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ELECTRONIC FILING

PUC Filing Center
Oregon Public Utility Commission
PO Box 2148
Salem, OR 97301-2148

Re: Docket No. UE 170

Enclosed for filing are an original and twenty copies of PacifiCorp's Application for Reconsideration or Rehearing of Commission Order No. 05-1050. Also enclosed are an original and five copies of the Supplemental Testimony and Exhibits of Bruce Williams and Larry Martin.

Very truly yours,

Katherine A. McDowell

KAM:jlf
Enclosure
cc: Service List

BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UE 170

In the Matter of PACIFIC POWER & LIGHT (d/b/a PacifiCorp) Request for a General Rate Increase in the Company's Oregon Annual Revenues

PACIFICORP'S APPLICATION FOR RECONSIDERATION OR REHEARING OF COMMISSION ORDER NO. 05-1050

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I. INTRODUCTION

On September 28, 2005, the Public Utility Commission of Oregon (the "Commission") issued its final rate order in this docket, Order 05-1050 (the "Order"), which included a $26.6 million revenue requirement reduction based on the provisions of Senate Bill 408 ("SB 408" or the "Act"), or, alternatively, its "principles."[1]

Pursuant to ORS 756.561 and OAR 860-014-0095, PacifiCorp requests that the Commission reconsider and eliminate this adjustment by calculating PacifiCorp's tax expense using the stand-alone ratemaking rules and practices in effect throughout the pendency of this case. In the alternative, PacifiCorp requests that the Commission grant rehearing and set an expedited schedule to hear PacifiCorp's evidence demonstrating the factual inaccuracy, as well as the financial impact, of the adjustment. This evidence demonstrates that, even under the rationale applied by the Commission, the adjustment is subject to a more than a tenfold reduction to $2.3 million.

It is clear from SB 408's statutory directives and legislative history that the legislature intended the Act to address the so-called "Enron" problem (*i.e.*, when an affiliated group paid less taxes to government than the utility collected in rates), while minimizing unintended consequences that could penalize tax-paying utilities or create disincentives to utility

[1] The Commission "decided that [it] must apply SB 408 to this docket," (Order at 18), but also stated, "Assuming, *arguendo*, that we are incorrect in holding that the legislature intended SB 408 to apply to this rate case, we choose to use our discretion and apply SB 408 principles to this rate case." *Id.* n 15.

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investment. Indeed, proponents of the Act, Industrial Customers of Northwest Utilities (ICNU) and Citizen's Utilities Board (CUB), argued to legislators the bill was "moderate" because it was not legislation that "fundamentally changed tax policy or ratemaking." (Utility Customers Ask for Fairness and Equity: Taxes Collected Must Align with Taxes Paid; Vote Yes on SB 408-C, Exhibit 1.) According to ICNU and CUB:

> "[T]he effect of the bill is very straightforward: utilities will have to report how much they collected in taxes and they will have to report how much they paid in taxes. If there's a difference between the two amounts of more than $100,000, there will have to be a true up. That's it. Nothing in utility ratemaking is changed." *Id.*

The Commission's application of SB 408 in this case, however, was not moderate.[2] It represented a fundamental change in the Commission's tax policy and ratemaking, as the Commission acknowledges in the Order. As outlined below, this change is ultimately inconsistent with the provisions of SB 408 and other applicable laws.[3]

II. GROUNDS FOR RECONSIDERATION/REHEARING UNDER OAR 860-014-0095(3)

A. Material Errors of Law or Fact That Justify Reconsideration or Rehearing.

The nine material errors of law or fact set forth below justify reconsideration or rehearing pursuant to OAR 860-014-0095(3):

1. The plain language of SB 408, including its preamble, demonstrates that the "fair, just and reasonable" clause in the bill does not authorize the adjustment.

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[2] Regardless of the manner in which SB 408 might be applied, PacifiCorp finds objectionable *any* allocation of affiliate losses to a utility because such allocations violate cost-causation principles and are likely unconstitutional.

[3] "The powers of a regulatory agency * * * are not without limits. Like the legislature itself, a regulatory agency is bound to exercise its authority within the confines of both state and federal constitutions. An agency's authority may be further limited by the legislature itself; its power arises from and cannot go beyond that expressly conferred upon it." *Pac. Northwest Bell Telephone Co. v. Sabin*, 21 Or App 200, 213 (1975) (cited in *Pac. Northwest Bell Telephone Co.*, 116 Or App 302, 309 (1992)).

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2. Indeed, the adjustment cannot be sustained under the "fair, just and reasonable" clause in SB 408. The adjustment reduces PacifiCorp's return on equity ("ROE") to 8.4 percent—just barely above the weighted cost of capital set in the Order—and deprives PacifiCorp of the opportunity to earn a reasonable return. This is because the Order assumes that PacifiCorp will not have certain tax expenses, an assumption that is erroneous. In the wake of the Order, Standard & Poor's issued a note warning that the Order was adverse for credit quality and could cause adverse ratings action. The adjustment violates the *Hope* standard,[4] as codified in SB 408's "fair, just and reasonable" standard and ORS 756.040.

3. SB 408's legislative history, which makes clear that SB 408 was not intended to change general Commission rate-setting practices, demonstrates that the Commission misinterpreted the law in making the adjustment.

4. The Commission's adjustment violates its rules and established precedent on setting tax expense in rates, which were not superseded or amended by SB 408.

5. The Commission unlawfully applied SB 408 to support the adjustment before the adoption of rules for SB 408's implementation.

6. The Commission's application in this case of the provisions or principles of SB 408, enacted after the close of the record and the submission of the case for decision, violated PacifiCorp's federal due process rights and its rights under the Oregon Administrative Procedures Act (the "APA").

7. The Commission's application of SB 408 or its principles in this case, in the absence of express language or clear legislative intent supporting retroactive application of the statute, violates Oregon law.

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[4] *Federal Power Comm'n v. Hope Natural Gas Pipeline*, 320 US 591 (1944).

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8. The Commission applied SB 408 in an incomplete and arbitrary fashion, not taking into account the express substantive and procedural requirements of the bill, which are now the subject of a rulemaking docket.

9. The Commission's adjustment violates the "benefits and burdens" test that, according to the Oregon Department of Justice's (the "DOJ") advice to the Commission issued during the pendency of this case, must be satisfied before the Commission can change its established stand-alone tax policy and make a consolidated tax adjustment.

B. New Evidence Essential to the Decision Was Not Previously Available and Should Be Considered as a Basis for Reconsideration or Rehearing.

New evidence exists on the following three issues, which the Commission should review on reconsideration or rehearing:

10. The Order refers to the interest deduction from PacifiCorp Holdings Inc. ("PHI") as a "constant." However, because of a change in PHI's debt structure that occurred on September 22, 2005, PHI's interest payment in 2006 will be $122 million, $38 million less than assumed in the Commission's adjustment.

11. Similarly, because of a change in U.K. tax laws, beginning on September 20, 2005 and continuing throughout 2006, ScottishPower will pay income tax on the PHI interest income at a rate of 30 percent, offsetting all but 7.95 percent of the tax benefit assumed in the Commission's adjustment.

12. Even if the tax expense adjustment approach adopted by the Commission were lawful and appropriate, the Commission should have allocated tax expense and benefits based on relative taxable income, not PacifiCorp's contribution to PHI's gross profits. Gross profits are not a rational allocation factor for taxes, because they do not consider expenses or other deductions. Based on the nearly finalized PHI fiscal year 2005 federal tax return, PacifiCorp has new evidence that its relative taxable income was 49 percent of PHI's total taxable income. Based on these known and measurable changes, and the allocation

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methodology correction, the tax expense adjustment should be approximately $1.4 million on an Oregon-allocated basis, or slightly less than $2.3 million on a grossed-up, revenue requirement basis.

C. Good Cause for Further Examination of the Decision Exists.

The following four issues provide good cause for reconsideration or rehearing of the Order:[5]

13. The Commission's SB 408 adjustment violates the constitutional prohibition against asymmetrical ratemaking, by reducing PacifiCorp's rates based on tax benefits generated by unregulated affiliates, while also prohibiting adjustments that would impose unregulated affiliate tax costs on ratepayers.

14. The adjustment unconstitutionally impairs the contract associated with the merger of ScottishPower and PacifiCorp. In the contract, ScottishPower agreed to shield ratepayers from a variety of costs of unregulated activities, including the cost of servicing the acquisition debt; in return, ScottishPower retained the tax benefits associated with such activities.

15. The adjustment violates the Equal Protection Clause of the U.S. Constitution by arbitrarily appropriating the tax benefits from utility affiliates.

16. The adjustment constitutes an unconstitutional taking under the U.S. and Oregon constitutions by appropriating the tax deductions and benefits generated from unregulated affiliates, which bear all of the risk of the underlying investments.

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[5] PacifiCorp raises these issues to advise the Commission of certain federal and state constitutional concerns that should be considered in determining whether the Order should be amended. PacifiCorp does not intend to assert in this proceeding challenges to the Commission's Order based on the Supremacy Clause or the Commerce Clause of the United States Constitution or other federal laws or regulations not expressly referenced in this submission, or facial challenges to SB 408 arising under the United States Constitution, federal law and/or federal regulations, and reserves its right under *England v. Louisiana Bd. Of Med. Examiners*, 312 US 411, 84 S Ct 461, 11 L Ed 2d 440 (1964) to bring such challenges in an appropriate federal court.

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III. SPECIFICATIONS REQUIRED UNDER OAR 860-014-0095(2)

A. PacifiCorp contends that the tax adjustment contained on pages 13 through 19 of the Order is erroneous and/or incomplete.

B. In support of this contention, PacifiCorp relies on the laws, rules, policies, and portions of the record cited in this application.

C. PacifiCorp requests that the Commission eliminate the tax adjustment, or, in the alternative, reduce it to $2.3 million.

D. PacifiCorp's requested change in the Order will alter the outcome by resetting PacifiCorp's tax expense in rates to reflect its expected stand-alone tax liability, a revenue requirement increase of $26.6 million. In the alternative, if the Commission decides to retain an adjustment, PacifiCorp's requested change in the Order will reduce the Commission's tax adjustment to $2.3 million, resulting in a revenue requirement increase of $24.3 million.

IV. ARGUMENT

A. The Conclusion That SB 408 Requires the Commission to Disregard Its Stand-Alone Precedent and Instead Apply an "Actual Taxes Paid" Standard in This Case Is Erroneous as a Matter of Law.

The Order concludes that SB 408 changed the rate standard in Oregon, requiring the Commission to apply an "actual taxes paid" standard in this case. (Order at 17.) This is despite the facts that: (1) neither by its terms, nor as shown in the legislative record, does the Act provide for a new rate standard to be applied in general rate cases; (2) the Commission's application in the Order of its "new" standard violated prohibitions on confiscatory rulemaking set forth not only in SB 408 but in Oregon statutes and the U.S. Constitution; (3) the Commission's current administrative rule, as well as long-standing precedent, require a stand-alone approach to ratemaking, which approach was neither superseded nor amended by passage of SB 408; and (4) in any event, the Commission violated the Oregon APA in changing its current administrative rule by not following required procedures set forth therein.

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1. SB 408 Did Not Change the Rate Standard in Oregon.

The Commission's conclusion that SB 408 changed the rate standard in Oregon to an actual-taxes-paid standard is not supported by the language of SB 408 and ignores the legislative intent that the Act "not change the original ratemaking process." Statement of Rep. Boquist, House of Representatives Chamber Session, July 30, 2005. Rather than change the ratemaking process, the legislature promulgated SB 408 to address a mismatch between taxes collected in rates and taxes paid to government through a narrowly crafted mechanism—that is, an automatic adjustment clause. The "fair, just and reasonable" language from Section 5 of SB 408 ensures that tax adjustments under the automatic adjustment clause do not violate the *Hope* standard, codified in SB 408 and ORS 756.040.

a. The Plain Language of SB 408 Demonstrates That the Act Does Not Change the Ratemaking Standard in Oregon.

The Commission concluded in the Order that, although Section 3 of the Act, which contains the reporting and automatic adjustment clause provisions, could not be implemented immediately, Sections 2 and 5 *could* be implemented immediately. (Order at 17.) Section 2 states the legislative findings and Section 5 amends ORS 757.210, adding the word "fair" to the description of the rate standard, so that it now reads "fair, just and reasonable," and adding the sentence: "The commission may not authorize a rate or schedule of rates that is not fair, just and reasonable." SB 408 §§ 2, 5.

As the Commission agreed in its Order, the substantive provisions in Section 5 do not demonstrate that the legislature intended to change the rate standard:

> "Another change to ORS 757.210(1)(a) was the addition of a sentence to the end of the section: 'The commission may not authorize a rate or schedule of rates that is not fair, just and reasonable.' Again, as we have always been required to establish fair and reasonable rates, we still were not convinced that the addition of this sentence by the legislature had added to or changed our ratemaking authority."

(Order at 17 (footnote omitted).)

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However, a "general policy statement in the preamble of SB 408 * * * cause[d the Commission] to believe that the legislature intended immediate action." (*Id.*) This particular provision in the preamble states: "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." SB 408 § 2(1)(f). Thus, without the legislative finding in Section 2(1)(f), the Commission concluded, it would not have interpreted the Act to change its ratemaking authority, requiring it to immediately depart from its precedent and administrative rule and to instead apply an actual-taxes-paid approach in this rate case. (Order at 17.)

The Commission's conclusion that SB 408 changes the rate standard places undue significance on Section 2(1)(f), a single statement in the Act's preamble. It is unreasonable to conclude that the legislature would make such a significant and far-reaching change to the Commission's rate making practices in this oblique and indirect manner. If the legislature had truly intended to change the ratemaking standard in Oregon, it would have said so in the substantive sections of the Act. It would not have tucked such a mandate into the preamble, a nonlegislative section of the Act. *See Sunshine Dairy v. Peterson*, 183 Or 305, 193 P2d 543 (1948) (legislative findings contained in preamble cannot create rights not otherwise found within statute, nor can they limit those actually given by legislation; preamble may be consulted to clarify ambiguities only); *Curly's Dairy, Inc. v. State Dept. of Agriculture*, 244 Or 15, 21, 415 P2d 740 (1966) (improper to read one statement in findings in vacuum, without guidance of statute as whole).

Here, the findings, when construed together and with the statute as a whole, do not mandate an actual-taxes-paid approach to general ratemaking. Instead, the findings acknowledge the legislative intent to true up taxes collected in rates to taxes "paid." SB 408 § 2(1)(f). This interpretation of legislative intent is consistent with the operative provisions of the Act, which provide for an automatic adjustment clause to account for differences

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between taxes collected and taxes actually paid, and which define "taxes paid" as amounts "received" by government. *Id.* § 3(4), (13)(f).

The Commission's reliance on Section 2(1)(f) disregards other legislative findings in the Act, which expressly recognize the current ratemaking practice of setting the tax expense in rates on a stand-alone basis. *See* SB 408 § 2(1)(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."). The findings do not say that this ratemaking practice must end. *See* SB 408 § 2(1). Another finding in the Act acknowledges that "the ratemaking process may result in collecting taxes from ratepayers that are not paid to units of government." *See id.* § 2(1)(e). When the findings are construed in conjunction with one another and the Act's provisions for an annual tax report and automatic adjustment clause, it becomes clear that the legislature intended the Act to create a mechanism—an automatic adjustment clause—to address concerns voiced in the findings. *See Curly's Dairy*, 244 Or at 21 (legislative intent must be gleaned from statute as whole, including particular directives).

The most reasonable interpretation of the amendments to ORS 757.210, taking into consideration the language of the Act and the legislative history, is that the amendments were enacted to make ORS 757.210 consistent with the tax report and automatic adjustment clause provisions, and to conform the "just and reasonable" language in ORS 757.210 to the "fair and reasonable" standard found in ORS 756.040, in which the *Hope* standard was previously codified, and in other Commission statutes. (*See, e.g.,* Order at 17 ("we have always been required to establish fair and reasonable rates").) *See also* ORS 756.040(1) ("The commission shall balance the interests of the utility investor and consumer in establishing fair and reasonable rates."); ORS 757.273 ("All rates * * * by any public utility or telecommunications utility for any attachment by a licensee shall be just, fair and reasonable."); ORS 757.285 ("Agreements regarding rates * * * [for] attachments shall be deemed to be just, fair and reasonable, unless the Public Utility Commission finds * * * that

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such rates * * * are adverse to the public interest and fail to comply with the provisions hereof."); ORS 757.495 (Commission must find certain contracts to be "fair and reasonable"); *In re Portland General Electric Co.*, UM 1105, Order No. 03-509 at 3 (OPUC Aug. 25, 2003) (approving equal pay packages as "fair, just and reasonable"). Construed in this manner, the "fair, just and reasonable" standard does not mandate the tax adjustment made in this case, but instead prohibits it, because as discussed in the following section, its effect on PacifiCorp is confiscatory.

The Commission's construction of Sections 2 and 5 also undermines the Act's express directives allowing tax adjustments through an automatic adjustment clause, subject to various safeguards and limitations. For example, Section 3(13)(b) excludes certain small utilities from the reporting and rate adjustment requirements of Section 3 of the Act;[6] Section 3(13)(d) excludes franchise fees and privilege "taxes" from the computation of taxes under Section 3 of the Act;[7] Section 3(13)(f) retains for utility investors the tax savings from the utility's charitable contributions, certain utility investments and deferred taxes by adjusting the computation of "taxes paid" under Section 3 of the Act;[8] Sections 3(8) and (9) prohibit the Commission from adjusting rates under Section 3 when doing so would cause the utility to lose the right to claim accelerated depreciation or cause ratepayers to suffer material adverse effects; and Section 4(2) provides that the automatic adjustment clause "shall apply only to taxes paid to units of government and collected from ratepayers on or after January 1, 2006."

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[6] Section 3(13)(b)(A) defines "[p]ublic utility" to exclude utilities with fewer than 50,000 customers in Oregon in 2003.

[7] Section 3(13)(d)(C) states that the definition of "[t]ax" does not include franchise fees or privilege taxes.

[8] Section 3(13)(f) increases the definition of "[t]axes paid" by the amount of tax savings realized as a result of utility charitable contribution deductions and certain utility investments in regulated operations, and deferred taxes related to the regulated operations of the utility.

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Thus rate adjustments under Section 3 are not applicable to small utilities, require adjustments to the computation of "taxes" and "taxes paid" to retain certain tax incentives for investors, provide a safety net against normalization violations and material adverse impacts, and are to be applied only to taxes paid on or after January 1, 2006. Many of these safeguards and limitations are now the subject of the Commission's SB 408 rulemaking docket, Docket AR 499. However, because none of these provisions apply to Sections 2 and 5, the Commission's construction of SB 408 in this case gives it unfettered power to make tax adjustments. This is an outcome squarely at odds with, and which undermines, the provisions of Section 3 of SB 408 and renders the AR 499 rulemaking little more than an academic exercise.

b. The Legislative History of SB 408 Demonstrates That the Legislature Did Not Intend to Change the Ratemaking Standard in Oregon.

