

**BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON**

UE 178

In the Matter of

OREGON PUBLIC UTILITY COMMISSION
STAFF

Requesting the Commission Direct
PORTLAND GENERAL ELECTRIC
COMPANY

To file tariffs establishing automatic
adjustment clauses under the terms of SB 408

**PORTLAND GENERAL ELECTRIC
COMPANY'S OPENING BRIEF**

I. INTRODUCTION

Portland General Electric Company ("PGE") has now filed its 2006 tax report pursuant to SB 408. Based on the tax report, PGE is expected to refund \$37.2 million to customers in connection with tax-year 2006. Staff, PGE, the Citizens' Utility Board of Oregon, and the Industrial Customers of Northwest Utilities have stipulated to the accuracy of the \$37.2 million calculation under the applicable Commission rule (OAR 860-22-0041), subject to the resolution of certain constitutional challenges, and no party objected to the stipulation. *See* Stipulation, UE 178, filed February 1, 2008 ("Stipulation") at 2-3; Joint Stipulating Parties/200, Owings-Ball-Tinker-Blumenthal-Jenks/2-4. PGE maintains that it is unconstitutional for the Commission to include in the refund amount \$4.9 million associated with PGE's loss on the sale of an unregulated asset in 2006. Due to the unique timing of the purchase and sale of that asset, PGE's shareholders have borne the entire risk of the investment but will now be deprived of a principal benefit of the investment—the income tax savings from the sale. This brief presents PGE's constitutional arguments.

This brief also addresses a second unresolved issue, which is whether the refund should be amortized over two years. Stipulation at 2 ¶ 3; Joint Stipulating

Parties/200, Owings-Ball-Tinker-Blumenthal-Jenks/4. PGE will be making a substantial refund to customers for tax-year 2006—either \$32.3 million or \$37.2 million depending on the outcome of the constitutional challenges. Whichever amount is ultimately held lawful, PGE requests that the Commission amortize the refund over two years. PGE anticipates a surcharge pursuant to SB 408 for tax-year 2007, so amortization of the refund for tax-year 2006 over two years will significantly smooth the rate impact of the two SB 408 adjustments and permit the 2006 refund to offset the 2007 surcharge.

II. THE \$4.9 MILLION TAX BENEFIT ASSOCIATED WITH THE TURBINE SHOULD NOT BE INCLUDED IN THE REFUND FOR 2006

A. Factual Background

In 2001, PGE entered into a contract to purchase an LM 6000 Gas Turbine Generator and associated transformer ("Turbine")¹ for a proposed Port of Morrow gas generating project. Order No. 07-421 at 2.² PGE ultimately decided not to proceed with the Port of Morrow project, due to a decrease in wholesale electricity prices, but did complete the acquisition of the Turbine. *Id.* PGE paid \$16.8 million for the turbine and \$414,800 for the transformer. *Id.*

Since the Turbine is an unregulated asset, PGE's customers did not pay for it. Instead, PGE used shareholder equity to purchase the Turbine. *Id.* PGE transferred the turbine to Portland General Resource Group, Inc. ("PGRD"), a non-regulated PGE subsidiary created for the purpose of owning it, and retained the transformer. *Id.* All costs associated with the Turbine were recorded in non-utility accounts. PGE's customers were never at risk of paying for the Turbine, nor were they ever at risk of incurring any tax liabilities associated

¹ The term "Turbine" is used herein to refer collectively to the turbine and the transformer.

² The Commission issued Order No. 07-421 on September 26, 2007, in UM 1271, another proceeding related to the Turbine. The facts were undisputed in UM 1271, and the Commission has taken official notice of Order No. 07-421 in this proceeding. *See* Ruling, "Motion to Take Official Notice Granted," UE 178 (November 8, 2007).

with the Turbine, since the Commission sets PGE's rates based on its operations as a stand-alone utility. *Id.*

In 2006, PGRD sold the turbine for \$6.1 million, resulting in a \$12 million tax loss. *Id.* PGE sold the transformer at the same time, resulting in an additional tax loss of approximately \$300,000. *Id.* The combined tax loss of \$12.3 million in connection with the sale of the Turbine decreased PGE's consolidated 2006 income tax liability by \$4.9 million. *Id.* at 3.

