BEFORE THE OREGON PUBLIC UTILITIES COMMISSION

UM 1271

In the Matter of the Application of Portland General Electric Co. for an Order Approving the Deferral of Certain Expenses/revenue Refunds Associated with SB 408.	**REPLY BRIEF OF UTILITY REFORM PROJECT, KEN LEWIS, AND NANCY NEWELL**

I. LIMITING TO ACTUAL TAXES PAID THE AMOUNT A UTILITY CAN CHARGE TO RATEPAYERS FOR A UTILITY'S "INCOME TAXES" IS NOT AN UNCONSTITUTIONAL TAKING OR CONFISCATION.

The PGE Opening Brief (pp. 12-14) contends that not allowing PGE to charge to ratepayers amounts for income taxes that the utility is not actually paying to government somehow impairs its constitutional rights, citing ***FPC v. Hope Natural Gas Co.***, 320 US 591, 602 (1944).

This contention has already been definitively rejected by no less an authority than the United States Supreme Court and Judge John Roberts (now Chief Justice). In ***BP West Coast Products v. FERC***, 374 F3d 1263 (DC Cir 2003), *rehearing en banc denied* (2004), *certiorari denied* 544 US 1043 (2005), the U.S. Circuit Court for the District of Columbia (which reviews actions by federal agencies) struck down FERC's attempt to allow a gas pipeline to include in rates the cost of income taxes that were not actually paid. The opinion was authored by Judges John Roberts, David Sentelle, and Judith Rogers.

The same court had previously concluded that both the "actual taxes paid" methods (embodied in SB 408) and the "stand-alone" method are legally acceptable. See ***City of Charlottesville v. FERC***, 774 F2d 1205, 1217 (DC Cir 1985), which the utilities have touted as having been authored by then-Judge Scalia. ***BP West Coast Products*** was issued 15 years later by the same court in a decision The U.S. Supreme Court declined to review.

The ***BP West*** decision struck down a FERC order allowing a pipeline to include "income taxes" in its rates when in fact the pipeline was not paying income taxes.

> We further conclude that the shipper petitioners offer a convincing analysis consistent with ratemaking principles and governing law, and that on the record before us SFPP is entitled to no allowance for the phantom income taxes it did not pay.
>
> . . .
>
> The ALJ correctly derived from *Hope Natural Gas* the more specific principle that the regulating commission is to set rates in such a fashion that the regulated entity yields returns for its investors commensurate with returns expected from an enterprise of like risks. Were the corporate unit holders investing in a non-regulated entity of like risk and otherwise similar return, they would of course expect to pay their own corporate tax on any profit they might realize from that investment. Should that profit generate dividends from the corporations, the shareholders would expect to pay their own taxes on such dividends. Likewise, individual investors in such a non-regulated enterprise would expect to pay their individual taxes thereon. Granted, the second group of investors would pay one level of taxation; the first group, at least potentially, two layers of taxation. This is a product of the corporate form, not of the regulated or unregulated nature of the pipeline or any comparable investment or of the risks involved therein. Therefore, consistent with *Hope Natural Gas,* the ALJ correctly concluded that where there is no tax generated by the regulated entity, either standing alone or as part of a consolidated corporate group, the regulator cannot create a phantom tax in order to create an allowance to pass through to the rate payer. The Commission erred when it rejected the ALJ's conclusion.

> As we have recited repeatedly above, and as the Commission itself has recognized in this very proceeding, under cost-of-service principles, a regulated company is entitled to a rate design to yield sufficient revenue to cover its appropriate cost; income tax allowance is no different from the allowance of any other costs. The regulated pipeline generates many costs, for example bookkeeping expenses. Presumably those bookkeeping expenses are recoverable in its rates. Its corporate unit holders, if any, presumably also have bookkeeping expenses. The bookkeeping expenses of the corporate unit holders are not recoverable in the rates of the pipeline, even though the corporation and its shareholders each may independently be paying bookkeepers and accountants unlike individual unit holders who pay only for their own accounting. All of this makes sense. It makes equal sense when applied to income taxes.
>
> . . .
>
> Nothing in the *City of Charlottesville* opinion suggests that it is the business of the Commission to create tax liability when neither an actual nor estimated tax is ever going to be paid or incurred on the income of the utility in the ratemaking proceeding.

