

Treatment of Income Taxes In Utility Ratemaking

**A White Paper Prepared for
The Oregon Legislative Assembly**

By

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February 2005

Income Taxes and Utility Ratemaking

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Introduction

Most states, including Oregon, use the traditional “stand-alone” method for calculating the amount of income taxes to be incorporated into a regulated utility company’s rates. 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. The “stand-alone” calculation is used so that the taxes in utility rates are based on the costs of providing the regulated utility service.

Federal and state tax laws, however, allow a corporate holding company to file consolidated tax returns reflecting its full span of regulated and unregulated operations. Losses in some corporate operations can offset profits in others for the purpose of determining corporate tax liability. In some instances, 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. Many people believe this result—which occurred during the past several years in the case of Portland General Electric (PGE) and Enron—is inequitable for utility customers.

This paper describes how the Oregon Public Utility Commission (Commission) determines utility income taxes for setting rates and discusses legal and policy implications of options for the treatment of income taxes in utility rate and tax filings. The paper identifies five alternatives for treating income taxes. The options are:

1. Continuing the current stand-alone method for income tax treatment.
2. To reflect “actual taxes paid,” requiring an annual *full* true up of income taxes for the difference between the amount of income taxes in customers’ rates and the amount of income taxes actually paid.
3. Requiring an annual *partial* true up of income taxes, preserving the benefits of accelerated tax deductions.
4. Using the parent company’s effective tax rate or an allocation of its tax benefits resulting from losses or larger deductions, except for accelerated deductions.
5. Requiring regulated utilities to file deconsolidated state income tax returns.

The first four methods address how the Commission sets rates, while the fifth affects how a utility pays its taxes. Legislation may be needed for Options 2-4 to allow the Commission access to corporate tax filings or to consider non-utility operations. Option 5, modifying how utilities file tax returns, would require a change in state tax law.

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Implementation of any change from the current method would need to address whether it would apply to: (a) the six energy utilities the Commission regulates--PGE, PacifiCorp, Idaho Power Company, Avista Utilities, Cascade Natural Gas, and NW Natural; (b) other regulated utilities such as certain telecommunications and water companies; and (c) for a tax filing change, all Oregon corporations. The effect of a change would vary depending on the structure of the utility's corporate entity.

Following is a summary of the pros and cons of each option, followed by a more detailed discussion of these issues.

Ratemaking Options	Pros	Cons	Comments
<p>1. Utility Stand-Alone (Current Method)</p>	<p>Consistent with fundamental principles of basing utility rates on utility costs and revenues, and prohibiting cross-subsidization between utility and non-utility operations.</p> <p>Treats income taxes in same manner as most other utility revenues and expenses: estimated in rate case and not trued up.</p>	<p>Potentially significant differences each year between income taxes in customer rates and what utility or its parent pays in income taxes to federal and state taxing authorities.</p>	<p>Most other regulatory jurisdictions use this approach.</p>
<p>2. Annual Full True Up (True up to (a) utility's payment to parent, or (b) utility's share of parent's payment to taxing authorities)</p>	<p>More closely matches taxes in customer rates with (a) utility's payment to parent, or (b) its share of actual taxes paid by parent.</p>	<p>Violates IRC normalization requirements and would give up accelerated deduction benefits for utility and customers.</p> <p>Treats taxes differently than most other costs.</p> <p>If truing up to what utility pays parent, difference remains between taxes customers pay and what parent pays to taxing authorities.</p>	<p>Deferral necessary for true up may be allowable under ORS 757.259.</p> <p>True up to utility's share of parent's payment would require allocation method.</p> <p>Customers pay more if utility has high earnings; get refund if it has lower earnings.</p>

