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May 3, 2006

Via Electronic and U.S. Mail

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

Re: In the Matter of the Adoption of Permanent Rules Implementing SB 408 Relating to Matching Utility Taxes Paid with Taxes Collected
Docket No. AR 499

Dear Filing Center:

Enclosed please find an original and two (2) copies of the Opening Comments of the Industrial Customers of Northwest Utilities and Northwest Industrial Gas Users in the above-captioned Docket.

Please return one file-stamped copy of the document in the self-addressed, stamped envelope provided. Thank you for your assistance.

Sincerely yours,

/s/ Anna E. Studenny
Anna E. Studenny

Enclosures
cc: Service List

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served a copy of the foregoing Opening Comments of the Industrial Customers of Northwest Utilities and the Northwest Industrial Gas Users, upon the parties, on the official service list for AR 499, by causing the same to be electronically served, to those parties with an email address, as well as mailed, postage-prepaid, through the U.S. Mail.

Dated at Portland, Oregon, this 3rd day of May, 2006.

/s/ Anna E. Studenny
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BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

AR 499

In the Matter of the Adoption of Permanent Rules Implementing SB 408 Relating to Utility Taxes.	)	OPENING COMMENTS OF THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES AND NORTHWEST INDUSTRIAL GAS USERS ON THE PROPERLY ATTRIBUTED AND TAXES COLLECTED/EARNINGS TEST STRAW PROPOSALS

Pursuant to Administrative Law Judge Kathryn Logan's Memorandum dated April 18, 2006, the Industrial Customers of Northwest Utilities ("ICNU") and Northwest Industrial Gas Users ("NWIGU") submit these Opening Comments regarding the Public Utility Commission of Oregon's ("OPUC" or the "Commission") adoption of rules to implement Senate Bill ("SB") 408. ICNU and NWIGU have submitted straw proposals regarding the proper manner in which to implement the provisions of SB 408 dealing with "properly attributed" and "taxes collected." Explained below are the policy reasons that support adopting rules consistent with ICNU and NWIGU's proposals.

I. A Series of Principles Should Guide the Appropriate Implementation of Properly Attributed

Adoption of rules to implement the SB 408 provisions for determining the portion of the total consolidated taxes paid that are properly attributed to the regulated operations of the utility should be guided by a series of principles that reflect the intent of SB 408 and sound regulatory policy. These principles include:

1. The utility income tax expense to be recovered from customers may not exceed the total consolidated tax payment;

2. Tax benefits supported by utility revenues belong to ratepayers;

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

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

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

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

Below are a series of simple examples that demonstrate that these principles are consistent with the legislative intent of SB 408 and sound policy. In broad terms, ICNU and NWIGU propose that the Commission determine the amount of taxes paid that is properly attributed to the regulated operations of the utility by implementing the §§ 3(12)(a) and (b) caps under SB 408 and by applying the "proportionate share" attribution methodology (or some variation of this methodology) to the consolidated tax group.

A. SB 408 Addresses the Mismatch Between Taxes Collected and the Taxes Paid that are Properly Attributed to Regulated Utility Operations

The Commission establishes rates that provide a utility with an opportunity to recover its costs, including its income tax expenses. The Commission traditionally determined a utility's income taxes by evaluating the utility on a "stand-alone" basis, i.e., the income taxes the utility would pay if it was a free-standing separate company, which for many years was the actual situation for Oregon utilities. Due to a series of corporate acquisitions, "stand-alone" no longer accurately represents the corporate structure of many Oregon utilities. This led to a mismatch between the amounts collected from customers for the utility's income tax cost and the amount of taxes paid that could be properly attributed to the utility. An obvious example was the

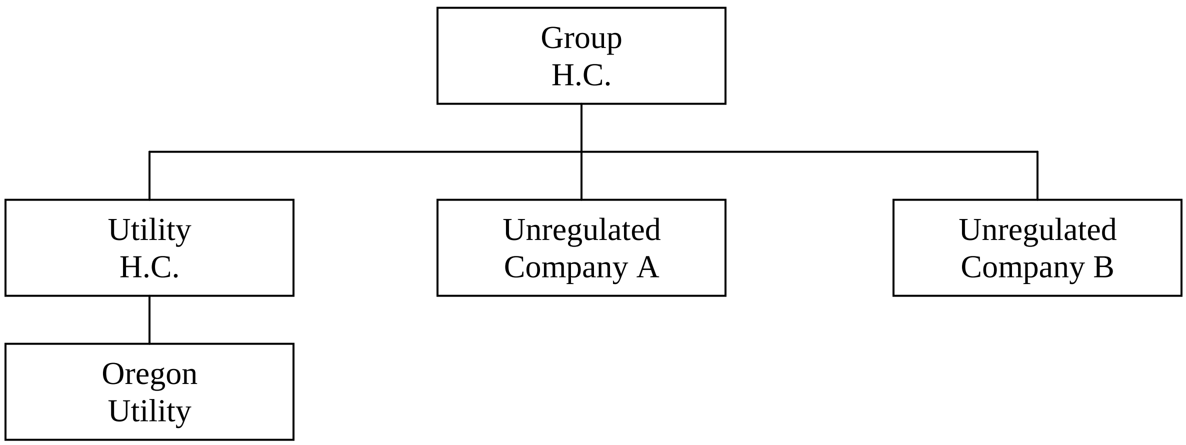
PGE/Enron situation in which PGE collected approximately $80 million per year for its income tax expense but paid no taxes because Enron filed on a consolidated tax basis and had large, offsetting tax losses in its unregulated businesses.

