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May 3, 2006

Via Electronic Filing and U.S. Mail

Oregon Public Utility Commission
Attention: Filing Center
PO Box 2148
Salem OR 97308-2148

Re: In the Matter of the Adoption of Permanent Rules to Implement SB 408,
Relating to Matching Utility Taxes Paid with Taxes Collected
OPUC Docket No. AR 499
Comments on Straw Proposals of PGE

Attention Filing Center:

Enclosed for filing in the above-captioned docket is Portland General Electric's Comments on Straw Proposals. This document is being filed by electronic mail with the Filing Center.

An extra copy of this cover letter is enclosed. Please date stamp the extra copy and return it to me in the envelope provided.

Thank you in advance for your assistance.

Sincerely,

/s/ INARA K. SCOTT
Inara K. Scott

cc: AR 499 Service List

Enclosure

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	COMMENTS OF PORTLAND GENERAL ELECTRIC ON STRAW PROPOSALS

I. INTRODUCTION

At this stage of the proceeding, we offer comments to the Commission on the straw proposals various parties have developed to implement Senate Bill 408 (SB 408). The relevant questions are:

- Does a given straw proposal implement SB 408 in a manner consistent with good regulatory policy?
- Does a given straw proposal satisfy the legal requirements of SB 408 and the other applicable statutory directives?

The straw proposals address how the Commission should determine the amount of taxes "properly attributed" to the utility from the subsidiaries, affiliates, and parent companies included with the utility in a consolidated tax return. Several also address how the Commission should address changes in expenses from the last rate proceeding when implementing an automatic adjustment clause under Section 3(6).

The question of regulatory policy is a critical one. The regulatory framework that the Commission provides, within its delegation of authority of the Legislature, sustains a unique service for Oregon's residents and businesses. That service provides utility customers as much electric power or natural gas as demanded, when demanded, at prices set from time to time by the Commission. Ensuring that this "on demand" service is safe and adequate requires that utilities constantly make expenditures, both operating and capital, in anticipation of what customers will require in the future. A utility cannot wait to "receive the order" before making investments necessary to serve future loads. In many cases, the utility cannot use assets for another purpose or at another time if the regulatory framework does not support the investment. As a result, the regulatory framework and the consequences of regulatory decisions must be sufficiently predictable for the utility to attract capital on an ongoing basis. Given this, one way to determine whether a proposal – in this case methods for implementing SB 408 – is good regulatory policy is by looking at its consequences, both intended and unintended.

No one disputes that the Legislature intended SB 408 to make some changes in Oregon's regulatory framework. As the legislation is implemented, however, we must identify what those changes are and what consequences they will have on Oregon's regulatory structure. As the participants to AR 499 can attest, this can be extremely complex and difficult because the effects of unintended consequences can easily exceed the intended ones. Just a few years ago, California provided utilities and regulators nationwide with a dramatic example of the unintended consequences of a change in utility regulation having a far greater effect than the intended consequences. The lesson from California is that the whole regulatory framework must be coherent and consistent to serve its function of assuring safe and adequate service at reasonable rates.

In addition to considering consequences, the Commission has used other tests to determine whether a given practice within the regulatory framework – proposed or existing – works toward or away from the goal of safe and adequate service. These include whether the practice:

- Aligns benefits with burdens (or costs), both between utility investors and customers and between customers across time;

- Is understandable by and transparent to all those interested, which includes not only the utility and its customers, but also the financial community and other constituents; and

- Can be applied in a non-arbitrary fashion.

PGE has already provided extensive comments addressing the legal context of SB 408 and this rulemaking. PGE's central position is that statutes are a whole, intended to have a whole effect, and that SB 408 does not "trump" the Commission's obligations, but instead rests within those obligations. *See* Opening Comments, Portland General Electric, AR 499 (Oct. 28, 2005) (PGE Opening Comments); Reply Comments, Portland General Electric, AR 499 (Nov. 10, 2005) (PGE Reply Comments); Opening Comments re Interpretation of SB 408 Section 3(13)(e), Portland General Electric, AR 499 (Nov. 10, 2005) (PGE Comments on Section 3(13)(e)); Reply Comments re Interpretation of SB 408 Section 3(13)(e), Portland General Electric, AR 499 (Nov. 18, 2005) (PGE Reply Comments on Section 3(13)(e)). The Commission cannot fulfill those obligations unless its implementation of this new practice comports with good regulatory policy.

II. STRAW PROPOSALS REGARDING PROPERLY ATTRIBUTED

Within the limitations of SB 408,[1] PGE believes that both the "Lesser Of" and "With and Without" attribution methods PacifiCorp presented as straw proposals come as close as is possible to sound regulatory policy. We do not believe that the Citizens' Utility Board (CUB) or Industrial Customers of Northwest Utilities (ICNU) and Northwest Industrial Gas Users (NWIGU) proposals, or the temporary rule, represent good policy.