At the time the Order was entered, the Commission had not yet compiled the legislative history of SB 408. *See* October 5, 2005 ALJ Ruling, AR 499 (SB 408 legislative history to be gathered and published by DOJ on October 7, 2005). Perhaps for this reason, the Order inaccurately states that "there is nothing in the legislative history to indicate the intent of the legislature when it added [the] word [fair]." (Order at 17.) It is true that no one in the record *ever* stated that the amendment to ORS 757.210 revised the rate standard in Oregon as the Commission found in this case. The legislative record does, however, provide guidance as to the meaning of "fair, just and reasonable," all of which is contrary to the Commission's interpretation of this language in the Order.

The legislative history demonstrates both that the heart of the Act is its automatic adjustment clause provisions and that the "fair, just and reasonable" language codified the *Hope* standard within ORS 757.210 in response to concerns that SB 408 could result in an unconstitutional taking. Legislative Counsel Dexter Johnson provided section-by-section analyses of the Act to the Senate Business and Economic Development Committee. There,

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Mr. Johnson described the legislative findings and did not at any time say that the findings indicated a legislative intent to change the rate standard in Oregon. *See* SB 408 Work Sessions, Senate Business and Economic Development Committee, May 26 and May 31, 2005. Rather, he stated that the findings are "fairly self explanatory." SB 408 Work Session, Senate Business and Economic Development Committee, May 26, 2005. Mr. Johnson explained that Section 2 "describes the concerns regarding * * * the current practices regarding taxes and how the cost for taxes are determined for ratemaking purposes and expresses the legislature's concern with those practices." *Id.*

Mr. Johnson also never stated that Section 5, which amended ORS 757.210 to insert the word "fair" before the phrase "just and reasonable," changed the rate standard in Oregon. Rather, Mr. Johnson explained that the revisions to ORS 757.210 were clean-up amendments. *Id.* ("Section 5 is an amendment to existing law, essentially to include cost for taxes in the definition of automatic adjustment clauses, which is set forth in 757.210. It makes consistent the standard of fair, just, and reasonable that appears elsewhere in the draft.").

This is in stark contrast to Mr. Johnson's description of the automatic adjustment clause provisions in the Act, which he characterized as "really the guts of the amendment." *Id.* The Act's proponents testified that the automatic adjustment clause is a "narrowly crafted" solution to the concerns identified in the legislative findings, "a solution that sticks within the parameters of existing OPUC mechanisms, the accelerated or the automatic adjustment clause." Statement of Melinda Davison, Attorney for Industrial Customers of Northwest Utilities, SB 408 Work Session, Senate Business and Economic Development Committee, May 31, 2005. Likewise, another SB 408 proponent explained:

> "Section 2, which goes through and talks about what I think you all believe. You believe that the taxes should not be collected in rates and then not paid. It says that this isn't the way we want to run our state and have the utilities handle it. It

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> attempts to find a solution and *the solution is what we call an automatic adjustment clause.*"

Statement of Ann Fisher, Attorney for Portland Metropolitan Association of Building Owners and Managers ("BOMA"), SB 408 Work Session, Senate Business and Economic Development Committee, May 31, 2005 (emphasis added).

Consistent with legislative counsel's and proponents' descriptions of the Act, the DOJ and others interpreted the insertion of the word "fair" into ORS 757.210 to be a prophylactic measure to assure that the *Hope* standard applies to SB 408 automatic adjustment clauses, thereby addressing concerns that the Act would result in confiscatory rates in violation of the *Hope* standard. On numerous occasions, the DOJ advised the legislature that the law must allow the Commission to set rates that are "fair"—otherwise, the law could result in an unconstitutional taking of private property under *Hope*. *See, e.g.,* Statement of Deputy Attorney General Peter Shepherd, SB 408 Public Hearing, House State and Federal Affairs Committee, June 30, 2005 ("rate setters must allow investors in a regulated utility to recover their prudent expenses and earn a fair return on their investment. This is, you'll hear people refer to this as the *Hope* Test."); Statement of Assistant Attorney General Paul Graham, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("[*Hope* is] the case that prohibits confiscatory rates and what the *Hope* case says is that a regulator can use any method it wants to set rates, but at the end of the day, the bottom line, has to be that the rates * * * allow[] the utility a reasonable opportunity to earn a fair return on the investment its made to serve rate payers.").

Thus, Deputy Attorney General Shepherd concluded, the inclusion of the "fair, just and reasonable" language in ORS 757.210 sets a "downward limitation" on the adjustment that the Commission can make under the Act. Statement of Deputy Attorney General Peter Shepherd, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("[The] PUC cannot allow the adjustment if it would result in a rate which is not fair, just and

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reasonable, as the terms of the total rate. So, that there would be an upward limitation, as well as a downward limitation."). *See also* Statement of Rep. Tom Butler, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("fair, just and reasonable" language "attempts to make [the adjustment] both symmetrical, as well as nonconfiscatory and in that regard completely constitutional"); Statement of Rep. Tom Butler, House Chamber Session, July 30, 2005 ("The bill's current proponents contend that the trigger to stop the downward spiral was that the rates must be fair, just and equitable—fair, just and reasonable."); Statement of Rep. Robert Ackerman, House Chamber Session, July 30, 2005 ("I conclude that the 'fair, just and reasonable' standard and the limited use of the automatic adjustment clause satisfies constitutional requirements. Now that is from our Legislative Council."); written Testimony of Deputy Attorney General Pete Shepherd, SB 408 Work Session, House State and Federal Affairs Committee, June 30, 2005 (describing "fair, just and reasonable" language as providing protection against *Hope* violation).

The legislative history of SB 408 conclusively demonstrates the Commission's misapplication of SB 408 in this case. *See* Statement of Rep. Boquist, House Chamber Session, July 30, 2005 (SB 408 "does not change the original ratemaking process").

2. The Tax Expense Adjustment Results in Rates That Are Not "Fair, Just and Reasonable," in Violation of SB 408, ORS 756.040, and *Hope*.

The reduction in utility revenues caused by the Order also violates prohibitions on confiscatory ratemaking found in SB 408, Oregon's utility code and the U.S. Constitution. *See Hope*, 320 US 591; *In re Util. Reform Project*, Order No. 03-214, App. A at 2-3 (OPUC 2003) (allocation of tax benefits to utility "may lead to confiscatory rates"). This is because the Order permanently lowers rates based on a single factor—debt service by an affiliate—that has nothing to do with the taxes actually paid by either PacifiCorp or its affiliated group.

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The impact the Order will have on PacifiCorp's revenues is significant. Rather than having any opportunity to earn the stipulated and approved return on equity of 10 percent, all else being equal, the tax adjustment will reduce the Company's return on equity to 8.4 percent, only a hair above the weighted average cost of capital set in this case. (*See* Supp. Test. of Bruce Williams.) Such a return, over 100 basis points lower than the lowest ROE recommendation in the case (by ICNU/CUB and Staff), is confiscatory and in violation of constitutional and statutory requirements. *See* ORS 756.040(1).

In addition to the immediate impact of the Order resulting in underearnings, the tax expense adjustment may lead to a downgrade to PacifiCorp's current "A-" credit rating by Standard & Poor's. (*See* Supp. Test. of Bruce Williams.) Such a downgrade would in turn lead to higher debt costs for PacifiCorp and higher rates for its customers. Moreover, a downgrade would limit PacifiCorp's access to the capital market at a time when that access is critical for infrastructure investment.

3. The Commission's Current Administrative Rule and Established Precedent Require a Stand-Alone Approach to Ratemaking and Were Neither Superseded nor Amended by Passage of SB 408.

In the Order, the Commission improperly disregarded its own administrative rules, OAR 860-027-0048(3)(g) and (4)(h), which require the tax expense in utility rates to be calculated using the "standalone" method (the "Stand-Alone Rule").

a. The Stand-Alone Rule Is a Ratemaking Rule, Not Merely a Record-Keeping Rule.

The Stand-Alone Rule provides: "Income taxes shall be calculated for the regulated activity [or the energy utility] on a standalone basis for both *ratemaking purposes* and regulatory reporting." OAR 860-027-0048(3)(g) and (4)(h) (emphasis added). Despite this, the Commission summarily dismissed PacifiCorp's argument that the Stand-Alone Rule requires a stand-alone approach to ratemaking, stating that the Stand-Alone Rule is "an accounting rule, which requires an energy utility to keep its books of account on a stand-

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alone basis" and as such has no effect on how a utility calculates its taxes for ratemaking purposes. (Order at 18.) Despite the fact that the Stand-Alone Rule, by its express terms, applies to "ratemaking," the Commission provided no further explanation or analysis in support of its conclusion that the rule is merely an accounting rule. (*See id.*)

The Commission's holding that the Stand-Alone Rule is only an accounting rule is inconsistent with the plain wording of the rule. *See* OAR 860-027-0048(3)(g) and (4)(h) ("Income taxes shall be calculated for the energy utility on a standalone basis for * * * *ratemaking purposes* * * *." (emphasis added).) Although the Stand-Alone Rule also regulates how a utility keeps its books, it is not limited to such purposes. Because an administrative rule must be construed to give effect to every section, clause, phrase, or word thereof, the Commission cannot read out the requirement that the Stand-Alone Rule applies to ratemaking. *See, e.g., Blyth & Co. v. City of Portland*, 282 P2d 363, 366 (Or 1955) (stating maxim of construction for statutes); *PGE v. Bureau of Labor and Industries*, 859 P2d 1143, 1147 n 4 (Or 1993) (statutory maxims of construction apply to interpretation of administrative rules).

Moreover, the Commission's conclusion in the Order that the Stand-Alone Rule is only an accounting rule is contradicted by the Commission's stated intent in promulgating the rule. The Commission promulgated the Stand-Alone Rule to "prevent[] cross-subsidization between regulated activities of a utility and its nonregulated activities, affiliates and competitive operations." *Re Affiliated Transactions for Energy Utils.*, Order No. 03-691 (AR 459), 2003 WL 23305011 at *1 (Or Pub Util Comm'n Dec. 1, 2003). Accounting practices alone would not accomplish such a purpose, because cross-subsidization is a ratemaking issue. The Commission has a statutory mandate to prevent cross-subsidization, which occurs when nonregulated expenses or revenues are included in a utility's rates, not necessarily when they are included on a utility's books of account. *See* ORS 757.646(2)(c)

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(requiring Commission to adopt rules that "prohibit[] cross-subsidization between competitive operations and regulated operations").

b. It Was Legal Error for the Commission to Disregard Its Established Stand-Alone Precedent.

The Commission violated the Oregon APA when it announced in the Order that its established stand-alone precedent no longer applies. Oregon law requires an agency to follow the procedures required by the APA when changing established rules. *Burke v. Children's Serv. Div.*, 288 Or 533, 538, 607 P2d 141 (1980) (agency is bound by its established rules and policies until it changes them pursuant to procedures required by APA). This is true regardless of whether those rules are formally promulgated administrative rules or rules arising from established precedent. *Id.* at 538-39 (agency statement of existing policy or practice remains binding on agency until repealed according to procedures required by APA). *See also Attorney General's Administrative Law Manual* at 9 (2004).

> "Once an agency has adopted a rule, the agency is bound to follow its terms. Moreover, an agency policy or practice that meets the definition of a rule but is not in the form of a written rule or has not been promulgated according to the APA is, nevertheless, binding on the agency until it is declared invalid by a court or until it is amended or repealed by the agency in accordance with proper rulemaking procedures."

Id. (footnotes omitted).

Nor did SB 408 somehow relieve the Commission of its obligation to comply with the APA. Even if SB 408 had directed the Commission to change its approach to setting the tax expense in base rates, the Commission would still be bound by the practices and policies declared by its own rules until it changed the existing rules pursuant to the procedures required by the APA. *Vier ex rel Torry v. State Office for Serv. to Children and Families*, 159 Or App 369, 374-75, 977 P2d 425, 428 (1999) ("an agency remains bound by the practices and policies declared by its rules, even in the face of newly enacted legislation changing the agency's responsibilities," unless and until existing practices and rules are

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judicially declared invalid or are changed by agency pursuant to formal rulemaking procedures).

Here, the Commission announced in the Order *for the first time* that it was abandoning its stand-alone approach and instead adopting an actual-taxes-paid approach, thus significantly changing its established approach to setting the tax expense in base rates. The Commission acknowledged that its practice until now has been to calculate utility taxes on a stand-alone basis and that it changed this practice with the Order. (Order at 17-18 (acknowledging that its past precedent had "always" been to calculate the tax expense on stand-alone basis and explaining that it was now departing from historical practice and considering taxes paid by a utility or its parent when setting rates); *id.* at 18 ("[w]e must reject PacifiCorp's recommendation to maintain our stand-alone approach").)

The Commission's reliance on SB 408 as a purported justification for this departure is erroneous. (*See* Order at 18 ("We are not, however, bound to maintain our practice of stand-alone calculations, particularly when a new statute comes into play.").) Even if SB 408 did require the Commission to change its established policy of setting the tax expense in base rates on a stand-alone basis, which it does not, Oregon law requires the Commission to change established policies in an orderly, deliberate, and forward-looking manner through the rulemaking process of the APA. In advance of such procedures, the Commission may not apply ad hoc legal standards as it has done in this docket.

B. The Commission's Ad Hoc Application of SB 408 Deprived PacifiCorp of the Opportunity to Present Evidence Relevant to the Applicable Legal Standard.

SB 408 was signed by the Governor and became effective almost three weeks after the close of the evidentiary record in this case. Despite the fact that SB 408 does not, by its terms, apply retroactively, the Commission applied the new law to this case. In doing so, the Commission acknowledged that the legislature may not have intended SB 408 to apply to this case, stating "[if] we are incorrect in holding that the legislature intended SB 408 to apply to

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this rate case, we choose to use our discretion and apply SB 408 principles to this rate case." (Order at 18 n 15.) However, the Commission does not have the discretion to apply a law retroactively; nor does the Commission have the discretion to apply SB 408's "principles." The Commission's tax adjustment unlawfully:

- applied SB 408 without *first* establishing standards by which the law is to be applied, in violation of Oregon law;
- deprived PacifiCorp of its right to present evidence regarding SB 408 in violation of the due process rights guaranteed by Amendments V and XIV of the U.S. Constitution;
- deprived PacifiCorp of its right to "respond and present evidence and argument on all issues involved" in the case, in violation of Section 183.415(3) of the APA; and
- violated the Oregon common-law rule against retroactive application of a statute.

1. Oregon Law Requires the Commission to Establish Standards *Before* It Applies SB 408.

The Commission admitted that SB 408, which imposes both substantive and procedural requirements, is "complex." (Order at 16.) Indeed, the Commission agreed with Governor Ted Kulongoski's observation that SB 408 "defers many of the difficult questions about the impact and implementation of SB 408 to the [Commission]." (*Id.* (citing September 2, 2005 letter from Governor Kulongoski to Secretary of State Bill Bradbury).) Accordingly, the Commission has opened a permanent rulemaking proceeding, Docket AR 499, to "address the many uncertainties of the interpretation and application of SB 408." (Order at 16-17.) Reflecting the complexity of SB 408, the Commission has also requested a legal opinion from the DOJ to clarify some of the legal uncertainties in SB 408. *See* October 5, 2005 ALJ Ruling, Docket AR 499.

Despite these uncertainties, the Commission nevertheless based its decision in this docket on SB 408. Moreover, the Commission admitted that the tax adjustment it pieced together in loose reliance on SB 408 was "not precise." (*Id.* at 19.) The Commission

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attempted to excuse this application of its ad hoc tax adjustment by stating that the adjustment was "the best [the Commission could] do under present circumstances." (*Id.*) Such an approach is not tenable under Oregon law.

In Oregon, an administrative agency is required to establish implementation standards *before* it applies the law. *Sun Ray Drive-In Dairy, Inc. v. Or. Liquor Contr. Comm'n*, 517 P2d 289, 292-93 (Or App 1973) (Oregon Liquor Control Commission ("OLCC") reliance on Oregon statute to deny application for liquor license was improper because OLCC had not yet published rules or regulations establishing standards by which statutory grounds for refusal were to be applied). Compliance with the APA is "much more than an act of technical legal ritual * * * [because w]ithout written, published standards, the entire system of administrative law loses its keystone." *Id.* at 293. The requirement that agencies establish standards before they apply the law achieves several important policies:

- Written rules inform the public.
- Written rules assure that the agency acts by rules and not from whim or corrupt motivation.
- The public is entitled to consistency of enforcement from the agency.
- The parties to a hearing of a contested case must know what is to be heard in the hearing and what they are required to prove and disprove in order to gather and present their evidence.
- The legislature is entitled to know whether or not the agency's policies and practices are consistent with the legislative directive.
- Judicial review requires written standards.

Id. These keystones of administrative law are protected whether the agency adopts standards through the promulgation of written administrative rules or through policies announced in a contested case, but only so long as the agency "provide[s] notice of the standard and allow[s] the parties to comment on it." *Save Our Rural Oregon v. Energy Facility Siting Council*, No. SC S52315, 2005 WL 2464570 at * 15 (Or Sept. 29, 2005) (citing *Marbet v. Portland Gen. Elect.*, 277 Or 447, 463, 561 P2d 154 (1977) (adoption of standard requires "notice and

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procedures that allow for the presentation of views and data on the issues involved, and sufficiently in advance of the final decision so that the applicant and other parties can address the import of the standard * * *. ")).

Here, the Commission announced for the first time in the Order that it was applying the "principles" of SB 408 to this case. Thus it failed to follow the procedures required by Oregon law for adoption of new standards.

2. State and Federal Law Requires the Commission to Provide PacifiCorp with an Opportunity to Present Argument and Evidence Regarding SB 408.

a. The Commission's Order Deprived PacifiCorp of Its Federal Due Process Rights.

By applying a law enacted after the evidentiary record closed, the Commission denied PacifiCorp any opportunity to present evidence regarding SB 408 in violation of the due process rights guaranteed by Amendments V and XIV of the U.S. Constitution. "The essence of fundamental fairness is the opportunity to be heard at a meaningful time and in a meaningful manner." *State ex rel Juv. Dept. v. Geist*, 310 Or 176, 189-90, 796 P2d 1193 (1990) citing *Mathews v. Eldridge*, 424 US 319, 333, 96 S Ct 893 (1976).

Evidentiary hearings in this case concluded July 21, 2005; the evidentiary record closed August 12, 2005; and oral argument took place August 15, 2005. SB 408, after undergoing substantial revision in the House, was passed by the House on July 30, 2005; repassed by the Senate on August 1, 2005; and signed into law on September 2, 2005. Until September 2, 2005, more than three weeks after the close of the evidentiary record, SB 408 was not the law of Oregon.

On August 8, 2005, the ALJ issued a memorandum directing the parties to "be prepared to address the impact of SB 408, if any, on this rate case" in oral argument. August 8, 2005 ALJ Memorandum, UE 170. However, a previous ALJ memorandum noting that the record would close on August 12, 2005, was not updated to keep the record open to

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address SB 408. August 3, 2005 ALJ Memorandum, UE 170. Of course, because the law enacted by SB 408 did not exist at the time this case was heard, there was no reason or practical ability for parties to present evidence regarding the law's application to this case, and indeed, no party presented any such evidence. (*See* Staff's Post-Hearing Reply Brief at 6 (Aug. 12, 2005) ("the record in this proceeding does not contain the requisite evidence to implement a SB 408-type calculation").)

