ORDER NO. 06-379

ENTERED 07/10/06

# BEFORE THE PUBLIC UTILITY COMMISSION

# OF OREGON

UE 170/UM 1229

| | | |
|---|---|---|
| In the Matters of | ) | |
| | ) | |
| PACIFIC POWER & LIGHT COMPANY | ) | |
| (dba PacifiCorp) | ) | |
| | ) | ORDER ON |
| Request for a General Rate Increase in the | ) | RECONSIDERATION |
| Company's Oregon Annual Revenues, | ) | |
| (UE 170) | ) | |
| | ) | |
| Application for a Deferred Accounting Order | ) | |
| Regarding Certain Tax Expenses. (UM 1229) | ) | |

DISPOSITION: ORDER NO. 05-1050 MODIFIED IN PART;
APPLICATION FOR DEFERRED ACCOUNTING
GRANTED IN PART

## SUMMARY

In this order, we clarify, but affirm, our application of Senate Bill 408 in this proceeding to reduce the amount of tax expense PacifiCorp may recover in rates. We adhere to our conclusion that, under the unique circumstances presented, SB 408 requires a prospective adjustment to PacifiCorp's base rates to reflect the taxes that are paid to units of government to ensure that customer rates are fair, just, and reasonable. We modify this disallowance, however, based on updated and more accurate information relating to the basis of the tax adjustment. This modification reduces the tax adjustment from $16.07 million to $12.4 million. We grant, in part, PacifiCorp's application for deferred accounting to allow the company to seek recovery of lost revenues associated with this adjustment through an amortization schedule. Finally, we conclude that the application of SB 408 and the corresponding tax adjustment do not result in confiscatory rates, and deny PacifiCorp's request for further rate relief.

**Procedural Background**

On December 19, 2005, we granted PacifiCorp's application for reconsideration and rehearing of our decision in this general rate proceeding. In that decision, we determined that recently enacted Senate Bill 408 required us to disallow certain tax expenses in approving new rate schedules for PacifiCorp. *See* Order No. 05-1050 at 17. Specifically, we reduced PacifiCorp's proposed tax expense by $16.07 million to recognize an offsetting tax deduction arising from the fact that

PacifiCorp's parent company, PacifiCorp Holdings, Inc (PHI), pays taxes on a consolidated basis.

PacifiCorp, the Industrial Customers of Northwest Utilities (ICNU) and the Citizens' Utility Board (CUB) filed testimony and participated in an evidentiary hearing on reconsideration on April 19, 2006. The parties subsequently filed briefs and presented oral arguments before the Commission on June 6, 2006. The Utility Reform Project (URP) also filed a brief.

Based on the record in this proceeding, we supplement Order No. 05-1050 with the following order on reconsideration.

## FINDINGS OF FACT

In 1999, PacifiCorp was purchased by ScottishPower, a British utility holding company. Shortly after the purchase, ScottishPower created PacifiCorp Holdings, Inc. (PHI) to serve as a non-operating, direct, wholly-owned subsidiary. ScottishPower capitalized PHI with an inter-company loan, which PHI used to acquire the shares of PacifiCorp. PHI served as the parent of PacifiCorp and of ScottishPower's other U. S. subsidiaries.

The interest that PHI paid to ScottishPower on the acquisition loan was deductible on the consolidated tax returns that PHI filed on behalf of PacifiCorp and the other U.S. subsidiaries. At fiscal year end March 31, 2005, PHI had a loan balance of about $2.4 billion with an interest rate of 6.75 percent, and had paid ScottishPower approximately $160 million in related interest. This deduction constituted a direct offset to PHI's consolidated group's taxable income, thus reducing the amount of income taxes paid on the profits generated from PacifiCorp's regulated utility operations.

On November 12, 2004, PacifiCorp filed a general rate request. Based on a normalized future test year ending December 31, 2006, the company sought a revenue requirement increase of approximately $102 million. The rate request included a claim for tax expense equal to PacifiCorp's full stand-alone tax liability. This Commission suspended the rate filing for investigation.

During the investigation, CUB and ICNU opposed PacifiCorp's request to recover its stand-alone tax liability in customer rates. In prefiled testimony, both parties proposed adjustments reducing PacifiCorp's tax expense by a proportionate share of the PHI interest deduction. For different reasons, CUB and ICNU argued that such an adjustment was required to better forecast PacifiCorp's actual tax liability in the 2006 test year and to minimize the amount of taxes being collected in rates by PacifiCorp that would not be paid to taxing authorities.

CUB's adjustment allocated the PHI interest expense deduction using PacifiCorp's share of gross profits to PHI. During the three-year period from 2001 to 2003, PacifiCorp represented 91.5 percent of PHI's consolidated gross profit. During this

same period, PacifiCorp represented 83 percent of PHI's consolidated total income. ICNU's adjustment allocated the PHI interest expense adjustment using the percentage of PHI assets related to PacifiCorp's activities.

After evidentiary hearings on PacifiCorp's rate request, but prior to final Commission action, the 2005 Legislative Assembly enacted SB 408 to address growing concerns that Oregon energy utilities were collecting income tax expenses in rates that are not ultimately paid to taxing authorities. The bill requires this Commission to track taxes collected in rates and compare these amounts against taxes paid. If amounts collected and amounts paid differ by more than $100,000, SB 408 requires this Commission to implement an automatic adjustment clause to ensure that ratepayers are not charged more tax than the utility or its affiliated group pays to units of government. Although SB 408 contained an emergency clause, making the bill effective on September 2, 2005, the automatic adjustment clause applies only to taxes paid to units of government and collected from ratepayers on or after January 1, 2006.

