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November 15, 2006

VIA ELECTRONIC FILING

Public Utility Commission of Oregon
550 Capitol Street N.E., Suite 215
P.O. Box 2148
Salem, OR 97308-2148

Attention: Filing Center

Re: Submission of Draft Private Letter Ruling Pursuant to Order No. 06-532 in AR 499

Northwest Natural Gas Company ("NW Natural") hereby submits the attached draft private letter ruling ("PLR") to the Oregon Public Utility Commission (the "Commission") pursuant to the final rules promulgated under Order No. 06-532. NW Natural is also providing a copy of the PLR to Commission staff, the Northwest Industrial Gas Users ("NWIGU") and the Citizens' Utility Board ("CUB"). A copy of the PLR is available to the other participants on the service list to Docket No. AR 499 upon request.

Sincerely,

/s/ Gregg S. Kantor

Gregg S. Kantor

Attachment: Draft Private Letter Ruling
cc: Ed Busch, OPUC Staff (w/attachment)
Judy Johnson, OPUC Staff (w/attachment)
Jason Jones, OPUC Staff (w/ attachment)
Paula Pyron, NWIGU (w/ attachment)
Jason Eisdorfer, CUB (w/ attachment)
Remaining AR 499 Service List (w/o attachment)

NW Natural

CERTIFICATE OF SERVICE

I hereby certify that on the 15th day of November, 2006, I served the foregoing NORTHWEST NATURAL'S SUBMISSION OF DRAFT PRIVATE LETTER RULING PURSUANT TO ORDER NO. 06-532 IN AR 499 – COVER LETTER ONLY upon each party listed below via electronic mail ("e-mail") if provided or by U.S. Mail if e-mail was not provided.

Kelley C. Miller
Kelley C. Miller, Staff Assistant
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OPUC DOCKET NO. AR 499

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December , 2006

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BY HAND DELIVERY

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Washington, DC 20224

Re: **Ruling Request for Northwest Natural Gas Company (EIN #930256722)**

Dear Sir or Madam:

On behalf of Northwest Natural Gas Company ("NWN" or "Taxpayer"), we respectfully request that the Internal Revenue Service ("Service") issue rulings under §168(i)(9) of the Internal Revenue Code of 1986, as amended ("Code"), former Code §167(l) and former Code §46(f) regarding the status under the depreciation and investment tax credit ("ITC") normalization rules of the ratemaking procedure which will be described in detail hereafter.

STATEMENT OF FACTS

Taxpayer

NWN is incorporated and headquartered in the State of Oregon. It is principally engaged in the distribution of natural gas in Oregon and southwest Washington. Taxpayer provides this service to over 500,000 residential, 59,000 commercial and 850 industrial customers. It is subject to regulation by the Oregon Public Utility Commission ("Commission") and the Washington Utilities and Transportation Commission ("WUTC") with respect to the terms and conditions of service and, most particularly, as to the rates it can charge for its service. NWN also engages in some relatively minor non-regulated activities.

Taxpayer is the parent of an affiliated group of corporations that files a consolidated U.S. Corporation Income Tax Return. The return includes NWN's two active affiliates. One of the

affiliates owns an interest in a FERC-regulated interstate natural gas pipeline and the other is engaged in various non-regulated activities. The consolidated return is filed with the Internal Revenue Service Center in Ogden, Utah. NWN employs a calendar year reporting period and uses the accrual method of accounting. It is currently under the audit jurisdiction of the Large and Midsize Business Division of the Internal Revenue Service, Natural Resources and Construction Group.

The Setting Of NWN's Rates

NWN's rates are established by the Commission on a "rate-of-return" basis. Taxpayer is, therefore, permitted an opportunity to recover its prudently incurred costs as well as to earn an appropriate return on its net invested capital (*i.e.*, rate base). Thus, it is subject to the depreciation and ITC normalization rules contained in Code §168(i)(9), former Code §167(l) and former Code §46(f). The above-described process of setting rates requires that NWN compute its tax expense element of cost of service, including both current and deferred components ("income tax expense"), so that all of its incurred costs can be ascertained. The assets used in this "cost-based" activity are subject to the depreciation and ITC normalization rules contained in Code §168(i)(9), former Code §167(l) and former Code §46(f).

The Oregon Legislation

In September of 2005, Senate Bill 408 ("SB 408") was signed into law.[1] A copy of SB 408 is appended as Exhibit 1. This legislation prescribed a new and different method for the treatment of the tax element of cost of service for certain Oregon utilities. Specifically, the legislation was intended to "more closely align taxes collected by a regulated utility from its ratepayers with taxes received by units of government." The new "alignment" procedures apply to all income taxes – federal, state and local.

SB 408 requires all regulated, investor-owned utilities that provided electric or natural gas service to an average of 50,000 or more customers in Oregon in 2003 to file an annual tax report with the Commission on or before October 15th following the year for which the report is being made. Among other information, the tax report must contain (1) the amount of taxes that were paid (a) by the utility or (b) by the affiliated group and that are "properly attributed" to the regulated operations of the utility and (2) the amount of taxes "authorized to be collected in rates." If the Commission determines that the amount of taxes "authorized to be collected" differs by more than $100,000 from the amount of "properly attributed" taxes paid in any one of the previous three years, it must order the subject public utility to implement a rate schedule with an automatic adjustment clause accounting for the difference by means of either a surcredit or a surcharge on its customers' utility bills. In other words, SB 408 seeks to reconcile and then to match taxes collected in rates with taxes paid by and properly attributed to the utility, as those terms are defined by the statute, for each annual period.

[1] SB 408 was codified at ORS 757.267 and 757.268.

There are, therefore, two measurements that are fundamental to the operation of the statute: (i) that of taxes paid and "properly attributed" to the Oregon regulated operations of the utility and (ii) that of "taxes authorized to be collected in rates."

The Permanent Rules

SB 408 did not define or even describe the phrase "properly attributed" and provided no methodology for its identification This task was delegated by the legislature to the Commission. A permanent rulemaking docket, AR 499, was opened by the Commission on September 15, 2005 to establish rules for the implementation of the SB 408 – including the procedures for quantifying "properly attributed" taxes. In Order No. 06-532 issued on September 14, 2006, the Commission adopted final administrative rules setting forth that methodology, as well as other items necessary for the implementation of SB 408 ("Permanent Rules"). A copy of the Permanent Rules is appended as Exhibit 2.

Taxes Authorized To Be Collected In Rates

The mechanics for computing taxes authorized to be collected in rates are established in Commission Order No. 06-400, AR 499. Per this order, the calculation must be driven by data from each utility's last rate case. From that data, each utility calculates the percentage of each dollar of revenue that, per the assumptions made when setting rates, is attributable to the recovery of the tax expense element of cost of service.[2] This percentage is then multiplied by the revenues actually collected as reported in the utility's regulatory operational report. The result of this computation represents the total taxes, both current and deferred, deemed collected as a result of the provision of the regulated service at the rates established in the prior rate case.

For example, if, in a utility's last prior rate case, the tax expense element of cost of service (both current tax expense and deferred tax expense) was assumed at $10 million and total projected revenues (*i.e.*, the revenue requirement upon which rates were based) were $200 million, it is presumed that 5% ($10/$200) of every dollar collected from customers while those rates are in effect represents the recovery of the tax expense element of cost of service. If, in a subsequent period, total revenues collected are $240 million, then that amount is multiplied by 5% to quantify the deemed "taxes authorized to be collected in rates." Under SB 408, this would be $12 million.

"Properly Attributed" Taxes

The Permanent Rules define the amount of federal, state, and local income taxes paid by the utility or by the affiliated group and that is "properly attributed" to the Oregon regulated operations of the utility. In general, it is the lowest of three alternative computations: (a) the "stand alone" tax liability of the utility (hereafter, Method 1), (b) the total tax liability of the affiliated group adjusted as described below (hereafter, Method 2) and (c) the total tax liability of

[2] Technically, this is accomplished in two steps: (1) a computation of a margin (net income before taxes divided by gross revenues) and (2) the multiplication of that margin by the tax rate.

the affiliated group (again, as adjusted) apportioned as prescribed by the Permanent Rules (hereafter, Method 3).

Adjustments

The adjustments to both the stand alone (Method 1) and consolidated (Methods 2 and 3) tax liabilities are of three basic types: (i) "incentive" adjustments that are meant to prevent certain tax benefits from being passed on to customers (*i.e.*, to encourage the activities which produce the tax benefits), (ii) "regulatory lag" adjustments that account for certain tax benefits that are not reflected in rates because they were recognized subsequent to the last rate setting and (iii) adjustments that are meant to ensure compliance with the normalization rules of the Code.

The incentive adjustments relate to items such as charitable contributions and the renewable electricity production credits provided for by Code §45. Under each of the three alternative methodologies, the tax benefits of some or all of these two items are added back to the relevant tax liability. The effect of this is that they are not used to reduce Oregon regulated rates. Thus, the benefits are retained by the utility, thereby promoting the underlying activity. Because the treatment of these two items in ratemaking does not implicate the normalization rules, the mechanics surrounding them will not be further described and no rulings will be requested with respect to these.

The "regulatory lag" adjustments relate to production tax credits and certain state credits. Insofar as these items do not implicate the normalization rules, the mechanics surrounding them will not be further described and no rulings will be requested with respect to these.

The general architecture of the "normalization protection" process is to adjust the starting tax liability (either consolidated or standalone, as the case may be) by "stripping out" the two tax benefits that are subject to the normalization rules - depreciation and ITC claimed with respect to public utility property ("PUP"). In the case of Method 1, the standalone tax liability is then adjusted to reflect the effects of both of these benefits on current and deferred taxes. Method 2 operates the same way as Method 1 except its starting point is the consolidated tax liability instead of a standalone one. In the case of Method 3, the consolidated tax liability so modified is subjected to an allocation procedure. After the application of this procedure, the same "back end" adjustments are made as in Methods 1 and 2. In each of the three methods, the benefits of depreciation and ITC are, thus, effectively isolated and handled discretely. In this way, the process is designed to ensure compliance with the normalization rules.

There follows a description of each of the three methods. In each description, the adjustments for anything other than depreciation and ITC-related tax benefits, *i.e.*, incentive and regulatory lag adjustments, have been excluded.[3] Additionally, while SB 408 and the Permanent

[3] A complete matrix of all adjustments cross-referenced to the relevant provision of the Permanent Rules is appended as Exhibit 3.

Rules subject state and local income taxes to the same procedures, these are not reflected in the descriptions below.

Method 1 (Stand Alone)

Starting point: Pro forma federal income tax liability computed by reference to the revenues and expenses included in the utility's Oregon regulatory report of operations for the period.

Adjustment 1 Recompute tax liability eliminating tax depreciation on PUP;

Adjustment 2 Add back the benefit of ITC;

Adjustment 3 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 4 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 5 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.[4]

Result: Method 1 properly attributed taxes.

Method 2 (Consolidated/Adjusted)

Starting point: Consolidated federal income tax (per return) after adjustments for subsequent changes (audits, amended returns, etc.).

Adjustment 1 Add back the tax benefit of *all* tax depreciation claimed with respect to *all* PUP anywhere in the group (calculated at statutory tax rate);

Adjustment 2 Add back the benefit of ITC claimed on *all* PUP anywhere in the group;

Adjustment 3 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 4 Adjust for deferred taxes related to the Oregon regulated operations; and

[4] There is also an adjustment for interest to conform it to the method used by the Commission in establishing rates. However, this adjustment is not germane to the normalization rules and, hence, this ruling request.

Adjustment 5 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.

Result: Method 2 properly attributed taxes.

Method 3 (Consolidated/Apportioned)

Starting point: Consolidated federal income tax (per return) after adjustments for subsequent changes (audits, amended returns, etc.).

Adjustment 1 Add back the tax benefit of *all* tax depreciation claimed with respect to *all* PUP anywhere in the group (calculated at statutory tax rate);

Adjustment 2 Add back the benefit of ITC claimed on *all* PUP anywhere in the group;

Adjustment 3 Apportion the amount after Adjustment 2 by applying a "three-factor" formula;[5]

Adjustment 4 Compare the result of Adjustment 3 to the standalone floor[6] and proceed using the greater of the two;

Adjustment 5 Deduct the benefit of tax depreciation claimed with respect to PUP used in the Oregon regulated operations;

Adjustment 6 Adjust for deferred taxes related to the Oregon regulated operations; and

Adjustment 7 Deduct the benefit of ITC amortization recognized by the Commission in establishing rates.

Result: Method 3 properly attributed taxes.

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[5] The "three factor" formula consists of a simple average of the ratios of Oregon regulated operations to the consolidated group total for plant, wages and sales.

[6] The standalone floor is the amount that results after Adjustment 2 of Method 1 (an adjusted standalone tax liability) reduced by an allocation of the imputed negative tax liability of affiliates with tax losses. This imputed negative tax liability is computed after eliminating depreciation and ITC claimed by each loss affiliate with respect to its PUP. The total of such imputed negative tax liabilities is apportioned based on a simple average of the ratios of Oregon regulated operations to all regulated operations for plant, wages and sales.

Comparison of "Taxes Authorized" To "Taxes Properly Attributed"

As described above, the result of the calculation described as representing the taxes authorized to be collected in rates is compared to the calculation described as representing the taxes properly attributed to the Oregon regulated operation for the same period. Starting in fiscal years beginning on or after January 1, 2006, if, for any of the previous three years, the difference between the two equals or exceeds $100,000 (for all income taxes), the Commission must implement an adjustment clause to "true up" the taxes collected to the taxes properly attributed by crediting or charging customers for the difference on future bills.

