Avista Corp.
1411 East Mission PO Box 3727
Spokane, Washington 99220-3727
Telephone 509-489-0500
Toll Free 800-727-9170

AVISTA Corp.

SENT ELECTRONICALLY AND VIA OVERNIGHT MAIL

November 15, 2006

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

Re: Draft Private Letter Ruling Request of Avista Corporation, Docket AR 499

Enclosed is a draft Private Letter Ruling (PLR) request of Avista Corporation dated 11/14/06. The draft PLR is being submitted in compliance with Order No. 06-532 in AR 499 entered September 14, 2006, which requires that a draft PLR be submitted on or before November 15, 2006.

Also enclosed is a certificate of service. The following parties were sent a copy of the draft PLR: Public Utility Commission of Oregon, Lowrey R. Brown, Jason Eisdorfer, Robert Jenks, Melinda J. Davison, Matthew W. Perkins, Michael Early, Paula E. Pyron, Judy Johnson, and Ed Busch. A copy of the draft PLR is available to the other parties on the service list upon request. Please e-mail your request to Patty Olsness at www.patty.olsness@avistacorp.com.

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

Sincerely,

Kelly Norwood

Kelly Norwood
Vice President, State and Federal Regulation

RM
Enclosures

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served Avista Corporation's Draft Private Letter Ruling as required by Order 06-532, upon the parties listed below by sending a copy via U.S. Mail and/or electronic mail.

