

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



April 11, 2006

Sent Via email and U.S. Mail

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

Re: **DOCKET AR 499: Straw Proposal of Avista Corporation**

Enclosed please find Avista Corporation's Straw Proposal, in the above-referenced docket, related to the implementation of "properly attributed" under Senate Bill 408.

Also enclosed is a write-up and example accounting entries regarding the "gross-up" and "iterative effect" issues. The write-up and illustrations show that neither the gross-up nor the iterative effect should occur. If either were allowed to occur, the result would be a rate adjustment in excess of what is called for under Senate Bill 408. Please direct any questions to 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

Enclosures

C: AR 499 Service List

Certificate of Service

I HEREBY CERTIFY that I have this day served Avista Corporation's Straw Proposal in Docket AR 499, upon the parties listed below by sending a copy via electronic mail and U.S. Mail.

Rep. Tom Butler
H-289 State Capitol
Salem, OR 97310
tom@butlert.com
cpatom@fintc.com

Jim Deason
Attorney at Law
521 SW Clay St. Ste. 107
Portland, OR 97201-5407
jimdeason@comcast.net

Ken Lewis
PO Box 29140
Portland, OR 97296
kl04@mailstation.com

Portland General Electric Co.
Rates & Regulatory Affairs
121 SW Salmon St. 1WTC0702
Portland, OR 97204
pge.opuc.filings@pgn.com

Ann L. Fisher
Attorney At Law
AF Legal & Consulting Services
2005 SW 71st Ave.
Portland, OR 97225-3705
energlaw@aol.com

Julie Brandis
Associated Oregon Industries
1149 Court St. NE
Salem, OR 97301-4030
jbrandis@aol.org

Lisa F. Rackner
Attorney
Ater Wynne LLP
222 SW Columbia St. Ste. 1800
Portland, OR 97201-6618
lfr@aterwynne.com

Edward A Finklea
Cable Huston Benedict
Haagensen & Lloyd LLP
1001 SW 5th - Ste. 2000
Portland, OR 97204
efinklea@chbh.com

Lowrey R. Brown lowrey@oregoncub.org
Jason Eisdorfer dockets@oregoncub.org
Robert Jenks bob@oregoncub.org
Citizens' Utility Board of Oregon
610 SW Broadway – Ste. 308
Portland, OR 97205

Melinda J. Davison mail@dvclaw.com
Matthew W. Perkins mwp@dvclaw.com
Davison Van Cleve PC
333 SW Taylor – Ste. 400
Portland, OR 97204

Daniel W. Meek
Attorney At Law
10949 SW 4th Ave.
Portland, OR 97219
dan@meek.net

Paul Graham paul.graham@state.or.us
Jason W. Jones Jason.w.jones@state.or.us
Department of Justice
Regulated Utility & Business Section
1162 Court St. NE
Salem, OR 97301-4096

Certificate of Service

Kelly Francone
Energy Strategies
215 South State St. – Ste. 200
Salt Lake City, UT 84111
kfrancone@energystrat.com

Michael Early
Industrial Customers of Northwest Utilities
333 SW Taylor Ste. 400
Portland, OR 97204
meearly@icnu.org

Andrea Fogue
League of Oregon Cities
PO Box 928
1201 Court St. NE Ste. 200
Salem, OR 97308
afogue@orcities.org

PacifiCorp
825 NE Multnomah, Ste. 800
Portland, OR 97232
Laura Beane laura.beane@pacificorp.com
Scott Bolton scott.Bolton@pacificorp.com
Blair Loftis blair.loftis@pacificorp.com
Christy Omohundro
christy.omohundro@pacificorp.com
Richard Peach
richard.peach@pacificorp.com

Paula E. Pyron
Northwest Industrial Gas Users
4113 Wolf Berry Court
Lake Oswego, OR 97035-1827
ppyron@nwigu.org

Benjamin Walters
City of Portland – Office of City Attorney
1221 SW 4th Ave. – Rm. 430
Portland, OR 97204
bwalters@ci.portland.or.us

Dan Pfeiffer
Idaho Public Utility Commission
472 West Washington St.
Boise, ID 83720
dan.pfeiffer@puc.idaho.gov