Had the Company been afforded an opportunity to present evidence, the revenue requirement adjustment that would have resulted from application of the methodology adopted by the Commission would have been significantly lower, as shown below. Whether the Order is based on the application of SB 408 itself or, alternatively, SB 408 "principles," fundamental fairness requires both notice that the Commission might apply the Act to the case *and* the opportunity to present evidence in light of the applicable legal standard. *See Harlan Bell Coal Co. v. Lemar*, 904 F2d 1042, 1048 (6th Cir 1990) (due process was denied when appellant was not allowed opportunity to present evidence made relevant by change in law occurring post-hearing but before ALJ's order). "Fundamental fairness requires that [a party] be granted an opportunity to address comprehensively the [new, post-hearing] standards." *Id.*

b. This Due Process Right Is Reflected in the APA.

Section 183.415(3) of the APA provides that a party to a contested case may elect to "respond and present evidence and argument on all issues involved" in the case. The Oregon Court of Appeals has held that this provision of the APA bars an agency from changing the established interpretation of a rule during the course of a contested case proceeding without giving parties to the case the "opportunity to present evidence and arguments that are responsive to the new standard [as interpreted by the agency]." *Martini v. Or. Liquor Contr. Comm'n*, 110 Or App 508, 513, 823 P2d 1015 (1992). The *Martini* court explained that, even though agencies can make "policy refinements" in deciding contested cases, agencies

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may not change the "established interpretation of a rule" without allowing parties to present their case under the new standards. *Id.* at 513.

Here, the Commission did not make a tax policy "refinement." Instead, the Commission changed its long-standing approach to utility taxes. It has been the Commission's policy for more than a decade that any approach to utility taxes that allocates tax liabilities or savings resulting from nonregulated operations to ratepayers would be contrary to the statutory obligation to prevent cross-subsidization between regulated and nonregulated operations. *See, e.g., In re PacifiCorp*, Order No. 03-726, app A at 5; *In re Util. Reform Project*, Order No. 03-214, app A at 2 (OPUC 2003); *Re Or. Exch. Carrier Ass'n*, 1993 WL 117620 at *6 (OPUC 1993); Staff Report at 4 (Or Pub Util Comm'n Aug. 7, 2003) (Stand-Alone Rule adopted to codify Commission's long-standing prohibition against cross-subsidization). (*See also* Order at 17-18 (Commission's past precedent has "always" been to calculate tax expense on a stand-alone basis).) Moreover, the Commission has specifically applied its stand-alone precedent to PacifiCorp. *See* Staff Audit Report (Or Pub Util Comm'n Dec. 1, 2004) ("[f]or ratemaking purposes, PacifiCorp is examined on a standalone basis.").

The Commission did not provide any notice before the evidentiary record closed that it was changing its policy. Instead, it announced the policy change in the Order itself. SB 408 did not become law until after the record closed in this case. Consequently, PacifiCorp had no opportunity to present evidence or arguments in light of the Commission's new policy. Thus the Commission's application of SB 408, or the principles of SB 408, to PacifiCorp's case was a violation of Section 183.415(3) of the APA.

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3. Even if the Commission Had Developed Standards Before Applying SB 408 in this Case, SB 408 Cannot Apply in This Case Because Oregon Law Prohibits Retroactive Application of SB 408.

Oregon courts reject the retroactive application of a statute that does not by its terms provide for retroactivity or whose legislative history does not clearly establish the intent that the statute be applied retroactively. *Guerrero v. Adult and Fam. Serv. Div.*, 676 P2d 928, 929 (Or App 1984); *Holmes v. State Accident Ins. Fund*, 589 P2d 1151, 1152 (Or App 1979) ("Many principles have been judicially enunciated applying, distinguishing, abandoning or modifying the substantive/procedural test for prospective or retrospective application of newly enacted statutes. They boil down to the general principle that the rights and liabilities of persons affected by an event are defined and measured by the statutes in effect at the time of the event and the adjudication of those rights and liabilities is accomplished under the statutes in effect at the time of the adjudication." (citations omitted)); *Joseph v. Lowery*, 495 P2d 273, 276 (Or 1972) ("We believe there is merit in the prior view of this court, as demonstrated by its decisions, that, in the absence of an indication to the contrary, legislative acts should not be construed in a manner which changes legal rights and responsibilities arising out of transactions which occur prior to the passage of such acts."); *Bohnert v. Comm'n Dunn*, 3 OTR 423, 426 (Or T C 1969); *Delahant v. Board on Police Standards and Training*, 312 Or 273, 855 P2d 1088 (1993).

The Commission argued that, because "the plain language of Section 6 of SB 408 declares that 'this 2005 Act takes effect on its passage,'" SB 408 should apply to this proceeding. (Order at 17.) Although SB 408 contains an emergency clause,[9] the Act does

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[9] The emergency clause states: "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." SB 408 § 6. In Oregon, an emergency clause does not require the retroactive application of a new law, unless there is clear indication of legislative intent to apply the law in such a way. *West. Communications, Inc. v. Deschutes Co.*, 788 P2d 1013 (Or App 1990).

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not by its terms provide for retroactivity.[10] Moreover, there is no indication in the legislative history that the Oregon legislature intended SB 408 to be applied retroactively either generally or to this rate case specifically.

Furthermore, the Oregon Supreme Court has held that statutes or regulations that say nothing about retroactive application cannot be applied retroactively if such a construction would (1) "impair existing rights," (2) "create new obligations," or (3) "impose additional duties with respect to past transactions." *Derenco, Inc. v. Benj. Franklin Fed. Savings & Loan*, 281 Or 533, 539 n 7 (1978); *see also*, *Guerrero v. AFSD*, 67 Or App 119, 122, 676 P2d 928 (1984) (applying *Derenco* test and holding that agency's retroactive application of rule to petitioner's Aid to Dependent Children benefits was improper because it was prejudicial to petitioner).

The retroactive application of SB 408 in this case unlawfully impairs PacifiCorp's right to recover its tax expense calculated on a stand-alone basis in rates. The Commission's retroactive application of SB 408 also impairs the value of the contract associated with the ScottishPower merger, as noted in Section IV.F.2.

C. Regardless of Whether SB 408 Changed the Rate Standard Applicable in This Case, the Commission Failed to Consider Facts Essential to an SB 408 Analysis.

Until the Commission changes OAR 860-027-0048(4) and its practice of treating taxes on a stand-alone basis, it is not authorized to implement SB 408 outside the parameters

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[10] For examples of valid retroactivity clauses, see *Volk v. America West Airlines*, 899 P2d 746, 748 (Or App 1995) ("Notwithstanding any other provision of law, this Act applies to all claims or causes of action existing or arising on or after the effective date of this Act, regardless of the date of injury or the date a claim is presented, and this Act is intended to be fully retroactive unless a specific exception is stated in this Act." (internal quotation marks and citation omitted)); *Robinson v. Lamb's Wilsonville Thriftway*, 31 P3d 421, 423-24 (Or 2001) ("the amendments * * * by Section 1 of this 1999 Act apply to all actions pending on or commenced after the effective date of this 1999 Act." (alterations, internal quotation marks, and citation omitted)).

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of the Act, which restricts adjustments to an automatic adjustment clause mechanism in certain circumstances only.[11] Section 3(4) of the Act is explicit on this point:

> "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 * * *."

(Emphasis added.)

Section 3(6) then states that the automatic adjustment clause *shall* account for all taxes paid to units of government by the public utility, or by the affiliated group, so that ratepayers are not charged for more tax than is paid. Section 3(7) confirms that an automatic adjustment clause established under Section 3 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. Finally, Section 4(2) of the Act states:

> "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."

(Emphasis added.)

The Act, therefore, imposes both substantive and procedural requirements, the "what" and "how" of adjusting tax expense to reflect taxes actually paid to units of government. It does not contemplate any other mechanism for carrying out its objectives—the Commission either makes the findings required to establish an automatic adjustment clause, or it may not disallow a tax expense for ratemaking purposes.

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[11] *See supra* note 2.

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Here, the Order purports to be based on SB 408, but fails to consider facts relevant to an SB 408 analysis—facts that, if considered, would have decreased the adjustment considerably. The Commission tries to explain away its error in not complying with the *terms* of SB 408 by stating that it may "use [its] discretion and apply SB 408 *principles* to this rate case." (Order at 18 n 15 (emphasis added).) As explained above, the Commission does not have any such discretion.

1. SB 408 Does Not Change Rates Until After 2006.

The Act does not contain any mechanism for the use of an automatic adjustment clause in 2005, nor does it authorize such use. Substantively, the Act requires the Commission to align taxes included in rates with taxes actually paid to units of government. Procedurally, the Act requires the Commission to consider the tax report filed by the utility on October 15, determine whether the $100,000 threshold has been exceeded, and notify the utility within 30 to 60 days of any need to establish an automatic adjustment clause. Under Section 4(2) of the Act, adjustments may be applied only to taxes paid and collected from ratepayers on or after January 1, 2006. Until that time (as well as afterwards), the utility and its affiliates may restructure their operations, defer tax-favored events, and conduct other legitimate business activities that would narrow or eliminate any gap between taxes actually paid and the tax expense included in rates. Because the Order adjusts pre-2006 rates based on pre-2006 data, the Order violates Section 4(2) of the Act.

2. SB 408 Requires the Commission to Adjust Rates Based on Historical, Not Forecasted, Data.

Both the plain language and legislative history of SB 408 demonstrate that the Act requires the Commission to adjust rates to align "taxes collected" with "taxes paid," based on historical, not forecasted, data. The backward-looking nature of SB 408 adjustments is particularly apparent from the definition of "taxes paid," a term that appears throughout the Act. Section 3(13)(f) defines "taxes paid" as follows:

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> "'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."

(Emphasis added.)

If the legislature had intended the Commission to base adjustments on forward-looking estimates, as opposed to actual historical data, it would not have directed the Commission to determine "taxes paid" by looking at amounts "received" by the government, adjusted for tax savings "realized." It would have been a simple matter for the legislature to say "taxes that will be paid," "rates that will be collected," "amounts that will be received," and "tax savings that will be realized," but it did not. Likewise, if the legislature had intended the Commission to base adjustments on forward-looking estimates, it would not have required utilities to report actual tax payments. *See* SB 408 § 3(1)(a) (requiring utilities to report tax payments for the prior three years "without regard to the tax year for which the taxes were paid"); *id.* § 3 (13)(f) (defining "taxes paid" as "amounts *received* by units of government" (emphasis added)). Actual taxes paid, which include settlement payments and are net of refunds received, do not provide a basis for estimating future tax liability, because settlements and refunds are not representative of future tax liability. Finally, had the legislature intended SB 408 to apply to forward-looking estimates, it would not have

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amended the bill to delete the phrase "[t]he automatic adjustment clause shall apply only prospectively." *See* B-Engrossed SB 408 § 3(3) (ordered by Senate June 6, 2005).

The participants in Docket AR 499, which include utilities, customer groups and Staff, have agreed that, whether or not the Act allows the Commission to use forecasted data, as a policy matter the Commission should base SB 408 adjustments on historical data only. (*See* Letter from Paul Graham, Assistant Attorney General, to Participants in Docket AR 499 at 1-2 (Oct. 7, 2005) (summarizing agreements of participants).)

Despite the Act's emphasis on "taxes paid," the removal of the "prospective" language, and the AR 499 parties' agreement that SB 408 adjustments should not be based on forecasted data, the Order nevertheless concludes that SB 408 requires the Commission to align *estimated future* taxes with taxes in rates:

> "Our first goal – one which we believe SB 408 requires – is to do our best to align the estimated taxes included in PacifiCorp's rates with the amount that PacifiCorp (or its affiliated group) will eventually pay."

(Order at 19.)

Thus the Commission disregarded the Act's mandate that adjustments be based on actual historical data only.

3. SB 408 Requires the Commission to Consider the Amount of Taxes "Paid" and "Incurred".

SB 408 requires a rate adjustment based on actual tax payments "paid" and "incurred", not an estimate of future tax liability based on any other consideration. Specifically, SB 408 directs the Commission to consider taxes "paid" (which means payments "received" by units of government) by the affiliated group and "incurred" by the utility in the fiscal year in question "without regard to the tax year for which the taxes were paid." *See* SB 408 § 3(1)(a), (13)(f). The Order fails to comply with these provisions of SB 408, because it does not consider the amount of tax payments that the utility incurred and

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the government received in fiscal year 2005 or known and measurable changes that will persist into the test year, calendar year 2006. For example, the Order did not consider tax settlement payments that PacifiCorp's affiliated group made to units of government in fiscal year 2005, which totaled more than $70 million. (Supp. Tes. of Larry O. Martin ("Martin Testimony") at 5.)

Nor did the Order even consider the amount of tax payments that have been or will be received by units of government from the PHI group. Instead, the Order bases the adjustment on the total dollar amount of a single deductible expense and CUB's estimate of PHI's gross profits, not taxable income, which is the basis for PHI's tax payments. (Order at 18.) There is no evidence in the record that this number has anything to do with the taxes PHI actually paid or will pay to any units of government. Indeed, the Commission admits that "[i]n reaching this decision, we acknowledge that this adjustment is not precise. But it is reasonable, and the best we can do under present circumstances." (Order at 19.) Because it is not based on evidence of the taxes "paid" by the PHI group and taxes "incurred" by PacifiCorp, the Order violates Sections 3(6), 3(7) and 3(12) of the Act.

4. SB 408 Requires the Amount of Taxes Paid to Be Increased to Account for Certain Charitable Contributions, Investments in Utility Operations, and Deferred Taxes.

SB 408 directs the Commission to compare taxes collected in rates with taxes actually paid and incurred, increased by the amount of tax savings from PacifiCorp's charitable contributions and associated with PacifiCorp's investments in utility operations, to the extent those expenditures were not included in rates, and adjusted by deferred taxes related to PacifiCorp's regulated operations. SB 408 § 3(13)(f). The Order fails to even consider the effect on the adjustment of these items, which in fiscal year 2005 totaled more than $44 million on an Oregon-allocated basis. (Martin Testimony at 5-6.)

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5. SB 408 Requires the Commission to Consider the Total Tax Paid by the Affiliated Group.

SB 408 directs the Commission to compare taxes collected in rates with taxes paid to the government from a utility or its affiliated group. SB 408 § 3. Nevertheless, in complete disregard of that requirement, the Order based the adjustment on a single deductible expense of a single affiliate and failed to even consider taxes paid by the affiliated group. (*See* Order at 18-19.)

6. SB 408 Prohibits the Commission from Making Any Adjustments Properly Attributed to Unregulated Affiliates.

SB 408 specifically prohibits rate adjustments "that are properly attributed to any unregulated affiliate of the public utility or to the parent of the utility." SB 408 § 3(7). Because the Order relies on estimates regarding PHI's interest expense, there is no way for the Commission to determine whether the adjustment to PacifiCorp's tax expense is being used to make adjustments for taxes that are properly attributed to any unregulated affiliate or PacifiCorp's parent, PHI. The failure to undertake any investigation of this issue or make any finding addressing this point, when it is known that PHI has affiliates such as PPM Energy, is a clear violation of Section 3(7) of the Act.

D. Assuming Arguendo That the Commission Could Consider the PHI Interest Expense When Calculating PacifiCorp's Tax Expense, the Tax Adjustment in the Order Is Improperly Calculated.

The Commission based its $26.6 million tax adjustment on the incorrect assumption that PHI's interest payment caused the PHI group's consolidated tax payments to be $16 million less than PacifiCorp's stand-alone tax liability. (Order at 14.)

> "The interest that PHI pays to ScottishPower is deductible on PHI's consolidated income tax returns (filed on behalf of PacifiCorp and other PHI affiliates). The effect of this deduction is to eliminate or substantially reduce the consolidated group's taxable income, *resulting in PacifiCorp*

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collecting more money from ratepayers than the consolidated group pays in taxes to governmental units."

(*Id.* at 14 (emphasis added).)

This assumption is premised on both legal and factual errors. The Commission must follow its precedent and rules by computing PacifiCorp's tax expense on a stand-alone basis in this case. The Commission not only failed to do this, but also failed to give PacifiCorp the opportunity to present evidence relevant to any change in law and policy. Furthermore, the Commission failed to base its adjustment on the test year expense, including known and measurable changes thereto, and instead based its adjustment on vague conclusions gleaned from historical data that is not representative of the period during which the rates will be in effect. (*See id.* at 18-19 (failing to make any findings or conclusions regarding test year expense); *id.* at 19 ("we acknowledge that this adjustment is not precise").) The adjustment, based on the approach adopted by the Commission, when properly calculated to take into consideration these facts, would be approximately $1.4 million on an Oregon-allocated basis, and $2.3 million on a grossed-up basis. (*See* Martin Testimony at 1.)

1. The Commission Failed to Base the Tax Adjustment on Evidence of PacifiCorp's Expenses in the Test Year.

The Order fails to account for known and measurable changes in the test year, calendar year 2006. The Order does not even contain findings about what the tax expense will be in calendar year 2006.

As a matter of law and "[c]onsistent with established Oregon ratemaking principles," rates must be based on a projection of the expenses and revenues for the period during which rates will be in effect. *See, e.g., In re US WEST Communications*, UT 125/UT 80, Order No. 00-191 at 14 (Or Pub Util Comm'n Apr. 14, 2000) ("The Commission must ensure that the historical period is reasonably representative of the period during which rates will be in effect. The point is to prevent overearning or underearning during that period."); *In re*

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Pacific Northwest Bell Telephone Co., UT 43, Order No. 87-406 at 11-12 (OPUC 1987) ("Ratemaking is done on a prospective basis. Therefore, recurring increases in revenues and expenses that are reasonably certain to occur are added to the test year. * * * [T]he purpose of a test year is to represent the period in which rates will be in effect."). This is accomplished by basing the utility's test year on actual or budgeted expenditures, and adjusting those expenditures to remove abnormalities and to include known and measurable changes that are expected to persist. *See American Can Co. v. Lobdell*, 55 Or App 451, 466, 638 P2d 1152 (1982) ("Abnormal events of the past are therefore excluded and all known future changes are included.").

2. The Commission Should Rehear or Reconsider Its Order, Because New Evidence Exists That Demonstrates That the Tax Expense in the Test Year Will Be Considerably Greater Than Assumed in the Order, Even Taking into Consideration Consolidated Tax Savings.

By disregarding its precedent and rules and instead applying SB 408 to this general rate case after the record closed, the Commission deprived PacifiCorp of the opportunity to present evidence of the calendar year 2006 tax expense relevant to the adjustment method adopted by the Commission. New evidence exists that demonstrates known and measurable changes to PacifiCorp's tax expense when considered on a consolidated basis.

In considering the effect of PHI's interest expense on PacifiCorp's expenses and revenues in calendar year 2006, the Commission must consider the following known and measurable changes that are expected to persist:

- A change in the PHI debt structure, which occurred on September 22, 2005, will decrease PHI's interest payment in calendar year 2006 to $122 million—$38 million less than the amount assumed in the Order. (Martin Testimony at 3-4.)

- Beginning September 20, 2005 and persisting throughout calendar year 2006, ScottishPower will pay income tax on its interest income from PHI at a rate of 30 percent, thus offsetting all but 7.95 percent of any alleged tax savings enjoyed as a result of the interest deduction. (*Id.* at 4.) Thus, as of September 20, 2005, the alleged benefit to the PHI group of the interest deduction cannot be more than the difference between the PHI tax deduction

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and the ScottishPower tax payment. To the extent the "tax benefit" (Order at 19) of the interest deduction is eliminated by the ScottishPower tax payment, it no longer exists and cannot again be passed on to customers.