JIM ANDERSON
JD ANDERSON ASSOCIATES
910 SAHALEE CT SE
SALEM OR 97306

GARY BAUER
NORTHWEST NATURAL
220 NW 2ND AVE
PORTLAND OR 97209

LAURA BEANE
PACIFICORP
825 MULTNOMAH STE 2000
PORTLAND OR 97232

SCOTT BOLTON
PACIFICORP
825 NE MULTNOMAH
PORTLAND OR 97232

JULIE BRANDIS
ASSOCIATED OREGON INDUSTRIES
1149 COURT ST NE
SALEM OR 97301-4030

LOWREY R BROWN
CITIZENS' UTILITY BOARD OF OREGON
610 SW BROADWAY - STE 308
PORTLAND OR 97205

ED BUSCH
PUBLIC UTILITY COMMISSION OF OREGON
PO BOX 2148
SALEM OR 97308-2148

REP TOM BUTLER
H-289 STATE CAPITOL
SALEM OR 97310

RANDALL DAHLGREN
PORTLAND GENERAL ELECTRIC
121 SW SALMON ST. 1WTC 0702
PORTLAND OR 97204

MELINDA J DAVISON
DAVISON VAN CLEVE PC
333 SW TAYLOR - STE 400
PORTLAND OR 97204

JIM DEASON
ATTORNEY AT LAW
521 SW CLAY ST STE 107
PORTLAND OR 97201-5407

MICHAEL EARLY
INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES
333 SW TAYLOR STE 400
PORTLAND OR 97204

JASON EISDORFER
CITIZENS' UTILITY BOARD OF OREGON
610 SW BROADWAY STE 308
PORTLAND OR 97205

STEVE EVANS
MIDAMERICAN ENGERY HOLDINGS COMPANY
666 GRAND AVE
DES MOINES IA 50303

EDWARD A FINKLEA
CABLE HUSTON BENEDICT HAAGENSEN & LLOYD LLP
1001 SW 5TH - STE 2000
PORTLAND OR 97204

ANN L FISHER
AF LEGAL & CONSULTING SERVICES
P.O. BOX 25302
PORTLAND OR 97298-0302

ANDREA FOGUE
LEAGUE OF OREGON CITIES
PO BOX 928
SALEM OR 97308

KELLY FRANCONE
ENERGY STRATEGIES
215 SOUTH STATE ST - STE 200
SALT LAKE CITY UT 84111

PAUL GRAHAM
DEPARTMENT OF JUSTICE REGULATED
UTILITY & BUSINESS SECTION
1162 COURT ST NE
SALEM OR 97301-4096

ROBERT JENKS
CITIZENS' UTILITY BOARD OF OREGON
610 SW BROADWAY STE 308
PORTLAND OR 97205

JUDY JOHNSON
PUBLIC UTILITY COMMISSION
PO BOX 2148
SALEM OR 97308-2148

JASON W JONES
DEPARTMENT OF JUSTICE
REGULATED UTILITY & BUSINESS SECTION
1162 COURT ST NE
SALEM OR 97301-4096

GREGG KANTOR
NORTHWEST NATURAL
220 NW SECOND
PORTLAND OR 97209

MARGARET D KIRKPATRICK
NORTHWEST NATURAL
220 NW 2ND AVE
PORTLAND OR 97209

ELISA M LARSON
NORTHWEST NATURAL
220 NW 2ND AVE
PORTLAND OR 97209

PAMELA G LESH
PORTLAND GENERAL ELECTRIC
121 SW SALMON ST 1 WTC 1703
PORTLAND OR 97204

KEN LEWIS
PO BOX 29140
PORTLAND OR 97296

RAUL MADARANG
PORTLAND GENERAL ELECTRIC
121 SW SALMON ST
PORTLAND OR 97204

LARRY O MARTIN
PACIFIC POWER & LIGHT
825 NE MULTNOMAH STE 800
PORTLAND OR 97232

DENNIS J MAURER
DEPARTMENT OF REVENUE

KATHERINE A MCDOWELL
SARAH J ADAMS LIEN
MCDOWELL & ASSOCIATES PC
520 SW SIXTH AVE - SUITE 830
PORTLAND OR 97204

DANIEL W MEEK
ATTORNEY AT LAW
10949 SW 4TH AVE
PORTLAND OR 97219

SENATOR RICK METSGER
STATE CAPITOL
900 COURT ST NE S-307
SALEM OR 97301

ALEX MILLER
NORTHWEST NATURAL GAS COMPANY
220 NW SECOND AVE
PORTLAND OR 97209-3991

JAN MITCHELL
PACIFIC POWER & LIGHT
825 NE MULTNOMAH - STE 2000
PORTLAND OR 97232

MARK NELSON
PUBLIC AFFAIRS COUNSEL
PO BOX 12945
SALEM OR 97309

RICHARD PEACH
PACIFICORP
825 NE MULTNOMAH
PORTLAND OR 97232

MATTHEW W PERKINS
DAVISON VAN CLEVE PC
333 SW TAYLOR - STE 400
PORTLAND OR 97204

DAN PFEIFFER
IDAHO PUBLIC UTILITY COMMISSION
472 WEST WASHINGTON ST
BOISE ID 83720

LISA F RACKNER
ATER WYNNE LLP
222 SW COLUMBIA ST STE 1800
PORTLAND OR 97201-6618

DAVE ROBERTSON
PORTLAND GENERAL ELECTRIC
121 SW SALMON ST
PORTLAND OR 97204

INARA K SCOTT
PORTLAND GENERAL ELECTRIC
121 SW SALMON ST
PORTLAND OR 97204

DOUGLAS C TINGEY
PORTLAND GENERAL ELECTRIC
121 SW SALMON 1WTC13
PORTLAND OR 97204

RICK TUNNING
MIDAMERICAN ENERGY HOLDINGS CO
666 GRAND AVENUE
DES MOINES IA 50303

BENJAMIN WALTERS
CITY OF PORTLAND
OFFICE OF CITY ATTORNEY
1221 SW 4TH AVE - RM 430
PORTLAND OR 97204

MARCUS A WOOD
STOEL RIVES LLP
900 SW FIFTH AVE - STE 2600
PORTLAND OR 97204

DAVE JUBB
CITY OF PORTLAND
dave@jubb.com

PAULA E PYRON
NORTHWEST INDUSTRIAL GAS USERS
4113 WOLF BERRY COURT
LAKE OSWEGO OR 97035-1827

PORTLAND GENERAL ELECTRIC CO.
RATES & REGULATORY AFFAIRS
PORTLAND GENERAL ELECTRIC COMPANY
121 SW SALMON ST 1WTC0702
PORTLAND OR 97204

AUSEY H ROBNETT III
PAINE HAMBLEN COFFIN BROOKE & MILLER
PO BOX E
COEUR D'ALENE ID 83816-0328

BOB TAMLYN
PORTLAND GENERAL ELECTRIC
121 SW SALMON ST
PORTLAND OR 97204

JAY TINKER
PORTLAND GENERAL ELECTRIC
121 SW SALMON ST 1WTC-0702
PORTLAND OR 97204

SENATOR VICKI L WALKER
STATE CAPITOL
900 COURT ST NE S-210
SALEM OR 97301

LINDA K WILLIAMS
KAFOURY & MCDOUGAL
10266 SW LANCASTER RD
PORTLAND OR 97219-6305

PAUL M WRIGLEY
PACIFIC POWER & LIGHT
825 NE MULTNOMAH STE 800
PORTLAND OR 97232

LINDA DECKARD
NORTHWEST NATURAL
lsd@nwnatural.com

I declare under penalty of perjury that the foregoing is true and correct.
Dated at Spokane, Washington this 14th day of November 2006.

Patty Olsness

James I. Warren
212.603.2072 Direct Dial
212.829.2010 Direct Fax
jwarren@thelenreid.com

December , 2006

DRAFT 11/14/06 – AVISTA CORPORATION
BY HAND DELIVERY

Associate Chief Counsel
Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:DRU, Room 5336
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: **Ruling Request for Avista Corporation (EIN #910462470)**

Dear Sir or Madam:

On behalf of Avista Corporation ("Avista" or "Taxpayer"), we respectfully request that the Internal Revenue Service ("Service") issue rulings under §168(i)(9) of the Internal Revenue Code of 1986, as amended ("Code"), former Code §167(l) and former Code §46(f) regarding the status under the depreciation and investment tax credit ("ITC") normalization rules of the ratemaking procedure which will be described in detail hereafter.

STATEMENT OF FACTS

Taxpayer

Avista is incorporated in the State of Washington and headquartered in Spokane, Washington. It is a combination electric and natural gas energy company engaged in the generation, transmission and distribution of energy as well as other energy-related businesses. Taxpayer has four business segments – Avista Utilities, Energy Marketing and Resource Management, Avista Advantage and Other. Avista Capital, a wholly owned subsidiary of Avista Corp., is the parent company of all of the subsidiary companies in the non-utility business segments. Avista Utilities, an operating division of Avista Corp. comprising the regulated utility operations, generates, transmits and distributes electricity and distributes natural gas. Avista Utilities also engages in wholesale purchases and sales of electricity and natural gas. Avista

Utilities supplies retail electric service to a total of 338,000 customers and retail natural gas service to a total of 297,000 customers across its entire service territory.

Avista Utilities provides electric distribution and transmission as well as natural gas distribution services in parts of eastern Washington and northern Idaho and also provides natural gas distribution service in parts of northeast and southwest Oregon. The retail electric and natural gas operations are subject to the jurisdiction of the Oregon Public Utility Commission ("Commission"), the Washington Utilities and Transportation Commission, the Idaho Public Utilities Commission and the Public Service Commission of the State of Montana with respect to prices, accounting, the issuance of securities, and other matters. Avista Utilities is also subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC") for its wholesale natural gas rates charged for the release of capacity from gas storage, and for electric transmission service and wholesale sales.

Taxpayer is the parent of an affiliated group of corporations that files a consolidated U.S. Corporation Income Tax Return. It has thirteen included affiliates – none of which is engaged in a regulated utility activity. This return is filed with the Internal Revenue Service Center in Ogden, Utah. Avista employs a calendar year reporting period and uses the accrual method of accounting. It is currently under the audit jurisdiction of the Large and Midsize Business Division of the Internal Revenue Service, Natural Resources and Construction Group.

The Setting of Avista's Rates

In each regulatory jurisdiction, Taxpayer's rates for retail electric and natural gas services are determined on a "cost of service" basis and are designed to provide, after recovery of allowable operating expenses, an opportunity to earn a reasonable return on "rate base." "Rate base" is generally determined by reference to the original cost (net of accumulated depreciation) of utility plant in service, subject to various adjustments for deferred taxes and other items. Rates for wholesale electric and natural gas services are based on either "cost of service" principles or market-based rates as set forth by the FERC. The assets used in these "cost-based" activities are subject to the depreciation and ITC normalization rules contained in Code §168(i)(9), former Code §167(l) and former Code §46(f). The above-described process of setting rates requires that Avista compute its tax expense element of cost of service, including both current and deferred components ("income tax expense"), so that all of its incurred costs can be ascertained.

The Oregon Legislation

In September of 2005, Senate Bill 408 ("SB 408") was signed into law.[1] A copy of SB 408 is appended as Exhibit 1. This legislation prescribed a new and different method for the treatment of the tax element of cost of service for certain Oregon utilities. Specifically, the legislation was intended to "more closely align taxes collected by a regulated utility from its

[1] SB 408 was codified at ORS 757.267 and 757.268.

ratepayers with taxes received by units of government." The new "alignment" procedures apply to all income taxes – federal, state and local.

