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August 10, 2007

VIA ELECTRONIC FILING

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

Re: Docket AR 517

Enclosed for filing in the above-referenced docket are PacifiCorp's Closing Comments. A copy of this filing has been served on all parties to this docket as indicated on the attached certificate of service.

Very truly yours,

A handwritten signature in black ink, appearing to read 'K.A. McDowell', with a small flourish at the end.

Katherine A. McDowell

Enclosures

cc: Service List

1 **BEFORE THE PUBLIC UTILITY COMMISSION**
2 **OF OREGON**

3 **AR 517**

4 In the Matter of Housekeeping and
5 Clarification Changes to OAR 860-022-
6 0041.

**REPLY COMMENTS
OF PACIFICORP**

7 **I. INTRODUCTION**

8 PacifiCorp appreciates the opportunity to comment on Staff's proposed
9 "housekeeping and clarification" amendments to the Commission's SB 408¹ administrative
10 rule, OAR 860-022-0041. All participants to this proceeding agree that Staff has done an
11 excellent job identifying the issues that must be resolved before the first SB 408 automatic
12 adjustment clause ("AAC") goes into effect and developing proposed rules to address these
13 issues. As a result, there is now almost complete consensus on the proposed rules,
14 notwithstanding their complexity.

15 As a result of this consensus, the following comments are limited to: (1) clarification
16 of questions raised in Opening Comments and at the July 31, 2007 hearing, (2) further
17 discussion of the two rule changes that implicate normalization concerns (Amendments 3
18 and 5), and (3) a proposal to address unanticipated implementation issues that arise as the
19 law goes into operation.

20 **II. QUESTIONS REGARDING HOUSEKEEPING AMENDMENTS**

21 **A. Amendment 1—Removal of the Iterative Effect**

22 All parties indicated support for Staff's Amendment 1 at the July 31 hearing, which
23 eliminates the iterative effect of SB 408 related rate adjustments. ICNU did, however, make
24 a recommendation in its Opening Comments that indicates a misunderstanding of the

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26 ¹ Codified at ORS 757.267-268 and Or. Laws 2005, c. 845, § 4 (eff. Sept. 2, 2005).

1 amendment. There, ICNU urged the Commission to apply the iterative effect rule “narrowly,”
2 stating that the reference in Amendment 1 to ORS 757.267 and 757.268 “means rate
3 adjustments made through the automatic adjustment clause called for in SB 408 rather than
4 adjustments to base rates in general rate cases.” (ICNU Opening Comments at 2.)

5 To clarify, Amendment 1, by its express language, already applies only to SB 408
6 related adjustments. (See proposed OAR 860-022-0041(2)(g) (limiting definition of “iterative
7 effect” to “rate adjustment[s] for taxes related to ORS 757.267 or ORS 757.268”).) Thus, by
8 its express terms, Amendment 1 does not apply to non-SB 408-related adjustments—
9 whether made in a utility’s general rate case or another proceeding. (*Id.*) However, by its
10 express terms, the amendment does eliminate the iterative effect of any SB 408-related
11 adjustment from the calculation of taxes paid whether that adjustment is made in an SB 408
12 AAC proceeding or a general rate case. (See proposed OAR 860-022-0041(4)(d)(E) and
13 (4)(j)(C) (permitting adjustment to federal/state and local total taxes paid to eliminate
14 iterative tax effect in rate case context); PacifiCorp Opening Comments at 2-5 (describing
15 operation of Amendment 1).)

16 **B. Amendment 2—One Time Election**

17 All parties support Staff’s second amendment, which allows a utility to change its one
18 time election if the utility’s ownership changes. One question regarding Amendment 2 was
19 raised at the hearing, however. Noting that Amendment 2 refers to changes in ownership
20 pursuant to ORS 757.511, ALJ Grant questioned whether it was Staff’s intent that this
21 amendment allow a utility to change its one time election upon approval of any
22 ORS 757.511 application (*e.g.*, upon approval of an application related to a corporation
23 indirectly acquiring 5% of the voting securities of the utility).

24 As PacifiCorp understands it, the intent of Staff’s proposed amendment is to allow a
25 new utility owner the opportunity to make the election between the two alternative
26 methodologies for calculating the multi-state tax rate in the first tax report filing that includes

1 a period reflecting new ownership. See OAR 860-022-0041(3)(c)(C). Rather than being
2 intended to expand this exception to the one-time election to include all affiliate interest
3 filings under ORS 757.511, the reference to ORS 757.511 is intended to limit the exception
4 to bona fide (*i.e.*, Commission-approved) changes in ownership. This is consistent with the
5 proposed amendment language, which states expressly that it applies “in the case of a utility
6 ownership change” and that it pertains to the reporting period “reflecting the new
7 ownership.”²

8 While ORS 757.511 covers actual changes in utility ownership as well as changes in
9 affiliate status, including affiliates that directly or indirectly acquire 5% of the voting securities
10 of the utility, Staff’s proposed amendment expressly and solely refers to changes in
11 ownership. The terms “change in ownership” and “new ownership” are not defined in
12 ORS 757.511 or anywhere else in the public utility statutes. Accordingly, these terms will be
13 interpreted pursuant to their plain meaning. The plain meaning of change in ownership of a
14 utility is a change in control of the utility—in other words, a change in the ownership of 51%
15 or more of the utility’s voting shares. Thus, the amended rule provides that, upon a change
16 in the ownership of 51% or more of the utility’s voting shares, approved by the Commission
17 under ORS 757.511, the new owner of the utility may make the election between the two
18 alternative methodologies for calculating the multi-state tax rate in the first tax report filing
19 that includes a period reflecting the new ownership.

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22 ² Staff’s proposed amendment provides:

23 If a utility’s taxes collected in rates reflect non-Oregon state income
24 taxes, the utility must make a one-time permanent election in its
25 October 15, 2006, tax report filing, **or in the case of a utility
ownership change pursuant to ORS 757.511, in the first tax
report filing that includes a tax reporting period reflecting the
new ownership**

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1 **C. Amendment 4—Exclusion of BETCs from SB 408**

2 All parties with the exception of ICNU support adoption of Staff's Amendment 4,
3 which conforms the rules to House Bill 3201³ by excluding Oregon business energy tax
4 credits (BETCs) from the operation of SB 408. ICNU raised two concerns regarding the
5 scope of Amendment 4 in its comments and at the hearing—stating that, to be excluded
6 from SB 408, the BETCs must be related to conservation and renewables and not paid for
7 by ratepayers.

8 With respect to both of ICNU's concerns, PacifiCorp joins in PGE's Reply
9 Comments, which provide further clarification of proposed Amendment 4 and HB 3201.
10 PacifiCorp also notes in response to ICNU's concern about customers paying for BETCs
11 that, as a practical matter, PacifiCorp pays for all BETCs below the line. Thus, PacifiCorp
12 customers never incur the expense of BETCs.

13 **III. RULE CHANGES RELATED TO NORMALIZATION**

14 PacifiCorp agrees with Staff—and every other party that has commented—that a rule
15 change to prevent a negative current taxes paid result is necessary to protect against a
16 violation of the normalization conditions of the Internal Revenue Code. The only point of
17 contention that remains is the degree of caution the Commission should take to prevent a
18 normalization violation and ensure a positive response from the IRS to the utilities' requests
19 for Private Letter Rulings ("PLRs").

20 To this end, PacifiCorp urges the Commission to continue to follow the conservative
21 approach to normalization that it adopted in its AR 499 order when it addresses the two
22 proposed rule amendments that impact normalization. These are the proposed change to
23 the Apportionment Method floor (Amendment 5) and the proposed safety net to prevent a
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25 ³ The Oregon Legislature passed HB 3201 on June 25, 2007 and the Governor signed the bill
26 into law on July 31, 2007.

1 negative current taxes paid number (Amendment 3). Of these two proposals, the more
2 critical one in terms of normalization is the safety net.

3 **A. Amendment 3—Normalization Safety Net**

4 The most important rule change proposed is Amendment 3, which is designed to
5 prevent a normalization violation. (See Staff's proposed OAR 860-022-0041(4)(d).) This
6 amendment is intended to preclude a "taxes paid" result that falls below the level of the
7 utility's deferred taxes related to depreciation on its public utility property—or, in other words,
8 the amendment is intended to avoid a negative current tax. All participants to this
9 proceeding agree that a negative current tax would likely violate normalization and should
10 be avoided.