On September 22, 2005, the inter-company loan between ScottishPower and PHI was refinanced for $2.731 billion. The new loan notes have a variable interest rate. The interest rate effective for the first quarter of 2006 was 4.97688 percent.

On September 28, 2005, this Commission concluded the rate investigation and issued Order No. 05-1050, which authorized PacifiCorp to increase its revenue requirement by $25.9 million. PacifiCorp subsequently filed revised tariff schedules to implement our decision, with new rates effective October 4, 2006.

On the issue of tax expense, we concluded that SB 408 required a departure from our historic use of the "stand-alone" methodology for calculating the amount of income taxes to be incorporated into PacifiCorp's rates. Rather than calculating taxes based simply on the regulated revenues and operating costs of the utility itself, we concluded that SB 408 required us, in setting base rates for PacifiCorp in this proceeding, to consider the taxes that would ultimately be paid to units of government.

We based that conclusion on two aspects of SB 408. First, the legislature made amendments to ORS 757.210(1) that became effective upon the bill's passage. Those amendments added the word "fair" to the requirement that rates must be "just and reasonable," and clarified that the Commission may not approve a rate "that is not fair, just and reasonable." Second, in the preamble to SB 408, the legislature specifically declared that "[u]tility rates that include amounts for taxes should reflect the taxes that are paid to units of government to be considered fair, just and reasonable." *See* ORS 757.267(1)(f). We concluded that the common use of the phrase "fair, just and reasonable" in the bill's general policy statement and in ORS 757.210 required us to consider taxes paid to governmental units when setting rates for PacifiCorp in this docket:

> The legislative intent behind SB 408 is clear – we are to depart from historic practice and consider taxes paid by a

> utility or its parent when setting rates. When we authorize rates for utilities covered by the bill, those rates must reflect the taxes paid to units of government in order to be fair, just and reasonable.

Order No. 05-1050 at 18 (footnote omitted).

To effectuate SB 408's mandate, we adopted an adjustment based on CUB's proposal to reduce PacifiCorp's proposed tax expense by $16.07 million. On a grossed-up basis, this disallowance translates to a $26.6 million revenue requirement decrease.

On October 28, 2005, PacifiCorp filed a request for reconsideration and rehearing of Order No. 05-1050. On that same date, PacifiCorp filed an application seeking authorization to defer the revenue shortfall related to the disputed tax expense adjustment. PacifiCorp sought deferral to allow the Commission to address the uncertainties of SB 408 without prejudicing the company's right to recover prudently incurred costs.

In Order No. 05-1254, we granted PacifiCorp's request for reconsideration and rehearing for two reasons. First, we acknowledged that SB 408 had been enacted after the close of the evidentiary record and shortly before the time of our decision. While the parties had opportunity to address the application of the then unsigned bill during oral arguments, we concluded additional proceedings were necessary to ensure that PacifiCorp, other parties, and this Commission had sufficient time to review and comprehend this complex legislation. Second, we concluded that additional hearings were required to address PacifiCorp's assertion that the $16.07 million tax adjustment resulted in confiscatory rates.

## CONCLUSIONS OF LAW

On reconsideration, we examine three issues. First, we must determine whether our disallowance of PacifiCorp's recovery of its full stand-alone tax liability was authorized under SB 408 or our broad regulatory authority. If such action was authorized, we must next examine the manner in which we made the tax expense adjustment and determine whether the adjustment was reasonable and supported by substantial evidence. Finally, we must examine whether the overall rates produced by the tax disallowance, as well as other determinations in the rate order, provide PacifiCorp the opportunity to recover its reasonable operating expenses and maintain financial integrity, credit, and the ability to attract necessary capital. *See* ORS 756.040. We address each issue separately.

### I. Was the Commission authorized to adjust PacifiCorp's stand-alone tax expense?

PacifiCorp contends that the Commission's application of SB 408 in the rate order was overly broad, premature and unlawful. PacifiCorp argues that SB 408

does not and should not apply to this proceeding because: (1) SB 408 does not require or authorize an immediate change to the calculation of taxes in rates, but rather only establishes a true-up mechanism to align taxes paid with those collected; (2) SB 408 applies only to taxes after 2006, and here the Commission applied it to a case with a rate effective date in 2005; and (3) the Commission has not yet adopted standards and rules for SB 408, and thus its application in this case is premature.

A. <u>SB 408 establishes only a true-up mechanism</u>

PacifiCorp assigns error to our conclusion that SB 408 required a change to how we consider tax expenses in setting base rates. According to PacifiCorp, SB 408 has but one purpose—to establish a backward-looking true-up mechanism through which actual taxes paid and those collected in rates are trued-up and aligned. The backward-looking nature of the SB 408 adjustments, PacifiCorp explains, is apparent from the requirement to adjust rates based on historical, not forecasted, data, as well as the bill's use of past tense in defining "taxes paid." Because this true-up mechanism effectuates the legislative goal of aligning taxes collected in rates with those paid to units of government, PacifiCorp concludes that SB 408 required neither a departure from the stand-alone methodology nor an examination of taxes paid by a utility or its parents in this rate proceeding.