1 PGE does not waive any future argument that SB 408 is unconstitutional, either on its face or as applied, or that rules developed in accordance with the "Lesser Of" approach or other proposals discussed herein are not fair, just or reasonable.

A. The Bookends

1. Lesser Of

In earlier comments, PGE explained in detail our belief that the "Lesser Of" test meets the intent of the legislature in enacting SB 408. *See* PGE Opening Comments at 7-16. Although the Attorney General's Opinion suggests that the Commission has been delegated the responsibility of determining the meaning of the term "properly attributed," the Commission nonetheless has the responsibility to "determine the legislative policy underlying the statute and construe and apply the term consistently with that policy." Attorney General Opinion Re: Oregon Laws 2005, Chapter 845 at 4 (Dec. 27, 2005) (Attorney General Opinion); *Bergerson v. Salem-Keizer Sch. Dist.*, 194 Or. App. 301, 311 (2004). Nothing in this subsequent phase of AR 499 has changed our opinion. The Lesser Of test is understandable and transparent, requiring Commission review only of two numbers: the consolidated taxpayer's tax return and the Commission's calculation of taxes collected and charged.

2. Temporary Rule

In earlier comments, PGE discussed why SB 408 does not legally require the attribution approach taken by the temporary rule. PGE Opening Comments at 7-16; PGE Reply Comments at 1-7. In addition, we believe this approach is not sound regulatory policy. First, because the temporary rule attributes to the utility tax losses from completely unrelated affiliates, this approach violates the Commission's longstanding policy that "the party which bears the financial burden of particular utility activity should also reap the benefits resulting therefrom." *Re PacifiCorp*, UP 168, Order No. 00-112 at 8 (Feb. 29, 2000) (citations omitted). The Commission should not adopt rules that counteract this principle except to the extent required by explicit legislation. Second, the approach is arbitrary because it excludes tax liabilities of various affiliates from attribution even if they fully absorb tax losses in the consolidated entity. When a consolidated entity calculates its actual tax liability, tax losses and tax liabilities of individuals net out, producing a tax payment that is either more or less than taxes collected or charged. The temporary rule ignores this net result. Last, although understandable and transparent in theory, the sheer effort potentially required to determine which of a utility's affiliates has a tax loss that the Commission will take for the utility's customers is daunting and could produce results that are neither understandable nor transparent.

B. New Proposals

1. With and Without

For all the reasons that PGE supports the "Lesser Of" test, PGE also finds the "With and Without" test an acceptable compromise for the interpretation of properly attributed. The With and Without test is understandable and transparent. It not only attributes tax losses according to the basic "Lesser Of" principle required under Section 3(12), but also attributes tax losses to the utility if the utility's presence in the consolidated group allows the group to offset more tax losses than it would if the utility was not part of the consolidated group. Although PGE does not believe SB 408 mandates the With or Without test, PGE does believe it represents a reasonable compromise position between the temporary rule and the Lesser Of test.

2. ICNU/NWIGU

While PGE appreciates ICNU/NWIGU's attempt to address some of the shortcomings of the temporary rule, its "nexus" straw proposal for properly attributed does not meet the tests of good regulatory policy, and bears no resemblance to the legislature's intent in enacting SB 408. *See* Revised Straw Proposal of ICNU and NWIGU at 1-5, AR 499 (April 24, 2006) (ICNU/NWIGU Straw Proposal). First, it requires an arbitrary and unpredictable determination of the "nexus" between an affiliate and a utility. The nexus proposal provides no coherent test or method for determining whether this "nexus" is present, and no rationale or philosophy in which to ground the nexus determination. Second, this proposal blatantly ignores the benefits-burdens analysis when attributing tax liabilities to the utility. For example, when faced with a $50 tax credit from a wind project "in which the generation costs are supported by a power sale to the utility," the nexus proposal would attribute that tax credit to the utility. ICNU/NWIGU Straw Proposal at 2-4. If the wind project generates a positive tax liability, however, the nexus proposal would apparently not attribute that liability to the utility, although such liability would have been "supported" by the utility for all the same reasons the tax credit had been supported by the utility.

The nexus proposal would also be enormously complex and difficult to administer in the case of a consolidated company that owns hundreds of subsidiaries. The proposal does not describe the process for reaching the nexus determinations or what type of audit or discovery process would be required to gather sufficient facts about a utility's affiliates to make the determination. Finally, the method by which the proposal attributes tax losses only to those companies within the "nexus bubble" results in an unfair proportion of those losses being attributed to the utility, for no discernable policy or philosophical reason.