SB 408 requires all regulated, investor-owned utilities that provided electric or natural gas service to an average of 50,000 or more customers in Oregon in 2003 to file an annual tax report with the Commission on or before October 15th following the year for which the report is being made. Among other information, the tax report must contain (1) the amount of taxes that were paid (a) by the utility or (b) by the affiliated group and that are "properly attributed" to the regulated operations of the utility and (2) the amount of taxes "authorized to be collected in rates." If the Commission determines that the amount of taxes "authorized to be collected" differs by more than $100,000 from the amount of "properly attributed" taxes paid in any one of the previous three years, it must order the subject public utility to implement a rate schedule with an automatic adjustment clause accounting for the difference by means of either a surcredit or a surcharge on its customers' utility bills. In other words, SB 408 seeks to reconcile and then to match taxes collected in rates with taxes paid by and properly attributed to the utility, as those terms are defined by the statute, for each annual period.

There are, therefore, two measurements that are fundamental to the operation of the statute: (i) that of taxes paid and "properly attributed" to the Oregon regulated operations of the utility and (ii) that of "taxes authorized to be collected in rates."

The Permanent Rules

SB 408 did not define or even describe the phrase "properly attributed" and provided no methodology for its identification. This task was delegated by the legislature to the Commission. A permanent rulemaking docket, AR 499, was opened by the Commission on September 15, 2005 to establish rules for the implementation of the SB 408 – including the procedures for quantifying "properly attributed" taxes. In Order No. 06-532 issued on September 14, 2006, the Commission adopted final administrative rules setting forth that methodology, as well as other items necessary for the implementation of SB 408 ("Permanent Rules"). A copy of the Permanent Rules is appended as Exhibit 2.

Taxes Authorized To Be Collected In Rates

The mechanics for computing taxes authorized to be collected in rates are established in Commission Order No. 06-400, AR 499. Per this order, the calculation must be driven by data from each utility's last rate case. From that data, each utility calculates the percentage of each dollar of revenue that, per the assumptions made when setting rates, is attributable to the recovery of the tax expense element of cost of service.[2] This percentage is then multiplied by the revenues actually collected as reported in the utility's regulatory operational report. The result of this computation represents the total taxes, both current and deferred, deemed collected as a result of the provision of the regulated service at the rates established in the prior rate case.

---

[2] Technically, this is accomplished in two steps: (1) a computation of a margin (net income before taxes divided by gross revenues) and (2) the multiplication of that margin by the tax rate.

For example, if, in a utility's last prior rate case, the tax expense element of cost of service (both current tax expense and deferred tax expense) was assumed at $10 million and total projected revenues (*i.e.*, the revenue requirement upon which rates were based) were $200 million, it is presumed that 5% ($10/$200) of every dollar collected from customers while those rates are in effect represents the recovery of the tax expense element of cost of service. If, in a subsequent period, total revenues collected are $240 million, then that amount is multiplied by 5% to quantify the deemed "taxes authorized to be collected in rates." Under SB 408, this would be $12 million.

"Properly Attributed" Taxes

The Permanent Rules define the amount of federal, state, and local income taxes paid by the utility or by the affiliated group and that is "properly attributed" to the Oregon regulated operations of the utility. In general, it is the lowest of three alternative computations: (a) the "stand alone" tax liability of the utility (hereafter, Method 1), (b) the total tax liability of the affiliated group adjusted as described below (hereafter, Method 2) and (c) the total tax liability of the affiliated group (again, as adjusted) apportioned as prescribed by the Permanent Rules (hereafter, Method 3).

Adjustments

The adjustments to both the stand alone (Method 1) and consolidated (Methods 2 and 3) tax liabilities are of three basic types: (i) "incentive" adjustments that are meant to prevent certain tax benefits from being passed on to customers (*i.e.*, to encourage the activities which produce the tax benefits), (ii) "regulatory lag" adjustments that account for certain tax benefits that are not reflected in rates because they were recognized subsequent to the last rate setting and (iii) adjustments that are meant to ensure compliance with the normalization rules of the Code.

The incentive adjustments relate to items such as charitable contributions and the renewable electricity production credits provided for by Code §45. Under each of the three alternative methodologies, the tax benefits of some or all of these two items are added back to the relevant tax liability. The effect of this is that they are not used to reduce Oregon regulated rates. Thus, the benefits are retained by the utility, thereby promoting the underlying activity. Because the treatment of these two items in ratemaking does not implicate the normalization rules, the mechanics surrounding them will not be further described and no rulings will be requested with respect to these.

The "regulatory lag" adjustments relate to production tax credits and certain state credits. Insofar as these items do not implicate the normalization rules, the mechanics surrounding them will not be further described and no rulings will be requested with respect to these.

The general architecture of the "normalization protection" process is to adjust the starting tax liability (either consolidated or standalone, as the case may be) by "stripping out" the two tax benefits that are subject to the normalization rules - depreciation and ITC claimed with respect to public utility property ("PUP"). In the case of Method 1, the standalone tax liability is then

adjusted to reflect the effects of both of these benefits on current and deferred taxes. Method 2 operates the same way as Method 1 except its starting point is the consolidated tax liability instead of a standalone one. In the case of Method 3, the consolidated tax liability so modified is subjected to an allocation procedure. After the application of this procedure, the same "back end" adjustments are made as in Methods 1 and 2. In each of the three methods, the benefits of depreciation and ITC are, thus, effectively isolated and handled discretely. In this way, the process is designed to ensure compliance with the normalization rules.

There follows a description of each of the three methods. In each description, the adjustments for anything other than depreciation and ITC-related tax benefits, *i.e.*, incentive and regulatory lag adjustments, have been excluded.[3] Additionally, while SB 408 and the Permanent Rules subject state and local income taxes to the same procedures, these are not reflected in the descriptions below.

Method 1 (Stand Alone)

Starting point: Pro forma federal income tax liability computed by reference to the revenues and expenses included in the utility's Oregon regulatory report of operations for the period.

Adjustment 1 Recompute tax liability eliminating tax depreciation on PUP;

Adjustment 2 Add back the benefit of ITC;

Adjustment 3 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 4 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 5 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.[4]

Result: Method 1 properly attributed taxes.

Method 2 (Consolidated/Adjusted)

[3] A complete matrix of all adjustments cross-referenced to the relevant provision of the Permanent Rules is appended as Exhibit 3.

[4] There is also an adjustment for interest to conform it to the method used by the Commission in establishing rates. However, this adjustment is not germane to the normalization rules and, hence, this ruling request.

Starting point: Consolidated federal income tax (per return) after adjustments for subsequent changes (audits, amended returns, etc.).

Adjustment 1 Add back the tax benefit of *all* tax depreciation claimed with respect to *all* PUP anywhere in the group (calculated at statutory tax rate);

Adjustment 2 Add back the benefit of ITC claimed on *all* PUP anywhere in the group;

Adjustment 3 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 4 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 5 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.

