



Oregon

Theodore R. Kulongoski, Governor

Public Utility Commission

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March 22, 2005

TO: Sen. Ryan Deckert, Chair, Senate Revenue Committee
Sen. Rick Metsger, Chair, Senate Business & Economic Development Committee

RE: Recommendation on treatment of utility income taxes

SUMMARY:

We recommend three changes in Oregon law to better match taxes collected and taxes paid by regulated utilities:

1. Require regulated utilities to file stand-alone (deconsolidated) income tax returns in Oregon.
2. Direct the Commission to consider consolidated tax benefits when it includes federal income taxes in customer rates.
3. Require regulated utilities to file a general rate case at least once every five years.

DISCUSSION:

Last month, we provided you a staff "white paper" discussing options for the treatment of income taxes in utility ratemaking. Since that time, we have obtained a legal review of the options from the Department of Justice, invited written comments on the white paper and legal memorandum, and held a public workshop to discuss the issues with interested parties. The legal memorandum and all the written comments we received are attached.

Today, we set a utility's rates on a stand-alone basis. The income taxes included in rates are based on the revenues and costs of the utility's regulated service. Customer rates do not include income taxes related to the utility's unregulated activities. Rates do not reflect the operations of the utility's parent or other affiliated companies.

Use of the stand-alone approach is long-standing regulatory practice in Oregon and in most other states. It protects utility customers from bearing the costs of other businesses run by the parent and affiliates. However, we recognize that it is widely perceived as unfair that taxes collected in utility rates aren't always paid to the taxing authorities.

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Most of the concern raised about the mismatch between taxes collected and taxes paid is directed at the effect of consolidated tax filing. When the utility's parent files taxes on a consolidated basis, losses in other, unregulated operations can offset the utility's taxable income and reduce the parent's overall tax liability.

OBJECTIVES:

In considering these issues and developing our recommendations, we focused on three objectives. First, better match taxes collected from customers with taxes paid to government. Second, get taxes collected paid to government. And third, conform to federal tax requirements and related case law.

RECOMMENDATIONS:

Based on our review, we recommend three changes in Oregon law to address consolidated tax filing.

1. Require regulated utilities to file stand-alone (deconsolidated) income tax returns in Oregon

Right now, if a utility's parent chooses to file its federal income taxes on a consolidated basis, then it must file its Oregon income taxes on a similar basis. This change would require a utility to file on a stand-alone basis in Oregon, regardless of how the parent files its federal taxes.

This approach would ensure that a utility's state income tax liability will not be offset by losses or other tax deductions in the parent's other businesses. Local jurisdictions like Multnomah County that levy local income taxes based on the state return would also benefit.

Requiring the utilities to file their state income taxes on a stand-alone basis would better match what customers pay for those taxes in their utility rates with what is actually paid to the state. However, the Legislature has no ability to require the companies to file their federal income taxes on a deconsolidated basis.

2. Direct the Commission to consider consolidated tax benefits when it includes federal income taxes in customer rates

This law would direct us to pass through to utility customers certain benefits of a consolidated federal income tax filing by the parent.

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The Department of Justice advises that this approach must meet the following two standards to be consistent with federal case law.

- Benefits follow burdens: Tax benefits from consolidation can be included in the utility's rates only to the extent customers are responsible for the deductible expenses that produced the benefits. The tax effect of losses in one of the parent's other operations could not be included in setting the utility's rates if customers don't have to pay any of the costs that contributed to the losses.
- Symmetry: If the Commission includes the effects of consolidation in utility rates when they produce a benefit, it cannot omit those effects when they happen to increase customer rates.

In order to address the utilities' different circumstances, we would consider the treatment of consolidated tax benefits in general rate cases for each company in the future. We would also need to ensure that any consolidated tax adjustment does not violate Internal Revenue Service (IRS) requirements for tax benefits like accelerated depreciation.

3. Require regulated utilities to file a general rate case at least once every five years.

Currently, a regulated utility is not required to file its rates for Commission review in a general rate case on any regular basis. Some companies have gone as long as ten years without a general rate case. Requiring a regulated utility to file at least every five years would enable the Commission to include any consolidated tax benefits in customer rates using up-to-date information on the parent company's tax situation.

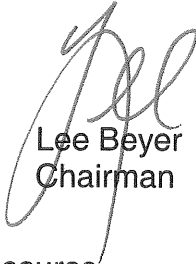
Finally, we do not recommend that the Legislature require a full true up between what is collected for taxes in customer rates and what is actually paid to the taxing authorities. It is not practical. A full true up would violate Internal Revenue Code requirements, and the utilities would lose the ability to use accelerated depreciation. In the white paper, Commission staff estimated that Portland General Electric and PacifiCorp likely would have to immediately re-pay the IRS \$150 million or more each in deferred taxes, and each utility's customers would lose a rate adjustment that saves them \$20-30 million a year.

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We are ready to assist in crafting any legislation you conclude is needed on these matters.



Lee Beyer
Chairman



John Savage
Commissioner



Ray Baum
Commissioner

Enclosures

CC: Senate Revenue and Business & Economic Development Committee Members:
Sen. Charles Starr
Sen. Gary George
Sen. Floyd Prozanski
Sen. Bruce Starr
Sen. Jason Atkinson
Sen. Laurie Monnes Anderson