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November 10, 2005

Via Electronically and US Mail

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

Re: In the Matter of the Adoption of Permanent Rules Implementing SB 408 Relating to Matching Utility Taxes Paid with Taxes Collected
Docket No. AR 499

Dear Filing Center:

Enclosed please find an original and six (6) copies of the Reply Legal Comments of the Industrial Customers of Northwest Utilities in the above-captioned Docket.

Please return one file-stamped copy of the document in the self-addressed, stamped envelope provided. Thank you for your assistance.

Sincerely yours,

/s/ Ruth A. Miller
Ruth A. Miller

Enclosures
cc: Service List

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served a copy of the foregoing Reply Legal Comments of the Industrial Customers of Northwest Utilities, upon the parties, on the official service list for AR 499, by causing the same to be electronically served, to those parties with an email address, as well as mailed, postage-prepaid, through the U.S. Mail.

Dated at Portland, Oregon, this 10th day of November, 2005.

/s/ Ruth A. Miller
Ruth A. Miller

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BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

AR 499

In the Matter of the Adoption of Permanent Rules Implementing SB 408 Relating to Utility Taxes.	)))))	REPLY LEGAL COMMENTS OF THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

The Industrial Customers of Northwest Utilities ("ICNU") submits these Reply Legal Comments regarding adoption of permanent rules to implement Senate Bill ("SB") 408. The Opening Legal Comments submitted by PacifiCorp, Avista Corporation ("Avista"), Portland General Electric Company ("PGE"), and Northwest Natural Gas Company ("Northwest Natural") in this proceeding reflect the investor-owned utilities' ("IOUs") desire to have the Public Utility Commission of Oregon ("OPUC" or the "Commission") interpret and implement the law as narrowly as possible, even if doing so conflicts with the plain language adopted by the legislature and undermines the intent of the law. The Commission should not be swayed by the IOUs' arguments. The Commission took the proper approach to implementing SB 408 when it adopted its temporary rules in AR 498, and ICNU urges the Commission to continue to adopt rules that implement SB 408 as the legislature intended.

In addition to the four issues initially identified by the ALJ to be addressed in legal comments, the ALJ identified in a memorandum dated November 3, 2005, an additional issue to be addressed in legal comments:

> Does SB 408 require that the Commission, in determining the amounts identified in 3(13) (e) (B) and (C), use the numbers calculated from test year data that the Commission has previously authorized?

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Re Adoption of Permanent Rules Implementing SB 408, OPUC Docket No. AR 499, Memorandum (Nov. 3, 2005). ICNU's response to these five issues is below.

A. Under the IOUs' Interpretation, the "Lesser Of" Comparison in Section 3(12) of SB 408 Defines "Properly Attributed" to the Regulated Operations of the Utility

The IOUs put forth a common interpretation of "properly attributed" that is inconsistent with the plain language and intent of SB 408. Northwest Natural sums up this interpretation most succinctly: "tax payments 'properly attributed' to the regulated operations of a utility are the tax payments incurred as a result of income generated by the 'stand-alone' regulated operations of the utility." Opening Comments of Northwest Natural at 3 (Oct. 28, 2005). Thus, the only instance in which taxes paid that are "properly attributed" to the regulated operations of the utility would not equal the utility's stand-alone tax liability is when the utility's stand-alone tax liability is greater than the total "taxes paid" by the consolidated group. Although the IOUs state this interpretation in different ways and put forth different arguments, they all reach the same conclusion. According to the utilities, taxes paid that are properly attributed will always be one of two amounts: 1) the utility's stand-alone tax liability; or 2) the total consolidated taxes paid.

PacifiCorp and Avista support this interpretation with the argument that "properly attributed" was intended to mean that the Commission may consider tax liabilities to reduce rates only when "the affiliated group paid less tax to units of government than the utility collected in rates." Joint Opening Comments of PacifiCorp and Avista at 7 (Oct. 28, 2005). PacifiCorp and Avista contend that properly attributed "means tax payments incurred as a result of economic activities of an entity without regard to the tax liabilities of other entities." Id. at 5. PacifiCorp

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and Avista concede that their definition of "properly attributed" provides for a stand-alone attribution. Id.

PGE takes a slightly different approach, arguing that "'properly attributed' by itself has no meaning—it is merely a descriptive phase that refers to the outcome of the 'lesser of' comparison" in Section 3(12). Opening Comments of PGE at 8 (Oct. 28, 2005). Nonetheless, PGE reaches the same conclusion as the other IOUs: utility rates are not adjusted down if the consolidated payment equals or exceeds the utility's stand-alone tax liability. Id. at 10.

As ICNU explained in its Opening Legal Comments, the effect of the IOUs' interpretation is to change the language of Section 3(12) of SB 408 into a definition of "properly attributed to the regulated operations of the utility." Section 3(12) provides that taxes paid that are properly attributed to the regulated operations of the utility may not exceed the lesser of: "(a) That portion of the total taxes paid that is incurred as a result of income generated by the regulated operations of the utility; or (b) The total amount of taxes paid to units of government by the utility or by the affiliated group, whichever applies." Under the IOU's interpretation of "properly attributed," however, Section 3(12) would provide that the amount of taxes paid that is properly attributed to regulated utility operations is the lesser of these two amounts. This is not the result intended by the legislature.

ICNU demonstrated in its Opening Legal Comments that the plain meaning of "properly attributed," when considered in the context of the other provisions of SB 408, demonstrates that the definition put forth by Staff and adopted by the Commission in AR 498 is correct. The stand-alone attribution proposed by the IOUs results in a different meaning for

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"properly attributed" as it applies to the regulated utility in Section 3(6) than the phrase would have as it applies to an "unregulated affiliate" under Section 3(7). In interpreting a statute, use of the same phrase in the same statute indicates that the term is intended to have the same meaning. PGE v. BOLI, 317 Or. 606, 610 (1993). Under the utilities' interpretation, "properly attributed" would mean stand-alone attribution as it applies to the regulated utility, but "properly attributed" would have an entirely different meaning for unregulated affiliates.

Given that the text and context of SB 408 demonstrated the correct definition of "properly attributed," ICNU did not discuss the legislative history of SB 408 in Opening Legal Comments. ICNU believes that the Commission should follow the plain meaning of the statute. The IOUs' opening comments, however, focused almost exclusively on using selective portions of the legislative history to support their different definitions of properly attributed for the regulated utility and its unregulated affiliates. ICNU, thus, is impelled to respond to and present a more accurate presentation of the legislative history.

1. SB 408 Was Not Intended to Affect the Corporate Organization of an Affiliated Group

PacifiCorp and Avista argue that the definition of "properly attributed" that the Commission adopted in the temporary rule is arbitrary because it "produces different results simply depending on the corporate organization of the utility's affiliated group." PacifiCorp/Avista Comments at 14. SB 408 was not intended to affect the corporate organization of affiliated companies, just as it was not intended to affect the decision to include or not include a utility in a consolidated tax group. SB 408 accepts the corporate organization in whatever form it exists and attempts to reconcile the taxes collected from ratepayers with the taxes paid to units of government and properly attributed to regulated operations of the utility.

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PacifiCorp's and Avista's claims about the differing results that occur under different organization of affiliated groups are irrelevant to the determination of the amount of taxes paid that is "properly attributed" to the regulated utility or its unregulated affiliates.

2. The Legislative History Confirms the Plain Meaning That Taxes Paid Are to Be Allocated Among All Affiliates on a Consistent Basis

The IOUs claim that the legislative history of SB 408 supports their interpretation of "properly attributed." Rather than providing a narrative history of the development of the law that shows the proposals that were accepted and those that were rejected, the IOUs rely upon selected excerpts in a work attempt to support their result-oriented approach. When viewed as a whole, the legislative history demonstrates that the legislature rejected the IOUs' definition of "properly attributed" and, instead, adopted a version of the bill that intended to apply "properly attributed" to all members of an affiliated group in a consistent manner. The Commission and Staff correctly applied this interpretation of "properly attributed" in AR 498.

a. The Staff White Paper Formed the Basis for the Legislative Debate

The starting point when considering the legislative development of SB 408 is the February 2005 OPUC Staff White Paper, Treatment of Income Taxes in Utility Ratemaking ("White Paper"), which the Commission submitted to the legislature and is attached as Attachment A.[1/] The Staff White Paper provided the context and the vocabulary that the legislature used in developing SB 408.

Staff's White Paper identified three general options for treatment of utility taxes in ratemaking. White Paper at 7-8. The first option was the "utility stand-alone" method, which

[1/] The Staff White Paper is referenced throughout the legislative history. ICNU has attached certain documents that are relevant to the development of SB 408 but that are not included in the legislative history that was compiled and made available by the Attorney General's office.

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was the method that the OPUC used prior to SB 408. This method created the problem that SB 408 was intended to remedy.

The second option was to change the tax laws rather than implementing a regulatory approach. This option would require the utility to file a separate (not consolidated) Oregon tax report. Tax law changes were initially considered in SB 171, but that approach ultimately was abandoned. Id. at 12-13.

The third option was an "actual taxes paid" method. Id. at 8-12. The Staff White Paper identified two potential ways to define "actual taxes paid":

> 'Actual taxes paid' could be defined as either (a) the amount of taxes the utility calculates on a stand-alone basis and pays to its parent, which then files a consolidated return; or (b) the utility's 'share' of the parent's actual tax payments to the income taxing authorities.

Id. at 8. In passing SB 408, the legislature plainly chose definition (b) of the Staff White Paper. SB 408 defines "Taxes" as the amount paid to units of government, not the amounts "paid" by the utility to its parent. SB 408 § 3(13)(d)(A). In discussing how an "actual taxes paid" approach based on the utility's "share" of the parent's actual tax payments would work, Staff specifically noted in its White Paper that "a sensible method would need to be adopted for allocating to the regulated utility a portion of the consolidated tax payment. Making the calculation would require Commission access to the details of the corporation's state and federal tax filings, which the agency currently does not have." White Paper at 9. SB 408 requires utilities to provide such information in the tax report and authorizes the Commission to obtain all other information necessary to make the required determinations, including how much of the consolidated tax payment is "properly attributed" to the regulated utility and each unregulated

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affiliate. In other words, SB 408 reflects the legislature's intent to provide the Commission with the authority to determine the utility's and its unregulated affiliates' "share" of the total taxes paid of an affiliated group, not merely the utility's stand-alone tax liability.