SB 408, the Permanent Rules and the Normalization Rules

By mandating the establishment of an adjustment clause for the tax expense element of cost of service, SB 408 and the Permanent Rules effectively establish a methodology for the computation of the tax expense element of cost of service itself. In other words, the requirement to "true up" to a measure of "properly attributed taxes" means that, ultimately, it is these "properly attributed taxes" that are collected in rates. Consequently, the normalization rules are clearly relevant to these calculations. In recognition of this fact, the Permanent Rules require that, on or before December 31, 2006, each utility subject to SB 408 must seek a private letter ruling from the Internal Revenue Service as to whether the utility's compliance with SB 408 and the Permanent Rules would cause the utility to fail to comply with any provision of the normalization rules. They further provide that no rate adjustment will be implemented while such a ruling request is pending. Finally, the Permanent Rules authorize a utility to propose an adjustment to its computation of properly attributed taxes in order to avoid a probable violation of the normalization rules.

RULINGS REQUESTED

Taxpayer respectfully requests the following rulings:

1. The use of Method 1 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

2. The use of Method 2 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

3. The use of Method 3 to calculate Taxpayer's tax expense element of cost of service is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

4. The automatic adjustment clause described above which conforms taxes collected by Taxpayer from its Oregon customers to taxes paid with respect to its Oregon regulated operations is consistent with the requirements of Code §168(i)(9), former Code §167(l) and former Code §46(f).

STATEMENT OF LAW

Code §168(i)(9)(A)(i) provides that, in order to use a normalization method of accounting with respect to any public utility property, the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes.

Code §168(i)(9)(A)(ii) requires that a taxpayer make adjustments to a reserve to reflect the deferral of such taxes resulting from the use of different depreciation methods for tax purposes and for purposes of computing its tax expense element of cost of service.

Code §168(i)(9)(B)(i) provides that the normalization requirements are not met if the taxpayer uses a procedure or adjustment that is inconsistent with the requirements of Code §168(i)(9)(A).

Code §168(i)(9)(B)(ii) provides that the procedures and adjustments that are inconsistent with these limitations include any procedure or adjustment for ratemaking purposes that uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless such estimate or projection is also used, for ratemaking purposes, with respect to the other two such items and with respect to rate base.[7]

Former Code §46(f) imposed limitations on the treatment of the ITC claimed by certain regulated public utility companies with respect to their "public utility property." The general rule under former Code §46(f)(1) stated that a taxpayer's cost of service cannot be reduced by any amount of the ITC. A taxpayer's rate base, however, may be reduced by the ITC amount provided that the reduction is restored no less rapidly than ratably over the useful life of the property.

Alternatively, taxpayers could elect the application of former Code §46(f)(2). This section provided that ITC will not be allowed with respect to public utility property if (1) the taxpayer's cost of service for ratemaking purposes and on its regulated books of account is reduced by more than a ratable portion of the ITC, or (2) taxpayer's rate base is reduced by reason of any portion of the ITC.

Former Code §46(f)(6) provides that, for purposes of determining whether or not the taxpayer's cost of service for ratemaking purposes is reduced by more than a ratable portion of

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[7] See also former Code §167(l)(3)(G).

ITC, the period of time used in computing depreciation expense for purposes of reflecting operating results in the taxpayer's regulated books of account will be used.

Reg. §1.46-6(g) provides that ITC amortization period must be no shorter than the one used to calculate ratemaking depreciation expense.

Reg. §1.46-6(b)(2)(ii) provides that, in determining whether or to what extent ITC has been used to reduce cost of service, reference will be made to any accounting treatment that affects cost of service.

Reg. §1.46-6(b)(3)(ii)(A) provides that, in determining whether or to what extent ITC has been used to reduce rate base, reference will be made to any accounting treatment that reduces the permitted return on investment by treating the credit less favorably than the capital that would have been provided if the credit was unavailable.

Reg. §1.46-6(b)(4)(i) provides that cost of service or rate base is also considered to have been reduced by reason of all or a portion of a credit if such reduction is made in an indirect manner.

Former Code §46(f)(10) provided that the normalization requirements are not met if the taxpayer uses a procedure or adjustment that is inconsistent with the limitations in former Code §46(f)(1) and 46(f)(2). The procedures and adjustments that are inconsistent with these limitations include any procedure or adjustment for ratemaking purposes that uses an estimate or projection of the taxpayer's qualified investment for purposes of the credit unless such estimate or projection is consistent with the estimates and projections of property which are also used for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

On September 11, 1991, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means held a hearing on the IRS withdrawal of the proposed regulations concerning the treatment of consolidated savings under the normalization requirements of the Code. At that hearing, Deputy Assistant Secretary (Tax Policy) Michael J. Graetz released a statement in which he set forth the IRS's position with regard to this issue. Attached to his statement was a memorandum to him from Abraham N. M. Shashy, Jr., Chief Counsel, which served as the basis for Mr. Graetz's conclusions. Serial 102-45, 102nd Congress, First Session.

ANALYSIS

As described above, SB 408 and the Permanent Rules effectively dictate the level of tax expense that can be included in rates over time. They do this by (1) prescribing the mechanics for arriving at a permissible amount ("properly attributed" taxes) and (2) requiring an automatic adjustment clause to ultimately achieve the quantity of rate collections appropriate to that level of tax expense – no more and no less. In order to facilitate a normalization analysis, this system of ratemaking for taxes is best divided into four components. The first three are the three alternative methodologies established by the Permanent Rules to quantify the "properly

attributed" taxes paid. Since, in each year, the lowest of the three computations is used and since there is no way to predict in advance which of the methods will produce the lowest amount, it is appropriate to subject each of the three to a separate normalization analysis. The fourth component is the "true up" procedure itself.

Three Methods and Deferred Taxes

The three methods of determining "properly attributed" tax amounts share two significant characteristics. The first is a lack of specificity in identifying the components of tax expense. The purpose of the three methods is to arrive at the amount of "taxes paid" that is "properly attributed" to the regulated operations in Oregon. Under the terms of SB 408, "taxes paid" includes "deferred taxes related to the regulated operations of the utility."[8] Thus, "taxes paid" as defined in SB 408, includes the entire tax expense element of cost of service for the Oregon regulated operation. The computational focus of the three methods on overall tax expense leaves some lack of clarity regarding the portion of the calculated amount that is current tax and the portion that is deferred tax. However, this lack of clarity can be readily overcome by the application of some logic and basic accounting principles, as will be illustrated hereafter.

More significantly, each of the three methods includes an adjustment for those deferred taxes "related to the regulated operations of the utility." For Methods 1 and 2, this is Adjustment 4. For Method 3 it is Adjustment 6. Section (2)(b) of the Permanent Rules defines a utility's "deferred taxes" as:

> "the total deferred tax expense of regulated operation, as reported in the deferred tax expense accounts as defined by the Federal Energy Regulatory Commission, that relate to the year being reported in the utility's results of operations report or tax returns."

This cross-reference to regulatory books of account creates an unusual situation with regard to deferred taxes. By defining deferred taxes in this way, the Permanent Rules require that the deferred portion of tax expense (*i.e.*, "taxes paid") equals that reflected on those books as of the end of the relevant measurement period. These regulatory books of account will, in the normal course, reflect deferred taxes (and, hence, deferred tax expense) generated by the temporary differences between the regulatory and tax treatment of all items of which the utility is aware as of the time of the closing of the regulatory books.[9] The deferred tax account balances will be "event driven" (*i.e.*, they will result from whatever actual events transpire). Since this closing of the regulatory books will, in the normal course, occur months prior to the filing of the relevant tax return, at least some elements of deferred tax expense will consist of estimates. However, the reference to "tax returns" in the definition above indicates that the level of deferred tax expense reflected in the regulatory books of account are to be "trued up" to the "actual" deferred tax amount. Thus, the deferred taxes recorded in these books will, in all cases, reflect the tax

[8] SB 408, Section 3(13)(f)(C).

[9] Note that this adjustment includes all deferred taxes – not just those associated with PUP. Because only the PUP-related deferred taxes are relevant to the normalization rules, the illustrations set out later in this ruling request will only focus on those.

deferrals (and reversals) that actually occur by virtue of the differences between the regulatory and tax treatment of items of income and expense.

By adopting the regulatory books as the deferred tax paradigm, compliance with SB 408 and the Permanent Rules will, of necessity, result in the consideration in the setting of rates of the amount of deferred taxes that is required by the depreciation normalization rules. This will include the treatment of excess deferred taxes. To the extent that the regulatory books of account employ the average rate assumption method to flow back these amounts, then that practice will be recognized in the setting of rates through the deferred tax adjustment.

The remaining issues are, therefore, (1) whether or not the SB 408 procedures permit the flowing through of the benefits of accelerated depreciation and/or ITC from other regulated operations and (2) the extent to which these procedures do something to the computation of the current provision of tax expense that may be deemed to be an indirect (and impermissible) adjustment to the deferred provision or an inconsistency that runs afoul of Code §168(i)(9)(B).

Analyses of the Three Methods

Each of the three following analyses proceeds from a single set of facts. NWN's base case consists of a single utility group member regulated by both the Commission and the WUTC and two non-regulated subsidiaries. The tax rate is 35%. The three members file a consolidated tax return incorporating the following results:

NWN Tax Expense - Base Data						
	NWN-Oregon	NWN-WUTC		Sub 1	Sub 2	Consolidated
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110
PUP Dep – Add'l Tax	$400	$40				$440
Other Dep				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250

METHOD 1 (Stand Alone)

The application of Method 1 to the base data produces the following results:

NWN-Oregon Tax Expense - Method 1						
	NWN-Oregon	**NWN– WUTC**		**Sub 1**	**Sub 2**	**Consolidated**
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110
PUP Dep - Add'l Tax	$400	$40				$440
Other Dep				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250
Standalone Tax Liability	$300					
Adjustment 1	$175	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$475					
Adjustment 2	$50	Tax benefit of ITC on Oregon PUP [$50]				
Sub-total	$525					
Adjustment 3	($175)	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$350					
Adjustment 4	$140	Deferred taxes on Oregon regulated operations				
Sub-total	$490					
Adjustment 5	($5)	Regulatory ITC amortization				
Total Tax Expense	$485					

Under this method, the current tax provision is $300. The deferred tax provision is $185. $140 of this is attributable to the Oregon PUP depreciation (*i.e.*, NWN's Oregon regulatory books will reflect $140 of deferred tax expense). There is another $45 of deferred tax expense relating to the ITC. While there is no deferred ITC provision labeled as such, Adjustment 2 (+$50) net of Adjustment 5 (-$5) effectively creates such a provision.

This method represents conventional, stand-alone ratemaking for taxes that is used in most jurisdictions. As indicated above, the level of deferred taxes provided should be adequate under the depreciation normalization rules. The net effect of the two ITC entries is that the credit is being amortized ratably as required by the ITC normalization rules. Finally there is nothing about the current provision that should give the slightest pause under either set of rules.

In short, this ratemaking should be non-controversial from a tax normalization perspective.

METHOD 2 (Consolidated/Adjusted)

The application of Method 2 to the base data produces the following results:

NWN-Oregon Tax Expense - Method 2						
	NWN-Oregon	**NWN- WUTC**		**Sub 1**	**Sub 2**	**Consolidated**
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110
PUP Dep – Add'l Tax	$400	$40				$440
Other Dep				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250
Consolidated Tax Liability	$250					
Adjustment 1	$193	Tax benefit of depreciation on all PUP [($500+$50) X 35%]				
Sub-total	$443					
Adjustment 2	$60	Tax benefit of ITC on all PUP [$50+$10]				
Sub-total	$503					
Adjustment 3	($175)	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$328					
Adjustment 4	$140	Deferred taxes on Oregon regulated operations				
Sub-total	$468					
Adjustment 5	($5)	Regulatory ITC amortization				
Total Tax Expense	$463					

The Method 2 example above results in a current tax provision of $278. This is the subtotal after Adjustment 3 ($328) less the $50 of ITC claimed with respect to Oregon PUP. The deferred tax provision consists of the $140 relating to Oregon PUP. There is an additional deferred tax provision of $45 relating to the NWN-Oregon ITC. Again, this latter provision is not explicitly described but must be extracted by netting the NWN-Oregon ITC portion of Adjustment 2 ($50) against Adjustment 5 ($5). Thus, when compared to Method 1, the total deferred tax provision remains unaffected.

The $22 difference between the $463 of total tax expense using Method 2 and the $485 using Method 1 is attributable to:

Method 1 tax expense	$485	
Reduction for non-NWN Oregon tax benefit	($50)	[$60-$140+$30]
NWN-WUTC depreciation	$18	[$50 X 35%]
NWN-WUTC ITC	$10	
Method 2 tax expense	$463	

The difference between this Method 2 calculation and the prior Method 1 calculation is entirely attributable to activities other than NWN-Oregon's. In this regard, this difference is of the nature of a consolidated tax adjustment ("CTA"). Generally, a CTA adjusts a utility's tax expense element of cost of service based on the "tax reducing" consequences (usually tax losses) of activities undertaken by consolidated return affiliates of the utility (*i.e.*, consolidated return benefits). Method 2 effectively does this, although, because its starting point is the consolidated tax liability, it also reflects the tax consequences of divisional activities.[10]

CTAs were very controversial in the latter part of the 1980s. During that period of time, a number of utilities requested guidance from the Service regarding the normalization implications of certain CTAs that resulted in reductions of the tax expense element of cost of service. The Service issued several private letter rulings (including PLRs 8525156, 8643024, 8711050 and 8801041) all of which concluded that the imposition of a CTA of this type would violate the normalization rules. These conclusions were based on the dual premises that (1) such ratemaking indirectly reduced the level of deferred tax required to be provided under the normalization rules and (2) that it violated the "consistency requirement" of those rules.

