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AVISTA
Corp.

May 19, 2006

Sent Via email and U.S. Mail

Oregon Public Utility Commission
Attn: Filing Center
550 Capitol St. NE, #215
PO Box 2148
Salem, OR 97308-2148

Re: **DOCKET AR 499: Avista Corporation's Reply Comments on Straw Proposals**

Enclosed please find Avista Corporation's Reply Comments on Straw Proposals in the above-referenced docket.

Please direct any questions to Ron McKenzie at (509) 495-4320.

Sincerely,

Kelly Norwood

Kelly Norwood
Vice President State and Federal Regulation

Enclosure

C: AR 499 Service List

Certificate of Service

I HEREBY CERTIFY that I have this day served Avista Corporation's Reply Comments on Straw Proposals in Docket AR 499, upon the parties listed below by sending a copy via electronic mail and U.S. Mail.

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I declare under penalty of perjury that the foregoing is true and correct.
Dated at Spokane, Washington this 19th day of May 2006.

Patty Olsness

SUBMITTED: May 19, 2006

BEFORE THE PUBLIC UITLITY COMMISSION
OF OREGON

In the Matter of the Adoption of Permanent Rules implementing SB 408 Relating to Utility Taxes	)))	AR 499

AVISTA CORPORATION'S REPLY COMMENTS
ON STRAW PROPOSALS

In its opening comments, Staff by way of introduction, appropriately noted that "The Commission has discretion to define and implement the phrase 'properly attributed,' subject to the general public policy and specific limits expressed in chapter 845 [Senate Bill 408]," referring to the Department of Justice's Opinion dated December 27, 2005. [Hereinafter DOJ Opinion.] The same DOJ Opinion concluded that neither the "loss-allocation" (i.e., proportionate share method) or the stand-alone utility approach is either required or forbidden by law. (Staff Comments at p. 1.) Accordingly, there is, in the final analysis, no specific legal requirement with respect to how the Commission must define the amount of taxes paid that are "properly attributed," as observed by Staff. (Id.) This is subject, of course, to the bedrock legal proposition that the final rates must be "fair and reasonable." (ORS 756.040(1).)

I. THE STAND-ALONE OR "WITH AND WITHOUT" APPROACHES BEST COMPORT WITH SOUND REGULATORY POLICY

Staff appropriately noted that there were, in fact, "several policy reasons supporting a stand-alone approach." (Id. at p. 2.) First and foremost, the Staff commented that attributing income taxes on a stand-alone basis is "consistent with the fundamental principle basing utility rates on utility costs and revenues, and prohibiting cross-subsidization between utility and non-utility operations." (Id.) Stated differently, ratepayers should only bear costs for which they are

responsible. Moreover, Avista agrees with Staff's observation that the stand-alone approach meets the "benefits and burdens" test. Avista also concurs with other reasons cited by Staff as arguing in favor of a stand-alone approach: Attributing taxes paid to the utilities' regulated operations using its stand-alone tax liability is "fair" to the utility, and, as a "practical matter," the stand-alone method may "reduce the chances that an adjustment under SB 408 would result in rates that are confiscatory and violate ORS 756.040." (Id. at p. 3.) Furthermore, a loss-allocation approach may result in "inequitable results among the four Oregon utilities," simply because the amount of taxes attributed to each utility could vary widely simply due to the "structure of the corporate family and the financial results of individual members." (Id.)[1]

The Company generally agrees with the "three main criteria" articulated by Staff with respect to the proper calculation of "properly attributed." That is to say, any such calculations should account for the amount of the affiliated groups' tax liability that is directly attributed to the revenues and expenses of the utility; it should reflect other income tax effects that the Commission, in a general rate proceeding, has determined to be appropriately borne by utility customers; and lastly, it should be administratively practical. (Id. at p. 3.) As measured against these criteria, Staff concluded — and Avista agrees — that PacifiCorp's "with and without" approach would most accurately capture the effects of a regulated utility's operations on the amount of the actual tax liability of the consolidated entity that files returns for the affiliated group. This approach would use the entire affiliated group's actual tax returns and would perform a pro forma calculation using tax returns to determine the amount of tax liability without the utility. The resulting difference would be the amount attributed to the utility. Such an

[1] Staff, at page 3 of its comments, also correctly observed that an attribution method that required gathering and auditing the confidential financial and tax records of hundreds of companies over which the Commission has no regulatory authority "would seem to be questionable public policy."

approach has the obvious benefit that Staff and other parties would be able to readily verify and audit this "with and without" calculation, insofar as it simply requires a mathematical computation "that does not entail the factual determinations that other approaches require," as noted by Staff. (Id.)

II. THE ICNU/NWIGU AND CUB PROPOSALS ARE FLAWED

While Staff disagrees with a proposed "earnings test," it does acknowledge that the final rules in this docket should include a "process by which a party makes a request and the Commission makes the determination, on a case-by-case basis, whether or not implementation of a proposed rate adjustment, in and of itself, would cause a 756.040 violation or material adverse effect." (Id. at p. 6.) This is entirely consistent with the DOJ Opinion, supra, that concludes that, in the final analysis, rates must be "fair and reasonable" under ORS 756.040(1).