Result: Method 2 properly attributed taxes.

Method 3 (Consolidated/Apportioned)

Starting point: Consolidated federal income tax (per return) after adjustments for subsequent changes (audits, amended returns, etc.).

Adjustment 1 Add back the tax benefit of *all* tax depreciation claimed with respect to *all* PUP anywhere in the group (calculated at statutory tax rate);

Adjustment 2 Add back the benefit of ITC claimed on *all* PUP anywhere in the group;

Adjustment 3 Apportion the amount after Adjustment 2 by applying a "three-factor" formula;[5]

Adjustment 4 Compare the result of Adjustment 3 to the standalone floor[6] and proceed using the greater of the two;

---

[5] The "three factor" formula consists of a simple average of the ratios of Oregon regulated operations to the consolidated group total for plant, wages and sales.

[6] The standalone floor is the amount that results after Adjustment 2 of Method 1 (an adjusted standalone tax liability) reduced by an allocation of the imputed negative tax liability of affiliates with tax losses. This imputed negative tax liability is computed after eliminating depreciation and ITC claimed by each loss affiliate with respect

Adjustment 5 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 6 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 7 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.

Result: Method 3 properly attributed taxes.

Comparison of "Taxes Authorized" To "Taxes Properly Attributed"

As described above, the result of the calculation described as representing the taxes authorized to be collected in rates is compared to the calculation described as representing the taxes properly attributed to the Oregon regulated operation for the same period. Starting in fiscal years beginning on or after January 1, 2006, if, for any of the previous three years, the difference between the two equals or exceeds $100,000 (for all income taxes), the Commission must implement an adjustment clause to "true up" the taxes collected to the taxes properly attributed by crediting or charging customers for the difference on future bills.

SB 408, the Permanent Rules and the Normalization Rules

By mandating the establishment of an adjustment clause for the tax expense element of cost of service, SB 408 and the Permanent Rules effectively establish a methodology for the computation of the tax expense element of cost of service itself. In other words, the requirement to "true up" to a measure of "properly attributed taxes" means that, ultimately, it is these "properly attributed taxes" that are collected in rates. Consequently, the normalization rules are clearly relevant to these calculations. In recognition of this fact, the Permanent Rules require that, on or before December 31, 2006, each utility subject to SB 408 must seek a private letter ruling from the Internal Revenue Service as to whether the utility's compliance with SB 408 and the Permanent Rules would cause the utility to fail to comply with any provision of the normalization rules. They further provide that no rate adjustment will be implemented while such a ruling request is pending. Finally, the Permanent Rules authorize a utility to propose an adjustment to its computation of properly attributed taxes in order to avoid a probable violation of the normalization rules.

RULINGS REQUESTED

Taxpayer respectfully requests the following rulings:

---

to its PUP. The total of such imputed negative tax liabilities is apportioned based on a simple average of the ratios of Oregon regulated operations to all regulated operations for plant, wages and sales.

1. The use of Method 1 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

2. The use of Method 2 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

3. The use of Method 3 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

4. The automatic adjustment clause described above which conforms taxes collected by Taxpayer from its Oregon customers to taxes paid with respect to its Oregon regulated operations is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

STATEMENT OF LAW

Code §168(i)(9)(A)(i) provides that, in order to use a normalization method of accounting with respect to any public utility property, the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes.

Code §168(i)(9)(A)(ii) requires that a taxpayer make adjustments to a reserve to reflect the deferral of such taxes resulting from the use of different depreciation methods for tax purposes and for purposes of computing its tax expense element of cost of service.

Code §168(i)(9)(B)(i) provides that the normalization requirements are not met if the taxpayer uses a procedure or adjustment that is inconsistent with the requirements of Code §168(i)(9)(A).

Code §168(i)(9)(B)(ii) provides that the procedures and adjustments that are inconsistent with these limitations include any procedure or adjustment for ratemaking purposes that uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to rate base.[7]

Former Code §46(f) imposed limitations on the treatment of the ITC claimed by certain regulated public utility companies with respect to their "public utility property." The general

[7] See also former Code §167(l)(3)(G).

rule under former Code §46(f)(1) stated that a taxpayer's cost of service cannot be reduced by any amount of the ITC. A taxpayer's rate base, however, may be reduced by the ITC amount provided that the reduction is restored no less rapidly than ratably over the useful life of the property.

Alternatively, taxpayers could elect the application of former Code §46(f)(2). This section provided that ITC will not be allowed with respect to public utility property if (1) the taxpayer's cost of service for ratemaking purposes and on its regulated books of account is reduced by more than a ratable portion of the ITC, or (2) taxpayer's rate base is reduced by reason of any portion of the ITC.

Former Code §46(f)(6) provides that, for purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of ITC, the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account will be used.

Reg. §1.46-6(g) provides that ITC amortization period must be no shorter than the one used to calculate ratemaking depreciation expense.

Reg. §1.46-6(b)(2)(ii) provides that, in determining whether or to what extent ITC has been used to reduce cost of service, reference will be made to any accounting treatment that affects cost of service.

Reg. §1.46-6(b)(3)(ii)(A) provides that, in determining whether or to what extent ITC has been used to reduce rate base, reference will be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit was unavailable.

Reg. §1.46-6(b)(4)(i) provides that cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner.

Former Code §46(f)(10) provided that the normalization requirements are not met if the taxpayer uses a procedure or adjustment that is inconsistent with the limitations in former Code §46(f)(1) and 46(f)(2). The procedures and adjustments that are inconsistent with these limitations include any procedure or adjustment for ratemaking purposes that uses an estimate or projection of the taxpayer's qualified investment for purposes of the credit unless such estimate or projection is consistent with the estimates and projections of property which are also used for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

On September 11, 1991, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means held a hearing on the IRS withdrawal of the proposed regulations concerning the treatment of consolidated savings under the normalization requirements of the Code. At that hearing, Deputy Assistant Secretary (Tax Policy) Michael J. Graetz released a statement in which he set forth the IRS's position with regard to this issue. Attached to his statement was a memorandum to him from Abraham N. M. Shashy, Jr., Chief

Counsel, which served as the basis for Mr. Graetz's conclusions. Serial 102-45, 102nd Congress, First Session.

ANALYSIS

As described above, SB 408 and the Permanent Rules effectively dictate the level of tax expense that can be included in rates over time. They do this by (1) prescribing the mechanics for arriving at a permissible amount ("properly attributed" taxes) and (2) requiring an automatic adjustment clause to ultimately achieve the quantity of rate collections appropriate to that level of tax expense – no more and no less. In order to facilitate a normalization analysis, this system of ratemaking for taxes is best divided into four components. The first three are the three alternative methodologies established by the Permanent Rules to quantify the "properly attributed" taxes paid. Since, in each year, the lowest of the three computations is used and since there is no way to predict in advance which of the methods will produce the lowest amount, it is appropriate to subject each of the three to a separate normalization analysis. The fourth component is the "true up" procedure itself.

