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**SENT VIA OVERNIGHT MAIL**

December 31, 2007

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

**Re: Avista Corporation's Response to Staff's Initial Findings  
UG 171 2006 Tax Report**

Enclosed are two copies of Avista Corporation's Response to Staff's Initial Findings in the above referenced docket. Copies have also been mailed to the parties on the enclosed service list.

If you have any questions, please contact Ron McKenzie at (509) 495-4320.

Sincerely,

A handwritten signature in cursive script that reads "Kelly Norwood".

Kelly Norwood  
Vice President, State and Federal Regulation  
RM  
Enclosures

**CERTIFICATE OF SERVICE**

I certify that on December 31, 2007, I served the foregoing upon all parties of record in Docket UG 171 by mailing a hard copy by postage prepaid first class mail to those parties accepting paper service.

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Ron McKenzie  
Manager Regulatory Accounting  
Avista Utilities

**Avista Corporation's Response to Staff's Initial Findings  
UG 171 2006 Tax Report  
December 31, 2007**

**1. Work papers:**

Staff Comment:

Although Avista submitted work papers with the original filing, documentation of calculations that appear in the Staff template would have greatly facilitated the review and likely would have narrowed the number of Data Requests and phone calls to the Company.

***Staff recommendation:***

***For the 2007 tax period filing, Staff recommends the Company provide all work papers used in the 2006 filing as well as the work papers submitted in response to Staff's Data Requests.***

***Avista's response:***

For the 2007 tax period filing Avista agrees to submit the work papers in support of its 2007 filing including the work papers submitted in response to Staff's Data Requests.

## **2. Wages and Salaries:**

Staff Comment:

On Page 2 of the Staff template, Lines 7 and 14, Avista provided its Oregon Regulated Operations Wages & Salaries amounts. This amount differed from the amount shown in Avista's Oregon State Income Tax Return, Schedule AP. In response to Data Requests, Staff discovered that the Company had made an adjustment to the Wages & Salaries amount in order to make this amount comparable to the amount shown on the Schedule AP for the Federal Taxpayer. Avista added allocated CWIP to the Oregon portion to make the amount compatible with the Federal number.

Staff agrees that the amounts shown for all apportionment factors should be compatible as possible and that the source for that information should be the Company's Schedule AP. Staff believes that the amounts shown on the Schedule AP should be the source of information for these apportionment to the extent it is possible. Staff believes that the adjustment should take place in a manner that removes CWIP from the Federal Taxpayer rather than to adjust the amount that reflects only Oregon Wages & Salaries.

### ***Staff recommendation:***

***Staff recommends that Avista revise its 2006 filing to remove CWIP from the Federal Taxpayer portion rather than to add CWIP to the State portion of the Wages & Salaries amounts.***

### ***Avista's response:***

Avista disagrees that CWIP-related labor be removed from the total labor amount shown on Schedule AP for Form 20 of the Oregon State Income Tax Return. The labor amount on Schedule AP is properly stated and is used on Schedule AP as the denominator in the labor allocator. Therefore, since CWIP-related labor is included in the denominator, Oregon labor that is used in the numerator should also include CWIP related labor. The labor amount on Schedule AP reflects paid labor, including CWIP-related labor, and labor from non-regulated affiliate operations. Since the total labor amount includes CWIP-related labor, it follows that the Oregon labor amount should also include CWIP-related labor, as the Oregon labor amount is expressed as a percentage of the total labor amount. Avista does not agree that the labor amount on Schedule AP should be restated to exclude CWIP-related labor. The Schedule AP labor amount is what it is, and it includes CWIP-related labor.

### **3. State of Oregon Deferred Taxes**

Staff Comment:

The deferred tax amounts reported by Avista, on Page 5, of the Staff Template include federal deferred taxes only. In response to Staff's Data Request No. 8, Avista explained that the State of Oregon income taxes are "flowed through" for rate making purposes rather than booked into in the deferred tax amounts.

Staff believes that, by virtue of being based on federal taxable income, the Oregon tax return will receive flow through effects of federal deferred tax items and therefore deferred Oregon income tax should be included on Page 5 of Staffs Template.

***Staff recommendation:***

***Staff recommends that Avista recalculate their deferred taxes to include Oregon deferred taxes.***

***Avista's response:***

Avista disagrees that deferred taxes should be recalculated to include deferred State of Oregon income taxes. As stated in the response to Staff Data Request No. 8:

"There are no deferred Oregon state income taxes included in those deferred tax amounts. There are no deferred Oregon state income taxes reflected for ratemaking. Oregon state income taxes are "flowed through" for ratemaking purposes."

The flow-through of Oregon state income taxes for ratemaking purposes does not result in a normalization violation. The normalization rules only apply to federal income taxes.

