adjustment and allow PacifiCorp to recover its lost revenues through deferred accounting. ICNU argues that the Commission should default to the CUB or ICNU adjustments in the initial rate case if SB 408 does not apply. ICNU Post-Hearing Brief at 25. The Commission cannot default to the CUB or ICNU positions, however, because the Commission must adhere to its stand-alone rule, which requires that the tax expense be computed on a stand-alone basis for ratemaking purposes.[6]

In any event, the Commission cannot implement an adjustment absent a benefits-burdens showing. The Department of Justice ("DOJ") has advised the Commission that it

[6] *See* sections I.5-6 *supra* at 3-5.

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must premise any departure from a stand-alone approach on a showing that customers bear the burden of the affiliate tax deductible expense. *See* PPL/1807/1 (Mar. 22, 2005 DOJ memorandum regarding Utility Reform Project's comments on tax treatment in utility ratemaking) (advising that Commission may change current stand-alone policy only "so long as the [new] policy is rational, including taking into account the benefits and burdens of its policy, and meets minimum constitutional requirements"); *id.* at 3 (state regulators may choose between different methods of calculating tax allowances, but "whichever method is chosen it should be applied in a way that matches benefits and burdens"). Nor is a benefits and burdens showing satisfied by the mere existence of debt within a utility's consolidated group:

> "[S]imply 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." AR 499, Staff Response Comments at 1 (OPUC May 19, 2006).

Rather, a benefits and burdens showing is made when substantial evidence in the record demonstrates that customers bear the burden of an affiliate's tax deductible expense—*e.g.*, through higher cost of debt. *Id.* at 2.

Here, ICNU's own expert acknowledges that such a showing has not been made with respect to PHI's interest deduction. *See* Cross-Examination of James Selecky, Tr. 84-86 (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); *see also* PacifiCorp's [Phase I] Opening Posthearing Brief at 13-22 (citing evidence in record that ICNU did not make a benefits/burdens argument and that CUB and Staff failed to present substantial evidence that customers bore the burden of PHI's interest payments); PacifiCorp's [Phase I]

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Posthearing Reply Brief at 7-9 (same).[7] The attributes that protect customers from the burden of affiliate expenses are even stronger under Berkshire Hathaway ownership than they were under ScottishPower ownership. *See* section II.3 *supra* at 10-11.

2. ICNU argues that authorization of a deferred accounting application to permit recovery of revenue due to a modification of the Rate Order on reconsideration would create dangerous precedent by threatening the finality of rate orders. ICNU Post-Hearing Brief at 25. ICNU's concern fails to appreciate the unique circumstances of the Rate Order. The Rate Order did not disallow cost-recovery based on a factual finding that PacifiCorp's tax expense was imprudent. In fact, the Rate Order did not make any factual finding at all about the expense. Instead, the Rate Order observed that SB 408 had become law after the close of the evidentiary record, submission of briefs and oral argument; recognized the complexity and uncertainty of the law, especially prior to compilation of the legislative history and promulgation of rulemaking; and attempted to apply that law to this case in order to minimize the amount of any future rate adjustments under the new law. Order 05-1050 at 13-19. In light of these unique circumstances, the Commission granted PacifiCorp's application for reconsideration and rehearing to provide the parties "a full and fair opportunity" to address the application of SB 408 to this docket. Order 05-1254 at 2-3. To the extent the Commission exceeded its authority in applying SB 408 to this case, or misapplied SB 408 to this case, deferred accounting is the only equitable remedy. Because of these unique

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[7] *See, e.g.,* Cross-Exam of Mr. Conway and Ms. Johnson, Tr. 191-92, Tr. 189 (acknowledging that PHI bears the burden of "paying the deductible expense that generated the savings"); CUB/200, Jenks/4 (same); Redirect-Exam of Mr. Conway and Ms. Johnson, Tr. 212-13 (focusing on negative attributes of PHI debt without regard to offsetting or positive attributes of the parent's financial structure); Recross-Exam of Mr. Conway and Ms. Johnson, Tr. 216-17 (same); Cross-Exam of Mr. Jenks, Tr. 156, 163 (same); Cross-Exam of Mr. Conway and Ms. Johnson, Tr. 194 (basing *burden* argument on claims that ring-fencing failed to protect customers from *positive* economic aspects of nonregulated operations); CUB/200, Jenks/3 (same); Staff/1000, Conway-Johnson/8 (disputing the relevance of any facts showing that PacifiCorp's customers have *benefited* from PacifiCorp's relationship with ScottishPower); Cross-Exam of Mr. Jenks, Tr. 162 (same).

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circumstances, authorization of deferred accounting in this case does not create dangerous precedent.

3. ICNU argues that PacifiCorp's request for deferred accounting does not satisfy the statutory or discretionary standards. As to the former, PacifiCorp submits that allowing deferred accounting produces an appropriate match between costs borne and benefits received by customers, because PacifiCorp has established that it will in fact incur its full stand-alone tax expense. See ORS 757.259(2)(e). As to the latter, in interpreting the Commission's discretionary standards, Staff has suggested that for certain Commission approved events, "such as a change in taxation," deferred accounting be allowed without a discretionary review of the type and magnitude of the event. *See* Order 05-1070, UM 1147 at 6. The Commission agreed in its Order in its generic deferred accounting docket that the Staff approach was generally illustrative of its policy. *Id.* at 7. If the Commission changes the tax expense allowed in this case, therefore, it is not required to apply the discretionary review standards in this case. Even if these standards were applicable, however, the tax adjustment amounts to $500,000 per week, which constitutes a substantial financial impact.

V. Conclusion.

Based upon all of the foregoing, as well as the evidence and argument PacifiCorp has previously presented, the Commission should vacate the tax adjustment in the Rate Order and grant PacifiCorp's request for deferred accounting to permit PacifiCorp full recovery of its lost revenues.

DATED: May 26, 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 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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May 26, 2006

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Re: Docket UE 170 (RECON)

Enclosed for filing in the above-referenced matter are an original and five copies of PacifiCorp's Reply Brief. 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