Linda K. Williams
Kafoury & McDougal
10266 SW Lancaster Rd.
Portland, OR 97219-6305
linda@lindawilliams.net

Midamerican Energy Holdings Company
Rick Tunning
Steve Evans srevans@midamerican.com
666 Grand Avenue
Des Moines, IA 50303
rrtunning@midamerican.com

Northwest Natural
220 NW 2nd Ave.
Portland, OR 97209
Gary Bauer
Gregg Kantor
Margaret D. Kirkpatrick
Elisa M. Larson
gary.bauer@nwnatural.com
gsk@nwnatural.com
margaret.kirkpatrick@nwnatural.com
elisa.larson@nwnatural.com

Ausey H. Robnett III
Paine, Hamblen, Coffin, Brooke &
Miller LLP
PO Box E
Coeur D'Alene, ID 83816-0328

Stoel Rives LLP
Katherine A. McDowell
Marcus A. Wood
900 SW Fifth Ave., Ste. 1600
Portland, OR 97204-1268
kamcdowell@stoel.com
mwood@stoel.com

Certificate of Service

Portland General Electric
Rates & Regulatory Affairs
121 SW Salmon St.
Portland, OR 97204

Randy Dahlgren

Pamela G. Lesh

Raul Madarang

Dave Robertson

Inara K. Scott

Bob Tamlyn

Douglas C. Tingey

Jay Tinker

randy.dahlgren@pgn.com

pamela.lesh@pgn.com

raul.madarang@pgn.com

dave.robertson@pgn.com

inara.scott@pgn.com

bob.tamlyn@pgn.com

doug.tingey@pgn.com

jay.tinker@pgn.com

Judy Johnson
Public Utility Commission
PO Box 2148
Salem, OR 97308-2148
judy.johnson@state.or.us

Kathryn Logan
Administrative Hearings Division
Public Utility Commission
PO Box 2148
Salem, OR 97308-2148
kathryn.logan@state.or.us

Ed Busch
Public Utility Commission of Oregon
PO Box 2148
Salem, OR 97308-2148
edbusch@state.or.us

Senator Rick Metsger
State Capitol
900 Court St. NE S-307
Salem, OR 97301
Sen.rickmetsger@state.or.us

Senator Vicki L. Walker
State Capitol
900 Court St. NE S-210
Salem, OR 97301
Sen.vickiwalker@state.or.us

Pacific Power & Light
825 NE Multnomah Ste. 2000
Portland, OR 97232
Larry O. Martin
Jan Mitchell
Paul Wrigley
larry.martin@pacificorp.com
jan.mitchell@pacificorp.com
paul.wrigley@pacificorp.com

I declare under penalty of perjury that the foregoing is true and correct.
Dated at Spokane, Washington this 11th day of April 2006.



Patty Olsness

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

In the Matter of the Adoption of Permanent)
Rules Implementing SB 408 Relating to)
Utility Taxes) AR 499

**STRAW PROPOSAL OF AVISTA CORPORATION
PROPERLY ATTRIBUTED**

Summary of Proposal

No attribution from non-Oregon regulated utility operations.

Taxes associated with non-regulated affiliate operations are grouped together.

Positive or negative tax liability of affiliate group determined.

If positive, no attribution to regulated utility operations is made.

If negative, adjustments made for deferred taxes.

Adjusted amount of negative non-regulated, affiliate group tax liability then allocated to all regulated operations.

Allocation to regulated utility operations based on each utility operation's proportionate share of the sum of the positive tax liabilities of all the regulated utility operations.

Adjust for tax impact of net cost changes since last rate case and regulatory disallowances.

Explanation of Proposal

The Attorney General's Opinion dated December 27, 2005 gives the Commission discretion to define and implement the term "properly attributed," subject to the general policy and specific limits expressed in chapter 845, Oregon Laws 2005, herein referred to as Senate Bill 408 (SB 408). Section (3)(12) of SB 408 requires that the "lesser of" the amount of taxes incurred as a result of income generated by Oregon regulated utility operations (Oregon stand-alone) or the total amount of taxes paid by the affiliated group is the amount properly attributed to Oregon regulated utility operations.