The mismatch and overcollection for taxes was not limited to this situation. A holding company structure provided opportunities for tax benefits supported by utility revenues to be shifted away from the "stand-alone" utility, and thus, under the then-existing methodology allowed those tax benefits to be captured by the holding company's shareholders rather than by the ratepayers. A consolidated tax filing and payment raised the further question of what portion of the single, actual tax payment by the group parent should be properly allocated to the utility, as opposed to allocated to the group parent's other businesses, particularly when some subsidiaries had net losses. Finally, without regard to tax issues raised by the holding company structure, there were concerns that the amount collected for taxes by a stand-alone utility could exceed its actual tax payment if it failed to control its costs. SB 408 is intended to address all of these concerns and assure ratepayers that they will be charged only for that portion of the actual tax payment made by the utility or its parent.

Specifically, SB 408 requires that the Commission determine what portion of the total "taxes paid" to units of government is "properly attributed to the regulated operations of the utility" and, conversely, what portions are properly attributed to each of the other affiliates. ICNU and NWIGU continue to believe that the Commission's temporary rule reflects the legally correct interpretation of "properly attributed" by allocating to the utility and <u>each</u> affiliate its proportionate share of "taxes paid" in a consistent manner and that this rule is supported by sound policy. We have spent considerable time in workshops working with the utilities to try to reach consensus on this issue. Such a consensus has eluded the groups.

B. The Principles Guiding Implementation of "Properly Attributed" Demonstrate that Proportionate Share Allocation is the Best Policy

Although we cannot anticipate how the utility may change its corporate arrangements, implementation of the "properly attributed" requirement should be guided by principles that are flexible enough to account for changed circumstances. The examples use variations of the following simplified holding structure:



Business operations and revenues are produced only by the Oregon Utility and Unregulated Companies A and B. The Group Holding Company is the taxpayer for the group. The Utility Holding Company is a "shell" whose sole function, in some cases, is to issue debt to third parties.

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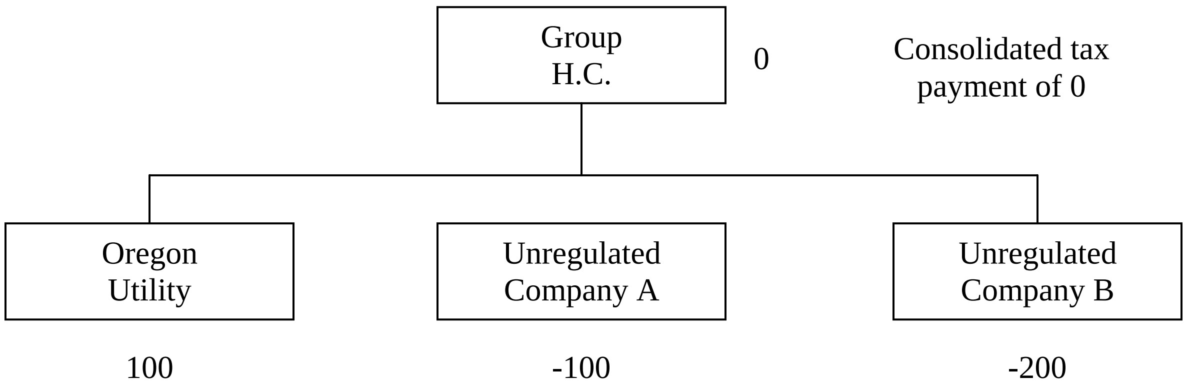
<u>Principle 1</u>: The utility income tax expense to be recovered from customers may not exceed the taxes paid by the Group Holding Company.