On September 11, 1991, Michael Graetz, Deputy Assistant Secretary (Tax Policy), announced a change in the Service's position with respect to CTAs at a hearing before the Committee on Ways and Means Subcommittee on Select Revenue Measures. At that time, Mr. Graetz, disavowed the previously issued letter rulings and declared:

> "It is the position of the Service that, in the absence of regulations specifically prohibiting consolidated tax adjustments, these adjustments can be made without violating the normalization requirements of the Code. Therefore, if requested in an appropriate circumstance, the Service would rule that these adjustments do not violate the normalization requirements of the Code, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property."

[10] Though Method 2 can also pick up incremental net tax from affiliates, as a practical matter, where this would be the case, Method 1 would always produce a lower level of tax expense. Thus, unless there is a net benefit from non-NWN-Oregon operations, Method 2 would never be the basis for the tax expense computation.

At that hearing, Mr. Graetz distributed the memorandum from IRS Chief Counsel, Abraham Shashy, upon which he based this statement. This memorandum was a bit more nuanced than was Mr. Graetz's testimony and stated:

> "These arguments do raise a concern that a consolidated tax adjustment might be used to offset a utility's deferred tax reserve from normalization or might be used to flow through the accelerated depreciation benefit of another regulated utility in the same consolidated group. These concerns are worthy of further study. Until they are resolved, we can only say with confidence that consolidated tax adjustments do not violate normalization, provided that the adjustments are applied only to the extent of current ratemaking tax expense and not to the deferred tax reserve applicable to accelerated depreciation on public utility property, and provided that the taxable income any other regulated utilities used in the calculation of the adjustments is computed on a normalized basis."

Taxpayer is aware of no authorities relevant to CTAs and the normalization rules issued subsequent to the hearing referenced above. Certainly no regulations such as those mentioned by Mr. Graetz have been promulgated – or even proposed.

Based on these "authorities," a CTA that (1) solely impacts the current portion of the tax expense element of cost of service, (2) doesn't impact (directly or indirectly) the level of deferred taxes required by the normalization rules and (3) doesn't effect a flow through of another utility's accelerated depreciation benefits should not run afoul of the depreciation normalization rules.

Method 2 reduces NWN-Oregon's Method 1 current tax provision from $300 to $278. By virtue of the $28 of normalization-protection adjustments, it is absolutely clear that the reduction does not have the capacity to flow through to NWN-Oregon customers the tax benefits of NWN-WUTC depreciation or ITC claimed with respect to PUP. It is likewise clear that deferred taxes have been provided on all tax deferrals. Finally, the reduction in the current tax provision attributable to the net reduction in consolidated tax attributable to operations other than those of NWN-Oregon would seem to be well within the tolerances of Mr. Graetz's testimony and Mr. Shashy's memorandum (assuming, of course, that those documents continue to reflect the position of the Service).

Consequently, the level of tax expense produced by Method 2 should be deemed consistent with both the depreciation and ITC normalization rules.

METHOD 3 (Consolidated/Apportioned)

The application of Method 3 to the base data produces the following results:

NWN-Oregon Tax Expense - Method 3						
	NWN-Oregon	**NWN - WUTC**		**Sub 1**	**Sub 2**	**Consolidated**
Pre-Dep Book Income	$1,500	$250		$200	$300	$2,250
Book PUP Dep	$100	$10				$110
PUP Dep - Add'l Tax	$400	$40				$440
Non-PUP Depreciation				$600	$100	$700
Taxable Income	$1,000	$200		($400)	$200	$1,000
Tax Liability	$350	$70		($140)	$70	$350
ITC	$50	$10			$40	$100
Current Tax Expense	$300	$60		($140)	$30	$250
Consolidated Tax Liability	$250					
Adjustment 1	$193	Tax benefit of depreciation on all PUP [($500+$50) X 35%]				
Sub-total	$443					
Adjustment 2	$60	Tax benefit of ITC on all PUP [$50+$10]				
Sub-total	$503					
Adjustment 3	$458	Apportion using a "3 factor" formula (91.13%)*				
Adjustment 4	$458	Compare to standalone floor and select greater of two**				
Adjustment 5	($175)	Tax benefit of depreciation on Oregon PUP [$500 X 35%]				
Sub-total	$283					
Adjustment 6	$140	Deferred taxes on Oregon regulated operations				
Sub-total	$423					
Adjustment 7	($5)	Regulatory ITC amortization				
Total Tax Expense	$418					
	*	Oregon Regulated		Total Group	Ratio	
	Plant	$2,500,000,000		$2,750,000,000	90.91%	
	Wages	$250,000,000		$265,000,000	94.34%	
	Sales	$1,300,000,000		$1,475,000,000	88.14%	
				Average	91.13%	
	**	Method 1 after Adjustment 2 (adjusted standalone)				$525
		Negative tax liabilities (Sub 1)			($140)	
		Allocated negative liabilities (93.87%)***				($131)
		Floor				$394
	***			Oregon Regulated	All Regulated	Ratio
		Plant		$2,500,000,000	$2,700,000,000	92.59%

		Wages		$250,000,000	$260,000,000	96.15%
		Sales		$1,300,000,000	$1,400,000,000	92.86%
					Average	93.87%

Assuming that the deferred tax provision is, as in the two prior methods, $140 plus the $45 for deferred ITC, the current tax provision using Method 3 is $233.

Whereas Methods 1 and 2 use only "tax data" in the calculation of tax expense, Method 3 employs a very different approach. It allocates the consolidated tax liability (as adjusted) based on non-tax events (*i.e.*, the "3-factor" formula). Unlike Method 2, its use is in no way premised on the existence of consolidated return benefits. In other words, for Method 3 to produce the lowest tax expense of the three methods, it is not necessary that any non-NWN-Oregon activity produce a net tax benefit (*e.g.*, a net operating loss). The mere allocation based on the three factors can render it the lowest of the three. It is, therefore, analytically quite different from a CTA.

It is useful to analyze the $67 source of the difference between the tax provision calculated under Method 3 ($418) and that calculated under Method 1 ($485). This is attributable to:

Method 1 tax expense	$485	
Reduction for non-NWN Oregon tax benefit	($50)	[$60-$140+$30]
NWN-WUTC dep	$18	[$50 X 35%]
NWN-WUTC ITC	$10	
Reduction due to apportionment	($45)	[$503 X (100%-91.13%)]
Method 3 tax expense	$418	

Insofar as the Method 3 allocation procedure is applied to the adjusted consolidated tax liability, it impacts all elements of that liability. This is evident from the table above. While the first three reconciling items represent the impact associated with non-NWN-Oregon activities, the fourth reflects the impact associated with NWN-Oregon-related activities.

In terms of the normalization rules, the Method 3 deferred tax provision (Adjustment 6) is identical to adjustments made in Methods 1 and 2. As was the case with those methods, the full effect of the deferral occasioned by accelerated depreciation is preserved. ITC is a somewhat more complex matter. Application of the apportionment process (Adjustment 3) to the adjusted consolidated tax liability may be viewed as effectively reducing the add-back of ITC claimed with respect to Oregon PUP ($50 of the $60 Adjustment 2). This add-back may be seen as necessary to produce deferred ITC so that the credit can be amortized ratably over its life. Consequently, if viewed mechanically, this procedure may be interpreted as failing to provide the necessary level of deferred ITC. Alternatively, so long as rates are reduced by no more than the Adjustment 7 amount ($5) each year, then the tax expense element of cost of service

complies with the normalization rules. So long as rate base is not reduced by any deferred ITC, the ITC normalization rules may be viewed as being comprehensively complied with.

With regard to the current tax provision, the normalization-protection adjustments (which are identical to those incorporated into Methods 1 and 2) operate to insulate the tax benefits of PUP depreciation and ITC from the impact of the "3-factor" allocation. They are "stripped out" (or, actually, added back) before the allocation is imposed.[11]

Consequently, the level of tax expense produced by Method 3 should be deemed consistent with both the depreciation and ITC normalization rules.[12]

The Tax Adjustment Clause

As described above, the automatic adjustment clause for taxes that is required under SB 408 conforms the rates previously charged to customers to actual events. In other words, like every "tracker" or "balancing account," it compares what was projected to occur when rates were set to what actually happened.

If the utility had the ability to perfectly forecast its financial (including its tax) future and the tax future of its affiliates, divisions, etc. at the time rates were being established, it would have included in its cost of service precisely the level of tax expense produced by the "properly attributed" procedures required under the Permanent Rules. Because it did not have to ability to do this, it incorporated some estimate of its "proper" tax expense into rates. The automatic adjustment clause effectively adjusts rates to what they would have been had there been perfect knowledge. Consequently, if the "properly attributable" tax amount as calculated pursuant to SB 408 and the Permanent Rules would have been permissible under the normalization rules had the utility had perfect knowledge, it should be no less permissible when it is the basis of a "true-up" procedure.

At a pre-submission meeting with representatives of the National Office, Taxpayer was specifically asked to address the implications of the SB 408 tax adjustment clause under the "consistency rules" of Code §168(i)(9).

Code §168(i)(9)(A) ["Section A"] describes the basic mechanic that constitutes the heart of the depreciation normalization rules – the necessity to reflect deferred taxes in ratemaking and to establish an ADFIT reserve. Code §168(i)(9)(B)(i) provides that any "procedure or adjustment" that is inconsistent with the requirements of Section A violates the depreciation

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[11] Note that, where the 3-factor apportionment ratio is very small (e.g., 2%) and the floor very low, it is possible for the subtotal after Adjustment 4 to be a very small number. When Adjustments 5 through 7 are then made, the resulting total tax expense can be a number lower than the total deferred tax provision or even a negative number. This would imply a negative current tax provision even where there is no tax loss.

[12] In the event that the "floor" is higher than the "basic" Method 3 calculation, then the Method 3 result can be viewed as a fairly standard CTA in which the current tax provision is adjusted for the tax reduction effects of affiliate activities. Moreover, the normalization-protection adjustments are still incorporated into the calculation, thereby preventing flow through from other regulated operations. Under the CTA analysis set forth in the discussion of Method 2, such an alternative Method 3 should not contravene the normalization rules.

normalization rules. As indicated above, because, pursuant to the Permanent Rules, Taxpayer uses its regulatory books of account to establish its deferred tax expense, it will, of necessity, reflect a level of such expense commensurate with the tax actually deferred. This procedure is in all regards consistent with Section A.

Code §168(i)(9)(B)(ii) ["Section B"] establishes what has been come to be known as the "consistency rules." This provision defines as inconsistent with Section A any estimate or projection that does not treat tax expense, depreciation expense, ADFIT and rate base symmetrically.

There are two respects in which the tax adjustment clause may be considered to incorporate "inconsistencies." The first relates to the dichotomy between the level of expenses considered for purposes of computing tax expense and those considered for other ratemaking purposes. The second relates to the calculation of the amount of taxes "authorized to be collected in rates." Each will be addressed separately.

Level of Expense

The "level of expense" inconsistency that is produced by the tax adjustment clause mechanism is attributable to the fact that an income tax liability does not exist on its own. It is purely a creature of other activities – specifically, accretions to and dispositions of wealth. The National Office representative recognized the fact that a tax adjustment clause effectively severs the link between the activities that give rise to a tax liability and the tax liability itself. This transpires whether or not the utility files as part of a consolidated group.

For example, if the tax expense element of cost of service is established based on a projection of revenue to be earned and costs to be incurred during a period and it turns out that a much higher level of expenses are, in fact, incurred during that period, the tax liability incorporated in rates will exceed the tax liability actually incurred. Under the SB 408 tax adjustment mechanism, a refund would be due customers notwithstanding that the utility is unable to recover from customers those incremental costs the incurrence of which caused the tax liability to diminish. The link between expenses and the resultant tax liability has been severed.

From a normalization perspective, this is of particular relevance where the additional expense that can't be recovered is depreciation with respect to PUP. A simple illustration of this situation follows.

	Rate Case	Actual
General Business Revenues	$10,000,000	$10,000,000
Book Depreciation on Public Utility Property	($2,000,000)	($6,000,000)
Regulatory Federal Taxable Income	$8,000,000	$4,000,000
Federal Statutory Tax Rate	35%	35%
Regulatory Federal Tax Expense (Current & Deferred)	**$2,800,000**	**$1,400,000**

In this case, the SB 408 tax adjustment clause mechanism would require a refund of $1,400,000 of taxes to customers even though the $4,000,000 of unanticipated PUP depreciation is not collected from customers. Thus, the mechanism is capable of providing a tax benefit to customers with respect to PUP depreciation they do not fund. This is the type of inconsistency that the National Office representative requested be addressed in connection with the requirements of Code §168(i)(9).

Taxes Authorized to be Collected in Rates

The calculation of the amount of taxes authorized to be collected in rates proceeds from the "margin" computation previously described. Essentially, it is presumed that each dollar of revenue has embedded within in it the level of tax expense recovery projected in the setting of rates. Obviously, the actual levels of both revenues and expenses invariably differ from those upon which rates are set. The presumption of a "standardized" tax collection rate has, therefore, the capacity to vary from actuality, thereby impacting the measurement of the required tax adjustment. A simple example follows.

