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VIA E-MAIL

Commission Chair Lee Beyer
Commissioner Ray Baum
Commissioner John Savage
Public Utility Commission of Oregon
550 Capitol Street NE, #215
P. O. Box 2148
Salem, OR 97308-2148

Re: Department of Justice February 18, 2005 Memorandum Regarding the Legality of Setting Utility Rates Based Upon the Tax Liability of its Parent

Dear Commissioners:

PGE is grateful for the opportunity to comment on the Department of Justice's Memorandum of February 18, 2005 on the treatment of income taxes in ratemaking. DOJ's Memorandum provides a thoughtful analysis of some key legal principles guiding the Commission's policy for calculating estimated tax expense in setting rates. We generally agree with DOJ's analysis and offer these comments to emphasize certain points and expand on others.

1. Legal and Constitutional Requirements

The Federal Constitution requires a utility commission to set rates that provide (1) adequate revenue to pay the utility's reasonable expenses and capital costs and (2) a return to the equity holder that is both commensurate with the return on investments in other enterprises having corresponding risks and also allows the utility to maintain its credit and attract capital. *Federal Power Commission v. Hope Natural Gas Pipeline*, 329 US 591 (1944). The Supreme Court reaffirmed the *Hope* standard in *Duquesne Light Co. v. Barasch*, 488 US 299 (1989). The Court further warned that "a State's decision to arbitrarily switch 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.* at 315. Under Oregon law, a "fair and reasonable" rate is one that conforms with the *Hope* standard. ORS 756.040(1).

The DOJ Memorandum explains that, to comply with *Hope*, any new tax policy should allocate benefits in accordance with the respective burdens undertaken by ratepayers and investors. Specifically, ratepayers or investors should enjoy the benefits of consolidated tax savings to the extent that they bore the burden of paying the expenses that generated the tax savings in the first place. See *City of Charlottesville, Virginia v. FERC*, 774 F2d 1205, 1208 (DC Cir 1985) (describing FERC's benefits-burdens test). Moreover, any new tax policy would need to be consistently applied to avoid the problem of arbitrary enforcement that the Supreme Court emphasized in *Duquesne*.

These are important insights. Many of the alternatives to the stand-alone methodology could raise problems under *Hope* and *Duquesne*. As the Oregon Public Utility Commission draft White Paper titled "Treatment of Income Taxes in Utility Ratemaking" (the "White Paper") shows, it may be difficult to match benefits and burdens under several of these alternatives. See White Paper at 3-4 (summarizing pros and cons of ratemaking options). Moreover, some approaches could perversely result in higher rates in years when a utility has high earnings. *Id.* Under *Duquesne*, an approach with such an effect would have to be consistently applied, even when detrimental to ratepayers.

2. Other States' Approaches

As DOJ explains, the very few states that apply a "consolidated tax adjustment" in estimating a utility's tax expense have done so in poorly reasoned decisions and have often failed to evaluate who bears the burdens associated with the losses that create tax savings. In addition, these states claim to include "actual taxes paid" in rates, when in fact they are using estimates and assumptions, as is true in any ratemaking proceeding. The DOJ Memorandum shows how the decisions in Pennsylvania are flawed in these two respects. DOJ's analysis applies with equal force to other states, like Connecticut and West Virginia, that apply consolidated tax adjustments without any regard for the source of the tax savings.¹ Oregon law requires that the Commission's policies rationally advance the goal of setting fair and reasonable rates. To the extent that state commissions have not examined important economic, constitutional and federal tax implications before deviating from the stand-alone methodology, their policies have little exemplary value.

It is worth noting that the impetus for change in some of the minority states came not from the utility commissions but instead from state courts, which from the reasoning in their opinions, apparently misunderstood fundamental regulatory principles. As DOJ explains, the

¹ For example, these states fail to acknowledge that a company with negative income, if it chooses to file on a stand-alone basis, often will be entitled to carry its losses forward to years in which it has positive income; but by participating in a consolidated tax filing, the company's losses are offset against affiliates' taxable income and the company gives up the right to use the loss in a future year.

Pennsylvania Public Utility Commission attempted various methods of estimating tax expenses that would align benefits and burdens. The state courts rejected these more nuanced approaches. A similar story unfolded in Indiana during the 1970s and 1980s. There, the state's intermediate appellate court rejected the Public Service Commission's stand-alone approach in a 1978 decision. *See City of Muncie v. Public Service Commission*, 378 NE2d 896 (Ind App 1978), 396 NE2d 927 (Ind App 1979). On remand, the Commission developed a benefits-burdens methodology that, it believed, complied with the appellate court's decision. The appellate court again reversed in a decision that failed to discuss the Commission's justifications for its benefits-burdens approach. *Office of Utility Consumer Counselor v. Indiana Cities Water Corp.*, 440 NE2d 14, 17-18 (Ind App 1982); *see also In re Indiana Cities Water Corp.*, Cause No. 38851, 115 PUR4th 470, 1990 WL 488768 (Ind URC July 5, 1990) (summarizing procedural history of this issue in Indiana).

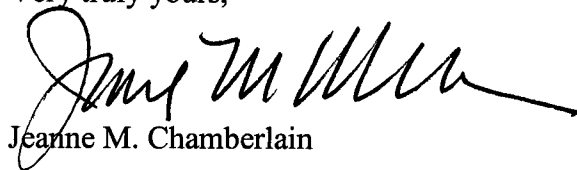
Vermont has traditionally followed a stand-alone approach, but a recent case in that state dealt with a rare situation – a utility organized as an S corporation. *In re Shoreham Telephone Company, Inc.*, Docket No. 6914. S corporations are not tax-paying entities; rather, their shareholders include corporate income on their personal tax returns. The Vermont Public Service Board rejected the utility's proposal to include tax expense at the rate applicable to C corporations. That decision is on appeal to the Vermont Supreme Court. Apart from this unique case, Vermont has not deviated from the stand-alone approach.

As the Commission examines the tax issue, it should bear in mind that the large majority of states follow the stand-alone approach that Oregon has also adopted. There is no clear, well-established minority approach. Within the handful of states that have deviated partially or completely from the stand-alone approach, a variety of policies have emerged, often without consideration of the important issues that Staff, DOJ and other parties have raised here.² Some of these states' policies have not yet been reviewed by courts. Many of these policies may ultimately fail to pass constitutional muster. By contrast, the stand-alone approach is well-established, and we know it can be consistently applied in compliance with the Supreme Court's decisions in *Hope* and *Duquesne*. We believe that continued adherence to the stand-alone approach for calculating income tax expense will best serve the goals of consistency and fairness.

² We have reservations about the comment found on page 9 of the DOJ Memorandum concerning potential PGE losses. Rates are set prospectively to cover reasonable costs. Rates are not set with the expectation that the utility will suffer a loss.

We very much appreciate the opportunity to comment on this important matter and thank DOJ for preparing its careful analysis of the legal issues surrounding calculation of taxes in ratemaking.

Very truly yours,

A handwritten signature in black ink, appearing to read "Jeanne M. Chamberlain". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Jeanne M. Chamberlain

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