3. CUB

PGE also appreciates CUB's attempt to create a proposal which includes an earnings test and which recognizes the unfortunate effect SB 408 will have on future utility purchases of Business Energy Tax Credits (BETC). Unfortunately, CUB's proposals only apply within the context of attribution, so they do nothing to address the unintended consequences of SB 408 on a stand-alone utility like PGE. Moreover, to the extent the CUB proposal focuses on double leverage, PGE believes it strays from the purpose of SB 408, which was to align taxes charged and collected with taxes paid. While the benefits or burdens of a leveraged capital structure and its impact on a utility may be debated, these debates are not truly about determining how much a utility "collects" in rates for taxes. PGE suggests that the double leverage question is more appropriately debated in the context of an acquisition docket, where the Commission may address it through ring-fencing and conditions, and not in the context of rulemaking for SB 408.

4. Avista

PGE agrees that it is important for the Commission to adopt rules for properly attributed that ensure that multi-state utilities like Avista do not violate normalization, either at the Oregon utility or any other utility. However, because PGE does not face this issue as a single-state utility, PGE is not commenting on the specifics of Avista's proposal.

III. TAXES CHARGED IN RATES

The amount of PGE revenues in a given year that the Commission deems are "taxes charged" for purposes of implementing an automatic adjustment clause under Section 3(6) is, without a doubt, the most important issue facing PGE. Various methods proposed for calculating this number, which is required for purposes of comparison to "taxes paid," range in their impact on the regulatory framework from those having little effect to those that would produce a significant overhaul. The financial effects, at least for PGE in 2006, could have a similar range: from $0 to tens of millions of dollars.

ICNU/NWIGU's "fixed ratio" proposal, which calculates the portion of the revenues a utility has received that is "taxes" based on <u>fixed ratios</u> of revenue to expense drawn from the projections used by the Commission when setting rates, will have a significant impact on the regulatory framework and utility finances. PGE's straw proposal, on the other hand, which calculates the portion of revenues a utility has received that is "taxes" based on the utility's actual ratios of revenue to expense, would have a minimal regulatory impact. We discuss the legal and regulatory policy support for our proposal to use actual ratios below. Following that is a discussion of the regulatory policy infirmities of the fixed ratio proposal. We conclude with the policy reasons supporting our other two straw proposals, and respond to the comments ICNU/NWIGU have offered on those proposals.

PGE also offers two other straw proposals that work to mitigate the unintended consequences of SB 408. These proposals also are supported by sound regulatory policy and have few unintended effects because they simply correct, in part, specific unintended consequences of SB 408.

A. PGE's Proposal for Using Actual Financial Results

Before addressing the specifics of PGE's straw proposal, it is worthwhile to review some basics about ratemaking, utility service, accounting, and income taxes. Both explicitly and implicitly, income taxes differ from any other cost of service incurred by a utility to provide its customers with electricity or natural gas. In general, PGE agrees with the ICNU/NWIGU statement that the Commission establishes rates that provide the utility with an opportunity to recover its forecasted costs of providing service, including a return on its investment and the income taxes payable upon that return. The utility charges these rates for its services, and the combination of service taken and rate charged produces revenue. The utility does not charge and "collect" rates, as the fixed ratio straw proposal states.

It is the revenue – the end result of the rates – that must be fair and reasonable. As ORS 756.040 states, "Rates are fair and reasonable for the purpose of this subsection if the rates provide adequate <u>revenue</u> both for operating expenses of the public utility . . . and for capital costs of the utility, with a return to the equity holder . . ."(emphasis added). Once a utility provides service and receives revenue, accounting dictates how the utility applies that revenue to its costs: first to operating costs, second to its debt investors, and last to its equity holders. Federal, state and local governments charge income taxes on the amount of revenue earned for equity holders. Thus, income taxes derive from income. Operating and capital recovery (depreciation and amortization) expenses derive from providing service. Explicitly, as a function of the regulatory framework and accounting, operating expenses and income taxes are different.

That operating expenses and income taxes are different in the regulatory framework and accounting is implicitly clear as well from the effect on net income of adjusting <u>revenues</u> (through a charge or credit to utility customers) for the difference between the forecasted and the actual amount of each. Adjusting revenues for the actual operating expenses compared to the forecasted operating expenses will bring the utility's actual "return to the equity holder" closer to the amount found by the Commission to be "commensurate with the return on investments in other enterprises having corresponding risks" and "sufficient to ensure confidence in the financial integrity of the utility." *See* Exhibit A, Example 1. Adjusting revenues for the actual income taxes (but not income)[2] incurred compared to the forecasted income taxes will move the utility's actual "return to the equity holder" farther away from the amount found by the Commission to meet the tests articulated above. *See* Exhibit A, Examples 2 and 3. To the extent that this revenue adjustment increases the return <u>above</u> what the Commission found reasonable when it set rates, it is arguably not "fair and reasonable" for customers; to the extent that it reduces the return below what the Commission found necessary, it is arguably not "fair and reasonable" for investors.

