

**SUMMARY OF ICNU STRAW PROPOSAL
AR 499 WORKSHOP
MAY 31, 2006**

Properly Attributed

- Apply the "Proportionate Share" allocation methodology, within the limitations established in section 3(12), to allocate the total "taxes paid" among the utility and all other entities in the entire consolidated tax group.
- ICNU's "compromise" proposal is to apply the "Proportionate Share" allocation methodology to only a specific sub-group of the consolidated tax group.
 - The sub-group should include each affiliate that has a transactional "nexus" with the utility.
 - Affiliates with a nexus include affiliates that transact with the utility and parent companies or affiliates with debt supported by utility revenues.
 - Ultimately, determining the affiliates with a "nexus" with the utility will be a fact-specific decision based on the information provided by the utility. This will allow the Commission flexibility in implementing "properly attributed."

Taxes Collected

- The amount of "taxes authorized to be collected in rates" should be based on test year data that the Commission approved in setting rates. AG Opinion at 28.
- Taxes collected should not be adjusted to reflect the utility's actual costs except when the Commission adjusts a specific forecasted cost after the fact for the actual cost incurred and the utility does not earn a return on such costs.

Earnings Test

- Neither the plain language of SB 408 nor the intent behind the law contemplates an earnings test.
- An earnings test will result in the tax expense collected in rates serving as a financial buffer for utility earnings that are affected by a whole host of factors.

ICNU'S RESPONSE TO IOUS' ARGUMENTS
AR 499 WORKSHOP
MAY 31, 2006

IOUs' Argument^{1/}	ICNU Response
<ul style="list-style-type: none"> All parties agree that the "matching principle" should govern the "properly attributed" determination. 	<ul style="list-style-type: none"> ICNU disagrees. The "matching principle" is merely restating that utility taxes should be based on stand-alone principles. SB 408 explicitly changed this practice. SB 408 should be implemented to promote the customer interests that it protects.
<ul style="list-style-type: none"> Applying the "Proportionate Share" methodology will be difficult and administratively burdensome. 	<ul style="list-style-type: none"> Once the utility provides the relevant information, applying the "Proportionate Share" method should be relatively simple. The parent company and utility control the complexity of the structure of the consolidated tax group. SB 408 specifically gives the Commission access to all the information that is necessary to make this determination.
<ul style="list-style-type: none"> The "With and Without" Proposal is a compromise from the "Lesser Of" bookend. 	<ul style="list-style-type: none"> The "With and Without" proposal generally reaches the same result as the "Lesser Of" proposal—the amount "properly attributed" to the utility will be the maximum amount in section 3(12) unless there is a net consolidated loss.
<ul style="list-style-type: none"> SB 408 was intended to fix only the "Enron problem." 	<ul style="list-style-type: none"> SB 408 addresses more than just the Enron problem; otherwise, the bill would have been much simpler. The discrepancy between "taxes collected" and taxes paid in the past is the result of many different issues that are addressed through the automatic adjustment clause.
<ul style="list-style-type: none"> An earnings test is necessary to ensure that SB 408 rate adjustments result in fair, just, and reasonable rates. 	<ul style="list-style-type: none"> SB 408 does not contemplate an earnings test. Excluding from rates amounts for taxes that are not paid to government does not result in rates that are unjust or unreasonable.

^{1/} For purposes of simplicity, ICNU has grouped all of the IOUs together, but ICNU recognizes that the IOUs have slightly different positions on certain issues.

Summary of the ICNU Proposal for Determining Properly Attributed ICNU Discussion Paper for May 31, 2006 AR 499 Workshop

SB 408 requires the Commission to determine the portion of the consolidated "taxes paid" to units of government that is "properly attributed to the regulated operations of the utility." The Commission rules implementing SB 408 should reflect both a legally correct interpretation and sound policy that effectuates the legislature's intent. ICNU continues to believe that the Commission's temporary rule applied the correct legal and appropriate policy interpretation of "properly attributed" by allocating to the utility and each affiliate a proportionate share of "taxes paid" in a consistent manner.

Under SB 408 and consistent with sound public policy, the amount of the consolidated tax payment properly attributed to the utility is the lowest of the following three amounts:

1. The Section 3(12)(a) Cap Amount

Section 3(12)(a) provides that the portion of taxes paid properly attributed to the utility cannot exceed "that portion of total taxes paid that is incurred as a result of income generated by the regulated operations of the utility." "Taxes paid" is defined as the consolidated tax payment, and thus, includes tax liabilities whether they are incurred by the utility or another affiliate so long as the tax liability is incurred, directly or indirectly, as a result of regulated income. The Commission must determine the amount of taxes paid by the parent of the consolidated group that is supported by income collected by the utility from ratepayers. The primary example of a tax liability incurred by an affiliate but supported by utility income is a ScottishPower/PHI arrangement. Affiliate debt is incurred and supported by utility income if it has no other financial means of support. An example is if the affiliate has debt with an interest cost of \$100 million but the affiliate does not have sufficient income from its own operations to support the debt. Instead, the interest payment is dependent on income from its subsidiary utility. The tax benefit of the interest expense must be attributed, in whole or in part, to the utility for the benefit of ratepayers. In the case of a parent with multiple subsidiaries supporting the parent's debt, the interest deduction should be allocated based on the net income of all the subsidiaries of the parent.

2. The Section 3(12)(b) Cap Amount

Section 3(12)(b) provides that the portion of the consolidated tax payment properly attributed to the utility may not exceed the amount of taxes actually paid by the "parent of the consolidated group" filing the tax return. This amount is readily determined from the parent company's federal and state tax filings. If the parent of the consolidated group pays little or no tax due to losses incurred in unregulated businesses, then the portion of taxes paid properly attributed to the utility cannot exceed this amount.

