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VIA E-MAIL (PUC.TAXWHITEPAPER@STATE.OR.US)

Commission Chair Lee Beyer
Commissioner Ray Baum
Commissioner John Savage
Public Utility Commission of Oregon
PO Box 2148
Salem, OR 97308-2148

Re: TREATMENT OF INCOME TAXES IN UTILITY RATEMAKING

Dear Commissioners:

At the public workshop on the treatment of income taxes in utility ratemaking held last week, you raised a number of legal questions regarding utility tax treatment and the Department of Justice's memorandum on this issue, dated February 18, 2005 (the "DOJ memorandum"). PacifiCorp appreciates this opportunity to provide written responses to these questions and supplement its comments filed on February 16, 2005 on the draft Staff White Paper on Utility Taxation.

1. What is the legal standard for matching benefits and burdens?

The benefits-and-burdens test is derived from the matching principle that generally governs tax accounting. The test is "whether the expenses that generate the deduction are used to determine the jurisdictional service's rates. Put more simply, the test is whether the expenses are included in the relevant cost of service." *Columbia Gulf Transmission Co.*, 23 F.E.R.C. ¶ 61,396, at 61,850-53 (1983) (footnote omitted). This means that "[t]he utility's tax base is determined by identifying the taxable income and deductions of the consolidated group specifically attributable to the utility's jurisdictional activities." *Charlottesville v. FERC*, 774 F.2d 1205, 1207 (D.C. Cir. 1985). Deductions are attributable to a utility's jurisdictional activities if "'the customers of a regulated entity contributed to the expenses which created the loss deductions.'" *Id.* at 1217 (citation omitted).

In determining whether the benefits-and-burdens test is satisfied, it may help to consider the policy behind the requirement. The benefits-and-burdens requirement achieves three synergistically-related policy goals: (1) it bases rates on the principle of "cost incurrence" or

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Washington
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Idaho

"cost responsibility," (2) it prevents cross-subsidization between utility and non-utility entities, and (3) it prevents uncompensated takings of private property.

The principle of "cost incurrence" means that "the allocation of the consolidated company's costs . . . to the regulated subsidiary [is] 'on the basis of a causal link,' [] between the costs and the services the subsidiary provides to its ratepayers. . . . '[T]he necessary causal link between the ratepayers and the deductions is the expenses the company incurs in providing service.'" *Charlottesville*, 774 F.2d at 1211 (citation omitted). *See also Panhandle E. Pipe Line Co. v. Fed. Power Comm'n*, 324 U.S. 635, 641-42 (1945) ("[T]he Commission must make a separation of the regulated and nonregulated business when it fixes . . . rates of a company whose activities embrace both.. Otherwise the profits or losses, as the case may be, of the unregulated business would be assigned to the regulated business . . . ."); *Re Or. Exch. Carrier Ass'n*, Order No. 93-325, 1993 WL 117620, at *6 (Mar. 12, 1993) (allocating tax liabilities resulting from nonregulated operations to ratepayers "is contrary to the Commission's statutory obligation to prevent subsidization by the ratepayers of unregulated activities") *recons. denied*, Order No. 93-879, 1993 WL 390953 (Or. Pub. Util. Comm'n June 28, 1993); *In re Util. Reform Project*, Order No. 03-214, App. A at 2 (Or. Pub. Util. Comm'n Apr. 10, 2003) ("Calculating [the utility]'s costs, including income taxes, for ratemaking on a stand-alone basis protects [the utility]'s customers from the financial difficulties experienced by [the parent]'s other subsidiaries."); *Re Affiliated Transactions for Energy Utils.*, Order No. 03-691, 2003 WL 23305011, at *1 (Or. Pub. Util. Comm'n Dec. 1, 2003) (the purpose of OAR 860-027-0048's standalone-reporting requirement is to prevent cross-subsidization between regulated utilities and nonregulated affiliates); *Re Potomac Elec. Power Co.*, 150 P.U.R.4th 528 (abstract, full text in Westlaw), 1994 WL 109204 (D.C. Pub. Serv. Comm'n 1994) ("[R]elating District of Columbia utility customers' cost of service to factors alien to utility operations distorts the true costs of electric service."); *Accounting for Public Utilities* § 7.08[3] (LexisNexis 2003) ("[t]he only approach that is consistent with standard ratemaking principles that prohibit cross-subsidization between utility and non-utility activities is to put the regulated operation on a 'stand-alone' basis and to assign the full tax burden to the taxable gain source and [the] full tax benefit to the tax loss source").

2. Would an approach that matches benefits-and-burdens require a legislative change or rulemaking?

No. The Commission's current approach matches benefits and burdens. Under the current approach, ratepayers are responsible for the expenses associated with the cost to serve them and are not entitled to the tax benefits associated with expenses for which they are not responsible. *In re Util. Reform Project*, Order No. 03-214, App. A at 2 (denying petition for investigation of

Portland General Electric (PGE) income tax rates; "For ratemaking purposes, the Commission sets PGE's rates to reflect the costs of the company's regulated operations. That is, in a rate proceeding, PGE's rates are set based on its own revenues, costs and rate base for a given test year.").