Ratemaking Options (continued)	Pros	Cons	Comments
<p>3. Annual Partial True Up</p> <p>(Same as Option 2 except for adjustment to retain benefits of accelerated tax deductions)</p>	<p>Better matches taxes collected from customers with a) utility's payment to parent, or b) its share of taxes paid by parent, than stand-alone method.</p> <p>Preserves benefits of accelerated tax deductions for utility and customers.</p>	<p>Not as close a match as Option 2.</p> <p>Treats taxes differently than most other costs.</p> <p>Necessary data may not be available from tax filings to calculate and exclude effects of accelerated tax deductions.</p>	<p>Deferral necessary for true up may be allowable under ORS 757.259.</p> <p>Customers pay more if utility has high earnings; get refund if it has low earnings.</p> <p>True up to utility payment to parent would use data already available.</p>
<p>4. Use Modified Consolidated Tax Rate or Savings</p>	<p>Captures effects of parent's consolidated taxes for utility customers.</p>	<p>Unclear whether tax data available in necessary detail.</p> <p>Tax rate would reflect costs and risks not related to providing utility service.</p> <p>Using results of non-utility operations may be illegal.</p>	<p>Method would have to be designed to avoid violating IRC normalization requirements and giving customers benefits of accelerated deductions on parent's other operations.</p>

Tax filing Option	Pros	Cons	Comments
<p>5. Require separate (deconsolidated) tax filings for regulated utilities</p>	<p>Ensures utility's tax liability (on combined regulated and unregulated operations) is actually paid to state.</p>	<p>Still potential difference between income taxes in customer rates and what utility or its parent pays in income taxes.</p> <p>State impact only; cannot require deconsolidation for federal tax filings.</p> <p>May be unconstitutional: unequal treatment of utilities from other corporations.</p> <p>Potential to shift tax payments from Oregon to other states.</p>	<p>Requires state legislation.</p>

Why Actual Taxes Paid May Not Equal Taxes Collected Through Rates

The Commission traditionally has calculated income taxes to be included in customers' rates based on the utility's stand-alone results in a rate case. The Commission calculates the amount of revenues the utility needs to collect in order to provide adequate service and earn a reasonable return on its investments.² That amount of revenues, called the utility's "revenue requirement," is determined during a rate case investigation in which the Commission estimates the utility's costs for a 12-month "test year." Costs include reasonable, ongoing expenses such as employee compensation, fuel costs, depreciation, and taxes. Costs also include a return on rate base, the net book value (not the market value) of the assets or investments used to provide utility service.³

In determining a utility's revenue requirement, the Commission establishes rates that provide the company an opportunity—*not a guarantee*—to recover its reasonable costs of providing utility service and earn its authorized rate of return on investments. That is, customers' rates are based on estimates of what costs the utility will incur to provide service when the new rates are in effect. It is virtually certain that actual revenues and costs will turn out to be different than the levels estimated for setting the rates. However, it is assumed that changing expenses and revenues will balance out between rate cases. It may be several years before the utility or another party files to reset rates to reflect new levels of revenues and costs. With few exceptions, rates are not adjusted "after the fact" to true up for the revenues and costs that actually occurred.⁴

There are three reasons why the income taxes actually paid to the federal and Oregon state taxing authorities are different from the amounts included in the utility's revenue requirement and collected in rates.

1. The utility's actual revenues and costs in any year are almost certain to be different from the estimates used to set rates. Many factors will cause actual results of operations to be different than projected, including weather, customer growth, inflation, and fuel prices. If a utility's costs are lower than the Commission projected, its net income will be higher. So will its income taxes. If the utility's costs are more than the

² ORS 756.040 states: "The commission shall balance the interests of the utility investor and the consumer in establishing fair and reasonable rates. Rates are fair and reasonable for the purposes of this subsection if the rates provide adequate revenue both for operating expenses of the public utility or telecommunications utility and for capital costs of the utility, with a return to the equity holder that is: (a) Commensurate with the return on investments in other enterprises having corresponding risks; and (b) Sufficient to ensure confidence in the financial integrity of the utility, allowing the utility to maintain its credit and attract capital."

³ Net book value is the original amount invested minus accumulated depreciation.

⁴ ORS 757.259 authorizes the Commission, in limited circumstances (for example, "to match appropriately the costs borne by and the benefits received by ratepayers"), to allow utilities to defer revenues or costs for later inclusion in rates.

Commission projected, its net income will be lower and so will its taxes. Taxes, therefore, are related to other costs.

