BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

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In the Matter of	)
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the Adoption of Permanent Rules to	)
Implement SB 408, Relating to Matching	)
Utility Taxes Paid with Taxes Collected.	)
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OPENING COMMENTS

OF THE

CITIZENS' UTILITY BOARD OF OREGON

July 31, 2006

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I. Introduction

First, we doff our collective hat to the Commission for its creative and insightful solution for the definition of "properly attributed." In these comments we offer recommendations regarding the use of Oregon regulated operations as a whole, as opposed to Oregon situs regulated operations, in determining the ratios of property, payroll, and sales; the use of a utility's unitary group when attributing state taxes; and the importance of closely monitoring the actions taken to avoid IRS normalization violations.

II. The Interim Order's Approach To Attribution

SB 408 passed because of the disconnect between the way taxes were set for ratemaking purposes and the way consolidated conglomerates actually pay taxes. In the past, when setting rates, the test year forecast assumed utilities were stand-alone entities that paid taxes on the net revenues generated from sales to utility customers. In reality, many of our utilities are now part of large conglomerates that pay taxes on a consolidated basis which includes the income, losses, and tax deductions from every company in the conglomerate. It was this disconnect that allowed PGE ratepayers to pay millions of dollars in taxes that were never paid to federal, state, or local taxing authorities.

A. Utilities Complain That The Temporary Rules Are Too Complex

The legislature passed SB 408 to fix this disconnect. SB 408 directs regulators to look at the actual tax payment made by a consolidated company, and attribute a portion of that actual tax payment to the regulated utility, and thereby its customers. Much has been written and discussed since the legislation passed concerning the proper way to attribute a portion of the consolidated tax liability to the utility.

Consumer groups argued for, and the Temporary Rules enacted, a methodology that attributed a portion of the overall tax burden to each affiliate of the consolidated company based on each affiliate's positive net income. Such a methodology would involve identifying all affiliates with a positive tax liability, and proportionally allocating the actual tax payment to each affiliate based on its contribution to the consolidated tax liability. This is a fair methodology that treats utilities and non-utility affiliates the same way.

The utilities were unhappy with this approach – and any approach other than stand-alone attribution – and argued that such a method of attribution would be far too complex, and that examining all of the affiliates of a conglomerate would place too large an auditing burden on Commission Staff. As potential compromises CUB and ICNU submitted proposals that would reduce the number of utility affiliates that would need to be examined for inclusion in the allocation of taxes. These proposals, however, still would have involved analyzing taxes and tax deductions associated with many of a utility's affiliates.

B. Utilities Complain The Draft Rules Are Too Imprecise

The Commission rejected the proposals that were made, and came up with the apportionment methodology which attributes a consolidated company's actual tax liability using a three-factor methodology. This is a creative and insightful approach. It is true to the intent of SB 408, straightforward, and avoids the need to examine all of a utility's affiliates. Instead, the three-factor apportionment method only involves examining the regulated utility and the consolidated company. The utility's proportional size within its consolidated company is determined by averaging the ratios, utility to conglomerate, of property, payroll, and sales.

At the July 21st workshop, PacifiCorp argued that the three-factor methodology was not workable in that it was not precise enough. The Company pointed out that the three-factor methodology would essentially attribute taxes to an affiliate with a negative stand-alone liability. Well, the Temporary Rules had a precise method, but utilities found it too complex. The Draft Rules have a simpler method, but utilities find it too imprecise. Enough. The Commission has determined a reasonable compromise for attribution that is simpler than the methodology presented in the Temporary Rules, but fair to the utility and its affiliates.

The three-factor methodology is the same approach used to allocate other consolidated costs. Utility holding companies have used a similar three-factor methodology to determine the share of its CEO salary attributable to a utility. It is a reasonable and fair approach to determining the utility's size within a consolidated company, and so was used to allocate corporate overhead. We have never understood why consolidated taxes have been treated differently than shareholder services or other consolidated costs that are allocated to a utility. That being said, for the purpose of attributing tax payments, it would be more accurate and reasonable to determine the ratios of property, payroll, and sales for the three-factor methodology based on the regulated operations of the utility as a whole, rather than on the utility operations that are geographically within Oregon, as suggested by the Draft Rules.

III. Calculation of Property, Payroll & Sales Ratios

Staff's Draft Rules take language from Appendix A of the Commission's Interim Order, and attribute taxes paid to the regulated utility as follows:

> The average of the ratios calculated for the utility's property, payroll and sales, as defined in ORS 314.650 through 314.675, using amounts for regulated operations of the utility in Oregon in the numerator and amounts for the taxpayer in the denominator.