Staff's White Paper also identified three alternative ways that the Commission could implement an "actual taxes paid" approach:

- A "full" true-up;
- A "partial" true-up that would exclude the effects of accelerated depreciation; and
- A modified effective tax rate or tax savings method that would use "the parent company's effective tax rate or an allocation of its projected or actual tax savings" in setting or adjusting rates.

Id. at 8-10. Staff specifically noted that the Pennsylvania Public Utility Commission applies an "'actual taxes paid' standard" in setting rates "that takes the consolidated tax savings generated by losses of non-regulated members of the group, and then spreads those savings to all members having positive taxable income." Id. at 11.

With the background and vocabulary provided by the Staff White Paper, the legislature addressed the problem: tax losses of unregulated affiliates were not accounted for in determining the utility's tax expense that was included in rates and collected from customers. The problem was the then current OPUC practice of keeping the tax losses and liabilities of regulated and unregulated operations separate in calculating utility rates:

> I want to clarify for the record that you [Kevin Lynch, Representative of PacifiCorp Holdings, Inc.] made a couple of points including during your conclusion about how important it is that we keep the line clear between regulated activities and risk, in this case, the ratepayers and unregulated activities. But in truth, isn't that exactly what we do under the status quo which is what we're trying to correct…

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Public Hearing on SB 171, Sen. Revenue Comm., 73d Leg., Regular Sess., 6 (Apr. 14, 2005) (Statement of Senator Richard Metsger).

In SB 408, the legislature crafted an "actual taxes paid" approach that incorporates elements from the three "actual taxes paid" alternatives identified by Staff: 1) SB 408 uses a true-up; 2) SB 408 accounts for accelerated depreciation and other factors (e.g., charitable contributions); and 3) SB 408 calls for attributing taxes paid on consolidated basis among all affiliates, including the utility. In other words, SB 408 nets gains and losses of all affiliates (similar to a modified effective tax rate or tax savings method), and performs the true-up by comparing taxes collected with the portion of taxes paid that is "properly attributed" to regulated utility operations.

b. The Development of Sections 3(6) and 3(7) Reflect the Intent to Allocate "Taxes Paid" Among All Affiliates

The best use of the legislative history in terms of determining the meaning of "properly attributed" in SB 408 is to consider the competing legislative proposals in the development of Sections 3(6), 3(7), and 3(12) in SB 408 as enacted, rather than focusing on selective legislative quotes without the benefit of any context. Several competing bills emerged for consideration in Public Hearings and Work Sessions before the House Committee on State and Federal Affairs, and the contents and eventual disposition of each these proposals confirms that the Commission adopted the correct definition of "properly attributed" in AR 498.

i. June 30, 2005 House Committee Public Hearing

There were three competing bills in a Public Hearing held on June 30, 2005.

- ***The IOUs' Bill (SB 408-B13).*** The IOUs' bill (B13) included an automatic adjustment clause that applied "only prospectively to reset the tax expense in rates so that rates

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reflect the amount that . . . (b) [in] the case of an affiliated group, the affiliated group will pay to units of government that is properly attributed to the regulated operations of the utility." Public Hearing on SB 408, House Comm. on State and Fed. Affairs, 73d Leg., Regular Sess., Exh. E at 4 (June 30, 2005). The IOUs' bill defined "properly attributed" as:

> [T]he attribution of tax <u>liabilities</u> or tax <u>benefits</u> to the entity or activity whose business or economic activities created the items of income, expenses, losses, deductions or credits that give rise to the tax liabilities or tax benefits.

<u>Id</u>. at 5 (emphasis added). The IOUs proposed to allocate separately tax losses and liabilities to each member of the affiliated group using a causation methodology. The IOUs' proposal effectively preserved the stand-alone approach because it allowed the utility to continue to collect its stand-alone tax liability. In other words, the IOUs' proposal provided for the attribution and outcome that the IOUs now contend that SB 408 requires. The legislature did not adopt the IOUs proposal. The Commission should refuse the IOUs' request to define "properly attributed" in a manner that the legislature has already rejected.

- ***The Department of Justice ("DOJ") Bill (SB 408-B15).*** The DOJ presented a bill (B15) that provided for an automatic adjustment clause that would "(a) [r]ecoup for ratepayers the amount of costs for taxes paid in rates by ratepayers but never received by units of government; or (b) [r]eimburse utility investors for the amount of taxes received by units of government but not collected in rates from ratepayers." Public Hearing on SB 408, House Comm. on State and Fed. Affairs, 73d Leg., Regular Sess., Exh. F at 5 (June 30, 2005). The DOJ bill did <u>not</u> provide for any "attribution" of the consolidated tax payment among the members of the consolidated tax group. Instead, the DOJ bill adjusted rates until the amount of taxes collected in rates equaled the total consolidated tax payment.

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- ***The Ratepayers' Bill (SB 408-B16).*** The Ratepayers' bill (B16) presented in this hearing provided for an automatic adjustment clause that adjusted the utility's rates for the difference between taxes collected and the consolidated taxes paid and properly attributed to the regulated operations of the utility. Public Hearing on SB 408, House Comm. on State and Fed. Affairs, 73d Leg., Regular Sess., Exh. G at 3 (June 30, 2005). Section 3(6) of the Ratepayers' bill is identical to the language in Section 3(6) of SB 408 as ultimately adopted.

ii. July 15, 2005 House Committee Work Session

The House Committee on State and Federal Affairs considered two competing versions of the bill at a Work Session on July 15, 2005.

- ***The IOUs' Bill (SB 408-B20).*** In the IOUs' bill (B20) the IOUs adopted the automatic adjustment clause provision from the DOJ bill (B15) presented on June 30, 2005. Work Session on SB 408, House Comm. on State and Fed. Affairs, 73d Leg., Regular Sess., Exh. B at 5 (July 15, 2005). Thus, the IOUs were now proposing an adjustment clause that provided for a rate decrease only if the consolidated tax payments were less than the taxes collected in rates. If the consolidated tax payments were more than the amount collected in rates, then the IOUs proposed to allocate the additional tax amount to ratepayers for a potential upward rate adjustment. There was no attribution of the consolidated tax liability to any other affiliate.

The IOUs' proposal abandoned any notion of maintaining a clear line between the utility's tax liabilities and unregulated affiliates' tax liabilities and losses. Rather, the IOUs advocated for allocating the <u>entire</u> consolidated tax liability to ratepayers, including amounts arising from unregulated businesses.

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The IOUs' B20 proposal also carried forward the stand-alone definition of "properly attributed" proposed in their earlier (B13) bill. Id. at 1. The IOUs did not use this definition of "properly attributed" in the section of their bill specifying the amounts to be recovered or credited through the automatic adjustment clause, because the automatic adjustment clause language that the IOUs had taken from the DOJ's earlier bill (B15) did not contemplate any attribution and did not include the "properly attributed" language. Nevertheless, the IOUs' did incorporate that definition of properly attributed in Section 3a(1)(a) of their bill, which provided that "[t]he automatic adjustment clause . . . may not be used to (a) [m]ake adjustments to rates that are properly attributed to any other affiliate of the public utility or to the parent of the utility." Id. at 5. The apparent conflict between these sections created confusion. In responding to comments from OPUC Staff, Deputy Attorney General Peter Shepherd noted on this conflict:

> The question that arises here is that under [Section 3a(1)(a)], the Commission is not allowed to use the automatic adjustment clause described in section 3 of the act, to make adjustments to rates that are properly attributed to any other affiliate of the public utility or to the parent of the utility. Now, I recognize that section 3 of the act does permit adjustments to be made based upon a consolidated return which necessarily implies that in the making of that adjustment on the consolidated return that we are taking into account the tax effects of other entities that are within the affiliated family. And so the questions comes up, logically, well, how do you square the language in [Section 3a(1)(a)] with the fact that section 3 appears to and does permit and indeed require the adjustment in an affiliated situation. And I think the best way to reconcile, the very best way would be to clean up the language to make clearer on its face, but if we were confronted with construing this language, I think the construction we would place on it is that the limitation in [Section 3a(1)(a)] means that when a company files as a stand alone utility, then it is not permitted to take into account any other affiliates or the tax consequences on a calculation of the activities of any of its other affiliates or of its

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> parent. But when it files as part of a consolidated, and when a consolidated return if filed, then of course, one has to take into account those effects.

Work Session on SB 408, House Comm. on State and Fed. Affairs, 73d Leg., Regular Sess., 10 (July 15, 2005) (Statement of Peter Shepherd, Deputy Att'y General of Oregon).

The confusion with respect to Section 3a(1)(a) was the language stating that the automatic adjustment clause may not be used to "make adjustments to rates that are properly attributed to any other affiliate . . . ." The adjustment in this section referred to an adjustment to the utility's rates (the unregulated affiliates do not have rates), but the utility's rates themselves could not be "properly attributed." Thus, Section 3a(1)(a) was unclear as to what cost or amount was to be properly attributed to each affiliate. The Ratepayer's bill (B21) discussed below addressed this ambiguity, and, in doing so, made clear that it was necessary to determine the portion of the total consolidated taxes paid that is "properly attributed" to each entity in the affiliated group, including the utility.

- ***The Ratepayers' Bill (SB 408-B21).*** The Ratepayers' bill (B21) included the same automatic adjustment clause provision that was included in the Ratepayers' previous version of the bill (B16). This provision provided for an adjustment to the utility's rates based on the difference between taxes collected in rates and the taxes paid by the affiliated group "that are properly attributed to the regulated operations of the utility." Work Session on SB 408, House Comm. on State and Fed. Affairs, 73d Leg., Regular Sess., Exh. D at 5 (July 15, 2005). The Ratepayers' bill also included the same definition of "taxes paid" as in the previous bill. In the affiliated group context, "taxes paid" was defined as the total consolidated tax payment received by government when the utility. Id. at 5-6.

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The Ratepayers' bill addressed the confusion regarding the apparent conflict in the IOUs' bill between the automatic adjustment clause provision and Section 3a(1)(a) by specifying that what was prohibited under the automatic adjustment clause was adjusting rates for taxes paid that were properly attributed to an unregulated affiliate or parent company:

> An automatic adjustment clause established under this section may not be used to make adjustments to rates for taxes paid that are properly attributed to any unregulated affiliate of the public utility or to the parent of the utility.

Id. at 4 (emphasis added). This change, when read in conjunction with the Ratepayers' definition of "taxes paid," clarified that: 1) the "adjustment to rates" in Section 3(7) referred to the utility's rates; and 2) this subsection precluded adjusting the utility's rates for any portion of the total consolidated "taxes paid" that was "properly attributed" to any unregulated affiliate.