2. All regulated energy utilities in Oregon have taxes set for ratemaking on a stand-alone basis, but each files income taxes on a consolidated basis. What the utility's parent files for income taxes reflects not only the regulated utility's taxable net income, but also the net income of the corporation's other businesses, including the utility's own subsidiaries and unregulated activities. On a consolidated basis, losses by other operations may offset taxable income from the utility's regulated operations and reduce the corporation's overall tax liability.

3. The Internal Revenue Code (IRC) and Oregon law allow businesses certain tax incentives, which cannot be passed through immediately to ratepayers. The most notable example is the timing difference associated with accelerated depreciation on plant investment. For tax filings, utilities calculate income tax liability using accelerated depreciation as a deduction. For book (i.e., regulatory and financial reporting) purposes, businesses must use "straight-line" depreciation to determine depreciation expense and to calculate income taxes. The difference in income taxes calculated using the two methods is the utility's "deferred tax," which represents the utility's tax liability in future periods.

IRC regulations require utilities to use normalization accounting for calculating income taxes in setting rates.⁵ Regulators are prohibited from immediately flowing through to customers, through rates, the higher tax deduction (the amount greater than provided by spreading the tax benefits of depreciation evenly over the life of the asset) from accelerated depreciation.⁶ The result is that, for most depreciable assets, actual taxes paid are lower in the earlier years of an asset's life than is calculated for financial statement and ratemaking purposes. This timing difference turns around in the later years of an asset's life so that book depreciation is greater than accelerated depreciation, and actual tax liability is higher than taxes calculated for ratemaking

⁵ Normalization accounting is a method of allocation used for accounting for timing differences of expenses (such as differences between book and tax depreciation) in the calculation of income taxes. Under normalization, the calculation of the utility's recoverable tax expense uses tax deductions only as the underlying expenditures become recoverable for rate purposes, not the accelerated deductions the IRC allows for tax filings.

⁶ IRC normalization requirements are contained in Internal Revenue Code Section 168(f)(2). The Internal Revenue Service has issued several rulings concluding that capturing accelerated tax deductions for ratemaking would violate normalization requirements. That is, if a utility did not use a normalization method of accounting, the IRS would not allow accelerated deductions for determining taxable income and tax payments.

purposes.⁷ The total tax deduction over the life of the asset is generally the same as for the financial statement and the ratemaking calculation.

While the utility enjoys, courtesy of the tax code, the “interest-free loan” from accelerated depreciation in the early years of the utility’s investment, customers benefit because the tax that customers pay earlier than the utility is subtracted from the utility’s rate base, thereby reducing the amount included in rates for return on investment. The interest free loan may also reduce the utility’s need for capital, which will reduce its projected return on investment and, therefore, its rates.

Attachment A shows a simplified example of current taxes, deferred taxes, and accumulated deferred taxes.

Ratemaking Options

1. Calculate income taxes based on the utility’s stand-alone results.

The first option is for the Commission to continue the current method for setting a utility’s rates. In order to set rates that reflect the costs of providing utility service, the Commission calculates the utility’s revenue requirement using the utility’s own revenues, expenses, and rate base for the given test year. Income taxes are calculated using the utility’s net operating income and debt costs. The tax effects of the utility’s non-regulated operations, as well as the utility’s parent and subsidiaries, are ignored for purposes of setting rates, so that rates reflect only the costs of providing utility service.

This approach is consistent with standard ratemaking principles, under which regulated costs should not be affected by the results from non-regulated operations. As explained in *Accounting for Public Utilities (Attachment B)*, this policy is:

[C]onsistent with a fundamental principle of the cost of service approach to ratemaking; the principle that consumers should bear only costs for which they are responsible. Under this principle, there is a well-reasoned, and widely recognized, postulate that taxes follow the events they give rise to. Thus, if ratepayers are held responsible for costs, they are entitled to the tax benefits associated with the costs. If ratepayers do not bear the costs, they are not entitled to the tax benefits associated with the costs.

⁷ When a utility’s asset (rate) base continues to grow each year, the total accelerated depreciation will continue to exceed book depreciation, but for individual assets, at some point book depreciation will be larger.