#### **4. Application of BETC's:**

Staff Comment:

Staff requested documentation for the tax credits associated with Oregon regulated operations and BETCs. In response, Avista demonstrated that the amount reported as credits associated with an Oregon BETC are added back on page 5 of the Staff Template. Staff believes it is inappropriate to include this credit in the add back on page 5, line 12, because the Stand-alone tax liability was never reduced by the Oregon BETC in Avista's Stand-alone calculation.

**Staff recommendation:**

***Staff recommends that Avista revise its state Stand-alone tax calculation to include Oregon tax credits associated with Oregon regulated operations and BETC's prior to entering the amount on Page 3 of the Staff Template. Staff believes that this change may change which method ends up being "greater of" method.***

**Avista's response:**

Avista disagrees that the Oregon state stand-alone calculation should be revised for BETC's. Avista does not pay Oregon state income taxes based on the stand-alone calculation. The Oregon state income tax stand-alone calculation and the stand-alone calculation with an allocation of imputed negative tax of all losses in the Oregon unitary group are defined in the rules. The stand-alone calculations result in derived numbers that are not necessarily representative of taxes paid. The problem is compounded when these numbers are compared to other numbers in the tax report. Avista believes that its Oregon state income tax stand-alone calculations comply with the rules. Page 5 of the Staff Template is designed to add back tax credits under all three of the tax calculation methods. Avista followed the Staff Template and added tax credits back under all three tax calculation methods.

## **5. Schedule M Adjustments Applied to the Stand-Alone Calculation:**

### **Staff Comment:**

When applying the Schedule M adjustments to the stand alone tax calculation, Avista applied the estimated book-tax differences related to Oregon regulated operations, rather than the actual differences as of the tax filing. Staff contends that the Avista should apply the actual Schedule M adjustments rather than the estimated amounts.

### **Staff recommendation:**

***Staff recommends that Avista recalculate their stand-alone tax liabilities using the actual Schedule M adjustments related to Oregon regulated operations.***

### **Avista's response:**

Avista addressed this issue in its responses to Staff Data Requests Nos. 6 and 7. The Schedule M adjustments shown on workpaper 26 are from the results of operations report for Oregon gas operations. The deferred tax amounts shown on workpapers 23, 24, and 25 are from the results of operations report for Oregon gas operations. Except for permanent timing differences, the deferred tax amounts from the results of operations reports should generally be offset by the current tax expense associated with Schedule M adjustments in the results of operations reports. That is, generally, deferred and current tax impacts cancel each other out.

After the federal income tax return is filed, current and deferred taxes are trueed-up based on amounts shown on the federal income tax return. The true-up adjustments are not analyzed to determine the utility service and jurisdiction to which they relate. Generally, the true-up adjustments are instead treated as being common to all utility services and jurisdictions. Hence, the true-up adjustments lack the degree of specificity necessary to accurately reflect the impact on Oregon gas operations.

## **6. Deferred Taxes:**

### **Staff Comment:**

The deferred tax amounts reported by Avista on Page 5, lines 4, 5, 12, 14, 22, and 23 of the Staff Template are based on the estimated book-tax differences from the results of operations report rather than the actual deferred tax amounts used to prepare the tax filing.

Staff believes that because SB 408 is attempting to compare the actual taxes paid, to the actual taxes collected, the deferred taxes on Page 5 should reflect actual deferred taxes.

### **Staff recommendation:**

***Staff recommends that Avista recalculate the deferred tax amounts on Page 6, of the Staff Template, based on the actual book-tax differences as of the tax filings.***

### **Avista's response:**

It is Avista's understanding that in the rulemaking proceedings OPUC Staff recommended that deferred tax amounts shown on the tax report should be from results of operations. Avista believes that it is appropriated to use the current and deferred tax amounts from results of operations as those figures are specifically directly assigned and apportioned to Oregon gas operations and are the amounts reported to the Commission, whereas, the true-up adjustments are not. Please see the response to Staff Issue No. 5.



## **7. Deferred Taxes Adjustment for Uncollectibles:**

### **Staff Comment:**

Prior to reporting the deferred tax amounts on Page 5 of Staff's Template, Avista made two adjustments. One adjustment was to remove the deferred taxes associated with a SB 408 accrual and the second adjustment was related to an uncollectible expense.

Avista explains that the adjustment associated with Uncollectibles was simply a reclassification of an item that should originally have been attributed to the Oregon Regulated Operations. Staff believes if Avista revises its SB408 filing compliant with Staff issue 6 above, then the reclassification of the uncollectible amount will no longer remain an issue.

### **Staff recommendation:**

***Staff recommends that Avista recalculate the deferred tax amounts on Page 6, of the Staff Template, based on the actual book-tax differences as of the tax filings.***

### **Avista's response:**

Avista believes that the adjustment to deferred taxes related to uncollectibles is appropriate. Avista has previously addressed this issue in its responses to Staff Data Request Nos. 5 and 11. The adjustment related to uncollectibles corrects deferred tax expense that should have been directly assigned to Oregon gas operations, but was mistakenly allocated to utility operations in all jurisdictions.