PacifiCorp contends our conclusion to examine the amount of taxes paid in setting base rates resulted from an incorrect interpretation of the text, context, and legislative history of SB 408. First, PacifiCorp argues that, rather than establishing a new ratemaking policy, the insertion of the word "fair" merely conformed ORS 757.210 to the Commission's traditional "just and reasonable" rate standard that protects utilities from confiscatory rates. Next, PacifiCorp contends that our reliance on legislative findings in the bill's preamble was improper and, even assuming they could be considered, faults our failure to examine other findings that support the continued use of the stand-alone methodology. Finally, PacifiCorp contends that the legislative history contains no support for our conclusion that SB 408 mandated changes to how the Commission sets base rates. To the contrary, PacifiCorp argues, the legislative history, including statements by Representative Boquist on the House floor, confirms that SB 408 simply establishes a mechanism to true-up amounts collected with amounts paid without changing "the original ratemaking process." PacifiCorp Opening Brief at 4 (May 2, 2006), citing Statement of Rep. Brian Boquist, House of Representatives Chamber Session, July 30, 2005.

CUB, ICNU and URP respond that, contrary to PacifiCorp's arguments, this Commission properly interpreted and applied SB 408 to this rate proceeding. These parties contend that, in addition to establishing a backward-looking automatic adjustment clause, SB 408 established a new legislative standard for setting the tax expense in rates on a going-forward basis. As ICNU explains:

> SB 408 is an unequivocal legislative directive that the mismatch between "taxes collected" and "taxes paid" that resulted under the

> stand-alone methodology is unacceptable, and the statute's emergency clause demonstrates that the legislature intended the Commission to correct that mismatch immediately.

ICNU Post-Hearing Brief at 3 (May 16, 2006).

CUB and ICNU also contend that it was appropriate and necessary to look at the legislative findings in the preamble, and that this Commission properly found a connection with the use of the phrase "fair, just and reasonable" throughout the bill. As to the legislative history, CUB, ICNU and URP contend that PacifiCorp's reliance on the cited statements is misplaced. The parties explain those statements merely clarify that SB 408, while not fundamentally altering ratemaking in general, requires that taxes in utility rates must be better aligned with actual utility tax payments in order to comply with the law.

*Resolution*

In the rate order, we recognized the complexity of SB 408 and the uncertainties related to the interpretation and application of the legislation. Since that time, with the AR 499 rulemaking docket, as well as this reconsideration proceeding, we have learned a great deal more about the intent and meaning of the legislation. We agree with PacifiCorp that the bill's primary feature is a backward-looking true-up mechanism to aligning taxes paid with those collected from ratepayers. We affirm our earlier decision, however, that the application of SB 408 to this proceeding required a prospective adjustment to PacifiCorp's base rates. We cannot ignore the bill's specific amendments to ORS 757.210, which, when read in concert with the legislative findings, make clear that, to approve "fair, just and reasonable rates" for PacifiCorp, we were required to consider taxes paid to units of government.

An important aspect of our decision, which we further clarify here, is the delayed implementation of SB 408's automatic adjustment clause. Although the legislature included an emergency clause to immediately implement its findings and amendments to ORS 757.210, it expressly reserved the application of the automatic adjustment clause "to taxes paid to units of government and collected from ratepayers on or after January 1, 2006." Section 4(2). Due to those timing differences, an approximate four-month period existed during which the legislature had mandated that rates reflect taxes paid to government units but did not yet allow the use of the true-up mechanism to accomplish that mandate. We were required to approve rates that became effective during this interim period. Absent use of the automatic adjustment clause to more closely align taxes collected from ratepayers with taxes paid to units of government, our only option to meet the legislative mandate to ensure that rates were fair, just, and reasonable was to make the necessary adjustments to PacifiCorp's base rates.

Because the meaning of the amendments to ORS 757.210, as applied to this proceeding, is clear from the text and context of the statute, there is no need to resort to legislative history. *See, e.g., PGE v. Bureau of Labor and Industries*, 317 Or 606

(1993). Nonetheless, even if such an examination were warranted, the limited history of the amendments to ORS 757.210 is not pertinent to our decision. The statements cited by PacifiCorp address the broader question of whether SB 408 requires a permanent change to the methodology by which this Commission sets base rates. Our decision here is limited to the application of SB 408 during that four-month interim period while SB 408 was in effect, but prior to our ability to use the automatic adjustment clause to help align taxes collected and taxes paid. We leave open the question, indirectly raised by the intervenors' arguments, whether SB 408 mandates a change in all future rate proceedings as to how we set base rates.

Accordingly, we conclude that, due to a unique combination of SB 408's effective date, the amendments to ORS 757.210 and corresponding clarification of those amendments in legislative findings, as well as the delayed implementation of the automatic adjustment clause, we were required to prospectively adjust PacifiCorp's base rates to reflect the taxes that are paid to units of government. While this result may have not been contemplated by the legislature, the application of these various provisions to this proceeding is clear and undeniable.

We also affirm our earlier conclusion that, even in the absence of SB 408, we could, and would, have departed from our traditional practice of treating taxes on a stand-alone basis and considered the taxes to be paid to units of government in setting PacifiCorp's rates. While raising procedural challenges, which we address later, as to our ability to modify our income tax policy in this proceeding, PacifiCorp does not dispute that the determination of income tax expense in ratemaking is a matter subject to broad Commission discretion and modification. We would have made such an adjustment to address wide-spread criticisms of the potential mismatch, resulting from the use of the stand-alone methodology, between monies collected from ratepayers to pay taxes and the actual amount of taxes paid to the taxing authorities. The nature of the adjustment would have been unchanged from the one we adopted in the challenged order. Indeed, as discussed above, our adjustment to PacifiCorp's income tax expense was based on a disallowance proposed in this proceeding by CUB months prior to the passage of SB 408.

