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July 31, 2006

VIA ELECTRONIC FILING

PUC Filing Center
Public Utility Commission of Oregon
PO Box 2148
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Re: Docket AR 499

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

Very truly yours,



Katherine A. McDowell

Enclosures

cc: Service List

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

3 **AR 499**

4 In the Matter of the Adoption of Permanent
5 Rules to Implement SB 408, Relating to
6 Matching Utility Taxes Paid with Taxes
7 Collected

**PACIFICORP'S OPENING COMMENTS
ON INTERIM ORDER AND DRAFT
RULES**

7 **I. Introduction**

8 PacifiCorp respectfully submits the following Opening Comments on the
9 Commission's Interim Order in this docket, *In re: Adoption of Permanent Rules to Implement*
10 *SB 408*, Order 06-400 (July 14, 2006) (the "Interim Order") and the AR 499 draft rules.

11 PacifiCorp's comments are based upon the following principles:

12 (1) Tax benefits (e.g., losses, credits, deductions) not associated with
13 regulated utility operations should not be imputed to the utility. The "With
14 and Without" method proposed by PacifiCorp and the Commission Staff
15 is consistent with this principle and with the statute, SB 408. The
16 Commission's proposed apportionment method is not consistent with this
17 principle.

18 (2) If the Commission nevertheless chooses to retain its proposed
19 apportionment method, the method must be properly applied consistent
20 with taxation and regulated ratemaking. Oregon taxation provides for
21 apportionment for utilities by a three-factor formula, and if the
22 Commission adopts an apportionment method it should use the three
23 factors. One of the three factors is property, which must reflect all the
24 property generating the revenue upon which the taxation is based, not
25 merely the property located in Oregon.

1 (3) State taxes should be based on the taxes paid by the unitary group of
2 which the utility is a member. Thus, if the utility files state taxes on a
3 unitary basis, those state taxes are the appropriate measure of state
4 taxes paid. There is no need or basis for the Commission to create an
5 artificial state tax-paying group or hypothetical taxes-paid amount.

6 PacifiCorp has had only two weeks to review the apportionment method, an
7 inadequate period in which to conduct a thorough analysis, particularly given the current
8 unknowns about the method and its application. The last-minute announcement of the
9 Commission's new approach to the determination of the term properly attributed, combined
10 with the absence of clarification at the subsequent workshop, has limited PacifiCorp's ability
11 to fully respond to the Commission's proposal and propose detailed rule revisions. As a
12 result, these comments are necessarily preliminary and limited, subject to change and
13 revision as PacifiCorp deepens its understanding of the apportionment method.

14 Notwithstanding PacifiCorp's concerns about the apportionment method, these
15 comments do include suggestions and some technical fixes designed to reduce (but are
16 unlikely to fully eliminate) the unintended consequences of adoption of this method.

17 **II. General Policy Concerns Regarding the Apportionment Approach.**

18 The Commission's Interim Order adopts a definition of "properly attributed" that
19 allocates to Oregon utility customers tax benefits for which they bear none of the underlying
20 risks or costs. This means that Oregon rates will be subsidized by business losses, tax
21 losses, tax deductions and tax credits from all companies in the Oregon utility's corporate
22 family engaged in businesses that are otherwise completely ring-fenced from the utility. In
23 the case of PacifiCorp and its Berkshire Hathaway affiliated group, this includes regulated
24 utilities and businesses as diverse as insurance, candy, trucking and real estate.

25 To date, PacifiCorp has identified several major policy concerns with the
26 apportionment method.

1 First, the Commission adopted a loss allocation/cross-subsidization approach even
2 though the Attorney General's opinion on SB 408 made clear that loss allocation was not
3 required by SB 408. See Interim Order at 4 (noting Commission's discretion to craft a
4 properly attributed definition equal to the section 3(12) caps). The Commission's Interim
5 Order cites no legislative history or policy justification for allocating tax benefits in this
6 manner. Instead, the Order focuses exclusively on the formula for allocation of a net tax
7 amount. The Order does not address the predicate question of whether assignment of tax
8 attributes from unregulated, unrelated companies is fair and reasonable and otherwise
9 consistent with Commission laws, rules and policies, most notably ORS 757.646(2)(c) which
10 prohibits cross-subsidization between unregulated companies and the utility.