Three Methods and Deferred Taxes

The three methods of determining "properly attributed" tax amounts share two significant characteristics. The first is a lack of specificity in identifying the components of tax expense. The purpose of the three methods is to arrive at the amount of "taxes paid" that is "properly attributed" to the regulated operations in Oregon. Under the terms of SB 408, "taxes paid" includes "deferred taxes related to the regulated operations of the utility."[8] Thus, "taxes paid" as defined in SB 408, includes the entire tax expense element of cost of service for the Oregon regulated operation. The computational focus of the three methods on overall tax expense leaves some lack of clarity regarding the portion of the calculated amount that is current tax and the portion that is deferred tax. However, this lack of clarity can be readily overcome by the application of some logic and basic accounting principles, as will be illustrated hereafter.

More significantly, each of the three methods includes an adjustment for those deferred taxes "related to the regulated operations of the utility." For Methods 1 and 2, this is Adjustment 4. For Method 3 it is Adjustment 6. Section (2)(b) of the Permanent Rules defines a utility's "deferred taxes" as:

> "the total deferred tax expense of regulated operation, as reported in the deferred tax expense accounts as defined by the Federal Energy Regulatory Commission, that relate to the year being reported in the utility's results of operations report or tax returns."

This cross-reference to regulatory books of account creates an unusual situation with regard to deferred taxes. By defining deferred taxes in this way, the Permanent Rules require that the

[8] SB 408, Section 3(13)(f)(C).

deferred portion of tax expense (*i.e.*, "taxes paid") equals that reflected on those books as of the end of the relevant measurement period. These regulatory books of account will, in the normal course, reflect deferred taxes (and, hence, deferred tax expense) generated by the temporary differences between the regulatory and tax treatment of all items of which the utility is aware as of the time of the closing of the regulatory books.[9] The deferred tax account balances will be "event driven" (*i.e.*, they will result from whatever actual events transpire). Since this closing of the regulatory books will, in the normal course, occur months prior to the filing of the relevant tax return, at least some elements of deferred tax expense will consist of estimates. However, the reference to "tax returns" in the definition above indicates that the levels of deferred tax expense reflected in the regulatory books of account are to be "trued up" to the "actual" deferred tax amount. Thus, the deferred taxes recorded in these books will, in all cases, reflect the tax deferrals (and reversals) that actually occur by virtue of the differences between the regulatory and tax treatment of items of income and expense.

By adopting the regulatory books as the deferred tax paradigm, compliance with SB 408 and the Permanent Rules will, of necessity, result in the consideration in the setting of rates of the amount of deferred taxes that is required by the depreciation normalization rules. This will include the treatment of excess deferred taxes. To the extent that the regulatory books of account employ the average rate assumption method to flow back these amounts, then that practice will be recognized in the setting of rates through the deferred tax adjustment.

The remaining issues are, therefore, (1) whether or not the SB 408 procedures permit the flowing through of the benefits of accelerated depreciation and/or ITC from other regulated operations and (2) the extent to which these procedures do something to the computation of the current provision of tax expense that may be deemed to be an indirect (and impermissible) adjustment to the deferred provision or an inconsistency that runs afoul of Code §168(i)(9)(B).

Analyses of the Three Methods

Each of the three following analyses proceeds from a single set of facts. Avista's base case consists of a single utility group member regulated by the Commission, the Washington Utilities and Transportation Commission and the Idaho Public Service Commission (the latter two referred to as "WA/ID") and two non-regulated subsidiaries. The tax rate is 35%. The three members file a consolidated tax return incorporating the following results:

Avista Tax Expense - Base Data						
	Avista-Oregon	Avista-WA/ID		Sub 1	Sub 2	Consolidated
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110

[9] Note that this adjustment includes all deferred taxes – not just those associated with PUP. Because only the PUP-related deferred taxes are relevant to the normalization rules, the illustrations set out later in this ruling request will only focus on those.

PUP Dep – Add'l Tax	$400	$40				$440
Other Dep				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250

METHOD 1 (Stand Alone)

The application of Method 1 to the base data produces the following results:

Avista-Oregon Tax Expense - Method 1						
	Avista-Oregon	**Avista–WA/ID**		**Sub 1**	**Sub 2**	**Consolidated**
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110
PUP Dep - Add'l Tax	$400	$40				$440
Other Dep				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250
Standalone Tax Liability	$300					
Adjustment 1	$175	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$475					
Adjustment 2	$50	Tax benefit of ITC on Oregon PUP [$50]				
Sub-total	$525					
Adjustment 3	($175)	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$350					
Adjustment 4	$140	Deferred taxes on Oregon regulated operations				
Sub-total	$490					
Adjustment 5	($5)	Regulatory ITC amortization				
Total Tax Expense	$485					

Under this method, the current tax provision is $300. The deferred tax provision is $185. $140 of this is attributable to the Oregon PUP depreciation (*i.e.*, Avista's Oregon regulatory books will reflect $140 of deferred tax expense). There is another $45 of deferred tax expense

relating to the ITC. While there is no deferred ITC provision labeled as such, Adjustment 2 (+$50) net of Adjustment 5 (-$5) effectively creates such a provision.

This method represents conventional, stand-alone ratemaking for taxes that is used in most jurisdictions. As indicated above, the level of deferred taxes provided should be adequate under the depreciation normalization rules. The net effect of the two ITC entries is that the credit is being amortized ratably as required by the ITC normalization rules. Finally there is nothing about the current provision that should give the slightest pause under either set of rules.

In short, this ratemaking should be non-controversial from a tax normalization perspective.

METHOD 2 (Consolidated/Adjusted)

The application of Method 2 to the base data produces the following results:

Avista-Oregon Tax Expense - Method 2						
	Avista-Oregon	**Avista- WA/ID**		**Sub 1**	**Sub 2**	**Consolidated**
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110
PUP Dep – Add'l Tax	$400	$40				$440
Other Dep				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250
Consolidated Tax Liability	$250					
Adjustment 1	$193	Tax benefit of depreciation on all PUP [($500+$50) X 35%]				
Sub-total	$443					
Adjustment 2	$60	Tax benefit of ITC on all PUP [$50+$10]				
Sub-total	$503					
Adjustment 3	($175)	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$328					
Adjustment 4	$140	Deferred taxes on Oregon regulated operations				
Sub-total	$468					
Adjustment 5	($5)	Regulatory ITC amortization				
Total Tax Expense	$463					

The Method 2 example above results in a current tax provision of $278. This is the subtotal after Adjustment 3 ($328) less the $50 of ITC claimed with respect to Oregon PUP. The deferred tax provision consists of the $140 relating to Oregon PUP. There is an additional deferred tax provision of $45 relating to the Avista-Oregon ITC. Again, this latter provision is not explicitly described but must be extracted by netting the Avista-Oregon ITC portion of Adjustment 2 ($50) against Adjustment 5 ($5). Thus, when compared to Method 1, the total deferred tax provision remains unaffected.