With respect to the other proposals for "properly attributed," the Staff properly observed that these proposals "introduce a level of complexity that is unwarranted." (Id. at p. 5.) Should the Commission otherwise reject the "with and without" approach advocated by PacifiCorp, Avista's alternative compromise approach would still have merit. As noted by Staff, "among the three proposals, the Avista approach seems the most justifiable because it would allocate losses to the utility only to the extent income of regulated operations enables non-utility losses to reduce the group's taxes." (Id. at p. 4.)[2]

By way of contrast, the ICNU/NWIGU proposal would require the identification of a subgroup of affiliates with a "transactional nexus" with the utility, after which there would be an allocation of a share of tax savings from the affiliates with losses to the utility. Staff went on to

[2] As characterized by Staff, Avista's alternative proposal would use the stand-alone tax liability of Oregon-regulated operations for properly attributed, except that amount would be reduced by a share of non-regulated tax savings when the group or subgroup has a net loss. (Id. at p. 4.)

characterize CUB's proposal as "even more complex," requiring an adjustment to the tax liability of each affiliate within the chain of ownership to account for accelerated depreciation and the share of net interest-related deductions. Avista agrees with Staff that each of these methods would "require time-consuming calculation and verification of each affiliate's tax liability," and would simply "mechanically reduce taxes paid for the tax benefits of non-utility debt or affiliate losses." (Id. at p. 5.) As noted by Staff, those are utility-specific factual determinations that should otherwise be made in the context of a general rate case. (Id.)

Avista also concurs with the opening comments of Northwest Natural Gas which described some of the practical defects of the straw proposals submitted by ICNU/NWIGU and CUB. ICNU/NWIGU seek to use their "nexus" approach to summarily attribute to the public utility all the tax losses of identified entities with a so-called "nexus." Northwest Natural provided examples of how this proposal would lead to "arbitrary and capricious results. (See, id. at p. 4.) Moreover, Northwest Natural correctly observed that, while CUB attempted to advance a "more moderate proposal," its proposed treatment of tax losses is "unworkable and inequitable." (Id.) The Commission would be required to individually audit the tax returns of dozens of non-regulated entities in the process and, as Staff also noted, this would ultimately prove unworkable.

ICNU/NWIGU's use of subgroups that have a "nexus" would also present practical difficulties, because it would attribute taxes without reference to an actual tax return; as noted by PacifiCorp, it would refer to a "hypothetical tax return for subgroups of the tax-paying entity." Moreover, the process of defining the relevant subgroup would be subjective, and the parties would be without the benefit of "clear policy principles and without explicit statutory guidance from the legislature," in that regard. (Opening comments of PacifiCorp, pp. 13-14.)

Avista also concurs with Portland General Electric's criticism of the "nexus" straw man proposal of ICNU/NWIGU. In its comments, Portland General noted that it would require "an arbitrary and unpredictable determination of the 'nexus' between an affiliate and a utility. (Comments at pp. 5-6.) The nexus proposal provides no coherent test or method for determining whether this 'nexus' is present and no rationale or philosophy in which to ground the nexus determination." (Id.) Moreover, as argued by Portland General, it would be "enormously complex and difficult to administer" in the case of a consolidated company with hundreds of subsidiaries. (Id.)[3]

As we work toward developing final rules related to SB 408, it is imperative that we continue to be mindful of what the language in SB 408 says, and what it does not say. ICNU/NWIGU and CUB continue to use as a foundation for their proposals a suggestion that "properly attributed" be based on a "proportionate share" or "allocation" of the overall corporate taxes paid. It is noteworthy that the words "proportion," "proportionate," "proportionate share," and "allocation" are no where to be found in the language of SB 408.

In addition, on pages 6 and 7 of ICNU/NWIGU's opening comments they make reference to Section 3(12)(a) of SB 408 in suggesting that "Tax benefits supported by utility revenues belong to ratepayers." (emphasis added). However, Section 3(12)(a) reads as follows: "That portion of the total taxes paid that is incurred as a result of income generated by the regulated operations of the utility; or" (emphasis added)

It is noteworthy that ICNU/NWIGU have not used the words of the law, i.e. "taxes paid that is incurred as a result of" (emphasis added) to support their proposal, but instead have found

[3] If the Commission were to adopt a "nexus" approach, however, as noted in Avista's opening comments, only those affiliates having direct business dealings with the utilities should be considered. (See opening comments at p. 3.) Avista acknowledges, however, that defining what constitutes "direct business dealings with a utility" would be difficult.

it necessary to change the words to "Tax benefits supported by utility revenues" (emphasis added) in order to support their proposal. Their proposal is not consistent with the language of SB 408.