Non-utility operations involve financial risks that are different from a utility's regulated operations. When these risks are not borne by the ratepayers, it is unfair to make use of the business losses generated in those nonregulated entities to reduce the utility's cost in determining the rates to be charged for utility services. By the same token, when a company's nonjurisdictional activities are profitable, the ratepayers have no right to share in those profits, but neither are they required to pay any of the income taxes that arise as a result of those profits. Thus, a "stand alone" method (as opposed to a consolidated effective tax rate method) for computing the income tax expense component of cost of service is the proper and equitable method to be followed for ratemaking purposes.

A simplified example of a ratemaking tax calculation is shown in *Attachment C*. Most state regulatory bodies use this stand-alone method for calculating income taxes. We have identified a few states that, as a general policy or in limited situations, set utility rates by taking into account taxable income of the utility's non-regulated affiliates. (See discussion under Option 4.)

The traditional stand-alone calculation of income taxes for ratemaking produces a result that may be significantly different than actual payments to federal and taxing authorities for the reasons already described: (a) actual revenues and costs are different than projected; (b) the benefits of consolidated tax filings are not reflected; and (c) the tax benefits of accelerated deductions cannot be passed through to customers.

2. Require an Annual Full True Up of Income Taxes Collected from Customers and Actual Tax Liability Related to Utility Operations.

The Commission could require utilities to true up, through a surcharge or refund each year, the difference between the amount of income taxes incorporated in rates and the amount of income taxes actually paid relating to the regulated utility's operations. A true up *may be allowable* under ORS 757.259. No changes to the method of tax filing would be required.

"Actual taxes paid" could be defined as either (a) the amount of taxes the utility calculates on a stand-alone basis and pays to its parent, which then files a consolidated return; or (b) the utility's "share" of the parent's actual tax payments to the income taxing authorities. Whichever definition is used, a full true up would closely match the amount of the utility's tax liability with the amount that is ultimately collected from customers.

Under the first definition, the calculation of "actual" taxes would be based on the annual actual financial results for the regulated utility's operations. Each regulated electric and

natural gas utility, for example, files its regulated results of operations with the Commission several months following each calendar (or fiscal) year. These results could be used to “update” and true up from the estimated taxes included in customer rates in the utility’s most recent general rate case.⁸ Rather than using the traditional ratemaking calculation of taxes, however, a full true up approach would calculate taxes including accelerated tax deductions and other differences the utility uses for tax filings.

Under the second definition, a sensible method would need to be adopted for allocating to the regulated utility a portion of the consolidated tax payment. Making the calculation would require Commission access to the details of the corporation’s state and federal tax filings, which the agency currently does not have.⁹

A primary downside of a full true up method is that it would violate IRC normalization requirements, and the utility would lose its ability to use accelerated depreciation. If that occurred, the IRS would likely require the accumulated deferred taxes to be immediately payable. For PGE and PacifiCorp, for example, OPUC staff’s initial estimate is that each utility’s liability ranges from roughly \$150 million to over \$200 million. (The utility’s shareholders would have to make that payment, since customers have already paid those taxes.) This would raise the utility’s costs because the company would no longer have the “interest free loan” available and would need to raise additional capital, possibly at a higher cost. In addition, customer rates also would increase from losing the benefit of accumulated deferred income taxes as a reduction to rate base. The rate impact from the loss of accumulated deferred taxes for Portland General Electric and PacifiCorp’s Oregon customers is likely between \$20 million and \$30 million per year for each utility.

Any true up approach based on actual utility results would have other implications. Income taxes would be treated differently from the utility’s other costs. As explained earlier, utility rates are set based on estimated normal levels of revenues and costs. Requiring a true up of income taxes alone would create a mismatch between the amount of income taxes ultimately included in customers’ rates and the other costs and revenues on which rates are based.

Moreover, an annual true up of income taxes would have the effect of raising or lowering customer rates in a perverse manner. When the utility is experiencing high earnings because its costs are lower or its revenues higher than expected, customers

⁸ Large corporations, such as electric and gas utilities, obtain extensions from the state and federal taxing authorities. As a result, their taxes are not known before October of the year after the tax year. Thus, any true up of taxes would take place at least a year following the year of service.