			Additional		SB 408
	Per Rate Case		Actual	Total Actual	Calculations
Revenue	$10,000,000	100%	$1,000,000	$11,000,000	$11,000,000
Expenses					
Fuel Cost	$4,000,000	40%		$4,000,000	
O&M	$2,000,000	20%	$1,000,000	$3,000,000	
Book Depreciation	$1,000,000	10%		$1,000,000	
	$7,000,000	70%		$8,000,000	
Net Margin/Ratio	$3,000,000	**30%**		$3,000,000	**30%**
Effective Tax Rate	35%			35%	**35%**
Tax Expense ("Collected")	$1,050,000	10.5%		$1,050,000	$1,155,000
Taxes Paid	$1,050,000			$1,050,000	$1,050,000
SB 408 adjustment					**$105,000**

In the illustration above, deductible O&M and revenue both increase by $1,000,000. Notwithstanding that the tax liability doesn't change, the net pre-tax margin does – from the 30% presumed in the rate case ($3,000,000/$10,000,000) to 27% actually experienced ($3,000,000/$11,000,000). Yet the computation of "taxes authorized" is unaffected by this variation. This also is the type of inconsistency that the National Office representative requested be addressed in connection with the requirements of Code §168(i)(9).

The Purview of the Consistency Rules

While it is literally true that the automatic tax adjustment procedure may be said to contain one or more elements of inconsistency, the purview of the normalization consistency rules is circumscribed. In short, those rules cover some – but not all – inconsistencies. And any inconsistencies created by a tax adjustment mechanism should be deemed not of the type covered by those rules.

Code §168(i)(9)(B)(ii) was added by §541 of the Highway Revenue Act of 1982 in direct response to regulatory developments in California in the 1970's. The California regulators were extremely unhappy about the imposition of the normalization rules. They devised a technique, the "average annual adjustment" or "AAA" method, to offset the impact of those rules. This procedure involved a projection of future deferred tax balances for purposes of the computation of rate base where there was no such projection for any other purpose. It resulted in a substantially larger rate base offset than would otherwise be the case. One or more of the affected utilities applied to the Service for guidance as to the consequences of this technique under the normalization rules. The Service ruled that it was violative, pointing to the section of the regulations, Treas. Reg. §1.167(l)-1(h)(6), which governs the quantity of deferred taxes that can offset rate base. The Service concluded that the technique failed to meet the regulatory requirement that the quantity of deferred taxes used to offset rate base could not exceed the amount of the reserve for the period used in determining the utility's tax expense element of cost of service.[13] In short, there was a lack of "temporal consistency" between the way in which cost of service was computed and the computation of the deferred tax balance used as a rate base offset.

While the Service held the technique violative, the California authorities continued to support the adjustment. Ultimately, a legislative solution was crafted to avoid the dramatically negative financial implications stemming from the imposition of penalties for violation of the normalization rules. This solution was enacted as §541 of the Highway Revenue Act of 1982. Under this legislation, those affected utilities that qualified under a transition rule would not be deemed to have violated the normalization rules (though they had to make substantial payments to the IRS). However, language was added to Code §168(i)(9) to make absolutely clear that the AAA method and techniques similar to it constituted a normalization violation. This language was Section B.

This history of Section B indicates its intention to render violative inconsistencies within a test period – but only a test period having some element of futurity. That, after all, is the import of the use of the terms "estimate or projection" in Section B. And there is nothing that can be further from an "estimate or projection" than a "true up" to "properly attributed" taxes after those taxes were incurred.

[13] PLR 7836038 (June 8, 1978) and PLR 7848048 (June 9, 1978).

Thus, although the SB 408 tax adjustment clause can be viewed as producing one or more inconsistencies, they are not the type of inconsistencies that the normalization rules are intended to address.

CONCLUSION

For the reasons stated above, we respectfully request that the Service issue the rulings requested.

PROCEDURAL STATEMENTS

A. Revenue Procedure 2006-1 Statements

1. Section 7.01(4) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, no return of Taxpayer (or any return of a related taxpayer within the meaning of §267 or of a member of an affiliated group of which Taxpayer is also a member within the meaning of §1504) that would be affected by the requested letter ruling is under examination, before Appeals, or before a federal court.

2. Section 7.01(5)(a) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, the Service has not previously ruled on the same or similar issue for Taxpayer, a related taxpayer (within the meaning of §267), a member of an affiliated group of which Taxpayer is also a member (within the meaning of §1504), or a predecessor.

3. Section 7.01(5)(b) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer, a related taxpayer, a predecessor, nor any representatives previously submitted a request (including an application for change in accounting method) involving the same or similar issue but with respect to which no letter ruling or determination letter was issued.

4. Section 7.01(5)(c) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer, a related taxpayer, nor a predecessor previously submitted a request (including an application for change in accounting method) involving the same or a similar issue that is currently pending with the Service.

5. Section 7.01(5)(d) - To the best of the knowledge of Taxpayer and Taxpayer's representatives, neither Taxpayer nor a related taxpayer is presently submitting another request (including an application for change in accounting method) involving the same or similar issue to the Service at the same time as this request.

6. Section 7.01(8) - The law in connection with this ruling request is uncertain and the issues discussed herein are not adequately addressed by relevant authorities.

7. Section 7.01(9) - Taxpayer has included all supportive as well as all contrary authorities of which it is aware.

8. Section 7.01(10) - Taxpayer and Taxpayer's representatives have no knowledge of any pending legislation that may affect the proposed transaction.

9. Section 7.02(5) - Taxpayer hereby requests a copy of the ruling and any written requests for additional information be sent by facsimile transmission (in addition to being mailed) and waives any disclosure violation resulting from such facsimile transmission. Please fax the ruling and any written requests to Mr. Warren at (212) 829-2010.

10. Section 7.02(6) - A conference on the issues involved in this ruling request is hereby respectfully requested in the event that the Service reaches a tentatively adverse conclusion.

11. The Commission has reviewed this request and determined that it is adequate and complete. See letter appended as Exhibit 4. Taxpayer will permit the Commission to participate in any Associate office conference concerning this request.

B. Administrative

1. The deletions statement required by Revenue Procedure 2006-1 is enclosed.

2. The checklist required by Revenue Procedure 2006-1 is enclosed.

3. The required user fee of $10,000 is enclosed.

4. A Power of Attorney granting Taxpayer's representative the right to represent the taxpayer is enclosed.

If you have any questions or need additional information regarding this ruling request, pursuant to the enclosed Power of Attorney please contact James I. Warren at (212) 603-2072.

Respectfully submitted,

_____

James I. Warren

Thelen Reid & Priest LLP
Attorney for
Northwest Natural Gas Company

NY #748630 v1

PENALTIES OF PERJURY STATEMENT

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts relating to the request, and such facts are true, correct, and complete.

_____ _____

Date

_____

DELETIONS STATEMENT

For purposes of Section 6110(c)(1) of the Internal Revenue Code of 1986, as amended, Taxpayer requests the deletion of all names, addresses, EINs, locations, dates, amounts, regulatory bodies and other taxpayer identifying information contained in the attached request for private letter ruling.

Taxpayer reserves the right to review, prior to disclosure to the public, any information related to this request for private letter ruling and to provide redacted copies of any documents to be released to the public.

Date: _____

_____

James I. Warren
Thelen Reid & Priest LLP
Attorney for
Northwest Natural Gas Company

EXHIBIT 1

Enrolled
Senate Bill 408

Sponsored by Senator WALKER; Senator METSGER

CHAPTER .....

AN ACT

Relating to rates of public utilities; creating new provisions; amending ORS 757.210; and declaring an emergency.

Be It Enacted by the People of the State of Oregon:

SECTION 1. Sections 2 and 3 of this 2005 Act are added to and made a part of ORS chapter 757.

SECTION 2. (1) The Legislative Assembly finds and declares that:

(a) The alignment of taxes collected by public utilities from utility customers with taxes paid to units of government by utilities, or affiliated groups that include utilities, is of special interest to this state.

(b) Taxes are a unique utility cost because the tax liability is affected by the operations or tax attributes of the parent company or other affiliates of the utility.

(c) The Public Utility Commission permits a utility to include costs for taxes that assume the utility is not part of an affiliated group of corporations for tax purposes.

(d) The parent company of a utility may employ accounting methods, debt, consolidated tax return rules and other techniques in a way that results in a difference between the tax liability paid to units of government by the utility, or the affiliated group of corporations of which the utility is a member, and the amount of taxes collected, directly or indirectly, from customers.

(e) Tax uncertainty in the ratemaking process may result in collecting taxes from ratepayers that are not paid to units of government.

(f) Utility rates that include amounts for taxes should reflect the taxes that are paid to units of government to be considered fair, just and reasonable.

(g) Tax information of a business is commercially sensitive. Public disclosure of tax information could provide a commercial advantage to other businesses.

(2) The definitions in section 3 of this 2005 Act apply to this section.

SECTION 3. (1) Every public utility shall file a tax report with the Public Utility Commission annually, on or before October 15 following the year for which the report is being made. The tax report shall contain the information required by the commission, including:

(a) The amount of taxes that was paid by the utility in the three preceding years, or that was paid by the affiliated group and that is properly attributed to the regulated operations of the utility, determined without regard to the tax year for which the taxes were paid; and

(b) The amount of taxes authorized to be collected in rates for the three preceding years.

(2) Every public utility shall be required to obtain and provide to the commission any other information that the commission requires to review the tax report and to implement and administer this section and ORS 757.210.

(3) The commission may disclose, or any intervenor may obtain and disclose, the amount by which the amount of taxes that units of government received from the public utility or from the affiliated group differs from the amount of costs for taxes collected, directly or indirectly, as part of rates paid by customers, including whether the difference is positive or negative.

(4) The commission shall review the tax report and any other information the commission has obtained and make the determinations described in this section within 90 days following the filing of the report, or within a further period of time that the commission may by rule establish for making determinations under this section that does not exceed 180 days following the filing of the report. If the commission determines that the amount of taxes assumed in rates or otherwise collected from ratepayers for any of the three preceding years differed by $100,000 or more from the amount of taxes paid to units of government by the public utility, or by the affiliated group and properly attributed to the regulated operations of the utility, the commission shall require the utility to establish an automatic adjustment clause, as defined in ORS 757.210, within 30 days following the date of the commission's determinations under this section, or by a later date that the commission may by rule prescribe for establishing an automatic adjustment clause that does not exceed 60 days following the date of the commission's determinations under this section.

(5) If an adjustment to rates is made under an automatic adjustment clause established under this section, the automatic adjustment clause shall remain in effect for each successive year after an adjustment is made and until an order terminating the automatic adjustment clause is made under subsection (9) of this section.

(6) The automatic adjustment clause shall account for all taxes paid to units of government by the public utility that are properly attributed to the regulated operations of the utility, or by the affiliated group that are properly attributed to the regulated operations of the utility, and all taxes that are authorized to be collected through rates, so that ratepayers are not charged for more tax than:

(a) The utility pays to units of government and that is properly attributed to the regulated operations of the utility; or

(b) In the case of an affiliated group, the affiliated group pays to units of government and that is properly attributed to the regulated operations of the utility.

(7) An automatic adjustment clause established under this section may not be used to make adjustments to rates for taxes paid that are properly attributed to any unregulated affiliate of the public utility or to the parent of the utility.

(8) Notwithstanding subsections (1) to (7) of this section, the commission may authorize a public utility to include in rates:

(a) Deferred taxes resulting from accelerated depreciation or other tax treatment of utility investment; and

(b) Tax requirements and benefits that are required to be included in order to ensure compliance with the normalization requirements of federal tax law.

(9) If the commission determines that establishing an automatic adjustment clause under this section would have a material adverse effect on customers of the public utility, the commission shall issue an order terminating the automatic adjustment clause. The order shall set forth the reasons for the commission's determination under this subsection.

(10) The commission shall conduct a hearing under ORS 757.210 prior to making a determination under subsection (9) of this section that an automatic adjustment clause would have a material adverse effect on customers of the public utility.

(11) The commission may not use the tax information obtained by the commission under this section for any purpose other than those described in subsections (1) to (10) of this

section. An intervenor in a commission proceeding to review the tax report or make rate adjustments described in this section may, upon signing a protective order prepared by the commission, obtain and use the information obtained by the commission that is not otherwise required to be made publicly available under this section, according to the terms of the protective order.

(12) For purposes of this section, taxes paid that are properly attributed to the regulated operations of the public utility may not exceed the lesser of:

(a) That portion of the total taxes paid that is incurred as a result of income generated by the regulated operations of the utility; or

(b) The total amount of taxes paid to units of government by the utility or by the affiliated group, whichever applies.

(13) As used in this section:

(a) "Affiliated group" means an affiliated group of corporations of which the public utility is a member and that files a consolidated federal income tax return.

(b) "Public utility" or "utility" means:

(A) A regulated investor-owned utility that provided electric or natural gas service to an average of 50,000 or more customers in Oregon in 2003; or

(B) A successor in interest to an entity described in subparagraph (A) of this paragraph that continues to be a regulated investor-owned utility.

(c) "Regulated operations of the utility" means those activities of a public utility that are subject to rate regulation by the commission.

(d) "Tax":

(A) Means a federal, state or local tax or fee that is imposed on or measured by income and that is paid to units of government.

(B) Does not include any amount that is refunded by a unit of government as a tax refund.

(C) Does not include franchise fees or privilege taxes.

(e) "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.

(f) "Taxes paid" means amounts received by units of government from the utility or from the affiliated group of which the utility is a member, whichever is applicable, adjusted as follows:

(A) Increased by the amount of tax savings realized as a result of charitable contribution deductions allowed because of charitable contributions made by the utility;

(B) Increased by the amount of tax savings realized as a result of tax credits associated with investment by the utility in the regulated operations of the utility, to the extent the expenditures giving rise to the tax credits and tax savings resulting from the tax credits have not been taken into account by the commission in the utility's last general ratemaking proceeding; and

(C) Adjusted by deferred taxes related to the regulated operations of the utility.

