BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

AR 517

In the Matter of Housekeeping and Clarification Changes to OAR 860-022-0041.	STAFF'S REPLY COMMENTS

INTRODUCTION

Following opening comments and rulemaking hearing, the Public Utility Commission of Oregon Staff (Staff) takes this opportunity to file reply comments on two issues. These two issues are: 1) correcting the calculation of the floor for the apportionment method, and 2) removing a potential federal tax law normalization problem caused by drawing down deferred taxes.

The two issues Staff will discuss in these comments involve protecting against federal tax normalization violations. Because of the nature of these issues, a tax expert, Jim Murray, has been retained as a consultant to assist with these complicated tax questions. These comments have been reviewed by Mr. Murray and he supports these comments in his role as a consultant on normalization issues.

At the rulemaking hearing, Judge Grant also requested that the parties provide numerical examples related to the floor calculation for the apportionment method. In response to Judge Grant's request, Staff has provided these examples in Appendix A to these comments.

DISCUSSION

1. The Commission should adopt Staff's proposed correction to the calculation of the floor for the Apportionment Method

The calculation that establishes a "floor" for the three-factor apportionment method starts with Oregon regulated operations' stand-alone tax liability, which is then reduced by a share of

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1162 Court Street NE
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(503) 378-6322 / Fax: (503) 378-5300

the imputed negative tax of all losses of the taxpayer group. In certain circumstances, that adjusted tax amount may need to be reduced by tax benefits related to public utility property (PUP) prior to being apportioned to Oregon. The issue before the Commission is what the limit of those PUP tax benefits that are "added back" needs to be set in order to avoid giving customers any benefits related to public utility property and thereby cause a normalization violation.[1]

Staff's proposed rules modify the floor calculation by adding back tax benefits related to PUP (removing their effect and increasing the utility's tax liability) to the extent those benefits were included in the income tax losses identified in the original calculation.[2]

PacifiCorp[3] and Portland General Electric disagree with the proposed change for several reasons. First, the change would require an amendment to the utilities' Private Letter Ruling (PLR) requests currently pending with the IRS, which the utilities contend would increase the "risk that the IRS will issue a negative or equivocal response to our Private Letter Ruling request or simply decline to respond."[4] Second, it doesn't lead to a "clear and complete isolation of all PUP depreciation and ITC in each step of the methodology."[5] Third, the change would decrease the "buffer effect the floor has on extreme" and "irrational" results under the Apportionment Method that "can threaten normalization by reducing taxes paid to below the level necessary to cover current taxes, potentially producing AAC [ORS 757.268 automatic adjustment clause] refunds that include a component of deferred taxes."[6]

Staff's proposed language change reflects what Staff believed to be the intent in the initial drafting of the rules. Only during the filing phase did Staff discover that there was a

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[1] All public utility property tax benefits are excluded from this stage of the Taxes Paid calculation. The appropriate amounts related to Oregon regulated operations are included at the end of the Taxes Paid calculation. See OAR 860-022-0041(4)(d).

[2] "Add back" means to increase tax liability by the amount of those tax benefits, which removes their effect prior to calculating the amount of Taxes Paid that are attributed to Oregon regulated operations.

[3] Avista filed opening comments in support of PacifiCorp comments; NW Natural filed opening comments in support of PacifiCorp's and PGE's comments related to the floor calculation.

[4] Portland General Electric Company's Opening Comments at 4.

[5] Opening comments of PacifiCorp at 9.

[6] Ibid.

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disparity in the interpretation of the rule language. In fact, the description of the floor calculation in the current PLR request is:

> "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 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**." (PacifiCorp Request for a Private Letter Ruling, page 6, footnote 6; emphasis added)

Remarkably, that is the description of the calculation that staff is proposing and the utilities, at least at the time of the PLR, apparently believed to be the Commission's intent: eliminate depreciation and ITC from the floor calculation only for those regulated entities that have losses.

Additionally, the utilities' first concern is misleading. The revised PLR request will be necessary with or without a change to the floor calculation, because another rule revision, a change to subsection (4)(d) to protect deferred taxes (which the utilities acknowledge is an important protection against normalization violations), will require modifications to the current request.