Furthermore, on page 11 of their opening comments, CUB expresses concern regarding customers receiving the tax benefit associated with debt. Customers do, in fact, receive appropriate tax benefits associated with debt through the general rate case process. In those cases a determination is made by the Commission related to the appropriate capital structure, cost of equity, cost of debt, and the resulting tax benefits associated with that debt, with an eye toward balancing the risks and rewards for shareholders and customers. If a different amount of debt, interest expense and associated tax benefits were to be imputed through the implementation of SB 408, as suggested by ICNU/NWIGU and CUB, it would change the balance of risks and rewards established by the Commission in the last rate case.

In the final analysis, the "with and without" approach is appropriate and comports with the key policies and principles articulated in PacifiCorp's opening comments — namely fairness and rationality, authenticity, consistency, practicality, and sustainability. This straightforward approach is consistent with a matching principle and the Commission's affiliated-interest policies. It is also inclusive, inasmuch as it includes the entire affiliated group, thereby avoiding the need to selectively choose which affiliates are in and out of the tax group. It also renders all tax attributes in the consolidated group subject to allocation to customers; these tax attributes would include interest-related tax deductions which, as PacifiCorp noted, are a "major focus of the customer group proposals." (PacifiCorp opening comments at pp. 10-11.)

III. EXPENSES BETWEEN RATE CASES

In Avista's Revised Straw Proposal in AR 499 dated April 24, 2006, the Company stated that the Attorney General's Opinion dated December 27, 2005, gives the Commission discretion to define and implement the term "properly attributed" in developing permanent rules to implement Senate Bill 408 (SB 408). Avista believes that it is also within the discretion of the Commission to allow adjustments for the income tax impacts of net cost changes (revenues and expenses) since the last rate case and for regulatory disallowances. It would not be fair to pass-through the income tax benefit of net expenses incurred by the utility that are not borne by ratepayers. In the case of a disallowed utility cost, it would not be fair to deny the utility the recovery of the cost and, in addition, require the utility to pass-through the tax benefit of the disallowed cost. Adjustments need to be made to the amount of taxes paid that are properly attributed to Oregon regulated utility operations to remove the taxes associated with net expenses between rate cases and for regulatory disallowances. Indeed, Staff in its comments at page 7, acknowledged that the utilities' proposals in this regard "might result in a more 'fair' outcome for taxes paid . . . ." In the final analysis, customers should not get the tax benefit for costs not included in rates. If they do not bear the "burden," it is not appropriated for them to receive the "benefit."

Staff contends, however, that allowing for adjustments to reflect expenses between rate cases or for disallowances "would be poor policy and [would] circumvent the plain intent of the new law," relying on the DOJ Opinion, supra. (Comments at p. 7.) However, that same DOJ Opinion recognized elsewhere that the constitutional standard mandating fair, just and reasonable rates essentially trumps the provisions of SB 408. (See DOJ Opinion at p. 16.) The Department of Justice appropriately noted that "[r]egardless of the approach finally adopted by the Commission, the rates ultimately allowed must be 'fair and reasonable' under ORS 756.040(1)."

After citing Hope Natural Gas (320 U.S. 591) as the constitutional foundation for ORS 756.040, the Department of Justice concluded that "ORS 756.040 thus limits utilities' exposure to rate reductions, regardless of how the Commission exercises its discretion in the application of the expression 'properly attributed'." (Id. at 16.)

In conclusion, Avista believes that the adjustments for income taxes associated with net expenses between rate cases and for regulatory disallowances should occur when calculating "properly attributed" taxes paid under the permanent rules yet to be adopted in AR 499. Avista believes that its proposal appropriately matches the costs borne by and benefits received by ratepayers, and, as such, represents sound regulatory policy.

IV. CONCLUSION

Avista agrees with Staff that there are several policy reasons supporting a "stand-alone" approach. Nevertheless, Avista concurs with Staff's observation that PacifiCorp's "with and without" approach would thus satisfy the policy criteria for calculating "properly attributed." It is a straightforward approach that is easily verifiable. By contrast, the ICNU/NWIGU proposal carries with it definitional issues surrounding what constitutes a "nexus," and, like the CUB proposal, would introduce needless complexity requiring time-consuming calculation and verification of each affiliate's tax liability, including adjustments for deferred taxes so as to avoid IRS normalization violations. If, however, the "with and without" approach is unacceptable, Avista continues to urge the Commission to consider Avista's approach as a reasonable compromise. It would use the stand-alone tax liability of Oregon-regulated operations, with a reduction for the share of non-regulated tax savings when the group or subgroup has a net loss. As noted by Staff, the proposal would be the "most justifiable [of the

alternatives] because it would allocate losses to the utility only to the extent income of regulated operations enables non-utility losses to reduce the group's taxes." (Staff comments at p. 4.)

RESPECTFULLY SUBMITTED this 19th day May, 2006.

AVISTA CORPORATION

By: Kelly Norwood

Kelly Norwood
Vice President, State and Federal Regulation

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