Id., 374 F.3d at 1288, 1290-91, 1292.

Earlier in ***Federal Power Commission v. United Gas Pipe Line Company et al.***, 386 US 237, 87 SCt 1003, 18 LEd2d 18 (1967), the Court ruled proper action by the Federal Power Commission to allow in rates only income taxes actually paid by the utility.

> In our view what the Commission did here did not exceed the powers granted to it by Congress. One of its statutory duties is to determine just and reasonable rates which will be sufficient to permit the company to recover its costs of service and a reasonable return on its investment. Cost of service is therefore a major focus of inquiry. Normally included as a cost of service is a proper allowance for taxes, including federal income taxes. The determination of this allowance, as a general proposition, is obviously within the jurisdiction of the Commission. Ratemaking is, of course subject to the rule that the income and expense of unregulated and regulated activities should be segregated. But there is no suggestion in these cases that in arriving at the net taxable income of United the Commission violated this rule. Nor did it in our view in determining the tax allowance. United

had not filed its own separate tax return. Instead it had joined with others in the filing of a consolidated return which resulted in the affiliated group's paying a lower total tax than would have been due had the affiliates filed on a separate-return basis. The question for the Commission was what portion of the single consolidated tax liability belonged to United. Other members of the group should not be required to pay any part of United's tax, but neither should United pay the tax of others. A proper allocation had to be made by the Commission. Respondents insist that in making the allocation the Commission would violate the statute unless in every conceivable circumstance, including this one, United is allowed an amount for taxes equal to what it would have paid had it filed a separate return. In their view United should never share in the tax savings inherent in a consolidated return, even if on a consolidated basis system losses exceed system gains and neither the affiliated group nor any member in it has any tax liability. This is an untenable position and we reject it. **Rates fixed on this basis would give the pipeline company and its stockholders not only the fair return to which they are entitled but also the full amount of an expense never in fact incurred. In such circumstances, the Commission could properly disallow the hypothetical tax expense and hold that rates based on such an unreal cost of service would not be just and reasonable.**

It is true that the avoidance of tax and the reduction of the tax allowance are accomplished only by applying losses of unregulated companies to the income of the regulated entity. But the Commission is not responsible for the use of consolidated returns. It is the tax law which permits an election by an appropriate group to file on a consolidated basis. The members of a group, as in these cases, themselves chose not to file separate returns and hence, for tax purposes, to mingle profits and losses of both regulated and unregulated concerns, apparently deeming it more desirable to attempt to turn the losses of some companies into immediate cash through tax savings rather than to count on the loss companies themselves having future profits against which prior losses could be applied. **Such a private decision made by the affiliates, including the regulated member, has the practical and intended consequence of reducing the group's federal income taxes, perhaps to zero, as was true of one of the years involved in the *Cities Service* case. But when the out-of-pocket tax cost of the regulated affiliate is reduced, there is an immediate confrontation with the ratemaking principle that limits cost of service to expenses actually incurred. Nothing in *Colorado Interstate* or *Panhandle* forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the**

contrary, both cases support the power and the duty of the Commission to limit cost of service to real expenses.

386 US at 243-44 (emphasis added). Thus, the highest court in the nation has upheld a regulator's decision to "limit cost of service to real expenses" by recognizing the fact that the utility was not actually paying the full amount of income taxes claimed in the rate case. The notion that such a limit would be unconstitutional is so far-fetched that the Court did not address it at all.