In the case of a company like Avista with utility operations in other jurisdictions, Oregon regulated utility operations cannot receive an attribution of tax benefits from regulated operations in other jurisdictions. To do so would cause a violation of IRS normalization rules. Also, no amount of positive taxes paid pertaining to regulated operations in other jurisdictions can be

assigned to Oregon utility operations. To do so would violate the “lesser of” provision of Section (3)(12).

Taxes associated with non-regulated affiliates, or a sub-group of non-regulated affiliates with a nexus to the utility, are reviewed to determine if the combined group or sub-group of non-regulated affiliates have a positive or negative tax liability. If the combined non-regulated affiliates have a positive tax liability, there is no attribution of such positive tax liability to the Oregon and non-Oregon regulated utility operations. To do so would violate the “lesser of” provision of Section (3)(12). In this instance the Oregon stand-alone amount is the amount that is properly attributed to Oregon regulated operations.

If the combined non-regulated affiliates have a negative tax liability, then the tax liabilities of the Oregon and non-Oregon regulated operations and the tax liabilities of the non-regulated affiliates within the group or nexus sub-group are adjusted for deferred income taxes. It is necessary to make adjustments for deferred income taxes before making attribution calculations since income tax liabilities for regulated utility operations may be negative before adjusting for deferred taxes. Negative regulated utility tax liabilities would primarily be caused by accelerated tax depreciation and deferred power or purchased gas costs. Also, adjusting for accelerated tax depreciation related deferred taxes eliminates any potential normalization violation. Deferred tax adjustments to non-regulated affiliate tax liabilities are necessary to reflect book/tax timing differences that reverse in subsequent periods. To not recognize those deferred tax adjustments could attribute tax benefits, but not attribute the corresponding tax costs in subsequent periods due to the one-way nature of the “lesser-of” provision of Section (3)(12). Once the adjustments for deferred taxes are made, the net negative tax liability of the non-regulated affiliate group is allocated to Oregon and non-Oregon regulated utility operations

based on their proportionate shares of the sum of the positive tax liabilities of the regulated utility operations.

Application of Proposal

	<u>Tax Return</u>	<u>Deferred Tax Adjustments</u>	<u>Adjusted</u>	<u>Attribution</u>	<u>Attributed</u>
Regulated Oregon Utility Operations	\$100	\$50	\$150	-\$83	\$67
Regulated Non-Oregon Utility Operations					
Utility Operation 1	-50	150	100	-56	44
Utility Operation 2	10	100	110	-61	49
Total Non-Oregon Utility Operations	-40	250	210	-117	93
Affiliate X	50	10	60	-60	0
Affiliate Y	-280	20	-260	260	0
Total Affiliates	-230	30	-200	200	0
Total Consolidated	-\$170	\$330	\$160	\$0	\$160

The example above shows how the proposal would work. The amounts are tax liability amounts. The first column shows amounts from the tax return. The second column shows adjustments for deferred taxes and the third column reflects the sum of the tax return amounts and the deferred tax adjustments. The fourth column labeled ‘Attribution’ shows how the -\$200 net negative tax liability of the non-regulated affiliate group is allocated to Oregon and non-Oregon regulated utility operations based on their proportionate shares of the sum of the positive tax liabilities of the regulated utility operations. The attribution to regulated Oregon utility operations is calculated as follows: $-\$200 \times \$150 / (\$150 + \$210) = -\$83$. The final column shows the result after attributing the -\$200 net negative tax liability of the non-regulated affiliate group to regulated Oregon and non-Oregon utility operations.

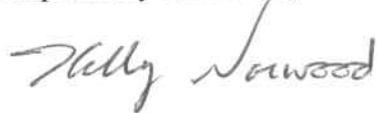
Net Cost Changes Since Last Rate Case and Regulatory Disallowances

As stated earlier, the Attorney General’s Opinion dated December 27, 2005 gives the Commission discretion to define and implement the term “properly attributed.” Avista believes

that it is within the discretion of the Commission to allow adjustments for the income tax impacts of net cost changes (revenues and expenses) since the last rate case and for regulatory disallowances. It is not fair to pass-through the income tax benefit of net costs incurred by the utility that are not borne by ratepayers. In the case of a disallowed utility cost, it is not fair to deny the utility the recovery of the cost and, in addition, require the utility to pass-through the tax benefit of the disallowed cost. Adjustments need to be made to the amount of taxes paid that are properly attributed to Oregon regulated utility operations to remove the taxes associated with net cost changes since the last rate case and for regulatory disallowances.