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[2] Proponents of the "fixed ratio" method of determining taxes collected actually create a hypothetical net income by applying the fixed ratios to the actual revenues received.

The example the fixed ratio straw proposal provides demonstrates the faulty logic of using "rates" as the relevant basis for the calculation of taxes charged rather than revenues. This example hypothesizes that one can divide a rate of $10 into so many dollars for operating expenses, so many for income, and so many for taxes, arguing that the utility then "collects" each of these hypothetical amounts because they were "fixed." The example "rate," however, does not specify to what service unit it applies. Is it the energy charge under Schedule 83? Is it the customer charge under Schedule 7? There is a different "rate" for each of these service units, based on rate spread and rate design methodologies. "Taxes" are a different percentage of each, and are not reflected in some rates at all, because taxes follow only allocations of capital costs, not operating expenses. The simple hypothetical in this proposal demonstrates precisely why this hypothetical does not accurately reflect ratemaking — either before or after SB 408.

PGE's straw proposal to use actual financial ratios is sound regulatory policy. It also has support in legal analysis that the AG's Opinion did not address or resolve. First, the actual ratios proposal accurately matches benefits and burdens. The tax effects of operating expenses the utility actually incurs to provide service in a given year should follow the expenses themselves. This properly allocates benefits and burdens, regardless of whether those operating expenses are less or more than forecasted for rate-setting purposes. If, for example, a utility incurs fewer operating expenses than forecasted when the Commission set rates, the utility will bear the additional taxes associated with the related net income increase. Linking the tax effects to the allocation of operating expenses and resulting net income will not change a utility's incentives to control costs: it remains far more desirable to have a dollar of additional net income than to avoid taxes of around 40 cents of that additional income.

Using actual ratios also is understandable and transparent. Utilities already report their operating results, using a well-established Commission methodology, on an annual basis. These reports can easily serve as the source of the "taxes charged" number required for the automatic adjustment clause. The reports draw from the utility's actual accounts, making the audit process simple. In addition, nothing about the actual ratio methodology requires an arbitrary determination.

The intended consequences of this methodology are, essentially, to make few changes to existing ratemaking for stand-alone utilities. Such utilities do not present the "Enron problem" that dominated the Legislative discussion and provided the impetus for SB 408.

From a legal perspective, Senate Bill 408 Section 3(6) prescribes the general purpose and structure for an automatic adjustment clause (AAC) established pursuant to Section 3(4). It states that the AAC "shall account for all taxes paid to units of government by the public utility that are properly attributed to the regulated operations of the utility. . . and all taxes that are authorized to be collected through rates, so that ratepayers are not charged for more tax than. . . the utility pays to units of government and that is properly attributed to the regulated operations of the utility . . . ."

Although this section of the bill uses some language that appears familiar, most of these terms are undefined. For example, Section 3(6) does not use the defined term appearing at Section 3(13)(e) ("taxes authorized to be collected in rates"). *See* Attorney General's Opinion at 27 (noting defined term 3(13)(e) only appears once, in Section 3(1)(b)). The term "account for" has no defined or generally accepted meaning in ratemaking or utility law, and standard dictionary definitions of "account for" do not make sense in this context. The essence of Section 3(6) appears to lie in the directive that ratepayers "shall not be charged for more tax than the utility pays to units of government." We must assume from the fact that the legislature used different terms that the amount of "taxes that are authorized to be collected through rates" is not identical to the amount that ratepayers are "charged" for taxes, and we have no guidance for determining how to compute the amount that ratepayers are "charged for taxes."

The lack of defined terms in Section 3(6) provides the Commission with the opportunity to implement the AAC in a manner that brings the intent of SB 408 in line with basic ratemaking principles and the requirements of ORS 757.210 and ORS 756.040. The terms "account for" and "charged" are delegative in nature. As the Attorney General's opinion described, the courts review an agency's decision concerning a "delegative term" to determine whether the decision is within the range of discretion allowed by the more general policy of the statute. Attorney General Opinion at 4, citing *Springfield Education Ass'n v. School Dist.*, 290 Or 17, 229 (1980). Where a statutory term is delegative, the agency must determine the legislative policy underlying the statute and construe the term consistent with that policy. *Bergerson v. Salem-Kaiser School District*, 194 Or App 301, 311 (2004). Accordingly, the commission must construe these terms in accordance with the general policy underlying SB 408. In carrying out this general policy, the commission must also establish rates that are fair, just, and reasonable. Attorney General's Opinion at page 17.

