

operations can offset profits in others for the purpose of determining corporate tax liability. In some cases, consolidated tax reporting has resulted in amounts collected for taxes in a utility's rates exceeding the income taxes the parent actually pays to the taxing authorities. The White Paper identifies and describes some alternatives to the current policy for the treatment of income taxes in utility rate and tax filings, and also discusses the implications of those options.

Specifically, the White Paper identifies the following five alternatives for the treatment of income taxes:

1. Stand-Alone Method. This is the current method being used for ratemaking. This method calculates taxes based on the regulated revenues and operating costs of the utility itself, without regard to the utility's unregulated activities or the operations of its parent and other affiliated companies. As discussed above, it treats income taxes in the same manner as most other utility revenues and expenses. Ratemaking income taxes are related to the normalized and adjusted test period results of regulated operations, and actual taxes paid subsequently are not trued up to rate case tax expense. This method does not reflect any benefits or detriments of consolidated tax filings.
2. Annual Full True Up Method. This method requires an annual *full* true up of income taxes through a surcharge or refund for the difference between the amount of income taxes in customer rates and the amount of income taxes actually paid. Under this option, taxes in customer rates more closely match actual taxes paid. However, a very significant downside of this method is that it would violate the IRS normalization requirement, and the company would be unable to utilize accelerated depreciation for tax return purposes. If this occurred, the IRS would require any accumulated deferred taxes to be immediately payable.
3. Annual Partial True Up Method. This method is very similar to Option 2, since the difference between the amount of income taxes included in the utility's rates and the amount actually paid is trued up. However, as opposed to Option 2, the effect of accelerated deductions would be excluded from the taxes paid amount. This would avoid violating the normalization requirement.
4. Require Utilities to Reflect Consolidated Income Tax Effects in Rates. This method would require that income taxes for ratemaking be calculated using the parent company's effective tax rate or an allocation of its projected or actual tax savings (except for accelerated deductions that the IRS has ruled cannot be used in customer's rates). Such an approach would more closely align taxes included in a utility's revenue requirement with taxes expected to be paid by the consolidated entity. Using this method could increase or reduce the utility's income taxes for ratemaking and raise or lower customer rates.

- 5 Require Regulated Utilities to File Separate (Deconsolidated) State Income Tax Returns. Under this option, state legislation could require deconsolidation of state income taxes, so that the regulated utility files Oregon income taxes separately from the parent company and subsidiaries. This would result in Oregon income taxes collected through rates more closely matching actual taxes paid. There would still be some differences caused by the utilities non-regulated operations, as well as the inability to capture accelerated deductions that the IRS does not allow to be passed through rates. However, the impact would be only at the state level, as the IRS would still allow a group of affiliated companies to file a consolidated federal income tax return. This option would also require a change in state law.

II. NW Natural's Comments

1. Stand-Alone Method. NW Natural endorses the Commission's continued use of the stand-alone method for income tax treatment. This is the method that most other regulatory jurisdictions use for ratemaking. It treats income taxes in the same manner as most other utility revenues and expenses and is consistent with standard ratemaking principles under which regulated costs should not be affected by results from non-regulated operations. From a tax standpoint, this method is desirable because it does not violate normalization requirements, and it preserves the use of deferred income taxes as a component of rate base financing.

For the reasons discussed below, NW Natural does not support the Commission's adoption or use of the other alternatives discussed in the White Paper.

2. Annual Full True Up Method. NW Natural is strongly opposed to the Commission's adoption of this option. The option is undesirable from a tax standpoint because it would create a normalization violation. Utilities, such as NW Natural would lose their ability to take accelerated depreciation deductions. With such a violation, the IRS would require accumulated deferred taxes to be immediately payable. The consequences of that would be a financing requirement for the utility company to fund the payment and an immediate rate case. Customer

rates would increase from losing the benefit of accumulated deferred income taxes as a reduction to rate base. The use of this method would also require utility companies to reserve some amount as a contingency for taxes since the final determination of taxes paid and applicable taxes recovered in rates would be unknown for several months following the close of the fiscal year.

3. Annual Partial True Up Method. This option is similar to Option 2, although it is less onerous for utilities because it does not result in a normalization violation. It would achieve the objective of a better matching of taxes collected from customers with the utility's actual taxes. However, the most significant hurdle associated with this option is the determination of the taxes collected in rates that are appropriate to compare against actual tax payments. The tax level identified in a test year for a rate case is no longer valid once new customers have been added and new investment has been made and inflation has occurred, and other taxable income effects arise as well over time. For NW Natural, the use of this option would not have a large impact since the most significant difference between taxes paid and tax expense collected is related to accelerated depreciation for tax purposes. As with Option 2, the use of this method would require companies to reserve some amount as a contingency for taxes since the determination of taxes paid and taxes recovered in rates would be unknown for several months following the close of the fiscal year. Because of the significant burden of administering the use of the option and the expected slight impact of its use, NW Natural opposes the Annual Partial True Up Method.

4. Require Utilities to Reflect Consolidated Income Tax Effects in Rates. NW Natural also opposes this option for treating income taxes. This method's intention is to capture the effects of the parent's consolidated taxes for utility customers. Depending on the tax situation of the consolidated entity, this method could result in higher or lower taxes than the stand-alone method, and higher or lower customer rates. If the method is not appropriately designed, however, there is a possibility that the normalization requirements could be violated. The arguments against the use of this option that are identified in the White Paper are compelling. In addition, the use of this option could motivate companies to avoid otherwise beneficial non-utility projects, and companies would tend toward becoming the stand-alone entity anyway, with no rate benefit or difference from the current state.

5. Require Regulated Utilities to File Separate (Deconsolidated) State Income Tax Returns. From a tax perspective, deconsolidation is generally not desirable. It would increase a company's compliance burden, by requiring it to file separate state returns for each of its subsidiaries. In addition, the benefits of consolidation (i.e., offsetting income and losses of members of the same affiliated group) would be lost. Because the treatment of federal taxes for ratemaking would not be changed, the use of this option would only provide limited matching of expenses and payments.

III. Conclusion

For the reasons discussed above, NW Natural urges the Commission to continue the use of the stand-alone method for calculating the amount of income taxes to be incorporated into a regulated utility's rates. The four alternative options to this method that are identified in the

White Paper either yield very little additional benefits over the current method or, among other things, would be more problematic to implement as they would require legislative changes, would result in utility normalization violations, involve greater administration, and/or reserves to be maintained. While NW Natural would not be as impacted by a change from the traditional method as would some of the other regulated utility companies in Oregon, it does not believe that the White Paper's discussion of the advantages of any of the alternatives provides a compelling reason to depart from the stand-alone method.

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Respectfully submitted,

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