11 Amendment 3 is critically important in the context of Amendment 5 (discussed
12 below), which removes the depreciation add-back from the calculation of the Apportionment
13 Method floor, thereby greatly increasing the likelihood of a negative current tax "taxes paid"
14 result. Thus, Amendment 3 provides a safety net against a normalization violation and
15 increases the likelihood of a positive response from the IRS on the utilities' PLR requests.

16 While a negative taxes paid outcome may seem unlikely or counter-intuitive, the
17 current methodology for calculating taxes paid, particularly under the Apportionment
18 Method, can produce such a result. In fact, the utilities' pending PLR requests demonstrate
19 this potential outcome with an example where the stand-alone result is \$490, the
20 consolidated result is \$468 and the Apportionment Method result is (\$19).⁴ Further, the IRS
21 typically examines just such extreme, yet still plausible, scenarios to evaluate normalization
22 effects.

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25 ⁴ See pages 11-18 of PacifiCorp's PLR request, a copy of which (exclusive of exhibits) is
26 attached hereto as Attachment A.

1 **1. Staff's Proposed Safety Net Leaves Too Much Room for a Possible**
2 **Normalization Violation.**

3 Staff attempts to ensure against a normalization violation by requiring a taxes paid
4 result of at least the amount of the utility's deferred taxes related to depreciation on the PUP
5 of the utility. Using the example in the PLR to illustrate, under Staff's proposed rule, the
6 (\$19) result of the Apportionment Method would be reset to the utility's deferred tax expense
7 of \$140 (*i.e.*, \$0 current tax), which would become the final taxes paid result.

8 While PacifiCorp supports the intent of Staff's proposed rule, which appears simple
9 on its face, PacifiCorp believes the proposal entails a degree of complexity (*e.g.*, in its
10 calculation of the amount of refund attributable to the regulated operations of the utility) and
11 leaves room for a normalization violation in at least two ways:

12 **First**, Staff's safety net proposal relies on a method that returns a negative current
13 tax number to \$0 to determine the ultimate taxes paid number, arbitrarily adjusting the final
14 result to \$0 current tax whenever the method produces a result that is a clear normalization
15 violation. In this way, the proposal fails to eliminate consideration of any result that
16 encroaches on deferred taxes by producing a negative current taxes paid amount.
17 Moreover, if the method of determining the deferred tax expense (and therefore current tax)
18 is in any way flawed, the safety net cannot assure against flowing through deferred taxes.
19 In this way, the safety net provides for the absolute minimum amount of required protection
20 with literally no margin for error—thereby providing inadequate assurance against a
21 normalization violation.

22 **Second**, depending on how Staff's safety net proposal is interpreted, it may fail to
23 accurately calculate the deferred tax expense, thereby exposing the utility to a significant
24 normalization risk. This is because Staff's safety net proposal reduces the deferred tax
25 amount by the amount of any tax refunds "apportioned" to the regulated operations of the
26 utility. If "apportioned" in this context is interpreted to mean apportioned based on the

1 Apportionment Method factors, deferred taxes will be reduced by an amount that is not tied
2 to the utility's tax accounting methodologies. Consequently, depending on the
3 Apportionment Method factors used in any given tax report to apportion the refund to the
4 utility's deferred taxes, Staff's proposed safety net may or may not actually ensure a taxes
5 paid result that covers the entire deferred tax expense.⁵

6 **2. PacifiCorp's Proposed Safety Net Provides More Comprehensive**
7 **Protection Against Normalization Violations.**

8 PacifiCorp has proposed a revision to Staff's proposed safety net that provides more
9 comprehensive protection against normalization violations while also ensuring that, in the
10 event the IRS rules negatively in the PLR, implementation of SB 408 is not delayed.

11 PacifiCorp's proposed safety net would preclude the use of any methodology (*i.e.*,
12 Standalone, Consolidated or Apportionment) that produces a negative current taxes paid
13 result in a given year. (See PacifiCorp Opening Comments at 10-13.) Each year, the utility
14 would provide in its annual tax report calculations and supporting documents applying all
15 three of the methods the Commission has set forth in the rules. However, in a given year,
16 should any of the three methods produce a current taxes paid result that is negative, that
17 method would be set aside for that year, and the lower of the results from the remaining
18 methods would be selected as the taxes paid amount for the year.

19 Under PacifiCorp's revised safety net, in the example from the PLR, the
20 Apportionment Method result of (\$19) would be eliminated from the "lesser of" comparison,
21 and the final taxes paid number for that year would be selected from the remaining two

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23 ⁵ This second concern would be alleviated if "apportioned" were interpreted in this context to
24 mean allocated pursuant to the utility's tax allocation methodology. However, if Staff's proposed
25 safety net is adopted as currently drafted, it is likely the IRS may deem the safety net insufficient to
26 ensure against normalization violations. PacifiCorp's proposed revisions to Staff's safety net rule,
included in PacifiCorp's Opening Comments at page 10, replace the word "apportioned" with the word
"allocated" to address this concern.

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1 results. This would produce a final taxes paid result of \$468, which was the Consolidated
2 result for the year.

3 PacifiCorp's normalization safety net provides more comprehensive and clearer
4 normalization protection for three reasons:

5 **First**, unlike Staff's proposed safety net, PacifiCorp's safety net does not arbitrarily
6 set current taxes paid at zero (*i.e.*, the deferred tax amount). Therefore, it neither bases the
7 taxes paid result on a method that initially produced a normalization-violating result nor does
8 it leave literally no margin for error. Thus, for example, if Staff's proposed calculation of the
9 deferred tax expense includes an error (*e.g.*, reduction of deferred taxes based on refunds
10 allocated pursuant to the Apportionment Method), Staff's safety net does not ensure against
11 flowing through deferred taxes in violation of normalization. PacifiCorp's safety net avoids
12 this risk by using the lesser-of amount derived from a method that does not violate
13 normalization, instead of reverting to a potentially miscalculated deferred tax amount.

14 **Second**, Staff's proposed rule would result in taxes paid being set at the lowest
15 possible level, deferred tax expense from depreciation on public utility property, without a
16 clear methodological basis for this outcome. From a normalization standpoint, it is difficult to
17 defend an outcome that is not transparent in terms of the inherent relationship between
18 current and deferred taxes. When current taxes are arbitrarily reset at a particular level, in
19 this case "zero," the depreciation and deferred taxes associated with that current tax number
20 are harder to define, isolate and protect. The IRS must be able to clearly discern that
21 normalization—which actually addresses the relationship between current and deferred
22 taxes related to depreciation—has been properly and squarely addressed within the context
23 of the three taxes paid computations we have presented to them for a favorable ruling.

24 **Third**, PacifiCorp's approach invalidates, rather than partially rehabilitates, a
25 calculation that violates normalization. This is a clearer, easier approach for the IRS to
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1 review and approve in the context of the pending PLR requests.⁶ This is important,
2 because, without a positive PLR, SB 408's AAC may never go into effect, at least for tax
3 refunds.⁷

4 **B. Amendment 5—Change in Apportionment Method Floor**

5 The second set of rule changes that impact normalization covers Staff's proposal to
6 eliminate the general depreciation add-back on the Apportionment Method floor.
7 PacifiCorp's principle objection to this set of changes is that it dramatically increases the
8 likelihood of a normalization violation. (See PacifiCorp Opening Br. at 6-10.) While
9 PacifiCorp believes the most conservative approach to normalization is to reject this set of
10 changes, PacifiCorp urges the Commission—if it decides to adopt Staff Amendment 5—to
11 adopt it in conjunction PacifiCorp's proposed normalization safety net. By adopting such a
12 comprehensive and clear normalization safety net, the Commission mitigates the increased
13 risk of a normalization violation presented by Amendment 5.

14 **IV. FLEXIBILITY TO ADDRESS IMPLEMENTATION ISSUES**

15 Finally, PacifiCorp respectfully requests that the Commission acknowledge that,
16 while Staff's proposed amendments have tried to anticipate and address the key
17 implementation issues, unanticipated issues will invariably emerge as the law begins to
18 operate. Existing OAR 860-022-0041(4)(o) provides a model for an efficient mechanism for
19 dealing with these unanticipated issues in a way that will not derail implementation of the
20 first AACs. That rule requires the utilities to identify in their tax reports any unanticipated
21 normalization concerns and propose solutions to those concerns. Similarly, the Commission

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23 ⁶ ALJ Grant asked at the July 31 hearing if rule amendments will require amendment of the
24 pending PLR requests, and, if so, what the procedure is for amending PLR requests. The original
25 PLR requests filed on December 29, 2006, will be supplemented by a letter from each utility
26 explaining the rule changes and updating the relevant sections and examples.