11 Second, application of the apportionment method abandons any pretext of
12 comparing actual taxes collected and actual taxes paid, instead comparing hypothetical
13 taxes collected and hypothetical taxes paid. This is inconsistent with SB 408's intent. See
14 Op Atty Gen re: SB 408 at 2 (the general policy of SB 408 is to more closely align taxes in
15 rates with taxes received by government). As suggested in Section IV below, redesigning
16 the apportionment method to focus on the taxpaying entity at each level of government will
17 partially mitigate this issue.

18 Third, the Commission justified its adoption of the apportionment method on the
19 basis that it was legislatively sanctioned and "has enjoyed widespread acceptance." Interim
20 Order at 5, 7. While the three-factor apportionment formula is a generally accepted concept
21 for allocating *income* for state tax purposes, it is a completely new and untested method for
22 allocating *taxes*. It is similarly unprecedented as applied to federal or local taxes. The
23 apportionment method should be modified as suggested in Section III below to better
24 acknowledge the regulatory context in which it is being applied.

25 Fourth, the Commission explained that its approach to determining "properly
26 attributed" should balance the interests of the utility and ratepayers. Interim Order at 5.

1 This balance is not readily apparent in reviewing the apportionment method because, on its
2 face, the method is potentially more extreme than the “bookend” of the temporary rule.
3 Unlike the temporary rule, the apportionment method mathematically: (1) allocates all tax
4 attributes from all members of the affiliated group—even from those that are positive tax-
5 paying companies—thus increasing the amount of unrelated tax savings that could be
6 allocated to utility customers; and (2) allocates taxes paid to loss companies thus diluting
7 the amount of taxes paid that will be attributed to the utility. PacifiCorp’s suggestions in
8 Sections VII and VIII below, regarding add-backs to the properly attributed calculation, are
9 necessary to produce a more balanced outcome.

10 Fifth, the Commission declared that its approach should be easy to administer, use
11 readily available information and be “automatic.” *Id.* In the case of PacifiCorp and its
12 Berkshire Hathaway group, the apportionment method is none of those things. As the
13 method is currently designed, PacifiCorp will need to separately determine and then
14 aggregate the property, payroll and sales figures for more than 600 affiliates. In PacifiCorp’s
15 case, the Commission’s assumption that the apportionment method could use existing,
16 verifiable information or calculate it based on well-established definitions is incorrect.

17 The Interim Order is silent on what information utilities will need to provide in
18 applying the apportionment method, what course the utility should follow if information is
19 unavailable (for example, when ownership of the utility or of any other entity in the federal
20 consolidated group changes and access to historical information from the former owner is
21 limited), how the Commission will verify the application of the apportionment method, and
22 the proper scope of litigation over all of these matters in automatic adjustment clause
23 proceedings. SB 408’s expedited timelines for reporting and calculation of the automatic
24 adjustment clause create additional challenges with respect to these compliance issues. As
25 a practical matter, the Commission will need to adopt a “substantial compliance” standard
26 with respect to utility reporting under the apportionment method.

1 In Section III below, PacifiCorp has proposed an approach to the apportionment
2 method that relies on information in the federal tax return. This modification would
3 significantly ease the compliance challenges associated with the current proposal.

4 Sixth, the Commission indicated that the use of the apportionment method will
5 provide a degree of certainty and consistency. Interim Order at 7. However, under the
6 apportionment method, annual results could vary widely depending on general economic
7 conditions, natural disasters, weather variances, losses and gains within the group,
8 companies joining or leaving the group and impacts of major federal tax legislation such as
9 bonus depreciation and production tax credits, etc. Any of these factors including events
10 impacting unrelated businesses could produce significant rate volatility, which would
11 function asymmetrically against the utility given the section 3(12) caps. Key elements of the
12 apportionment method equation—apportionment factors and taxes themselves—will move
13 up and down each year based on the aforementioned variables. The uncertainty introduces
14 new elements of risk to utility investment in this state, and will necessitate setting higher
15 rates of return. Adoption of the suggestions and proposals PacifiCorp has submitted in
16 these comments should add stability and fairness to the apportionment method.