With this change, the Ratepayers' bill made clear that the amount that must be "properly attributed" under both Section 3(6) and 3(7) is "taxes paid," and that "taxes paid" is the net consolidated tax liability of the affiliated group. After netting the gains and losses of the affiliated group (which includes the utility), the positive amount of taxes paid must be "properly attributed" to the "regulated operations of the utility" and to each "unregulated affiliate" on a consistent basis. By attributing "taxes paid" to the utility and each unregulated affiliate on a consistent basis, the Commission correctly determine the amount of taxes paid that is "properly attributed" to each member of the affiliated group, which is necessary to ensure that a disproportionate share of "taxes paid" is not allocated to the utility and its ratepayers. Implementing a rate adjustment that was based on attributing a disproportionate share of taxes paid to the regulated utility would violate Section 3(7) of SB 408, which prohibits an adjustment to rates for "taxes paid that are properly attributed to any unregulated affiliate[.]"

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Although the Committee ultimately adopted the IOUs' B20 bill, as explained below, the IOUs' B20 bill was subsequently rejected in favor of a Ratepayer bill that was in all relevant respects identical to the B21 bill. This version of the bill (B22) was ultimately passed by the legislature.

iii. July 26, 2005 House Committee Hearing

At the July 26, 2005 work session, the Committee took back the IOUs' B20 bill. The Committee adopted Ratepayers' B22 bill and that version of SB 408 was subsequently passed by the House and Senate and signed by the Governor.

In rejecting the IOUs' B20 bill and the earlier B13 bill, the legislature refused to adopt the following elements of the IOUs' bills:

- For a utility that is part of a consolidated tax group, an adjustment to rates would reduce rates only when the consolidated payment was less than the taxes collected in rates, which was to continue to be established based on the utility's stand-alone tax.

- "Properly attributed" should be defined and implemented to allocate tax losses and liabilities on a stand-alone basis.

Although the legislature rejected these concepts by adopting the Ratepayers' Bill, the IOUs continue to argue in support of these policies in asserting their "interpretation" of SB 408 and the legislative intent to the OPUC. Notably, the "stand-alone" definition of "properly attributed" that the IOUs now urge the OPUC to adopt is the same definition that the IOUs proposed in the B13 and B20 bills that were not adopted by the legislature. Further, the IOUs also now contend that the legislature intended the automatic adjustment clause to prohibit a downward adjustment to rates if the total consolidated taxes paid exceeds the taxes collected. The IOUs also made this proposal before the legislature and it was rejected as well.

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In adopting the Ratepayers' B22 bill, the legislature approved the following:

- The starting point of the rate adjustment and the amount to be properly attributed among all affiliates is "taxes paid," in which losses and gains of all affiliates, including the utility, are netted.

- "Properly attributed" does not allow unbundling of "taxes paid" into gains and losses. The legislature rejected this definition of "properly attributed" in B20.

- The adjustment to rates cannot include any portion of taxes paid that is properly attributed to any other affiliate. Thus, the determination of whether the rate adjustment complies with both Sections 3(6) and 3(7) requires the Commission to determine the amount of taxes paid properly attributed to each affiliate, including the utility, on a consistent basis.

- The rate adjustment should be based on the difference between taxes collected in rates and that portion of taxes paid properly attributed to the utility—not just taxes paid. Thus, a downward rate adjustment can occur even when taxes paid exceeded the utility's stand-alone tax.

c. The IOUs' Selected Excerpts From the Legislative History Do Not Support the IOUs' Interpretation

The IOUs quote selectively from the legislative history in an attempt to overcome both the plain meaning of SB 408 and the intent of the law demonstrated by the comprehensive review of its development. PacifiCorp, Avista, and Northwest Natural quote the following statement made by Senator Metsger during the May 26, 2005 Work Session to support the assertion that affiliate losses do not affect utility rates: "It has nothing to do with other corporations, it's only the utility itself, no other affiliations are affected by this . . . . It has nothing to do with any other affiliates you have." PacifiCorp/Avista Comments at 8; Northwest Natural Comments at 8-9. Taken literally, this statement proves too much. Even the IOUs' incorrect interpretation of "properly attributed" concedes that the Commission should adjust

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rates downward if affiliate losses reduce the total consolidated taxes paid to an amount that is less than the amount collected by the utility based on its stand-alone tax liability.

PGE contends that a colloquy between Representative Boquist and Representative Butler during the July 30, 2005 House Chamber debate demonstrates that the utility stand-alone tax liability and the consolidated tax liability provide "the boundaries for the potential adjustments to rates." PGE Comments at 11. The colloquy is somewhat confusing and relies on the imprecise use of language that permeates much of the legislative history. Nevertheless, PGE reads this exchange to indicate that Section 3(12) establishes "boundaries" to the potential rate adjustment based on either: 1) the utility's stand-alone tax liability; or 2) the consolidated tax liability. Id. The exchange in the House Chamber does not support such an interpretation. Section 3(12) does not say that the amount of taxes paid that is properly attributed to the regulated operations of the utility will be the lesser of these two amounts. Reading this Section in the manner suggested by PGE would render meaningless Sections 3(6) and 3(7) of SB 408.

PGE also cites examples given by Michael Early, Executive Director of ICNU, during the July 26, 2005 Work Session. PGE Comments at 11. Mr. Early's full statement was:

> The B22 amendments provide for adjustments to the rate either up or down, so it is symmetrical in terms of adjusting increasing rates or decreasing rates. The fundamental difference between the B20 and the B22 is what the target of the automatic adjustment clause is. And specifically in the context of a utility that is owned by a parent and the parent files on a consolidated tax basis, what B20 said was that the adjustment would attempt to true-up the taxes collected from Oregon rate payers with the total consolidated tax bill of the utility. So, for example, if one of our utilities was owned by an out-of-state entity that was engaged in very profitable unregulated businesses, the Commission, the Oregon Public Utilities Commission, would include in rates, say $50 million recovered from Oregon citizens, but the parent chooses to file under a consolidated basis, it's very profitable. Let's say its

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> income tax liability is $500 million, it's ten times the amount that is recovered from utility customers and rates. * * * What's different about our bill, is our bill gets to the heart of the question. In that same fact situation, what we're truing-up is, we're saying is we want to match the dollars collected from rate payers with the tax dollars by the utility and attributable to regulated operations. So, the Commission looks at the $500 million and asks itself what portion of that $500 million was attributable to regulated operations in Oregon and that answer's going to be, it's going to be $50 million. So, then it says, well, it did collect and did pay to taxing authorities the amount of taxes collected. So, in that case, the adjustment is, there would be no adjustment, because in fact what was expected to happen, did happen. It collected $50 million and it paid $50 million.

Work Session on SB 408, House Comm. on State and Fed. Affairs., 73d Leg., Regular Sess., 2 (July 26, 2005) (Statement of Michael Early, Exec. Dir. of ICNU) (emphasis added). PGE's misleading reference to this example does not specify that it expressly assumed that the parent has "very profitable unregulated businesses" and that it did <u>not</u> posit any unregulated affiliate with a net loss. Under these circumstances, the amount of "taxes paid" that is properly attributed to the regulated operations of the utility is the amount of utility's stand-alone tax liability. This may not necessarily be the result, however, if the example did not explicitly assume that the affiliated group does not includes multiple unregulated affiliates with positive stand-alone tax liability that contributed to the overall consolidated taxes paid. In other words, it is improper for PGE to conclude from one limited example that the same result would occur under different circumstances.

PacifiCorp and Avista cite a statement made by Legislative Counsel Dexter Johnson for the proposition that Section 3(7) precludes the attribution of any affiliate losses to the utility. PacifiCorp/Avista Comments at 8. At the May 31, 2005 Work Session, the Committee discussed SB 408-A, which provided for an automatic adjustment clause "so that

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ratepayers are not charged for more tax than . . . (b) the affiliated group pays to units of government that is properly attributed to the regulated operations of the utility." Work Session on SB 408, Sen. Business and Economic Dev. Comm., 73d Leg., Regular Sess., Exh. B at 2-3 (May 31, 2005). Mr. Johnson noted that a new Section 3(4) had been added to the Bill, providing that "the automatic adjustment clause . . . may not be used to make adjustments to rates that are attributable to any other affiliate of the utility" or to the parent. Work Session on SB 408, Sen. Business and Economic Dev. Comm., 73d Leg., Regular Sess., 4 (May 31, 2005) (statement of Dexter Johnson, Legislative Counsel). In describing this provision, Mr. Johnson stated that:

> So if the utility either is in a parent subsidiary relationship or is in fact the parent of subsidiaries, the automatic adjustment clause does not apply to the activities of other entities however they are related to the utility, but only to the utility itself.

Id. Similar to PGE's claim discussed above, PacifiCorp and Avista claims regarding this statement prove too much. PacifiCorp and Avista would prevent an allocation to the utility in the rate adjustment of any tax losses of any unregulated affiliates under SB 408, which is what the Commission historically did under the stand-alone approach. As Senator Metsger remarked at the April 14, 2005 Public Hearing of the Senate Revenue Committee, this would merely preserve the "status quo," which "is what we're trying to correct." Public Hearing on SB 171, Sen. Revenue Comm., 73d Leg., Regular Sess., 6 (Apr. 14, 2005) (statement of Senator Richard Metsger). Furthermore, as discussed below, even PacifiCorp's approach applies for "pour-over" of affiliate losses in certain circumstances.

In addition, Mr. Johnson's statement refers to an earlier version of the provision that eventually became Section 3(7) in the B22 version of SB 408 that the legislature enacted.

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As discussed above, this language was the source of confusion, and Deputy Attorney General Shepherd stated that it should be clarified. The Ratepayers clarified this language in their B20 bill, and the result is that Sections 3(6) and (7) together provide that "taxes paid" must be attributed to <u>each</u> affiliate on a consistent basis in order to prevent any upward adjustment to rates to reflect any portion of taxes paid that is properly attributed to any unregulated affiliate.

The inconsistency with respect to PacifiCorp's interpretation of "properly attributed" as that phrase is used in Sections 3(6) and 3(7) is clear from PacifiCorp's August 30, 2005 response to certain questions regarding SB 408 posed by Staff:

> **6. In Section 3(6), how should "properly attributed to the regulated operations of the utility" be defined and calculated?**
>
> "Properly attributed to the regulated operations of the utility" means the portion of taxes paid to all units of government by a utility or its affiliated group equal to the tax expense associated with regulated operations calculated on a stand-alone basis.
>
> **7. In Section 3(7), how should "properly attributed to any unregulated affiliate" be defined and calculated?**
>
> "Properly attributed to any unregulated affiliate" means the portion of taxes paid to all units of government by a utility's affiliated group that is greater than the tax expense associated with regulated operations calculated on a stand-alone basis.