SB 408 was intended to more closely align the taxes collected by public utilities with the amount of taxes paid to units of government. Section 2(1)(f) specifically notes that utility rates should "reflect the taxes that are paid to units of government." PGE has emphasized throughout the AR 499 proceeding that the only way to accurately calculate the amount of "taxes collected" "or taxes charged" is to use the utility's actual financial results. For this reason, PGE interprets the undefined language of Section 3(6) to permit a very simple comparison between "taxes paid" and "taxes charged," with the latter term being defined as the utility's actual revenues multiplied by its actual net to gross ratio multiplied by its actual effective tax rate. This latter calculation uses the same basic formula set forth in SB 408 Section 3(13)(e), but updates the calculation with actual financial results.

SB 408 Section 2(1)(f) states that "Utility rates that include amounts for taxes should reflect the taxes that are paid to units of government to be considered fair, just and reasonable." If the Commission interprets the language that appears in Section 3(6) as referring to actual utility financial results, the result will be a fair comparison between an amount of "taxes charged" based on actual utility financial results and an amount of "taxes paid" based on actual amounts paid to units of government. Rate adjustments will track these actual financial results and ensure that the utility collects in revenue no more and no less than the amount of taxes it actually pays to units of government. This is precisely the result the legislature intended.

B. ICNU/NWIGU Proposal for Using Fixed Ratios

The fixed ratio straw proposal for determining the taxes charged to or collected from customers does not produce the intended consequences of SB 408 and finds no support in regulatory policy. Moreover, it presents significant unintended consequences for customers and utilities.

As noted above, using the actual ratios methodology fairly compares taxes paid with taxes charged, using consistent and coherent data to ensure that utilities collect no more or less than they actually pay. Using fixed ratios from old test year data to calculate the amount of taxes charged, on the other hand, causes precisely the opposite effect. Test year results would not reflect the utility's actual financial results, resulting in an automatic adjustment clause that forces the utility to under- or over-collect for taxes. This result runs directly counter to the essence of SB 408.

The proposal paper claims that PGE's straw proposal would "undercut" SB 408, based on the assertion that SB 408 was intended to drive utilities to control their costs. This "cost-control" rationale was never an intended consequence of SB 408. As discussed above, this rationale also ignores the large percentage of a utility's costs which the utility does not control because they are based on how, when, where or how much service its customers will demand. For example, the utility does not control the power and natural gas markets from which it purchases; it does not control the labor markets from which it recruits employees. It would be unrealistic to argue that a utility has no discretion over its operating and capital expenditures because it has some, often with respect to timing more than anything else. However, the fixed ratio proposal includes no reasons why the regulatory framework now requires exacerbating the effect of expenditure changes between forecasted and actual amounts by de-linking the tax effects from the changes themselves, to the detriment of customers or the utilities.

The fixed ratio straw proposal violates the benefits-burdens policy in other ways beside the obvious one outlined above. Either temporarily or permanently, the Commission does not include some costs when setting rates, including capital recovery on investments between rate cases and disallowed capital or operating expenditures. The fixed ratio methodology excludes all of these expenditures from the calculation of "taxes authorized to be collected," but captures the tax consequences of any of them through the comprehensive calculation of "taxes paid." Customers benefit from a disallowed expense, or benefit from a utility investment even before the utility begins to recover its capital, while utilities bear the financial penalty for making these investments or having non-utility tax losses. Thus, how the methodology treats operating or capital costs that are temporarily or permanently not part of the rate-setting process is a one-sided penalty for utilities.

The fixed ratio methodology is relatively transparent; the calculations would not be difficult. For the reasons discussed above, however, it poses significant challenges to understandability. Would customers understand why they pay a surcharge after a utility reports exceptional earnings for a given year? Will the financial community understand why a utility's poor earnings became dismal because of the operation of SB 408's automatic adjustment clause?

PGE suggests that the fixed ratio straw proposal presents numerous unintended consequences. Some of these are adverse to utility customers; others to the public interest generally. The fixed ratio methodology will increase utility earnings volatility; investors require a higher return from firms with higher earnings volatility, even if the mean is stable. Because the likely results of applying the fixed ratios to a business that has high and unavoidable service obligations is largely negative, however, the negative volatility will increase the cost of capital even more. PGE suggests that customers will not receive any benefit from this increased cost of capital; the "incentive" to control costs it allegedly provides already exists without this penalty.

The fixed ratio method may also discourage utilities from making investments for utility service because the consequences of an imprudence finding will now be not only loss of the investment but an additional 40% (or more, if grossed-up) under the automatic adjustment clause. Utilities are also unlikely to participate in worthwhile programs that provide tax credits for qualifying investments, such as Oregon's BETCs or the credits available for investments in affordable housing, if those credits will result in a loss to the utility through the operation of the automatic adjustment clause.