DATED: this 11th day of April 2006

Respectfully submitted,

A handwritten signature in cursive script, reading "Kelly Norwood".

Kelly Norwood
Vice President State and Federal Regulation

Avista Corporation
Oregon Senate Bill 408, ARR 499
Gross-Up and Iterative Effect

Gross-Up

The gross-up issue deals with whether or not to increase any SB 408 rate adjustment (surcharge or rebate) for the income tax impact of the rate adjustment. In a general rate case the amount of net operating income deficiency is grossed-up to a revenue requirement by dividing the net operating income deficiency by one minus the tax rate. For example, assuming a 40% tax rate and a net operating income deficiency of \$10,000, the revenue requirement would be calculated by dividing \$10,000 by $(1-.40)$, yielding a revenue requirement of \$16,667. Since the increased revenue of \$16,667 is taxable with the amount of tax being 40% times \$16,667, or \$6,667, the resulting amount of net operating income is \$10,000.

SB 408 requires that the difference between taxes collected and taxes paid be surcharged or rebated to customers. There is no mention of a gross-up. Applying a gross-up would result in a revenue adjustment that is greater than the difference between taxes collected and taxes paid. In the case of income taxes related to an affiliate that are determined to be properly attributed to Oregon utility operations, grossing-up those income taxes would, again, result in a rate adjustment in excess of what is called for under SB 408.

Conclusion: Surcharges or rebates to pass through differences between taxes collected and taxes paid under SB 408 should **not** be grossed-up. Not applying a gross-up results in a rate adjustment that is equal to the difference between taxes collected and taxes paid, which is what is required under SB 408. Applying a gross-up would result in a rate adjustment in excess of what is called for under SB 408.

Iterative Effect

The iterative effect occurs when the tax impact of a SB 408 surcharge or rebate is included in the calculation of a SB 408 rate adjustment. This iterative effect can occur whether a SB 408 surcharge or rebate is grossed-up, or not grossed-up. For example, assume that Oregon utility income taxes have increased by \$10,000. Assuming no other changes, there would be a \$10,000 SB 408 surcharge (not grossed-up) in a subsequent period. Assuming a 40% tax rate, the \$10,000 surcharge revenue would increase income taxes paid by \$4,000. The \$4,000 increase in income taxes paid would trigger a \$4,000 surcharge in a subsequent period. The \$4,000 surcharge would increase income taxes by \$1,600 ($\$4,000 \times 40\%$), which would then trigger a \$1,600 surcharge in a subsequent period, which would increase income taxes by \$640 ($\$1,600 \times 40\%$), and so on. If the iterative effect is allowed to occur, the cumulative rate adjustments amount to \$16,667 in this example, which is the same amount derived by grossing-up the assumed \$10,000 rate adjustment. As is the case with grossing-up a SB 408 rate adjustment, the iterative effect would result in rate adjustments in excess of what is called for under SB 408.

Conclusion: The iterative effect should **not** be allowed to occur. Not allowing the iterative effect to occur results in a rate adjustment that is equal to the difference between

taxes collected and taxes paid, which is what is required under SB 408. The iterative effect would result in multiple rate adjustments that exceed the original difference between taxes collected and taxes paid. The following section explains how the iterative effect is not allowed to occur through the use of deferred accounting and amortization.

Example Accounting Entries, No Gross-up, No Iterative Effect

Attached is a sheet showing accounting entries under two separate examples. In both examples there is an assumed 40% income tax rate, with an expense decrease of \$25,000 assumed in Example 1 and an expense increase of \$25,000 assumed in Example 2, resulting in income taxes going up \$10,000 in Example 1 and down \$10,000 in Example 2. All other things remaining the same, the \$10,000 increase in income taxes results in a \$10,000 surcharge in Example 1 and the \$10,000 decrease in income taxes results in a \$10,000 rebate in Example 2.

