

February 16, 2005

Oregon Public Utility Commission
P.O. Box 2148
Salem, OR 97308-2148

Re: OPUC Staff White Paper on Utility Taxes

To the Commissioners:

Sprint appreciates the opportunity to provide comments on the Staff's white paper entitled "Treatment of Income Taxes in Utility Ratemaking." We commend staff on their excellent work in explaining how taxes are currently computed for ratemaking and the repercussions of moving to methods that would reflect the taxes utilities actually pay on a consolidated return basis.

Sprint firmly believes that the Oregon Public Utility Commission (OPUC) should continue to treat taxes on a stand-alone basis rather than attempt to reflect "actual taxes paid" by Corporations that file tax returns on a consolidated basis. The idea of setting regulated utility rates that reflect actual taxes paid by utility corporations may sound logical, but in fact it would violate basic tenets of accounting and ratemaking principles. These principles ensure that rates are stable and designed to cover proper cost levels, and prevent cross-subsidization with non-regulated operations. Likewise, it would be imprudent, if not illegal, for the Oregon Public Utility Commission to attempt to require regulated utilities to file deconsolidated state income taxes. Such action could result in higher costs for utilities and ratepayers, less income for the state, and would disadvantage utilities relative to other corporations. Moreover, requiring utilities to file deconsolidated tax returns, or forcing utilities to give up their ability to use accelerated depreciation would constitute unequal treatment under the law and would be unconstitutional.

Background

The notion that utility rates should reflect actual taxes paid by utility corporations may stem from the faulty premise that utility rates are based on actual costs. In fact, that is not the case. Regulated utilities are not guaranteed a fair rate of return on investment, but merely the opportunity to earn a fair rate of return based on what regulators consider a reasonable rate base and prudent expenses that are reflective of the period during which rates will be in effect. What this means is that there is a certain amount of negotiation between regulated utilities and Commission staff in preparing a test year income statement. Even though the test year may begin with actual expenses incurred by the company at a point in time (usually the most current year-end), Commission staff may make many adjustments to arrive at what they consider to be a reasonable approximation of the level of expense that the utility will incur over the prospective rate

period. For instance, especially large expenditures may be reduced to better reflect ongoing expense levels. Any significant out-of-period expenses are likewise removed. Each of these adjustments to revenues and expenses necessitates the recalculation of taxes in order to approximate the tax the regulated utility would incur in a representative period. Thus the resulting income statement is hypothetical, and there can be no economic rationale for using hypothetical revenues and expenses and actual taxes paid.

We will begin our discussion with Proposal 4 since Proposal 1 represents the status quo, which we support, and 2 and 3 are variations of Proposal 4.

PROPOSAL 4 – REQUIRE UTILITIES TO REFLECT CONSOLIDATED INCOME TAX EFFECT IN RATES

I. Adjusting Taxes to Reflect Consolidated Returns would be Inconsistent with Accounting Principles and Would Violate Laws Concerning Cross-Subsidization.

The current treatment of taxes for regulated rate-making is in accordance with strict accounting and public policy principles that prohibit cross-subsidies between regulated and deregulated services. For regulated rate-making purposes, a test-year income statement is prepared based on a given accounting period, typically the most recent year-end results. Principles of accounting dictate that expenses must be matched with the related revenues earned during the period, using an accrual method, in order to assess accurately whether a profit or a loss occurred within that period. Likewise, when analyzing the profitability of a given service, only those expenses that correspond to the revenue stream for the service under analysis should be included in the income statement for that particular service. This way the analyst can accurately determine whether rates cover costs. Expenses that cannot be directly related to a particular service but are shared over several services, such as general administrative costs, are allocated to services based upon FCC rules that follow the principle of cost causation. The accounting principle of consistency is followed from one period to another so that valid comparisons can be made over time. Variations in these basic accounting methods are only made if the FCC and OPUC adopt new rules on cost allocation, or if the Financial Accounting Standards Board (FASB) and OPUC adopt new accounting rules.