Example 1



The numbers represent the "stand-alone" tax liability for each company. The stand-alone tax liability of the Group Holding Company is zero, i.e., it produces no revenues itself. The "taxes paid" by the Group Holding Company is the sum of the "stand-alone" amounts of the three operating companies; in this case the sum is -200, so the consolidated tax payment is zero.

This is similar to the PGE/Enron situation: As a "stand-alone" entity, the Oregon Utility would have incurred a tax cost of $100. But, it is not a "stand-alone" entity; the only taxpayer is the Group Holding Company and it pays zero taxes due to the losses in Companies A and B.

Section 3(12)(b) of SB 408 addresses this situation and provides that the taxes paid properly attributed to the utility cannot exceed the amount paid by the Group Holding Company. Consequently, any taxes collected from customers must be returned. We do not believe that any party disputes this principle or result.

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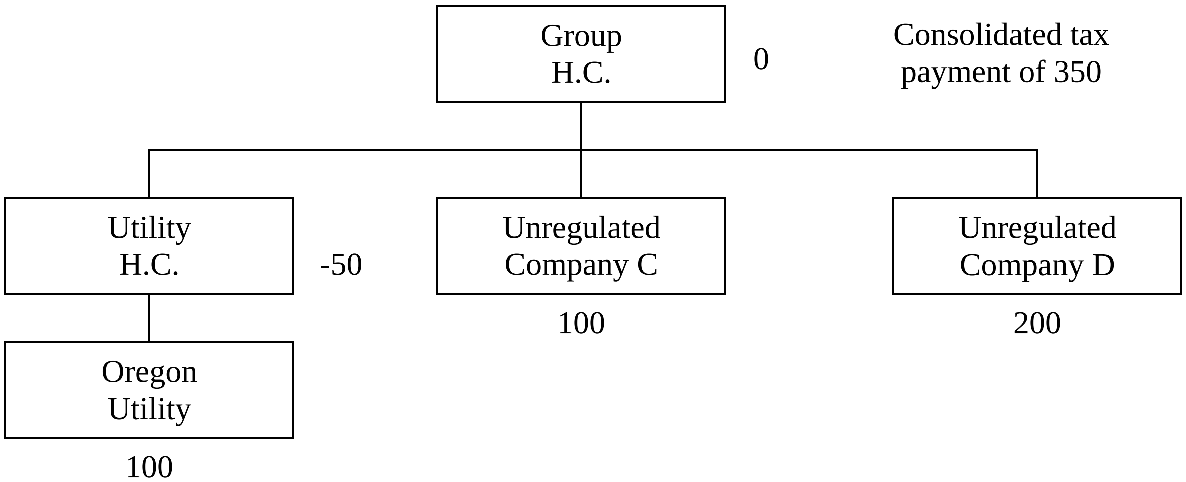
<u>Principle 2</u>: Tax benefits supported by utility revenues belong to ratepayers.

Example 2



A New Owner has acquired the Oregon Utility in Example 1, so the old Group Holding Company and Companies A and B are gone. The new owner has profitable subsidiaries, Unregulated Companies C and D. The Utility Holding Company issues debt to third parties and holds the equity in the Oregon Utility. The Utility Holding Company debt produces an interest deduction of $50. The Utility Holding Company has limited or no business operations and produces little or no revenue.

There is no issue in Example 2 of attribution of losses from Unregulated Companies C and D. The sole issue is who should capture the $50 of tax benefits of the Utility Holding Company: the shareholders of the Group Holding Company or the customers of the Oregon Utility?

The Utility Holding Company generates no revenues itself, and thus, the debt is supported by income from the Oregon Utility. On a "stand-alone" basis, the Oregon Utility would be entitled to collect $100 from customers as its income tax expense and the $50 tax benefit of the Utility Holding Company would be captured by the shareholders of the Group Holding Company. This result is unfair and was rejected by the legislature.

Section 3(12)(a) of SB 408 addresses this issue and provides that taxes, including tax benefits, incurred as a result of utility income belong to ratepayers. Thus, the amount of taxes paid properly attributed to the utility is the "stand-alone" amount of $100 reduced by the $50 tax credit of the Utility Holding Company. Any amount of taxes collected over $50 must be returned to ratepayers.

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

Principle 3 is a corollary to Principle 1. The recognition of the tax losses by the unregulated businesses yields the result in Principle 1. But Principle 3 is broader: the OPUC must consider these tax losses, not just when the consolidated tax payment is zero or less than the "stand-alone" utility amount, but even when the consolidated tax payment is greater than the stand-alone amount. Prior to SB 408, the Commission did not look beyond the utility. SB 408 now requires the Commission to look at the reality of the corporate structure. Nothing in SB 408 suggests, nor does any policy support, that the Commission should ignore the entire corporate structure if the consolidated tax payment exceeds the stand-alone amount.