Coincidentally, the year PGE sold the Turbine, 2006, was also the first year for which PGE was required to issue a tax-related refund or surcharge to customers pursuant to SB 408. SB 408 was enacted in 2005, shortly before the Turbine was sold. Under SB 408 and its implementing rules, the tax benefit from the Turbine loss will be passed on to customers even though it is an unregulated asset for which the customers bore no risk. SB 408 compares "taxes paid" with "taxes collected" and refunds or surcharges customers for the difference. ORS 757.268(4). As the Commission has defined it, "taxes collected" is based on the utility's actual revenue and certain ratios established in the utility's most recent rate case. OAR 860-22-0041(2)(q). "Taxes paid," on the other hand, is based on actual tax payments to governmental entities. ORS 757.268(13)(f). By reducing PGE's taxable income, the loss on the sale of the Turbine reduces PGE's "taxes paid" for 2006 by \$4.9 million, while leaving the "taxes collected" side of the equation unaffected. Thus, under the Commission's current SB 408 rules, customers will receive the full \$4.9 million tax benefit of the Turbine loss, while the shareholders who paid for the Turbine receive nothing.

Seeking to avoid what it considers an unlawful impact of SB 408, PGE filed a deferred accounting application in UM 1271 on July 14, 2006, asking the Commission to either defer the \$4.9 million refund related to the Turbine or defer the underlying tax effect from the sale of the Turbine. The Commission denied the application. Order No. 07-421. In

its order, the Commission recognized the constitutional issues raised by PGE but concluded that those issues were premature for determination. *See id.* at 7-8. The Commission noted that PGE would be able to raise its constitutional concerns in the 2006 tax report docket, once PGE knew the actual impact of the Turbine on its 2006 tax liability. *See id.* at 8.

PGE has now filed its 2006 tax report and confirmed that, as expected, the loss on the sale of the Turbine has resulted in a \$4.9 million tax benefit. Stipulation at 3. PGE believes that taking this tax benefit from PGE's shareholders (who paid for the Turbine and bore all its risks) and transferring it to PGE's customers (who have been completely insulated from the costs and risks of the Turbine) violates both state and federal constitutional principles.

B. Appropriating the \$4.9 million Tax Benefit Constitutes an Unconstitutional Taking

Both the United States Constitution and the Oregon Constitution prohibit the taking of property without just compensation. *See* United States Constitution, Amendments V, XIV; Oregon Constitution, Art. I, § 18. Shielding PGE's customers from the costs and risks of the Turbine investment, while giving them the full tax benefit from the loss on the Turbine sale, violates the "benefits follows burden" principle and results in an unconstitutional taking.

The Department of Justice ("DOJ") recognized the necessity of matching benefits and burdens in several memoranda issued in 2005, the year SB 408 was enacted. For example, a March 2005 memorandum to Senators Ryan Deckert and Rick Metsger states:

Tax benefits from consolidation can be included in the utility's rates only to the extent customers are responsible for the deductible expenses that produced the benefits. The tax effect of losses in one of the parent's other operations could not be included in setting the utility's rates if customers don't have to pay any of the costs that contributed to the losses.

DOJ Memorandum, "Recommendation on Treatment of Utility Income Taxes," at 3

(March 22, 2005). *See also* DOJ Memorandum to Commissioners Baum, Beyer and Savage, "Legality of Setting Utility Rates Based Upon the Tax Liability of Its Parent," at 1 (February 18, 2005) ("Taking into account the 'benefits and burdens' of its policy means the benefits of consolidated tax savings are given to ratepayers (by reducing the utility's tax allowance) if the customers bore the burden of paying the deductible expenses that generated the savings. If the Commission matches the benefits and burdens in some rational manner, I conclude that the Commission's choice would meet legal requirements.").

When the Utility Reform Project ("URP") challenged the DOJ's legal concerns, the DOJ stood by its position and explained why the URP was incorrect. *See* Department of Justice Memorandum to Commissioners Baum, Beyer and Savage, "Reply to the Utility Reform Project's Comments on Tax Treatment in Utility Ratemaking," at 4 (March 22, 2005) ("it is clear that regulators have discretion to use different methods of calculating tax allowances, but it is also true that whichever method is chosen it should be applied in a way that matches benefits and burdens") (emphasis in original).