⁹ ORS 314.835 generally prohibits the Department of Revenue from divulging particulars of tax returns and reports. ORS 314.840(2)(j) allows the Department of Revenue to disclose and give access to information to a state agency “to whom disclosure or access is given by state law.” State law to date has not given the OPUC those rights.

would end up paying even more. When the utility is experiencing poor earnings and not adequately recovering its costs, customers would get a refund.

Under current ratemaking, the risks of unusual conditions occurring are generally borne by the utility, not customers. True up of income taxes would shift the tax-related benefits and costs of abnormal weather and operating conditions to customers. For example, warm weather can reduce both the demand for and the price of natural gas, thereby lowering an electric utility's fuel costs and increasing its earnings and income taxes. A true up of taxes would cause rates to increase to reflect the higher taxes, even though customers received no benefit from the lower fuel costs since rates are set on a normalized expected basis.

3. Require an Annual Partial True Up of Income Taxes Collected from Customers and Actual Tax Liability Related to Utility Operations.

The Commission could require utilities to implement a partial true up each year. This partial method would true up the difference between the amount of income taxes included in the utility's rates and the amount actually paid, except that the effect of accelerated deductions would be excluded.

If "actual taxes paid" were defined as the utility's stand-alone calculated income taxes paid to its parent, the utility's financial reports submitted each year to the Commission would provide the data needed. The calculation would be done on a ratemaking basis—that is, not using accelerated tax deductions—to avoid violating IRC normalization requirements. Alternatively, "actual taxes paid" could be defined as the utility's share of the parent's payments to taxing authorities. In that case, it is unclear whether the data necessary is available from tax filings; for example, it may not be possible from the filings to determine the difference between accelerated and book tax deductions.

A partial true up approach would have the other effects described above for a full true up: a mismatch of income taxes and the other costs and revenues underlying rates, a shift of risk (with both potential benefits and costs) from the utility to customers, and income tax surcharges or refunds contrary to what would be expected from typical ratemaking treatment.

4. Require Utilities to Reflect Consolidated Income Tax Effects in Rates

The Legislature or the Commission could require that utility 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 recognized in customers' 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, because it would reflect the interest deductions and net operating income of the parent and non-regulated subsidiaries.

There are different ways to capture the benefits of consolidated income tax filings in customer rates. Any calculation would require allocating the benefits among the corporate businesses on a transparent and rational basis. As mentioned above, the Commission would need access to the details of the corporation's state and federal tax filings.

OPUC staff conducted an informal survey of other states' practices for calculating income taxes for setting rates, requesting information where a method other than stand-alone was used. In addition, we contacted several state commissions individually. Based on this review, it appears that most state regulators use the stand-alone method. While we found no states that use an income tax true up approach, a few states use a modified stand-alone approach in rate cases that recognizes tax savings of the consolidated corporation in certain circumstances.¹⁰ 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.

The Pennsylvania PUC, consistent with that state's Supreme Court decisions,¹¹ applies an "actual taxes paid" standard by including a utility's share of consolidated federal tax benefits in setting rates. The PUC uses a Modified Effective Tax Rate Method that takes the consolidated tax savings generated by losses of non-regulated members of the group, and then spreads those savings to all members having positive taxable income.¹² The savings allocated to the regulated utility are included as an adjustment to the federal income taxes included in customer rates. The adjustment is made in a rate case.

In virtually all cases, using the parent's effective tax rate or consolidated tax benefits would reduce the utility's income taxes for ratemaking and, all else equal, lower customer rates. However, there are several arguments against incorporating these benefits in utility income tax ratemaking calculations:

¹⁰ Connecticut, Florida, Indiana, Pennsylvania, Tennessee, Virginia, and West Virginia reported that savings from filing of consolidated returns have been recognized for ratemaking purposes. Vermont recently adopted, for S Corporations, an "effective tax rate" policy that purportedly has not yet been applied.

¹¹ See, e.g., *Barasch v. Pennsylvania Public Utility Commission*, 548 A.2d 1310 (1988).

¹² The calculation excludes the effects of investment tax credits and losses of regulated companies, which reportedly avoids violating the Internal Revenue Code.

- 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.
- Rate stability could be lessened as gains or losses for non-regulated businesses change consolidated tax obligations.
- 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.¹³ 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.
- 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 losses or tax savings from non-regulated affiliates could result in rates that overall are unreasonable.