In both examples, deferred income taxes associated with the regulatory asset or liability are recorded in Year 1. The recording of deferred income taxes recognizes that the future surcharge or rebate will impact current income tax expense. When the surcharge or rebate occurs, an amortization of the regulatory asset or liability is recorded. Also, an amortization of the associated deferred income taxes is recorded.

Please refer to Example 1. In Year 3 a surcharge is implemented for \$10,000. Revenues increase by \$10,000 and current income tax expense increases by \$4,000. Deferred accounting amortization entries record an increase to expense (Account 407.3) of \$10,000 and a reduction to deferred income tax expense of \$4,000. The bottom-line impact on net income is zero. Revenues go up by \$10,000 and amortization expense goes up by \$10,000. Current income tax expense goes up by \$4,000 and deferred income tax expense goes down by \$4,000.

In Example 2 the concept is the same except that this example addresses a rebate rather than a surcharge. The bottom line impact on net income, again, is zero. Revenues go down by \$10,000 and amortization expense goes down by \$10,000. Current income tax expense goes down by \$4,000 and deferred income tax expense goes up by \$4,000.

The iterative effect does not occur when deferred taxes are recorded and amortized since the amortization offsets the income tax impact of the rate adjustment. Current and deferred income taxes related to the rate adjustment net to zero.

Avista Corporation
Example Accounting Entries Associated
With SB 408 Rate Adjustments

	<u>Example 1</u>	<u>Example 2</u>
Tax rate	40%	
Expense increase (decrease)	-\$25,000	\$25,000
Tax increase (decrease)	\$10,000	-\$10,000
Future revenue increase (decrease)	\$10,000	-\$10,000

EXAMPLE 1 ACCOUNTING ENTRIES**Year 1: Record Regulatory Asset or Liability**

	<u>Debit</u>	<u>Credit</u>
Account 182.3 Other Regulatory Assets - SB 408	10,000	
Account 407.4 Regulatory Credits - SB 408		10,000
Account 410.1 Deferred Income Tax Expense	4,000	
Account 283 Accumulated Deferred Income Taxes		4,000
To record regulatory asset associated with SB 408 surcharge to be made in Year 3 and to record associated deferred taxes.		

Year 2: File Year 1 Tax Report, Make True-ups to Year 1 Entries, Record Regulatory Asset or Liability for Year 2
(not shown)

Year 3: Implement Surcharge Related to Year 1, Amortize Deferrals Related to Year 1

Account 142 Customer Accounts Receivable	10,000	
Account 400 Operating Revenues		10,000
Account 409.1 Income Taxes Current	4,000	
Account 236 Taxes Accrued		4,000
Entries associated with implementation of surcharge related to Year 1.		

Account 407.3 Regulatory Debits - SB 408	10,000	
Account 182.3 Other Regulatory Assets - SB 408		10,000
Account 283 Accumulated Deferred Income Taxes	4,000	
Account 411.1 Deferred Income Tax Expense - Credit		4,000
Amortization of deferrals related to Year 1.		

EXAMPLE 2 ACCOUNTING ENTRIES**Year 1: Record Regulatory Asset or Liability**

	<u>Debit</u>	<u>Credit</u>
Account 407.3 Regulatory Debits - SB 408	10,000	
Account 254 Other Regulatory Liabilities - SB 408		10,000
Account 190 Accumulated Deferred Income Taxes	4,000	
Account 411.1 Deferred Income Tax Expense - Credit		4,000
To record regulatory liability associated with SB 408 rebate to be made in Year 3 and to record associated deferred taxes.		

Year 2: File Year 1 Tax Report, Make True-ups to Year 1 Entries, Record Regulatory Asset or Liability for Year 2
(not shown)

Year 3: Implement Rebate Related to Year 1, Amortize Deferrals Related to Year 1

Account 400 Operating Revenues	10,000	
Account 142 Customer Accounts Receivable		10,000
Account 236 Taxes Accrued	4,000	
Account 409.1 Income Taxes Current		4,000
Entries associated with implementation of rebate related to Year 1.		

Account 254 Other Regulatory Liabilities - SB 408	10,000	
Account 407.4 Regulatory Credits - SB 408		10,000
Account 410.1 Deferred Income Tax Expense	4,000	
Account 190 Accumulated Deferred Income Taxes		4,000
Amortization of deferrals related to Year 1.		