This evidence came into existence after the close of discovery and after the evidentiary record closed. It is therefore properly the subject of rehearing.

3. The Commission Should Base an Allocation of the Tax Expense on Relative Net Taxable Income, Not Gross Profits.

The Commission must allocate the tax expenses based on a rational tax allocation factor, such as net taxable income. The Order incorrectly calculates the tax adjustment by apportioning to PacifiCorp a percentage of the fiscal year 2005 PHI interest deduction based on PacifiCorp's contribution of "gross profits" to the PHI consolidated group, which was 91.5 percent. (Order at 14.) This is not a rational method of apportionment. Gross profits have no rational relationship to the interest deduction. Indeed, the Commission recognizes that a more appropriate apportionment factor is relative taxable income. (*See id.* at 18.) Based on the substantially completed PHI fiscal year 2005 tax return, which was not available at the hearing, in fiscal year 2005, PacifiCorp's contribution to the PHI group's taxable income in fiscal year 2005 was 49 percent. (Martin Testimony at 3.)

E. In Any Event, the Commission May Only Allocate to Ratepayers Affiliate Tax Savings if the "Benefits and Burdens" Test Is Satisfied.

The Commission's decision to allocate tax savings attributable to PHI's deductible expense improperly disregarded the "benefits and burdens" standard, which, shortly after this case was filed, the DOJ advised the Commission it must satisfy to change its general tax expense policy. (*See* PPL/1807/1 (Commission may change current stand-alone policy only "so long as the [new] policy is rational, including taking into account the benefits and burdens of its policy, and meets minimum constitutional requirements"); *id.* at 3 (state regulators may choose between different methods of calculating tax allowances, but "whichever method is chosen it should be *applied* in a way that matches benefits and

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burdens" (emphasis in original).) PacifiCorp, Staff, and CUB all presented evidence in this case consistent with the rate standard articulated by the DOJ for tax adjustments. (PPL/1300, Martin/6; PPL/1301, Martin/3-4; Staff/1000, Conway-Johnson/4; CUB/100, Jenks/4.)

The "benefits and burdens" test requires the Commission to give consolidated tax savings to customers only "if the customers bore the burden of *paying the deductible expense that generated the savings*." (Staff/1002, Conway-Johnson/1 (emphasis added); *see also id.* at 7 ("The benefits and burdens test can be simply stated as: the benefits of consolidated tax savings are given to ratepayers (by reducing the utilities tax allowance) if the customers bore the burden of *paying the deductible expenses that generated the savings*." (emphasis added).) *See also Charlottesville, Va. v. FERC*, 774 F2d 1205, 1217 (DC Cir 1985) (deductions are attributable to utility's jurisdictional activities if "'the customers of a regulated entity contributed to the expenses which created the loss deductions'" (citation omitted)).

This principle was reflected in the White Paper prepared by Staff for the legislature, which stated:

> "Unless the underlying revenues and costs of the parent and subsidiaries were also reflected in rates, setting rates based on consolidated tax payments would be considered poor regulatory policy * * *. Regulators should reflect tax benefits in rates to the same extent that customers bear the expenses creating those benefits. There is no economic rationale for a regulatory body to pick and choose which non-utility revenues and expenses—including tax savings—to include for purposes of setting Oregon customers' rates."

(PPL/1806/12.)

The DOJ advised the Commission that changing its policy on utility taxes to one that "picks and chooses in an arbitrary manner how it *treats* expenses and investments" implicates the serious constitutional concerns raised by the U.S. Supreme Court in *Duquesne Light Co. v. Barasch*, 488 US 299, 109 S Ct 609, 102 L Ed 2d 646 (1989). (PPL/1807/3.) *See also In re Util. Reform Project*, Order No. 03-214, App. A at 2-3 (allocation of affiliate tax benefits to utility "may lead to confiscatory rates"); *Re Potomac Elec. Power Co.*, 150

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Pub Util Rep 4th (PUR) 528 (DC Pub Serv Comm'n 1994); *Iowa Elec. Light & Power Co.*, 135 Pub Util Rep 4th (PUR) 522, 527 (Iowa Utils Bd 1992) ("The affiliates' financial losses which create the tax savings exist only because of the investment and expenses borne by the stockholders. It is clear the losses which created the tax savings belong to the affiliates * * *."). Thus the DOJ summarized its advice to the Commission as follows:

> "Any change in policy must be consistent with Oregon law and constitutional requirements. A policy that considers the benefits and burdens of the utility's participation in a consolidated tax group, consistent with the *Hope* standard, would result in [a] decision that would be consistent with *Duquesne* and administrative law requirements."

(Staff/1002, Conway-Johnson/3.)

1. The Evidence Here Does Not Satisfy the "Benefits and Burdens" Test.

As demonstrated in PacifiCorp's posthearing briefs, the parties proposing tax adjustments in this case failed to establish that their proposed consolidated tax adjustments satisfied the "benefits and burdens" test. ICNU eschewed the benefits and burdens test altogether, and Staff's and CUB's arguments were seriously flawed and speculative: (1) both Staff and CUB acknowledged that PHI bears the burden of "paying the deductible expense that generated the savings" (Cross-Exam. of Mr. Conway and Ms. Johnson, Tr. 191-92, Tr. 189; CUB/200, Jenks/4); (2) both focus on negative attributes of PHI debt without regard to offsetting or positive attributes of the parent's financial structure (*see* Redirect-Exam. of Mr. Conway and Ms. Johnson, Tr. 212-13; Recross-Exam of Mr. Conway and Ms. Johnson, Tr. 216-17; Cross-Exam of Mr. Jenks, Tr. 156, 163); and (3) both based their *burden* argument on claims that ring-fencing failed to protect customers from *positive* economic aspects of nonregulated operations. (*See* Cross-Exam. Of Mr. Conway and Ms. Johnson, Tr. 194; CUB/200, Jenks/3.)

Staff and CUB both disputed the relevance of any facts showing that PacifiCorp's customers have *benefited* from PacifiCorp's relationship with ScottishPower. (*See*

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Staff/1000, Conway-Johnson/8; Cross-Exam. of Mr. Jenks, Tr. 162.) Moreover, Staff's and CUB's proposed allocations of tax savings bear no rational relationship to the alleged burden on customers. (*See* PacifiCorp's Opening Posthearing Brief at 13-22; PacifiCorp's Posthearing Reply Brief at 7-9.) Thus the consolidated tax adjustment is not supported by substantial evidence that customers bore the burden of the deductible expense.

Further evidence of the fact that PacifiCorp has benefited from its relationship is provided by a recent Standard & Poor's ratings note attached as PPL Exhibit 319 to the Supplemental Testimony of Bruce Williams. The note, which was issued in September 2005 and was not available earlier in the case, states that "the current 'A-' corporate credit rating on PacifiCorp is based on ScottishPower's consolidated credit profile, whose solid financial performance has compensated for its weaker U.S. utility."

2. The Commission's Order Failed to Even Make a Finding Regarding Whether the Consolidated Tax Adjustment Is Supported by Substantial Evidence That Customers Bore the Burden of the Deductible Expense.

The Commission failed to do precisely what the DOJ advised the Commission it must do. It did not consider the benefits *and burdens* of the utility's participation in a consolidated tax group. The Commission failed to even make a finding in the Order regarding whether the evidence showed that the benefits and burdens standard was satisfied. (*See* Order at 16-19.) In its Discussion and Resolution regarding the consolidated tax adjustment issue, the Commission neglected to mention the DOJ advice or the constitutional limitations applicable to its action. (*See id.* at 16-19.) Instead, the Commission merely stated that "customers *may* be bearing the burden of PHI debt." (*Id.* at 18.) The Commission did not address whether this possible burden is offset by benefits. (*See id.* at 16-19.)

Rather than recognizing the constitutional requirements that its Order must satisfy, the Commission stated that the following two goals were essential to its resolution: (1) "to do our best to align the estimated taxes included in PacifiCorp's rates with the amount that PacifiCorp (or its affiliated group) will eventually pay" and (2) "to reduce, to the extent

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possible, the amount that flows through the automatic adjustment clause." (*id.* at 19.) Neither goal reflects any consideration of benefits and burdens, which the DOJ has advised is a constitutional requirement and a standard applicable to any consolidated tax adjustment.

F. The Order Also Has Serious Constitutional Defects.

The Order not only is procedurally defective and inconsistent with the text and legislative history of SB 408, but also violates a number of substantive provisions of the U.S. and Oregon constitutions.

1. The Order Violates *Duquesne Light.*

The U.S. Supreme Court has made clear that asymmetrical ratemaking is constitutionally suspect. In *Duquesne Light*, 488 US at 314, the Court observed that, although the "Constitution [only] protects the utility from the net effect of the rate order on its property" as a whole, "[o]ne of the elements always relevant to setting the rate * * * is the return investors expect given the risk of the enterprise." The Court further explained:

> "Consequently, a State's decision to arbitrarily switch back and forth between [rate] methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions."

Id. at 315.

The DOJ has specifically advised the Commission of this issue in discussing potential ratemaking methodologies for taxes. (*See* Staff/1002, Conway-Johnson/7 (DOJ memorandum regarding legality of setting utility rates based on tax liability of parent, dated Feb. 18, 2005); PPL/1807/1 and 3 (DOJ memorandum regarding Utility Reform Project's comments on tax treatment in utility ratemaking, dated Mar. 22, 2005).)

The Order cannot be squared with either *Duquesne Light* or the DOJ's advice. The Commission's consistent practice and rules have calculated the tax component of utility rates on a stand-alone basis. Now, for the first time and without prior warning, the Commission has switched methodologies and reduced PacifiCorp's rates based on tax benefits generated

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by unregulated affiliates. It is clear, however, that the Commission's new methodology cannot and will not work both ways; to the contrary, SB 408 is clear that the tax components of utility rates must be the lesser of the stand-alone tax liability or the amount that a consolidated group actually pays to taxing authorities. *See* SB 408 § 3(12).

This is a classic example of an approach to ratemaking that gives ratepayers the "good" features of affiliates' investments in the form of tax deductions, but insulates them from the "bad" consequences of those investments, such as increased tax liability if the affiliates are highly profitable or risks associated with direct liability for debt. The Commission insisted that the costs of the debt incurred as part of the ScottishPower/PacifiCorp merger not be included in the utility's costs and that ratepayers be held harmless for any costs associated with that debt. (*See* Section IV.F.2, *infra*.) The Order represents precisely the type of asymmetrical ratemaking methodology switching that was condemned by *Duquesne Light* and warned against by the DOJ.

2. The Order Unconstitutionally Impairs the Merger Contract.

At the time of the merger between ScottishPower and PacifiCorp, parties to the regulatory proceedings before the Commission entered into a Stipulation Supporting Approval of Application of ScottishPower and PacifiCorp under ORS 757.511 (the "Stipulation"). (Order No. 99-616, appendix 5, Docket UM 918 (Oct. 6, 1999).) The Stipulation was adopted by the Commission and incorporated in the order approving the merger transaction. (*Id.*) Among other things, the Stipulation provided that "all costs of completing the merger" (which include the substantial amount of debt incurred to do so) would be excluded from PacifiCorp's "utility accounts." (*Id.*, Merger Condition No. 3.) Other conditions imposed by the Stipulation confirmed that PacifiCorp and its ratepayers were to be shielded from the risks of activities or investments by entities not subject to Commission jurisdiction. (*See, e.g., id.*, Merger Conditions No. 5 (PacifiCorp cost of capital to be no higher than without merger), No. 10 (ratepayers to be held harmless from higher

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revenue requirement due to merger), No. 11 (ScottishPower not to subsidize other activities by charging expenses to PacifiCorp), No. 12 (corporate costs to be no higher than without merger).) In the order approving the merger, the Commission observed that "PacifiCorp will operate on a stand-alone basis after the merger." (*Id.* at 21.)

The result is that PacifiCorp and ScottishPower are bound by contract as well as by administrative order to shield ratepayers from a variety of costs of nonregulated activities, including the cost of servicing the debt incurred to consummate the merger. A necessary corollary of that contractual obligation is that PacifiCorp's nonregulated affiliates are entitled to retain the tax benefits flowing from the debt service. The Commission's policy at the time, which later was incorporated into an administrative rule, was to calculate taxes for rate purposes on a stand-alone basis for utilities that filed consolidated tax returns. *E.g., Re Or. Exch. Carrier Ass'n.*, 1993 WL 117620 at *5; OAR 860-027-0048. The Order breaches and impairs the contract between PacifiCorp and ScottishPower by appropriating the tax benefits for ratepayers and continuing to absolve them of any investment risk. Impairment of these benefits without providing any comparable substitute constitutes a violation of the Contract Clauses of the U.S. and Oregon constitutions. US Const, Art I, § 10; Or Const, Art I, § 21; *see U.S. Trust Co. v. New Jersey*, 431 US 1, 19, 97 S Ct 1505, 52 L Ed 2d 92 (1977); *Eckles v. State of Oregon*, 306 Or 380, 760 P2d 846 (1988).

This impairment of the merger contract is analogous to the situation in *U.S. Trust*, in which the state of New Jersey attempted to change bond covenants after the bonds had been issued and purchased by third parties. The U.S. Supreme Court struck down the New Jersey law under the Contract Clause of the U.S. Constitution because "the covenant [was not] merely modified or replaced by an arguably comparable security provision. Its outright repeal totally eliminated an important security provision and thus impaired the obligation of the States' contract." 431 US at 19.

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So here, ScottishPower entered into a contract that, along with the Commission's consistent practice of calculating utility tax liability on a stand-alone basis, gave ScottishPower the tax benefits of debt it incurred in reliance on the contract. *See id.* at 19 n 17 ("contracting parties adopt the terms of their bargain in reliance on the law in effect at the time the agreement is reached"). The Order does not provide a comparable substitute; rather, it appropriates the tax benefits of the debt, yet continues to shield ratepayers from its risks. This impairment of the merger contract is the second constitutional flaw in the Order.

3. The Order Arbitrarily Appropriates the Benefits from Affiliates of Utilities in Violation of the Equal Protection Clause of the U.S. Constitution.

The Order denies ScottishPower and PHI the benefits of certain tax deductions simply because they are affiliated with a public utility; no other corporate parent or affiliate in Oregon is required to pass such deductions on to the customers of another affiliate rather than to investors. Such disparate treatment violates the Equal Protection Clause of the U.S. Constitution. US Const, Amend XIV, § 1.

A "class" for equal protection purposes can consist of a single member. *See Indiana State Teachers Ass'n v. Board of School Commissioners of the City of Indianapolis*, 101 F3d 1179, 1181 (7th Cir 1996). Thus, it can consist of a company such as PacifiCorp that has been denied tax benefits because of a state administrative order. The U.S. Supreme Court has ruled that states have "'large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation;'" however, a system of taxation that discriminates will be upheld only if "'the legislature could have reasonably concluded that the challenged classification would promote a legitimate state purpose.'" *Williams v. Vermont*, 472 US 14, 22-23 (1985) (citations omitted). In justifying a discriminatory scheme, it is not enough for a state to "observ[e] that in light of the statutory classification all those within the burdened class are similarly situated;" instead, the classification "must reflect pre-existing differences." *Id.* at 27.

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The Order does not promote a "legitimate state purpose" sufficient to pass constitutional muster. Although the stated purpose of the Order—to implement the goal of SB 408 to align taxes collected from ratepayers with taxes actually paid by utilities—might be seen superficially as "legitimate," the reality is that the Order does not do that at all. Instead, the Order appropriates a single type of tax deduction—namely, the deduction for interest paid on affiliate debt—to reduce utility rates without any consideration of the overall tax payments by either PacifiCorp or its affiliated group as a whole. The Order is irrational even on its own terms, and violates the Equal Protection Clause.

4. The Order Constitutes an Unconstitutional Taking and Results in Confiscatory Rates.

The Order results in an unconstitutional taking of property in violation of the Takings Clauses of the U.S. and Oregon constitutions. US Const, Amend V, XIV; Or Const, Art I, § 18. The tax deductions and benefits generated from investments by nonregulated affiliates are the property of those companies and their investors, which bear all of the risks of the investments. *See Re Potomac Elec. Power Co.*, 150 Pub Util Rep 4th 528; *Iowa Elec. Light & Power Co.*, 135 Pub Util Rep 4th at 527 ("The affiliates' financial losses which create the tax savings exist only because of the investment and expenses borne by the stockholders. It is clear the losses which created the tax savings belong to the affiliates * * *."). The Order appropriates that property for an allegedly "public" purpose; specifically, lower rates for customers of PacifiCorp in Oregon. Such an uncompensated taking of private property is patently unconstitutional. *See U.S. Trust*, 431 US at 19 n 16, (such rights "are a form of property and as such may be taken for a public purpose [only if] just compensation is paid").

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V. CONCLUSION

Based on the evidence and arguments presented, the Commission should reconsider and remove the tax adjustment in Order 05-1050. In the alternative, the Commission should rehear this case and reduce the tax adjustment to $2.3 million.

DATED: October 28, 2005.

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BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UE 170

In the Matter of PACIFIC POWER & LIGHT (d/b/a PacifiCorp) Request for a General Rate Increase in the Company's Oregon Annual Revenues

EXHIBIT 1

PACIFICORP'S APPLICATION FOR RECONSIDERATION OR REHEARING OF COMMISSION ORDER NO. 05-1050

INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

UTILITY CUSTOMERS ASK FOR FAIRNESS AND EQUITY: TAXES COLLECTED MUST ALIGN WITH TAXES PAID VOTE YES ON SB 408-C

Customers have crafted a bill that ensures that taxes collected through our rates are actually paid. However, there have been serious misrepresentations about SB 408-C. Yet the effect of the bill is very straightforward: utilities will have to report how much they collected in taxes and they will have to report how much they paid in taxes. If there's a difference between the two amounts of more than $100,000, there will have to be a true up. That's it. Nothing in utility ratemaking is changed. Nothing in tax policy is changed.

Let's look at the misrepresentations one by one.

The utilities say, "The bill is 'constitutionally unsound.' "
RESPONSE: SB 408-C does not violate either the state or the US Constitution.

The bill does not switch between methodologies. In fact, it picks a method and applies it consistently. Regulators have tremendous discretion in determining rates and how to calculate charges, including taxes, within those rates. All that is required is a rational explanation. "Taxes collected equals taxes paid" is a rational explanation. Is it a change from the current practice? Yes. But that's the point.

Neither would the bill result in confiscatory rates. This would mean that somehow the utility would be prevented from making its regulated rate of return. This is patently absurd. Having a utility report how much they collect in taxes, having them report how much they paid in taxes and making sure those two amounts are closely aligned does not result in confiscatory rates. It results in better accountability.

The utilities are fond of quoting *Hope Natural Gas v. Federal Power Commission*, saying that utility investors must have an opportunity to earn a fair and reasonable return on their investment. Customers have no quarrel with that premise. But making sure that taxes collected in rates are actually paid does not prevent that opportunity in any way. Investors should not be able to increase their profit margins by simply keeping taxes collected in rates.

The utilities say, "The bill undermines Oregon's renewable energy industry."
RESPONSE: Tax credits and tax incentives that exist today will exist after the bill's passage.