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

The Commission recognized in UE 170 that the Legislature enacted SB 408 to address the flaws in the policy of calculating the amount of utility taxes in rates on a stand-alone basis:

> Recently, the Commission's use of the stand-alone methodology has come under criticism due to the potential mismatch between monies collected from ratepayers to pay taxes and the actual amount of taxes paid to the taxing authorities. Because tax laws

> allow a utility's corporate holding company to file consolidated tax returns reflecting its full span of operations, losses in some operations can offset profits in others. Thus, consolidated tax reporting may result in amounts collected for taxes in a utility's rates to exceed the taxes the parent company actually pays.

Re PacifiCorp, OPUC Docket No. UE 170, Order No. 1050 at 13 (Sept. 28, 2005). The Commission noted that SB 408 corrected this mismatch by calling for an annual adjustment to rates that would "ensure that ratepayers are not charged more tax than the utility or its affiliated group pays to units of government that is properly attributed to the regulated operations of the utility." Id. at 14. Given that the legislature enacted SB 408 to correct the inequity of customers paying for taxes that are not paid to units of government and properly attributed to the utility's regulated operations, the rules implementing SB 408 should reflect a policy that results in the utility paying no more than its proportionate share of the income tax liability of the entire consolidated group.

The Supreme Court of Pennsylvania has described at length the policy underlying the requirement that utility customers pay no more than the utility's proportionate share of total consolidated tax liability, explaining that policy is grounded in fundamental ratemaking such as charging customers for only expenses that are actually incurred and for property that is "used and useful." Barasch v. Penn. Pub. Util. Comm'n, 493 A.2d 653, 656 (1985). The court's explanation of this policy within the context of the ratemaking process is consistent with the OPUC's ratemaking authority and policy:

> The rates of a utility are to be completed on the basis of providing a fair return on the fair value of its property used and useful in the public service after allowance for proper operating expenses, taxes, depreciation, and any other legitimate item. In computing the cost of operation and service, the Commission considers evidence of the *actual expenses*, properly adjusted when the evidence warrants; there is no legal or equitable reason for a supplemental return *in*

> *the guise of allowances for taxes or other expenses which are not incurred*.

Id. (quoting City of Pittsburgh v. Penn. Pub. Util. Comm'n, 182 Pa.Super. 551 (1956) (emphasis in original). The court elaborated that applying these concepts to tax expenses is no different than other types of expenses:

> If a utility, because of its combining with a group, is able to obtain a desirable long term lease of property containing a very favorable rental which, through the passing years, becomes considerably less than market value, we would not sanction the inclusion of the market rental value in the place of the actual rent in the ratemaking process. If a utility joins with non-utility companies in a buying group, and because of the increased purchasing power wielded by the group, it is able to purchase material, equipment, supplies, etc. at discount prices—lower than that which it would be required to pay if it made the purchases as a separate entity, we would not condone the inclusion of higher costs in the rate-making process. It is a violation of basic rate-making principles to charge ratepayers for theoretical expenses which in practice the utility bears no liability. This is true no matter the category of expense. The ratepayers are entitled to the benefits of reduced tax expenses accruing to the utility by participation in a consolidated tax return as was filed in this case.

Id. at 657.

The "used and useful" concept is codified in Oregon statute at ORS § 757.355. Including in rates only those expenses that are actually incurred is a fundamental assumption of Oregon ratemaking. Re PacifiCorp, OPUC Docket No. UE 116, Order No. 01-787 at 42 (Sept. 7, 2001). Furthermore, the Commission recognizes that including the utility in a larger corporate structure sometimes affects costs that must be adjusted in rate cases. In the recent proceeding related to MidAmerican Energy Holdings Company's ("MEHC") acquisition of PacifiCorp, for example, the Commission approved a $4.3 million rate credit to reflect the potential elimination of insurance cost savings as a result of removing PacifiCorp from the corporate structure that included ScottishPower's captive insurance company. Re MEHC, OPUC Docket No. UM 1209, Order No. 06-082, Appendix A at 37-38 (Feb. 29, 2006).

The Pennsylvania court relied on these same principles to determine that the proper amount of taxes to include in the revenue requirement is the utility's "proportionate share" of the total taxes paid by a consolidated group. Barasch, 493 A.2d at 656. The court found that "*all* tax savings arising out of participation in a consolidated return must be recognized in rate-making, otherwise we would be condoning the inclusion of fictitious expenses in the rates to be charged to the ratepayers." Id. (emphasis added).