PacifiCorp's Responses to Questions from Staff's Aug. 12, 2005 Letter at 6-7 (Aug. 30, 2005). In Section 3(6), PacifiCorp would use a stand-alone rule for attribution of taxes paid to the utility. In Section 3(7), however, PacifiCorp would not apply the same rule to "any unregulated affiliate" even though the statutory language and directive is identical. PacifiCorp's interpretation does not allow for a determination of the portion of taxes paid that is properly attributed to any particular unregulated affiliate. PacifiCorp's interpretation only allows that <u>all</u>

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other unregulated affiliates will be "properly attributed" the remainder of taxes paid once the utility is allocated the full amount of its stand-alone tax liability.

PacifiCorp and Avista also cite a memorandum from Deputy Attorney General Shepherd to Representative Tom Butler dated July 30, 2005, which is attached as Attachment B. PacifiCorp/Avista Comments at 9-10. Mr. Shepherd's memorandum responds to a request to review whether Michael Early's testimony that the Ratepayers' bill B-22 was "symmetrical" was accurate. Memorandum from Peter Shepherd, Deputy Att'y General of Oregon, to Rep. Tom Butler at 1 (July 30, 2005) ("Shepherd Memorandum"). Mr. Shepherd concluded that the testimony was principled and reasonable because the Ratepayers' B22 bill (unlike the IOUs' bill) applied "properly attributed" to the utility whether it filed on a stand-alone or consolidated tax basis. Id. at 1. Thus, the premise of the memorandum is that the B22 bill provided for a rate adjustment based on a comparison of taxes collected in rates and taxes paid and properly attributed to the utility.

Mr. Shepherd concluded that rates would "stay the same" if the utility filed on a consolidated basis and "affiliated businesses (unrelated to the regulated business) were profitable." Id. This is the same example based on profitable unregulated affiliates that Mr. Early used in the July 26, 2005 Work Session discussed above. PacifiCorp and Avista, like PGE, leave out the important assumption about profitable unregulated affiliates in claiming that these examples demonstrate that SB 408 provides that "rates would 'stay the same' if the affiliated group paid more tax to government than the utility collected in rates." PacifiCorp/Avista Comments at 9.

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Mr. Shepherd also concluded that rates would go down if the utility is included in a consolidated tax filing and "losses incurred by affiliated companies offset the tax liability in the consolidated return so that the amount of tax received by the government is less than the amount allowed as estimated taxes." Shepherd Memorandum at 2. This statement must be considered in the context of the B22 bill, which provided for a rate adjustment based on a comparison of taxes collected with taxes received by the government and properly attributed to the utility. Rates would be adjusted downward under the B22 bill when unregulated affiliate losses offset the tax liability in the consolidated return so that the amount of taxes received by the government that is properly attributed to the utility is less than the amount allowed in rates as estimated taxes. The subsequent paragraph of Mr. Shepherd's memorandum confirms this reading. Referring to the previous statement, Mr. Shepherd noted that "[u]nder the -B22s, losses incurred by the non-regulated activities of affiliated companies drives rates down." Id.

Finally, PacifiCorp's own actions belie its suggestion that no one understood that SB 408 contemplated the sharing of tax losses. PacifiCorp argues that, at most, SB 408 intended a "pour-over" sharing of unregulated losses. PacifiCorp/Avista Comments at 10 n.7. PacifiCorp discussed this approach in its request to repeal the Commission's temporary rule:

> The plain language of SB 408 is consistent with the approach favorably passed on by the Supreme Court in *Federal Power Commission v. United Gas Pipeline*. There, affiliate losses were applied to reduce utility stand-alone tax expense only if such losses were not fully offset by affiliate gains. Under this approach, as apparently intended by SB 408, affiliate losses are taken into account only if the consolidated tax liability is less than the utility's stand-alone tax liability.

Re Adoption of Temporary Rules Implementing SB 408, OPUC Docket No. AR 498, PacifiCorp Petition to Repeal and Amend at 12 (Oct. 14, 2005) (internal citations omitted). PacifiCorp

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acknowledges in its Petition that the U.S. Supreme Court has approved of this method of sharing tax losses,[2/] yet PacifiCorp contends in Opening Legal Comments that Staff's definition of "properly attributed" is unconstitutional. PacifiCorp/Avista Comments at 13. Given that PacifiCorp raised these same Constitutional concerns in the legislative hearings, PacifiCorp must have understood that the Ratepayers' bill was not just a pour-over allocation. Public Hearing on SB 408, House Comm. on State and Fed. Affairs, 73d Leg., Regular Sess., 16-17 (June 30, 2005) (Statement of Sarah Lien, Att'y for PacifiCorp); see Memorandum From Michael Early to Dexter Johnson (July 22, 2005) (responding to IOUs' Constitutional concerns with the Ratepayers' bill) (Attached as Attachment C). PacifiCorp should not be allowed to suggest, as it does now, that it or anyone else understood at the time that the Ratepayers' bill intended only a pour-over loss allocation.

3. SB 408 Presents the Opportunity for the Commission to Provide Ratepayer Protections That Should Exist in All States

PacifiCorp and Avista argue that SB 408 is not identical to the approach to utility income taxes adopted in Pennsylvania or the approach in any other state. PacifiCorp/Avista Comments at 16-20. SB 408 provides for an adjustment to rates based on a difference between taxes collected and the amount of taxes paid that is properly attributed to regulated utility operations, and it accounts for certain specific adjustments to "taxes paid." This is unlike any of the approaches discussed in the legislative history. Although the parties and the legislature considered approaches from a number of different jurisdictions in formulating SB 408, the

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[2/] ICNU is not acknowledging that this legislature intended the result or that it should have been the correct choice in enacting SB 408. PacifiCorp has reserved its right to assert a challenge to SB 408 under the U.S. Constitution but also acknowledges that the U.S. Supreme Court did not find the method that the company claims was "apparently intended" in SB 408 violated the takings provision of the U.S. Constitution.

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legislature ultimately incorporated the best elements of certain of those methods along with new ideas to create a comprehensive solution for Oregon. The plain language of SB 408, the context of other provisions of the statute, and the legislative history all demonstrate that the Commission correctly interpreted "properly attributed" when it adopted the temporary rule in AR 498.

B. Section 3(13)(f)(B) Creates A Limited Adjustment to "Taxes Paid"

PacifiCorp and Avista put forth a broad interpretation of SB 408 § 3(13)(f)(B) that would expand the adjustment in this Section beyond the purposes for which it was intended. Section 3(13)(f)(B) provides that "taxes paid" will be:

> Increased by the amount of tax savings realized as a result of tax credits associated with investment by the utility in the regulated operations of the utility, to the extent the expenditures giving rise to the tax credits and tax savings resulting from the tax credits have not been taken into account by the commission in the utility's last general ratemaking proceeding.

Basic examples of the types of credits to which this section was intended to apply are those related to investment in renewable energy or energy conservation measures. This includes both Oregon's Business Energy Tax Credit and the Federal Production Tax Credit, assuming that the "investment" associated with these credits meets all the other requirements in this provision. ORS § 315.354; 26 U.S.C. § 45. These are both "tax credits" that apply to "investments" made by a utility in its regulated operations, and this Section is written broadly enough to encompass credits that a utility purchases from another entity.

The IOUs argue that this Section applies more broadly, and that it provides "an adjustment to 'taxes paid' for tax savings arising from <u>any expenditure</u> in the regulated operations of a utility that was not taken into account in ratemaking." PacifiCorp/Avista Comments at 22-23 (emphasis added). Northwest Natural also argues that an expansive

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interpretation should be applied. Northwest Natural Comments at 18. The Commission should not adopt this overly broad interpretation.

The IOUs' interpretation disregards the legislature's specific use of "tax credits" associated with "investment" in the utility as opposed to "deductions" associated with any utility "expense." The IOUs argue that "tax credit" is a generic reference to "anything that give rise to tax savings" and "includes not only items that are themselves tax savings, but also items that, when applied, produce tax savings (i.e., deductions)." PacifiCorp/Avista Comments at 23. This interpretation is inconsistent with the legislature's specific use of "tax credit" in this section. If the legislature would have intended for the adjustment in this Section to apply to a tax "deduction," it is presumed that it would have used that term. See Bayridge Ass'n Ltd. Partnership v. Dep't of Revenue, 321 Or. 21, 31 (1995). Indeed, the legislature created a similar adjustment to "taxes paid" for charitable contributions in Section 3(13)(f)(A). This Section provides that taxes paid will be "increased by the amount of tax savings realized as a result of charitable contribution deductions allowed because of charitable contributions made by the utility." SB 408 § 3(13)(f)(A) (emphasis added). The legislature's use of "deductions" in Section 3(13)(f)(A) and "tax credits" in Section 3(13)(f)(B) demonstrates the intent to distinguish between the two. Interpreting "tax credit" to mean "anything that gives rise to tax savings" is overly broad.

Northwest Natural argues that under its expansive interpretation of Section 3(13)(f)(B) the contributions it made to its pension fund in 2006 would give rise to an adjustment to "taxes paid" because those contributions resulted in "tax savings." Northwest Natural Comments at 19. Section 3(13)(f)(B) was not intended to apply to pension fund

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contributions and other general expenses incurred by the utility between rate cases. First, contributions to a pension fund are not an "investment." The definition of "investment" is an "expenditure of money for income or profit or to purchase something of intrinsic value." Merriam-Webster, Webster's Third New Int'l Dictionary at 1190 (Unabridged Ed. 1993). Northwest Natural presumably did not contribute to its pension fund to generate income or profit for the utility or because it has intrinsic value. Pension costs are an expense incurred in doing business, not an "investment: by the utility.

Second, the ICNU and CUB information sheet that PacifiCorp and Avista attached as Exhibit B to their opening comments confirms that Section 3(13)(f)(B) was intended to apply to tax credits associated with "investments" in renewable resources not general utility expenses. PacifiCorp/Avista Comments at Exhibit B. In response to the IOUs' unfounded claims that SB 408 would undermine Oregon's "renewable energy industry," ICNU and CUB identified the adjustment to taxes paid in Section 3(13)(f)(B) as maintaining the incentives provided by the tax credits for investment in renewables. Id.