Again, the bill changes nothing in utility ratemaking or tax policy. If a utility wishes to avail themselves of tax credits and incentives, customers can support that. The bill discourages nothing. In fact, Section 3(f)(B) allows the amount of taxes paid to be **"(i)ncreased 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."** This means that the utility can take into account any tax credits or incentives when reporting its taxes paid, as long as those credits were not already accounted for in a previous rate case.

-over-

The utilities say, "The bill discourages charitable contributions and economic development."
RESPONSE: Even the utilities admit utility charitable contributions are exempt from adjustment in SB 408-C. And they don't explain how their dire predictions will come to pass.

But the utilities keep bringing up contributions and business activities of affiliates. If a utilities is part of a larger corporate structure or has other subsidiaries, it can still file consolidated tax returns if that is the wish of the utility or its corporate parent. However, for taxes collected in rates, SB 408-C asks only that the utility report the amount it collected for taxes in its rates, based on activities "properly attributed to the utility," and how much was actually paid to governmental entities. If there is a difference – either up or down – then there needs to be a true up. There is nothing in the bill that prevents a utility's corporate parent from investing in job creation, business development or making charitable contributions. But ratepayers should no longer pay for those activities by allowing unpaid taxes to be a slush fund for either utility investors or a utility's corporate parent.

The utilities say, "The bill is an extreme reaction to the Enron bankruptcy."
RESPONSE: The bill is a moderate approach to addressing a serious ratepayer concern.

The bill could have attempted to have the utilities to repay the hundreds of millions of dollars in collected taxes that were never paid to government entities to customers. The bill could have fundamentally changed tax policy or ratemaking. The bill could have done many things that could be labeled extreme. But SB 408-C is very moderate in its approach and is not a reaction to the Enron bankruptcy, although customers do not want that situation to occur again. The Enron bankruptcy simply brought the problem to light. It is fundamentally unfair for utilities – any utility – to keep money that customers paid as part of their rates, understanding that money will be paid to government. Rather than undertake a radical approach to the problem, all customers want is to know how much is collected for taxes in rates, how much is actually paid and to make sure those numbers are closely aligned. And that's all SB 408-C does.

SB 408-C is fair.
SB 408-C is moderate.
SB 408-C is straightforward.
SB 408-C is what customers are requesting.

Please Vote Yes on SB 408-C.

For more information, please contact: *Mark Nelson, ICNU: 503-363-7084*
Jeff Bissonnette, CUB: 503-516-1636

CERTIFICATE OF SERVICE

I hereby certify that I served a true and correct copy of the foregoing document in Docket UE 170 on the following named person(s) on the date indicated below by email and first-class mail addressed to said person(s) at his or her last-known address(es) indicated below.

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BEFORE THE PUBLIC UTILITY COMMISSION
OF OREGON

UE 170

In the Matter of PACIFIC POWER & LIGHT (d/b/a PacifiCorp) Request for a General Rate Increase in the Company's Oregon Annual Revenues

PACIFICORP'S APPLICATION FOR RECONSIDERATION OR REHEARING OF COMMISSION ORDER NO. 05-1050

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I. INTRODUCTION

On September 28, 2005, the Public Utility Commission of Oregon (the "Commission") issued its final rate order in this docket, Order 05-1050 (the "Order"), which included a $26.6 million revenue requirement reduction based on the provisions of Senate Bill 408 ("SB 408" or the "Act"), or, alternatively, its "principles."[1]

Pursuant to ORS 756.561 and OAR 860-014-0095, PacifiCorp requests that the Commission reconsider and eliminate this adjustment by calculating PacifiCorp's tax expense using the stand-alone ratemaking rules and practices in effect throughout the pendency of this case. In the alternative, PacifiCorp requests that the Commission grant rehearing and set an expedited schedule to hear PacifiCorp's evidence demonstrating the factual inaccuracy, as well as the financial impact, of the adjustment. This evidence demonstrates that, even under the rationale applied by the Commission, the adjustment is subject to a more than a tenfold reduction to $2.3 million.

It is clear from SB 408's statutory directives and legislative history that the legislature intended the Act to address the so-called "Enron" problem (*i.e.*, when an affiliated group paid less taxes to government than the utility collected in rates), while minimizing unintended consequences that could penalize tax-paying utilities or create disincentives to utility

[1] The Commission "decided that [it] must apply SB 408 to this docket," (Order at 18), but also stated, "Assuming, *arguendo*, that we are incorrect in holding that the legislature intended SB 408 to apply to this rate case, we choose to use our discretion and apply SB 408 principles to this rate case." *Id.* n 15.

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investment. Indeed, proponents of the Act, Industrial Customers of Northwest Utilities (ICNU) and Citizen's Utilities Board (CUB), argued to legislators the bill was "moderate" because it was not legislation that "fundamentally changed tax policy or ratemaking." (Utility Customers Ask for Fairness and Equity: Taxes Collected Must Align with Taxes Paid; Vote Yes on SB 408-C, Exhibit 1.) According to ICNU and CUB:

> "[T]he effect of the bill is very straightforward: utilities will have to report how much they collected in taxes and they will have to report how much they paid in taxes. If there's a difference between the two amounts of more than $100,000, there will have to be a true up. That's it. Nothing in utility ratemaking is changed." *Id.*

The Commission's application of SB 408 in this case, however, was not moderate.[2] It represented a fundamental change in the Commission's tax policy and ratemaking, as the Commission acknowledges in the Order. As outlined below, this change is ultimately inconsistent with the provisions of SB 408 and other applicable laws.[3]

II. GROUNDS FOR RECONSIDERATION/REHEARING UNDER OAR 860-014-0095(3)

A. Material Errors of Law or Fact That Justify Reconsideration or Rehearing.

The nine material errors of law or fact set forth below justify reconsideration or rehearing pursuant to OAR 860-014-0095(3):

1. The plain language of SB 408, including its preamble, demonstrates that the "fair, just and reasonable" clause in the bill does not authorize the adjustment.

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[2] Regardless of the manner in which SB 408 might be applied, PacifiCorp finds objectionable *any* allocation of affiliate losses to a utility because such allocations violate cost-causation principles and are likely unconstitutional.

[3] "The powers of a regulatory agency * * * are not without limits. Like the legislature itself, a regulatory agency is bound to exercise its authority within the confines of both state and federal constitutions. An agency's authority may be further limited by the legislature itself; its power arises from and cannot go beyond that expressly conferred upon it." *Pac. Northwest Bell Telephone Co. v. Sabin*, 21 Or App 200, 213 (1975) (cited in *Pac. Northwest Bell Telephone Co.*, 116 Or App 302, 309 (1992)).

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2. Indeed, the adjustment cannot be sustained under the "fair, just and reasonable" clause in SB 408. The adjustment reduces PacifiCorp's return on equity ("ROE") to 8.4 percent—just barely above the weighted cost of capital set in the Order—and deprives PacifiCorp of the opportunity to earn a reasonable return. This is because the Order assumes that PacifiCorp will not have certain tax expenses, an assumption that is erroneous. In the wake of the Order, Standard & Poor's issued a note warning that the Order was adverse for credit quality and could cause adverse ratings action. The adjustment violates the *Hope* standard,[4] as codified in SB 408's "fair, just and reasonable" standard and ORS 756.040.

3. SB 408's legislative history, which makes clear that SB 408 was not intended to change general Commission rate-setting practices, demonstrates that the Commission misinterpreted the law in making the adjustment.

4. The Commission's adjustment violates its rules and established precedent on setting tax expense in rates, which were not superseded or amended by SB 408.

5. The Commission unlawfully applied SB 408 to support the adjustment before the adoption of rules for SB 408's implementation.

6. The Commission's application in this case of the provisions or principles of SB 408, enacted after the close of the record and the submission of the case for decision, violated PacifiCorp's federal due process rights and its rights under the Oregon Administrative Procedures Act (the "APA").

7. The Commission's application of SB 408 or its principles in this case, in the absence of express language or clear legislative intent supporting retroactive application of the statute, violates Oregon law.

[4] *Federal Power Comm'n v. Hope Natural Gas Pipeline*, 320 US 591 (1944).

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8. The Commission applied SB 408 in an incomplete and arbitrary fashion, not taking into account the express substantive and procedural requirements of the bill, which are now the subject of a rulemaking docket.

9. The Commission's adjustment violates the "benefits and burdens" test that, according to the Oregon Department of Justice's (the "DOJ") advice to the Commission issued during the pendency of this case, must be satisfied before the Commission can change its established stand-alone tax policy and make a consolidated tax adjustment.

B. New Evidence Essential to the Decision Was Not Previously Available and Should Be Considered as a Basis for Reconsideration or Rehearing.

New evidence exists on the following three issues, which the Commission should review on reconsideration or rehearing:

10. The Order refers to the interest deduction from PacifiCorp Holdings Inc. ("PHI") as a "constant." However, because of a change in PHI's debt structure that occurred on September 22, 2005, PHI's interest payment in 2006 will be $122 million, $38 million less than assumed in the Commission's adjustment.

11. Similarly, because of a change in U.K. tax laws, beginning on September 20, 2005 and continuing throughout 2006, ScottishPower will pay income tax on the PHI interest income at a rate of 30 percent, offsetting all but 7.95 percent of the tax benefit assumed in the Commission's adjustment.

12. Even if the tax expense adjustment approach adopted by the Commission were lawful and appropriate, the Commission should have allocated tax expense and benefits based on relative taxable income, not PacifiCorp's contribution to PHI's gross profits. Gross profits are not a rational allocation factor for taxes, because they do not consider expenses or other deductions. Based on the nearly finalized PHI fiscal year 2005 federal tax return, PacifiCorp has new evidence that its relative taxable income was 49 percent of PHI's total taxable income. Based on these known and measurable changes, and the allocation

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methodology correction, the tax expense adjustment should be approximately $1.4 million on an Oregon-allocated basis, or slightly less than $2.3 million on a grossed-up, revenue requirement basis.

C. Good Cause for Further Examination of the Decision Exists.

The following four issues provide good cause for reconsideration or rehearing of the Order:[5]

13. The Commission's SB 408 adjustment violates the constitutional prohibition against asymmetrical ratemaking, by reducing PacifiCorp's rates based on tax benefits generated by unregulated affiliates, while also prohibiting adjustments that would impose unregulated affiliate tax costs on ratepayers.

14. The adjustment unconstitutionally impairs the contract associated with the merger of ScottishPower and PacifiCorp. In the contract, ScottishPower agreed to shield ratepayers from a variety of costs of unregulated activities, including the cost of servicing the acquisition debt; in return, ScottishPower retained the tax benefits associated with such activities.

15. The adjustment violates the Equal Protection Clause of the U.S. Constitution by arbitrarily appropriating the tax benefits from utility affiliates.

16. The adjustment constitutes an unconstitutional taking under the U.S. and Oregon constitutions by appropriating the tax deductions and benefits generated from unregulated affiliates, which bear all of the risk of the underlying investments.

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[5] PacifiCorp raises these issues to advise the Commission of certain federal and state constitutional concerns that should be considered in determining whether the Order should be amended. PacifiCorp does not intend to assert in this proceeding challenges to the Commission's Order based on the Supremacy Clause or the Commerce Clause of the United States Constitution or other federal laws or regulations not expressly referenced in this submission, or facial challenges to SB 408 arising under the United States Constitution, federal law and/or federal regulations, and reserves its right under *England v. Louisiana Bd. Of Med. Examiners*, 312 US 411, 84 S Ct 461, 11 L Ed 2d 440 (1964) to bring such challenges in an appropriate federal court.

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III. SPECIFICATIONS REQUIRED UNDER OAR 860-014-0095(2)

A. PacifiCorp contends that the tax adjustment contained on pages 13 through 19 of the Order is erroneous and/or incomplete.

B. In support of this contention, PacifiCorp relies on the laws, rules, policies, and portions of the record cited in this application.

C. PacifiCorp requests that the Commission eliminate the tax adjustment, or, in the alternative, reduce it to $2.3 million.

D. PacifiCorp's requested change in the Order will alter the outcome by resetting PacifiCorp's tax expense in rates to reflect its expected stand-alone tax liability, a revenue requirement increase of $26.6 million. In the alternative, if the Commission decides to retain an adjustment, PacifiCorp's requested change in the Order will reduce the Commission's tax adjustment to $2.3 million, resulting in a revenue requirement increase of $24.3 million.

IV. ARGUMENT

A. The Conclusion That SB 408 Requires the Commission to Disregard Its Stand-Alone Precedent and Instead Apply an "Actual Taxes Paid" Standard in This Case Is Erroneous as a Matter of Law.

The Order concludes that SB 408 changed the rate standard in Oregon, requiring the Commission to apply an "actual taxes paid" standard in this case. (Order at 17.) This is despite the facts that: (1) neither by its terms, nor as shown in the legislative record, does the Act provide for a new rate standard to be applied in general rate cases; (2) the Commission's application in the Order of its "new" standard violated prohibitions on confiscatory rulemaking set forth not only in SB 408 but in Oregon statutes and the U.S. Constitution; (3) the Commission's current administrative rule, as well as long-standing precedent, require a stand-alone approach to ratemaking, which approach was neither superseded nor amended by passage of SB 408; and (4) in any event, the Commission violated the Oregon APA in changing its current administrative rule by not following required procedures set forth therein.

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1. SB 408 Did Not Change the Rate Standard in Oregon.

The Commission's conclusion that SB 408 changed the rate standard in Oregon to an actual-taxes-paid standard is not supported by the language of SB 408 and ignores the legislative intent that the Act "not change the original ratemaking process." Statement of Rep. Boquist, House of Representatives Chamber Session, July 30, 2005. Rather than change the ratemaking process, the legislature promulgated SB 408 to address a mismatch between taxes collected in rates and taxes paid to government through a narrowly crafted mechanism—that is, an automatic adjustment clause. The "fair, just and reasonable" language from Section 5 of SB 408 ensures that tax adjustments under the automatic adjustment clause do not violate the *Hope* standard, codified in SB 408 and ORS 756.040.

a. The Plain Language of SB 408 Demonstrates That the Act Does Not Change the Ratemaking Standard in Oregon.

The Commission concluded in the Order that, although Section 3 of the Act, which contains the reporting and automatic adjustment clause provisions, could not be implemented immediately, Sections 2 and 5 *could* be implemented immediately. (Order at 17.) Section 2 states the legislative findings and Section 5 amends ORS 757.210, adding the word "fair" to the description of the rate standard, so that it now reads "fair, just and reasonable," and adding the sentence: "The commission may not authorize a rate or schedule of rates that is not fair, just and reasonable." SB 408 §§ 2, 5.

As the Commission agreed in its Order, the substantive provisions in Section 5 do not demonstrate that the legislature intended to change the rate standard:

> "Another change to ORS 757.210(1)(a) was the addition of a sentence to the end of the section: 'The commission may not authorize a rate or schedule of rates that is not fair, just and reasonable.' Again, as we have always been required to establish fair and reasonable rates, we still were not convinced that the addition of this sentence by the legislature had added to or changed our ratemaking authority."

(Order at 17 (footnote omitted).)

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However, a "general policy statement in the preamble of SB 408 * * * cause[d the Commission] to believe that the legislature intended immediate action." (*Id.*) This particular provision in the preamble states: "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." SB 408 § 2(1)(f). Thus, without the legislative finding in Section 2(1)(f), the Commission concluded, it would not have interpreted the Act to change its ratemaking authority, requiring it to immediately depart from its precedent and administrative rule and to instead apply an actual-taxes-paid approach in this rate case. (Order at 17.)

The Commission's conclusion that SB 408 changes the rate standard places undue significance on Section 2(1)(f), a single statement in the Act's preamble. It is unreasonable to conclude that the legislature would make such a significant and far-reaching change to the Commission's rate making practices in this oblique and indirect manner. If the legislature had truly intended to change the ratemaking standard in Oregon, it would have said so in the substantive sections of the Act. It would not have tucked such a mandate into the preamble, a nonlegislative section of the Act. *See Sunshine Dairy v. Peterson*, 183 Or 305, 193 P2d 543 (1948) (legislative findings contained in preamble cannot create rights not otherwise found within statute, nor can they limit those actually given by legislation; preamble may be consulted to clarify ambiguities only); *Curly's Dairy, Inc. v. State Dept. of Agriculture*, 244 Or 15, 21, 415 P2d 740 (1966) (improper to read one statement in findings in vacuum, without guidance of statute as whole).

Here, the findings, when construed together and with the statute as a whole, do not mandate an actual-taxes-paid approach to general ratemaking. Instead, the findings acknowledge the legislative intent to true up taxes collected in rates to taxes "paid." SB 408 § 2(1)(f). This interpretation of legislative intent is consistent with the operative provisions of the Act, which provide for an automatic adjustment clause to account for differences

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between taxes collected and taxes actually paid, and which define "taxes paid" as amounts "received" by government. *Id.* § 3(4), (13)(f).

The Commission's reliance on Section 2(1)(f) disregards other legislative findings in the Act, which expressly recognize the current ratemaking practice of setting the tax expense in rates on a stand-alone basis. *See* SB 408 § 2(1)(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."). The findings do not say that this ratemaking practice must end. *See* SB 408 § 2(1). Another finding in the Act acknowledges that "the ratemaking process may result in collecting taxes from ratepayers that are not paid to units of government." *See id.* § 2(1)(e). When the findings are construed in conjunction with one another and the Act's provisions for an annual tax report and automatic adjustment clause, it becomes clear that the legislature intended the Act to create a mechanism—an automatic adjustment clause—to address concerns voiced in the findings. *See Curly's Dairy*, 244 Or at 21 (legislative intent must be gleaned from statute as whole, including particular directives).

The most reasonable interpretation of the amendments to ORS 757.210, taking into consideration the language of the Act and the legislative history, is that the amendments were enacted to make ORS 757.210 consistent with the tax report and automatic adjustment clause provisions, and to conform the "just and reasonable" language in ORS 757.210 to the "fair and reasonable" standard found in ORS 756.040, in which the *Hope* standard was previously codified, and in other Commission statutes. (*See, e.g.,* Order at 17 ("we have always been required to establish fair and reasonable rates").) *See also* ORS 756.040(1) ("The commission shall balance the interests of the utility investor and consumer in establishing fair and reasonable rates."); ORS 757.273 ("All rates * * * by any public utility or telecommunications utility for any attachment by a licensee shall be just, fair and reasonable."); ORS 757.285 ("Agreements regarding rates * * * [for] attachments shall be deemed to be just, fair and reasonable, unless the Public Utility Commission finds * * * that

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such rates * * * are adverse to the public interest and fail to comply with the provisions hereof."); ORS 757.495 (Commission must find certain contracts to be "fair and reasonable"); *In re Portland General Electric Co.*, UM 1105, Order No. 03-509 at 3 (OPUC Aug. 25, 2003) (approving equal pay packages as "fair, just and reasonable"). Construed in this manner, the "fair, just and reasonable" standard does not mandate the tax adjustment made in this case, but instead prohibits it, because as discussed in the following section, its effect on PacifiCorp is confiscatory.