B. SB 408 only applies to taxes after 2006

PacifiCorp also contends that our application of SB 408 was premature. The company maintains that Section 4(2) expressly prohibits any rate adjustments to taxes collected in rates prior to January 1, 2006. It also explains that, due to the mechanics of the tax adjustment mechanism, SB 408 will not result in any rate changes until after the filing of a tax report in 2007, more than two years after the date of the rate order. Consequently, PacifiCorp argues, the two-year lag between the rate adjustment in the rate order and the commencement of rate adjustments contemplated under the tax adjustment mechanism confirms the premature and unjustified application of SB 408 in this proceeding.

In response, ICNU criticizes PacifiCorp for failing to recognize the dual nature of SB 408. While the tax adjustment mechanism could not be implemented until a

later date, ICNU explains the Commission was required to immediately implement the way it calculates taxes for setting base utility rates. Thus, ICNU maintains, PacifiCorp's reliance on Section 4(2) and the timing of the adjustment mechanism is misplaced.

*Resolution*

PacifiCorp's arguments rest on the assumption that our adjustment to its tax expense for ratemaking purposes was based on SB 408's automatic adjustment clause. That assumption is incorrect. As clarified above, the tax adjustment was made pursuant to amendments set forth in ORS 757.210 which, unlike the automatic adjustment clause, took effect immediately upon the bill's passage. We have already affirmed our authority to make an adjustment to PacifiCorp's rates pursuant to that provision. While the legislature delayed the adjustment of rates under the automatic adjustment clause, it immediately implemented the amendments to ORS 757.210 to mandate that rates must reflect taxes that are paid to units of government.

C. Application of SB 408 requires prior rulemaking

PacifiCorp contends our departure from the stand-alone tax policy and application of SB 408 in this rate proceeding violated the Administrative Procedures Act (APA). PacifiCorp's arguments are two-fold. First, PacifiCorp contends that our use of the stand-alone tax methodology constitutes a rule, one established both formally through the promulgation of OAR 860-027-0048 and informally through application in prior cases. Because the Commission has not repealed or amended the stand-alone tax rule, PacifiCorp contends it remains "an existing statement of practice or policy, binding on the agency" and this rate proceeding. *Burke v. Children's Services Div*., 288 Or 533, 537 (1980). Second, PacifiCorp contends that SB 408 is not a self-implementing piece of legislation and, consequently, cannot be applied until standards governing its application are established. PacifiCorp contends the Commission's actions here—for example, allocating to a utility the benefits of participating in a consolidated tax with unregulated entities prior to defining the term "properly attributed"—conflicts with numerous Oregon cases requiring prior rulemaking before application of new legislation. *See, e.g., Trebesch v. Employment Division*, 300 Or 264 (1985); *Megdal v. Board of Dental Examiners*, 288 Or 293 (1980); and *Forelaws on Board v. Energy Facility Siting Council*, 306 Or 205 (1988).

ICNU, CUB and URP disagree with PacifiCorp's assertions. ICNU responds that PacifiCorp's arguments mischaracterize Oregon law and, once again, assume that the Commission could lawfully give effect to SB 408 only by implementing the automatic adjustment clause. All intervenors maintain that the Commission has discretion to implement SB 408 without prior rulemaking, so long as the parties have notice and an opportunity to present evidence as to how the statute should be implemented.

*Resolution*

At the outset, we reject PacifiCorp's assertion that OAR 860-027-0048 mandates the use of the stand-alone methodology for estimating a utility's income tax for ratemaking purposes. As we explained in the rate order, this rule speaks not to Commission ratemaking, but utility accounting. The rule requires an energy utility to use specified cost allocation methods when engaging in transactions with non-regulated activities or affiliates. These transactions include the transfer of assets or supplies or the provision or receipt of services. As relevant here, the rule requires a utility engaging in such transactions to record income taxes on a stand-alone basis:

> Income taxes shall be calculated for the regulated activity [or energy utility] on a standalone basis for both ratemaking purposes and regulatory reporting. When income taxes are determined on a consolidated basis, the regulated activity [or energy utility] shall record income tax expense as if it were determined for the regulated activity separately for all time periods.

OAR 860-027-0048(3)(g) and (4)(h).

This accounting requirement reflects, rather than creates, our traditional practice of calculating taxes on a stand-alone basis. We acknowledge, as PacifiCorp argues, that the purpose of the rule—to prevent cross-subsidization of regulated and non-regulated functions—cannot be realized if the rule only applies to a utility's accounting and not its rates. In the rate order, in fact, we noted the passage of SB 408 may require the adoption of different accounting rules. *See* Order No. 05-1050 at 18. Nonetheless, because OAR 860-027-0048 addresses a utility's reporting requirements, the rule does not apply to ratemaking proceedings.