⁷ OAR 860-022-0041(8)(g) ("While a utility's request for a Private Letter Ruling is pending, or
a related Revenue Ruling is pending, no rate adjustment will be implemented . . .").

1 should direct the utilities to identify in their tax reports any remaining implementation issues
2 and propose approaches for addressing those issues.

3 **V. CONCLUSION**

4 PacifiCorp appreciates the opportunity to comment on the draft rules. For the
5 reasons stated above, in PacifiCorp's Opening Comments, and at the rulemaking hearing,
6 PacifiCorp supports adoption of Staff's proposed rule changes with respect to removal of the
7 iterative effect (Amendment 1), allowance of a change in methodology if ownership of the
8 utility changes (Amendment 2), and exclusion of BETCs from the SB 408 calculation of
9 taxes paid (Amendment 4). PacifiCorp urges the Commission to continue to recognize the
10 critical importance of avoiding a normalization violation and receiving a positive ruling from
11 the IRS on the pending PLRs. Accordingly, if the Commission adopts Staff's proposed
12 change to the Apportionment Method Floor (Amendment 5), PacifiCorp urges the
13 Commission to protect against the increased risk of normalization violations by also
14 adopting PacifiCorp's proposed revisions to Staff's safety-net rule (Amendment 3).
15 Additionally, PacifiCorp respectfully requests that the Commission acknowledge that
16 unanticipated issues will invariably emerge as the law begins to operate and direct the
17 utilities to identify in their tax reports any remaining implementation issues and propose
18 approaches for addressing those issues.

19 DATED: August 10, 2007

20 MCDOWELL & RACKNER PC

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22 _____
23 Katherine A. McDowell

24 Attorney for PacifiCorp

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CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in Docket AR 517 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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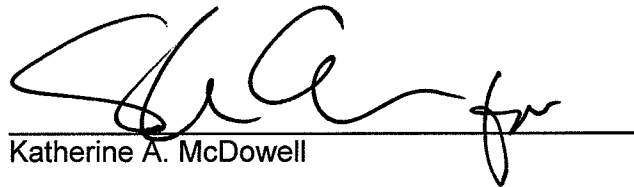
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DATED: August 10, 2007.

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Attachment A

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December 29, 2006

VIA OVERNIGHT COURIER

Associate Chief Counsel
Internal Revenue Service
Attn: CC:PA:LPD:DRU, Room 5336
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: **Ruling Request for PacifiCorp (EIN #930246090)**

Dear Sir or Madam:

On behalf of PacifiCorp ("PacifiCorp" or "Taxpayer"), we respectfully request that the Internal Revenue Service ("Service") issue rulings under §168(i)(9) of the Internal Revenue Code of 1986, as amended ("Code"), former Code §167(l) and former Code §46(f) regarding the status under the depreciation and investment tax credit ("ITC") normalization rules of the ratemaking procedure which will be described in detail hereafter. PacifiCorp is required under rules recently issued by the Oregon Public Utility Commission to seek this private letter ruling.

STATEMENT OF FACTS

Taxpayer

PacifiCorp is both incorporated and headquartered in the State of Oregon. It is a vertically integrated regulated electric company serving retail customers in portions of the states of Oregon, Utah, Wyoming, Washington, Idaho and California. PacifiCorp also sells electricity in the wholesale market. In connection with these activities, it is regulated by the Oregon Public Utility Commission ("Commission"), the Wyoming Public Service Commission, the Utah Public Service Commission, the Washington Utilities and Transportation Commission, the Idaho Public Utility Commission, the California Public Utilities Commission and the Federal Energy Regulatory Commission ("FERC") with respect to the terms and conditions of service and, most

particularly, as to the rates it can charge for its service. PacifiCorp accounts for its Oregon-jurisdictional ITC pursuant to former Code §46(f)(1).

PacifiCorp is an indirect subsidiary of MidAmerican Energy Holdings Company ("MEHC"). MEHC owns subsidiaries other than PacifiCorp that provide regulated electric and gas and interstate gas pipeline services to customers in a number of geographical areas (including Iowa, Illinois, South Dakota and Nebraska). MEHC is, itself, 88.2% owned by Berkshire Hathaway, Inc. ("BHI"). BHI, MEHC and PacifiCorp own numerous subsidiaries that engage in non-regulated activities.

BHI is the parent of an affiliated group of corporations that files a consolidated U.S. Corporation Income Tax Return. This group includes both MidAmerican and PacifiCorp and their respective subsidiaries. This return is filed with the Internal Revenue Service Center in Ogden, Utah. BHI, and, hence, PacifiCorp, employs a calendar year reporting period. PacifiCorp uses the accrual method of accounting.

The Setting of PacifiCorp's Rates

In each regulatory jurisdiction, Taxpayer's rates for retail electric service are determined on a "cost of service" basis and are designed to provide, after recovery of allowable operating expenses, an opportunity to earn a reasonable return on "rate base." "Rate base" is generally determined by reference to the original cost (net of accumulated depreciation) of utility plant in service, subject to various adjustments for deferred taxes and other items. The assets used in these "cost-based" activities are subject to the depreciation and ITC normalization rules contained in Code §168(i)(9), former Code §167(l) and former Code §46(f). The above-described process of setting rates requires that PacifiCorp compute its tax expense element of cost of service, including both current and deferred components ("income tax expense"), so that all of its incurred costs can be ascertained.

The Oregon Legislation

In September of 2005, Senate Bill 408 ("SB 408") was signed into law.¹ A copy of SB 408 is appended as Exhibit 1. This legislation prescribed a new and different method for the treatment of the tax element of cost of service for certain Oregon utilities. Specifically, the legislation was intended to "more closely align taxes collected by a regulated utility from its ratepayers with taxes received by units of government." The new "alignment" procedures apply to all income taxes – federal, state and local.

SB 408 requires all regulated, investor-owned utilities that provided electric or natural gas service to an average of 50,000 or more customers in Oregon in 2003 to file an annual tax report with the Commission on or before October 15th following the year for which the report is being made. Among other information, the tax report must contain (1) the amount of taxes that were paid (a) by the utility or (b) by the affiliated group and that are "properly attributed" to the

¹ SB 408 was codified at ORS 757.267 and 757.268.

regulated operations of the utility and (2) the amount of taxes "authorized to be collected in rates." If the Commission determines that the amount of taxes "authorized to be collected" differs by more than \$100,000 from the amount of "properly attributed" taxes paid in any one of the previous three years, it must order the subject public utility to implement a rate schedule with an automatic adjustment clause accounting for the difference by means of either a surcredit or a surcharge on its customers' utility bills. In other words, SB 408 seeks to reconcile and then to match taxes collected in rates with taxes paid by and properly attributed to the utility, as those terms are defined by the statute, for each annual period.

There are, therefore, two measurements that are fundamental to the operation of the statute: (i) that of taxes paid and "properly attributed" to the Oregon regulated operations of the utility and (ii) that of "taxes authorized to be collected in rates."

The Permanent Rules

SB 408 did not define or even describe the phrase "properly attributed" and provided no methodology for its identification. This task was delegated by the legislature to the Commission. A permanent rulemaking docket, AR 499, was opened by the Commission on September 15, 2005 to establish rules for the implementation of SB 408 – including the procedures for quantifying "properly attributed" taxes. In Order No. 06-532 issued on September 14, 2006, the Commission adopted final administrative rules setting forth that methodology, as well as other items necessary for the implementation of SB 408 ("Permanent Rules"). A copy of the Permanent Rules is appended as Exhibit 2.

Taxes Authorized To Be Collected In Rates

The mechanics for computing taxes authorized to be collected in rates are established in Commission Order No. 06-400, AR 499. Per this order, the calculation must be driven by data from each utility's last rate case. From that data, each utility calculates the percentage of each dollar of revenue that, per the assumptions made when setting rates, is attributable to the recovery of the tax expense element of cost of service.² This percentage is then multiplied by the revenues actually collected as reported in the utility's regulatory operational report. The result of this computation represents the total taxes, both current and deferred, deemed collected as a result of the provision of the regulated service at the rates established in the prior rate case.

For example, if, in a utility's last prior rate case, the tax expense element of cost of service (both current tax expense and deferred tax expense) was assumed at \$10 million and total projected revenues (*i.e.*, the revenue requirement upon which rates were based) were \$200 million, it is presumed that 5% ($\$10/\200) of every dollar collected from customers while those rates are in effect represents the recovery of the tax expense element of cost of service. If, in a subsequent period, total revenues collected are \$240 million, then that amount is multiplied by 5% to quantify the deemed "taxes authorized to be collected in rates." Under SB 408, this would be \$12 million.