Regulatory commissions throughout the country have also recognized the importance of matching benefits and burdens in utility ratemaking. *See Washington Utils. & Transp. Comm'n v. PacifiCorp*, 2006 WL 1517095 *50 (Wash UTC) ("If the risks and costs of activities at the parent-level are borne exclusively by shareholders—because customers are insulated from them by [a] ring fence—then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities."); *Iowa Elec. Light & Power Co.*, 135 Pub Util Rep 4th (PUR) 522, 527 (Iowa Utils Bd 1992) ("The affiliates' financial losses which create the tax savings exist only because of the investment and expenses borne by stockholders. It is clear the losses which created the tax savings belong to the affiliates.").

PGE shareholders who assumed the risk that the Turbine might not be financially successful did so with the understanding that, if that investment ultimately did result in a loss, then the actual cost to shareholders would be mitigated by benefits available under federal tax law. These tax benefits equate to \$4.9 million in cash. That is \$4.9 million of cash that PGE and its shareholders are entitled to as the ones who bore the cost and risk of the investment.

If the Commission now seizes the \$4.9 million from PGE's shareholders and transfers it to the public as part of the SB 408 refund for 2006, PGE's property will have been taken by the State without just compensation. See *Phillips v. Washington Legal Found.*, 524 US 156, 160 (1998) (money and interest from fund of money can be protected under the Takings Clause); *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 US 155, 164-65 (1980) (constitutional prohibition against taking property without just compensation applies to monetary interest from identifiable fund of money); *GTE Northwest, Inc. v. Public Util. Comm'n of Oregon*, 321 Or 458, 900 P2d 495, 164 PUR 4th 392 (1995) (en banc) (PUC rules requiring co-location of competitors' equipment on property owned by utility constituted an unconstitutional taking).

C. Applying SB 408 to the Turbine Tax Benefit in this Unique Circumstance Is an Arbitrary and Opportunistic Change in Regulation

Including the \$4.9 million tax benefit from the Turbine loss in PGE's SB 408 refund for 2006 also amounts to an arbitrary and opportunistic change in regulation. As the United States Supreme Court explained in *Duquesne Light*, "a State's decision to arbitrarily switch back and forth between methodologies in a way which require[s] investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional concerns." 488 US at 315 (emphasis added). In other words, utility regulation must be appropriately symmetrical. See also DOJ Memorandum to Senators Deckert and Metsger (March 22, 2005), *supra*, at 3 ("If the

Commission includes the effects of consolidation in utility rates when they produce a benefit, it cannot omit those effects when they happen to increase customer rates.").

SB 408, in particular section 12 codified at ORS 757.268(12), does exactly what the United States Supreme Court says raises "serious constitutional concerns." *Duquesne Light*, 488 US at 315. It forces the Commission to arbitrarily switch back and forth in how it apportions tax effects, depending on whether the unregulated asset is sold for a loss or sold for a profit. Tax effects that prove beneficial at a consolidated level go entirely to the public, while tax effects that prove detrimental at a consolidated level are borne entirely by PGE and its shareholders.

PGE made the Turbine investment before SB 408 was enacted or even contemplated, resulting in an unexpected disruption in the benefit-burden relationship. The warning in *Duquesne* is clear and sets forth a constitutional principle against which legislative and administrative decisions must be tested. Taking the entire \$4.9 million tax benefit of the Turbine away from the shareholders who paid for the Turbine, and giving it to customers who did not bear any corresponding risk for the Turbine, has an arbitrary impact on shareholders and creates a windfall to customers. This is an additional reason SB 408 is unconstitutional, in particular as applied to the Turbine loss.

D. Federal Tax Law Preempts State Law in This Circumstance

The State of Oregon's appropriation of the federal tax benefits associated with the Turbine also violates the Supremacy Clause of the federal constitution. Federal law preempts state law when application of state law "would disturb, interfere with, or seriously compromise the purposes of the federal statutory scheme. In other words, an application of state law that would frustrate the purpose of a federal statutory scheme is preempted." *City of Morgan City v. South Louisiana Elec. Coop. Assoc.*, 31 F3d 319, 322 (5th Cir 1994). Preemption occurs even if the state law does not directly conflict with federal law such that

compliance with both would be impossible. *See id.* The question is whether the state law disturbs, interferes with, or seriously compromises the federal law.

That is the case here. Pursuant to federal tax law, PGE is entitled to use its PGRD losses (and its losses from the sale of the transformer) to offset PGE income and thereby significantly reduce the actual financial impact of those losses on the company and its shareholders. *See* 26 USC §§ 1501 to 1563. This is an affirmative benefit that Congress has provided to companies that file consolidated federal tax returns. Applying SB 408 to include the \$4.9 million tax benefit from the sale of the Turbine would deprive PGE and its shareholders of that federal tax benefit. It would force PGE and its shareholders to bear the entire loss related to the Turbine, essentially nullifying the federal tax benefits to which they are entitled.