This proposition is so unexceptional that it appears in a bland legal encyclopedia, CORPUS JURIS SECUNDUM in its Public Utilities topic (updated October 2004):

> Public Utilities
>
> IV. Rates and Rate Making
> C. Reasonableness of Rates; Fair Return
> 2. Sufficiency of Rate of Return
> b. Operating Expenses
> (2). Taxes Paid by Utility
>
> Rate-making authorities may consider the income tax consequences of a subsidiary corporation's dealings with its parent company. [FN1] Thus, where a utility and its parent corporation file a consolidated return for federal income tax purposes, the portion of the tax to be allowed in fixing rates for the subsidiary utility company is for the rate making authorities to determine. [FN2]
>
> A public utility regulatory commission's discretion on the proper method for calculating a utility's tax savings, by virtue of the utility's participation in a consolidated tax return by its parent corporation, is limited. [FN3] Not only must all tax savings resulting from consolidation be recognized in ratemaking, but the only proper tax expense which a utility may pass on to its customers is its proportionate share, after the consolidated return is filed and the actual tax is paid. [FN4] It is not an abuse of the regulatory commission's discretion in the allocation of a federal income tax expense to a utility company on the basis of an average rate taken from a consolidated tax return of the utility company's parent company. [FN5]

[FN1]. N.Y.-- ***Long Island Water Corp. v. Public Service Commission***, 49 A.D.2d 392, 374 N.Y.S.2d 841 (3d Dep't 1975).

[FN2]. Pa.-- ***Western Pennsylvania Water Co. v. Pennsylvania Public Utility Commission***, 54 Pa. Commw. 187, 422 A.2d 906 (1980).

[FN3]. Pa.-- ***Barasch v. Pennsylvania Public Utility Com'n***, 120 Pa. Commw. 292, 548 A.2d 1310 (1988).

[FN4]. Pa.-- ***Barasch v. Pennsylvania Public Utility Com'n***, 120 Pa. Commw. 292, 548 A.2d 1310 (1988).

[FN5]. Ohio-- ***Ohio Utilities Co. v. Public Utilities Commission***, 58 Ohio St. 2d 153, 12 Ohio Op. 3d 167, 389 N.E.2d 483 (1979).

Again, there is no mention of unconstitutionality.

II. STATE LAW LIMITING TO ACTUAL TAXES PAID THE CHARGES TO RATEPAYERS FOR A UTILITY'S "INCOME TAXES" IS NOT PREEMPTED BY FEDERAL LAW.

The PGE Opening Brief (pp. 16-17) offers this argument but never cites the specific federal law that would be the source of the alleged preemption. SB 408 does not affect the operation of federal tax law. PGE will continue to pay the same federal taxes on its income as before. SB 408 only affects what PGE may charge to Oregon ratepayers in rates. Even if SB 408 somehow affected what PGE pays in federal taxes, that does not establish preemption, because it is not impossible for PGE to comply with both SB 408 and federal law.

Further, PGE misstates the proper standard for determining whether federal preemption exists. PGE cites only an obscure opinion of the Fifth Circuit Court of Appeals, disregarding the dozens of United States Supreme Court decisions on this

subject. A far better statement of the requirements for preemption are states in ***Cipollone v. Liggett Group, Inc.***, 505 US 504, 516 (1992):