The Commission's construction of Sections 2 and 5 also undermines the Act's express directives allowing tax adjustments through an automatic adjustment clause, subject to various safeguards and limitations. For example, Section 3(13)(b) excludes certain small utilities from the reporting and rate adjustment requirements of Section 3 of the Act;[6] Section 3(13)(d) excludes franchise fees and privilege "taxes" from the computation of taxes under Section 3 of the Act;[7] Section 3(13)(f) retains for utility investors the tax savings from the utility's charitable contributions, certain utility investments and deferred taxes by adjusting the computation of "taxes paid" under Section 3 of the Act;[8] Sections 3(8) and (9) prohibit the Commission from adjusting rates under Section 3 when doing so would cause the utility to lose the right to claim accelerated depreciation or cause ratepayers to suffer material adverse effects; and Section 4(2) provides that the automatic adjustment clause "shall apply only to taxes paid to units of government and collected from ratepayers on or after January 1, 2006."

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[6] Section 3(13)(b)(A) defines "[p]ublic utility" to exclude utilities with fewer than 50,000 customers in Oregon in 2003.

[7] Section 3(13)(d)(C) states that the definition of "[t]ax" does not include franchise fees or privilege taxes.

[8] Section 3(13)(f) increases the definition of "[t]axes paid" by the amount of tax savings realized as a result of utility charitable contribution deductions and certain utility investments in regulated operations, and deferred taxes related to the regulated operations of the utility.

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Thus rate adjustments under Section 3 are not applicable to small utilities, require adjustments to the computation of "taxes" and "taxes paid" to retain certain tax incentives for investors, provide a safety net against normalization violations and material adverse impacts, and are to be applied only to taxes paid on or after January 1, 2006. Many of these safeguards and limitations are now the subject of the Commission's SB 408 rulemaking docket, Docket AR 499. However, because none of these provisions apply to Sections 2 and 5, the Commission's construction of SB 408 in this case gives it unfettered power to make tax adjustments. This is an outcome squarely at odds with, and which undermines, the provisions of Section 3 of SB 408 and renders the AR 499 rulemaking little more than an academic exercise.

b. The Legislative History of SB 408 Demonstrates That the Legislature Did Not Intend to Change the Ratemaking Standard in Oregon.

At the time the Order was entered, the Commission had not yet compiled the legislative history of SB 408. *See* October 5, 2005 ALJ Ruling, AR 499 (SB 408 legislative history to be gathered and published by DOJ on October 7, 2005). Perhaps for this reason, the Order inaccurately states that "there is nothing in the legislative history to indicate the intent of the legislature when it added [the] word [fair]." (Order at 17.) It is true that no one in the record *ever* stated that the amendment to ORS 757.210 revised the rate standard in Oregon as the Commission found in this case. The legislative record does, however, provide guidance as to the meaning of "fair, just and reasonable," all of which is contrary to the Commission's interpretation of this language in the Order.

The legislative history demonstrates both that the heart of the Act is its automatic adjustment clause provisions and that the "fair, just and reasonable" language codified the *Hope* standard within ORS 757.210 in response to concerns that SB 408 could result in an unconstitutional taking. Legislative Counsel Dexter Johnson provided section-by-section analyses of the Act to the Senate Business and Economic Development Committee. There,

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Mr. Johnson described the legislative findings and did not at any time say that the findings indicated a legislative intent to change the rate standard in Oregon. *See* SB 408 Work Sessions, Senate Business and Economic Development Committee, May 26 and May 31, 2005. Rather, he stated that the findings are "fairly self explanatory." SB 408 Work Session, Senate Business and Economic Development Committee, May 26, 2005. Mr. Johnson explained that Section 2 "describes the concerns regarding * * * the current practices regarding taxes and how the cost for taxes are determined for ratemaking purposes and expresses the legislature's concern with those practices." *Id.*

Mr. Johnson also never stated that Section 5, which amended ORS 757.210 to insert the word "fair" before the phrase "just and reasonable," changed the rate standard in Oregon. Rather, Mr. Johnson explained that the revisions to ORS 757.210 were clean-up amendments. *Id.* ("Section 5 is an amendment to existing law, essentially to include cost for taxes in the definition of automatic adjustment clauses, which is set forth in 757.210. It makes consistent the standard of fair, just, and reasonable that appears elsewhere in the draft.").

This is in stark contrast to Mr. Johnson's description of the automatic adjustment clause provisions in the Act, which he characterized as "really the guts of the amendment." *Id.* The Act's proponents testified that the automatic adjustment clause is a "narrowly crafted" solution to the concerns identified in the legislative findings, "a solution that sticks within the parameters of existing OPUC mechanisms, the accelerated or the automatic adjustment clause." Statement of Melinda Davison, Attorney for Industrial Customers of Northwest Utilities, SB 408 Work Session, Senate Business and Economic Development Committee, May 31, 2005. Likewise, another SB 408 proponent explained:

> "Section 2, which goes through and talks about what I think you all believe. You believe that the taxes should not be collected in rates and then not paid. It says that this isn't the way we want to run our state and have the utilities handle it. It

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> attempts to find a solution and *the solution is what we call an automatic adjustment clause*."

Statement of Ann Fisher, Attorney for Portland Metropolitan Association of Building Owners and Managers ("BOMA"), SB 408 Work Session, Senate Business and Economic Development Committee, May 31, 2005 (emphasis added).

Consistent with legislative counsel's and proponents' descriptions of the Act, the DOJ and others interpreted the insertion of the word "fair" into ORS 757.210 to be a prophylactic measure to assure that the *Hope* standard applies to SB 408 automatic adjustment clauses, thereby addressing concerns that the Act would result in confiscatory rates in violation of the *Hope* standard. On numerous occasions, the DOJ advised the legislature that the law must allow the Commission to set rates that are "fair"—otherwise, the law could result in an unconstitutional taking of private property under *Hope*. *See, e.g.,* Statement of Deputy Attorney General Peter Shepherd, SB 408 Public Hearing, House State and Federal Affairs Committee, June 30, 2005 ("rate setters must allow investors in a regulated utility to recover their prudent expenses and earn a fair return on their investment. This is, you'll hear people refer to this as the *Hope* Test."); Statement of Assistant Attorney General Paul Graham, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("[*Hope* is] the case that prohibits confiscatory rates and what the *Hope* case says is that a regulator can use any method it wants to set rates, but at the end of the day, the bottom line, has to be that the rates * * * allow[] the utility a reasonable opportunity to earn a fair return on the investment its made to serve rate payers.").

Thus, Deputy Attorney General Shepherd concluded, the inclusion of the "fair, just and reasonable" language in ORS 757.210 sets a "downward limitation" on the adjustment that the Commission can make under the Act. Statement of Deputy Attorney General Peter Shepherd, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("[The] PUC cannot allow the adjustment if it would result in a rate which is not fair, just and

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reasonable, as the terms of the total rate. So, that there would be an upward limitation, as well as a downward limitation."). *See also* Statement of Rep. Tom Butler, SB 408 Work Session, House State and Federal Affairs Committee, July 15, 2005 ("fair, just and reasonable" language "attempts to make [the adjustment] both symmetrical, as well as nonconfiscatory and in that regard completely constitutional"); Statement of Rep. Tom Butler, House Chamber Session, July 30, 2005 ("The bill's current proponents contend that the trigger to stop the downward spiral was that the rates must be fair, just and equitable—fair, just and reasonable."); Statement of Rep. Robert Ackerman, House Chamber Session, July 30, 2005 ("I conclude that the 'fair, just and reasonable' standard and the limited use of the automatic adjustment clause satisfies constitutional requirements. Now that is from our Legislative Council."); written Testimony of Deputy Attorney General Pete Shepherd, SB 408 Work Session, House State and Federal Affairs Committee, June 30, 2005 (describing "fair, just and reasonable" language as providing protection against *Hope* violation).

The legislative history of SB 408 conclusively demonstrates the Commission's misapplication of SB 408 in this case. *See* Statement of Rep. Boquist, House Chamber Session, July 30, 2005 (SB 408 "does not change the original ratemaking process").

2. The Tax Expense Adjustment Results in Rates That Are Not "Fair, Just and Reasonable," in Violation of SB 408, ORS 756.040, and *Hope*.

The reduction in utility revenues caused by the Order also violates prohibitions on confiscatory ratemaking found in SB 408, Oregon's utility code and the U.S. Constitution. *See Hope*, 320 US 591; *In re Util. Reform Project*, Order No. 03-214, App. A at 2-3 (OPUC 2003) (allocation of tax benefits to utility "may lead to confiscatory rates"). This is because the Order permanently lowers rates based on a single factor—debt service by an affiliate—that has nothing to do with the taxes actually paid by either PacifiCorp or its affiliated group.

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The impact the Order will have on PacifiCorp's revenues is significant. Rather than having any opportunity to earn the stipulated and approved return on equity of 10 percent, all else being equal, the tax adjustment will reduce the Company's return on equity to 8.4 percent, only a hair above the weighted average cost of capital set in this case. (*See* Supp. Test. of Bruce Williams.) Such a return, over 100 basis points lower than the lowest ROE recommendation in the case (by ICNU/CUB and Staff), is confiscatory and in violation of constitutional and statutory requirements. *See* ORS 756.040(1).

In addition to the immediate impact of the Order resulting in underearnings, the tax expense adjustment may lead to a downgrade to PacifiCorp's current "A-" credit rating by Standard & Poor's. (*See* Supp. Test. of Bruce Williams.) Such a downgrade would in turn lead to higher debt costs for PacifiCorp and higher rates for its customers. Moreover, a downgrade would limit PacifiCorp's access to the capital market at a time when that access is critical for infrastructure investment.

3. The Commission's Current Administrative Rule and Established Precedent Require a Stand-Alone Approach to Ratemaking and Were Neither Superseded nor Amended by Passage of SB 408.

In the Order, the Commission improperly disregarded its own administrative rules, OAR 860-027-0048(3)(g) and (4)(h), which require the tax expense in utility rates to be calculated using the "standalone" method (the "Stand-Alone Rule").

a. The Stand-Alone Rule Is a Ratemaking Rule, Not Merely a Record-Keeping Rule.

The Stand-Alone Rule provides: "Income taxes shall be calculated for the regulated activity [or the energy utility] on a standalone basis for both *ratemaking purposes* and regulatory reporting." OAR 860-027-0048(3)(g) and (4)(h) (emphasis added). Despite this, the Commission summarily dismissed PacifiCorp's argument that the Stand-Alone Rule requires a stand-alone approach to ratemaking, stating that the Stand-Alone Rule is "an accounting rule, which requires an energy utility to keep its books of account on a stand-

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alone basis" and as such has no effect on how a utility calculates its taxes for ratemaking purposes. (Order at 18.) Despite the fact that the Stand-Alone Rule, by its express terms, applies to "ratemaking," the Commission provided no further explanation or analysis in support of its conclusion that the rule is merely an accounting rule. (*See id.*)

The Commission's holding that the Stand-Alone Rule is only an accounting rule is inconsistent with the plain wording of the rule. *See* OAR 860-027-0048(3)(g) and (4)(h) ("Income taxes shall be calculated for the energy utility on a standalone basis for * * * *ratemaking purposes* * * *." (emphasis added).) Although the Stand-Alone Rule also regulates how a utility keeps its books, it is not limited to such purposes. Because an administrative rule must be construed to give effect to every section, clause, phrase, or word thereof, the Commission cannot read out the requirement that the Stand-Alone Rule applies to ratemaking. *See, e.g., Blyth & Co. v. City of Portland*, 282 P2d 363, 366 (Or 1955) (stating maxim of construction for statutes); *PGE v. Bureau of Labor and Industries*, 859 P2d 1143, 1147 n 4 (Or 1993) (statutory maxims of construction apply to interpretation of administrative rules).

Moreover, the Commission's conclusion in the Order that the Stand-Alone Rule is only an accounting rule is contradicted by the Commission's stated intent in promulgating the rule. The Commission promulgated the Stand-Alone Rule to "prevent[] cross-subsidization between regulated activities of a utility and its nonregulated activities, affiliates and competitive operations." *Re Affiliated Transactions for Energy Utils.*, Order No. 03-691 (AR 459), 2003 WL 23305011 at *1 (Or Pub Util Comm'n Dec. 1, 2003). Accounting practices alone would not accomplish such a purpose, because cross-subsidization is a ratemaking issue. The Commission has a statutory mandate to prevent cross-subsidization, which occurs when nonregulated expenses or revenues are included in a utility's rates, not necessarily when they are included on a utility's books of account. *See* ORS 757.646(2)(c)

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(requiring Commission to adopt rules that "prohibit[] cross-subsidization between competitive operations and regulated operations").

b. It Was Legal Error for the Commission to Disregard Its Established Stand-Alone Precedent.

The Commission violated the Oregon APA when it announced in the Order that its established stand-alone precedent no longer applies. Oregon law requires an agency to follow the procedures required by the APA when changing established rules. *Burke v. Children's Serv. Div.*, 288 Or 533, 538, 607 P2d 141 (1980) (agency is bound by its established rules and policies until it changes them pursuant to procedures required by APA). This is true regardless of whether those rules are formally promulgated administrative rules or rules arising from established precedent. *Id.* at 538-39 (agency statement of existing policy or practice remains binding on agency until repealed according to procedures required by APA). *See also Attorney General's Administrative Law Manual* at 9 (2004).

> "Once an agency has adopted a rule, the agency is bound to follow its terms. Moreover, an agency policy or practice that meets the definition of a rule but is not in the form of a written rule or has not been promulgated according to the APA is, nevertheless, binding on the agency until it is declared invalid by a court or until it is amended or repealed by the agency in accordance with proper rulemaking procedures."

Id. (footnotes omitted).

Nor did SB 408 somehow relieve the Commission of its obligation to comply with the APA. Even if SB 408 had directed the Commission to change its approach to setting the tax expense in base rates, the Commission would still be bound by the practices and policies declared by its own rules until it changed the existing rules pursuant to the procedures required by the APA. *Vier ex rel Torry v. State Office for Serv. to Children and Families*, 159 Or App 369, 374-75, 977 P2d 425, 428 (1999) ("an agency remains bound by the practices and policies declared by its rules, even in the face of newly enacted legislation changing the agency's responsibilities," unless and until existing practices and rules are

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judicially declared invalid or are changed by agency pursuant to formal rulemaking procedures).

Here, the Commission announced in the Order *for the first time* that it was abandoning its stand-alone approach and instead adopting an actual-taxes-paid approach, thus significantly changing its established approach to setting the tax expense in base rates. The Commission acknowledged that its practice until now has been to calculate utility taxes on a stand-alone basis and that it changed this practice with the Order. (Order at 17-18 (acknowledging that its past precedent had "always" been to calculate the tax expense on stand-alone basis and explaining that it was now departing from historical practice and considering taxes paid by a utility or its parent when setting rates); *id.* at 18 ("[w]e must reject PacifiCorp's recommendation to maintain our stand-alone approach").)

The Commission's reliance on SB 408 as a purported justification for this departure is erroneous. (*See* Order at 18 ("We are not, however, bound to maintain our practice of stand-alone calculations, particularly when a new statute comes into play.").) Even if SB 408 did require the Commission to change its established policy of setting the tax expense in base rates on a stand-alone basis, which it does not, Oregon law requires the Commission to change established policies in an orderly, deliberate, and forward-looking manner through the rulemaking process of the APA. In advance of such procedures, the Commission may not apply ad hoc legal standards as it has done in this docket.

B. The Commission's Ad Hoc Application of SB 408 Deprived PacifiCorp of the Opportunity to Present Evidence Relevant to the Applicable Legal Standard.

SB 408 was signed by the Governor and became effective almost three weeks after the close of the evidentiary record in this case. Despite the fact that SB 408 does not, by its terms, apply retroactively, the Commission applied the new law to this case. In doing so, the Commission acknowledged that the legislature may not have intended SB 408 to apply to this case, stating "[if] we are incorrect in holding that the legislature intended SB 408 to apply to

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this rate case, we choose to use our discretion and apply SB 408 principles to this rate case." (Order at 18 n 15.) However, the Commission does not have the discretion to apply a law retroactively; nor does the Commission have the discretion to apply SB 408's "principles." The Commission's tax adjustment unlawfully:

- applied SB 408 without *first* establishing standards by which the law is to be applied, in violation of Oregon law;
- deprived PacifiCorp of its right to present evidence regarding SB 408 in violation of the due process rights guaranteed by Amendments V and XIV of the U.S. Constitution;
- deprived PacifiCorp of its right to "respond and present evidence and argument on all issues involved" in the case, in violation of Section 183.415(3) of the APA; and
- violated the Oregon common-law rule against retroactive application of a statute.

1. Oregon Law Requires the Commission to Establish Standards *Before* It Applies SB 408.

The Commission admitted that SB 408, which imposes both substantive and procedural requirements, is "complex." (Order at 16.) Indeed, the Commission agreed with Governor Ted Kulongoski's observation that SB 408 "defers many of the difficult questions about the impact and implementation of SB 408 to the [Commission]." (*Id*. (citing September 2, 2005 letter from Governor Kulongoski to Secretary of State Bill Bradbury).) Accordingly, the Commission has opened a permanent rulemaking proceeding, Docket AR 499, to "address the many uncertainties of the interpretation and application of SB 408." (Order at 16-17.) Reflecting the complexity of SB 408, the Commission has also requested a legal opinion from the DOJ to clarify some of the legal uncertainties in SB 408. *See* October 5, 2005 ALJ Ruling, Docket AR 499.

Despite these uncertainties, the Commission nevertheless based its decision in this docket on SB 408. Moreover, the Commission admitted that the tax adjustment it pieced together in loose reliance on SB 408 was "not precise." (*Id.* at 19.) The Commission

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attempted to excuse this application of its ad hoc tax adjustment by stating that the adjustment was "the best [the Commission could] do under present circumstances." (*Id*.) Such an approach is not tenable under Oregon law.

In Oregon, an administrative agency is required to establish implementation standards *before* it applies the law. *Sun Ray Drive-In Dairy, Inc. v. Or. Liquor Contr. Comm'n*, 517 P2d 289, 292-93 (Or App 1973) (Oregon Liquor Control Commission ("OLCC") reliance on Oregon statute to deny application for liquor license was improper because OLCC had not yet published rules or regulations establishing standards by which statutory grounds for refusal were to be applied). Compliance with the APA is "much more than an act of technical legal ritual * * * [because w]ithout written, published standards, the entire system of administrative law loses its keystone." *Id*. at 293. The requirement that agencies establish standards before they apply the law achieves several important policies:

- Written rules inform the public.
- Written rules assure that the agency acts by rules and not from whim or corrupt motivation.
- The public is entitled to consistency of enforcement from the agency.
- The parties to a hearing of a contested case must know what is to be heard in the hearing and what they are required to prove and disprove in order to gather and present their evidence.
- The legislature is entitled to know whether or not the agency's policies and practices are consistent with the legislative directive.
- Judicial review requires written standards.

Id. These keystones of administrative law are protected whether the agency adopts standards through the promulgation of written administrative rules or through policies announced in a contested case, but only so long as the agency "provide[s] notice of the standard and allow[s] the parties to comment on it." *Save Our Rural Oregon v. Energy Facility Siting Council*, No. SC S52315, 2005 WL 2464570 at * 15 (Or Sept. 29, 2005) (citing *Marbet v. Portland Gen. Elect.*, 277 Or 447, 463, 561 P2d 154 (1977) (adoption of standard requires "notice and

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procedures that allow for the presentation of views and data on the issues involved, and sufficiently in advance of the final decision so that the applicant and other parties can address the import of the standard * * *. ")).