The utilities' third argument is irrelevant for purposes of the floor calculation, because the rule revision to (4)(d) squarely addresses the need for Taxes Paid—no matter which of the three methods produces the result—to be at least as large as the amount of deferred taxes.

The utilities' view that the Apportionment Formula result, including the floor calculation, can produce "extreme" or "irrational" outcomes, does not justify retaining a flawed calculation. The argument for a "buffer effect" seems to be that anything that increases Taxes Paid reduces the chances of a normalization violation. This claim obscures the issue because the real question is whether the revised floor calculation would pass through to customers the effect of deferred taxes and lead to a normalization violation. Either it does or it does not.

With that in mind, the utilities' assertion that the floor calculation as modified does not isolate all PUC depreciation and ITC is erroneous. As staff pointed out in our opening

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comments, the floor calculation begins with the stand-alone tax liability of Oregon operations. The key is that the rule defines "Stand-alone tax liability" as excluding all tax benefits from PUP.[7] In other words, at the beginning the floor calculation, none of those tax benefits are being passed on to customers. The calculation then reduces that stand-alone liability by the Oregon regulated operations' share of all losses in the taxpaying group. If none of those losses are attributable to regulated operations, there is no need to add back <u>any</u> PUP-related tax benefits, because none are reflected in the calculation. If a portion of the losses are attributable to one or more regulated entities, then it is necessary to add back the PUP tax benefits <u>only</u> for those regulated entities to remove those benefits that otherwise would be apportioned to Oregon customers.

This issue is straightforward: If the effects of tax benefits from public utility property are brought into the floor calculation, that amount must be removed through an "add back." If those benefits are not included in the floor calculation in the first place, there's no need to do any add back.

As Staff noted at the rulemaking hearing, if the Commission does not make this correction to the floor calculation, Staff expects that in most cases the tax effect of depreciation on all PUP would more than offset the taxpaying entity's losses. Without this correction, the floor calculation would then equal the utility's stand-alone tax liability, a result that would utterly eliminate the three-factor apportionment method the Commission has adopted.

2. <u>The Commission should adopt Staff's proposed rule revision to remove a normalization problem caused by drawing down deferred taxes.</u>

The parties agree that a normalization problem could occur when the amount of federal "Taxes Paid" is less than the amount of deferred taxes related to depreciation of PUP for Oregon regulated operations (the parties refer to this situation as "negative current taxes paid" or "drawing down deferred taxes"). To avoid this result, Staff proposes to make an adjustment that

[7] See OAR 860-022-0041(2).

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changes a negative current tax result to a result equal to zero current taxes (i.e., so that Taxes Paid equal deferred taxes).

PacifiCorp criticizes Staff's proposal. PacifiCorp alleges that Staff's approach is "no more rational or fair" than the Apportionment Method result that could assign a utility less than zero credit for current taxes paid. Instead, the company proposes to eliminate the entire method when a negative taxes paid outcome results from using that method, an approach they argue "the IRS may view as a stronger response, one that provides additional normalization protection" and that provides a "safety net."

Staff's is perplexed by these arguments. As the pending PLR makes clear, the determination should be based on whether the result can be viewed as flowing through in rates *any* tax benefits related to deferred taxes on PUP. This is a "yes or no" question, not a matter of degree or that more is better.

There can be a considerable difference in the Taxes Paid amount resulting from the approaches proposed by PacifiCorp and Staff. Consider an example where the Apportionment Method (including the effect of the floor calculation) provides a Taxes Paid amount of $20 million, and the next lowest method provides a Taxes Paid amount of $45 million. Assume that the amount of deferred taxes related to public utility property for Oregon regulated operations is $20 million plus $1.

In this example, deferred taxes exceed the lowest Taxes Paid amount by $1, thereby creating a potential normalization violation. Under staff's proposal, a $1 adjustment would be made so that Taxes Paid equals $20 million plus $1, assuring that deferred taxes are fully covered. Under PacifiCorp's approach, the Apportionment Method would be thrown out and the Taxes Paid amount would be $45 million, or higher by nearly $25 million.