(g) "Three preceding years" means the three most recent consecutive fiscal years preceding the date the tax report is required to be filed.

SECTION 4. (1) The tax report that, under section 3 of this 2005 Act, is required to be filed on or before October 15, 2005, shall set forth the information required to be reported under section 3 of this 2005 Act for the three most recent consecutive fiscal years of the public utility that concluded prior to the date of the filing of the tax report.

(2) If an automatic adjustment clause is established under section 3 of this 2005 Act, notwithstanding any other provision of section 3 of this 2005 Act, the automatic adjustment clause shall apply only to taxes paid to units of government and collected from ratepayers on or after January 1, 2006.

SECTION 5. ORS 757.210 is amended to read:

757.210. (1)(a) Whenever any public utility files with the Public Utility Commission any rate or schedule of rates stating or establishing a new rate or schedule of rates or increasing an existing rate or schedule of rates, the commission may, either upon written complaint or upon the commission's own initiative, after reasonable notice, conduct a hearing to determine [*the propriety and reasonableness of such rate or schedule*] **whether the rate or schedule is fair, just and reasonable.** The commission shall conduct [*such a*] **the** hearing upon written complaint filed by the utility, its customer or customers, or any other proper party within 60 days of the utility's filing; provided that no hearing need be held if the particular rate change is the result of an automatic adjustment clause. At [*such*] **the** hearing the utility shall bear the burden of showing that the rate or schedule of rates proposed to be established or increased or changed is [*just and reasonable. The term*] **fair, just and reasonable. The commission may not authorize a rate or schedule of rates that is not fair, just and reasonable.**

(b) As used in this subsection, "automatic adjustment clause" means a provision of a rate schedule [*which*] **that** provides for rate increases or decreases or both, without prior hearing, reflecting increases or decreases or both in costs incurred**, taxes paid to units of government** or revenues earned by a utility and [*which*] **that** is subject to review by the commission at least once every two years.

(2)(a) Subsection (1) of this section does not apply to rate changes under an approved alternative form of regulation plan, including a resource rate plan under ORS 757.212.

(b) Any alternative form of regulation plan shall include provisions to ensure that the plan operates in the interests of utility customers and the public generally and results in rates that are just and reasonable and may include provisions establishing a reasonable range for rate of return on investment. In approving a plan, the commission shall, at a minimum, consider whether the plan:

(A) Promotes increased efficiencies and cost control;

(B) Is consistent with least-cost resources acquisition policies;

(C) Yields rates that are consistent with those that would be obtained following application of section 3 of this 2005 Act;

[*(C)*] **(D)** Is consistent with maintenance of safe, adequate and reliable service; and

[*(D)*] **(E)** Is beneficial to utility customers generally, for example, by minimizing utility rates.

(c) As used in this subsection, "alternative form of regulation plan" means a plan adopted by the commission upon petition by a public utility, after notice and an opportunity for a hearing, that sets rates and revenues and a method for changes in rates and revenues using alternatives to cost-of-service rate regulation.

(d) Prior to implementing a rate change under an alternative form of regulation plan, the utility shall present a report that demonstrates the calculation of any proposed rate change at a public meeting of the commission.

(3) Except as provided in ORS 757.212, the commission, at any time, may order a utility to appear and establish that any, or all, of its rates in a plan authorized under subsection (2) of this section are in conformity with the plan and are just and reasonable. Except as provided in ORS 757.212, such rates, and the alternative form of regulation plan under which the rates are set, also shall be subject to complaint under ORS 756.500.

(4) Periodically, but not less often than every two years after the implementation of a plan referred to in subsection (2) of this section, the commission shall submit a report to the Legislative Assembly that shows the impact of the plan on rates paid by utility customers.

(5) The commission and staff may consult at any time with, and provide technical assistance to, utilities, their customers, and other interested parties on matters relevant to utility rates and

charges. If a hearing is held with respect to a rate change, the commission's decisions shall be based on the record made at the hearing.

SECTION 6. This 2005 Act being necessary for the immediate preservation of the public peace, health and safety, an emergency is declared to exist, and this 2005 Act takes effect on its passage.

Passed by Senate June 8, 2005

Repassed by Senate August 1, 2005

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Secretary of Senate

.....
President of Senate

Passed by House July 30, 2005

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Speaker of House

Received by Governor:

.....M., ..., 2005

Approved:

.....M., ..., 2005

.....
Governor

Filed in Office of Secretary of State:

.....M., ..., 2005

.....
Secretary of State

EXHIBIT 2

ORDER NO. 06-532

ENTERED 09/14/06

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

AR 499

In the Matter of	)	
	)	
Adoption of Permanent Rules to Implement SB 408 Relating to Utility Taxes.	)	ORDER

DISPOSITION: PERMANENT RULES ADOPTED

In this order, we adopt administrative rules, attached as Appendix A, necessary to implement Senate Bill 408 (SB 408). This bill, passed by the 2005 Legislative Assembly and generally codified at ORS 757.268,[1] requires certain public utilities to file annual tax reports and other information with the Public Utility Commission of Oregon (Commission). In this annual filing, the affected utilities[2] must identify the amount of income taxes paid, either by the public utility itself or its consolidated group and properly attributed to the utility, and the amount of taxes authorized to be collected in rates during specified time periods. If amounts collected and amounts paid differ by more than $100,000 for any utility, SB 408 requires this Commission to direct the public utility to implement a rate schedule with an automatic adjustment clause accounting for the difference.

This process of "truing up" a utility's cost for taxes constitutes a departure from ratemaking methods traditionally employed by the Commission. Instead of calculating taxes on a stand-alone basis, SB 408 requires this Commission to track the amount of taxes actually paid and determine what portion of those amounts are properly attributed to the regulated operations of the utility. Where taxes are paid on a consolidated basis by a utility parent, this task necessarily involves an apportionment of the paid taxes to all affiliates within a taxpaying entity, to ensure that ratepayers only pay the utility's share of the taxes paid.

Background

On April 10, 2006, the Commission filed a Notice of Proposed Rulemaking Hearing and Statement of Need and Fiscal Impact with the Secretary of

[1] This order generally refers to the part of the statute codified at ORS 757.268, in Section 3 of SB 408. References refer to citations of ORS 757.268.

[2] The affected utilities are Avista Utilities (Avista), Northwest Natural Gas Company (NW Natural), Portland General Electric Company (PGE), and Pacific Power & Light (PacifiCorp).

State. On April 21, 2006, notice was provided to certain legislators specified in ORS 183.335(1)(d) and to all interested persons on the service lists maintained pursuant to OAR 860-011-0001. Notice of the rulemaking was published in the *Oregon Bulletin* on May 1, 2006.

A number of participants contributed regularly in this docket, including the affected utilities, the Citizens' Utility Board (CUB), Industrial Customers of Northwest Utilities (ICNU), Northwest Industrial Gas Users (NWIGU), Utility Reform Project (URP), and the City of Portland. On September 15, 2005, we adopted temporary rules in Order No. 05-991. Subsequently, Administrative Law Judges and Commission staff (Staff) conducted several workshops and received public comments to assess legal issues associated with SB 408. At our request, the Oregon Attorney General issued a letter of advice addressing specified legal questions on December 27, 2005.

Rulemaking participants developed straw proposals on the definition of "properly attributed." After revision and comment, we held a workshop to discuss the merits of various interpretations of the law, whether an earnings test should be adopted, whether actual figures should be used for certain components of the "taxes authorized to be collected" calculation, whether deferred accounting and offsets from other deferred accounts should be used, and how Section (12)(a) should be interpreted.

On July 14, 2006, we entered an interim order proposing the adoption of the "Apportionment Method" to calculate taxes "properly attributed" to the utility. *See* Order No. 06-400. Rulemaking participants filed two additional rounds of comments in response to that interim order, and also participated in two workshops and a final rulemaking hearing on August 21, 2006.

COMMENTS AND DISCUSSION

Comments from rulemaking participants primarily focused on our proposed interpretation of "properly attributed." Other comments addressed the so-called "double whammy," the interpretation of Section (12)(a), and the date of accrual of interest for the automatic adjustment clause. We address these four issues separately.

I. "Properly Attributed"

In Order No. 06-400, we identified a method to determine taxes that are "properly attributed" to the utility. Specifically, we proposed the use of an adaptation of the three-factor method used by states to apportion the income of multi-state corporations for the purposes of assessing state income tax. Dubbed the "Apportionment Method," our adaptation apportions taxes paid by calculating the utility's amounts of payroll, property, and sales compared to the consolidated group's amounts for the same items. A combination of the three ratios would then be multiplied by the amount of taxes paid to units of government, yielding the utility's attributed portion.

In this order, we formally adopt the "Apportionment Method" to determine the amount of taxes paid that are properly attributed to the utility, specifically, the Oregon portion of the utility. In response to certain concerns raised by the rulemaking participants, however, we make certain modifications to this method for use in attributing taxes paid to the utility.

Normalization requirements

ORS 757.268(8) provides that, notwithstanding other sections of SB 408, "the commission may authorize a public utility to include in rates: (a) Deferred taxes resulting from accelerated depreciation or other tax treatment of utility investment; and (b) Tax requirements and benefits that are required to be included in order to ensure compliance with the normalization requirements of federal tax law." Rulemaking participants propose several modifications to the Apportionment Method to ensure that the normalization requirements are not violated, "even though the parties may have had differing understandings of what those requirements were." NW Natural Comments, 12 (July 31, 2006).

To ensure that normalization issues are simply eliminated from the calculation, PacifiCorp proposes that all regulated entities within the affiliated group, other than Oregon regulated operations, be excluded from the taxes paid calculation. *See* PacifiCorp comments, 8-9 (July 31, 2006). Avista suggests apportioning losses from non-regulated affiliates to regulated operations, rather than apportioning total taxes paid or, alternatively, adjusting "taxes paid" for deferred taxes before apportioning the taxes paid to the various affiliates. *See* Avista comments, 3-4 (July 31, 2006).

Staff, Avista, NW Natural, PacifiCorp, and PGE (Joint Parties), assert that "taxes paid" should be adjusted prior to apportionment for deferred taxes related to non-Oregon regulated operations. *See* Joint Comments, 4 (Aug 14, 2006). PacifiCorp also states that another "possible way to minimize normalization issues" is to add back the imputed tax benefit of tax depreciation on Oregon disallowed capital costs. *See* PacifiCorp comments, 3 (Aug 14, 2006).

PGE also notes the problem of passing along the accelerated depreciation amounts to customers, thereby violating normalization requirements, and putting the benefits of accelerated depreciation at risk. To address this concern, PGE proposes that utilities be allowed to make changes to their tax report filings to avoid normalization problems. *See* PGE comments, 11-12 (July 31, 2006). PacifiCorp also endorses the idea of allowing utilities to adjust their compliance filings as necessary "to address normalization risk." *See* PacifiCorp comments, 9 (July 31, 2006). ICNU proposes allowing utilities to identify tax normalization issues and possible solutions in their tax filings, for Commission review and approval. *See* ICNU comments, 7-8 (July 31, 2006). ICNU emphasizes, however, that any normalization adjustment "should be construed

narrowly to focus on compliance with normalization requirements as applied to regulated utilities and deferred taxes," and cautions against "attempts to expand [the authority to adjust for normalization issues] to address other issues." ICNU comments, 7 (Aug 14, 2006).

CUB requests an opportunity to review any letters submitted by utilities seeking Private Letter Rulings from the Internal Revenue Service (IRS) regarding normalization issues. *See* CUB comments, 9-10 (July 31, 2006). The Joint Parties also request that the deadline by which utilities must seek a Private Letter Ruling should be pushed back from October 15, 2006, to December 31, 2006. *See* Joint Comments, 9 (Aug 14, 2006).

Commission Resolution

ORS 757.268(8) provides that this Commission may allow a utility to recover all tax requirements and benefits necessary to ensure compliance with the normalization requirements of federal tax law. We agree that the Apportionment Method for determining properly attributed amounts could result in a violation of federal tax normalization requirements unless certain adjustments are made. Accordingly, we will modify the definition of "taxes paid" to remove all tax effects resulting from accelerated depreciation on public utility property. To accomplish this, the utility, in reporting taxes paid, will first remove the tax benefits of depreciation and federal investment tax credits by adding back the related tax effects to the amount of taxes paid to each taxing authority. *See* Appendix A, OAR 860-022-0041(2)(r) (adjustments for all taxes after apportionment); OAR 860-022-0041(3)(a)(A)(i) through (iii) (adjustments prior to apportionment for federal taxes), OAR 860-022-0041(3)(c)(A)(i) (adjustments prior to apportionment for state taxes), OAR 860-022-0041(3)(e)(A)(i) (adjustments prior to apportionment for local taxes), OAR 860-022-0041(4)(a) and (g) (amount of taxes paid to federal, state and local taxing authorities), OAR 860-022-0041(2)(n) and OAR 860-022-0041(4)(b) (calculation of stand-alone tax liability). When the final taxes paid amounts are calculated, an adjustment will be made to reflect the proper amount of current and deferred taxes related to Oregon regulated operations. *See* Appendix A, OAR 860-022-0041(4)(d) (adjustments to federal and state taxes paid), OAR 860-022-0041(4)(j) (adjustments to local taxes paid). These steps should ensure that no tax benefits flow to Oregon customers that would cause a violation of normalization requirements.

Further, we agree that utilities should have the flexibility to separately identify additional normalization issues as they arise, and propose solutions to those issues. We will then review possible normalization violations, decide whether to consider them and, if necessary, resolve them in an order establishing the amount of the automatic adjustment clause for that period. *See* Appendix A, OAR 860-022-0041(4)(o).