AR 499 Staff Draft Rules, July 25, 2006, (3)(a)(B), (3)(b)(B), and (3)(c)(B), page 3.

A. State Lines Are Not Important In Serving Regulated Utility Customers

The fundamental problem with a strict use of ORS 314.650-675 is that these statutes apportion business income, for the purpose of income taxes, to each state of a multi-state business, while SB 408 was intended to attribute taxes paid to regulated utility operations which are not categorized by state lines. For purposes of apportioning business income between states, state lines are critical. For purposes of apportioning taxes paid to a utility's regulated operations, state lines are irrelevant; it is the utility's operations themselves, regardless of physical location, that are pertinent. Following are excerpts from ORS 314 describing the property, payroll, and sales factors used for apportioning business income:

> (1) As used in ORS 314.650, the property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented *and used in this state*…
>
> (1) As used in ORS 314.650, the payroll factor is a fraction, the numerator of which is the total amount *paid in this state*…
>
> (1) As used in ORS 314.650, the sales factor is a fraction, the numerator of which is the total sales of the taxpayer *in this state*…

ORS 314.655, 314.660, and 314.665 respectively. Emphasis added.

Using the definitions in ORS 314 to attribute tax payments limits the property, payroll, and sales serving Oregon customers to the property, payroll, and sales serving Oregon customers within the state of Oregon. This does not make sense for attributing a consolidated cost to Oregon regulated operations. The problem stems from the fact that a utility often has property and payroll in other states that serve Oregon customers. Under the Draft's definition of properly attributed, a plant in Idaho that serves Oregon customers would not be considered in determining taxes attributable to Oregon regulated operations.

Besides being illogical, this attribution would provide a utility with an incentive to site utility plant and employees in Oregon, even if it would be in customers' interest to site them elsewhere. There is no reason a plant on the eastern edge of Oregon should be treated differently for tax attribution purposes than a plant on the western edge of Idaho. PGE provides a good example. The Company's retail customers are only in Oregon, but PGE has assets outside of Oregon. Under the attribution in Staff's Draft, because PGE owns a share of Colstrip in Montana, the Company's retail customers would be not be attributed a portion of the Company's tax liability, because a portion of the Company's regulated operations are outside of Oregon. This means that PGE would never have the opportunity to recover 100% of the taxes associated with its regulated operations.

This creates a poor incentive for PGE. As PGE develops its infrastructure, it should do so in the least-cost, least-risk manner. If the Company were to consider two wind sites, one in Oregon and one in Washington, we would expect the Company to evaluate the wind resource, transmission, and other factors to develop the site that would be best for its customers. How taxes are attributed to the Company should not factor into this decision. Under the attribution methodology in Staff's Draft, however, if PGE developed a site outside of Oregon, the Company's Oregon retail customers – which is to say, <u>all</u> of its retail customers – would be attributed a smaller share of the Company's taxes.

B. A Better Use Of The Three-Factor Apportionment Method

Our reading of the Commission's Interim Order was a three-factor apportionment using property, sales, and employees related to serving Oregon customers. Despite the use of ORS 314.650-675 in Appendix A of the Commission's Order, the Order itself suggests a use of the principles of the three-factor apportionment method, adapted to apply to a utility's regulated operations.

> The *principles underlying* the Apportionment method may also be used to determine taxes paid "that are properly attributed to the regulated operations of the utility."

AR 499 Order No. 06-400, page 6. Emphasis added.

> To determine that amount, we may apply the Apportionment method to isolate the amount of taxes *related to a utility's regulated operations* from other entities and activities in an affiliated group…
> In adopting the Apportionment method, we implement SB 408 using a method *based on* tax principles…

AR 499 Order No. 06-400, page 7. Emphasis added.

A calculation based on property, payroll, and sales serving regulated customers, regardless of geographical location, makes more sense than only the subset of that property, payroll, and sales occurring within the State's geographical boundaries. This is how the three-factor method is used to allocate shareholder services and other costs of a consolidated company to the regulated operations of a utility, and it should be a reasonable and fair way to identify a utility's share of its consolidated company's tax burden.

The Draft Rules should be adjusted so that a utility's property, payroll, and sales ratios are based on the regulated operations of the utility, and not upon state geography. We offer the following suggested wording:

> The average of the ratios calculated for the utility's property, payroll and sales, using amounts for the regulated operations used to serve Oregon retail customers in the numerator and amounts for the taxpayer in the denominator.