The $22 difference between the $463 of total tax expense using Method 2 and the $485 using Method 1 is attributable to:

Method 1 tax expense	$485	
Reduction for non-Avista Oregon tax benefit	($50)	[$60-$140+$30]
Avista-WA/ID depreciation	$18	[$50 X 35%]
Avista-WA/ID ITC	$10	
Method 2 tax expense	$463	

The difference between this Method 2 calculation and the prior Method 1 calculation is entirely attributable to activities other than Avista-Oregon's. In this regard, this difference is of the nature of a consolidated tax adjustment ("CTA"). Generally, a CTA adjusts a utility's tax expense element of cost of service based on the "tax reducing" consequences (usually tax losses) of activities undertaken by consolidated return affiliates of the utility (*i.e.*, consolidated return benefits). Method 2 effectively does this, although, because its starting point is the consolidated tax liability, it also reflects the tax consequences of divisional activities.[10]

CTAs were very controversial in the latter part of the 1980s. During that period of time, a number of utilities requested guidance from the Service regarding the normalization implications of certain CTAs that resulted in reductions of the tax expense element of cost of service. The Service issued several private letter rulings (including PLRs 8525156, 8643024, 8711050 and 8801041) all of which concluded that the imposition of a CTA of this type would violate the normalization rules. These conclusions were based on the dual premises that (1) such ratemaking indirectly reduced the level of deferred tax required to be provided under the normalization rules and (2) that it violated the "consistency requirement" of those rules.

On September 11, 1991, Michael Graetz, Deputy Assistant Secretary (Tax Policy), announced a change in the Service's position with respect to CTAs at a hearing before the Committee on Ways and Means Subcommittee on Select Revenue Measures. At that time, Mr. Graetz, disavowed the previously issued letter rulings and declared:

---

[10] Though Method 2 can also pick up incremental net tax from affiliates, as a practical matter, where this would be the case, Method 1 would always produce a lower level of tax expense. Thus, unless there is a net benefit from non-Avista-Oregon operations, Method 2 would never be the basis for the tax expense computation.

> "It is the position of the Service that, in the absence of regulations specifically prohibiting consolidated tax adjustments, these adjustments can be made without violating the normalization requirements of the Code. Therefore, if requested in an appropriate circumstance, the Service would rule that these adjustments do not violate the normalization requirements of the Code, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property."

At that hearing, Mr. Graetz distributed the memorandum from IRS Chief Counsel, Abraham Shashy, upon which he based this statement. This memorandum was a bit more nuanced than was Mr. Graetz's testimony and stated:

> "These arguments do raise a concern that a consolidated tax adjustment might be used to offset a utility's deferred tax reserve from normalization or might be used to flow through the accelerated depreciation benefit of another regulated utility in the same consolidated group. These concerns are worthy of further study. Until they are resolved, we can only say with confidence that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property, and provided that the taxable income any other regulated utilities used in the calculation of the adjustments is computed on a normalized basis."

Taxpayer is aware of no authorities relevant to CTAs and the normalization rules issued subsequent to the hearing referenced above. Certainly no regulations such as those mentioned by Mr. Graetz have been promulgated – or even proposed.

Based on these "authorities," a CTA that (1) solely impacts the current portion of the tax expense element of cost of service, (2) doesn't impact (directly or indirectly) the level of deferred taxes required by the normalization rules and (3) doesn't effect a flow through of another utility's accelerated depreciation benefits should not run afoul of the depreciation normalization rules.

Method 2 reduces Avista-Oregon's Method 1 current tax provision from $300 to $278. By virtue of the $28 of normalization-protection adjustments, it is absolutely clear that the reduction does not have the capacity to flow through to Avista-Oregon customers the tax benefits of Avista-WA/ID depreciation or ITC claimed with respect to PUP. It is likewise clear that deferred taxes have been provided on all tax deferrals. Finally, the reduction in the current tax provision attributable to the net reduction in consolidated tax attributable to operations other than those of Avista-Oregon would seem to be well within the tolerances of Mr. Graetz's testimony and Mr. Shashy's memorandum (assuming, of course, that those documents continue to reflect the position of the Service).

Consequently, the level of tax expense produced by Method 2 should be deemed consistent with both the depreciation and ITC normalization rules.

METHOD 3 (Consolidated/Apportioned)

The application of Method 3 to the base data produces the following results:

Avista-Oregon Tax Expense - Method 3						
	Avista-Oregon	**Avista-WA/ID**		**Sub 1**	**Sub 2**	**Consolidated**
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110
PUP Dep - Add'l Tax	$400	$40				$440
Non-PUP Depreciation				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250
Consolidated Tax Liability	$250					
Adjustment 1	$193	Tax benefit of depreciation on all PUP [($500+$50) X 35%]				
Sub-total	$443					
Adjustment 2	$60	Tax benefit of ITC on all PUP [$50+$10]				
Sub-total	$503					
Adjustment 3	$23	Apportion using a "3 factor" formula (4.52%)*				
Adjustment 4	$514	Compare to standalone floor and select greater of two**				
Adjustment 5	($175)	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$339					
Adjustment 6	$140	Deferred taxes on Oregon regulated operations				
Sub-total	$479					
Adjustment 7	($5)	Regulatory ITC amortization				
Total Tax Expense	$474					
	*	Oregon Regulated		Total Group	Ratio	
	Plant	$170,000,000		$2,900,000,000	5.86%	
	Wages	$6,000,000		$130,000,000	4.62%	
	Sales	$133,000,000		$4,300,000,000	3.09%	
				Average	4.52%	

	**	Method 1 after Adjustment 2 (adjusted standalone)				$525
		Negative tax liabilities (Sub 1)			($140)	
		Allocated negative liabilities (8.07%)***				($11)
		Floor				$514
	***			Oregon Regulated	All Regulated	Ratio
		Plant		$170,000,000	$2,800,000,000	6.07%
		Wages		$6,000,000	$80,000,000	7.50%
		Sales		$133,000,000	$1,250,000,000	10.64%
					Average	8.07%

Assuming that the deferred tax provision is, as in the two prior methods, $140 plus the $45 for deferred ITC, the current tax provision using Method 3 is $289.