E. The Commission Should Not Rely on Cases That Lack Constitutional Relevance

PGE recognizes that there is little to no caselaw applying Oregon and federal constitutional principles to a situation such as this one. That is hardly surprising—SB 408 is a new and unique statute, and this is the first time it has been constitutionally tested.

However, it is beyond dispute that SB 408 cannot and should not be applied in a manner that violates the state or federal constitutions, and the Commission should resist the temptation to rely on cases that do not involve constitutional challenges as authority to reject PGE's constitutional challenges in this case.

PGE previously raised its constitutional concerns regarding the application of SB 408 to the Turbine loss in UM 1271. Several parties argued in response that various courts have already rejected similar arguments, including the U.S. Supreme Court. PGE maintains that such assertion is inaccurate, and that the cases on which the other parties relied are inapt because they did not involve constitutional challenges. *See, e.g., Federal Power Comm'n v. United Gas Pipe Line Co.*, 386 US 237, 246 (1967) (only question was whether

the agency had violated its statutory authority by adopting the flow-through method); *BP West Coast Prods., LLC v. FERC*, 374 F3d 1263 (DC Cir 2003) (no discussion of constitutional issues); *City of Charlottesville v. FERC*, 774 F2d 1205 (DC Cir 1985) (court rejected challenge to the stand-alone method, providing no opportunity for court to evaluate constitutionality of the flow-through method).³ PGE is unaware of any federal or state statute comparable to SB 408 that has been challenged on constitutional grounds and held constitutional.

F. Conclusion Regarding \$4.9 million Turbine Tax Benefit

For all of the foregoing reasons, it would be unconstitutional for the Commission to include the \$4.9 million tax benefit related to the sale of the Turbine in PGE's SB 408 refund for 2006. The Commission should exclude such amount from the calculation and order a refund to customers in the amount of \$32.3 million for tax-year 2006.

III. THE COMMISSION SHOULD AMORTIZE THE REFUND FOR 2006 OVER TWO YEARS

PGE requests that the adjustment amount determined in this proceeding be refunded to customers over a two-year period. Spreading the refund over two years will mitigate the rate volatility of the SB 408 adjustments over the next two years. The \$32.3 or \$37.2 million refund for tax-year 2006 will be followed by an expected surcharge of approximately \$16 million for tax-year 2007, which will be surcharged beginning on June 1, 2009. If PGE's proposal is not adopted and instead the 2006 refund is returned over one year, customers will experience a rate increase on June 1, 2009, totaling about \$48.3 or \$53.2 million, all else being equal. Application of a two-year refunding period will smooth the rate impact of the rate adjustment this year and mitigate rate volatility next year by

³ See also *Greeley Gas Co. v. State Corp. Comm'n of State of Kansas*, 807 P3d 167 (Kan App 1991) (no discussion of constitutional issues); *City of Muncie v. Public Serv. Comm'n of Indiana*, 378 NE2d 896 (Ind App 1978) (same); *Central Power & Light Co. v. Public Util. Comm'n of Texas*, 36 SW3d 547 (Tex App 2000) (same); *In Re New Jersey Nat'l Gas Co.*, 1991 WL 501940, 128 PUR4th 199 (NJ Board of Reg. Comm'rs 1991) (same).

permitting an offset of SB 408 refunds and surcharges for tax-years 2006 and 2007.

Applying a two-year refund period will not diminish the refund benefit because interest will continue to accrue on the SB 408 outstanding balance.

IV. CONCLUSION

For the foregoing reasons, with respect to tax-year 2006, the Commission should refund \$32.3 million to PGE's customers over a two-year period commencing June 1, 2008.

DATED this 3rd day of March, 2008.

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CERTIFICATE OF SERVICE

I hereby certify that on this day I served the foregoing **PORTLAND GENERAL ELECTRIC COMPANY'S OPENING BRIEF** by e-mail and/or mailing a copy thereof, to each party that has not waived paper service, in a sealed, first-class postage prepaid envelope, addressed to each party listed below and depositing in the US mail at Portland, Oregon.

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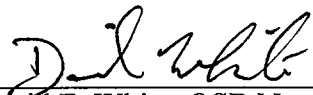
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