Here, the Commission announced for the first time in the Order that it was applying the "principles" of SB 408 to this case. Thus it failed to follow the procedures required by Oregon law for adoption of new standards.

2. State and Federal Law Requires the Commission to Provide PacifiCorp with an Opportunity to Present Argument and Evidence Regarding SB 408.

a. The Commission's Order Deprived PacifiCorp of Its Federal Due Process Rights.

By applying a law enacted after the evidentiary record closed, the Commission denied PacifiCorp any opportunity to present evidence regarding SB 408 in violation of the due process rights guaranteed by Amendments V and XIV of the U.S. Constitution. "The essence of fundamental fairness is the opportunity to be heard at a meaningful time and in a meaningful manner." *State ex rel Juv. Dept. v. Geist*, 310 Or 176, 189-90, 796 P2d 1193 (1990) citing *Mathews v. Eldridge*, 424 US 319, 333, 96 S Ct 893 (1976).

Evidentiary hearings in this case concluded July 21, 2005; the evidentiary record closed August 12, 2005; and oral argument took place August 15, 2005. SB 408, after undergoing substantial revision in the House, was passed by the House on July 30, 2005; repassed by the Senate on August 1, 2005; and signed into law on September 2, 2005. Until September 2, 2005, more than three weeks after the close of the evidentiary record, SB 408 was not the law of Oregon.

On August 8, 2005, the ALJ issued a memorandum directing the parties to "be prepared to address the impact of SB 408, if any, on this rate case" in oral argument. August 8, 2005 ALJ Memorandum, UE 170. However, a previous ALJ memorandum noting that the record would close on August 12, 2005, was not updated to keep the record open to

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address SB 408. August 3, 2005 ALJ Memorandum, UE 170. Of course, because the law enacted by SB 408 did not exist at the time this case was heard, there was no reason or practical ability for parties to present evidence regarding the law's application to this case, and indeed, no party presented any such evidence. (*See* Staff's Post-Hearing Reply Brief at 6 (Aug. 12, 2005) ("the record in this proceeding does not contain the requisite evidence to implement a SB 408-type calculation").)

Had the Company been afforded an opportunity to present evidence, the revenue requirement adjustment that would have resulted from application of the methodology adopted by the Commission would have been significantly lower, as shown below. Whether the Order is based on the application of SB 408 itself or, alternatively, SB 408 "principles," fundamental fairness requires both notice that the Commission might apply the Act to the case *and* the opportunity to present evidence in light of the applicable legal standard. *See Harlan Bell Coal Co. v. Lemar*, 904 F2d 1042, 1048 (6th Cir 1990) (due process was denied when appellant was not allowed opportunity to present evidence made relevant by change in law occurring post-hearing but before ALJ's order). "Fundamental fairness requires that [a party] be granted an opportunity to address comprehensively the [new, post-hearing] standards." *Id.*

b. This Due Process Right Is Reflected in the APA.

Section 183.415(3) of the APA provides that a party to a contested case may elect to "respond and present evidence and argument on all issues involved" in the case. The Oregon Court of Appeals has held that this provision of the APA bars an agency from changing the established interpretation of a rule during the course of a contested case proceeding without giving parties to the case the "opportunity to present evidence and arguments that are responsive to the new standard [as interpreted by the agency]." *Martini v. Or. Liquor Contr. Comm'n*, 110 Or App 508, 513, 823 P2d 1015 (1992). The *Martini* court explained that, even though agencies can make "policy refinements" in deciding contested cases, agencies

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may not change the "established interpretation of a rule" without allowing parties to present their case under the new standards. *Id*. at 513.

Here, the Commission did not make a tax policy "refinement." Instead, the Commission changed its long-standing approach to utility taxes. It has been the Commission's policy for more than a decade that any approach to utility taxes that allocates tax liabilities or savings resulting from nonregulated operations to ratepayers would be contrary to the statutory obligation to prevent cross-subsidization between regulated and nonregulated operations. *See, e.g., In re PacifiCorp*, Order No. 03-726, app A at 5; *In re Util. Reform Project*, Order No. 03-214, app A at 2 (OPUC 2003); *Re Or. Exch. Carrier Ass'n*, 1993 WL 117620 at *6 (OPUC 1993); Staff Report at 4 (Or Pub Util Comm'n Aug. 7, 2003) (Stand-Alone Rule adopted to codify Commission's long-standing prohibition against cross-subsidization). (*See also* Order at 17-18 (Commission's past precedent has "always" been to calculate tax expense on a stand-alone basis).) Moreover, the Commission has specifically applied its stand-alone precedent to PacifiCorp. *See* Staff Audit Report (Or Pub Util Comm'n Dec. 1, 2004) ("[f]or ratemaking purposes, PacifiCorp is examined on a standalone basis.").

The Commission did not provide any notice before the evidentiary record closed that it was changing its policy. Instead, it announced the policy change in the Order itself. SB 408 did not become law until after the record closed in this case. Consequently, PacifiCorp had no opportunity to present evidence or arguments in light of the Commission's new policy. Thus the Commission's application of SB 408, or the principles of SB 408, to PacifiCorp's case was a violation of Section 183.415(3) of the APA.

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3. Even if the Commission Had Developed Standards Before Applying SB 408 in this Case, SB 408 Cannot Apply in This Case Because Oregon Law Prohibits Retroactive Application of SB 408.

Oregon courts reject the retroactive application of a statute that does not by its terms provide for retroactivity or whose legislative history does not clearly establish the intent that the statute be applied retroactively. *Guerrero v. Adult and Fam. Serv. Div.*, 676 P2d 928, 929 (Or App 1984); *Holmes v. State Accident Ins. Fund*, 589 P2d 1151, 1152 (Or App 1979) ("Many principles have been judicially enunciated applying, distinguishing, abandoning or modifying the substantive/procedural test for prospective or retrospective application of newly enacted statutes. They boil down to the general principle that the rights and liabilities of persons affected by an event are defined and measured by the statutes in effect at the time of the event and the adjudication of those rights and liabilities is accomplished under the statutes in effect at the time of the adjudication." (citations omitted)); *Joseph v. Lowery*, 495 P2d 273, 276 (Or 1972) ("We believe there is merit in the prior view of this court, as demonstrated by its decisions, that, in the absence of an indication to the contrary, legislative acts should not be construed in a manner which changes legal rights and responsibilities arising out of transactions which occur prior to the passage of such acts."); *Bohnert v. Comm'n Dunn*, 3 OTR 423, 426 (Or T C 1969); *Delahant v. Board on Police Standards and Training*, 312 Or 273, 855 P2d 1088 (1993).

The Commission argued that, because "the plain language of Section 6 of SB 408 declares that 'this 2005 Act takes effect on its passage,'" SB 408 should apply to this proceeding. (Order at 17.) Although SB 408 contains an emergency clause,[9] the Act does

[9] The emergency clause states: "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." SB 408 § 6. In Oregon, an emergency clause does not require the retroactive application of a new law, unless there is clear indication of legislative intent to apply the law in such a way. *West. Communications, Inc. v. Deschutes Co.*, 788 P2d 1013 (Or App 1990).

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not by its terms provide for retroactivity.[10] Moreover, there is no indication in the legislative history that the Oregon legislature intended SB 408 to be applied retroactively either generally or to this rate case specifically.

Furthermore, the Oregon Supreme Court has held that statutes or regulations that say nothing about retroactive application cannot be applied retroactively if such a construction would (1) "impair existing rights," (2) "create new obligations," or (3) "impose additional duties with respect to past transactions." *Derenco, Inc. v. Benj. Franklin Fed. Savings & Loan*, 281 Or 533, 539 n 7 (1978); *see also, Guerrero v. AFSD*, 67 Or App 119, 122, 676 P2d 928 (1984) (applying *Derenco* test and holding that agency's retroactive application of rule to petitioner's Aid to Dependent Children benefits was improper because it was prejudicial to petitioner).

The retroactive application of SB 408 in this case unlawfully impairs PacifiCorp's right to recover its tax expense calculated on a stand-alone basis in rates. The Commission's retroactive application of SB 408 also impairs the value of the contract associated with the ScottishPower merger, as noted in Section IV.F.2.

C. Regardless of Whether SB 408 Changed the Rate Standard Applicable in This Case, the Commission Failed to Consider Facts Essential to an SB 408 Analysis.

Until the Commission changes OAR 860-027-0048(4) and its practice of treating taxes on a stand-alone basis, it is not authorized to implement SB 408 outside the parameters

[10] For examples of valid retroactivity clauses, see *Volk v. America West Airlines*, 899 P2d 746, 748 (Or App 1995) ("Notwithstanding any other provision of law, this Act applies to all claims or causes of action existing or arising on or after the effective date of this Act, regardless of the date of injury or the date a claim is presented, and this Act is intended to be fully retroactive unless a specific exception is stated in this Act." (internal quotation marks and citation omitted)); *Robinson v. Lamb's Wilsonville Thriftway*, 31 P3d 421, 423-24 (Or 2001) ("the amendments * * * by Section 1 of this 1999 Act apply to all actions pending on or commenced after the effective date of this 1999 Act." (alterations, internal quotation marks, and citation omitted)).

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of the Act, which restricts adjustments to an automatic adjustment clause mechanism in certain circumstances only.[11] Section 3(4) of the Act is explicit on this point:

> "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 * * *."

(Emphasis added.)

Section 3(6) then states that the automatic adjustment clause *shall* account for all taxes paid to units of government by the public utility, or by the affiliated group, so that ratepayers are not charged for more tax than is paid. Section 3(7) confirms that an automatic adjustment clause established under Section 3 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. Finally, Section 4(2) of the Act states:

> "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."

(Emphasis added.)

The Act, therefore, imposes both substantive and procedural requirements, the "what" and "how" of adjusting tax expense to reflect taxes actually paid to units of government. It does not contemplate any other mechanism for carrying out its objectives—the Commission either makes the findings required to establish an automatic adjustment clause, or it may not disallow a tax expense for ratemaking purposes.

[11] *See supra* note 2.

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Here, the Order purports to be based on SB 408, but fails to consider facts relevant to an SB 408 analysis—facts that, if considered, would have decreased the adjustment considerably. The Commission tries to explain away its error in not complying with the *terms* of SB 408 by stating that it may "use [its] discretion and apply SB 408 *principles* to this rate case." (Order at 18 n 15 (emphasis added).) As explained above, the Commission does not have any such discretion.

1. SB 408 Does Not Change Rates Until After 2006.

The Act does not contain any mechanism for the use of an automatic adjustment clause in 2005, nor does it authorize such use. Substantively, the Act requires the Commission to align taxes included in rates with taxes actually paid to units of government. Procedurally, the Act requires the Commission to consider the tax report filed by the utility on October 15, determine whether the $100,000 threshold has been exceeded, and notify the utility within 30 to 60 days of any need to establish an automatic adjustment clause. Under Section 4(2) of the Act, adjustments may be applied only to taxes paid and collected from ratepayers on or after January 1, 2006. Until that time (as well as afterwards), the utility and its affiliates may restructure their operations, defer tax-favored events, and conduct other legitimate business activities that would narrow or eliminate any gap between taxes actually paid and the tax expense included in rates. Because the Order adjusts pre-2006 rates based on pre-2006 data, the Order violates Section 4(2) of the Act.

2. SB 408 Requires the Commission to Adjust Rates Based on Historical, Not Forecasted, Data.

Both the plain language and legislative history of SB 408 demonstrate that the Act requires the Commission to adjust rates to align "taxes collected" with "taxes paid," based on historical, not forecasted, data. The backward-looking nature of SB 408 adjustments is particularly apparent from the definition of "taxes paid," a term that appears throughout the Act. Section 3(13)(f) defines "taxes paid" as follows:

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> "'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."

(Emphasis added.)

If the legislature had intended the Commission to base adjustments on forward-looking estimates, as opposed to actual historical data, it would not have directed the Commission to determine "taxes paid" by looking at amounts "received" by the government, adjusted for tax savings "realized." It would have been a simple matter for the legislature to say "taxes that will be paid," "rates that will be collected," "amounts that will be received," and "tax savings that will be realized," but it did not. Likewise, if the legislature had intended the Commission to base adjustments on forward-looking estimates, it would not have required utilities to report actual tax payments. *See* SB 408 § 3(1)(a) (requiring utilities to report tax payments for the prior three years "without regard to the tax year for which the taxes were paid"); *id.* § 3 (13)(f) (defining "taxes paid" as "amounts *received* by units of government" (emphasis added)). Actual taxes paid, which include settlement payments and are net of refunds received, do not provide a basis for estimating future tax liability, because settlements and refunds are not representative of future tax liability. Finally, had the legislature intended SB 408 to apply to forward-looking estimates, it would not have

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amended the bill to delete the phrase "[t]he automatic adjustment clause shall apply only prospectively." *See* B-Engrossed SB 408 § 3(3) (ordered by Senate June 6, 2005).

The participants in Docket AR 499, which include utilities, customer groups and Staff, have agreed that, whether or not the Act allows the Commission to use forecasted data, as a policy matter the Commission should base SB 408 adjustments on historical data only. (*See* Letter from Paul Graham, Assistant Attorney General, to Participants in Docket AR 499 at 1-2 (Oct. 7, 2005) (summarizing agreements of participants).)

Despite the Act's emphasis on "taxes paid," the removal of the "prospective" language, and the AR 499 parties' agreement that SB 408 adjustments should not be based on forecasted data, the Order nevertheless concludes that SB 408 requires the Commission to align *estimated future* taxes with taxes in rates:

> "Our first goal – one which we believe SB 408 requires – is to do our best to align the estimated taxes included in PacifiCorp's rates with the amount that PacifiCorp (or its affiliated group) will eventually pay."

(Order at 19.)

Thus the Commission disregarded the Act's mandate that adjustments be based on actual historical data only.

3. SB 408 Requires the Commission to Consider the Amount of Taxes "Paid" and "Incurred".

SB 408 requires a rate adjustment based on actual tax payments "paid" and "incurred", not an estimate of future tax liability based on any other consideration. Specifically, SB 408 directs the Commission to consider taxes "paid" (which means payments "received" by units of government) by the affiliated group and "incurred" by the utility in the fiscal year in question "without regard to the tax year for which the taxes were paid." *See* SB 408 § 3(1)(a), (13)(f). The Order fails to comply with these provisions of SB 408, because it does not consider the amount of tax payments that the utility incurred and

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the government received in fiscal year 2005 or known and measurable changes that will persist into the test year, calendar year 2006. For example, the Order did not consider tax settlement payments that PacifiCorp's affiliated group made to units of government in fiscal year 2005, which totaled more than $70 million. (Supp. Tes. of Larry O. Martin ("Martin Testimony") at 5.)

Nor did the Order even consider the amount of tax payments that have been or will be received by units of government from the PHI group. Instead, the Order bases the adjustment on the total dollar amount of a single deductible expense and CUB's estimate of PHI's gross profits, not taxable income, which is the basis for PHI's tax payments. (Order at 18.) There is no evidence in the record that this number has anything to do with the taxes PHI actually paid or will pay to any units of government. Indeed, the Commission admits that "[i]n reaching this decision, we acknowledge that this adjustment is not precise. But it is reasonable, and the best we can do under present circumstances." (Order at 19.) Because it is not based on evidence of the taxes "paid" by the PHI group and taxes "incurred" by PacifiCorp, the Order violates Sections 3(6), 3(7) and 3(12) of the Act.

4. SB 408 Requires the Amount of Taxes Paid to Be Increased to Account for Certain Charitable Contributions, Investments in Utility Operations, and Deferred Taxes.

SB 408 directs the Commission to compare taxes collected in rates with taxes actually paid and incurred, increased by the amount of tax savings from PacifiCorp's charitable contributions and associated with PacifiCorp's investments in utility operations, to the extent those expenditures were not included in rates, and adjusted by deferred taxes related to PacifiCorp's regulated operations. SB 408 § 3(13)(f). The Order fails to even consider the effect on the adjustment of these items, which in fiscal year 2005 totaled more than $44 million on an Oregon-allocated basis. (Martin Testimony at 5-6.)

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5. SB 408 Requires the Commission to Consider the Total Tax Paid by the Affiliated Group.

SB 408 directs the Commission to compare taxes collected in rates with taxes paid to the government from a utility or its affiliated group. SB 408 § 3. Nevertheless, in complete disregard of that requirement, the Order based the adjustment on a single deductible expense of a single affiliate and failed to even consider taxes paid by the affiliated group. (*See* Order at 18-19.)

6. SB 408 Prohibits the Commission from Making Any Adjustments Properly Attributed to Unregulated Affiliates.

SB 408 specifically prohibits rate adjustments "that are properly attributed to any unregulated affiliate of the public utility or to the parent of the utility." SB 408 § 3(7). Because the Order relies on estimates regarding PHI's interest expense, there is no way for the Commission to determine whether the adjustment to PacifiCorp's tax expense is being used to make adjustments for taxes that are properly attributed to any unregulated affiliate or PacifiCorp's parent, PHI. The failure to undertake any investigation of this issue or make any finding addressing this point, when it is known that PHI has affiliates such as PPM Energy, is a clear violation of Section 3(7) of the Act.

D. Assuming Arguendo That the Commission Could Consider the PHI Interest Expense When Calculating PacifiCorp's Tax Expense, the Tax Adjustment in the Order Is Improperly Calculated.

The Commission based its $26.6 million tax adjustment on the incorrect assumption that PHI's interest payment caused the PHI group's consolidated tax payments to be $16 million less than PacifiCorp's stand-alone tax liability. (Order at 14.)

> "The interest that PHI pays to ScottishPower is deductible on PHI's consolidated income tax returns (filed on behalf of PacifiCorp and other PHI affiliates). The effect of this deduction is to eliminate or substantially reduce the consolidated group's taxable income, *resulting in PacifiCorp*

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> *collecting more money from ratepayers than the consolidated group pays in taxes to governmental units*."

(*Id.* at 14 (emphasis added).)

This assumption is premised on both legal and factual errors. The Commission must follow its precedent and rules by computing PacifiCorp's tax expense on a stand-alone basis in this case. The Commission not only failed to do this, but also failed to give PacifiCorp the opportunity to present evidence relevant to any change in law and policy. Furthermore, the Commission failed to base its adjustment on the test year expense, including known and measurable changes thereto, and instead based its adjustment on vague conclusions gleaned from historical data that is not representative of the period during which the rates will be in effect. (*See id.* at 18-19 (failing to make any findings or conclusions regarding test year expense); *id.* at 19 ("we acknowledge that this adjustment is not precise").) The adjustment, based on the approach adopted by the Commission, when properly calculated to take into consideration these facts, would be approximately $1.4 million on an Oregon-allocated basis, and $2.3 million on a grossed-up basis. (*See* Martin Testimony at 1.)

1. The Commission Failed to Base the Tax Adjustment on Evidence of PacifiCorp's Expenses in the Test Year.

The Order fails to account for known and measurable changes in the test year, calendar year 2006. The Order does not even contain findings about what the tax expense will be in calendar year 2006.