> Article VI of the Constitution provides that the laws of the United States shall be the supreme Law of the Land; ... any Thing in the Constitution or Laws of any state to the Contrary notwithstanding. Art VI, cl 2. Thus, since our decision in ***M'Culloch v. Maryland***, 17 US (4 Wheat) 316, 427, 4 LEd 579 (1819), it has been settled that state law that conflicts with federal law is without effect. ***Maryland v. Louisiana***, 451 US 725, 746, 101 SCt 2114, 2128, 68 LEd2d 576 (1981). Consideration of issues arising under the Supremacy Clause start[s] with the assumption that the historic police powers of the States [are] not to be superseded by ... Federal Act unless that [is] the clear and manifest purpose of Congress. ***Rice v. Santa Fe Elevator Corp.***, 331 US 218, 230, 67 SCt 1146, 1152, 91 LEd 1447 (1947). Accordingly, [t]he purpose of Congress is the ultimate touchstone of pre-emption analysis. ***Malone v. White Motor Corp.***, 435 US 497, 504, 98 SCt 1185, 1189, 55 LEd2d 443 (1978) (quoting ***Retail Clerks v. Schermerhorn***, 375 US 96, 103, 84 SCt 219, 222, 11 LEd2d 179 (1963)).
>
> Congress' intent may be explicitly stated in the statute's language or implicitly contained in its structure and purpose. ***Jones v. Rath Packing Co.***, 430 US 519, 525, 97 SCt 1305, 1309, 51 LEd2d 604 (1977). In the absence of an express congressional command, state law is pre-empted if that law actually conflicts with federal law, see ***Pacific Gas & Elec. Co. v. State Energy Resources Conservation and Development Comm'n***, 461 US 190, 204, 103 SCt 1713, 1722, 75 LEd2d 752 (1983), or if federal law so thoroughly occupies a legislative field as to make reasonable the inference that Congress left no room for the States to supplement it. ***Fidelity Fed. Sav. & Loan Assn. v. De la Cuesta***, 458 US 141, 153, 102 SCt 3014, 3022, 73 LEd2d 664 (1982) (quoting ***Rice v. Santa Fe Elevator Corp.***, 331 US, at 230, 67 SCt, at 1152).

The Court has more specifically defined "conflict with federal law." ***Sprietsma v. Mercury Marine***, 537 US 51, 64 (2002), stated:

> We have recognized that a federal statute implicitly overrides state law either when the scope of a statute indicates that Congress intended federal law to occupy a field exclusively, ***English v. General Elec. Co.***, 496 US 72, 78-79[, 110 SCt 2270, 110 L.Ed.2d 65] (1990), or when state law is in actual conflict with federal law. We have found implied conflict pre-emption

> where it is impossible for a private party to comply with both state and federal requirements, *id.*, at 79[, 110 SCt 2270], or where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress. ***Hines v. Davidowitz***, 312 US 65, 52, 67[, 61 SCt 399, 85 LEd 581] (1941). ***Freightliner Corp. v. Myrick***, 514 US 280, 287[, 115 SCt 1483, 131 LEd2d 385] (1995).

PGE has not even attempted to meet any of these tests. Where is "the clear and manifest intent of Congress" to nullify laws such as SB 408? Where is the impossibility of complying with both federal law and state law? What is the purpose and objective of Congress that is destroyed by SB 408?

Finally, if there is federal preemption against limiting a utility's charges to ratepayers for "income taxes" to something less than the imaginary level of "income taxes" that PGE insists upon, then dozens of state utility commissions and court decisions over the past 30 years are all wrong, since those decisions show the authority of states to allow into rates a level of "income taxes" that takes into account or is limited to the actual amount of income tax paid by the utility. Various state utility commissions have for decades imposed the actual taxes paid method or other techniques that do not allow utilities to charge to ratepayers an imaginary level of income taxes.

We have cited several such state utility commission decisions and court decisions above, from CORPUS JURIS SECUNDUM. Other relevant cases are legion. Not only do those cases approve regulatory decisions not allowing utilities to charge phony income taxes to ratepayers, they approve further **reducing** rates in the circumstance where it is the utility that is the money-losing subsidiary (because the

utility should be compensated by the other subsidiaries for the valuable tax deductions the utility is providing to them). ***Central Power & Light Co. v. Public Utility Commission of Texas***, 36 SW3d 547 (Tex App 2001). This is the opposite of the "benefits and burdens" test claimed by PGE to be so crucial.

In ***Greeley Gas Co. v. State Corp. Com'n of State of Kansas***, 15 KanApp2d 285, 807 P2d 167, (KanApp 1991), the court upheld a complete disallowance of alleged income tax expense, when actual taxes paid were not proven.

> Even under the reasoning of ***Suburban***, it was Greeley's burden to establish the income taxes actually paid by its shareholders on its behalf.
>
> In the present case, had the KCC recognized the reasoning of Suburban and allowed the estimated income tax expense in Greeley's cost of service, it would have, in our opinion, been allowing an expense unsupported by substantial competent evidence.
>
> Based on Greeley's lack of competent evidence to support its position, the KCC's disallowance of the income tax expense is affirmed.