² Technically, this is accomplished in two steps: (1) a computation of a margin (net income before taxes divided by gross revenues) and (2) the multiplication of that margin by the tax rate.

"Properly Attributed" Taxes

The Permanent Rules define the amount of federal, state, and local income taxes paid by the utility or by the affiliated group and that is "properly attributed" to the Oregon regulated operations of the utility. In general, it is the lowest of three alternative computations: (a) the "stand alone" tax liability of the utility (hereafter, Method 1), (b) the total tax liability of the affiliated group adjusted as described below (hereafter, Method 2) and (c) the total tax liability of the affiliated group (again, as adjusted) apportioned as prescribed by the Permanent Rules (hereafter, Method 3).

Adjustments

The adjustments to both the stand alone (Method 1) and consolidated (Methods 2 and 3) tax liabilities are of three basic types: (i) "incentive" adjustments that are meant to prevent certain tax benefits from being passed on to customers (*i.e.*, to encourage the activities which produce the tax benefits), (ii) "regulatory lag" adjustments that account for certain tax benefits that are not reflected in rates because they were recognized subsequent to the last rate setting and (iii) adjustments that are meant to ensure compliance with the normalization rules of the Code.

The incentive adjustments relate to items such as charitable contributions and the renewable electricity production credits provided for by Code §45. Under each of the three alternative methodologies, the tax benefits of some or all of these two items are added back to the relevant tax liability. The effect of this is that they are not used to reduce Oregon regulated rates. Thus, the benefits are retained by the utility, thereby promoting the underlying activity. Because the treatment of these two items in ratemaking does not implicate the normalization rules, the mechanics surrounding them will not be further described and no rulings will be requested with respect to these.

The "regulatory lag" adjustments relate to production tax credits and certain state credits. Insofar as these items do not implicate the normalization rules, the mechanics surrounding them will not be further described and no rulings will be requested with respect to these.

The general architecture of the "normalization protection" process is to adjust the starting tax liability (either consolidated or standalone, as the case may be) by "stripping out" the two tax benefits that are subject to the normalization rules - depreciation and ITC claimed with respect to public utility property ("PUP"). In the case of Method 1, the standalone tax liability is then adjusted to reflect the effects of both of these benefits on current and deferred taxes. Method 2 operates the same way as Method 1 except its starting point is the consolidated tax liability instead of a standalone one. In the case of Method 3, the consolidated tax liability so modified is subjected to an allocation procedure. After the application of this procedure, the same "back end" adjustments are made as in Methods 1 and 2. In each of the three methods, the benefits of depreciation and ITC are, thus, effectively isolated and handled discretely. In this way, the process is designed to ensure compliance with the normalization rules.

There follows a description of each of the three methods. In each description, the adjustments for anything other than depreciation and ITC-related tax benefits, *i.e.*, incentive and regulatory lag adjustments, have been excluded.³ Additionally, while SB 408 and the Permanent Rules subject state and local income taxes to the same procedures, these are not reflected in the descriptions below.

Method 1 (Stand Alone)

Starting point: Pro forma federal income tax liability computed by reference to the revenues and expenses included in the utility's Oregon regulatory report of operations for the period.

Adjustment 1 Recompute tax liability eliminating tax depreciation on PUP;

Adjustment 2 Add back the benefit of ITC;

Adjustment 3 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 4 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 5 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.⁴

Result: Method 1 properly attributed taxes.

Method 2 (Consolidated/Adjusted)

Starting point: Consolidated federal income tax (per return) after adjustments for subsequent changes (audits, amended returns, etc.).

Adjustment 1 Add back the tax benefit of *all* tax depreciation claimed with respect to *all* PUP anywhere in the group (calculated at statutory tax rate);

Adjustment 2 Add back the benefit of ITC claimed on *all* PUP anywhere in the group;

³ A complete matrix of all adjustments cross-referenced to the relevant provision of the Permanent Rules is appended as Exhibit 3.

⁴ There is also an adjustment for interest to conform it to the method used by the Commission in establishing rates. However, this adjustment is not germane to the normalization rules and, hence, this ruling request.

Adjustment 3 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 4 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 5 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.

Result: Method 2 properly attributed taxes.

Method 3 (Consolidated/Appportioned)

Starting point: Consolidated federal income tax (per return) after adjustments for subsequent changes (audits, amended returns, etc.).

Adjustment 1 Add back the tax benefit of *all* tax depreciation claimed with respect to *all* PUP anywhere in the group (calculated at statutory tax rate);

Adjustment 2 Add back the benefit of ITC claimed on *all* PUP anywhere in the group;

Adjustment 3 Apportion the amount after Adjustment 2 by applying a “three-factor” formula;⁵

Adjustment 4 Compare the result of Adjustment 3 to the standalone floor⁶ and proceed using the greater of the two;

Adjustment 5 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 6 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 7 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.

⁵ The “three factor” formula consists of a simple average of the ratios of Oregon regulated operations to the consolidated group total for plant, wages and sales.

⁶ The standalone floor is the amount that results after Adjustment 2 of Method 1 (an adjusted standalone tax liability) reduced by an allocation of the imputed negative tax liability of affiliates with tax losses. This imputed negative tax liability is computed after eliminating depreciation and ITC claimed by each loss affiliate with respect to its PUP. The total of such imputed negative tax liabilities is apportioned based on a simple average of the ratios of Oregon regulated operations to all regulated operations for plant, wages and sales.

Result: Method 3 properly attributed taxes.

Comparison of "Taxes Authorized" To "Taxes Properly Attributed"

As indicated above, the result of the calculation described as representing the taxes authorized to be collected in rates is compared to the calculation described as representing the taxes properly attributed to the Oregon regulated operation for the same period. Starting in fiscal years beginning on or after January 1, 2006, if, for any of the previous three years, the difference between the two equals or exceeds \$100,000 (for all income taxes), the Commission must implement an adjustment clause to "true up" the taxes collected to the taxes properly attributed by crediting or charging customers for the difference on future bills. The Commission has developed a template that provides a comprehensive example of the computations required under SB 408 and the Permanent Rules. For purposes of providing a sense of the flow of the process, this template is appended as Exhibit 4.

SB 408, the Permanent Rules and the Normalization Rules

By mandating the establishment of an adjustment clause for the tax expense element of cost of service, SB 408 and the Permanent Rules effectively establish a methodology for the computation of the tax expense element of cost of service itself. In other words, the requirement to "true up" to a measure of "properly attributed taxes" means that, ultimately, it is these "properly attributed taxes" that are collected in rates. Consequently, the normalization rules are clearly relevant to these calculations. In recognition of this fact, the Permanent Rules require that, on or before December 31, 2006, each utility subject to SB 408 must seek a private letter ruling from the Internal Revenue Service as to whether the utility's compliance with SB 408 and the Permanent Rules would cause the utility to fail to comply with any provision of the normalization rules. They further provide that no rate adjustment will be implemented while such a ruling request is pending. Finally, the Permanent Rules authorize a utility to propose an adjustment to its computation of properly attributed taxes in order to avoid a probable violation of the normalization rules.

RULINGS REQUESTED

Taxpayer respectfully requests the following rulings:

1. The use of Method 1 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).
2. The use of Method 2 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

3. The use of Method 3 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).
4. The automatic adjustment clause described above which conforms taxes collected by Taxpayer from its Oregon customers to taxes paid with respect to its Oregon regulated operations is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

STATEMENT OF LAW

Code §168(i)(9)(A)(i) provides that, in order to use a normalization method of accounting with respect to any public utility property, the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes.

Code §168(i)(9)(A)(ii) requires that a taxpayer make adjustments to a reserve to reflect the deferral of such taxes resulting from the use of different depreciation methods for tax purposes and for purposes of computing its tax expense element of cost of service.

Code §168(i)(9)(B)(i) provides that the normalization requirements are not met if the taxpayer uses a procedure or adjustment that is inconsistent with the requirements of Code §168(i)(9)(A).

Code §168(i)(9)(B)(ii) provides that the procedures and adjustments that are inconsistent with these limitations include any procedure or adjustment for ratemaking purposes that uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to rate base.⁷

Former Code §46(f) imposed limitations on the treatment of the ITC claimed by certain regulated public utility companies with respect to their "public utility property." The general rule under former Code §46(f)(1) stated that a taxpayer's cost of service cannot be reduced by any amount of the ITC. A taxpayer's rate base, however, may be reduced by the ITC amount provided that the reduction is restored no less rapidly than ratably over the useful life of the property.