We focus our inquiry, therefore, on PacifiCorp's assertion that the Commission's use of the stand-alone methodology in prior rate proceedings has elevated that practice to a "rule" that the Commission is bound to follow unless it is repealed through formal rulemaking. The APA broadly defines a "rule" as "any agency directive, standard, regulation or statement of general applicability that implements, interprets or prescribes law or policy" or that describes the agency's procedure or practice requirements. ORS 183.310(9); *See also Attorney General's Administrative Law Manual* at 7 (2006). If an agency policy or practice meets the definition of a rule, but has not been promulgated in the form of a rule according to the APA, it may be binding on the agency until it is declared invalid by a court or until it is amended or repealed. *Burke v. Children's Services Division*, 288 Or 533 (1980).[1]

[1] PacifiCorp relies on a quote, taken from the 2004 edition of the Attorney General's Administrative Law Manual, that states: "Moreover, an agency policy or practice that meets the definition of a rule but is not in the form of a written rule or has not been promulgated according to the APA is, nevertheless, binding on the agency[.]" That sentence has been modified in the 2006 version of the AG's manual and now provides that such a policy or practice "*may* be binding on the agency[.]" (emphasis added.) Atty Gen's Admin Law Manual at 7 (2006).

We conclude that this Commission's practice of estimating tax expense based on stand-alone tax liability does not constitute a rule under the APA. Due to its complexity and technicality, the process of ratemaking requires considerable discretion and flexibility on the part of the Commission as to the methods it uses to establish fair, just, and reasonable rates. The Commission uses a variety of means to estimate operating expenses, rate base, and rate of return to determine a utility's allowed revenue requirement. It would be unreasonable, if not impossible, for the Commission to promulgate formal rules every time a method used in prior ratemakings is modified. Furthermore, the standard by which the rates set by the Commission are judged is whether the outcome is just and reasonable, not whether the methods used to obtain the rates are themselves reasonable. *Federal Power Commission et. al. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

There are numerous examples where this Commission, many times at the request of the utility, modified ratemaking practices without prior rulemaking to ensure proper ratemaking. For instance, this Commission had, for over 20 years, used the Capital Asset Pricing Model (CAPM) to help determine a utility's reasonable return on equity in rate proceedings. However, in PacifiCorp's general rate proceeding, docket UE 116, as well as a concurrent rate proceeding for Portland General Electric, docket UE 115, we deviated from this traditional practice and declined to rely on the CAPM analysis because we did not believe the methodology produced reasonable results. *See* Orders No. 01-777 at 32 and 01-787 at 31. Based on growing concerns with this reliability of the CAPM methodology, and on the availability of better forecasting information, we departed from our traditional practice in the course of these ratemaking proceedings without prior rulemaking. The Commission must maintain this flexibility to effectively set fair, just and reasonable rates for the utility and its customers.

Even if, as PacifiCorp contends, the stand-alone practice constituted a "rule" under the APA, the failure to adopt a temporary rule was harmless error. PacifiCorp had ample notice of questions regarding the use of stand-alone tax liability to estimate PacifiCorp's tax expense and presented evidence and legal argument in support of its continued use. Consequently, PacifiCorp has not been deprived of due process by the Commission's departure from the stand-alone practice and subsequent disallowance of the proposed tax expense.

Finally, we further conclude that our application of SB 408 in making the tax adjustment did not require prior rulemaking. At the outset, we again clarify the limited nature of our application of SB 408 in this proceeding. As explained above, the tax adjustment was based on amendments to ORS 757.210 relating to "fair, just and reasonable rates," not the automatic adjustment clause mechanism. Accordingly, PacifiCorp's arguments of the need for rulemaking to interpret delegative terms necessary to implement the automatic adjustment clause mechanism are misplaced. More importantly, an agency may interpret legislative policy expressed in a statute either by rulemaking or by adopting a policy of general applicability when issuing an order in a contested case. ORS 183.355(5); *See also Attorney General's Administrative Law*

*Manual* at 8-9 (2006). As the court explained in *Marbet v. Portland General Electric Co.,* 277 Or 447, 463 (1977):

> [I]t is not indispensable that every standard [under those statutes] have been adopted in the form of a rule before the initiation of a contested case, as long as it is in fact adopted as a standard, upon notice and procedures that allow for the presentation of views and data on the issues involved, and sufficiently in advance of the final decision so that the applicant and other parties can address the import of the standard for the particular project. * * * We do not prescribe one specific procedure where the act does not itself prescribe that standards must be rules.

Here, PacifiCorp had notice of the possible application of SB 408 and was able to voice its concerns regarding our use of the legislation. Due to this fact, and given the unique circumstances surrounding SB 408 and its passage, the clear legislative intent and this Commission's broad authority in the regulation of public utilities, we conclude that a prior rulemaking was neither required nor necessary.

**II. Is the tax adjustment reasonable and supported by substantial evidence?**

PacifiCorp contends the Commission's adjustment, based on the PHI tax benefit, was legally insufficient, unnecessary and, even if warranted, excessive, in light of new information. First, PacifiCorp contends, while concluding that "the PHI tax benefit is a constant that SB 408 requires to be passed on to customers," the rate order failed to support this ruling with the required factual determination, based on substantial evidence, that the adjustment is necessary to align paid taxes with taxes collected. *See* Order No. 05-1050 at 19. PacifiCorp contends that the Commission could not make such findings without first defining "taxes collected," "taxes paid," and taxes "properly attributed."

Second, PacifiCorp also contends there is no basis to support a finding that an adjustment was necessary, given new evidence that PacifiCorp had significant taxes-paid add-backs that fully or partially offset the PHI tax deduction. PacifiCorp also contends that the PHI tax benefit will not lower PacifiCorp's 2006 actual taxes paid for several reasons, the most important being that PHI ceased to be PacifiCorp's holding company on March 21, 2006, when MidAmerican Energy Holdings Company (MEHC) purchased PacifiCorp. For these reasons, PacifiCorp does not believe that any tax adjustment is necessary.