Section 3(13)(f)(B) was intended to provide for a limited adjustment to taxes paid under specific circumstances. The Commission should reject the IOUs' attempt to apply this adjustment to all utility expenditures that are not recognized in rates.

C. The Commission May Not Terminate the Automatic Adjustment Clause Based on a Material Adverse Effect on the Utility

In addressing the question about whether the Commission may terminate the automatic adjustment clause based on a "material adverse effect" on customers, the IOUs have, for the most part, answered a question that has not been asked. PacifiCorp and Avista discuss at length the fact that Section 5(1)(a) of SB 408 "prohibits the Commission from authorizing a rate

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or schedule of rates that is not 'fair, just and reasonable.'" PacifiCorp/Avista Comments at 26. According to PacifiCorp and Avista, the use of "fair, just and reasonable" in SB 408 invokes the constitutional Hope standard that prohibits confiscatory rates. Id. As a result, PacifiCorp and Avista argue, Section 5(1)(a) prohibits establishing rates that are "so low as to materially adversely affect the utility," because a material adverse effect on the utility would result in an unconstitutional taking. Id. at 29.

The Commission should reject the IOUs' strained connection between "fair, just, and reasonable," "material adverse effect," and an unconstitutional taking. The term "material adverse effect" is used in SB 408 to define an instance in which the Commission must terminate an automatic adjustment clause, and it applies to customers only. SB 408 § 3(9). Section 3(10) of SB 408 requires the Commission to conduct a hearing prior to making this determination. Notably, no provision of SB 408 refers to a "material adverse effect" on the utility or requires a hearing to consider such an effect. In construing a statute, a court "assumes that, when the legislature includes a provision in one section of an act, but omits it from another, it does so intentionally." Bayridge Assocs., 321 Or. at 31. The reference to "fair, just, and reasonable" in Section 5(1)(a) is entirely separate from any consideration of "material adverse effect" on customers. There is simply no basis in the law for the attempt of PacifiCorp and Avista to connect "material adverse effect' with "fair, just, and reasonable" or to argue for a termination of an automatic adjustment clause based on a finding of "material adverse effect" on the utility.

SB 408 amended ORS § 757.210 to include the term "fair, just and reasonable" and this language was added in order to tie this statute directly to the new provisions of SB 408 that state that "Utility rates that include amounts for taxes should reflect the taxes that are paid to

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units of government to be considered fair, just and reasonable." SB 408 § 2(f). As a result, "fair, just and reasonable" is a pro-customer change to the law that creates a new standard that related directly to the need to adjust utility rates to accurately reflect the amount of "taxes paid" that are properly attributed to the regulated operations of the utility. The IOUs' suggestion that this language incorporates the Hope standard in ORS § 757.210 and creates the opportunity to terminate the automatic adjustment clause based on a material adverse effect on the utility is incorrect and misstates the purpose of this revision.

D. The Commission Has Discretion to Determine the Implementation of Rate Adjustments

As ICNU explained in its Opening Comments, ICNU believes that SB 408 leaves this matter to the Commission's discretion to determine how to implement the automatic adjustment clause consistent with the requirements of the law.

E. The Amount of Taxes Authorized to Be Collected in Rates Should Be Determined Based on Data From Utility's Last Rate Case

SB 408 requires that the Commission use data from the utility's last general rate in determining the values in Section 3(13)(e)(B) and (C) that provide the basis for calculating the amount of taxes authorized to be collected in rates. SB 408 attempts to establish a uniform basis for determining the amount of the taxes authorized to be collected in rates for each utility. Using the data from the utility's last rate case accomplishes this task and ensures that utilities will provide tax reports with this information calculated on a common basis. In addition, using data from the utility's rate case is consistent with other Sections of the statute. Section 3(4) provides that the Commission shall determine whether the amount of "taxes paid" differed by more than $100,000 from the "amount of taxes assumed in rates or otherwise collected from ratepayers."

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(Emphasis added). The direct reference to the amount of taxes "assumed in rates" demonstrates that this amount must be determined according to rate case data. Without using the information from the utility's last rate case, different utilities may submit tax reports based on different values, creating difficulty for the Commission in auditing the reports and making the determinations required under Section 3 of SB 408.

CONCLUSION

The Commission should reject the IOUs' interpretations of SB 408 that are inconsistent with the intent of the Bill. The legislature passed SB 408 in order to provide protections for ratepayers, and the IOUs' efforts to undercut those protections do not provide full effect to the law.

Dated this 10th day of November, 2005.

Respectfully submitted,

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Treatment of Income Taxes
In
Utility Ratemaking

A White Paper Prepared for
The Oregon Legislative Assembly

By

Public Utility Commission of Oregon Staff

February 2005

Income Taxes and Utility Ratemaking

Prepared By Ed Busch and Judy Johnson[1]

Introduction

Most states, including Oregon, use the traditional "stand-alone" method for calculating the amount of income taxes to be incorporated into a regulated utility company's rates. This method calculates taxes based on the regulated revenues and operating costs of the utility itself, without regard to the utility's unregulated activities or the operations of its parent and other affiliated companies. The "stand-alone" calculation is used so that the taxes in utility rates are based on the costs of providing the regulated utility service.

Federal and state tax laws, however, allow a corporate holding company to file consolidated tax returns reflecting its full span of regulated and unregulated operations. Losses in some corporate operations can offset profits in others for the purpose of determining corporate tax liability. In some instances, consolidated tax reporting has resulted in amounts collected for taxes in a utility's rates exceeding the income taxes the parent actually pays to the taxing authorities. Many people believe this result—which occurred during the past several years in the case of Portland General Electric (PGE) and Enron—is inequitable for utility customers.

This paper describes how the Oregon Public Utility Commission (Commission) determines utility income taxes for setting rates and discusses legal and policy implications of options for the treatment of income taxes in utility rate and tax filings. The paper identifies five alternatives for treating income taxes. The options are:

1. Continuing the current stand-alone method for income tax treatment.
2. To reflect "actual taxes paid," requiring an annual *full* true up of income taxes for the difference between the amount of income taxes in customers' rates and the amount of income taxes actually paid.
3. Requiring an annual *partial* true up of income taxes, preserving the benefits of accelerated tax deductions.
4. Using the parent company's effective tax rate or an allocation of its tax benefits resulting from losses or larger deductions, except for accelerated deductions.
5. Requiring regulated utilities to file deconsolidated state income tax returns.

The first four methods address how the Commission sets rates, while the fifth affects how a utility pays its taxes. Legislation may be needed for Options 2-4 to allow the Commission access to corporate tax filings or to consider non-utility operations. Option 5, modifying how utilities file tax returns, would require a change in state tax law.

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[1] Mr. Busch, Administrator of the Electric & Natural Gas Division, has been with the Commission Staff for 22 years and holds an MBA. Ms. Johnson, Program Manager of Revenue Requirements, has an MBA and 27 years of experience in the utility industry.

Implementation of any change from the current method would need to address whether it would apply to: (a) the six energy utilities the Commission regulates--PGE, PacifiCorp, Idaho Power Company, Avista Utilities, Cascade Natural Gas, and NW Natural; (b) other regulated utilities such as certain telecommunications and water companies; and (c) for a tax filing change, all Oregon corporations. The effect of a change would vary depending on the structure of the utility's corporate entity.

Following is a summary of the pros and cons of each option, followed by a more detailed discussion of these issues.

Ratemaking Options	Pros	Cons	Comments
1. Utility Stand-Alone (Current Method)	Consistent with fundamental principles of basing utility rates on utility costs and revenues, and prohibiting cross-subsidization between utility and non-utility operations. Treats income taxes in same manner as most other utility revenues and expenses: estimated in rate case and not trued up.	Potentially significant differences each year between income taxes in customer rates and what utility or its parent pays in income taxes to federal and state taxing authorities.	Most other regulatory jurisdictions use this approach.
2. Annual Full True Up (True up to (a) utility's payment to parent, or (b) utility's share of parent's payment to taxing authorities)	More closely matches taxes in customer rates with (a) utility's payment to parent, or (b) its share of actual taxes paid by parent.	Violates IRC normalization requirements and would give up accelerated deduction benefits for utility and customers. Treats taxes differently than most other costs. If truing up to what utility pays parent, difference remains between taxes customers pay and what parent pays to taxing authorities.	Deferral necessary for true up may be allowable under ORS 757.259. True up to utility's share of parent's payment would require allocation method. Customers pay more if utility has high earnings; get refund if it has lower earnings.

Ratemaking Options (continued)	Pros	Cons	Comments
3. Annual Partial True Up (Same as Option 2 except for adjustment to retain benefits of accelerated tax deductions)	Better matches taxes collected from customers with a) utility's payment to parent, or b) its share of taxes paid by parent, than stand-alone method. Preserves benefits of accelerated tax deductions for utility and customers.	Not as close a match as Option 2. Treats taxes differently than most other costs. Necessary data may not be available from tax filings to calculate and exclude effects of accelerated tax deductions.	Deferral necessary for true up may be allowable under ORS 757.259. Customers pay more if utility has high earnings; get refund if it has low earnings. True up to utility payment to parent would use data already available.
4. Use Modified Consolidated Tax Rate or Savings	Captures effects of parent's consolidated taxes for utility customers.	Unclear whether tax data available in necessary detail. Tax rate would reflect costs and risks not related to providing utility service. Using results of non-utility operations may be illegal.	Method would have to be designed to avoid violating IRC normalization requirements and giving customers benefits of accelerated deductions on parent's other operations.

Tax filing Option	Pros	Cons	Comments
5. Require separate (deconsolidated) tax filings for regulated utilities	Ensures utility's tax liability (on combined regulated and unregulated operations) is actually paid to state.	Still potential difference between income taxes in customer rates and what utility or its parent pays in income taxes. State impact only; cannot require deconsolidation for federal tax filings. May be unconstitutional: unequal treatment of utilities from other corporations. Potential to shift tax payments from Oregon to other states.	Requires state legislation.