To facilitate review of utility letters seeking Private Letter Rulings from the IRS, we establish a deadline for draft letters to be submitted by the utilities to the

Commission and all participants in this docket on or before November 15, 2006. *See* Appendix A, OAR 860-022-0041(8)(g). Participants may review the letters and submit proposed edits and comments to all participants and the Commission on or before December 4, 2006. The Commission will review the proposed edits and work with the utilities on a final draft, to be submitted to the IRS on or before December 31, 2006. *See id.*

Other add-backs

ORS 757.268 provides for "add-backs" for certain items in determining "taxes paid." In addition to add-backs for deferred taxes, which must be added back to prevent a normalization violation, *see infra* 2-4, the statute allows for adding back of tax savings realized as a result of charitable contributions made by the Oregon utility and tax savings associated with investment by the utility in the regulated operations of the utility which have not yet been taken into account by the Commission in the utility's last general rate case. *See* ORS 757.268(13)(f)(A) and (B). The Commission has the discretion to add-back other items to "taxes paid" as part of the properly attributed calculation as a matter of policy.

NW Natural proposes additional add-backs be allowed, such as tax credits associated with renewable electricity production and business energy tax credits. *See* NW Natural Comments, 3 (July 31, 2006). PacifiCorp also suggests further add-backs, including all deferred taxes, tax credits, and charitable contributions incurred by non-regulated affiliates. *See* PacifiCorp comments, 9-10 (July 31, 2006). CUB agrees that certain add-backs should be made, including the Business Energy Tax Credit (BETC). *See* CUB straw proposal (April 11, 2006). ICNU opposes further modifications. It argues that, because add-backs were carefully selected by the Legislative Assembly, no additional add-backs should be considered. *See* ICNU comments, 7 (Aug 14, 2006).

Commission Resolution

In determining what amounts of taxes paid are properly attributed to the utility, we have broad discretion to include add-backs in addition to those identified by the legislature. We exercise this discretion to avoid unintended consequences that would be contrary to the public interest. Accordingly, we conclude that charitable contributions for all affiliates should be added-back prior to apportionment in order to not discourage worthy contributions. Further, we agree that certain tax credits should be added to taxes paid for purposes of determining amounts properly attributed to the utility. On the state level, we agree BETCs related to conservation and renewable resources for all affiliates should be added back so that these kinds of investments are encouraged. This will allow the benefits of these credits go to shareholders as intended under law and not be flowed through to ratepayers except when they bear the associated cost. On the federal level, Internal Revenue Code section 45 renewable electricity production tax credits for all affiliates should be added back prior to apportionment so that these credits do not go to

ratepayers. These credits are tied to tax policy to promote renewable energy sources, and, as a matter of policy, we exercise our discretion in adding them to "taxes paid" to determine the proper attribution of taxes paid by the utility.

Situs and Alternatives

In the interim order, we stated that the numerators for the ratios to determine the utility's portion of taxes paid should account for the utility's property, payroll, and sales in the state of Oregon. This was derived from the origination of the Apportionment Method, which was developed to determine a state's share of income from a multi-state corporation in order to apply that state's income tax.

Several rulemaking participants argue that the numerator should reflect all utility property, payroll, and sales used to provide regulated service for Oregon customers, including those amounts located or incurred outside the state of Oregon. *See, e.g.,* PGE comments, 8-9 (July 31, 2006), CUB comments, 4-7 (July 31, 2006), URP comments, 1 (Aug 14, 2006). Otherwise, CUB contends, to calculate the numerator according to the utility assets located solely in Oregon would result in "perverse incentives." CUB comments, public comment hearing (Aug 21, 2006).[3] For example, CUB explains that the resulting tax consequences may cause a utility to make a decision on the siting of a particular resource based on issues other than which location provides the least risk and cost for customers. ICNU opposes any deviation from our interim decision. It argues that, while the situs figures for the numerator are not precise, they approximate the taxes for which the utility's Oregon ratepayers are liable and should be used. *See* ICNU comments, 2-4 (Aug 14, 2006).

Commission Resolution

We agree with the majority of rulemaking participants that Oregon ratepayers should be responsible for the tax effects of all assets in rate base, whether located in Oregon or not. Regardless of their respective locations, all these assets have been approved by this Commission as necessary and useful in providing service to Oregon ratepayers. This requires an adjustment to the Apportionment Method. In the numerator, utilities should use the utility's gross plant, wages and salaries, and sales, as set forth in the utility's "results of operations" report to determine the amount of those ratios in relation to the entire consolidated entity's amount of payroll, property, and sales. That ratio will then be multiplied against the total taxes paid by the consolidated taxpayer, yielding the amount of taxes properly attributed to the utility. If necessary, this amount will be further adjusted to determine the amount of taxes attributed to the Oregon portion of a multi-state utility.

[3] The audio files for the August 21, 2006, public comment hearing can be found, as of the date of this order, at http://apps.puc.state.or.us/agenda/audio/2006/082106/default.htm.

Multi-State Tax Rate

The interim order also determined state taxes paid for the state of Oregon only. This is also a hold-over from the Apportionment Method's initial purpose of attributing taxes to Oregon alone. As noted above, however, utility resources used to serve Oregon customers are not necessarily located in Oregon. As several participants note, the interim order does not give proper consideration to taxes paid in other states on resources used to provide energy service to Oregon customers. For instance, PGE operates the Colstrip plant in Montana, which is used to provide electricity to Oregon customers. Therefore, the argument goes, Montana taxes, incurred at least in part by the Colstrip plant, should be properly attributed to the utility's regulated operations.

Participants put forth several solutions. One proposal requires the utility to calculate its proper attribution of taxes paid in each state where it has property, payroll, or sales used to provide service to Oregon customers. Another proposal allows the utility to calculate its proper attribution of taxes paid only in Oregon, but using an "effective tax rate" used to determine taxes collected in the rate case. Utilities have proposed allowing them to make the choice between the two options. *See* Joint Comments, 5-7 (Aug 14, 2006). Customer groups, however, are wary of allowing utilities to run both sets of numbers and then unilaterally choose which method to report, and note that utilities may not make the choice that is in the best interests of customers. *See* ICNU comments, public comment hearing (Aug 21, 2006).

Commission Resolution

We adopt the participants' proposal that we should consider state taxes paid on a wider basis than just those paid in Oregon, either by examining taxes paid in all states in which the utility pays state income taxes, or by an "effective tax rate" approach to taxes paid in Oregon. To resolve the concern of the customer groups, we require the utilities to make a one-time election and decide which methodology they will use to calculate their state taxes paid. *See* Appendix A, OAR 860-022-0041(3)(c)(C).

Apportionment of Local Taxes Paid

In the interim order, we decided that taxes paid should be apportioned at each level according to property, payroll, and sales, with the understanding that the multi-state companies would have those figures readily available on a statewide basis to calculate the portion of their income subject to each state's income taxes. Since then, we have learned that those factors are not necessarily calculated on a local basis. Instead, local taxes are determined by other measures.

NW Natural appears to argue that local taxes need not be apportioned, because they are essentially paid on a stand-alone basis and are collected only from impacted ratepayers in a separate surcharge. *See* NW Natural, 12 (July 31, 2006). PGE

also argues that local taxes should not be apportioned. *See* PGE comments, 9 (July 31, 2006). URP and ICNU oppose calculating local taxes paid on a stand-alone basis, and assert that local taxes should be apportioned. *See* URP comments, 2 (Aug 14, 2006); ICNU comments, 4-5 (Aug 14, 2006). Staff and the Joint Parties argue that local taxes should be apportioned, but not necessarily based on the same three factors used to apportion federal and state taxes. *See* Joint Comments, 7 (Aug 14, 2006).

Commission Resolution

The Apportionment Method was selected in part because the amounts for property, payroll, and sales would be readily available for other purposes, and could easily be used to calculate the utility's portion of taxes paid. Following that reasoning, we agree that it makes sense to apportion local taxes based on the factor used to assess those taxes. For example, the taxable income used to calculate the Multnomah County Business Income Tax (MCBIT) is apportioned based on gross income; therefore, determination of taxes properly attributed to the utility on the local level should be based on an apportionment by gross income for the MCBIT. *See* Appendix A, OAR 860-022-0041(3)(e)(B). If other local taxes arise, they too will be apportioned based on the factor used to assess those taxes, and will be dealt with on a case by case basis.

Lower Limit on Properly Attributed

The Joint Parties express concern that the Apportionment Method could yield a result in which customers receive more than 100 percent of the tax benefits from losses within the taxpaying group. *See* Joint Comments, 8 (Aug 14, 2006). To illustrate, the Joint Parties assume a utility has a stand-alone tax liability of $50 and a sole affiliate with a loss of $5. In this example, the utility's affiliated group's consolidated tax liability is $45. Application of the Apportionment Method, however, would produce a "properly attributed" amount lower than this $45 figure, because a portion of that consolidated tax liability would be attributed to the affiliate. To avoid this result, the Joint Parties recommend the Commission include a "floor" for the three-factor attributed amount. The proposed floor: the utility's stand-along tax liability minus the total amount of negative tax liabilities of affiliates in the applicable federal or state tax filing. *See id.*

Customer groups express concern about the inclusion of a floor. ICNU contends that any floor should be "narrowly tailored," beginning with the amount in ORS 757.268(12)(a) and attributing losses from all entities in the consolidated federal tax group. *See* ICNU comments, 8-9 (Aug 14, 2006). CUB opposes the proposed floor as an inappropriate limit on the method for properly attributing taxes that had been adopted by the Commission. CUB comments, public comment hearing (Aug 21, 2006).

Commission Resolution

The Apportionment Method allocates any taxes paid to all affiliates in the taxpaying group, including entities with no tax liability. As a result, we agree with the Joint Parties that this could produce a result in which customers receive more than 100 percent of the benefit from the tax losses of the utility's taypaying group. We agree with the Joint Parties that the Apportionment Method should be revised to preclude such an unjust result.

To provide a safety net against this result, we will include a "floor" beneath which the taxes paid that are properly attributed to the utility cannot fall. The floor will be calculated at the federal and state level by first determining the federal and state stand-alone tax liability for the utility. On the federal level, and at the state level for a utility with a multi-state tax rate, these amounts will then be reduced by the sum of the tax effects of all income tax losses of entities within the taxpaying group, as allocated to the Oregon operations of the utility using the ratios derived from the utility's gross plant, wages and salaries, and sales. On the state level for a utility for which Oregon state income taxes are the only state income taxes included in rates, the amounts equal to the stand-alone tax liability will be reduced by the sum of the tax benefits of all income tax losses of entities within the unitary group. These amounts will establish the lowest amounts of "taxes paid," determined under the Apportionment Method, that are properly attributed to the regulated operations of the utility. *See* Appendix A, OAR 860-022-0041(3)(b) (floor for federal taxes), OAR 860-022-0041(3)(d) (floor for state taxes).

Unitary Group

ORS 757.268 refers to the utility's "affiliated group," which includes every entity that is part of the consolidated federal tax return. *See* ORS 757.268(13)(a). The interim order stated that, to determine the "affiliated group" on the state level, "the various unitary groups that include entities in the consolidated federal return must be aggregated to determine the amount of taxes paid by the affiliated group in Oregon." Order No. 06-400, 6.

The participants agree that, rather than using all the state unitary groups as the taxpaying entity, the Commission should instead focus solely on the unitary group containing the utility. *See, e.g.*, CUB comments, 8 (July 31, 2006); PacifiCorp comments, 7 (July 31, 2006); Joint Parties, 7 (Aug 14, 2006). Staff adds that the Commission had discretion to use this single unitary group to calculate the properly attributed amount, and agrees that it would be "appropriate" because the unitary group is the taxpaying entity. *See* Staff comments, 2-3 (July 31, 2006).

Commission Resolution

We agree that taxes paid should be determined by the amount paid by the entity that includes the utility. On the state level, that means that state taxes should be gauged only by the amount paid by the unitary group that includes the utility.

II. "Double Whammy"

In Order No. 06-400, 8, we described the oft-discussed "double whammy" problem:

> The so-called "double whammy" situation arises because taxes vary with a utility's earnings. When lower than expected earnings reduce the amount of taxes that will be paid, provision of service is more expensive than was predicted in the rate case, and consumers pay less than the utility's actual costs. At the same time, customers will receive a SB 408 refund because income taxes are less than expected. Utilities argue that this result is unreasonable because it exacerbates their under-recovery and customers do not bear the higher cost of service. Conversely, when a utility's earnings are higher than expected as a result of higher revenues or lower costs, income taxes will also rise, and SB 408 requires a surcharge on ratepayers to compensate for those higher taxes. This would result in further increases in the utility's earnings.

We concluded that, while this is a difficult problem posed by SB 408, we believed, "that it would be contrary to the intent of the legislature to effectively offset the automatic adjustment clause so that it did not "adjust" rates, as it was designed to do. That is, the earnings test offset could net out the automatic adjustment clause." Order No. 06-400, 9.

After the interim order, utilities continue to express concern about the effect of the "double whammy." PacifiCorp suggests that the Commission allow utilities to add in the tax effect of expenses between rate cases to the extent there is a difference between the properly attributed amount and the stand-alone amount of taxes paid. *See* PacifiCorp comments, 8 (Aug 14, 2006). NW Natural urges the Commission to exercise its discretion to allow deferrals to mitigate the "double whammy" problem, or recommend a statutory solution to the next Legislative Assembly. *See* NW Natural comments, 13-14 (July 31, 2006). At the public comment hearing, ICNU questioned the utilities' characterization of the "double whammy" problem and disagreed that any remedies should be implemented in this rulemaking. *See* ICNU comments, public comment hearing (Aug 21, 2006).