CONCLUSION

The Commission has already made its decision that the Apportionment Method, subject to the statutory caps, should be used as a reasonable estimation of taxes paid that are properly

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attributable to Oregon regulated operations. As a result, Staff's modifications are not aimed at whether the Apportionment Method may produce "extreme and irrational" outcomes. Instead, Staff's modifications are aimed at making sure that the Taxes Paid result – whichever method produces it – avoids any normalization violations. Staff's proposed changes both protect against normalization violations while also maintaining the Commission's decision that the Apportionment Method should be used as a reasonable estimation of taxes paid.

DATED this 10th day of August 2007.

Respectfully submitted,

HARDY MYERS
Attorney General

s/Jason W. Jones ________________
Jason W. Jones, #00059
Assistant Attorney General
Of Attorneys for Staff of the Public Utility Commission of Oregon

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 378-6322 / Fax: (503) 378-5300

Appendix A provides two examples that illustrate how Staff's proposal and the utilities' approach will result in significantly different amounts for Taxes Paid.

In summary, Staff's proposed change to the floor accomplishes a clear and straightforward isolation of PUP-related tax benefits to protect against normalization violations. The utilities' proposal to leave the rule as it currently stands and remove (by adding back) all PUP tax benefits—even those tax benefits that are not in the calculation in the first place—makes no sense. Such a position is akin to purchasing car insurance without owning a vehicle to insure. Staff expects that in most cases for the four utilities subject to SB 408, total PUP tax benefits will exceed the taxpayer's losses, so that the floor would equal the stand-alone result and eliminate the three-factor apportionment method entirely.

Appendix A: Examples of Floor Calculation

The floor calculation applicable to the Apportionment Method can be expressed as follows for the Federal Taxes Paid calculation (the state tax calculation is done in the same manner):

Floor = SA + ((L + PUP) x R)

Where:

SA = the proforma federal stand-alone tax liability of Oregon regulated operations

L = imputed negative tax of all losses in the federal taxpayer group (expressed as a negative number)

PUP = the current deduction of tax depreciation on public utility property (PUP) and federal investment tax credits (ITC) related to PUP

R = Average of the ratios of Oregon regulated operations to system regulated operations for gross plant, wages and salaries and sales.

(Note that L + PUP must be less than or equal to zero, because only losses are apportioned to Oregon regulated operations—see examples, below.)

Example 1: all losses attributable to non-regulated operations

SA (proforma tax liability) = $100 million
L (negative tax of losses) = ($50) million
PUP (tax benefits) = $60 million for taxpayer group
$0 for entities with losses (i.e., no regulated entity has losses)
R (Oregon regulated share) = 60%

Utilities' Proposal:

Floor = SA + ((L + PUP) x R)
= $100 + ((-50 + 60) x .60)
= $100 + (0 x .60)) [as noted above, L + PUP must be no less than 0]
= $100

Staff's Proposal:

Floor = SA + ((L + PUP) x R)
= $100 + ((-50 + 0) x .60)
= $100 + (-50 x .60)
= $100 + (-30)
= $70

Staff's proposal correctly apportions the losses to Oregon regulated operations in calculating the floor. No add back (removal) of PUP-related benefits is necessary, because none of those benefits have been included anywhere in the calculation. By contrast, in the utilities' proposal, all PUP-related benefits of the taxpaying group are added back, even though none of those benefits were passed through to customers in the first place. Because that amount ($60) is greater than the sum of the losses ($50), there are no net losses to apportion. The result is that the floor is equal to the stand-alone (ORS 757.268(12)(a)) cap, which eliminates any consideration of the three-factor apportionment method. Staff expects that this will be the result in most instances. In this example, the utility is over-credited for Taxes Paid (and ratepayers are worse off) by $30 million.

Example 2: a portion of losses are attributable to regulated entities

SA (proforma tax liability) = $100 million
L (negative tax of losses) = ($50) million
PUP (tax benefits) = $60 million for taxpayer group
$20 million for entities with losses
R (Oregon regulated share)= 60%

Utilities' Proposal:

Floor = SA + ((L + PUP) x R)
= $100 + ((-50 + 60) x .60)
= $100 + (0 x .60))
= $100

Staff's Proposal:

Floor = SA + ((L + PUP) x R)
= $100 + ((-50 + 20) x .60)
= $100 + (-30 x .60)
= $100 + (-18)
= $82

This example is the same as the first, except that one or more regulated entities have losses. If the PUP-related tax benefits related to those entities are not removed from the floor calculation, there would be a normalization violation. Staff's proposal isolates those benefits ($20) and removes their effects before apportioning total losses to Oregon regulated operations. As in the previous example, the utilities would add back all PUP-related benefits of the taxpaying group so that there are no net losses to apportion, the floor equals the stand-alone result, and the three-factor method is eliminated. In this example, the Taxes Paid amount is too high by $18 million.