IV. Using A Utility's Unitary Group When Attributing State Taxes

> "Affiliated group" means an affiliated group of corporations of which the public utility is a member and that files a consolidated federal income tax return.

SB 408 Section 3(13)(a).

> "Affiliated group" means the group of corporations of which the utility is a member and that files a consolidated federal income tax return.

AR 499 Staff Draft Rules, July 25, 2006.

The definition of "affiliated group" from SB 408, paraphrased by Staff for its draft rules, seems clear in regard to federal taxes. In regard to state taxes, however, the taxpayer is not the entire consolidated company, but the unitary group which contains the utility. A consolidated federal tax filer might file multiple Oregon filings for different unitary groups within the conglomerate. Berkshire Hathaway, for example, probably has several different unitary taxpayer groups in Oregon (PacifiCorp, Dairy Queen, Geico Insurance, etc.).

At the July workshop participants discussed whether to isolate the unitary group containing the utility, or group all unitary groups belonging to a utility's federal affiliated group. As a practical matter, both approaches are consistent with the principles of the law, both start with actual tax payments to a government entity, and both allocate the utility its fair proportion of the tax payments. Both options involve actual taxpayers, and there is no immediate reason to believe that one method would lead to a higher or lower attribution than the other. That being said, the Commission's interim order clearly favors including all unitary groups that are a part of the utility's corporate family.

> To comply with the language of SB 408, particularly the definitions set forth in the law, the various unitary groups that include entities in the consolidated federal return must be aggregated to determine the amount of taxes paid by the affiliated group in Oregon.

AR 499 Order No. 06-400, page 6. Footnotes omitted.

This approach is consistent with the principles of SB 408. However, we also think it would be consistent with SB 408 to examine only the unitary group containing the utility. The theory behind this approach is that the utility's unitary group is an actual taxpayer with an actual tax payment to attribute. Unlike a federal consolidated filing, where every single company affects the consolidated tax liability, companies in other unitary groups do not affect the tax liability of the utility's unitary group. The first step in attributing state tax payments from the utility's affiliated group could be an attribution of each Oregon unitary group's payment to that unitary group. This is probably a simpler approach, as it involves examination of only one state tax filing, and, as stated earlier, it is consistent with SB 408 in that it attributes an actual tax payment to a government entity.

V. IRS Normalization

It is clear that, in SB 408, the legislature intended to avoid violations of IRS normalization requirements, and the legislature gave the Commission discretion with which to do so.

> (8) Notwithstanding subsections (1) to (7) of this section, the commission may authorize a public utility to include in rates:
> (a) Deferred taxes resulting from accelerated depreciation or other tax treatment of utility investment; and
> (b) Tax requirements and benefits that are required to be included in order to ensure compliance with the normalization requirements of federal tax law.

SB 408 Section 3(8).

The long-term workability of SB 408 and the Commission's rules implementing it depend, in part, on satisfying IRS normalization requirements without harming the overall intent of the Bill, which is to match taxes collected with taxes paid. We have become a little concerned over the process which will be used to determine whether the rules implementing SB 408 violate IRS tax normalization requirements, and how the rules might be tweaked to avoid any such violations. The Draft Rules read:

> By October 15, 2006, each utility must seek a Private Letter Ruling from the Internal Revenue Service on whether the utility's compliance with Senate Bill 408, this rule, or any other relevant guidance or authorities would cause the utility to fail to comply with federal normalization requirements or other requirements of federal tax law.

AR 499, Staff Draft Rules, 7-25-06 (9)(g).

This wording is very open, and in so being, invites utilities to describe compliance with SB 408 in such a way as to implicate a normalization violation. Needless to say, how something is described has an enormous impact on how it is received, and we suggest the following addition to the above-cited draft rule to ensure the private letter ruling request is based on a fair and balanced description of the rules implementing

SB 408:

> Each utility will submit a draft of its request for a Private Letter Ruling for review by the Commission, Staff, and interested parties.

VI. Conclusion

In the rules implementing SB 408, we recommend that the Commission:

- Use Oregon regulated operations, as opposed to Oregon situs regulated operations, when calculating the ratios of property, payroll, and sales.
- Consider the first step in attributing state taxes to be an attribution of the utility's unitary group tax liability to that unitary group.
- Require utilities to submit for review a draft of the letters requesting a private letter ruling from the IRS to the Commission, Staff, and interested parties.

Respectfully Submitted,
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