



# Citizens' Utility Board of Oregon

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Public Utility Commission of Oregon  
PO Box 2148  
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Re: Comments of the Citizens' Utility Board in Response to Staff's White Paper  
on the Treatment of Income Taxes in Utility Ratemaking

Dear Chairman Beyer and Commissioners Baum and Savage,

The Citizens' Utility Board appreciates the effort by the Public Utility Commission Staff to clarify and explore the Commission's utility tax treatment policy in its recent White Paper. However, the White Paper on tax policy seems like a missed opportunity for the PUC Staff to recognize the obvious equity issues and to advance a middle ground in this controversy. Staff and its legal counsel use the White Paper primarily to advance arguments to justify the current policy, even as those arguments seem stretched and uneven.

We agree generally with Staff that a full, annual true-up of income taxes (Option 2) presents numerous regulatory challenges, and could have some adverse consequences for customers, although a true-up could be part of a thoughtful solution to the problem.

We also believe, however, that the Staff did not adequately challenge the current tax treatment policy, referred to as the stand-alone approach (Option 1). The White Paper's ultimate justification of the present stand-alone approach is based on the myth of revenue requirement based on a stand-alone utility. A utility's revenue requirement is based on a stand-alone utility *adjusted to include parent company costs that are allocated to this stand alone utility*. When looking at taxes, the White Paper calls this the "modified stand-alone approach" (Option 4). The White Paper simply ignores that the "modified stand-alone approach" is the general basis for revenue requirement, not just an option for taxes.

The White Paper further muddies the water by mixing the various options for this modified approach together and then mixing the arguments against the various options

together, so as to suggest that even the limited application of this approach that is already used in several states seems unworkable and unconstitutional. The arguments against including unregulated losses or gains of a separate subsidiary in a forecasted test year are different than the arguments against including the allocated portion of the tax deduction associated with debt at the parent company level.

CUB believes that there is a workable middle ground in this argument that does not involve the profits and losses of unregulated businesses, but at the same time, responds to the public's justifiable concern that we should not place taxes in rates that we know will not be paid to state and federal government.

### **CUB's Recommended Approach**

Our ratemaking tradition is based on forecasting a utility's costs and, while there is recognition that our forecasts generally are not perfect, the goal of a forecast is to be reasonably accurate. CUB believes that the Commission should attempt to more accurately forecast taxes by including known and measurable tax deductions at the parent company that are related to the regulated utility and are properly allocated to the regulated utility. This approach would create a much closer match between charges in rates for taxes and the actual taxes paid. While it might not be as perfect a match as an annual true-up, it also does not cause the same kind of interruption in regulation that a true-up might.

The modified approach is not a crazy idea that will throw out our history of ratemaking and violate the constitutional rights of utility shareholders, as Staff's White Paper implies. We currently allocate costs of corporate services at the parent company which have a relationship to the regulated company into our ratemaking and allocate these costs to customers. Specifically these costs include the following areas: executive, legal, accounting and compliance, corporate tax, shareholder services, risk management and insurance premiums, supply chain, human resources, public affairs and administration, and community relations. Tax deductions that are related to financing of the total enterprise (utility, subsidiaries and parent company) should not be treated differently. They should be allocated among the various subsidiaries of the parent company and the regulated utility's share of this tax deduction should be included in rates.

### **Staff's Arguments Against A Modified Approach Are Weak Or Irrelevant**

The White Paper did identify several states that use a modified stand-alone approach, including Connecticut, Florida, Indiana, Pennsylvania, Tennessee, Virginia and West Virginia. Staff points out that these states use an approach which "recognizes tax savings of the consolidated corporation in certain circumstances. In most cases, the regulator recognized those savings in calculating the utility's tax deduction for debt by considering the interest deduction at the holding company level." White Paper, p. 11.

The White Paper acknowledges that this will in "virtually all cases" reduce the utility's revenue requirement, but lists four "arguments against incorporating these benefits. We will list these arguments and respond to each one:

1. Staff: decreasing the utility's revenues would reduce net income and be viewed negatively from a credit perspective, which could result in higher costs of capital for utility customers and put upward pressure on rates.

As the argument goes: if we incorporate the tax deduction from debt at the utility holding company into rates this will reduce rates, but this reduction "could" raise the cost capital and result in higher costs and higher rates. Yet, this is a throw-away argument that could be applied to any Commission rejection of any cost for recovery in rates. The Commission decreases the utility's revenue requirement from its filed rate case for many reasons, and these reductions reduce revenues and reduce net income. The White Paper fails to provide any discussion of the likely size of such a reduction, how it compares to other Commission adjustments, and the likelihood that it will impact the utility's cost of capital. In the Texas Pacific case, a case where the holding company debt is so significant that it raises significant regulatory concern, the tax adjustment to revenue requirement would only be \$15 million per year. This is smaller than many other adjustments the Commission routinely makes.