CERTIFICATE OF SERVICE

I certify that on August 10, 2007, I served the foregoing upon all parties of record in this proceeding by delivering a copy by electronic mail and by mailing a copy by postage prepaid first class mail or by hand delivery/shuttle mail to the parties accepting paper service.

AVISTA CORPORATION
DAVID J MEYER
VICE PRESIDENT & CHIEF COUNSEL
PO BOX 3727
SPOKANE WA 99220-3727
david.meyer@avistacorp.com

AVISTA UTILITIES
JAMES MCDOUGALL
PO BOX 3727
SPOKANE WA 99220-3727
james.mcdougall@avistacorp.com

RON MCKENZIE
MANAGER - REGULATORY ACCOUNTING
PO BOX 3727
SPOKANE WA 99220-3727
ron.mckenzie@avistacorp.com

DAVISON VAN CLEVE PC
MELINDA J DAVISON
333 SW TAYLOR - STE 400
PORTLAND OR 97204
mail@dvclaw.com

MATTHEW W PERKINS
333 SW TAYLOR - STE 400
PORTLAND OR 97204
mwp@dvclaw.com

W
MCDOWELL & ASSOCIATES PC
SARAH J ADAMS LIEN
ATTORNEY
520 SW SIXTH AVE - STE 830
PORTLAND OR 97204
sarah@mcd-law.com

W
MCDOWELL & RACKNER PC
KATHERINE A MCDOWELL
ATTORNEY
520 SW SIXTH AVE - SUITE 830
PORTLAND OR 97204
katherine@mcd-law.com

NORTHWEST NATURAL
INARA K SCOTT
REGULATORY AFFAIRS MANAGER
220 NW 2ND AVE
PORTLAND OR 97209
inara.scott@nwnatural.com

NW NATURAL
RATES & REGULATORY AFFAIRS
220 NW 2ND AVE
PORTLAND OR 97209-3991
efiling@nwnatural.com

W
PACIFIC POWER & LIGHT
STEVE EVANS
steve.evans@pacificorp.com

RYAN FULLER
825 NE MULTNOMAH STE 800
PORTLAND OR 97232
ryan.fuller@pacificorp.com

PAUL M WRIGLEY
MANAGER - REGULATION
825 NE MULTNOMAH ST, STE 2000
PORTLAND OR 97232
paul.wrigley@pacificorp.com

W
PACIFICORP
OREGON DOCKETS
825 NE MULTNOMAH ST
STE 2000
PORTLAND OR 97232
oregondockets@pacificorp.com

NATALIE HOCKEN
825 NE MULTNOMAH
SUITE 2000
PORTLAND OR 97232
natalie.hocken@pacificorp.com

D DOUGLAS LARSON
ONE UTAH CENTER
201 S MAIN ST - SUITE 2300
SALT LAKE CITY UT 84111
doug.larson@pacificorp.com

Department of Justice
1162 Court Street NE
Salem, OR 97301-4096
(503) 378-6322

PORTLAND GENERAL ELECTRIC
RATES & REGULATORY AFFAIRS
RATES & REGULATORY AFFAIRS
121 SW SALMON ST 1WTC0702
PORTLAND OR 97204
pge.opuc.filings@pgn.com

RANDALL DAHLGREN
121 SW SALMON ST 1WTC 0702
PORTLAND OR 97204
randy.dahlgren@pgn.com

PORTLAND GENERAL ELECTRIC
DOUGLAS C TINGEY
121 SW SALMON 1WTC13
PORTLAND OR 97204
doug.tingey@pgn.com

TONKON TORP LLP
DAVID F WHITE
1600 PIONEER TOWER 888 SW FIFTH AVE
PORTLAND OR 97204
davidw@tonkon.com

Neoma Lane

Neoma Lane
Legal Secretary
Department of Justice
Regulated Utility & Business Section