It would be a radical departure from these generally accepted accounting principles to impute taxes to regulated services that relate to other unregulated services or deregulated operating entities. For example, if a corporation were to pay no taxes on a consolidated basis due to losses on deregulated businesses that fully offset income from regulated operations, it would be inappropriate to attribute no tax expense to regulated operations for ratemaking purposes. Conversely, if the corporation's unregulated businesses gave rise to high taxes they should not be imputed into the rates of regulated operations. Not only would this practice violate all of the accounting rules regarding matching and consistency, but it would constitute cross-subsidization which is very poor public policy (as explained in Attachment B to the white paper). Why should utility ratepayers subsidize unregulated, and presumably competitive, services? Likewise, why should unregulated competitive services be saddled with the burden of having to subsidize non-regulated utility services? Certainly any such requirement would put the unregulated company at a competitive disadvantage vis a vis its competitors that have no regulated affiliates.

Moreover, we agree with the authors of the white paper that setting rates based on the results of non-utility operations could result in confiscatory rates that are unlawful under ORS 756.040.

PROPOSAL 2- REQUIRE AN ANNUAL FULL TRUE UP OF INCOME TAXES COLLECTED FROM CUSTOMERS AND ACTUAL TAX LIABILITY RELATED TO UTILITY OPERATIONS

It is clear from the white paper that this approach is highly inadvisable. The approach would violate Internal Revenue Code (IRC) normalization requirements, and the utility would lose its ability to use accelerated depreciation. Such action would constitute unequal treatment under the law and would be unconstitutional. It would also raise the utility's costs and consequently result in increased utility rates for customers. As noted by the OPUC staff, the cost increase would result because companies would no longer have an interest-free loan available; consequently they would need to raise additional capital, and customer would lose the benefit of accumulated deferred income taxes as a reduction to rate base. Additionally, regulatory costs would increase because any unusual conditions resulting in the need to "true-up" taxes would lead to a rate-case proceeding. This method would violate accounting principles by mismatching income taxes and the other costs and revenues used for ratemaking purposes. The reason the Commission uses normalization today is that it follows the GAAP matching principle by matching the tax benefit over the life of the asset that gave rise to the benefit.

The proposal would create more risk for ratepayers and lead to instability in customer rates as described in the white paper. Utility customers would be affected by profit and loss attributable to the parent's other subsidiaries, including unregulated, competitive activities that may be much more risky than regulated utility operations.

PROPOSAL 3 - REQUIRE AN ANNUAL PARTIAL TRUE-UP OF INCOME TAXES COLLECTED FROM CUSTOMERS AND ACTUAL TAX LIABILITY RELATED TO UTILITY OPERATIONS

Proposal 3 suffers from all the infirmities that plague Proposal 2 except that it would not violate IRC normalization and companies would not lose their ability to use accelerated depreciation. As such, the potential impact of higher rates is lessened, but like Proposal 2, rates would be subject to more risk and fluctuation than today. Additionally, income taxes would be inconsistent with the revenue and expenses used for ratemaking in violation of standard accounting and ratemaking principles.

PROPOSAL 5 REQUIRE UTILITIES TO FILE OREGON TAXES ON A DECONSOLIDATED BASIS, SO THEY PAY STAND-ALONE TAXES DIRECTLY TO THE TAXING AUTHORITY

As explained in the white paper, this proposal is really not an option since the state cannot require deconsolidation for federal income taxes. Additionally, as the white paper further explains, doing so could mean less income for Oregon:

[O]ur understanding from the Department of Revenue is that Oregon tax collections are more likely to be higher under the current requirement of consolidated reporting. This is because corporations often set up affiliates in no tax or low tax states to provide services to the instate corporation. Without

consolidated tax filings, the income from those transactions would move to the other states, and the Oregon corporation would claim the expense as a tax deduction.

Therefore, adopting this proposal could result in economic harm to Oregon.

To summarize, the Commission's treatment of taxes in the development of regulated rates is based on sound accounting and public policy standards. Modifying these methods in an attempt to capture for ratepayers the "benefits" that utility Corporations receive by filing consolidated tax returns would be improper, if not illegal, and could very well have unintended negative consequences for ratepayers, utilities, taxpayers, and the State of Oregon. For these reasons we strongly urge the Legislature and Commission to maintain the status quo.

Should there be any questions, please contact me at (541) 387-9265 or by e-mail at nancy.judy@mail.sprint.com.

Sincerely,

Nancy L. Judy