807 P2d at 170.

The Indiana Utility Regulatory Commission regularly refuses to allow utilities to charge phony income taxes to ratepayers. See, e.g., ***Indiana Cities Water Corp, Cause 38851***, 1991 WL 503056 (Ind URC). One reason is that the Indiana courts have reversed earlier agency decisions that did allow the charging of these phony taxes. In ***City of Muncie v. Indiana PSC***, 177 IndApp 155, 378 NE2d 896 (1978), the court stated:

> The evidence in the case before us is uncontroverted: Petitioner did not file a separate federal income tax return and did not compute its taxes at a rate of 48%. Therefore, it was error for the Commission to arbitrarily allow petitioner's tax expense to be computed on that basis.

* * *

Just as the Commission in Indiana Bell could not arbitrarily disallow taxes actually paid under a capital structure which did not exist, in this case the Commission cannot arbitrarily allow a tax expense computed on the basis of a separate tax return when such a return was not actually filed. This does not mean that the expenses and revenues of affiliated companies must be attributed to Petitioner for rate-making purposes. Rather, it means that some determination must be made as to the tax savings accruing To Petitioner as a result of its participation in the filing of a consolidated federal income tax return. In this manner, a more accurate computation of Petitioner's actual federal income tax liability can be made. * * *

We feel that by automatically assuming a tax rate of 48%, without any determination of the effective tax rate, and without any determination of the properly allowable income tax expense, the Commission is allowing an additional, hidden return on capital to the shareholders at the expense of the rate-payer. Furthermore, our research indicates that at least thirteen other jurisdictions have reached the same conclusion on this issue.[FN1]

FN1. ***Long Island Water Corp. v. Public Service Commission*** (1975), 49 AD2d 392, 374 NYS2d 841; Pennsylvania Public Utility Commission v. South Pittsburgh Water Co. (Penn Public Utility Comm. 1970), 84 PUR3d 487; Re Jersey Central Power and Light Co. (NJ Board of Public Utility Commissioner 1973), 2 PUR4th 70; Re Salisbury Water Supply Co. (Mass Dept of Public Utilities 1964), 54 PUR3d 196; Re Arkansas Louisiana Gas Co. (Ark. Public Service Comm 1974), 4 PUR4th 265; Re Central Vermont Public Service Corp. (Vt Public Ser Bd 1971), 89 PUR3d 121; Re City Water Co. of Chattanooga (Tenn. Public Ser Comm. 1970), 84 PUR3d 264; Re Davenport Water Co. (Iowa State Commerce Comm 1968), 76 PUR3d 209; Re Lexington Water Co. (Ky Public Ser Comm 1968), 72 PUR3d 253; Re Michigan Consolidated Gas Co. (Mich Public Ser Comm. 1969), 79 PUR3d 375; Re Minneapolis Transit Co. (Minn Public Ser. Comm. 1969), 81 PUR3d 232; Re Potomac Edison Co. of W. Virginia (W Va Public Serv Comm 1974), 6 PUR4th 183; Re Stamford Water Co. (Conn Public Utilities Comm. 1971), 89 PUR3d 502.

378 NE2d at 898-99 (emphasis added).

In Re New Jersey Natural Gas Company, Docket Nos. GR89030335J -- Phase II, GR90080786J, 1991 WL 501940 (NJ BRC), the New Jersey Board of Regulatory Commissioners stated:

> It has been the Board's long-time policy to adjust operating income to reflect savings resulting from the filing of a consolidated income tax return by a utility's parent company. As early as 1952 the courts recognized that a utility attempting to establish its proper operating income level in a rate proceeding is "entitled to allowance for expense of actual taxes and not for higher taxes which it would have to pay if it filed on a separate basis." ***In re New Jersey Power & Light Co. v. P.U.C.***, 9 NJ 498, 528, 95 PUR NJ 467, 89 A2d 26 (1952). In 1976, the Court affirmed a decision in which the Board indicated that such an adjustment was part of the Board's regular policy, which was made consistently for water and electric holding companies. ***New Jersey Bell Telephone Company v. New Jersey Dept. of Public Utilities***, 162 NJ Super 60 (Appl Div 1978).
>
> This policy, which required that consolidated tax savings be passed along to consumers, has been both affirmed and mandated by the courts of this state. ***In re Lambertville***, 153 NJ Super 24, 378 A2d 1158 (App Div 1977), reversed in part on other grounds, 79 NJ 449, 401 A2d 211 (1979). In ***Lambertville***, the Court stated that the utility was not entitled to the then statutory 48% rate merely because that was the amount paid to its parent as a result of inter-company policy or agreement. The Court stated:
>
>> If Lambertville is part of a conglomerate of regulated and unregulated companies which profits by consequential tax benefits from Lambertville's contributions, the utility consumers are entitled to have the computation of those benefits reflected in their utility rates.
>
> It is only the real tax figure which should control rather than that which is purely hypothetical. Se ***In re New Jersey Power and Light Co.***, 9 NJ 498, 528-29 (1952). And the PUC Commissioners therefore have the power and function to take into consideration the tax savings flowing from the filing of the consolidated tax return and determining what proportion of the consolidated tax is reasonable attributable to Lambertville. See ***FPC v. United Gas Pipe Line Co.***, 386 US 237 (1967), 158 NJ Super at 28.

PGE offers no showing that all of these actions of state regulatory bodies are unconstitutional in any fashion, whether styled a taking or confiscation or federally preempted.

III. CONCLUSION.

Neither SB 408 nor its application to PGE is in any manner unconstitutional.

Dated: May 18, 2007

Respectfully Submitted,

____

DANIEL W. MEEK
OSB No. 79124
10949 S.W. 4th Avenue
Portland, OR 97219
(503) 293-9021 fax 293-9099

Attorney for
Utility Reform Project,
Ken Lewis, and
Nancy Newell

CERTIFICATE OF SERVICE

I hereby certify I FILED the foregoing **REPLY BRIEF OF UTILITY REFORM PROJECT, KEN LEWIS, AND NANCY NEWELL** by e-mail upon the OPUC, followed by mail of the original and 5 copies this date to the Oregon Public Utility Commission, and further I certify that I served a copy as noted, by email and by placing a true copy of the foregoing placed in a sealed envelope and deposited in the U.S. Postal Service at Portland, Oregon, with first class postage prepaid, to:

LOWREY R BROWN
CITIZENS' UTILITY BOARD
610 SW BROADWAY - STE 308
PORTLAND OR 97205
lowrey@oregoncub.org

MELINDA J DAVISON
DAVISON VAN CLEVE PC
333 SW TAYLOR - STE 400
PORTLAND OR 97204
mail@dvclaw.com

JASON EISDORFER
CITIZENS' UTILITY BOARD OF OREGON
610 SW BROADWAY STE 308
PORTLAND OR 97205
jason@oregoncub.org

MATTHEW W PERKINS
DAVISON VAN CLEVE PC
333 SW TAYLOR - STE 400
PORTLAND OR 97204
mwp@dvclaw.com

DOUGLAS C TINGEY
PORTLAND GENERAL ELECTRIC
121 SW SALMON 1WTC13
PORTLAND OR 97204
doug.tingey@pgn.com

JASON W JONES
DEPARTMENT OF JUSTICE
1162 COURT ST NE
SALEM OR 97301-4096
jason.w.jones@state.or.us

JUDY JOHNSON
Oregon PUC
P.O. Box 2148
Salem, OR 97308-2148
judy.johnson@state.or.us

LINDA K. WILLIAMS
Attorney
10266 S.W. Lancaster Road
Portland, OR 97219
linda@lindawilliams.net

Dated: May 18, 2007

____
Daniel W. Meek