If any adjustment is made, PacifiCorp urges the Commission to use the most accurate and up-to-date information possible to ensure the adjustment is as precise as possible. Specifically, PacifiCorp recommends four corrections and updates. First, the Commission should use the relative taxable income as the allocation factor for determining PacifiCorp's share of any PHI tax benefit. Based on its most recent tax return, PacifiCorp contends this percentage is 50 percent. Second, the adjustment should

recognize that the interest rate on the PHI debt was reduced on September 22, 2005, from 6.75 to 4.98 percent. Third, the adjustment should be reduced because ScottishPower paid taxes at a 30 percent rate under the UK Finance Act of 2005, offsetting a significant portion of the PHI tax benefit. Fourth, the adjustment should be reduced to one-fourth of the test year period to reflect that PHI ceased to exist as ScottishPower's parent as of March 21, 2006. The use of these corrections and updates, according to PacifiCorp, results in an adjustment of approximately $0.66 million on a grossed-up basis.

CUB and ICNU respond that the Commission's rate adjustments in compliance with SB 408 were reasonable and supported by the testimony, evidence, and legal arguments presented. The parties criticize PacifiCorp's attempts to introduce new evidence in this phase of the proceeding, and particularly object to PacifiCorp's adjustments based on MEHC's ownership. As ICNU explains:

> Recognizing MEHC ownership for purposes of PacifiCorp's income tax expense constitutes unlawful single issue ratemaking * * * Many of PacifiCorp's costs other than income taxes may have changed since the record was closed in UE 170, but none of those changes have been addressed here because they are more properly addressed in [PacifiCorp's pending ratemaking proceeding] UE 179.

ICNU Post-Hearing Brief at 15 (May 15, 2006).

CUB acknowledges that the Commission may consider new evidence relating to the PHI tax adjustment, but only if that evidence was previously unavailable and representative for the 2006 test period adopted in the rate proceeding.

*Resolution*

We dismiss PacifiCorp's contention that the PHI tax adjustment was not factually supported. In this rate proceeding, we found that the interest that PHI pays to ScottishPower on the acquisition loan was deductible on the consolidated tax returns that PHI filed on behalf of PacifiCorp and the other U.S. subsidiaries. In addition, we found that this deduction, amounting to approximately $160 million, constituted a direct offset to PHI's consolidated group taxable income, thus reducing the amount of income taxes paid on the profits generated from PacifiCorp's regulated utility operations. Those findings provide the necessary basis for our adjustment, mandated by SB 408, to help ensure that the rates are fair, just and reasonable by reflecting the amount of taxes that are paid to units of government. Furthermore, because the adjustment was not based on the automatic adjustment clause of SB 408, no preliminary definitions of "properly attributed" and related terms used in that true-up mechanism were necessary.

Next, we affirm our prior conclusion that the tax adjustment was necessary to comply with SB 408. Again, the adjustment was made pursuant to amendments to ORS 757.210, not the automatic adjustment clause. Therefore, PacifiCorp's arguments

relating to taxes-paid add-backs arising from deferred taxes and charitable contributions are misplaced.

Turning to PacifiCorp's proposed adjustments, we decline all requests to update the utility's tax expense based on MEHC's ownership. While we recognize that a subsequent change in PacifiCorp's ownership has eliminated the basis for the tax adjustment, the nature of rate cases requires that an estimate be made at a specific point in time as to the utility's reasonable operating costs and other expenses to determine its revenue requirement. As this Commission has previously explained:

> A basic premise of utility regulation is that when the Commission prescribes or approves a utility's rates, it does so according to the rules of rate setting in a rate case. If it follows those court-prescribed rules in the review of a utility's proposed rates, its job is finished, until the next rate case. * * *
>
> As every utility scholar knows and declares: The rate case decision must provide the opportunity only, no promises, no guarantees [to earn a reasonable return]. This means that once a rate case is completed and rates are set which, by the court standards, provide the opportunity, it makes no difference what actually happens from then on. The reasonableness of the rates under consideration is judged at an instant in time - namely, the rate case decision.

*In the Matter of Portland General Electric*, Docket Nos. UE 47/UE 48, Order No. 89-687 at 8 (May 24, 1989) (internal citations omitted).

Our decision in the rate order was based on PacifiCorp's proposed 2006 test year period that assumed continued ownership by ScottishPower. To now modify PacifiCorp's income tax expense in rates assuming MEHC ownership but retaining all other costs based on ScottishPower ownership, would be inappropriate. As ICNU notes, an examination of all cost changes due to MEHC ownership, including income tax expense, is more properly performed in PacifiCorp's pending rate proceeding, UE 179.

We may, however, consider evidence relating to the PHI tax adjustment, assuming that the information was previously unavailable and representative of the 2006 test period adopted in the rate proceeding. Of PacifiCorp's three remaining corrections and updates related to the PHI tax adjustment, we reject the proposal related to the passage of the UK Finance Act of 2005. Even if we assume the UK tax law is relevant to the PHI adjustment, the provision of the new act took effect on March 16, 2005, giving PacifiCorp a reasonable opportunity to have raised this matter prior to the August 11, 2005 closure of the evidentiary record.