The manner in which the fixed ratio methodology changes Oregon's current regulatory framework creates numerous unintended effects. Further, because it changes the framework in a way contrary to good regulatory policy, the unintended consequences are largely negative. The Commission can avoid these unintended consequences by rejecting this straw proposal.

C. PGE's Earnings Test[3]

PGE proposed a simple earnings test to accompany other proposals for implementing SB 408. This proposal would help minimize the unintended consequences of the bill. It would establish predictability in SB 408 adjustments and would minimize rate volatility in a manner that benefits customers both directly (through less volatile rates) and indirectly (through better credit ratings). The proposal is transparent and would be easy to administer; it requires no arbitrary decision-making and uses well-established regulatory principles. It enables the Commission to interpret SB 408 as a consistent part of the whole of the regulatory framework, and as such, represents good regulatory policy.

When the Commission sets the utility's authorized return on equity (ROE), it sets that return at a level it finds just and reasonable. Although the utility's actual earnings may vary from this level, the authorized ROE represents a level of return that the Commission deems is fair, and the general rate case sets rates with the intention of providing the utility with the opportunity to earn that rate of return. As noted above, when the Commission adjusts revenues for actual operating expenses, it does so to move the utility closer (upward or downward) to that ROE, or at least give the utility an opportunity to earn that ROE, given the specific operating expenses it has incurred. *See* Exhibit A, Example 1. In the context of income taxes, however, adjusting revenues for actual taxes paid moves the utility further away from its ROE; an under-

[3] Northwest Natural Gas's Earnings Test proposal works in a similar manner to PGE's. We do not, therefore, specifically comment on that proposal.

earning utility will earn less and an overearning utility will earn more. *See* Exhibit A, Examples 2 and 3. Thus the very principle of an adjustment under SB 408, using the fixed ratio, is to move the utility away from the level of return the Commission has judged fair, just and reasonable. No other automatic adjustment clause or rate adjustment is intended to operate in such a manner.

Due to this unusual posture, an earnings test is necessary to ensure that adjustments under SB 408 do not prevent the utility from earning a fair and reasonable rate of return. The test proposed by PGE would prevent an SB 408 adjustment from moving the utility away from the rate of return the Commission has already judged fair and reasonable. It is a prescriptive test that ensures before a rate goes into effect that the proposed rate is not unfair or unreasonable. As such, this proposal represents good regulatory policy. The Commission's duty under the amended ORS 757.210 is a prospective one – the Commission may not authorize a rate that is not fair, just and reasonable. That means that the Commission cannot set a rate adjustment into effect via the AAC without considering the impact on the utility.

The earnings test would not "undo" the central purpose of SB 408, which is the consideration of consolidated tax payments by utilities to units of government. In both PGE and Northwest Natural's earnings test proposals, the utility's earnings are calculated by reference to "taxes paid and properly attributed," not to the utility's stand-alone tax expense. Nothing in SB 408 prohibits the Commission from using an earnings test to minimize SB 408's unintended consequences and discharge its duty under ORS 756.040 and ORS 757.210.

Notably, the Commission has only 180 days after receiving all of the utilities' tax reports to order the utilities to establish an AAC. Section 3(4). This short time period does not mean that the Commission can disclaim responsibility and fail to give the utilities appropriate due process rights. Rather, the Commission should carefully consider how it might streamline this process by providing an alternative means of testing the fairness and reasonableness of the AAC through a method other than a contested case procedure. This time period also gives us an indication of the level of complexity the Legislature believed a review of the AAC would require. An earnings test would be relatively fast and easy to administer, would comport with basic ratemaking standards of fairness and reasonableness, and could be accomplished in this short time period.[4]

The ICNU/NWIGU straw proposal claims that an earnings test is not necessary under SB 408. ICNU/NWIGU argues that adjustments under the statute are inherently "fair" because "[t]he utility has the opportunity to earn its authorized return. It failed to control its costs and consequently its before tax earnings fell short . . . ." ICNU/NWIGU Straw Proposal at 7. As noted above, this argument ignores the numerous adjustments that would otherwise result under SB 408 from expenses that are 1) outside the control of the utility, and 2) have never been included in rates and therefore are not included in "taxes authorized to be collected in rates." It also fails to account for the effect of an SB 408 adjustment based on fixed ratios, which moves the utility further from its ROE, and as a result, further from the rate of return the Commission judged fair and reasonable. Perhaps most importantly, however, it neglects the crucial point that the Commission must comply not only with SB 408, but also with its other statutory directives in structuring the automatic adjustment clause. The fact that SB 408 does not mandate an earnings test should not prevent the Commission from adopting an earnings test that is consistent with

[4] This is not meant to suggest that a contested case procedure would not be available. The earnings test would be a means for the Commission to discharge its duty to consider the impact of the rate on the utility prior to imposing a rate change through the AAC.