Alternatively, taxpayers could elect the application of former Code §46(f)(2). This section provided that ITC will not be allowed with respect to public utility property if (1) the taxpayer's cost of service for ratemaking purposes and on its regulated books of account is

⁷ See also former Code §167(l)(3)(G).

reduced by more than a ratable portion of the ITC, or (2) taxpayer's rate base is reduced by reason of any portion of the ITC.

Former Code §46(f)(6) provides that, for purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of ITC, the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account will be used.

Reg. §1.46-6(g) provides that ITC amortization period must be no shorter than the one used to calculate ratemaking depreciation expense.

Reg. §1.46-6(b)(2)(ii) provides that, in determining whether or to what extent ITC has been used to reduce cost of service, reference will be made to any accounting treatment that affects cost of service.

Reg. §1.46-6(b)(3)(ii)(A) provides that, in determining whether or to what extent ITC has been used to reduce rate base, reference will be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit was unavailable.

Reg. §1.46-6(b)(4)(i) provides that cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner.

Former Code §46(f)(10) provided that the normalization requirements are not met if the taxpayer uses a procedure or adjustment that is inconsistent with the limitations in former Code §46(f)(1) and 46(f)(2). The procedures and adjustments that are inconsistent with these limitations include any procedure or adjustment for ratemaking purposes that uses an estimate or projection of the taxpayer's qualified investment for purposes of the credit unless such estimate or projection is consistent with the estimates and projections of property which are also used for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

On September 11, 1991, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means held a hearing on the IRS withdrawal of the proposed regulations concerning the treatment of consolidated savings under the normalization requirements of the Code. At that hearing, Deputy Assistant Secretary (Tax Policy) Michael J. Graetz released a statement in which he set forth the IRS's position with regard to this issue. Attached to his statement was a memorandum to him from Abraham N. M. Shashy, Jr., Chief Counsel, which served as the basis for Mr. Graetz's conclusions. Serial 102-45, 102nd Congress, First Session.

ANALYSIS

As described above, SB 408 and the Permanent Rules effectively dictate the level of tax expense that can be included in rates over time. They do this by (1) prescribing the mechanics for arriving at a permissible amount ("properly attributed" taxes) and (2) requiring an automatic adjustment clause to ultimately achieve the quantity of rate collections appropriate to that level of tax expense – no more and no less. In order to facilitate a normalization analysis, this system of ratemaking for taxes is best divided into four components. The first three are the three alternative methodologies established by the Permanent Rules to quantify the "properly attributed" taxes paid. Since, in each year, the lowest of the three computations is used and since there is no way to predict in advance which of the methods will produce the lowest amount, it is appropriate to subject each of the three to a separate normalization analysis. The fourth component is the "true up" procedure itself.

Three Methods and Deferred Taxes

The three methods of determining "properly attributed" tax amounts share two significant characteristics. The first is a lack of specificity in identifying the components of tax expense. The purpose of the three methods is to arrive at the amount of "taxes paid" that is "properly attributed" to the regulated operations in Oregon. Under the terms of SB 408, "taxes paid" includes "deferred taxes related to the regulated operations of the utility."⁸ Thus, "taxes paid," as defined in SB 408, includes the entire tax expense element of cost of service for the Oregon regulated operation. The computational focus of the three methods on overall tax expense leaves some lack of clarity regarding the portion of the calculated amount that is current tax and the portion that is deferred tax. However, this lack of clarity can be readily overcome by the application of some logic and basic accounting principles, as will be illustrated hereafter.

More significantly, each of the three methods includes an adjustment for those deferred taxes "related to the regulated operations of the utility." For Methods 1 and 2, this is Adjustment 4. For Method 3 it is Adjustment 6. Section (2)(b) of the Permanent Rules defines a utility's "deferred taxes" as:

"the total deferred tax expense of regulated operation, as reported in the deferred tax expense accounts as defined by the Federal Energy Regulatory Commission, that relate to the year being reported in the utility's results of operations report or tax returns."

This cross-reference to regulatory books of account creates an unusual situation with regard to deferred taxes. By defining deferred taxes in this way, the Permanent Rules require that the deferred portion of tax expense (*i.e.*, "taxes paid") equals that reflected on those books as of the end of the relevant measurement period. These regulatory books of account will, in the normal course, reflect deferred taxes (and, hence, deferred tax expense) generated by the temporary

⁸ SB 408, Section 3(13)(f)(C).

differences between the regulatory and the tax treatments of all items of which the utility is aware as of the time of the closing of the regulatory books.⁹ The deferred tax account balances will be "event driven" (*i.e.*, they will result from whatever actual events transpire). Since this closing of the regulatory books will, in the normal course, occur months prior to the filing of the relevant tax return, at least some elements of deferred tax expense will consist of estimates. However, the reference to "tax returns" in the definition excerpted above indicates that the level of deferred tax expense reflected in the regulatory books of account are to be "trued up" to the "actual" deferred tax amount. Thus, the deferred taxes recorded in these books will, in all cases, reflect the tax deferrals (and reversals) that actually occur by virtue of the differences between the regulatory and the tax treatments of items of income and expense.

By adopting the regulatory books as the deferred tax paradigm, compliance with SB 408 and the Permanent Rules will, of necessity, result in the consideration in the setting of rates of the level of deferred taxes that is required by the depreciation normalization rules. This will include the treatment of excess deferred taxes. To the extent that the regulatory books of account employ the average rate assumption method to flow back these amounts, then that practice will be recognized in the setting of rates through the deferred tax adjustment.

The remaining issues are, therefore, (1) whether or not the SB 408 procedures permit the flowing through of the benefits of accelerated depreciation and/or ITC from other regulated operations and (2) the extent to which these procedures do something to the computation of the current provision of tax expense that may be deemed to be an indirect (and impermissible) adjustment to the deferred provision or an inconsistency that runs afoul of Code §168(i)(9)(B).

Analyses of the Three Methods

Each of the three following analyses proceeds from a single set of facts. PacifiCorp's base case consists of a single utility group member regulated by both the Commission and by FERC and two non-regulated subsidiaries. The tax rate is 35%. The three members file a consolidated tax return incorporating the following results:

PacifiCorp Tax Expense - Base Data					
	PacifiCorp-Oregon	PacifiCorp-FERC	Sub 1	Sub 2	Consolidated
Pre-Dep Book Income	\$1,500	\$250	\$200	\$9,100	\$11,050
Book PUP Dep	\$100	\$10			\$110
PUP Dep – Add'l Tax	\$400	\$40			\$440
Other Dep			\$9,400	\$100	\$9,500
Taxable Income	\$1,000	\$200	(\$9,200)	\$9,000	\$1,000
Tax Liability	\$350	\$70	(\$3,220)	\$3,150	\$350

⁹ Note that this adjustment includes all deferred taxes – not just those associated with PUP. Because only the PUP-related deferred taxes are relevant to the normalization rules, the illustrations set out later in this ruling request will only focus on those.

ITC	\$50	\$10		\$40	\$100
Current Tax Expense	\$300	\$60	(\$3,220)	\$3,110	\$250

METHOD 1 (Stand Alone)

The application of Method 1 to the base data produces the following results:

PacifiCorp-Oregon Tax Expense - Method 1					
	PacifiCorp-Oregon	PacifiCorp-FERC	Sub 1	Sub 2	Consolidated
Pre-Dep Book Income	\$1,500	\$250	\$200	\$9,100	\$11,050
Book PUP Dep	\$100	\$10			\$110
PUP Dep - Add'l Tax	\$400	\$40			\$440
Other Dep			\$9,400	\$100	\$9,500
Taxable Income	\$1,000	\$200	(\$9,200)	\$9,000	\$1,000
Tax Liability	\$350	\$70	(\$3,220)	\$3,150	\$350
ITC	\$50	\$10		\$40	\$100
Current Tax Expense	\$300	\$60	(\$3,220)	\$3,110	\$250
Standalone Tax Liability	\$300				
Adjustment 1	\$175	Tax benefit of depreciation on Oregon PUP [\$500 X 35%]			
Sub-total	\$475				
Adjustment 2	\$50	Tax benefit of ITC on Oregon PUP [\$50]			
Sub-total	\$525				
Adjustment 3	(\$175)	Tax benefit of depreciation on Oregon PUP [\$500 X 35%]			
Sub-total	\$350				
Adjustment 4	\$140	Deferred taxes on Oregon regulated operations			
Sub-total	\$490				
Adjustment 5	\$0	Regulatory ITC amortization			
Total Tax Expense	\$490				

Under this method, the current tax provision is \$300. The deferred tax provision is \$140 which is attributable to the Oregon PUP depreciation (*i.e.*, PacifiCorp's Oregon regulatory books will reflect \$140 of deferred tax expense). There is another \$50 adjustment (Adjustment 2) which eliminates the effect of ITC on tax expense. Because PacifiCorp accounts for its Oregon-jurisdictional ITC pursuant to former Code §46(f)(1), there is no regulatory amortization reflected in Adjustment 5. This is in keeping with the requirements of its normalization accounting method (*i.e.*, ITC does not reduce cost of service).