We adopt PacifiCorp's proposed adjustment to recognize that, as of September 22, 2005, the PHI debt structure was changed, resulting in decreased interest

expense going forward. Under the new structure, the current debt is $2.731 billion at 4.98 percent interest, thus reducing the PHI interest payments from the $160 million annual amount used in the rate order to approximately $136 million. We agree with PacifiCorp that this new debt structure is most representative, for purposes of this rate order, of the 2006 test year period. Moreover, because this change occurred less than a week prior to the issuance of the rate order, evidence of the change was previously unavailable.

We also modify the tax adjustment based on a change in the allocation factor used to determine PacifiCorp's share of the PHI tax benefit, but for reasons other than those argued by PacifiCorp. In making the tax adjustment, we adopted CUB's methodology that based its allocation on gross profits, even though we recognized that net taxable income would be a better allocation factor. On reconsideration, PacifiCorp agrees that net taxable income should be used, and presents PHI's most recent tax return as evidence that this allocation percentage is 50 percent.

The difficulty with PacifiCorp's proposed adjustment is the fact that the company had earlier waived its opportunity to introduce evidence as to an allocation factor based on net taxable income. While it presented, at hearing, an allocation percentage based on an estimate of PacifiCorp's contribution to PHI consolidated group's tax liability using net taxable income, PacifiCorp later withdrew this evidence from the record. Had PacifiCorp pursued its challenge and let stand this evidence, we might entertain the company's request to update that evidence with new information derived from PHI's actual 2005 tax filing. We will not, however, allow PacifiCorp to present, on reconsideration, evidence to update information it earlier removed from the record.

We find other evidence in the record, however, to improve our allocation of PHI's consolidated tax liability. In presenting its proposed tax adjustment in the original proceeding, CUB included evidence showing PacifiCorp's relative contribution to the PHI consolidated group based on total income. Specifically, CUB reported, and we so find, that PacifiCorp contributed 83.4 percent of PHI's total income for the three-year period concluding in 2003. *See* CUB/102/Jenks/1. While still distinguishable from net taxable income, total income represents a better allocation factor than using gross profits, as we did in the rate order.[2]

Accordingly, we adjust the PHI tax adjustment to recognize the change in the PHI debt structure and to more accurately allocate the consolidated group's tax liability. We begin with the revised PHI interest deduction, which is $136 million. Multiplying that figure by the combined U.S. effective tax rate of 37.95 percent yields $51.6 million. This figure is then reduced with two calculations: First, multiplying it by the 83.4 percent allocation of PHI group net income lowers the amount to $43.034 million. Second, multiplying this lower figure by the Oregon allocation factor of 28.8723 percent produces a tax adjustment of approximately $12.4 million.

---

[2] We note that this allocation methodology is done solely for purposes of making a prospective adjustment to base rates in this proceeding.

To implement this adjustment, we grant PacifiCorp's application for deferred accounting, but only for the revenue requirement effect of the reduction in the tax adjustment ordered here. A deferral is appropriate to provide PacifiCorp meaningful relief of these adjustments, thereby matching appropriately the costs borne by and benefits received by ratepayers. *See* ORS 757.259(2)(e). PacifiCorp may request to amortize this deferral to recover the additional revenues associated with this adjustment, from the date of the deferral application, October 28, 2005, until the company puts new base rates into effect. Upon such request, we will conduct a proceeding under ORS 757.210, which will include an earnings review. *See* ORS 757.259(5).[3]

## III. Does the tax adjustment result in rates violative of ORS 756.040?

PacifiCorp contends that the $16.07 million tax expense disallowance resulted in rates that are confiscatory because it will have no reasonable opportunity to earn the approved return on equity (ROE) of 10 percent. According to PacifiCorp, the $16.07 million disallowance reduces the company's ROE by 160 basis points to 8.4 percent. PacifiCorp explains that this reduced ROE results from the fact that the rate order imputes the tax expense reduction despite the fact that PacifiCorp will incur its full stand-alone tax expense in 2006. PacifiCorp contends that an 8.4 percent ROE is not commensurate with returns on investment in similar enterprises, noting that the U.S. industry average is 11.3 percent for the 12 months ending September 30, 2005.

In addition, PacifiCorp contends the tax expense adjustment had led to a deterioration of PacifiCorp's credit ratings. Earlier this year, Fitch Ratings lowered PacifiCorp's credit ratings on senior unsecured debt to "BBB+" from "A-," and noted our rate order and tax expense adjustment. Standard & Poor's placed PacifiCorp on its CreditWatch with negative implications, and Moody's expressed concerns about the "difficult regulatory environment" in Oregon, but took no formal rating action. PacifiCorp concludes that this evidence demonstrates the tax expense disallowance has a substantial impact on the company's ability to maintain its financial integrity.

ICNU and CUB dispute PacifiCorp's allegations and question a utility's ability to use the disallowance of an excessive cost as the basis to establish confiscatory rates. Assuming such argument is proper, both parties contend PacifiCorp has provided no legal basis to conclude that an 8.4 percent ROE violated statutory or constitutional standards. ICNU notes that the Commission Staff's analysis showed that an 8.4 percent ROE was within the range of reasonable results for three of its four discounted cash flow models presented. *See* Staff/200, Morgan/5. With regard to the credit rating agencies, ICNU contends that Fitch's downgrade was based on numerous factors, including poor hydroelectric conditions and exposure to high natural gas prices. ICNU also notes that Standard & Poor's and Moody's have both affirmed PacifiCorp's credits ratings since the rate order issued, and that Standard & Poor's removed the company's ratings from its

[3] Consistent with the Administrative Law Judge's Ruling issued February 3, 2006, PacifiCorp may ask for further proceedings in UM 1229 following the issuance of this order.