Commission Resolution

We continue to believe that, as the agency charged with implementing SB 408, the proposed solutions to the "double whammy" problem may run contrary to the intent of the Legislative Assembly. However, as we stated earlier, we will be responsive to concerns related to the consequences of the "double whammy" problem, and may address those in ORS 756.040 proceedings, general rate cases, and power cost adjustment mechanism dockets. *See* Order No. 06-400, 9.

III. Section 12(a) Cap

ORS 757.268(12)(a) states that the amount of taxes properly attributed to a utility shall not exceed "[t]hat portion of the total taxes paid that is incurred as a result of income generated by the regulated operations of the utility." The Attorney General's letter of advice examined Section 12(a), and interpreted it as addressing "those taxes that would not have been received by units of government "but for" the existence of the regulated operations." Letter from Hardy Meyers, Or Atty Gen, to Lee Beyer, Commn Chair, at 15 (Dec 27, 2005) (available at http://www.puc.state.or.us/PUC/leg/sb408/index.shtml). In the interim order, we interpreted the Section 12(a) cap as best calculated by using the "With and Without" methodology proposed by PacifiCorp to determine what portion of taxes is directly tied to the utility. *See* Order No. 06-400, 4 n 3.

The utilities argue that we incorrectly interpreted Section 12(a). PGE asserted that the Section 12(a) cap was designed "to remove the effect of other tax group members to focus on what would have been the taxes paid by the stand-alone utility." PGE comments, 12 (July 31, 2006). Other utilities agree that Section 12(a) should be calculated based on the utility as a stand-alone entity. *See* PacifiCorp comments, 11-12 (July 31, 2006); NW Natural comments, 3 (Aug 14, 2006). Staff also agrees with that interpretation, asserting that the Commission has discretion in interpreting the cap in Section 12(a). *See* Joint Comments, 8 (Aug 14, 2006). ICNU argues that the Section 12(a) cap should include "all tax liabilities and credit that are supported, directly or indirectly, by the utility's regulated revenues." ICNU comments, 8 (July 31, 2006).

Commission Resolution

We agree with Staff that this Commission has discretion in interpreting the meaning of Section 12(a). In exercising that discretion, we may interpret the 12(a) cap as either a utility's stand-alone tax liability or as the amount produced under the "With and Without" methodology. There is little practical effect in choosing one interpretation over the other, however. The two interpretations will produce different amounts when all other members of the affiliated group together have a tax loss. In that case, however, the Section 12(b) cap will be no higher than either result produced under the competing interpretations of the Section 12(a) cap and, consequently, will establish the cap under

Section 12.[4] Due to this interaction between the Section 12(a) and 12(b) caps, and to simplify the Section 12(a) calculation, we will require the utilities to report the amount of stand-alone tax liability for purposes of the Section 12(a) cap. *See* Appendix A, OAR 860-022-0041(4)(b) (for federal and state taxes), OAR 860-022-0041(4)(h) (for local taxes).

IV. Date of Accrual of Interest

In the interim order, we stated that interest on the amount of the adjustment should begin to accrue on January 1 after the tax year for the difference for which the adjustment must be applied. For instance, a utility will track and report taxes collected and taxes paid for the year 2006 in a filing to be submitted on or before October 15, 2007. The Commission will then have 180 days to determine the amount of the automatic adjustment clause, which would take effect on June 1, 2008. Under the draft rule, interest would begin to accrue January 1, 2007. *See* Order No. 06-400, Draft Rule 9(e). PGE argues that interest should begin to accrue one year later, on January 1, 2008, to "dampen" volatile fluctuations that could have a harmful impact as a result of SB 408. *See* PGE comments, 13 (July 31, 2006).

Commission Resolution

SB 408's primary feature is a backward-looking true-up mechanism designed to align taxes paid with those collected from ratepayers. As explained above, this mechanism takes time to implement. Taxes collected in rates beginning in January 2006 will not be trued-up until June 2008. To ensure that neither utilities nor ratepayers are harmed by this delay, we find that interest should accrue as of the start date for the adjustment period. Thus, rather than the January 1, 2007 date proposed in Staff's proposed rules, circulated on July 25, 2006, we conclude that interest should begin to accrue for differences beginning January 1, 2006. The timing of the interest accrual is consistent with policies governing the accrual of interest on deferred accounts. *See* ORS 757.259. For purposes of calculating interest, we will assume that the mismatch of taxes paid with those collected accrues and accumulates evenly over the course of the entire tax year. Using this mid-year convention, interest will accrue on the amount of the annual difference as of July 1 of the tax year.

[4] In the example discussed above on page 8, the utility's stand-alone tax liability is $50 and the other affiliate(s) have a tax loss of $5. The "With and Without" approach to the Section 12(a) cap yields $45, since the group's tax liability is $45 with the utility and $0 without it. The "With and Without" cap is lower than a stand-alone approach to the Section 12(a) cap, but it is the same as the Section 12(b) cap, which is the affiliated group's tax payment.

ORDER

IT IS ORDERED that:

1. OAR 860-022-0041, as set forth in Appendix A, is adopted.

2. The rule shall become effective upon filing with the Secretary of State.

3. Avista Utilities, Northwest Natural Gas Company, Pacific Power & Light, and Portland General Electric Company shall file their tax reports on or before October 15, 2006, in compliance with the rule in Appendix A and this order.

4. Avista Utilities, Northwest Natural Gas Company, Pacific Power & Light, and Portland General Electric Company shall submit their draft requests for a Private Letter Ruling from the Internal Revenue Service to the Public Utility Commission of Oregon and all participants in this docket on or before November 15, 2006.

Made, entered, and effective SEP 1 4 2006.

Lee Beyer
Chairman

John Savage
Commissioner

Ray Baum
Commissioner

A person may petition the Commission for the amendment or repeal of a rule pursuant to ORS 183.390. A person may petition the Court of Appeals to determine the validity of a rule pursuant to ORS 183.400.

860-022-0041
Annual Tax Reports and Automatic Adjustment Clauses Relating to Utility Taxes

(1) This rule applies to regulated investor-owned utilities that provided electric or natural gas service to an average of 50,000 or more customers in Oregon in 2003, or to any successors in interest of those utilities that continue to be regulated investor-owned utilities.

(2) As used in this rule:

(a) "Affiliated group" has the meaning given to "affiliated group" in ORS 757.268(13)(a);

(b) "Deferred taxes" for purposes of the utility means the total deferred tax expense of regulated operations, as reported in the deferred tax expense accounts as defined by the Federal Energy Regulatory Commission, that relate to the year being reported in the utility's results of operations report or tax returns;

(c) "Income" means taxable income as determined by the applicable taxing authority, except that income means regulatory taxable income when reporting or computing the stand-alone tax liability resulting from a utility's regulated operations;

(d) "IRC" means Internal Revenue Code;

(e) "Investment" means capital outlays for utility property necessary or useful in providing regulated service to customers;

(f) "Local taxes collected" means the total amount collected by the utility from customers under the local tax line-item of customers' bills calculated on a separate city or county basis;

(g) "Pre-tax income" means the utility's net revenues before income taxes and interest expense, as determined by the Commission in a general rate proceeding;

(h) "Properly attributed" means the share of taxes paid that is apportioned to the regulated operations of the utility as calculated in section (3), subject to subsections (4)(a), (4)(b), (4)(g) and (4)(h), of this rule;

(i) "Public utility property" means property as defined by the Code of Federal Regulations, Title 26, Section 168(i)(10);

(j) "Regulated operations of the utility" has the meaning given to "regulated operations of the utility" in ORS 757.268(13)(c);

(k) "Results of operations report" means the utility's annual results of operations report filed with the Commission;

(l) "Revenue" means utility retail revenues received from ratepayers in Oregon, excluding supplemental schedules or other revenues not included in the utility's revenue requirement and adjusted for any rate adjustment imposed under this rule;

(m) "Revenue requirement" means the total revenue the Commission authorizes a utility an opportunity to recover in rates pursuant to a general rate proceeding or other general rate revision, including an annual automatic adjustment clause under ORS 757.210;

(n) "Stand-alone tax liability" means the amount of income tax liability calculated using a pro forma tax return and revenues and expenses in the utility's results of operations report for the year, except using zero depreciation expense for public utility property, excluding any tax effects from investment tax credits, and calculating interest expense in the manner used by the Commission in establishing rates;

(o) "System regulated operations" means those activities of the utility, in Oregon and other jurisdictions, that are subject to rate regulation by any state commission;

(p) "Tax" has the meaning given to "tax" in ORS 757.268(13)(d);

(q) "Taxes authorized to be collected in rates" means:

(A) The following for federal and state income taxes calculated by multiplying the following three values:

(i) The revenue the utility collects, as reported in the utility's results of operations report;

(ii) The ratio of the net revenues from regulated operations of the utility to gross revenues from regulated operations of the utility, calculated using the pre-tax income and revenue the Commission authorized in establishing rates and revenue requirement; and

(iii) The effective tax rate used by the Commission in establishing rates for the time period covered by the tax report as set forth in the most recent general rate order or other order that establishes an effective tax rate, calculated as the ratio of total income tax expense in revenue requirement to pre-tax income;

(B) For purposes of paragraph (2)(q)(A) of this rule, when the Commission has authorized a change during the tax year for gross revenues, net revenues or effective tax rate, the amount of taxes authorized to be collected in rates will be calculated using a weighted average of months in effect;

(r) "Taxes paid" has the meaning given to "taxes paid" in ORS 757.268(13)(f);

(s) "Taxpayer" means the utility, the affiliated group or the unitary group that files income tax returns with units of government;

(t) "Tax report" means the tax filing each utility must file with the Commission annually, on or before October 15 following the year for which the filing is being made, pursuant to ORS 757.268;

(u) "Unitary group" means the utility or the group of corporations of which the utility is a member that files a consolidated state income tax return; and

(v) "Units of government" means federal, state, and local taxing authorities.

(3) The amount of income taxes paid that is properly attributed to regulated operations of the utility is calculated as follows:

(a) The amount of federal income taxes paid to units of government that is properly attributed to the regulated operations of the utility is the product of the values in paragraphs (3)(a)(A) and (B), subject to subsection (3)(b) of this rule:

(A) The total amount of federal income taxes paid by the federal taxpayer, to which is added:

(i) The current tax benefit, at the statutory federal income tax rate, of tax depreciation on public utility property;

(ii) The tax benefits associated with federal investment tax credits related to public utility property; and

(iii) Imputed tax benefits on charitable contributions and IRC section 45 renewable electricity production tax credits of the affiliated group, except those tax benefits or credits associated with regulated operations of the utility; and

(B) The average of the ratios calculated for the utility's gross plant, wages and salaries and sales, using amounts allocated to regulated operations of the utility as set forth in the utility's results of operations report in the numerator and amounts for the federal taxpayer in the denominator;

(b) The amount of federal income taxes paid that is properly attributed to the regulated operations of the utility under subsection (3)(a) of this rule shall not be less than

the amount of the federal stand-alone tax liability calculated for the regulated operations of the utility, reduced by the product of:

(A) The imputed negative tax associated with all federal income tax losses of entities in the utility's federal taxpayer group, after making the adjustments in subparagraphs (3)(a)(A)(i) and (ii) of this rule; and

(B) The average of the ratios for the utility's gross plant, wages and salaries and sales, using amounts allocated to the regulated operations of the utility as set forth in the utility's results of operations report in the numerator and amounts for the system regulated operations in the denominator;

(c) The total amount of state income taxes paid to units of government that is properly attributed to the regulated operations of the utility is the product of the values in paragraphs (3)(c)(A) and (B), subject to paragraphs (3)(c)(C) and (D) and subsection (3)(d) of this rule:

(A) The total amount of Oregon income taxes paid by the Oregon unitary group taxpayer, to which is added:

(i) The current tax benefit, at the state statutory rate, of tax depreciation on public utility property; and

(ii) Imputed Oregon tax benefits on charitable contributions and state business energy tax credits related to conservation and renewable energy production of the unitary group, except those tax benefits or credits associated with regulated operations of the utility; and

(B) The average of the ratios calculated for the utility's gross plant, wages and salaries and sales using amounts allocated to regulated operations of the utility as set forth in the utility's results of operations report in the numerator and amounts for the unitary group taxpayer in Oregon, adjusted to reflect amounts allocated to regulated operations of the utility, in the denominator;

(C) If a utility's taxes collected in rates reflect non-Oregon state income taxes, the utility must make a one-time permanent election in its October 15, 2006, tax report filing to either:

(i) Multiply the total amount of Oregon income taxes paid in paragraph (3)(c)(A) of this rule before adjustments by the ratio calculated as the state income tax rate used by the Commission in establishing rates divided by the Oregon statutory tax rate set forth in ORS 317.061; or

(ii) Calculate the total state taxes paid using the formula set forth in paragraphs (3)(c)(A) and (B) of this rule on a state by state basis, apportioned to Oregon by multiplying the total state taxes paid by the average of the ratios calculated for gross plant, wages and salaries and sales using amounts allocated to the regulated operations of the utility in the numerator and amounts for the system regulated operations in the denominator;

(D) When Oregon income tax attributable to system regulated operations is 100 percent allocated to Oregon in setting rates, 100 percent of the Oregon income tax of system regulated operations must be attributed to the regulated operations of the utility;

(d) The amount of state income taxes paid that is properly attributed to the regulated utility operations of the utility under subsection (3)(c) of this rule must not be less than:

(A) For a utility for which Oregon state income taxes are the only state income taxes included in rates, the amount of the Oregon state stand-alone tax liability calculated for the regulated operations of the utility, minus the imputed negative tax associated with all

Oregon state income tax losses of entities in the utility's unitary group after making the adjustment in subparagraph (3)(c)(A)(i) of this rule; or

(B) For a utility for which non-Oregon state income taxes are included in rates, the product of:

(i) The sum of the state stand-alone tax liability calculated for the applicable system regulated operations in each state in which the utility is a member of a unitary group, minus the sum of the imputed negative tax associated with all state income tax losses of entities in the utility's unitary group in each state, after making the adjustment in subparagraph (3)(c)(A)(i) of this rule for each state; and

(ii) The average of the ratios calculated for gross plant, wages and salaries and sales using amounts allocated to the regulated operations of the utility in the numerator and amounts for the system regulated operations in the denominator;

(e) The amount of local income taxes paid to units of government that is properly attributed to the regulated operations of a utility is the product of the values in paragraphs (3)(e)(A) and (B) of this rule for each local taxing authority in Oregon:

(A) The total amount of income taxes paid by the taxpayer to the local taxing authority, as adjusted to include the imputed effect on local income taxes of:

(i) The current tax benefit of tax depreciation on public utility property; and

(ii) Imputed tax benefits on charitable contributions of the taxpayer except those associated with regulated operations of the utility; and

(B) The ratio calculated using the method for apportioning taxable income used by the local taxing authority, with the amount for the regulated operations of the utility in the local taxing authority in the numerator and the amount for the taxpayer in the local taxing authority in the denominator.