Why Actual Taxes Paid May Not Equal Taxes Collected Through Rates

The Commission traditionally has calculated income taxes to be included in customers' rates based on the utility's stand-alone results in a rate case. The Commission calculates the amount of revenues the utility needs to collect in order to provide adequate service and earn a reasonable return on its investments.[2] That amount of revenues, called the utility's "revenue requirement," is determined during a rate case investigation in which the Commission estimates the utility's costs for a 12-month "test year." Costs include reasonable, ongoing expenses such as employee compensation, fuel costs, depreciation, and taxes. Costs also include a return on rate base, the net book value (not the market value) of the assets or investments used to provide utility service.[3]

In determining a utility's revenue requirement, the Commission establishes rates that provide the company an opportunity—*not a guarantee*—to recover its reasonable costs of providing utility service and earn its authorized rate of return on investments. That is, customers' rates are based on estimates of what costs the utility will incur to provide service when the new rates are in effect. It is virtually certain that actual revenues and costs will turn out to be different than the levels estimated for setting the rates. However, it is assumed that changing expenses and revenues will balance out between rate cases. It may be several years before the utility or another party files to reset rates to reflect new levels of revenues and costs. With few exceptions, rates are not adjusted "after the fact" to true up for the revenues and costs that actually occurred.[4]

There are three reasons why the income taxes actually paid to the federal and Oregon state taxing authorities are different from the amounts included in the utility's revenue requirement and collected in rates.

1. The utility's actual revenues and costs in any year are almost certain to be different from the estimates used to set rates. Many factors will cause actual results of operations to be different than projected, including weather, customer growth, inflation, and fuel prices. If a utility's costs are lower than the Commission projected, its net income will be higher. So will its income taxes. If the utility's costs are more than the

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[2] ORS 756.040 states: "The commission shall balance the interests of the utility investor and the consumer in establishing fair and reasonable rates. Rates are fair and reasonable for the purposes of this subsection if the rates provide adequate revenue both for operating expenses of the public utility or telecommunications utility and for capital costs of the utility, with a return to the equity holder that is: (a) Commensurate with the return on investments in other enterprises having corresponding risks; and (b) Sufficient to ensure confidence in the financial integrity of the utility, allowing the utility to maintain its credit and attract capital."

[3] Net book value is the original amount invested minus accumulated depreciation.

[4] ORS 757.259 authorizes the Commission, in limited circumstances (for example, "to match appropriately the costs borne by and the benefits received by ratepayers"), to allow utilities to defer revenues or costs for later inclusion in rates.

Commission projected, its net income will be lower and so will its taxes. Taxes, therefore, are related to other costs.

2. All regulated energy utilities in Oregon have taxes set for ratemaking on a stand-alone basis, but each files income taxes on a consolidated basis. What the utility's parent files for income taxes reflects not only the regulated utility's taxable net income, but also the net income of the corporation's other businesses, including the utility's own subsidiaries and unregulated activities. On a consolidated basis, losses by other operations may offset taxable income from the utility's regulated operations and reduce the corporation's overall tax liability.

3. The Internal Revenue Code (IRC) and Oregon law allow businesses certain tax incentives, which cannot be passed through immediately to ratepayers. The most notable example is the timing difference associated with accelerated depreciation on plant investment. For tax filings, utilities calculate income tax liability using accelerated depreciation as a deduction. For book (i.e., regulatory and financial reporting) purposes, businesses must use "straight-line" depreciation to determine depreciation expense and to calculate income taxes. The difference in income taxes calculated using the two methods is the utility's "deferred tax," which represents the utility's tax liability in future periods.

IRC regulations require utilities to use normalization accounting for calculating income taxes in setting rates.[5] Regulators are prohibited from immediately flowing through to customers, through rates, the higher tax deduction (the amount greater than provided by spreading the tax benefits of depreciation evenly over the life of the asset) from accelerated depreciation.[6] The result is that, for most depreciable assets, actual taxes paid are lower in the earlier years of an asset's life than is calculated for financial statement and ratemaking purposes. This timing difference turns around in the later years of an asset's life so that book depreciation is greater than accelerated depreciation, and actual tax liability is higher than taxes calculated for ratemaking

[5] Normalization accounting is a method of allocation used for accounting for timing differences of expenses (such as differences between book and tax depreciation) in the calculation of income taxes. Under normalization, the calculation of the utility's recoverable tax expense uses tax deductions only as the underlying expenditures become recoverable for rate purposes, not the accelerated deductions the IRC allows for tax filings.

[6] IRC normalization requirements are contained in Internal Revenue Code Section 168(f)(2). The Internal Revenue Service has issued several rulings concluding that capturing accelerated tax deductions for ratemaking would violate normalization requirements. That is, if a utility did not use a normalization method of accounting, the IRS would not allow accelerated deductions for determining taxable income and tax payments.

purposes.[7] The total tax deduction over the life of the asset is generally the same as for the financial statement and the ratemaking calculation.

While the utility enjoys, courtesy of the tax code, the "interest-free loan" from accelerated depreciation in the early years of the utility's investment, customers benefit because the tax that customers pay earlier than the utility is subtracted from the utility's rate base, thereby reducing the amount included in rates for return on investment. The interest free loan may also reduce the utility's need for capital, which will reduce its projected return on investment and, therefore, its rates.

Attachment A shows a simplified example of current taxes, deferred taxes, and accumulated deferred taxes.

Ratemaking Options

1. Calculate income taxes based on the utility's stand-alone results.

The first option is for the Commission to continue the current method for setting a utility's rates. In order to set rates that reflect the costs of providing utility service, the Commission calculates the utility's revenue requirement using the utility's own revenues, expenses, and rate base for the given test year. Income taxes are calculated using the utility's net operating income and debt costs. The tax effects of the utility's non-regulated operations, as well as the utility's parent and subsidiaries, are ignored for purposes of setting rates, so that rates reflect only the costs of providing utility service.

This approach is consistent with standard ratemaking principles, under which regulated costs should not be affected by the results from non-regulated operations. As explained in Accounting for Public Utilities (*Attachment B*), this policy is:

> [C]onsistent with a fundamental principle of the cost of service approach to ratemaking; the principle that consumers should bear only costs for which they are responsible. Under this principle, there is a well-reasoned, and widely recognized, postulate that taxes follow the events they give rise to. Thus, if ratepayers are held responsible for costs, they are entitled to the tax benefits associated with the costs. If ratepayers do not bear the costs, they are not entitled to the tax benefits associated with the costs.

[7] When a utility's asset (rate) base continues to grow each year, the total accelerated depreciation will continue to exceed book depreciation, but for individual assets, at some point book depreciation will be larger.

> Non-utility operations involve financial risks that are different from a utility's regulated operations. When these risks are not borne by the ratepayers, it is unfair to make use of the business losses generated in those nonregulated entities to reduce the utility's cost in determining the rates to be charged for utility services. By the same token, when a company's nonjurisdictional activities are profitable, the ratepayers have no right to share in those profits, but neither are they required to pay any of the income taxes that arise as a result of those profits. Thus, a "stand alone" method (as opposed to a consolidated effective tax rate method) for computing the income tax expense component of cost of service is the proper and equitable method to be followed for ratemaking purposes.

A simplified example of a ratemaking tax calculation is shown in *Attachment C*. Most state regulatory bodies use this stand-alone method for calculating income taxes. We have identified a few states that, as a general policy or in limited situations, set utility rates by taking into account taxable income of the utility's non-regulated affiliates. (See discussion under Option 4.)

The traditional stand-alone calculation of income taxes for ratemaking produces a result that may be significantly different than actual payments to federal and taxing authorities for the reasons already described: (a) actual revenues and costs are different than projected; (b) the benefits of consolidated tax filings are not reflected; and (c) the tax benefits of accelerated deductions cannot be passed through to customers.

2. Require an Annual Full True Up of Income Taxes Collected from Customers and Actual Tax Liability Related to Utility Operations.

The Commission could require utilities to true up, through a surcharge or refund each year, the difference between the amount of income taxes incorporated in rates and the amount of income taxes actually paid relating to the regulated utility's operations. A true up *may be allowable* under ORS 757.259. No changes to the method of tax filing would be required.

"Actual taxes paid" could be defined as either (a) the amount of taxes the utility calculates on a stand-alone basis and pays to its parent, which then files a consolidated return; or (b) the utility's "share" of the parent's actual tax payments to the income taxing authorities. Whichever definition is used, a full true up would closely match the amount of the utility's tax liability with the amount that is ultimately collected from customers.

Under the first definition, the calculation of "actual" taxes would be based on the annual actual financial results for the regulated utility's operations. Each regulated electric and natural gas utility, for example, files its regulated results of operations with the Commission several months following each calendar (or fiscal) year. These results could be used to "update" and true up from the estimated taxes included in customer rates in the utility's most recent general rate case.[8] Rather than using the traditional ratemaking calculation of taxes, however, a full true up approach would calculate taxes including accelerated tax deductions and other differences the utility uses for tax filings.

Under the second definition, a sensible method would need to be adopted for allocating to the regulated utility a portion of the consolidated tax payment. Making the calculation would require Commission access to the details of the corporation's state and federal tax filings, which the agency currently does not have.[9]

A primary downside of a full true up method is that it would violate IRC normalization requirements, and the utility would lose its ability to use accelerated depreciation. If that occurred, the IRS would likely require the accumulated deferred taxes to be immediately payable. For PGE and PacifiCorp, for example, OPUC staff's initial estimate is that each utility's liability ranges from roughly $150 million to over $200 million. (The utility's shareholders would have to make that payment, since customers have already paid those taxes.) This would raise the utility's costs because the company would no longer have the "interest free loan" available and would need to raise additional capital, possibly at a higher cost. In addition, customer rates also would increase from losing the benefit of accumulated deferred income taxes as a reduction to rate base. The rate impact from the loss of accumulated deferred taxes for Portland General Electric and PacifiCorp's Oregon customers is likely between $20 million and $30 million per year for each utility.

Any true up approach based on actual utility results would have other implications. Income taxes would be treated differently from the utility's other costs. As explained earlier, utility rates are set based on estimated normal levels of revenues and costs. Requiring a true up of income taxes alone would create a mismatch between the amount of income taxes ultimately included in customers' rates and the other costs and revenues on which rates are based.

Moreover, an annual true up of income taxes would have the effect of raising or lowering customer rates in a perverse manner. When the utility is experiencing high earnings because its costs are lower or its revenues higher than expected, customers

[8] Large corporations, such as electric and gas utilities, obtain extensions from the state and federal taxing authorities. As a result, their taxes are not known before October of the year after the tax year. Thus, any true up of taxes would take place at least a year following the year of service.
[9] ORS 314.835 generally prohibits the Department of Revenue from divulging particulars of tax returns and reports. ORS 314.840(2)(j) allows the Department of Revenue to disclose and give access to information to a state agency "to whom disclosure or access is given by state law." State law to date has not given the OPUC those rights.

would end up paying even more. When the utility is experiencing poor earnings and not adequately recovering its costs, customers would get a refund.