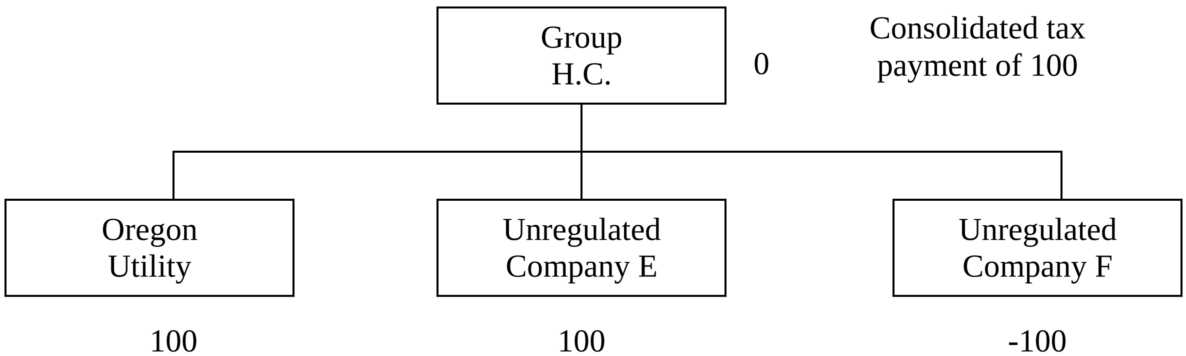
The Commonwealth Court of Pennsylvania struck down using the "pour-over" allocation method to set rates using this rationale, because that methodology would result in customers paying more than the utility's fair share of the consolidated group's total tax liability. Barasch v. Penn. Pub. Util. Comm'n, 548 A.2d 1310, 1315 (1988). The court determined that, given the focus under Pennsylvania law on including only actual expenses in rates, the "benefits accruing to the parent company as a result of the filing of a consolidated tax return be apportioned among all members of the consolidated group, and not be withheld discriminatorily from some members simply because those members happen to be regulated utilities." Id. at 1316. The court determined that a more appropriate methodology was a modified effective tax rate that fairly apportioned consolidated tax liability among all members of the group. Id. at 1314.

SB 408 authorizes a unique mechanism that, among other things, provides for an after-the-fact adjustment to rates based on the differences between taxes collected and taxes paid. Nevertheless, the Pennsylvania decisions are informative as to the proper policies to incorporate in the Commission's rules. Like Pennsylvania, Oregon has determined that customers should not be responsible for paying the costs of taxes that are not paid to taxing authorities or exceed the utility's share of taxes paid. Oregon law also follows the "used and useful" principle and prohibits customers from paying costs that the utility does not actually incur. SB 408 calls for adjustments to rates to ensure that taxes collected reflect taxes paid and properly attributed to regulated utility operations but also provides for specific adjustments in that determination that are similar to those in the modified effective tax rate methodology endorsed in Pennsylvania. Given these similarities, the Pennsylvania courts' rationale demonstrates that the best policy is to adopt an allocation methodology that results in Oregon customers paying rates that include only the utility's proportionate share of consolidated tax liability.

The pour-over method advocated by certain investor owned utilities ("IOUs") does not result in an equitable and non-discriminatory sharing of consolidated tax liability. Under that methodology, the utility is allocated the full amount of its stand-alone tax liability, and other members of the consolidated group are allocated only any remaining amount. This represents a poor policy that discriminates against the regulated utility and its customers. Moreover, such a policy is inconsistent with SB 408. The legislature did not pass this controversial legislation merely to lessen the burden on customers of tax expenses that are not paid to government; the legislature sought to eliminate that burden. A pour-over methodology that results in customers paying for tax liabilities that are the result of income of a utility affiliate does not fulfill the purpose for which SB 408 was passed. It is not enough simply to ensure that rates are adjusted if the consolidated tax liability is less than the utility's stand-alone tax liability. Customers are only responsible under SB 408 for that portion of taxes paid that is properly attributed to the regulated operations of the utility. The means of ensuring that occurs is developing a proportionate share allocation methodology as set forth in the temporary rules.

The following example demonstrates this methodology in practice, along with the adjustments that ICNU and NWIGU propose to make as a compromise:

Example 3



Principles 1 and 2 are not raised by this example. This example poses the question raised in Principle 3: how should affiliate tax losses be allocated when the consolidated tax payment equals or exceeds the stand-alone tax? In the example, the only tax paid is $100 by the Group Holding Company, which equals the utility stand-alone amount. The issue is how the $100 consolidated tax liability should be allocated among the operating companies, which is necessary to determine how much of this $100 is properly attributed to the Oregon Utility, to Company E and to Company F. Sections 3(6) and (7) of SB 408 require an allocation that treats the Oregon Utility and Company E the same. The $100 tax paid by the Group Holding Company should be allocated $50 to the Oregon Utility and $50 to Company E, i.e., each dollar of the consolidated tax liability is allocated 50/50 between the Oregon Utility and Company E. This follows the Temporary Rule.