However, implementation of the alternative approaches discussed in the draft White Paper would require legislation and/or rulemaking proceedings as well as reversal of long-standing Commission precedent. *See, e.g.,* OAR 860-027-0048 (requiring standalone reporting of income taxes for ratemaking purposes); ORS 756.040 (utility rates must be based on cost-of-service); *In re Util. Reform Project*, Order No. 03-214, App. A at 2 (ratemaking on a standalone basis is "[c]onsistent with long-standing OPUC policy," which "'protect[s] [utility] customers, competitors, and the public generally'" (citation omitted)); *In re PacifiCorp, Application for Approval of a Cross Charge Contract with ScottishPower UK plc*, UI 221, Order No. 03-726 (Or. Pub. Util. Comm'n Dec. 12, 2003) (requiring use of standalone method); *Re Or. Exch. Carrier Ass'n*, 1993 WL 117620, at *5 (the Commission's policy is to "calculate tax liability on a stand alone basis").

3. Is Pennsylvania's "effective rate" approach unconstitutional?

Probably yes. As the DOJ memorandum recognizes, Pennsylvania's "effective rate" approach fails to match benefits and burdens. Although the Supreme Court has not yet addressed whether such a failure is constitutionally impermissible, the burden it places on non-utility property may not be justly compensated by a reasonable return on equity ("ROE") for the utility. *See Duquesne Light Co. v. Barasch*, 488 U.S. 299, 315 (1989). A state scheme that "arbitrarily switch[ed] back and forth between 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.* Pennsylvania's approach, like all asymmetrical approaches, does just that.

Pennsylvania's approach allocates tax credits and deductions flowing from losses of nonregulated entities to utility customers but does not allocate tax liabilities flowing from gains of nonregulated entities to utility customers. Furthermore, Pennsylvania does not appear to require a causal link between the losses (burdens) on which the tax credits (benefits) are premised and utility cost-of-service. Although any approach that allows utilities to earn a reasonable ROE probably does not constitute confiscatory ratemaking under a traditional *Hope* analysis, the Pennsylvania approach introduces a utility-nonutility distinction that is not present in the traditional *Hope* analysis. *See id.* ("Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by counterveiling factors in some other aspect."). Whereas, under the traditional *Hope* analysis, no unconstitutional taking of utility property occurs as long as utility shareholders earn an overall satisfactory ROE, the property being taken as a result of flow-through tax schemes that fail to match benefits and burdens is *non-utility property*, which is not compensated for by a satisfactory ROE for the utility.

4. Could an actual-taxes-paid approach result in allocation of nonregulated parent, subsidiary or affiliate tax *liabilities* to ratepayers?

Yes. Under symmetrical actual-taxes-paid approaches, ratepayers would subsidize nonregulated investments whenever nonregulated parents, subsidiaries or affiliates reported earnings—*i.e.,* ratepayers would pay increased rates when affiliated entities have taxable gains. The Commission has already denied a utility's request for a "true-up" to offset such affiliate gains. *See, e.g., Re Or. Exch. Carrier Ass'n*, 1993 WL 117620, at *5; *see also Re Southwestern Tel. Co.*, Decision No. 60741, 1998 WL 265335, at *11 (Ariz. Corp. Comm'n Mar. 26, 1998); *Re Utils., Inc. of Md.*, Order No. 73482, 1997 WL 1015905, at *14-16 (Md. Pub. Serv. Comm'n May 28, 1997). *Cf. In re PacifiCorp*, Order No. 03-726, App. at 5 (standalone method prevents "cross-subsidization").

5. Does the Commission have authority to require a regulated utility to produce tax records of the utility's parent company?

No, unless the regulated utility has actual possession or control of the requested records because, for example, they relate in some way to utility operations. *See* ORS 756.105(2); 756.115. Information that is solely within the control of a utility's unregulated parent, subsidiary or affiliate is outside the scope of the Commission's investigative powers, which are limited to regulated utilities within the Commission's jurisdiction. *See* ORS 756.070-125 (stating that Commission has authority to investigate management of "public utilities"); ORS § 757.005 (defining "public utility").

6. Would a state stand-alone requirement (Option 5) unconstitutionally discriminate against utilities?

Probably yes. Any income tax method that treats electric utilities differently than other businesses raises constitutional concerns. Or. Const. art. I, § 32 (requiring uniform taxation among same class of subjects); Or. Const. art. IX, § 1 (requiring uniform assessment and collection of taxes); *Mathias v. Dep't of Revenue*, 312 Or. 50 (1991) (holding that statute violated uniformity requirements of state constitution); *Huckaba v. Johnson*, 281 Or. 23, 24-45

(1978) (differences justifying attempted classification must bear reasonable relationship to legislative purpose).

7. Are Options 2-5 consistent with state and federal policies encouraging investment in renewables?

No. By reducing the value of tax incentives, Options 2-5 would undermine environmental and socially valuable programs. Tax credits, such as the Oregon business energy tax credit, pollution control credit, and credit for installing fish-screening devices, motivate companies to invest in "green" energy projects, install pollution-control devices, and undertake other socially beneficial projects. *See, e.g.,* ORS 469.190 (business energy tax credit encourages use of renewable resources); Oregon Dep't of Energy, Second Draft: Renewable Action Plan at 1 (2004) ("We can make Oregon the national leader in renewable energy and renewable product manufacturing. . . . Development of renewable energy will lessen our reliance on fossil fuels, protect Oregon's clean air and create jobs." (quoting Governor Kulongoski (2003)).[1] The value of such credits is normally captured through consolidated tax filing. Allocating the tax benefits of participation in these ventures to entities that do not take the risk of investment would decrease or eliminate the economic value of these tax incentives. This would also put nonregulated affiliates that invest in these ventures at a competitive disadvantage to other businesses in the industry that are not subject to the reallocation of benefits.

Thank you for this opportunity to respond to the questions raised at the public workshop.

Very truly yours,

for

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[1] The draft Renewable Action Plan is available at http://www.energy.state.or.us/renew/RenewPlan.htm.