SB 408, accommodates the Commission's other regulatory directives, and reflects good regulatory policy.

D. PGE's Deferral Proposal

The deferral is a statutory tool that the Commission can use to ensure that the operation of SB 408 does not violate the Commission's overall statutory duty. Like PGE's other proposals, this proposal represents good regulatory policy, and offers the Commission a means of integrating SB 408 into existing statutory requirements in a consistent manner. Deferrals are familiar regulatory tools that are considered in a transparent and non-arbitrary process, under familiar precedents and clear rules. Use of a deferral allows the Commission to match benefits and burdens in situations where SB 408 throws that matching principle into misalignment. SB 408 in no way prevents the Commission from using this tool to balance the effect of SB 408 to achieve a just result.

As PGE described in its straw proposal, the tax effect of disallowed expenses, investments that have not been included in rates, or other expenses not included in rates, could result in rate adjustments under SB 408. These adjustments would not be fair, just or reasonable, because the utility has never included the expenses related to these items in rates. For example, consider a utility investment in an asset, such as a turbine, that was never included in rates. If the utility later was forced to sell the asset at a loss, a tax deduction would result, which would lower the utility's "taxes paid" amount. This tax deduction would flow directly to customers, because the utility would be forced to refund that amount to customers through the AAC.[6]

ICNU/NWIGU's response to PGE's straw proposal is puzzling. First, the response argues that in its rate-setting process, the Commission establishes rates that:

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[6] The amount of tax benefit refunded to customers may depend on how the tax effect is 'properly attributed' to the utility.

> [P]rovide the utility with an opportunity to recover its forecasted costs, including its income tax expense, and a return on its investment. For example, a rate of $10 could include $8 for forecasted costs (excluding taxes) with a before taxes profit of $2 divided into $1 for taxes and $1 for after-tax profit.

ICNU/NWIGU Straw Proposal at 6. The ICNU/NWIGU proposal goes on to suggest that SB 408 simply returns the difference between the forecasted cost for taxes ($1) and the utility's actual tax payment. *Id.*

However, when viewed in the light of the tax impact of a cost that had never been included in rates, this descriptive scenario highlights the perverse result of SB 408. Even taking the above as true, if an investment or disallowed expense was never included in the utility's forecasted expenses, neither was any tax liability associated with that investment. As a result, even if the utility experiences actual financial results that <u>precisely mirror</u> those forecast in its rate case ($8), and "collects" taxes in rates in an amount <u>identical</u> to that forecast in the rate case ($1), the utility will be required to refund money to customers an amount equal to the tax effect of the new or disallowed investment. Quite simply, the utility customers receive a significant financial benefit from the sale of a non-utility asset that has never been included in rates.

The ICNU/NWIGU proposal states,

> [T]he suggestion that the tax effect of disallowed expenses should be deferred should be rejected. SB 408 is clear that ratepayers do not pay these costs – either directly in rates or indirectly by allowing the utility to retain monies collected as a tax expense which is not incurred due to these disallowed costs."

ICNU/NWIGU Straw Proposal at 7. Yet even under the ICNU/NWIGU hypothetical the utility <u>never</u> collected tax dollars related to the disallowed costs. This statement that customers would somehow "indirectly" pay for the disallowed expense makes no sense.

IV. CONCLUSION

PGE has offered several straw proposals that would serve to integrate SB 408 into the existing regulatory framework in a manner that preserves the Commission's responsibility to set only just and reasonable rates. PGE's proposals are well within the Commission's statutory authority, both under the specific language of SB 408 and the broader context of ORS Chapters 756 and 757. These proposals represent good regulatory policy. They are simple and could be administered in a non-arbitrary and transparent manner. They retain the Commission's familiar principle of matching benefits and burdens, and they comport with the basic principles of ratemaking outlined in ORS 756.040 and 757.210.

PGE supports the proposals for the Lesser Of and With and Without tests for properly attributing tax losses of affiliated entities. Within the context of SB 408, PGE believes these proposals come the closest to effectuating the intent of the Legislature in enacting SB 408, and represent the best regulatory policy possible under the circumstances.

DATED this 3rd day of May, 2006.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this day caused the foregoing COMMENTS OF PORTLAND GENERAL ELECTRIC COMPANY ON STRAW PROPOSALS to be served by First Class US Mail, postage prepaid and properly addressed, and by electronic mail, upon each party on the attached service list.

Dated at Portland, Oregon, this 3rd day of May, 2006.