Certain IOUs propose that all $100 of the consolidated tax liability should be allocated to the Oregon Utility and to ratepayers, and NONE allocated to the shareholders of Company E, i.e., ratepayers are first in line to pay the consolidated tax liability. This result is unfair, contrary to the intent of SB 408, and would be bad public policy for Oregon.

Nonetheless, because the Commission has requested options, ICNU and NWIGU's straw proposals reflect a modified proportionate share allocation methodology in which consolidated tax liability would be allocated among only those members of the corporate group that have some direct relationship with the regulated utility. This includes: 1) all subsidiaries of the utility; 2) all "sister" affiliates of the utility; and 3) all affiliates that have a "nexus" with the utility. This compromise proposal works in concert with the other principles identified in these comments and is based on the assumption that the other Principles are adopted.

A consolidated tax filing reflects the common ownership of all affiliates within the holding company. Certain IOUs contend that this is an insufficient reason to share tax losses when there is no other relationship between the utility and the affiliate with the tax loss. As a compromise, instead of applying Principle 4 to the entire group, the OPUC could identify those affiliates that had a transactional relationship with the Oregon Utility (e.g., sold power to the Oregon Utility) or a financial relationship with the utility (e.g., if the affiliate held debt supported by utility revenues) and would apply Principle 4 only to this subgroup, including the common parent. Utility management could control the size of the subgroup by limiting such transactions or financial relationships and thereby insulate from tax loss sharing under Principle 4 any losses of affiliates without such a nexus.

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

Actual holding company structure will almost certainly be more complex than these examples, and the holding company structure may evolve and adopt financial arrangements or time financial arrangements in an attempt to circumvent direct application of these principles and the rules. First, in Example 2 the debt supported by utility income may not reside in the Utility Holding Company but may reside in the Group Holding Company or in a new intermediary

Holding Company. Principle 2 should still apply; the tax benefits associated with the debt of each parent directly in line from the utility to the Group Parent should be separately evaluated and allocated based on net income of those businesses supporting the debt of each parent. If the debt held by the parent is disproportionate to the income generated by the parent itself, then the tax benefit associated with the debt must be allocated to the subsidiary operating businesses of the parent supporting the debt. Second, again in Example 2, the Utility Holding Company may have subsidiaries with business operations in addition to the Oregon Utility. Principle 2 still applies; the interest on the debt should be allocated among such operating subsidiaries, including the Oregon Utility, based on net income. Third, again in Example 2, the Utility Holding Company may have operations and revenues itself which support a portion of the Utility Holding Company debt. Principle 2 still applies; the Utility Holding Company is just allocated a portion of the debt interest as if it were a subsidiary. Finally, debt and cash may be used in ways, particularly in the timing of its use, to suggest that Holding Company cash but not debt is committed to the Utility. Principle 2 still applies; it should be implemented to recognize that cash and debt are interchangeable and ignore timing differences.

Principle 6: Implementation of the Principles will be fact-specific.

Annual implementation of SB 408 should not be reduced to a simple mechanical formula, but will require—both in the rate case establishing the tax component in rates and in the after-the-fact determination of taxes paid properly attributed to the utility—a factual inquiry and determination by the Commission. The tax reports and implementation process should be adequate to make these determinations without being unduly burdensome to the utility or to the Commission.

C. PacifiCorp's "With and Without" Proposal Would Continue the Mismatch that SB 408 was Intended to Correct

PacifiCorp's "with and without" straw proposal determines the difference between the Group Holding Company tax "with and without" the Oregon Utility included and deems this difference to be the portion of taxes paid properly attributed to the utility, if this difference is less than the utility stand-alone amount. The sole substance of the proposal is captured in footnote 1 of PacifiCorp's straw proposal—speculating on what factors could cause the "with and without" result to differ from the stand-alone amount. This "with and without" proposal differs very little from the IOUs' initial proposal (taxes paid is the stand-alone amount unless there is a <u>net</u> unregulated loss). This difference will be the same as the Oregon Utility's "stand-alone" tax liability except for certain anomalies, e.g., if the alternative minimum tax would apply to the Oregon Utility as a "stand-alone" entity, then the "with and without" difference would be less than the stand-alone tax liability by this amount.