An accrual for uncollectibles related to Oregon operations was recorded as an operating expense for book purposes. The accrued expense was directly assigned to Oregon. The accrual is not deductible for tax purposes. The deduction for tax purposes is based on actual net write-offs. Hence, a Schedule M adjustment was made to remove the accrued expense and to add a deduction for actual net write-offs. The Schedule M adjustment was directly assigned to Oregon in determining current federal income tax expense. Deferred federal income taxes were then recorded to reflect the tax effect of the difference between the amount of uncollectibles reflected for book purposes and the amount of uncollectibles reflected for tax purposes. The deferred federal income tax amount should have been directly assigned to Oregon. It was not. Rather, it was mistakenly allocated to utility operations in all ratemaking jurisdictions. A correction of the mistake is shown on workpaper 23 of the tax report.

**Generic issues:**

Following is a description of generic issues Staff raises regarding the rules in general, followed by the specific issues Staff has identified.

***Generic Issue 1) Modifications to the Staff template***

In its review, Staff recommends modifications to the Staff template in order to facilitate more consistency in the Company filings.

- a. Add a column to the Staff Template between the Line No. Column and the boxes used to report dollar amounts so that the Company can input a reference to the source document related to the dollar amount in the associated box.
- b. Add a blank header line to the Staff Template that will allow the Company to add the Company name so each page of the template will contain the Company name.
- c. Add a worksheet to the Staff Template packet that contains a format for the Stand-alone calculation in order to create consistency as to how the Stand-alone calculation should be done and the source information that should be used to calculate Stand-alone.
- d. Each Company should provide an electronic version on a CD of the Staff template in order to facilitate the review of calculations.

***Avista's response:***

Avista is in agreement with Items (a) and (b). With respect to Item (c), it may not be practical to construct a template that will apply to all utilities in all circumstances. With respect to Item (d), it is not clear how the electronic version could be kept confidential in the Safe Room.

## **Generic Issue 2) Calculation of Stand-alone Utility.**

Staff Comments:

Pursuant to OAR 860-022-0041(2)(p), the Utility's Stand-alone calculation means the amount of income tax liability calculated using a *pro forma* tax return and revenues and expenses in the Utility's results of operations report for the year, except using zero depreciation expense for the public utility property, excluding any tax effects from the investment tax credits, and calculating interest expense in the manner used by the Commission in establishing rates.

Staff found that the utility companies interpret this calculation differently. One company used the actual tax liability from the consolidated tax return, and applied the *actual* Schedule M adjustments (rather than the estimated amounts that would be used to prepare its results of operations report) in order to derive a pre-tax income from the results of operations. The Company then used this calculation as the outcome of the Stand-alone tax liability.

Another Company used the Revenues and Expenses reported in the results of operations, applied *estimated* Schedule M adjustments (as used in the results of operations report) and then used the interest synchronization method as an interest expense pursuant to the method described in the rule above.

Yet another Company used the revenues and expenses from the results of operations and calculated interest as directed in the rules, but did not apply *any* Schedule M adjustments (the current rules do not direct the Utility to apply Schedule M's).

***Staff believes that the rules as they currently written are unclear and that they do (not) provide an accurate proxy for the calculation of Stand-Alone Utility Tax Liability.***

The results of operations report is a proforma regulatory report that requires that the Company use Annual Average amounts rather than the actual End-of-Period amount. For an actual Tax Return, the Company would be required to use actual revenues and expenses on a cash basis (not accrued). To accomplish this, the Company applies Schedule M adjustments on a permanent and temporary basis. These adjustments simply bring the Company from a "book" basis to a cash basis. The appropriate interest deduction is accounted for when the actual Schedule M adjustments are applied to the cash basis of revenues and expenses, making it unnecessary to calculate interest using the Company's weighted cost of debt and annual average rate base.

The rules, as written, create an inaccurate view of the Utility's Stand-alone tax liability by requiring the Company to use annual average amounts and interest synchronization without consideration of the application of Schedule M's, whether estimated or actual. Additionally, as the rules currently exist, there is no direction as to all the functions that should be required in order to perform the Stand-alone calculation.

Staff believes the Stand-alone Utility calculation should use revenues and expenses on a cash basis, apply actual Schedule M adjustments, appropriately deduct all interest associated with its actual debt (not a proxy for debt) and other allowable interest expenses, and then apply Tax Credits that may, or may not be, available to the Utility on a Consolidated basis.

***Staff recommendation:***

***Staff suggests a housekeeping change to this section of the rule to revise the “Stand-alone” calculation in order to develop a method to perform this calculation more consistently to what a pro forma tax return would look like for a Stand-alone Utility. Staff will make a recommendation in the rulemaking, which is expected next spring.***

***Avista’s response:***

It appears that Staff is proposing a new and different method of calculating interest expense. Avista opposes the Staff’s new methodology, believes that it is contrary to the rule, and believes that it would have the unintended effect of undoing the capital structure and associated debt cost approved by the Commission and used in establishing rates.