Under current ratemaking, the risks of unusual conditions occurring are generally borne by the utility, not customers. True up of income taxes would shift the tax-related benefits and costs of abnormal weather and operating conditions to customers. For example, warm weather can reduce both the demand for and the price of natural gas, thereby lowering an electric utility's fuel costs and increasing its earnings and income taxes. A true up of taxes would cause rates to increase to reflect the higher taxes, even though customers received no benefit from the lower fuel costs since rates are set on a normalized expected basis.

3. Require an Annual Partial True Up of Income Taxes Collected from Customers and Actual Tax Liability Related to Utility Operations.

The Commission could require utilities to implement a partial true up each year. This partial method would true up the difference between the amount of income taxes included in the utility's rates and the amount actually paid, except that the effect of accelerated deductions would be excluded.

If "actual taxes paid" were defined as the utility's stand-alone calculated income taxes paid to its parent, the utility's financial reports submitted each year to the Commission would provide the data needed. The calculation would be done on a ratemaking basis—that is, not using accelerated tax deductions—to avoid violating IRC normalization requirements. Alternatively, "actual taxes paid" could be defined as the utility's share of the parent's payments to taxing authorities. In that case, it is unclear whether the data necessary is available from tax filings; for example, it may not be possible from the filings to determine the difference between accelerated and book tax deductions.

A partial true up approach would have the other effects described above for a full true up: a mismatch of income taxes and the other costs and revenues underlying rates, a shift of risk (with both potential benefits and costs) from the utility to customers, and income tax surcharges or refunds contrary to what would be expected from typical ratemaking treatment.

4. Require Utilities to Reflect Consolidated Income Tax Effects in Rates

The Legislature or the Commission could require that utility income taxes for ratemaking be calculated using the parent company's effective tax rate or an allocation of its projected or actual tax savings (except for accelerated deductions that the IRS has ruled cannot be recognized in customers' rates). Such an approach would more closely align taxes included in a utility's revenue requirement with taxes expected to be paid by the consolidated entity, because it would reflect the interest deductions and net operating income of the parent and non-regulated subsidiaries.

There are different ways to capture the benefits of consolidated income tax filings in customer rates. Any calculation would require allocating the benefits among the corporate businesses on a transparent and rational basis. As mentioned above, the Commission would need access to the details of the corporation's state and federal tax filings.

OPUC staff conducted an informal survey of other states' practices for calculating income taxes for setting rates, requesting information where a method other than stand-alone was used. In addition, we contacted several state commissions individually. Based on this review, it appears that most state regulators use the stand-alone method. While we found no states that use an income tax true up approach, a few states use a modified stand-alone approach in rate cases that recognizes tax savings of the consolidated corporation in certain circumstances.[10] In most cases, the regulator recognized those savings in calculating the utility's tax deduction for debt by considering the interest deduction at the holding company level.

The Pennsylvania PUC, consistent with that state's Supreme Court decisions,[11] applies an "actual taxes paid" standard by including a utility's share of consolidated federal tax benefits in setting rates. The PUC uses a Modified Effective Tax Rate Method that takes the consolidated tax savings generated by losses of non-regulated members of the group, and then spreads those savings to all members having positive taxable income.[12] The savings allocated to the regulated utility are included as an adjustment to the federal income taxes included in customer rates. The adjustment is made in a rate case.

In virtually all cases, using the parent's effective tax rate or consolidated tax benefits would reduce the utility's income taxes for ratemaking and, all else equal, lower customer rates. However, there are several arguments against incorporating these benefits in utility income tax ratemaking calculations:

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[10] Connecticut, Florida, Indiana, Pennsylvania, Tennessee, Virginia, and West Virginia reported that savings from filing of consolidated returns have been recognized for ratemaking purposes. Vermont recently adopted, for S Corporations, an "effective tax rate" policy that purportedly has not yet been applied.
[11] See, e.g., Barasch v. Pennsylvania Public Utility Commission, 548 A.2nd 1310 (1988).
[12] The calculation excludes the effects of investment tax credits and losses of regulated companies, which reportedly avoids violating the Internal Revenue Code.

- Decreasing the utility's revenues would reduce net income and be viewed negatively from a credit perspective, which could result in higher costs of capital for utility customers and put upward pressure on rates.

- Rate stability could be lessened as gains or losses for non-regulated businesses change consolidated tax obligations.

- Unless the underlying revenues and costs of the parent and subsidiaries were also reflected in rates, setting rates based on consolidated tax payments would be considered poor regulatory policy (as discussed in *Attachment B*). Regulators should reflect tax benefits in rates to the same extent that customers bear the expenses creating those benefits. There is no economic rationale for a regulatory body to pick and choose which non-utility revenues and expenses—including tax savings—to include for purposes of setting Oregon customers' rates.[13] The Commission's counsel advises that those making a legal challenge to this approach will likely point to the lack of an economic rationale in attacking it.

- The Commission's counsel has advised that an approach that bases utility rates on the tax results of non-utility operations could be determined to result in confiscatory rates and be unlawful under ORS 756.040. This statute codified what is known as the Hope standard (Federal Power Commission v. Hope Natural Gas Pipeline, 320 US 591 (1944)). Courts have held that it is the end result that must be fair; i.e., the regulator must set rates to provide sufficient revenues to pay the reasonable expenses and capital costs of a utility overall. Adjusting the tax component of utility rates because of losses or tax savings from non-regulated affiliates could result in rates that overall are unreasonable.

Tax Filing Option

5. Require utilities to file Oregon taxes on a deconsolidated basis, so they pay stand-alone taxes directly to the taxing authority.

[13] For example, assume the amount of actual taxes paid was small due to low taxable income for the consolidated entity, and regulators wanted to include those lower taxes in rates. In a ratemaking calculation, under the principle of matching costs and benefits, the low taxable income generating that tax level would be recognized—with the result that rates would be increased to provide the utility an opportunity to earn a reasonable rate of return. Moreover, non-regulated businesses are often riskier than regulated utilities, and those additional risks are borne by their investors, who require a higher return and should receive the corresponding tax savings.

Currently, an affiliated group that elects to file a consolidated federal income tax return, and has members that are unitary, must also file a consolidated Oregon return.[14] State legislation could require deconsolidation for state income taxes, so that the regulated utility files Oregon income taxes separately from the parent company and subsidiaries. This would result in Oregon income taxes collected through rates more closely matching actual taxes paid. There would still be differences caused by the utility's non-regulated operations, as well as the inability to capture accelerated deductions that, as described above, the IRC does not allow to be passed through immediately in rates.

However, a state cannot require deconsolidation for federal income taxes, because the Internal Revenue Code would still allow the group of affiliated companies to file a consolidated federal income tax return.[15]

Also, our understanding from the Department of Revenue is that Oregon tax collections are more likely to be higher under the current requirement of consolidated reporting. This is because corporations often set up affiliates in no tax or low tax states to provide services to the instate corporation. Without consolidated tax filings, the income from those transactions would move to the other states, and the Oregon corporation would claim the expense as a tax deduction. This would result in a loss of taxable income to Oregon. In a consolidated return, these transactions are eliminated and have no effect on taxable income.

Conclusions

The Commission currently calculates income taxes for utility ratemaking based on the regulated utility's revenues and costs. The actual taxes the utility or its parent pays each year will be different than the ratemaking calculation due to the utility's actual results of operations, as well as the benefits of consolidated tax filings and accelerated deductions.

The Commission and the Legislature can consider options for more closely aligning income taxes included in customers' rates with actual taxes paid. Any changes that entailed calculations based on actual tax filing information would require a change in state law to allow disclosure to the Commission. Several legal and policy considerations may limit the ability to make, or the effectiveness of, changes. These factors include:

(a) The Internal Revenue Code allows affiliated companies to elect to file federal income taxes on a consolidated basis.

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[14] "Unitary" refers to members of an affiliated group engaged in a single trade or business.
[15] The consolidated filing requirements are codified at Internal Revenue Code Sections 1501 through 1505.

(b) The Internal Revenue Code requires utilities to use normalization accounting for calculating income taxes for ratemaking; violating that requirement would result in the loss of the benefits to utilities and their customers of accelerated deductions for tax filings.
(c) Standard ratemaking principles prohibit cross-subsidization between utility and non-utility operations. As a result, most states calculate utility income taxes for ratemaking on a stand-alone utility basis.
(d) Including the effect of non-utility operations in utility tax calculations for ratemaking could be determined to result in confiscatory and unlawful rates.
(e) True up of taxes to actual payments would result in a shift of risk to utility customers, and the potential for cost increases as well as cost decreases.
(f) Any change may affect more than just the six electric and gas utilities in Oregon.

ATTACHMENT A

Example of Accelerated Depreciation Effects on Income Taxes for Ratemaking

Assumptions*

Original Cost of Asset: $10,000
Book and tax depreciable basis are equal.
Book and tax lives are both 10 years
Zero net salvage value
Composite (state and federal) tax rate is 39 percent
Asset in service at beginning of year 1

Year	Straight Line Depreciation	Accelerated Depreciation	Current Tax	Effect on Taxable Income	Provision for Deferred Taxes	Book Tax	Accumulated Deferred Tax
	(a)	(b)	(c) = -(b)*.39	(d) = (a)-(b)	(e) = -(d)*.39	(f) = (c)+(e) or, -(a)*.39	(g) = sum(e)
1	1,000	2,000	(780)	(1,000)	390	(390)	390
2	1,000	1,600	(624)	(600)	234	(390)	624
3	1,000	1,280	(499)	(280)	109	(390)	733
4	1,000	1,024	(399)	(24)	9	(390)	743
5	1,000	819	(319)	181	(71)	(390)	672
6	1,000	655	(255)	345	(135)	(390)	537
7	1,000	656	(256)	344	(134)	(390)	403
8	1,000	655	(255)	345	(135)	(390)	269
9	1,000	656	(256)	344	(134)	(390)	135
10	1,000	655	(255)	345	(135)	(390)	-
	10,000	10,000	(3,900)	-0-	-0 -	(3,900)	4,506

* Note: Assumptions and analysis for illustrative purposes.

Income tax deduction for customers' rates (book tax) based on straight-line depreciation.
Income tax deduction for utility's tax filings (current tax) based on accelerated depreciation.
Over the life of the asset, the tax deduction is the same.
During the life of the asset, customers receive the value of the accumulated deferred taxes as a reduction to rate base and required return.