/s/ INARA K. SCOTT________________________
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AR 499
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EXAMPLE 1

RATE CASE ASSUMPTIONS

	Rate Case	*Utility has PCA, Poor Hydro* Poor Hydro Actuals	PCA w/ 80% Sharing	Actuals w/PCA	*Utility has PCA, Good Hydro* Poor Hydro Actuals	PCA w/ 80% Sharing	Actuals w/PCA
Revenues	291,667	291,667	16,000	307,667	291,667	(16,000)	275,667
Net Variable Power Costs	100,000	120,000		120,000	80,000		80,000
Other Costs Except Income Taxes	50,000	50,000		50,000	50,000		50,000
Income Taxes (@40% of Pre-Tax Income)	56,667	48,667	6,400	55,067	64,667	(6,400)	58,267
Total Expenses	206,667	218,667	6,400	225,067	194,667	(6,400)	188,267
Operating Income	85,000	73,000	9,600	82,600	97,000	(9,600)	87,400
Rate Base	1,000,000	1,000,000		1,000,000	1,000,000		1,000,000
Rate of Return	8.50%	7.30%		8.26%	9.70%		8.74%
Return on Equity	10.00%	7.60%	→	9.52%	12.40%	→	10.48%
		PCA moves ROE closer to Authorized			PCA moves ROE closer to Authorized		
Weighted Cost of Equity (50% Share, 10% Cost)	5.00%						
Weighted Cost of Debt (50% Share, 7% Cost)	3.50%						
Cost of Capital	8.50%						

EXAMPLE 2

	Utility has PCA, Bad Hydro, SB 408						*Utility has PCA, Good Hydro, SB 408*				
	Poor Hydro Actuals	PCA w/ 80% Sharing	Actuals w/PCA	SB 408	Actuals w/SB 408		Poor Hydro Actuals	PCA w/ 80% Sharing	Actuals w/PCA	SB 408	Actuals w/SB 408
Revenues	291,667	16,000	307,667	(1,600)	306,067		291,667	(16,000)	275,667	1,600	277,267
Net Variable Power Costs	120,000		120,000		120,000		80,000		80,000		80,000
Other Costs Except Income Taxes	50,000		50,000		50,000		50,000		50,000		50,000
Income Taxes (@40% of Pre-Tax Income)	48,667	6,400	55,067	(640)	54,427		64,667	(6,400)	58,267	640	58,907
Total Expenses	218,667	6,400	225,067	(640)	224,427		194,667	(6,400)	188,267	640	188,907
Operating Income	73,000	9,600	82,600	(960)	81,640		97,000	(9,600)	87,400	960	88,360
Rate Base	1,000,000		1,000,000		1,000,000		1,000,000		1,000,000		1,000,000
Rate of Return	7.30%		8.26%		8.16%		9.70%		8.74%		8.84%
Return on Equity	7.60%		9.52%		9.33%		12.40%		10.48%		10.67%

PCA moves ROE closer to Authorized, SB 408 moves it away

PCA Adjustment = 80% * (120,000 - 100,000)
SB 408 Adjustment = 55,067 - 56,667

PCA moves ROE closer to Authorized, SB 408 moves it away

PCA Adjustment = 80% * (80,000 - 100,000)
SB 408 Adjustment = 58,267 - 56,667

EXAMPLE 3

*Utility has **no** PCA, Bad Hydro, SB 408*

	Poor Hydro Actuals	PCA w/ 80% Sharing	Actuals w/PCA	SB 408	Actuals w/SB 408
Revenues	291,667	-	291,667	(8,000)	283,667
Net Variable Power Costs	120,000		120,000		120,000
Other Costs Except Income Taxes	50,000		50,000		50,000
Income Taxes (@40% of Pre-Tax Income)	48,667	-	48,667	(3,200)	45,467
Total Expenses	218,667	-	218,667	(3,200)	215,467
Operating Income	73,000	-	73,000	(4,800)	68,200
Rate Base	1,000,000		1,000,000		1,000,000
Rate of Return	7.30%		7.30%		6.82%
Return on Equity	7.60%		7.60%		6.64%

SB 408 moves ROE away from Authorized

PCA Adjustment = 0
SB 408 Adjustment = 48,667 - 56,667

*Utility has **no** PCA, Good Hydro, SB 408*

	Poor Hydro Actuals	PCA w/ 80% Sharing	Actuals w/PCA	SB 408	Actuals w/SB 408
Revenues	291,667	-	291,667	8,000	299,667
Net Variable Power Costs	80,000		80,000		80,000
Other Costs Except Income Taxes	50,000		50,000		50,000
Income Taxes (@40% of Pre-Tax Income)	64,667	-	64,667	3,200	67,867
Total Expenses	194,667	-	194,667	3,200	197,867
Operating Income	97,000	-	97,000	4,800	101,800
Rate Base	1,000,000		1,000,000		1,000,000
Rate of Return	9.70%		9.70%		10.18%
Return on Equity	12.40%		12.40%		13.36%

SB 408 moves ROE away from Authorized

PCA Adjustment = 0
SB 408 Adjustment = 64,667 - 56,667