(4) On or before October 15 of each year, each utility must file a tax report with the Commission. The tax report must contain the following applicable information for each of the three preceding fiscal years:

(a) The amount of federal and state income taxes paid to units of government by the taxpayer, as adjusted pursuant to subparagraphs (3)(a)(A)(i) and (ii) of this rule;

(b) The amount of the utility's federal and state income taxes paid that is incurred as a result of income generated by the regulated operations of the utility, where:

(A) The amount of federal income taxes paid is equal to the federal stand-alone tax liability calculated for the regulated operations of the utility;

(B) For a utility for which Oregon state income taxes are the only state income taxes included in rates, the utility's state income taxes paid is the Oregon state stand-alone tax liability calculated for the regulated operations of the utility; and

(C) For a utility for which non-Oregon state income taxes are included in rates, the amount of state income taxes paid is the product of:

(i) The sum of the state stand-alone tax liability calculated for the applicable system regulated operations in each state in which the utility is a member of a unitary group; and

(ii) The ratio calculated as the income of the regulated operations of the utility divided by the income of the system regulated operations;

(c) The amount of federal and state income taxes paid to units of government by the taxpayer that is properly attributed to the regulated operations of the utility, as calculated in section (3) of this rule;

(d) The lowest of the amounts in subsections (4)(a), (4)(b) and (4)(c) of this rule, after making adjustments for:

(A) The items defined in subsection (2)(r) of this rule;

(B) A reduction equal to the current tax benefit related to tax depreciation of public utility property for regulated operations of the utility; and

(C) A reduction equal to the tax benefit related to federal investment tax credits recognized by the Commission in establishing rates;

(e) The amount of federal and state income taxes authorized to be collected in rates;

(f) The amount of the difference between the amounts in subsections (4)(d) and (4)(e) of this rule;

(g) The amount of local income taxes paid to units of government by the taxpayer, calculated for each local taxing authority, and to which is added the imputed effect on local income taxes of the amount in subparagraph (3)(e)(A)(i) of this rule;

(h) The amount of local income taxes paid to units of government by the taxpayer that is incurred as a result of income generated by the regulated operations of the utility, calculated as the stand-alone tax liability in each local taxing authority;

(i) The amount of local income taxes paid to units of government by the taxpayer that is properly attributed to the regulated operations of the utility, as calculated in section (3) of this rule for each local taxing authority;

(j) The lowest of the amounts in subsections (4)(g), (4)(h) and (4)(i) of this rule, calculated for each local taxing authority, after making adjustments for:

(A) The items defined in subsection (2)(r) of this rule; and

(B) A reduction equal to the local tax effect of the current tax benefit related to tax depreciation of public utility property for regulated operations of the utility;

(k) The amount of local income taxes collected from Oregon customers, calculated for each local taxing authority;

(l) The amount of the difference between the amounts in subsection (4)(j) and (4)(k) of this rule, calculated for each local taxing authority;

(m) The proposed surcharge or surcredit rate adjustments for each customer rate schedule to charge or refund customers the amount of the differences in subsections (4)(f) and (4)(l) of this rule;

(n) If the utility claims the minimum taxes paid amount set by subsections (3)(b) and (3)(d) of this rule, the total federal and state income tax losses in the utility's affiliated and unitary groups associated with the imputed negative tax claimed; and

(o) Any adjustments, in addition to the adjustments required in section (3) and subsections (4)(a) through (4)(n) of this rule, that the utility proposes to avoid probable violations of federal tax normalization requirements.

(5) In calculating the amount of taxes paid under sections (3) and (4) of this rule:

(a) "Taxes paid" must be allocated to each tax year employed by the utility for reporting its tax liability in the following manner:

(A) For any tax return prepared for the preceding tax year and filed on or before the date the tax report is due for such tax year, the utility must allocate each reported tax liability to the tax year for which such return is filed;

(B) For each tax liability or tax adjustment shown on an amended tax return or made as a result of a tax audit, that is filed, paid or received after the date the tax report is due

for the applicable tax year, the utility must allocate the tax liability or tax adjustment to the tax year that is recognized by the utility for accounting purposes;

(C) Taxes paid must include any interest paid to or interest received from units of government with respect to tax liabilities;

(b) When a utility's fiscal year or parent changes, and a partial year consolidated federal income tax return is filed during the year, taxes paid must be calculated in the manner defined by ORS 314.355 and OAR 150-314.355. For purposes of this rule, the amount of taxes paid must reflect a weighted average of the months in effect related to each tax return filing.

(6) The utility must explain the method used for calculating the amounts in this rule and provide copies of all workpapers and documents supporting the calculations.

(7) The Commission will establish an ongoing docket for each of the October 15 tax report filings. Upon signing a protective order prepared by the Commission, any intervenor may have access to all such tax report filings, subject to the terms of the protective order;

(a) Within 20 days following the tax report filings, an Administrative Law Judge will conduct a conference and adopt a schedule;

(b) Within 180 days of the tax report filings, the Commission will issue an order that contains the following findings:

(A) Whether the taxes authorized to be collected in rates for any of the three preceding fiscal years differs by $100,000 or more from the amount of taxes paid to units of government that is properly attributed to the regulated operations of the utility;

(B) For the preceding fiscal year, the difference between the amount of federal and state income taxes paid to units of government by the taxpayer that is properly attributed to the regulated operations of the utility and the amount of taxes authorized to be collected in rates;

(C) For the preceding fiscal year, the difference between the amount of local income taxes paid to units of government by the taxpayer that is properly attributed to the regulated operations of the utility and the amount of local taxes collected in rates; and

(c) Any other finding or determination necessary to implement the automatic adjustment clause.

(8) Upon entry of an order finding a difference of $100,000 or more in section (7) of this rule, the utility must file an amended tariff, to be effective each June 1 unless otherwise authorized by the Commission, to implement a rate adjustment applying to taxes paid to units of government and collected from ratepayers for each fiscal year beginning on or after January 1, 2006;

(a) The utility must establish a balancing account and automatic adjustment clause tariff to recover or refund the difference determined by the Commission in paragraph (7)(b)(B) of this rule through a surcharge or surcredit rate adjustment;

(b) A utility that is assessed a local income tax must establish a separate balancing account and automatic adjustment clause tariff for each local taxing authority assessing such tax. The utility must apply a surcharge or surcredit on the bills of customers within the local taxing authority assessing the tax. The amount of the surcharge or surcredit must be calculated to recover or refund the difference determined by the Commission in paragraph (7)(b)(C) of this rule;

(c) Any rate adjustment must be calculated to amortize the difference determined by the Commission in paragraphs (7)(b)(B) and (7)(b)(C) of this rule over a period authorized by the Commission;

(d) Any rate adjustment must be allocated by customer rate schedule according to equal percentage of margin for natural gas utilities and equal cents per kilowatt-hour for electric utilities, unless otherwise authorized by the Commission;

(e) Each balancing account must accrue interest at the Commission-authorized rate for deferred accounts. For purposes of calculating interest, the amount of the difference calculated in this section of the rule will be deemed to be added to the balancing account on July 1 of the tax year;

(f) The automatic adjustment clause must not operate in a manner that allocates to customers any portion of the benefits of deferred taxes resulting from accelerated depreciation or other tax treatment of utility investment or regulated affiliate investment required to ensure compliance with the normalization method of accounting or any other requirements of federal tax law;

(g) On or before December 31, 2006, each utility must seek a Private Letter Ruling from the Internal Revenue Service on whether the utility's compliance with ORS 757.268 or this rule would cause the utility to fail to comply with any provision of federal tax law, including normalization requirements. Each utility must file a draft of its Private Letter Ruling Request with the Commission on or before November 15, 2006. While a utility's request for a Private Letter Ruling is pending, or a related Revenue Ruling is pending, no rate adjustment will be implemented, but interest will accrue according to subsection (8)(e) of this rule on the amount of any rate adjustment determined by the Commission pursuant to paragraphs (7)(b)(B) and (7)(b)(C) of this rule.

(9) No later than 30 days following the Commission's findings in section (7) of this rule, any person may petition to terminate the automatic adjustment clause on the basis that it would result in a material adverse effect on customers. In the event of a filing under this section, the applicable rate adjustment will not be implemented until the Commission makes its determination. If the Commission denies the request to terminate the rate adjustment, interest will accrue according to subsection (8)(e) of this rule on the final amount of the rate adjustment.

(10) At any time, a utility may file a claim that a rate adjustment under the automatic adjustment clause violates ORS 756.040 or other applicable law. In making a determination regarding a potential violation of ORS 756.040, the Commission will perform an earnings review using the utility's results of operations report for the applicable tax year.

Stat. Auth.: ORS Ch. 183, 756, 757 & 759
Stats. Implemented: ORS 756.040, 756.060, 757.267 & 757.268
Hist.: NEW

EXHIBIT 3

Comparison Chart of Consolidated, Standalone, and Apportionment Method Calculations
SB 408 / AR 498

PROPERLY ATTRIBUTED CACLULATION - FEDERAL

		Method		
		(4)(a) Consolidated	(2)(n)/(4)(b) Standalone	(3)(a)/(4)(c) Apportionment
	Federal Tax After Net Operating Losses, Special Deductions, and Credits	X	X	X
(5)(a)(B)	Adjust: Federal Tax Paid or Received on Exam, Amended Return, or Otherwise	X	X	X
(5)(a)(C)	Adjust: Interest Paid or Received on Federal Tax Paid on Exam, Amended Return, or Otherwise	X	X	X
	Adjusted Federal Tax After Net Operating Losses, Special Deductions, and Credits	X	X	X
(3)(a)(A)(i)	Addback: CurrentTax Benefit of Tax Depreciation on All Public Utility Property in the Affiliated Group	X	X	X
(3)(a)(A)(ii)	Addback: Tax Benefits Associated with Federal Investment Tax Credits Related to All Public Utility Property in the Affiliated Group	X	X	X
(3)(a)(A)(iii)	Addback: Imputed Tax Benefit on Charitable Contributions of All Members of the Affiliated Group Except those Associated with the Regulated Operations of the Utility	N/A	N/A	X
(3)(a)(A)(iii)	Addback: Tax Benefits on IRC Section 45 Credits of All Members of the Affiliated Group Except those Associated with the Regulated Operations of the Utility	N/A	N/A	X
	Federal Tax After Section (3)(a)(A) Adjustments	X	X	X
(3)(a)(B)	Apportionment Factor	N/A	N/A	X
	Apportioned Federal Tax After Section (3)(a)(A) Adjustments	X	X	X
(4)(d)(A)	Addback: Tax Savings Realized as a Result of Charitable Contribution Deductions Allowed Because of Charitable Contributions Made by the Utility	X	X	X
(4)(d)(A)	Addback: Tax Savings Realized as a Result of Tax Credits Associated with Investment in the Regulated Operations of the Utility to the Extent Not Considered in the Last Ratemaking Proceeding	X	X	X
(4)(d)(A)	Adjust: Deferred Taxes Related to the Regulated Operations of the Utility	X	X	X
(4)(d)(B)	Less: Current Tax Benefit Related to Tax Depreciation of Public Utility Property for the Regulated Operations of the Utility	X	X	X
(4)(d)(C)	Less: Tax Benefit Related to Federal Investment Tax Credits Recognized by the Commission in Establishing Rates	X	X	X
	Federal Tax After Section (4)(d) Adjustments	X	X	X

"Regulated Operations of the Utility" is defined in Section (2)(j) of Order No. 06-532 as those activities of a public utility that are subject to rate regulation by the commission. In other words, Oregon regulated operations.

The apportionment factor applied pursuant to Section (3)(a)(B) of Order No. 06-532 is an evenly weighted 3-Factor formula with the utility's gross plant, wages, and salaries, using amounts allocated to the regulated operations of the utility as set forth in the utility's results of operations report in the numerator and amounts for the federal taxpayer in the denominator.

The Consolidated and "Apportionment Method" calculations are based off of regulatory filings and the federal consolidated tax return. The Standalone calculation is based off regulatory filings and the income tax liability calculated using a pro forma tax return and revenues and expenses in the utility's results of operations report for the year, except using zero depreciation expense for public utility property, excluding any tax effects from investment tax credits, and calculating interest expense in the manner used by the Commission in establishing rates pursuant to section (2)(n) of Order No. 06-532.