Whereas Methods 1 and 2 use only "tax data" in the calculation of tax expense, Method 3 employs a very different approach. It allocates the consolidated tax liability (as adjusted) based on non-tax events (*i.e.*, the "3-factor" formula). Unlike Method 2, its use is in no way premised on the existence of consolidated return benefits. In other words, for Method 3 to produce the lowest tax expense of the three methods, it is not necessary that any non-Avista-Oregon activity produce a net tax benefit (*e.g.*, a net operating loss). The mere allocation based on the three factors can render it the lowest of the three. It is, therefore, analytically quite different from a CTA.

The $11 difference between the tax provision calculated under Method 3 ($474) and that calculated under Method 1 ($485) is attributable to:

Method 1 tax expense	$485	
Reduction for tax benefit allocated in "floor" computation	($11)	[$140 X 8.07%]
Method 3 tax expense	$474	

Due to the low allocation factors, in this example the "floor" is higher than the "basic" Method 3 calculation. Under different assumptions, the floor may not apply. When applicable, the "floor" computation operates like a fairly standard CTA in which the current tax provision is adjusted for the tax reduction effects of affiliate activities. Moreover, the normalization-protection adjustments are still incorporated into the calculation, thereby preventing flow through from other regulated operations. Under the CTA analysis set forth in the discussion of Method 2, such an alternative Method 3 calculation should not contravene the normalization rules.

Consequently, the level of tax expense produced by Method 3 should be deemed consistent with both the depreciation and ITC normalization rules.

The Tax Adjustment Clause

As described above, the automatic adjustment clause for taxes that is required under SB 408 conforms the rates previously charged to customers to actual events. In other words, like every "tracker" or "balancing account," it compares what was projected to occur when rates were set to what actually happened.

If the utility had the ability to perfectly forecast its financial (including its tax) future and the tax future of its affiliates, divisions, etc. at the time rates were being established, it would have included in its cost of service precisely the level of tax expense produced by the "properly attributed" procedures required under the Permanent Rules. Because it did not have the ability to do this, it incorporated some estimate of its "proper" tax expense into rates. The automatic adjustment clause effectively adjusts rates to what they would have been had there been perfect knowledge. Consequently, if the "properly attributable" tax amount as calculated pursuant to SB 408 and the Permanent Rules would have been permissible under the normalization rules had the utility had perfect knowledge, it should be no less permissible when it is the basis of a "true-up" procedure.

At a pre-submission meeting with representatives of the National Office, Taxpayer was specifically asked to address the implications of the SB 408 tax adjustment clause under the "consistency rules" of Code §168(i)(9).

Code §168(i)(9)(A) ["Section A"] describes the basic mechanic that constitutes the heart of the depreciation normalization rules – the necessity to reflect deferred taxes in ratemaking and to establish an ADFIT reserve. Code §168(i)(9)(B)(i) provides that any "procedure or adjustment" that is inconsistent with the requirements of Section A violates the depreciation normalization rules. As indicated above, because, pursuant to the Permanent Rules, Taxpayer uses its regulatory books of account to establish its deferred tax expense, it will, of necessity, reflect a level of such expense commensurate with the tax actually deferred. This procedure is in all regards consistent with Section A.

Code §168(i)(9)(B)(ii) ["Section B"] establishes what has been come to be known as the "consistency rules." This provision defines as inconsistent with Section A any estimate or projection that does not treat tax expense, depreciation expense, ADFIT and rate base symmetrically.

There are two respects in which the tax adjustment clause may be considered to incorporate "inconsistencies." The first relates to the dichotomy between the level of expenses considered for purposes of computing tax expense and those considered for other ratemaking purposes. The second relates to the calculation of the amount of taxes "authorized to be collected in rates." Each will be addressed separately.

Level of Expense

The "level of expense" inconsistency that is produced by the tax adjustment clause mechanism is attributable to the fact that an income tax liability does not exist on its own. It is purely a creature of other activities – specifically, accretions to and dispositions of wealth. The National Office representative recognized the fact that a tax adjustment clause effectively severs the link between the activities that give rise to a tax liability and the tax liability itself. This transpires whether or not the utility files as part of a consolidated group.

For example, if the tax expense element of cost of service is established based on a projection of revenue to be earned and costs to be incurred during a period and it turns out that a much higher level of expenses are, in fact, incurred during that period, the tax liability incorporated in rates will exceed the tax liability actually incurred. Under the SB 408 tax adjustment mechanism, a refund would be due customers notwithstanding that the utility is unable to recover from customers those incremental costs the incurrence of which caused the tax liability to diminish. The link between expenses and the resultant tax liability has been severed.

From a normalization perspective, this is of particular relevance where the additional expense that can't be recovered is depreciation with respect to PUP. A simple illustration of this situation follows.

	Rate Case	Actual
General Business Revenues	$10,000,000	$10,000,000
Book Depreciation on Public Utility Property	($2,000,000)	($6,000,000)
Regulatory Federal Taxable Income	$8,000,000	$4,000,000
Federal Statutory Tax Rate	35%	35%
Regulatory Federal Tax Expense (Current & Deferred)	**$2,800,000**	**$1,400,000**

In this case, the SB 408 tax adjustment clause mechanism would require a refund of $1,400,000 of taxes to customers even though the $4,000,000 of unanticipated PUP depreciation is not collected from customers. Thus, the mechanism is capable of providing a tax benefit to customers with respect to PUP depreciation they do not fund. This is the type of inconsistency that the National Office representative requested be addressed in connection with the requirements of Code §168(i)(9).

Taxes Authorized to be Collected in Rates

The calculation of the amount of taxes authorized to be collected in rates proceeds from the "margin" computation previously described. Essentially, it is presumed that each dollar of revenue has embedded within in it the level of tax expense recovery projected in the setting of rates. Obviously, the actual levels of both revenues and expenses invariably differ from those upon which rates are set. The presumption of a "standardized" tax collection rate has, therefore, the capacity to vary from actuality, thereby impacting the measurement of the required tax adjustment. A simple example follows.