17 **III. Proper Application of the Apportionment Approach.**

18 While not expressly stated in the Interim Order, the draft rule in Appendix A looks to
19 state tax law apportionment definitions to suggest that the utility should calculate its Oregon
20 property, sales and payroll on a situs basis—in other words, based solely on property
21 physically located in Oregon. For regulatory purposes, such a situs approach is
22 incompatible with a system-based, multi-state business such as PacifiCorp's. It is also
23 contrary to the Commission's approach to ratemaking which assigns property, sales and
24 payroll to Oregon to the extent these are used to provide utility service in Oregon,
25 irrespective of physical location.

26

1 A situs approach could lead to a result where a utility with operations only in Oregon
2 gets reduced credit for "taxes paid" solely because it relies on plant located outside of the
3 state to serve Oregon customers, even though that plant is allocated 100% to Oregon for
4 ratemaking purposes. A failure to remedy this problem in the apportionment method could
5 deter utility investment in out-of-state facilities to serve Oregon customers, even if these are
6 the most cost-effective options.

7 This problem can be solved by looking to the PacifiCorp affiliated group tax return
8 results to determine the apportionment factors. Elements of property, sales, and payroll for
9 Berkshire and PacifiCorp are found across various supporting schedules within the federal
10 return. Once the apportionment factors are derived on a total affiliated group and total utility
11 basis, then the results can be allocated to Oregon. This approach relies on the federal tax
12 return as the primary source document and is thus relatively straightforward to calculate and
13 administer.

14 **IV. If the Commission Retains the Apportionment Approach, It Should**
15 **Adhere to a Single, Readily Verifiable Approach in Implementing the**
16 **Apportionment Method.**

17 In the discussions at the July 21, 2006 workshop, parties suggested various
18 modifications to the apportionment method, some of which could be combined into "elective"
19 alternative approaches. While PacifiCorp agrees that the apportionment method must be
20 changed to produce fair results, PacifiCorp also has concerns about any redesign of the
21 apportionment method that could lead to incremental, alternative properly attributed tests.
22 The potential introduction of such alternatives—though possibly cast as proposals to provide
23 flexibility to the Commission's apportionment method—would tend to add complexity, rather
24 than flexibility, and thereby reduce the ability to verify the numbers.

25 In the SB 408 tax allocation context, there is a high risk that such approaches will:
26 (1) become required instead of elective; and (2) add to SB 408's basic asymmetry,
27 complicate compliance with the apportionment method and increase normalization

1 problems, instead of providing flexibility and fairness. For this reason, PacifiCorp urges the
2 Commission to use the basic three factors in its apportionment approach and reject
3 "elective" alternatives, especially when these are proposed as additional "lesser of"
4 comparators.

5 **V. The Commission Should Calculate State Taxes By Reference to the**
6 **Utility's Unitary Group.**

7 The Interim Order proposes application of the apportionment method to state and
8 local taxes in a manner that refers back to the federal consolidated tax group. The Interim
9 Order does this by creating hypothetical state and local tax groups that consist of all of the
10 members of the "affiliated group" (defined as the group that files a consolidated federal
11 income tax return) which pay taxes on a state or local level, even if they file taxes separately
12 from the utility.

13 PacifiCorp submits that this approach is unnecessarily complicated and a departure
14 from the legislative intent of matching utility taxes collected with taxes actually paid. While
15 SB 408 ties the properly attributed exercise to the affiliated group, the most logical
16 construction of this limitation is to restrict the required properly attributed calculation to
17 federal taxes, not to expand the calculation to companies who file state and local taxes
18 separately from the utility. For this reason, the Commission is not required to apply the
19 apportionment method to all federal consolidated group members on a state and local level,
20 when to do so presents significantly greater complexities involving significantly smaller tax
21 amounts, especially when they are not the taxpayer.

22 With respect to state taxes, the Commission's application of the apportionment
23 method leads to a grouping of taxpayers that are required to file separately from the utility
24 under Oregon unitary group standards. These businesses would not be grouped for any
25 purpose other than SB 408 compliance and the allocation of taxes from those businesses to
26

1 the regulated operations of the utility. This result is counter-intuitive for a method that
2 purports to be based on state tax concepts and adds significant compliance challenges.

3 In the case of PacifiCorp, the effect will be that Berkshire Hathaway companies who
4 operate in Oregon and file separate Oregon returns (such as See's Candies, Inc., Dairy
5 Queen, and various insurance companies) would be combined for this rulemaking and
6 subsidize PacifiCorp's Oregon retail electric rates, a deterrent for such unregulated and
7 unrelated companies to do business in Oregon. Loss allocation from far-flung companies in
8 the affiliated group has been a concern of many in these proceedings, leading to straw
9 proposals requiring a nexus to the utility as a prerequisite to loss allocation.