The "with and without" proposal is simply a mechanism, not a principle. The "with" result is actual consolidated taxes paid; but, the "without" result, like any mechanism, is driven by the inputs—i.e., what specifically is taken out. PacifiCorp does not propose that the "without" inputs would make adjustments to any affiliate other than the Oregon Utility. Thus, by arbitrarily limiting the inputs in the "without" mechanism, PacifiCorp does not address either Principles 3 or 4. For example, in Example 3 the tax benefit of the $50 interest on debt held by the Utility Holding Company, but supported by income from the Oregon Utility, would remain with the shareholders of the Group Holding Company under PacifiCorp's "with and without" proposal. The interest deduction would not benefit ratepayers, unless the $50 tax liability is also removed as a "without" input and reflected in the "without" result. This is contrary to the legislature's intent in passing SB 408.

The "with and without" mechanism cannot be left to the utility accountants but would require the Commission to make a factual inquiry and determination about what tax benefits should be removed in the "without" case. This is likely to be a very subjective and contentious process. The Commission should reject this proposal on the basis that it fails to meet the goals and policies of the Legislature in enacting SB 408.

II. PGE's Proposed New Category of "Taxes Charged" Would Rewrite SB 408's Definition of "Taxes Authorized to be Collected in Rates" Based on Actual Results

Determining the amount of "taxes authorized to be collected in rates" is a relatively straightforward matter that relies on the amounts previously recognized by the Commission in setting rates. SB 408 § 3(13)(e) states:

> 'Taxes authorized to be collected in rates' means the product determined by multiplying the following three values: (A) The revenues the utility collects from ratepayers in Oregon, adjusted for any rate adjustment imposed under this section; (B) The ratio of the net revenues from regulated operations of the utility to gross revenues from regulated operations of the utility, as determined by the commission in establishing rates; and (C) The effective tax rate used by the commission in establishing rates.

The Attorney General unequivocally concluded that, in determining the amount of "taxes authorized to be collected in rates," the utility "must use the ratio of net to gross revenues (3(13(e)(B)) and the effective tax rate (3(13(e)(C)) determined and used, respectively, by the Commission in previously establishing rates for the utility." Op. Att'y Gen. at 28 (Dec. 17, 2005). This refers to "prior actions by the Commission." Id. The amount is determined independently of any adjustments made under SB 408 and does not include any adjustment for changes in utility's actual costs between rate cases. Id. at 27-28.

PGE's suggestion that the Commission create a new category of "taxes charged" to ratepayers that reflects a utility's actual financial results has no basis in SB 408, would undercut the intent of the law, and would undermine the emphasis on producing reliable cost estimates in a rate case. By its express terms, PGE's proposal would calculate "taxes charged" according to "*actual* net to gross ratios" as a component of determining "taxes authorized to be collected" in rates. PGE Straw Proposal at 1 (emphasis added). This is inconsistent with SB 408's explicit definition, which the Attorney General found to refer to data previously approved by the Commission. There is no basis to adopt such an unlawful departure from the statute as part of the OPUC's rules.

A cost increase that lowers a utility's overall net income in a given year may reduce stand-alone income tax liability, but it does not decrease the amount of income tax expense that the Commission authorized the utility to collect in rates. Adjusting the amount of "taxes collected" based on actual costs for purposes of determining an adjustment to rates under SB 408 will maintain the mismatch between taxes collected and taxes paid that SB 408 was intended to remedy.

ICNU and NWIGU propose to exclude consideration of any cost true-up for a natural gas utility performed pursuant to the purchased gas adjustment ("PGA"). These amounts are known when the amount of "taxes collected" is determined and are passed through to customers without affecting the utility's profits.

III. Authorizing Deferred Accounting to Address Disallowed Expenses Conflicts with SB 408 and ORS § 757.259

PGE proposes that the Commission adopt a rule calling for a deferral account to be set up each year to account for the tax implications of disallowed expenses or investments that are not included in rates. PGE Straw Proposal at 4. The tax benefit associated with expenses such as disallowed costs is one reason why the legislature sought to match the amount of taxes collected and taxes paid that are properly attributed to the utility. Authorizing a deferred account to allow the utility to retain the amounts of tax benefits associated with expenses that are disallowed due to imprudence or other reasons effectively would allow recovery of this cost as a "tax expense." Allowing a utility to indirectly recover as a "tax expense" the costs of an investment that it was not allowed to recover directly is contrary to the intent of SB 408.