While Section 3(12)(b) addresses the "Enron problem," it also stands for the general legislative principle rejecting the calculation of a utility's tax expense to be recovered in rates on a hypothetical "stand-alone" basis. Instead, losses incurred by unregulated affiliates

must be considered by the Commission in determining the amount of taxes paid that are properly attributed to the utility.

3. Allocation of Taxes Paid under Sections 3(6) and (7)

Under §3(12), the amount of the consolidated tax payment that is properly attributed to the utility cannot exceed the lower of the §3(12)(a) cap or the §3(12)(b) cap. Under the Attorney General's opinion, the Commission has the discretion to allocate to the utility a lower amount of the consolidated tax payment and, thereby, provide that the utility is entitled to recover from ratepayers only this lower amount as its tax expense. The question for the Commission is whether it exercises this discretion and, if so, how. We believe failure to exercise this discretion would be contrary to legislative intent.

To be clear, first, if the Commission declines to exercise its discretion, then the tax expense recovered from ratepayers will be the maximum allowed by the two caps. Second, PacifiCorp's "lesser-of" and "with and without" proposals do not provide for any adjustment to the amount of taxes paid properly attributed to regulated operations beyond the §§3(12)(a) and (b) caps. Only the Temporary Rule and the compromise proposals of ICNU/NWIGU and CUB offer any avenue for the Commission to exercise its discretion.

Sections 3(6) and (7) require the consolidated taxes payment to be allocated among the utility and each affiliate in a manner that treats the utility and each affiliate consistently. This is achieved by a proportionate share methodology applied to the entire corporate family, as set forth in the temporary rule. Contrary to some parties' suggestions, this amount can be readily determined from the tax reports, even for complicated corporate structures. If "ease of implementation" is a critical concern, then the proportionate share methodology meets this concern.

As a compromise, ICNU and NWIGU proposed to determine taxes paid properly attributed to the utility by applying the proportionate share method to a sub-group of the corporate family. Given the IOUs' steadfast refusal to offer any compromise beyond the cap amounts, we are reluctant to continue our support for any compromise. Nonetheless, because we understand the Commission is interested in alternatives, we offer a brief version of the compromise. The sub-group is determined as follows:

- a) All affiliates that have a nexus with the utility are included in the sub-group. A nexus is established between the utility and:
 - i. All affiliates that buy or sell services or products to the utility, directly or indirectly, with the following exceptions:
 - Total annual value of the affiliated transaction is less than \$100,000.
 - The service or product sold by the affiliate is purchased by the utility at a price subject to rate regulation by FERC (not a market-based rate), the

- price is regulated, and the service and price is generally available (not a special contract or a tariff of limited applicability).
 - Service agreements that are subject to a cap approved by the OPUC.
- ii. The immediate parent of the utility and all affiliates that have debt supported by utility revenues, directly or indirectly.
- b) All affiliates upstream from the utility and all affiliates identified in subpart (a) up to and including the common parent of the utility and such affiliates.

The method for determining the amount of taxes paid properly attributed to the utility is as follows:

ICNU's Principles

ICNU identified six principles, consistent with the statute and sound policy, to develop its proposal.

Principle 1. The utility's income tax expense to be recovered from ratepayers may not exceed the total consolidated tax payment.

This Principle simply states the §3(12)(b) cap and is captured in Section 1 of the ICNU Proposal.

Principle 2. Tax benefits supported by utility income belong to ratepayers.

Section 3(12)(a) recognizes that the "stand-alone" tax liability of the utility within a holding company is only a hypothetical number. There are opportunities for financial arrangements within the holding company that benefit the parent company and result in a tax deduction to an affiliate for debt held by the affiliate when the debt is incurred due to and supported by utility income. Thus, the §3(12)(a) cap captures all of the consolidated tax payment that is incurred as a result of utility income whether incurred by the utility or an affiliate and is not limited to a "stand-alone" type calculation. Principle 2 simply states the §3(12)(a) cap, as it applies to affiliate debt. Section 2 of the ICNU proposal captures this Principle.

Principle 3. In determining the utility income tax expense to be borne by customers, the OPUC must allocate to the Oregon utility some portion of the tax losses of unregulated businesses within the consolidated tax group.

This Principle states that the Legislature intended the Commission to exercise its discretion beyond the §§3(12) caps. Otherwise, the Legislature would have made SB 408 more

simple by defining the amount of taxes paid that is properly attributed as the §3(12) caps. The Legislature intended the Commission to consider affiliate tax losses that reduced the consolidated tax payment, even when the consolidated tax payment did not create an Enron-type problem.

Principle 4. Ratepayers are not first in line to pay the consolidated income tax, and should pay only their proportionate share of each dollar of the consolidated income tax.

Principle 3 provides that the Commission should exercise its discretion and Principle 4 determines how the Commission should exercise that discretion. SB 408 is a pro-ratepayer bill and the Legislature did not intend that ratepayers should pay first. Principle 4 provides that each actual dollar of the consolidated payment is divided proportionately among all affiliates with positive income.

Principle 5. The rules and principles should be implemented flexibly to reflect substance over form.

This Principle recognizes that the holding company structure and transactions may change over time and may well change in an attempt to circumvent SB 408 and the Commission rules. The rules must be sufficiently flexible to respond to such changes.

Principle 6. Implementation of the rules and principles will be fact-specific.

A fact-specific inquiry is unavoidable if the Commission is to do the job that the Legislature has charged them with. However, it is neither insurmountable nor should it drive policy decision. The proportionate share methodology in the Temporary Rule, while fact-specific, can be implemented without imposing an unreasonable burden on the Commission, Commission Staff or the utilities.