This method represents conventional, stand-alone ratemaking for taxes of the type that is used in most regulatory jurisdictions. As indicated above, the level of deferred taxes provided should be adequate under the depreciation normalization rules. The treatment of ITC is consistent with the ITC normalization rules. Finally there is nothing about the current provision that should give the slightest pause under either set of rules.

In short, this ratemaking should be non-controversial from a tax normalization perspective.

METHOD 2 (Consolidated/Adjusted)

The application of Method 2 to the base data produces the following results:

PacifiCorp-Oregon Tax Expense - Method 2					
	PacifiCorp-Oregon	PacifiCorp-FERC	Sub 1	Sub 2	Consolidated
Pre-Dep Book Income	\$1,500	\$250	\$200	\$9,100	\$11,050
Book PUP Dep	\$100	\$10			\$110
PUP Dep - Add'l Tax	\$400	\$40			\$440
Other Dep			\$9,400	\$100	\$9,500
Taxable Income	\$1,000	\$200	(\$9,200)	\$9,000	\$1,000
Tax Liability	\$350	\$70	(\$3,220)	\$3,150	\$350
ITC	\$50	\$10		\$40	\$100
Current Tax Expense	\$300	\$60	(\$3,220)	\$3,110	\$250
Consolidated Tax Liability	\$250				
Adjustment 1	\$193	Tax benefit of depreciation on all PUP [(\$500+\$50) X 35%]			
Sub-total	\$443				
Adjustment 2	\$60	Tax benefit of ITC on all PUP [\$50+\$10]			
Sub-total	\$503				
Adjustment 3	(\$175)	Tax benefit of depreciation on Oregon PUP [\$500 X 35%]			
Sub-total	\$328				
Adjustment 4	\$140	Deferred taxes on Oregon regulated operations			
Sub-total	\$468				
Adjustment 5	\$0	Regulatory ITC amortization			
Total Tax Expense	\$468				

The Method 2 example above results in a current tax provision of \$278. This is the subtotal after Adjustment 3 (\$328) less the \$50 of ITC claimed with respect to Oregon PUP. The

deferred tax provision consists of the \$140 relating to Oregon PUP. There is an additional cost of service adjustment of \$50 relating to the PacifiCorp-Oregon ITC. Thus, when compared to Method 1, the total deferred tax provision remains unaffected.

The \$22 difference between the \$468 of total tax expense using Method 2 and the \$490 using Method 1 is attributable to:

Method 1 tax expense	\$490	
Reduction for non-PacifiCorp Oregon tax benefit	(\$50)	[\$60-\$3,220+\$3,110]
PacifiCorp-FERC depreciation	\$18	[\$50 X 35%]
PacifiCorp-FERC ITC	\$10	
Method 2 tax expense	\$468	

The difference between this Method 2 calculation and the prior Method 1 calculation is entirely attributable to activities other than PacifiCorp-Oregon's. In this regard, this difference is in the nature of a consolidated tax adjustment ("CTA"). Generally, a CTA adjusts a utility's tax expense element of cost of service based on the "tax reducing" consequences (usually tax losses) of activities undertaken by consolidated return affiliates of the utility (*i.e.*, consolidated return benefits). Method 2 effectively does this, although, because its starting point is the consolidated tax liability, it also reflects the tax consequences of divisional activities.¹⁰

CTAs were very controversial in the latter part of the 1980s. During that period of time, a number of utilities requested guidance from the Service regarding the normalization implications of certain CTAs that resulted in reductions of the tax expense element of cost of service. The Service issued several private letter rulings (including PLRs 8525156, 8643024, 8711050 and 8801041) all of which concluded that the imposition of a CTA of this type would violate the normalization rules. These conclusions were based on the dual premises that (1) such ratemaking indirectly reduced the level of deferred tax required to be provided under the normalization rules and (2) that it violated the "consistency requirement" of those rules.

On September 11, 1991, Michael Graetz, Deputy Assistant Secretary (Tax Policy), announced a change in the Service's position with respect to CTAs at a hearing before the Committee on Ways and Means Subcommittee on Select Revenue Measures. At that time, Mr. Graetz, disavowed the previously issued letter rulings and declared:

"It is the position of the Service that, in the absence of regulations specifically prohibiting consolidated tax adjustments, these adjustments can be made without

¹⁰ Though Method 2 can also pick up incremental net tax from affiliates, as a practical matter, where this would be the case, Method 1 would always produce a lower level of tax expense. Thus, unless there is a net benefit from non-PacifiCorp-Oregon operations, Method 2 would never be the basis for the tax expense computation.

violating the normalization requirements of the Code. Therefore, if requested in an appropriate circumstance, the Service would rule that these adjustments do not violate the normalization requirements of the Code, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property.”

At that hearing, Mr. Graetz distributed the memorandum from IRS Chief Counsel, Abraham Shashy, upon which he based this statement. This memorandum was a bit more nuanced than was Mr. Graetz’s testimony and stated:

“These arguments do raise a concern that a consolidated tax adjustment might be used to offset a utility’s deferred tax reserve from normalization or might be used to flow through the accelerated depreciation benefit of another regulated utility in the same consolidated group. These concerns are worthy of further study. Until they are resolved, we can only say with confidence that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property, and provided that the taxable income any other regulated utilities used in the calculation of the adjustments is computed on a normalized basis.”

Taxpayer is aware of no authorities relevant to CTAs and the normalization rules issued subsequent to the hearing referenced above. Certainly no regulations such as those mentioned by Mr. Graetz have been promulgated – or even proposed.

Based on these “authorities,” a CTA that (1) solely impacts the current portion of the tax expense element of cost of service, (2) doesn’t impact (directly or indirectly) the level of deferred taxes required by the normalization rules and (3) doesn’t effect a flow through of another utility’s accelerated depreciation benefits should not run afoul of the depreciation normalization rules.

Method 2 reduces PacifiCorp-Oregon’s Method 1 current tax provision from \$300 to \$278. By virtue of the \$28 of normalization-protection adjustments, it is absolutely clear that the reduction does not have the capacity to flow through to PacifiCorp-Oregon customers the tax benefits of PacifiCorp-FERC depreciation or ITC claimed with respect to PUP. It is likewise clear that deferred taxes have been provided on all Oregon PUP-related tax deferrals. Finally, the reduction in the current tax provision attributable to the net reduction in consolidated tax attributable to operations other than those of PacifiCorp-Oregon would seem to be well within the tolerances of Mr. Graetz’s testimony and Mr. Shashy’s memorandum (assuming, of course, that those documents continue to reflect the position of the Service).

Consequently, the level of tax expense produced by Method 2 should be deemed consistent with both the depreciation and ITC normalization rules.