	Per Rate Case		Additional Actual	Total Actual	SB 408 Calculations
Revenue	$10,000,000	100%	$1,000,000	$11,000,000	$11,000,000
Expenses					
Fuel Cost	$4,000,000	40%	$1,000,000	$5,000,000	
O&M	$2,000,000	20%		$2,000,000	
Book Depreciation	$1,000,000	10%		$1,000,000	
	$7,000,000	70%		$8,000,000	
Net Margin/Ratio	$3,000,000	**30%**		$3,000,000	**30%**
Effective Tax Rate	35%			35%	**35%**
Tax Expense ("Collected")	$1,050,000	10.5%		$1,050,000	$1,155,000
Taxes Paid	$1,050,000			$1,050,000	$1,050,000
SB 408 adjustment					**$105,000**

In the illustration above, deductible fuel cost and revenue both increase by $1,000,000. Notwithstanding that the tax liability doesn't change, the net pre-tax margin does – from the 30% presumed in the rate case ($3,000,000/$10,000,000) to 27% actually experienced ($3,000,000/$11,000,000). Yet the computation of "taxes authorized" is unaffected by this variation. This also is the type of inconsistency that the National Office representative requested be addressed in connection with the requirements of Code §168(i)(9).

The Purview of the Consistency Rules

While it is literally true that the automatic tax adjustment procedure may be said to contain one or more elements of inconsistency, the purview of the normalization consistency rules is circumscribed. In short, those rules cover some – but not all – inconsistencies. And any inconsistencies created by a tax adjustment mechanism should be deemed not of the type covered by those rules.

Code §168(i)(9)(B)(ii) was added by §541 of the Highway Revenue Act of 1982 in direct response to regulatory developments in California in the 1970's. The California regulators were extremely unhappy about the imposition of the normalization rules. They devised a technique, the "average annual adjustment" or "AAA" method, to offset the impact of those rules. This procedure involved a projection of future deferred tax balances for purposes of the computation of rate base where there was no such projection for any other purpose. It resulted in a substantially larger rate base offset than would otherwise be the case. One or more of the affected utilities applied to the Service for guidance as to the consequences of this technique under the normalization rules. The Service ruled that it was violative, pointing to the section of the regulations, Treas. Reg. §1.167(l)-1(h)(6), which governs the quantity of deferred taxes that

can offset rate base. The Service concluded that the technique failed to meet the regulatory requirement that the quantity of deferred taxes used to offset rate base could not exceed the amount of the reserve for the period used in determining the utility's tax expense element of cost of service.[11] In short, there was a lack of "temporal consistency" between the way in which cost of service was computed and the computation of the deferred tax balance used as a rate base offset.

While the Service held the technique violative, the California authorities continued to support the adjustment. Ultimately, a legislative solution was crafted to avoid the dramatically negative financial implications stemming from the imposition of penalties for violation of the normalization rules. This solution was enacted as §541 of the Highway Revenue Act of 1982. Under this legislation, those affected utilities that qualified under a transition rule would not be deemed to have violated the normalization rules (though they had to make substantial payments to the IRS). However, language was added to Code §168(i)(9) to make absolutely clear that the AAA method and techniques similar to it constituted a normalization violation. This language was Section B.

This history of Section B indicates its intention to render violative inconsistencies within a test period – but only a test period having some element of futurity. That, after all, is the import of the use of the terms "estimate or projection" in Section B. And there is nothing that can be further from an "estimate or projection" than a "true up" to "properly attributed" taxes after those taxes were incurred.

Thus, although the SB 408 tax adjustment clause can be viewed as producing one or more inconsistencies, they are not the type of inconsistencies that the normalization rules are intended to address.

CONCLUSION

For the reasons stated above, we respectfully request that the Service issue the rulings requested.

[11] PLR 7836038 (June 8, 1978) and PLR 7848048 (June 9, 1978).

PROCEDURAL STATEMENTS

A. Revenue Procedure 2006-1 Statements

1. Section 7.01(4) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, no return of Taxpayer (or any return of a related taxpayer within the meaning of §267 or of a member of an affiliated group of which Taxpayer is also a member within the meaning of §1504) that would be affected by the requested letter ruling is under examination, before Appeals, or before a federal court.

2. Section 7.01(5)(a) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, the Service has not previously ruled on the same or similar issue for Taxpayer, a related taxpayer (within the meaning of §267), a member of an affiliated group of which Taxpayer is also a member (within the meaning of §1504), or a predecessor.

3. Section 7.01(5)(b) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer, a related taxpayer, a predecessor, nor any representatives previously submitted a request (including an application for change in accounting method) involving the same or similar issue but with respect to which no letter ruling or determination letter was issued.

4. Section 7.01(5)(c) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer, a related taxpayer, nor a predecessor previously submitted a request (including an application for change in accounting method) involving the same or a similar issue that is currently pending with the Service.

5. Section 7.01(5)(d) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer nor a related taxpayer is presently submitting another request (including an application for change in accounting method) involving the same or similar issue to the Service at the same time as this request.

6. Section 7.01(8) - The law in connection with this ruling request is uncertain and the issues discussed herein are not adequately addressed by relevant authorities.

7. Section 7.01(9) - Taxpayer has included all supportive as well as all contrary authorities of which it is aware.

8. Section 7.01(10) - Taxpayer and Taxpayer's representatives have no knowledge of any pending legislation that may affect the proposed transaction.

9. Section 7.02(5) - Taxpayer hereby requests a copy of the ruling and any written requests for additional information be sent by facsimile transmission (in addition to being mailed) and waives any disclosure violation resulting from such facsimile transmission. Please fax the ruling and any written requests to Mr. Warren at (212) 829-2010.

10. Section 7.02(6) - A conference on the issues involved in this ruling request is hereby respectfully requested in the event that the Service reaches a tentatively adverse conclusion.

11. The Commission has reviewed this request and determined that it is adequate and complete. See letter appended as Exhibit 4. Taxpayer will permit the Commission to participate in any Associate office conference concerning this request.

B. Administrative

1. The deletions statement required by Revenue Procedure 2006-1 is enclosed.

2. The checklist required by Revenue Procedure 2006-1 is enclosed.

3. The required user fee of $10,000 is enclosed.

4. A Power of Attorney granting Taxpayer's representative the right to represent the taxpayer is enclosed.

If you have any questions or need additional information regarding this ruling request, pursuant to the enclosed Power of Attorney please contact James I. Warren at (212) 603-2072.

Respectfully submitted,

_____

James I. Warren

Thelen Reid & Priest LLP
Attorney for
Avista Corporation

NY #748624 v1

PENALTIES OF PERJURY STATEMENT

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

_____ _____

Date

_____

DELETIONS STATEMENT

For purposes of Section 6110(c)(1) of the Internal Revenue Code of 1986, as amended, Taxpayer requests the deletion of all names, addresses, EINs, locations, dates, amounts, regulatory bodies and other taxpayer identifying information contained in the attached request for private letter ruling.

Taxpayer reserves the right to review, prior to disclosure to the public, any information related to this request for private letter ruling and to provide redacted copies of any documents to be released to the public.

Date: _____

_____

James I. Warren
Thelen Reid & Priest LLP
Attorney for
Avista Corporation