ATTACHMENT B

Excerpts from
Accounting for Public Utilities
Matthew Bender & Company, Inc.
Publication 016, Release 21, October 2004

Section 7.08[3]:

"It is not uncommon for a regulated utility to have subsidiary operations that produce tax losses which, on a consolidated tax return, offset taxable income from utility operations. . .The only approach that is consistent with standard ratemaking principles that prohibit cross-subsidization between utility and non-utility activities is to put the regulated operations on a 'stand-alone' basis and to assign the full tax burden to the taxable gain source and a tax benefit to the tax loss source. The basic theory is that the regulated costs should not be affected by the results from nonregulated operations."

Section 17.04[2]:

"Income tax normalization is consistent with a fundamental principle of the cost of service approach to ratemaking; the principle that consumers should bear only costs for which they are responsible. Under this principle, there is a well-reasoned, and widely recognized, postulate that taxes follow the events they give rise to. Thus, if ratepayers are held responsible for costs, they are entitled to the tax benefits associated with the costs. If ratepayers do not bear the costs, they are not entitled to the tax benefits associated with the costs.

"Regulators have long used a ratemaking procedure that explicitly embraces this principle. The procedure is to identify utility activities (revenues and costs) and compute taxes directly related to the utility activities.

"Non-utility operations involve financial risks that are different from a utility's regulated operations. When these risks are not borne by the ratepayers, it is unfair to make use of the business losses generated in those nonregulated entities to reduce the utility's cost in determining the rates to be charged for utility services. By the same token, when a company's nonjurisdictional activities are profitable, the ratepayers have no right to share in those profits, but neither are they required to pay any of the income taxes that arise as a result of those profits. Thus, a "stand alone" method (as opposed to a consolidated effective tax rate method) for computing the income tax expense component of cost of service is the proper and equitable method to be followed for ratemaking purposes."

ATTACHMENT C

STAND-ALONE METHOD OF CALCULATING INCOME TAXES
Simplified Example

Income taxes included in rates are calculated based on the revenues, expenses and rate base the Commission determines are adequate to provide the utility an opportunity to earn a reasonable rate of return.

Simplified example of a ratemaking tax calculation:

$521,190	Rate Base
8.0%	Reasonable Rate of Return
$ 41,695	Required Net Operating Income ($521,190 multiplied by 8.0%)
$360,897	Operating Revenues
-232,942	Book Expenses other than Depreciation
- 35,583	Book Depreciation
- 23,693	Interest Expense (Rate Base multiplied by weighted cost of debt)
$ 68,679	Regular Taxable Income
4,533	State Income Tax ($68,679 multiplied by 6.6% Oregon SIT rate)
22,451	Federal Income Tax ($68,679 minus 4,533, multiplied by 35% FIT rate)
$ 41,695	Net Operating Income

The calculation above shows “book” taxes used for ratemaking purposes. For “tax” (filing) purposes, IRC and Oregon regulations allow for certain timing and other differences from the book tax computation in calculating taxable income and current tax liability. The taxes related to these timing differences are called “deferred taxes.” Book and ratemaking tax expense includes both current taxes and deferred taxes. The calculation of both federal and state taxes also includes tax credits, as applicable.

DEPARTMENT OF JUSTICE
INTEROFFICE MEMO

DATE: July 30, 2005

TO: Representative Tom Butler

FROM: Peter D. Shepherd, Deputy Attorney General

SUBJECT: SB 408C

You asked that I review testimony recently presented by ICNUs representatives to the House State and Federal Affairs Committee. I have listened very carefully to the archived testimony. Then I had a meeting with Michael Early. I also reviewed the issues discussed in this memo with Sarah Adams-Lien.

In response to a question from Rep. Macpherson, ICNU's representative testified that the -B22 amendments are "symmetrical" and then elaborated on that answer. I believe that ICNU's testimony was principled and reasonable -- though not indisputable.

ICNU would assert, I believe, that the -B22s are "symmetrical" because they apply the "properly attributable to the regulated operations of the public utility" test to stand-alone as well as to consolidated returns. In that view, the -B22 system exhibits the property of "symmetry" because the same test -- proper attribution to regulated operations -- applies to opposite sides of the dividing line between stand-alone and consolidated filings.

But if one were to consider "symmetry" in terms of the rate outcome of the -B22 amendments, then the answer to the question of whether the -B22s are "symmetrical" is more complex. Here is how I understand the -B22s.

1. Rates would rise if:

(a) The regulated utility files as a stand-alone and had an unexpectedly profitable year, or

(b) The regulated utility is included in a consolidated return and the regulated utility had an unexpectedly profitable year.

2. Rates would stay the same if:

(a) The regulated utility files as a stand-alone, the amount allowed as estimated tax was received by the government, and had the expected year in terms of taxable income, or

(b) The regulated utility files as part of a consolidated return, affiliated businesses (unrelated to the regulated business) were profitable, and in the consolidated return the amount of tax allowed as estimated tax in the rate and attributed by the PUC to the regulated activity was received by the government.

3. Rates would go down if:

(a) The regulated utility files as a stand-alone and had an unexpectedly unprofitable year in terms of taxable income, or

(b) The regulated utility files as part of a consolidated return and the regulated utility had an unexpectedly unprofitable year, or

(c) The regulated utility files as part of a consolidated return, the regulated utility had the expected year, but losses incurred by affiliated companies offset the tax liability in the consolidated return so that the amount of tax received by the government is less than the amount allowed as estimated taxes.

Under the -B22s, losses incurred by the non-regulated activities of affiliated companies drive rates down [Scenario 3(c)], but profits by the non-regulated activities of affiliated companies do not drive rates up [Scenario 2(b)]. This is the core difference – accurately described as such by Mr. Early in his testimony -- between the -B22s and the -B20s. It is this feature of the -B22s that could lead one to describe the B22s as lacking the quality of "symmetry."

While it is not my purpose here to defend the -20s, I wouldn't want it to be forgotten that the -20s fully protect ratepayers by forbidding the PUC from allowing rates to rise -- in any scenario -- beyond the point at which they are "fair, just and reasonable." The -22s seek to protect consumers by applying the "attribution" test to stand-alone and consolidated filings. The -20s also expressly protect investors against rate reductions -- in any scenario -- below a confiscatory level. The -22s rely for investor protection on the federal constitutional prohibition against confiscatory rates without purporting to express that prohibition in statutory form. As we have consistently reported, DOJ would defend all proposals that the Legislative Assembly has under consideration – including the – B22s – against facial constitutional attack.

Cc: Representatives Macpherson and Boquist
Chair Krieger

INDUSTRIAL
CUSTOMERS OF
NORTHWEST
UTILITIES

MICHAEL B. EARLY

MEMORANDUM

July 22, 2005

TO: Dexter Johnson

FROM: Michael B. Early

CC: Mark Nelson

RE: SB 408 – Other Jurisdictions

The IOU/AG's suggestion that only "pure" stand-alone tax treatment or "pure" consolidated tax treatment is constitutionally allowable is not supported by the facts. While not identical to our proposal, at least two states jurisdictions have used a different approach without a successful constitutional challenge.

1. Pennsylvania

Pennsylvania courts have held that "ratepayers are entitled to the benefits of reduced tax expenses accruing to the utility by participation in a consolidated tax return . . . ." Barasch v. Pennsylvania Public Utility Commission, 507 Pa. 561, 493 A.2d 653 (1985).

> Our Courts have consistently held it to be improper to include, for rate-making purposes, tax expenses which, because of the filing of a consolidated return, are not actually payable. All tax savings arising out of participation in a consolidated return must be recognized in rate-making, otherwise we would be condoning the inclusion of fictitious expenses in the rates charged to the ratepayers.

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In particular, the Court quoted with emphasis a prior decision:

> The fact that Riverton actually pays to [its parent company] an amount for taxes greater than its proper proportionate share of the consolidated tax liability merely accomplishes in fact that which it is forbidden to do. The making of an improper payment does not eliminate its impropriety. *The only proper tax expense which Riverton may pass on to its customers is its proportionate share after the consolidated return is filed and the actual tax paid.* (Emphasis supplied).

Riverton Consolidated Water Co. v. Pennsylvania Public Utility Commission, 186 Pa.Super. 1, 140 A.2d 114 (1958).

In a more recent case, Barasch v. Pennsylvania Public Utility Commission, 120 Pa. Cmwlth 292, 548 A.2d 1310 (1988), the court found that the earlier Barasch decision required an "effective tax rate" method, *i.e.*, the total tax savings (defined as the difference between the total tax liability determined on a stand-alone basis of all members of the group and the tax actually paid as a consolidated group) is allocated among the members.

2. Texas

The Texas Supreme Court has held that "ratepayers can be held accountable only for those tax expenses that are actually incurred by the utility." Public Utility Commission of Texas v. Houston Lighting & Power Co., 748 S.W.2d 439 (1987) (holding that the tax savings due to disallowed costs must inure to the benefit of ratepayers).

In addition, Texas has a statute that addresses tax savings due to filing on a consolidated basis:

> Tex. Utilities Code §36.060
>
> (a) Unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns, an electric utility's income taxes shall be computed as though a consolidated return had been filed and the utility had realized its fair share of the savings resulting from that return, if:
>
> (1) the utility is a member of an affiliated group eligible to file a consolidated income tax return; and
>
> (2) it is advantageous to the utility to do so.

The adjustment is for "savings". The Texas Commission has interpreted this provision to reduce taxes from the stand-alone amount.

> The consolidated tax savings adjustment . . . . is mandated by PURA Section 41(c). The examiners do not believe that the Legislature would have enacted that section intending that the utility's "fair share" of consolidated tax savings would always be zero.
>
> Second, the consolidated tax savings adjustment is not unfair. It does not deprive shareholders of deductions rightfully theirs, because the relevant expenses--those of the unprofitable affiliate--would not separately have reduced tax expense because the affiliate had no taxable income. Although losses may be carried forward, HII has chosen not to do so. That situation is precisely the one contemplated by PURA Section 41.

The Texas Commission allocates the consolidated savings among those members of the group with positive taxable income.

> The consolidated tax savings adjustment should be based on the relative contribution of each affiliate with positive taxable income to HII's positive taxable income, as of the end of the test year, with known and measurable changes.

Application of Houston Power & Light Co. for Authority and Change Rates, Docket No. 8425, 16 Tex P.U.C. Bull. 2199 (1998).

Conclusion

Attribution of losses (tax savings) from non-regulated businesses to the utility in setting rates has been allowed without successful constitutional challenge.