METHOD 3 (Consolidated/AppORTioned)

The application of Method 3 to the base data produces the following results:

PacifiCorp-Oregon Tax Expense - Method 3					
	PacifiCorp-Oregon	PacifiCorp - FERC	Sub 1	Sub 2	Consolidated
Pre-Dep Book Income	\$1,500	\$250	\$200	\$9,100	\$11,050
Book PUP Dep	\$100	\$10			\$110
PUP Dep - Add'l Tax	\$400	\$40			\$440
Non-PUP Depreciation			\$9,400	\$100	\$9,500
Taxable Income	\$1,000	\$200	(\$9,200)	\$9,000	\$1,000
Tax Liability	\$350	\$70	(\$3,220)	\$3,150	\$350
ITC	\$50	\$10		\$40	\$100
Current Tax Expense	\$300	\$60	(\$3,220)	\$3,110	\$250
Consolidated Tax Liability	\$250				
Adjustment 1	\$193	Tax benefit of depreciation on all PUP [(\$500+\$50) X 35%]			
Sub-total	\$443				
Adjustment 2	\$60	Tax benefit of ITC on all PUP [\$50+\$10]			
Sub-total	\$503				
Adjustment 3	\$16	Apportion using a "3 factor" formula (3.26%)*			
Adjustment 4	\$16	Compare to standalone floor and select greater of two**			
Adjustment 5	(\$175)	Tax benefit of depreciation on Oregon PUP [\$500 X 35%]			
Sub-total	(\$159)				
Adjustment 6	\$140	Deferred taxes on Oregon regulated operations			
Sub-total	(\$19)				
Adjustment 7	\$0	Regulatory ITC amortization			
Total Tax Expense	(\$19)				
	*	Oregon Regulated	Total Group	Ratio	
	Plant	\$2,600,000,000	\$44,600,000,000	5.83%	
	Wages	\$214,000,000	\$7,500,000,000	2.85%	
	Sales	\$945,000,000	\$87,132,000,000	1.08%	
			Average	3.26%	
	**	Method 1 after Adjustment 2 (adjusted standalone)			\$525
		Negative tax liabilities (Sub 1)		(\$3,220)	
		Allocated negative liabilities (16.04%***)			(\$516)
		Floor			\$9

	***		Oregon Regulated	All Regulated	Ratio
		Plant	\$2,600,000,000	\$23,200,000,000	11.21%
		Wages	\$214,000,000	\$900,000,000	23.78%
		Sales	\$945,000,000	\$7,200,000,000	13.13%
				Average	16.04%

Assuming that the deferred tax provision is, as in the two prior methods, \$140, the current tax provision using Method 3 is (\$209).¹¹

Whereas Methods 1 and 2 use only "tax data" in the calculation of tax expense, Method 3 employs a very different approach. It allocates the consolidated tax liability (as adjusted) based on non-tax events (*i.e.*, the "3-factor" formula). Unlike Method 2, its use is in no way premised on the existence of consolidated return benefits. In other words, for Method 3 to produce the lowest tax expense of the three methods, it is not necessary that any non-PacifiCorp-Oregon activity produce a net tax benefit (*e.g.*, a net operating loss). The mere allocation based on the three factors can render it the lowest of the three. It is, therefore, analytically quite different from a CTA.

The \$509 difference between the tax provision calculated under Method 3 (-\$19) and that calculated under Method 1 (\$490) is attributable to:

Method 1 tax expense	\$490	
Reduction for non-PacifiCorp Oregon tax benefit	(\$50)	[\$\$60 - \$3,220 + \$3,110]
PacifiCorp-FERC depreciation	\$18	[\$50 X 35%]
PacifiCorp-FERC ITC	\$10	
Reduction due to apportionment	(\$487)	[\$503 X (100%-3.26%)]
Method 3 tax expense	(\$19)	

Insofar as the Method 3 allocation procedure is applied to the adjusted consolidated tax liability, it impacts all elements of that liability. This is evident from the table above. While the first three reconciling items represent the impact associated with non-PacifiCorp-Oregon activities, the fourth reflects the impact associated with PacifiCorp-Oregon-related activities.

In terms of the normalization rules, the Method 3 deferred tax provision (Adjustment 6) is identical to adjustments made in Methods 1 and 2. As was the case with those methods, the full effect of the deferral occasioned by accelerated depreciation is preserved. With respect to ITC, because the application of the allocation factor (Adjustment 3) takes place after the effect of

¹¹ That is also considering Adjustment 2 which eliminates the \$50 of Oregon ITC from the tax expense computation.

ITC is removed (in Adjustment 2), it does not seem that the former adjustment can reasonably be viewed as flowing through any quantity whatsoever of ITC on PUP. And since, as an Option 1 company in Oregon, Taxpayer amortizes no ITC in its Oregon cost of service, Adjustment 7 is \$0.

Taxes Properly Attributed

For purposes of completing the illustration, the results of the three methods using the Base Data are:

Method 1	\$490
Method 2	\$468
Method 3	-\$19

Under the Permanent Rules, the "taxes properly attributed" would be -\$19, the lowest of the three. If, for instance, "taxes authorized to be collected in rates" for the period were \$500, then \$519 would be refunded to customers through the tax adjustment clause (ignoring, for purposes of this example, the \$100,000 difference threshold).

Consequently, the level of tax expense produced by Method 3 should be deemed consistent with both the depreciation and ITC normalization rules.

The Tax Adjustment Clause

As described above, the automatic adjustment clause for taxes that is required under SB 408 conforms the rates previously charged to customers to actual events. In other words, like every "tracker" or "balancing account," it compares what was projected to occur when rates were set to what actually happened.

If the utility had the ability to perfectly forecast its financial (including its tax) future and the tax future of its affiliates, divisions, etc. at the time rates were being established, it would have included in its cost of service precisely the level of tax expense produced by the "properly attributed" procedures required under the Permanent Rules. Because it did not have the ability to do this, it incorporated some estimate of its "proper" tax expense into rates. The automatic adjustment clause effectively adjusts rates to what they would have been had there been perfect knowledge. Consequently, if the "properly attributable" tax amount as calculated pursuant to SB 408 and the Permanent Rules would have been permissible under the normalization rules had the utility had perfect knowledge, it should be no less permissible when it is the basis of a "true-up" procedure.

At a pre-submission meeting with representatives of the National Office, Taxpayer was specifically asked to address the implications of the SB 408 tax adjustment clause under the "consistency rules" of Code §168(i)(9).

Code §168(i)(9)(A) ["Section A"] describes the basic mechanic that constitutes the heart of the depreciation normalization rules – the necessity to reflect deferred taxes in ratemaking and to establish an ADFIT reserve. Code §168(i)(9)(B)(i) provides that any "procedure or adjustment" that is inconsistent with the requirements of Section A violates the depreciation normalization rules. As indicated above, because, pursuant to the Permanent Rules, Taxpayer uses its regulatory books of account to establish its deferred tax expense, it will, of necessity, reflect a level of such expense commensurate with the tax actually deferred. This procedure is in all regards consistent with Section A.

Code §168(i)(9)(B)(ii) ["Section B"] establishes what has been come to be known as the "consistency rules." This provision defines as inconsistent with Section A any estimate or projection that does not treat tax expense, depreciation expense, ADFIT and rate base symmetrically.

There are two respects in which the tax adjustment clause may be considered to incorporate "inconsistencies." The first relates to the dichotomy between the level of expenses considered for purposes of computing tax expense and those considered for other ratemaking purposes. The second relates to the calculation of the amount of taxes "authorized to be collected in rates." Each will be addressed separately.

Level of Expense

The "level of expense" inconsistency that is produced by the tax adjustment clause mechanism is attributable to the fact that an income tax liability does not exist on its own. It is purely a creature of other activities – specifically, accretions to and dispositions of wealth. The National Office representative recognized the fact that a tax adjustment clause effectively severs the link between the activities that give rise to a tax liability and the tax liability itself. This transpires whether or not the utility files as part of a consolidated group.

For example, if the tax expense element of cost of service is established based on a projection of revenue to be earned and costs to be incurred during a period and it turns out that a much higher level of expenses are, in fact, incurred during that period, the tax liability incorporated in rates will exceed the tax liability actually incurred. Under the SB 408 tax adjustment mechanism, a refund would be due customers notwithstanding that the utility is unable to recover from customers those incremental costs the incurrence of which caused the tax liability to diminish. The link between expenses and the resultant tax liability has been severed.

From a normalization perspective, this is of particular relevance where the additional expense that can't be recovered is depreciation with respect to PUP. A simple illustration of this situation follows.

	Rate Case	Actual
General Business Revenues	\$10,000,000	\$10,000,000
Book Depreciation on Public Utility Property	(\$2,000,000)	(\$6,000,000)

Regulatory Federal Taxable Income	\$8,000,000	\$4,000,000
Federal Statutory Tax Rate	35%	35%
Regulatory Federal Tax Expense (Current & Deferred)	\$2,800,000	\$1,400,000

In this case, the SB 408 tax adjustment clause mechanism would require a refund of \$1,400,000 of taxes to customers even though the \$4,000,000 of unanticipated PUP depreciation is not collected from customers. Thus, the mechanism is capable of providing a tax benefit to customers with respect to PUP depreciation they do not fund. This is the type of inconsistency that the National Office representative requested be addressed in connection with the requirements of Code §168(i)(9).