CreditWatch and also noted the negligible impact of the tax expense disallowance from the consolidated perspective.

*Resolution*

In establishing fair and reasonable rates, this Commission is required to balance the interests of the utility investor and the consumer. ORS 756.040(1), which essentially codifies the constitutional standard established in *Hope* for avoiding confiscatory utility rates, provides, in part:

> Rates are fair and reasonable for purposes of this subsection if the rates provide adequate revenue both for operating expenses * * * and for capital costs of the utility, with a return to the equity holder that is:
>
> (a) Commensurate with the return on investments in other enterprises having corresponding risks; and
>
> (b) Sufficient to ensure confidence in the financial integrity of the utility, allowing the utility to maintain its credit and attract capital.

This Commission is not required to use any specific method of ratemaking. Rather, "if the total effect of a rate order cannot be said to be unreasonable, judicial inquiry * * * is at an end." *Hope*, 320 U.S. at 602. If the rates "do not afford sufficient compensation, the State has taken the use of the utility property without paying just compensation[.]" *Duquesne Light Co. v. Barasch*, 488 US 299, 308 (1989). Any party challenging a rate order, however, "carries a heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences." *Hope* at 602.

Turning to this case, we initially note that PacifiCorp's claim of confiscatory rates has been partially addressed by our reduction of the tax expense disallowance from $16.07 to $12.4 million. The rate consequences of that adjustment, therefore, have been partially mitigated. In addition, we also emphasize the limited time period the tax adjustment will impact PacifiCorp. As detailed above, the SB 408 automatic adjustment clause will begin aligning taxes collected in rates with taxes actually paid on January 1, 2006. Through this true-up mechanism, PacifiCorp will have the opportunity to recover tax payments made after that date that exceed the allowable tax expense in rates. Consequently, the company's actual financial exposure is limited to a three-month period, that is, from the October 4, 2005, effective date for the new rates through December 31, 2005.

Given our reduction to the tax adjustment and the limited time period that this adjustment will impact PacifiCorp, we conclude that PacifiCorp has failed to establish that our decision results in confiscatory rates. We reject PacifiCorp's use of new evidence, such as MEHC's purchase of PacifiCorp and the resulting impact on the

utility's tax expense, to evaluate the validity of the challenged rates. As we have previously discussed, ratemaking requires that an estimate be made at a specific point in time as to the utility's reasonable operating costs. Accordingly, "[t]he reasonableness of the rates under consideration is judged at an instant in time - namely, the rate case decision." *Portland General Electric*, Order No. 89-687 at 8. While the fact that PacifiCorp may incur its full stand-alone tax expense under MEHC ownership is relevant in determining costs in a new rate proceeding, it serves no use in our examination as to whether the rates adopted in the challenged order are fair and reasonable.

We also discount evidence related to actions taken by the credit rating agencies. Although some agencies expressed some concern about the adjustment, all action taken since the rate order—both positive and negative—resulted from a combination of factors, not solely our rate decision. Furthermore, even if we were to accept PacifiCorp's apparent assumption that Fitch's downgrade was based solely on our tax adjustment, that downgrade left PacifiCorp at BBB+, a strong credit rating that should not preclude PacifiCorp's ability to attract necessary capital.

In summary, PacifiCorp has produced little evidence to establish that, when viewed from the time the decision was made, the rates approved in Order No. 05-1050 fail to provide adequate revenue to cover the company's operating expenses and capital costs. While the tax adjustment obviously impacts, to some degree, PacifiCorp's revenues, the resulting rates are far from confiscatory. As the Court in *Hope* explained:

> Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, *even though they might provide only a meager return*[.]"

320 U.S. at 605 (*emphasis added*).

**ORDER**

IT IS ORDERED that:

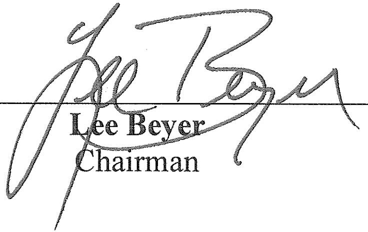
1. The tax adjustment made in Order No. 05-1050 is reduced, as provided in this order.

2. The remainder of Order No. 05-1050 remains unchanged.

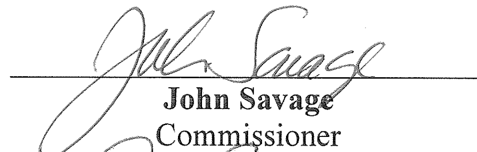
3. PacifiCorp may file new rate schedules consistent with the findings of fact and conclusions of law in this order.

4. Deferred accounting for the revenue requirement impact of the reduction in the tax adjustment ordered here, for the period beginning October 28, 2005, and ending when PacifiCorp puts new base rates into effect, is granted.

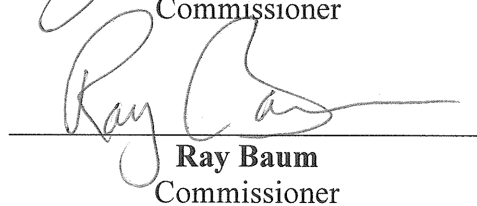
Made, entered, and effective JUL 10 2006.



**Lee Beyer**
Chairman



**John Savage**
Commissioner



**Ray Baum**
Commissioner

A party may appeal this order to a court pursuant to applicable law.