10 A much more straightforward approach to state taxes, and one that PacifiCorp
11 endorses, would be to apply the apportionment method only to the state unitary group of
12 which the utility is a member. Similar to the consolidated group as it appears on the federal
13 return, the utility's unitary state tax group represents an actual taxpaying entity on an
14 Oregon tax return.

15 **VI. The Apportionment Approach Must Be Made Consistent With**
16 **Internal Revenue Code (IRC) Normalization Rules.**

17 To the extent the apportionment approach comprehensively allocates taxes in a
18 consolidated group that includes regulated utilities, the approach violates IRC normalization
19 rules. The add-back of Oregon regulated deferred taxes as a part of the method falls short
20 of full compliance with normalization and is insufficient to cure the complete melding of
21 regulated and unregulated taxes embedded in the apportionment method. Based upon the
22 discussion on this point at the July 21, 2006 workshop, there seems to be little dispute that
23 the apportionment method raises serious normalization issues, which could either put
24 accelerated tax benefits at severe risk or serve to derail SB 408 implementation.

25 Section 3(8)(b) of SB 408 permits the Commission to authorize a utility to include in
26 rates "tax requirements and benefits that are required to be included in order to ensure

1 compliance with normalization requirements of federal tax law.” Consistent with this
2 provision, the Commission should add two refining adjustments to the apportionment
3 method: (1) exclude all regulated entities within the affiliated group (other than Oregon
4 regulated operations), as well as expenses associated with disallowed capital costs, if any,
5 from the entire computation to determine the apportionment of *current* taxes, and (2) once
6 the properly attributed amount of *current* taxes is computed, add back the full
7 (unapportioned) amount of PacifiCorp’s Oregon deferred income taxes. The resulting tax
8 figure would be the properly attributed amount of income taxes (current and deferred).

9 While these steps would appear to help cure the normalization issues and provide
10 some consistency in this area of exposure, it will be the IRS who will provide the ultimate
11 determination that normalization is protected by these measures. Thus, the Commission
12 should also consider adoption of a rule that permits the utility to adjust its compliance filings
13 as necessary to help address normalization risk. PacifiCorp supports the proposed draft
14 rule that would require the IRS to issue a Private Letter Ruling clearing normalization issues
15 prior to any automatic adjustment clause rate change.

16 **VII. The Apportionment Method Should Not Allocate Group Unregulated**
17 **Deferred Taxes, Tax Credits and Charitable Deductions.**

18 The apportionment method is poor public policy because it allocates to utility
19 customers the benefits associated with unregulated deferred taxes, tax credits, such as
20 BETCs and PTCs, and charitable contributions held by other companies in the consolidated
21 tax group. Allocation of deferred taxes exacerbates the symmetry issues raised by SB 408.
22 The adoption of an approach to properly attributed that discourages investment in
23 renewable energy directly conflicts with state of Oregon policy on this issue. Similar issues
24 are raised by the apportionment method’s allocation of group charitable deductions.

25 To address this public policy problem, the Commission should restrict allocation of
26 group unregulated deferred taxes, tax credits and charitable contributions by requiring

1 additions of these amounts to total taxes paid before application of the apportionment
2 factors. While this modification is not mandated by SB 408 (except to the extent that the
3 add-back of the unregulated deferred taxes mitigates normalization concerns), the
4 Commission has authority to define properly attributed in this manner by virtue of its broad
5 discretion. The Commission should exercise its discretion to take these particular items off
6 the allocation table.

