

February 16, 2005

Public Utility Commission of Oregon
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Attn: Lee Sparling
Director of Utility Programs

RE: Comments on Staff White Paper on Income Taxes and Utility Ratemaking

Thank you for the opportunity to comment on Staff's white paper on ratemaking for income taxes. Staff has conducted a thorough review of the state's policy for determining utility income taxes as part of the ratemaking process in response to the request from the Oregon Legislature's Revenue Committee – amidst questions from the public about how utility income taxes are assessed and collected. We believe the white paper is a cogent and detailed assessment of the state's policy on this matter.

The purpose of our comments here is to provide some specific feedback for Staff's consideration as it seeks input on the first public draft of this white paper.

Overall, Staff does a good job of noting the legal requirements around ratemaking, both in statutory and constitutional contexts. Specifically, statutory and constitutional requirements give the Commission great discretion to set rates, as long as the end result is reasonable in terms of the opportunity for a return provided to investors and in terms of the overall rates established for customers. There are few (albeit some) restrictions on what the Commission can do in this matter. However, another important consideration is that both utility customers and utility investors must have confidence in the system of regulation. To gain confidence in the process requires that the Commission's methodologies should be internally consistent and not arbitrary. They should be predictable and easy to understand. The stand-alone practice meets all of these criteria; alternatively, using the tax deduction for interest at a holding company or the tax effects of losses in an affiliate would not.

A second advantage of the stand-alone methodology is that it results in an internally consistent after-tax cost of capital. All of the assumptions belong together: capital structure, cost of each component of capital, and related taxes. The taxes will not relate, however, if they include the deductibility of interest cost that the utility does not bear or losses on enterprises for which customers bear none of the costs and have none of the revenue included in the revenue requirement formula. To focus on the first instance – interest costs customers don't bear but interest deductions they receive – only rarely would the cost of capital for the entity whose tax deductions are being “imputed” for

ratemaking purposes be the same as the cost of capital for the utility. We analyzed this for Oregon Electric in UM 1121, and we found that Oregon Electric's cost of capital (both debt and equity) would be higher than PGE's. The Commission could achieve regulatory consistency in these cases by using the holding company's full after-tax cost of capital or the affiliate's costs and revenues for ratemaking purposes. Even this step would not likely promote confidence, however, among either customers or utility investors. Customers would dislike any cost-increasing effects of such consistent methodologies. Investors would dislike the added complication of considering holding company or affiliate operations and costs in evaluating whether any change of rates was necessary. Rate cases would be much more complicated, displeasing both customers and investors.

In review of the descriptions of potential true-up options, we want to emphasize that a true up to actual utility stand-alone taxes is an extremely contrary measure. That is because taxes dampen the effects of either good or poor financial results for the utility, depending on the variances between ratemaking assumptions and actual events. It doesn't make sense that customers would pay more taxes when earnings are up or receive the tax benefit of an increased cost that they did not pay for. Also, the Commission would not want to do anything that would lose tax benefits that flow to utility customers, whether such benefits flow over time or immediately. A benefit is a benefit.

In summary, this draft white paper outlines how the state has a good regulatory policy in place for utility income taxes and ratemaking that benefits customers directly and indirectly. Alternatively, poor regulatory policy in this regard can harm customers, both directly by weakening confidence in the regulatory system and indirectly through the loss of investor confidence, which in turn, increases the cost of capital.

We very much appreciate the opportunity to comment on this important matter, and thank Staff for preparing this white paper that gets to the heart of the issues and carefully considers the existing system in context with other models.

Sincerely,

Randy Dahlgren
Director, Regulatory Policy & Affairs

cc: Pamela Lesh