Taxes Authorized to be Collected in Rates

The calculation of the amount of taxes authorized to be collected in rates proceeds from the "margin" computation previously described. Essentially, it is presumed that each dollar of revenue has embedded within in it the level of tax expense recovery projected in the setting of rates. Obviously, the actual levels of both revenues and expenses invariably differ from those upon which rates are set. The presumption of a "standardized" tax collection rate has, therefore, the capacity to vary from actuality, thereby impacting the measurement of the required tax adjustment. A simple example follows.

	Per Rate Case		Additional Actual	Total Actual	SB 408 Calculations
Revenue	\$10,000,000	100%	\$1,000,000	\$11,000,000	\$11,000,000
Expenses					
Fuel Cost	\$4,000,000	40%		\$4,000,000	
O&M	\$2,000,000	20%	\$1,000,000	\$3,000,000	
Book Depreciation	\$1,000,000	10%		\$1,000,000	
	\$7,000,000	70%		\$8,000,000	
Net Margin/Ratio	\$3,000,000	30%		\$3,000,000	30%
Effective Tax Rate	35%			35%	35%
Tax Expense ("Collected")	\$1,050,000	10.5%		\$1,050,000	\$1,155,000
Taxes Paid	\$1,050,000			\$1,050,000	\$1,050,000
SB 408 adjustment					\$105,000

In the illustration above, deductible O&M and revenue both increase by \$1,000,000. Notwithstanding that the tax liability doesn't change, the net pre-tax margin does – from the 30% presumed in the rate case (\$3,000,000/\$10,000,000) to 27% actually experienced (\$3,000,000/\$11,000,000). Yet the computation of "taxes authorized" is unaffected by this

variation. This also is the type of inconsistency that the National Office representative requested be addressed in connection with the requirements of Code §168(i)(9).

The Purview of the Consistency Rules

While it is literally true that the automatic tax adjustment procedure may be said to contain one or more elements of inconsistency, the purview of the normalization consistency rules is circumscribed. In short, those rules cover some – but not all – inconsistencies. And any inconsistencies created by a tax adjustment mechanism should be deemed not of the type covered by those rules.

Code §168(i)(9)(B)(ii) was added by §541 of the Highway Revenue Act of 1982 in direct response to regulatory developments in California in the 1970's. The California regulators were extremely unhappy about the imposition of the normalization rules. They devised a technique, the "average annual adjustment" or "AAA" method, to offset the impact of those rules. This procedure involved a projection of future deferred tax balances for purposes of the computation of rate base where there was no such projection for any other purpose. It resulted in a substantially larger rate base offset than would otherwise be the case. One or more of the affected utilities applied to the Service for guidance as to the consequences of this technique under the normalization rules. The Service ruled that it was violative, pointing to the section of the regulations, Treas. Reg. §1.167(l)-1(h)(6), which governs the quantity of deferred taxes that can offset rate base. The Service concluded that the technique failed to meet the regulatory requirement that the quantity of deferred taxes used to offset rate base could not exceed the amount of the reserve for the period used in determining the utility's tax expense element of cost of service.¹² In short, there was a lack of "temporal consistency" between the way in which cost of service was computed and the computation of the deferred tax balance used as a rate base offset.

While the Service held the technique violative, the California authorities continued to support the adjustment. Ultimately, a legislative solution was crafted to avoid the dramatically negative financial implications stemming from the imposition of penalties for violation of the normalization rules. This solution was enacted as §541 of the Highway Revenue Act of 1982. Under this legislation, those affected utilities that qualified under a transition rule would not be deemed to have violated the normalization rules (though they had to make substantial payments to the IRS). However, language was added to Code §168(i)(9) to make absolutely clear that the AAA method and techniques similar to it constituted a normalization violation. This language was Section B.

This history of Section B indicates its intention to render violative inconsistencies within a test period – but only a test period having some element of futurity. That, after all, is the import of the use of the terms "estimate or projection" in Section B. And there is nothing that can be further from an "estimate or projection" than a "true up" to "properly attributed" taxes after those taxes were incurred.

¹² PLR 7836038 (June 8, 1978) and PLR 7848048 (June 9, 1978).

For purposes of the consistency rules, Oregon ratemaking for taxes under SB 408 and the Permanent Rules should be viewed holistically. It contains no attempt to exploit discrepancies between the treatment of rate base, depreciation, tax expense or deferred taxes. In fact, the "normalization protection" adjustments coupled with the adjustments to tax expense for deferred tax expense as reported on the regulated books are explicit attempts at compliance with the normalization rules. Plant additions are added to rate base and depreciated for book and tax purposes. Deferred taxes are provided on the difference in the computation of tax expense and rate base is offset by the deferred taxes so established. Putting aside the "level of expense" and "taxes authorized" computational characteristics described above (because they are not of the type that should be deemed to come within the purview of the consistency rules), there is consistency within consideration of the four elements that are important to the tax law.

Thus, although the SB 408 tax adjustment clause can be viewed as producing one or more inconsistencies, they are not the type of inconsistencies that the normalization rules are intended to address and should not invalidate an otherwise consistent ratemaking procedure.

CONCLUSION

For the reasons stated above, we respectfully request that the Service issue the rulings requested.

PROCEDURAL STATEMENTS

A. Revenue Procedure 2006-1 Statements

1. Section 7.01(4) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, no return of Taxpayer (or any return of a related taxpayer within the meaning of §267 or of a member of an affiliated group of which Taxpayer is also a member within the meaning of §1504) that would be affected by the requested letter ruling is under examination, before Appeals, or before a federal court.
2. Section 7.01(5)(a) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, the Service has not previously ruled on the same or similar issue for Taxpayer, a related taxpayer (within the meaning of §267), a member of an affiliated group of which Taxpayer is also a member (within the meaning of §1504), or a predecessor.
3. Section 7.01(5)(b) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer, a related taxpayer, a predecessor, nor any representatives previously submitted a request (including an application for change in accounting method) involving the same or similar issue but with respect to which no letter ruling or determination letter was issued.
4. Section 7.01(5)(c) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer, a related taxpayer, nor a predecessor previously submitted a request (including an application for change in accounting method) involving the same or a similar issue that is currently pending with the Service.
5. Section 7.01(5)(d) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer nor a related taxpayer is presently submitting another request (including an application for change in accounting method) involving the same or similar issue to the Service at the same time as this request.
6. Section 7.01(8) - The law in connection with this ruling request is uncertain and the issues discussed herein are not adequately addressed by relevant authorities.
7. Section 7.01(9) - Taxpayer has included all supportive as well as all contrary authorities of which it is aware.
8. Section 7.01(10) - Taxpayer and Taxpayer's representatives have no knowledge of any pending legislation that may affect the proposed transaction.
9. Section 7.02(5) - Taxpayer hereby requests a copy of the ruling and any written requests for additional information be sent by facsimile transmission (in addition to being mailed) and waives any disclosure violation resulting from such facsimile transmission. Please fax the ruling and any written requests to Mr. Warren at (212) 829-2010.

10. Section 7.02(6) - A conference on the issues involved in this ruling request is hereby respectfully requested in the event that the Service reaches a tentatively adverse conclusion.

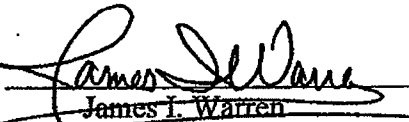
11. The Commission has reviewed this request and determined that it is adequate and complete. See letter appended as Exhibit 5. Taxpayer will permit the Commission to participate in any Associate office conference concerning this request.

B. Administrative

1. The deletions statement required by Revenue Procedure 2006-1 is enclosed.
2. The checklist required by Revenue Procedure 2006-1 is enclosed.
3. The required user fee of \$10,000 is enclosed.
4. A Power of Attorney granting Taxpayer's representative the right to represent the taxpayer is enclosed.

If you have any questions or need additional information regarding this ruling request, pursuant to the enclosed Power of Attorney please contact James I. Warren at (212) 603-2072.

Respectfully submitted,


James I. Warren

Dated: 12/29/06

Thelen Reid & Priest LLP
Attorney for PacifiCorp

DECLARATION OF PACIFICORP

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

By:

Jonathan D. Hale

Jonathan D. Hale
Senior Tax Director
PacifiCorp

Date:

12-28-2006

DECLARATION OF BERKSHIRE HATHAWAY INC.

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

By: Marc D. Hamburg

Marc D. Hamburg
Vice President and Chief Financial Officer
Berkshire Hathaway Inc.

Date: 12/28/06