7 **VIII. Through Slight Modification of the Apportionment Method, the**
8 **Commission Can Address the Negative Impacts of Expenses Between**
9 **Rate Cases in a Manner Consistent with Legislative Intent.**

10 In the Interim Order, the Commission rejected proposals to use an earnings test or a
11 deferred accounting approach to systematically address the mismatch created by measuring
12 taxes collected using rate case estimates and measuring taxes paid on an actual basis.
13 Interim Order at 9, 12. While the Commission acknowledged the concerns of the utilities on
14 this issue, it concluded that the utility proposals were contrary to legislative intent by
15 effectively offsetting the operation of the automatic adjustment clause. *Id.*

16 By a slight modification to the apportionment method, the Commission can address
17 the earnings between rate case issue on a situational basis without interfering with the
18 operation of the automatic adjustment clause. Under the proposed rules, the Commission
19 compares the number derived from the Section 3(12) cap and the properly attributed
20 amount derived from the apportionment approach and selects the lower of the two amounts
21 as the taxes paid amount. If the properly attributed amount is below the section 3(12) cap,
22 however, the Commission has discretion to permit an increase to the properly attributed
23 amount, up to the section 3(12) cap, without offsetting the operation of the automatic
24 adjustment clause.

25 In a case where the comparison of taxes collected and taxes paid is skewed by
26 expenses between rate cases (such as those caused by abnormal weather, low hydro
conditions or a run-up in market prices), and where there is headroom between the properly

1 attributed amount and the section 3(12) cap, the Commission should permit the utility to
2 apply to credit the properly attributed amount with the tax effect of the unanticipated
3 expense. Depending on the amount of headroom between the properly attributed amount
4 and the section 3(12) cap, the nature of the expense and other factors, the Commission
5 could allow this credit to offset the double financial hit on the utility (and prevent the
6 concomitant windfall to the customers) without interfering with the basic operation of the
7 automatic adjustment clause. By modifying the apportionment method in this manner, the
8 Commission can also limit potential violations of ORS 756.040.

9 **IX. The With and Without Method Should Be Used for Determining the**
10 **Properly Attributed Amount, Not the Section 3(12)(a) Cap.**

11 In footnote 3 of the Interim Order, the Commission suggests that the Section 3(12)(a)
12 cap should be determined by applying the With and Without method. Throughout the
13 rulemaking, there was almost complete agreement that the Commission should determine
14 the section 3(12)(a) cap by reference to the stand-alone tax calculation used to determine
15 taxes collected in rates.

16 PacifiCorp developed the With and Without method as a way to measure the tax
17 benefits associated with the utility's consolidated group membership, not as a replacement
18 calculation for the baseline stand-alone calculation. The misapplication of the With and
19 Without method to the section 3(12)(a) cap is a way of further lowering the taxes paid
20 number, exacerbating the embedded mismatches in the automatic adjustment clause
21 mechanism and increasing the basic asymmetry of SB 408.

22 The draft rules propose use of the With and Without method for determining the
23 section 3(12)(a) cap for purposes of calculating state and local taxes paid. There are
24 several problems with this approach. First, it is not clear whether the section 3(12) caps
25 even apply at this level. Second, PacifiCorp never proposed to apply the With and Without
26 approach on a state and local level as contemplated by the draft rules. Third, the method

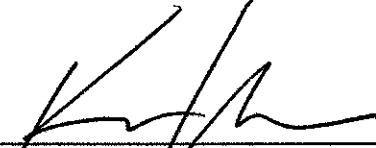
1 for calculating the With and Without amount on these levels has not been developed, in part
2 because of the complexities associated with the calculation at these levels. Fourth,
3 customer groups dismissed the With and Without approach as a stand-alone equivalent and
4 the Commission implicitly acknowledged this criticism in refusing to adopt it as the properly
5 attributed approach. It is unfair to reject the With and Without approach because it is too
6 close to stand-alone and then force the utilities to use the approach instead of the stand-
7 alone approach. This outcome is harmful to the utilities because it requires additional
8 compliance effort and exposes them to new mismatch risk.

9 **X. Technical Changes to Rules**

10 PacifiCorp is currently working on changes to the draft rules that conform to its
11 comments above and incorporate solutions to various technical issues raised at the July 21,
12 2006 workshop. PacifiCorp intends to submit these rule revisions with its Reply Comments.

13 DATED: July 31, 2006.

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CERTIFICATE OF SERVICE

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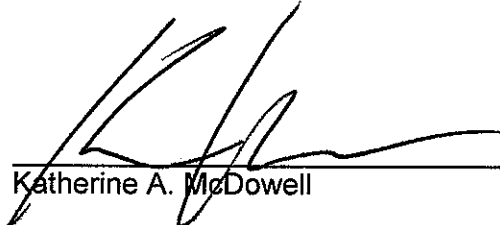
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6 DATED: July 31, 2006.

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