In addition, ORS § 757.259 provides no basis for authorizing deferred accounting in these circumstances. Deferred accounting was not intended to be used as an ongoing mechanism to permit utilities to recover the tax benefits of disallowances, and the Commission should not adopt rules that call for reauthorization of a deferred account "each year." PGE Straw Proposal at 4. Furthermore, the Commission's deferred accounting principles limit the use of the mechanism to situations in which a particular type of event has a requisite financial impact on the utility. Re Staff Request to Open an Investigation Related to Deferred Accounting, OPUC Docket No. UM 1147, Order No. 05-1070 at 3 (Oct. 5, 2005). The financial impact on a utility of a disallowed cost would not fit either of these criteria. Although ICNU believes that utilities continue to overuse and abuse deferred accounting, it is not the catch-all mechanism to address the utilities' complaints about SB 408.

IV. The Earnings Test Proposals Would Lead to the Income Tax Expense Collected from Customers Serving as the Utilities' Financial Buffer

PGE and Northwest Natural both propose that the Commission adopt an earnings test that would limit the amount of the surcharge or refund by a utility as a result of a SB 408 automatic adjustment clause to ensure that such an adjustment would not cause the utility to earn above or below its authorized return on equity. This proposal conflicts with the intent of the law, represents poor policy, and was rejected by the Legislature.

The earnings test would change an SB 408 rate adjustment to match taxes collected and taxes paid into a means of insulating the utility from a variety of factors that could limit its ability to earn its authorized rate of return. This proposal focuses solely on altering the adjustment to the income tax expense collected by a utility without respect to the multitude of other factors that affect utility earnings. This would effectively provide the utilities a financial buffer from the effect of cost increases in other areas. SB 408 was enacted to ensure that rates would be adjusted if there was a mismatch between the amount of taxes collected and the amount of taxes paid that is properly attributed to regulated utility operations. Adopting an earnings test that caps any adjustment to ensure a utility would not earn above or below its authorized rate of return would limit the effectiveness of SB 408 with respect to this primary goal. In fact, the Legislature rejected this approach, which is why SB 408 does not permit consideration of an earnings test.

The Commission's treatment of the natural gas utilities' PGAs provides guidance with respect to the earnings test. In UM 903, the Commission imposed a one-way earnings test for local distribution companies ("LDCs") as part of a PGA. See Re Investigation into Policy Issues and Procedures Associated with Recovery of Purchased Gas Costs by Oregon's Regulated Gas Distribution Utilities, OPUC Docket UM 903, Order No 99-272 (Apr. 19, 1999). If an LDC's earnings exceed its authorized return on equity by more than 300 basis points, then some level of rate reduction is required to pass through to customers the changes in purchased gas costs. In adopting this approach, the Commission stated:

> The objective should be simply to determine whether or not an LDC's earnings are excessive prior to passing through prudently incurred gas cost changes in rates. It should not be structured so as to turn each PGA filing into an annual rate case or show cause hearing where the company's earnings would be subject to detailed review and adjustment. Indeed, such scrutiny may eliminate any incentive for the company to pursue efficiencies.

Id. at 8 (emphasis added).

The so-called "earnings test" that the utilities seek to superimpose on SB 408 implementation would have the precise effect that the Commission rejected in the context of PGAs, turning each SB 408 tax filing into a mini rate case and eliminating the incentives to control costs. Instead of protecting consumers from paying rates that included tax expenses that are not actually paid by utilities, the earnings test advanced by the utilities would provide an opportunity for an annual earnings review, enhancing its ability to earn its authorized return each year. If a utility has not earned its authorized return in a given year, that is not a reason to fail to adjust taxes collected to match taxes paid. SB 408 has no language that limits its applicability to utilities that are earning at or above their authorized return.

Furthermore, the fact that the OPUC requires LDCs to lower their rates in the context of a PGA if the utility has excessive earnings is not a reason to impose a two-way earnings test in the context of SB 408 implementation. Gas utilities are allowed to pass through purchased gas costs as a matter of sound policy. The excess earnings test was adopted in Order No. 99-272 as part of a broader policy concerning the sharing of gas price risk between LDCs and their customers. As part of Order No. 99-272, the OPUC also adopted a policy of sharing a percentage of the gas-cost risk between LDC shareholders and ratepayers. Id. at 17-18. The fact that LDC's ratepayers are protected against excessive earnings as one component of the OPUC's PGA policies is not a sound reason for superimposing an earnings test on SB 408 implementation that would allow utilities to retain taxes not paid but collected in order to enhance their earnings.

V. Conclusion

Sound regulatory policy and principles support applying the proportionate share allocation methodology to the consolidated tax group to implement SB 408's provisions regarding "properly attributed." The IOUs' proposed implementation of properly attributed would merely extend the mismatch between taxes collected and taxes paid that SB 408 was passed to correct. The Commission should reject the IOUs' suggested implementation of properly attributed and the proposals for an earnings test and deferred account that would undermine the intent behind SB 408's important customer protections.

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Respectfully submitted,

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