As a matter of law and "[c]onsistent with established Oregon ratemaking principles," rates must be based on a projection of the expenses and revenues for the period during which rates will be in effect. *See, e.g., In re US WEST Communications*, UT 125/UT 80, Order No. 00-191 at 14 (Or Pub Util Comm'n Apr. 14, 2000) ("The Commission must ensure that the historical period is reasonably representative of the period during which rates will be in effect. The point is to prevent overearning or underearning during that period."); *In re*

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Pacific Northwest Bell Telephone Co., UT 43, Order No. 87-406 at 11-12 (OPUC 1987) ("Ratemaking is done on a prospective basis. Therefore, recurring increases in revenues and expenses that are reasonably certain to occur are added to the test year. * * * [T]he purpose of a test year is to represent the period in which rates will be in effect."). This is accomplished by basing the utility's test year on actual or budgeted expenditures, and adjusting those expenditures to remove abnormalities and to include known and measurable changes that are expected to persist. *See American Can Co. v. Lobdell*, 55 Or App 451, 466, 638 P2d 1152 (1982) ("Abnormal events of the past are therefore excluded and all known future changes are included.").

2. The Commission Should Rehear or Reconsider Its Order, Because New Evidence Exists That Demonstrates That the Tax Expense in the Test Year Will Be Considerably Greater Than Assumed in the Order, Even Taking into Consideration Consolidated Tax Savings.

By disregarding its precedent and rules and instead applying SB 408 to this general rate case after the record closed, the Commission deprived PacifiCorp of the opportunity to present evidence of the calendar year 2006 tax expense relevant to the adjustment method adopted by the Commission. New evidence exists that demonstrates known and measurable changes to PacifiCorp's tax expense when considered on a consolidated basis.

In considering the effect of PHI's interest expense on PacifiCorp's expenses and revenues in calendar year 2006, the Commission must consider the following known and measurable changes that are expected to persist:

- A change in the PHI debt structure, which occurred on September 22, 2005, will decrease PHI's interest payment in calendar year 2006 to $122 million—$38 million less than the amount assumed in the Order. (Martin Testimony at 3-4.)

- Beginning September 20, 2005 and persisting throughout calendar year 2006, ScottishPower will pay income tax on its interest income from PHI at a rate of 30 percent, thus offsetting all but 7.95 percent of any alleged tax savings enjoyed as a result of the interest deduction. (*Id.* at 4.) Thus, as of September 20, 2005, the alleged benefit to the PHI group of the interest deduction cannot be more than the difference between the PHI tax deduction

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> and the ScottishPower tax payment. To the extent the "tax benefit" (Order at 19) of the interest deduction is eliminated by the ScottishPower tax payment, it no longer exists and cannot again be passed on to customers.

This evidence came into existence after the close of discovery and after the evidentiary record closed. It is therefore properly the subject of rehearing.

3. The Commission Should Base an Allocation of the Tax Expense on Relative Net Taxable Income, Not Gross Profits.

The Commission must allocate the tax expenses based on a rational tax allocation factor, such as net taxable income. The Order incorrectly calculates the tax adjustment by apportioning to PacifiCorp a percentage of the fiscal year 2005 PHI interest deduction based on PacifiCorp's contribution of "gross profits" to the PHI consolidated group, which was 91.5 percent. (Order at 14.) This is not a rational method of apportionment. Gross profits have no rational relationship to the interest deduction. Indeed, the Commission recognizes that a more appropriate apportionment factor is relative taxable income. (*See id.* at 18.) Based on the substantially completed PHI fiscal year 2005 tax return, which was not available at the hearing, in fiscal year 2005, PacifiCorp's contribution to the PHI group's taxable income in fiscal year 2005 was 49 percent. (Martin Testimony at 3.)

E. In Any Event, the Commission May Only Allocate to Ratepayers Affiliate Tax Savings if the "Benefits and Burdens" Test Is Satisfied.

The Commission's decision to allocate tax savings attributable to PHI's deductible expense improperly disregarded the "benefits and burdens" standard, which, shortly after this case was filed, the DOJ advised the Commission it must satisfy to change its general tax expense policy. (*See* PPL/1807/1 (Commission may change current stand-alone policy only "so long as the [new] policy is rational, including taking into account the benefits and burdens of its policy, and meets minimum constitutional requirements"); *id.* at 3 (state regulators may choose between different methods of calculating tax allowances, but "whichever method is chosen it should be *applied* in a way that matches benefits and

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burdens" (emphasis in original).) PacifiCorp, Staff, and CUB all presented evidence in this case consistent with the rate standard articulated by the DOJ for tax adjustments. (PPL/1300, Martin/6; PPL/1301, Martin/3-4; Staff/1000, Conway-Johnson/4; CUB/100, Jenks/4.)

The "benefits and burdens" test requires the Commission to give consolidated tax savings to customers only "if the customers bore the burden of *paying the deductible expense that generated the savings*." (Staff/1002, Conway-Johnson/1 (emphasis added); *see also id.* at 7 ("The benefits and burdens test can be simply stated as: the benefits of consolidated tax savings are given to ratepayers (by reducing the utilities tax allowance) if the customers bore the burden of *paying the deductible expenses that generated the savings*." (emphasis added).) *See also Charlottesville, Va. v. FERC*, 774 F2d 1205, 1217 (DC Cir 1985) (deductions are attributable to utility's jurisdictional activities if '"the customers of a regulated entity contributed to the expenses which created the loss deductions'" (citation omitted)).

This principle was reflected in the White Paper prepared by Staff for the legislature, which stated:

> "Unless the underlying revenues and costs of the parent and subsidiaries were also reflected in rates, setting rates based on consolidated tax payments would be considered poor regulatory policy * * *. Regulators should reflect tax benefits in rates to the same extent that customers bear the expenses creating those benefits. There is no economic rationale for a regulatory body to pick and choose which non-utility revenues and expenses—including tax savings—to include for purposes of setting Oregon customers' rates."

(PPL/1806/12.)

The DOJ advised the Commission that changing its policy on utility taxes to one that "picks and chooses in an arbitrary manner how it *treats* expenses and investments" implicates the serious constitutional concerns raised by the U.S. Supreme Court in *Duquesne Light Co. v. Barasch*, 488 US 299, 109 S Ct 609, 102 L Ed 2d 646 (1989). (PPL/1807/3.) *See also In re Util. Reform Project*, Order No. 03-214, App. A at 2-3 (allocation of affiliate tax benefits to utility "may lead to confiscatory rates"); *Re Potomac Elec. Power Co.*, 150

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Pub Util Rep 4th (PUR) 528 (DC Pub Serv Comm'n 1994); *Iowa Elec. Light & Power Co.*, 135 Pub Util Rep 4th (PUR) 522, 527 (Iowa Utils Bd 1992) ("The affiliates' financial losses which create the tax savings exist only because of the investment and expenses borne by the stockholders. It is clear the losses which created the tax savings belong to the affiliates * * *."). Thus the DOJ summarized its advice to the Commission as follows:

> "Any change in policy must be consistent with Oregon law and constitutional requirements. A policy that considers the benefits and burdens of the utility's participation in a consolidated tax group, consistent with the *Hope* standard, would result in [a] decision that would be consistent with *Duquesne* and administrative law requirements."

(Staff/1002, Conway-Johnson/3.)

1. The Evidence Here Does Not Satisfy the "Benefits and Burdens" Test.

As demonstrated in PacifiCorp's posthearing briefs, the parties proposing tax adjustments in this case failed to establish that their proposed consolidated tax adjustments satisfied the "benefits and burdens" test. ICNU eschewed the benefits and burdens test altogether, and Staff's and CUB's arguments were seriously flawed and speculative: (1) both Staff and CUB acknowledged that PHI bears the burden of "paying the deductible expense that generated the savings" (Cross-Exam. of Mr. Conway and Ms. Johnson, Tr. 191-92, Tr. 189; CUB/200, Jenks/4); (2) both focus on negative attributes of PHI debt without regard to offsetting or positive attributes of the parent's financial structure (*see* Redirect-Exam. of Mr. Conway and Ms. Johnson, Tr. 212-13; Recross-Exam of Mr. Conway and Ms. Johnson, Tr. 216-17; Cross-Exam of Mr. Jenks, Tr. 156, 163); and (3) both based their *burden* argument on claims that ring-fencing failed to protect customers from *positive* economic aspects of nonregulated operations. (*See* Cross-Exam. Of Mr. Conway and Ms. Johnson, Tr. 194; CUB/200, Jenks/3.)

Staff and CUB both disputed the relevance of any facts showing that PacifiCorp's customers have *benefited* from PacifiCorp's relationship with ScottishPower. (*See*

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Staff/1000, Conway-Johnson/8; Cross-Exam. of Mr. Jenks, Tr. 162.) Moreover, Staff's and CUB's proposed allocations of tax savings bear no rational relationship to the alleged burden on customers. (*See* PacifiCorp's Opening Posthearing Brief at 13-22; PacifiCorp's Posthearing Reply Brief at 7-9.) Thus the consolidated tax adjustment is not supported by substantial evidence that customers bore the burden of the deductible expense.

Further evidence of the fact that PacifiCorp has benefited from its relationship is provided by a recent Standard & Poor's ratings note attached as PPL Exhibit 319 to the Supplemental Testimony of Bruce Williams. The note, which was issued in September 2005 and was not available earlier in the case, states that "the current 'A-' corporate credit rating on PacifiCorp is based on ScottishPower's consolidated credit profile, whose solid financial performance has compensated for its weaker U.S. utility."

2. The Commission's Order Failed to Even Make a Finding Regarding Whether the Consolidated Tax Adjustment Is Supported by Substantial Evidence That Customers Bore the Burden of the Deductible Expense.

The Commission failed to do precisely what the DOJ advised the Commission it must do. It did not consider the benefits *and burdens* of the utility's participation in a consolidated tax group. The Commission failed to even make a finding in the Order regarding whether the evidence showed that the benefits and burdens standard was satisfied. (*See* Order at 16-19.) In its Discussion and Resolution regarding the consolidated tax adjustment issue, the Commission neglected to mention the DOJ advice or the constitutional limitations applicable to its action. (*See id.* at 16-19.) Instead, the Commission merely stated that "customers *may* be bearing the burden of PHI debt." (*Id.* at 18.) The Commission did not address whether this possible burden is offset by benefits. (*See id.* at 16-19.)

Rather than recognizing the constitutional requirements that its Order must satisfy, the Commission stated that the following two goals were essential to its resolution: (1) "to do our best to align the estimated taxes included in PacifiCorp's rates with the amount that PacifiCorp (or its affiliated group) will eventually pay" and (2) "to reduce, to the extent

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possible, the amount that flows through the automatic adjustment clause." (*id.* at 19.) Neither goal reflects any consideration of benefits and burdens, which the DOJ has advised is a constitutional requirement and a standard applicable to any consolidated tax adjustment.

F. The Order Also Has Serious Constitutional Defects.

The Order not only is procedurally defective and inconsistent with the text and legislative history of SB 408, but also violates a number of substantive provisions of the U.S. and Oregon constitutions.

1. The Order Violates *Duquesne Light*.

The U.S. Supreme Court has made clear that asymmetrical ratemaking is constitutionally suspect. In *Duquesne Light*, 488 US at 314, the Court observed that, although the "Constitution [only] protects the utility from the net effect of the rate order on its property" as a whole, "[o]ne of the elements always relevant to setting the rate * * * is the return investors expect given the risk of the enterprise." The Court further explained:

> "Consequently, a State's decision to arbitrarily switch back and forth between [rate] methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions."

Id. at 315.

The DOJ has specifically advised the Commission of this issue in discussing potential ratemaking methodologies for taxes. (*See* Staff/1002, Conway-Johnson/7 (DOJ memorandum regarding legality of setting utility rates based on tax liability of parent, dated Feb. 18, 2005); PPL/1807/1 and 3 (DOJ memorandum regarding Utility Reform Project's comments on tax treatment in utility ratemaking, dated Mar. 22, 2005).)

The Order cannot be squared with either *Duquesne Light* or the DOJ's advice. The Commission's consistent practice and rules have calculated the tax component of utility rates on a stand-alone basis. Now, for the first time and without prior warning, the Commission has switched methodologies and reduced PacifiCorp's rates based on tax benefits generated

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by unregulated affiliates. It is clear, however, that the Commission's new methodology cannot and will not work both ways; to the contrary, SB 408 is clear that the tax components of utility rates must be the lesser of the stand-alone tax liability or the amount that a consolidated group actually pays to taxing authorities. *See* SB 408 § 3(12).

This is a classic example of an approach to ratemaking that gives ratepayers the "good" features of affiliates' investments in the form of tax deductions, but insulates them from the "bad" consequences of those investments, such as increased tax liability if the affiliates are highly profitable or risks associated with direct liability for debt. The Commission insisted that the costs of the debt incurred as part of the ScottishPower/PacifiCorp merger not be included in the utility's costs and that ratepayers be held harmless for any costs associated with that debt. (*See* Section IV.F.2, *infra*.) The Order represents precisely the type of asymmetrical ratemaking methodology switching that was condemned by *Duquesne Light* and warned against by the DOJ.

2. The Order Unconstitutionally Impairs the Merger Contract.

At the time of the merger between ScottishPower and PacifiCorp, parties to the regulatory proceedings before the Commission entered into a Stipulation Supporting Approval of Application of ScottishPower and PacifiCorp under ORS 757.511 (the "Stipulation"). (Order No. 99-616, appendix 5, Docket UM 918 (Oct. 6, 1999).) The Stipulation was adopted by the Commission and incorporated in the order approving the merger transaction. (*Id.*) Among other things, the Stipulation provided that "all costs of completing the merger" (which include the substantial amount of debt incurred to do so) would be excluded from PacifiCorp's "utility accounts." (*Id*., Merger Condition No. 3.) Other conditions imposed by the Stipulation confirmed that PacifiCorp and its ratepayers were to be shielded from the risks of activities or investments by entities not subject to Commission jurisdiction. (*See, e.g., id.*, Merger Conditions No. 5 (PacifiCorp cost of capital to be no higher than without merger), No. 10 (ratepayers to be held harmless from higher

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revenue requirement due to merger), No. 11 (ScottishPower not to subsidize other activities by charging expenses to PacifiCorp), No. 12 (corporate costs to be no higher than without merger).) In the order approving the merger, the Commission observed that "PacifiCorp will operate on a stand-alone basis after the merger." (*Id.* at 21.)

The result is that PacifiCorp and ScottishPower are bound by contract as well as by administrative order to shield ratepayers from a variety of costs of nonregulated activities, including the cost of servicing the debt incurred to consummate the merger. A necessary corollary of that contractual obligation is that PacifiCorp's nonregulated affiliates are entitled to retain the tax benefits flowing from the debt service. The Commission's policy at the time, which later was incorporated into an administrative rule, was to calculate taxes for rate purposes on a stand-alone basis for utilities that filed consolidated tax returns. *E.g., Re Or. Exch. Carrier Ass'n.,* 1993 WL 117620 at *5; OAR 860-027-0048. The Order breaches and impairs the contract between PacifiCorp and ScottishPower by appropriating the tax benefits for ratepayers and continuing to absolve them of any investment risk. Impairment of these benefits without providing any comparable substitute constitutes a violation of the Contract Clauses of the U.S. and Oregon constitutions. US Const, Art I, § 10; Or Const, Art I, § 21; *see U.S. Trust Co. v. New Jersey*, 431 US 1, 19, 97 S Ct 1505, 52 L Ed 2d 92 (1977); *Eckles v. State of Oregon*, 306 Or 380, 760 P2d 846 (1988).

This impairment of the merger contract is analogous to the situation in *U.S. Trust*, in which the state of New Jersey attempted to change bond covenants after the bonds had been issued and purchased by third parties. The U.S. Supreme Court struck down the New Jersey law under the Contract Clause of the U.S. Constitution because "the covenant [was not] merely modified or replaced by an arguably comparable security provision. Its outright repeal totally eliminated an important security provision and thus impaired the obligation of the States' contract." 431 US at 19.

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So here, ScottishPower entered into a contract that, along with the Commission's consistent practice of calculating utility tax liability on a stand-alone basis, gave ScottishPower the tax benefits of debt it incurred in reliance on the contract. *See id.* at 19 n 17 ("contracting parties adopt the terms of their bargain in reliance on the law in effect at the time the agreement is reached"). The Order does not provide a comparable substitute; rather, it appropriates the tax benefits of the debt, yet continues to shield ratepayers from its risks. This impairment of the merger contract is the second constitutional flaw in the Order.

3. The Order Arbitrarily Appropriates the Benefits from Affiliates of Utilities in Violation of the Equal Protection Clause of the U.S. Constitution.

The Order denies ScottishPower and PHI the benefits of certain tax deductions simply because they are affiliated with a public utility; no other corporate parent or affiliate in Oregon is required to pass such deductions on to the customers of another affiliate rather than to investors. Such disparate treatment violates the Equal Protection Clause of the U.S. Constitution. US Const, Amend XIV, § 1.

A "class" for equal protection purposes can consist of a single member. *See Indiana State Teachers Ass'n v. Board of School Commissioners of the City of Indianapolis*, 101 F3d 1179, 1181 (7th Cir 1996). Thus, it can consist of a company such as PacifiCorp that has been denied tax benefits because of a state administrative order. The U.S. Supreme Court has ruled that states have "'large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation;'" however, a system of taxation that discriminates will be upheld only if "'the legislature could have reasonably concluded that the challenged classification would promote a legitimate state purpose.'" *Williams v. Vermont*, 472 US 14, 22-23 (1985) (citations omitted). In justifying a discriminatory scheme, it is not enough for a state to "observ[e] that in light of the statutory classification all those within the burdened class are similarly situated;" instead, the classification "must reflect pre-existing differences." *Id.* at 27.

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The Order does not promote a "legitimate state purpose" sufficient to pass constitutional muster. Although the stated purpose of the Order—to implement the goal of SB 408 to align taxes collected from ratepayers with taxes actually paid by utilities—might be seen superficially as "legitimate," the reality is that the Order does not do that at all. Instead, the Order appropriates a single type of tax deduction—namely, the deduction for interest paid on affiliate debt—to reduce utility rates without any consideration of the overall tax payments by either PacifiCorp or its affiliated group as a whole. The Order is irrational even on its own terms, and violates the Equal Protection Clause.

4. The Order Constitutes an Unconstitutional Taking and Results in Confiscatory Rates.

The Order results in an unconstitutional taking of property in violation of the Takings Clauses of the U.S. and Oregon constitutions. US Const, Amend V, XIV; Or Const, Art I, § 18. The tax deductions and benefits generated from investments by nonregulated affiliates are the property of those companies and their investors, which bear all of the risks of the investments. *See Re Potomac Elec. Power Co.*, 150 Pub Util Rep 4th 528; *Iowa Elec. Light & Power Co.*, 135 Pub Util Rep 4th at 527 ("The affiliates' financial losses which create the tax savings exist only because of the investment and expenses borne by the stockholders. It is clear the losses which created the tax savings belong to the affiliates * * *."). The Order appropriates that property for an allegedly "public" purpose; specifically, lower rates for customers of PacifiCorp in Oregon. Such an uncompensated taking of private property is patently unconstitutional. *See U.S. Trust*, 431 US at 19 n 16, (such rights "are a form of property and as such may be taken for a public purpose [only if] just compensation is paid").

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V. CONCLUSION

Based on the evidence and arguments presented, the Commission should reconsider and remove the tax adjustment in Order 05-1050. In the alternative, the Commission should rehear this case and reduce the tax adjustment to $2.3 million.

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