While providing no analysis to support the argument that incorporating the interest deduction into rates would raise the cost of capital, the White Paper fails to recognize that debt at the company level does impact a utility's cost of capital. Coming out of the Texas Pacific case, Staff is well aware that significant debt at the holding company level impacts the cost of capital for the utility. It is precisely because this debt at the holding company level impacts the utility that customers should share in the benefits of the tax deduction.

2. Staff: rate stability could be lessened as gains or losses for non-regulated businesses change consolidated tax obligations.

CUB's approach, like the approach that Staff acknowledges is practiced in other states, uses the modified stand-alone method, and would not include gains or losses from non-regulated businesses. Therefore this argument is not relevant. Staff's argument is only relevant if the modified approach is poorly designed.

3. Staff: 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 (as discussed in Attachment B). 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. The Commission's counsel advises that those making a legal challenge to this approach will likely point to the lack of an economic rationale in attacking it.

Attachment B which is the basis of this "poor regulatory policy" argument is two excerpts from the book, Accounting for Public Utilities. The problem is that both of these excerpts deal with other subsidiaries that have losses or gains, not the debt at the parent company. The first refers to "subsidiary operations that produce tax losses which" offset taxable income from utility operations. The second refers to "business losses

generated in those nonregulated entities” and states that customers do not share in income tax generated by profitable subsidiaries.

Neither excerpt seems to say anything about whether some of the interest deduction from debt at the holding company level should be allocated to the regulated utility, just as many costs of the holding company, such as shareholder services, accounting, and legal expense are allocated to the utility.

4. Staff: the Commission’s counsel has advised that an approach that bases utility rates on the tax results of non-utility operations could be determined to result in confiscatory rates and be unlawful under ORS 756.040. This statute codified what is known as the *Hope* standard, (Federal Power Commission v. Hope Natural Gas Pipeline, 320 US 591 (1944)). Courts have held that it is the end result that must be fair; i.e., the regulator must set rates to provide sufficient revenues to pay the reasonable expenses and capital costs of a utility overall. Adjusting the tax component of utility rates because of tax losses or tax savings from non-regulated affiliates could result in rates that overall are unreasonable.

If, as we believe, ORS 756.040 codifies the *Hope* standard and nothing more, then PUC’s counsel is saying that the states that use the modified approach are violating the Constitution of the United States. We tend to think that if others believed this, most pertinently the utilities regulated in these states, that argument would have been tried and would have been successful. Such is not the case, so PUC’s counsel seems to be standing alone in opining a constitutional violation.

The reference in the White Paper to a legal argument is insufficient to make any point at all. What there is of a legal argument is internally inconsistent. The argument seems to be that a treatment of taxes other than the PUC’s current policy might violate the *Hope* standard because, in looking at the whole, the tax treatment might cause the rates to be low enough to equate to a takings. But a *Hope* takings analysis will never isolate the tax treatment. *Hope* says that in determining what is just and reasonable, it is the result reached and not the method employed that is important. The Court applied no rate level test and said as long as regulators create rates that allow the utility to operate, to attract capital and compensate investors for risks undertaken, even if the return is “meager”, the Court will not interfere with regulation.

*Hope* and ORS 756.040 explicitly do not apply to a single element of a rate case, such as taxes, but address the question of whether rates are so unfair that they are constitutionally prohibited under the Fifth Amendment to the Constitution. In other words, elements of a rate cases, such as taxes, would not be viewed as confiscatory and unlawful under *Hope*, because the test is to look at overall rates. Under this logic, each rate adjustment by the Commission might be unconstitutional because it could be the straw that breaks the camel’s back and could result in rates that are a takings - exactly the analysis *Hope* tries to avoid.

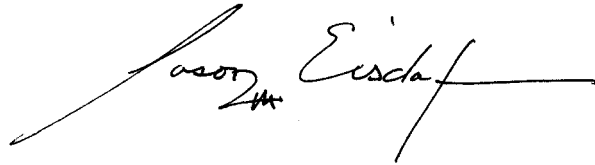
None of the arguments advanced by the White Paper against the modified stand-alone approach which includes a tax adjustment for debt at the holding company level is strong or convincing, though the argument for moving to such an approach is compelling and

simple. The argument is one of just and reasonable rates based on the common sense principal of fairness. Should the Commission include in rates a level for taxes that it knows is greater than the utility's share of the overall tax burden of the consolidated company?

Respectfully submitted,  
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