Tax Filing Option

5. Require utilities to file Oregon taxes on a deconsolidated basis, so they pay stand-alone taxes directly to the taxing authority.

¹³ For example, assume the amount of actual taxes paid was small due to low taxable income for the consolidated entity, and regulators wanted to include those lower taxes in rates. In a ratemaking calculation, under the principle of matching costs and benefits, the low taxable income generating that tax level would be recognized—with the result that rates would be increased to provide the utility an opportunity to earn a reasonable rate of return. Moreover, non-regulated businesses are often riskier than regulated utilities, and those additional risks are borne by their investors, who require a higher return and should receive the corresponding tax savings.

Currently, an affiliated group that elects to file a consolidated federal income tax return, and has members that are unitary, must also file a consolidated Oregon return.¹⁴ State legislation could require deconsolidation for 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 differences caused by the utility's non-regulated operations, as well as the inability to capture accelerated deductions that, as described above, the IRC does not allow to be passed through immediately in rates.

However, a state cannot require deconsolidation for federal income taxes, because the Internal Revenue Code would still allow the group of affiliated companies to file a consolidated federal income tax return.¹⁵

Also, our 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. This would result in a loss of taxable income to Oregon. In a consolidated return, these transactions are eliminated and have no effect on taxable income.

Conclusions

The Commission currently calculates income taxes for utility ratemaking based on the regulated utility's revenues and costs. The actual taxes the utility or its parent pays each year will be different than the ratemaking calculation due to the utility's actual results of operations, as well as the benefits of consolidated tax filings and accelerated deductions.

The Commission and the Legislature can consider options for more closely aligning income taxes included in customers' rates with actual taxes paid. Any changes that entailed calculations based on actual tax filing information would require a change in state law to allow disclosure to the Commission. Several legal and policy considerations may limit the ability to make, or the effectiveness of, changes. These factors include:

- (a) The Internal Revenue Code allows affiliated companies to elect to file federal income taxes on a consolidated basis.

¹⁴ "Unitary" refers to members of an affiliated group engaged in a single trade or business.

¹⁵ The consolidated filing requirements are codified at Internal Revenue Code Sections 1501 through 1505.

- (b) The Internal Revenue Code requires utilities to use normalization accounting for calculating income taxes for ratemaking; violating that requirement would result in the loss of the benefits to utilities and their customers of accelerated deductions for tax filings.
- (c) Standard ratemaking principles prohibit cross-subsidization between utility and non-utility operations. As a result, most states calculate utility income taxes for ratemaking on a stand-alone utility basis.
- (d) Including the effect of non-utility operations in utility tax calculations for ratemaking could be determined to result in confiscatory and unlawful rates.
- (e) True up of taxes to actual payments would result in a shift of risk to utility customers, and the potential for cost increases as well as cost decreases.
- (f) Any change may affect more than just the six electric and gas utilities in Oregon.

ATTACHMENT A

Example of Accelerated Depreciation Effects on Income Taxes for Ratemaking

Assumptions*

- Original Cost of Asset: \$10,000
- Book and tax depreciable basis are equal.
- Book and tax lives are both 10 years
- Zero net salvage value
- Composite (state and federal) tax rate is 39 percent
- Asset in service at beginning of year 1

	Straight			Effect on	Provision for		Accumulated
	Line	Accelerated	Current	Taxable	Deferred	Book	Deferred
Year	Depreciation	Depreciation	Tax	Income	Taxes	Tax	Tax
	(a)	(b)	(c) = -(b)*.39	(d) = (a)-(b)	(e) = -(d)*.39	(f) = (c)+(e) or, -(a)*.39	(g) = sum(e)
1	1,000	2,000	(780)	(1,000)	390	(390)	390
2	1,000	1,600	(624)	(600)	234	(390)	624
3	1,000	1,280	(499)	(280)	109	(390)	733
4	1,000	1,024	(399)	(24)	9	(390)	743
5	1,000	819	(319)	181	(71)	(390)	672
6	1,000	655	(255)	345	(135)	(390)	537
7	1,000	656	(256)	344	(134)	(390)	403
8	1,000	655	(255)	345	(135)	(390)	269
9	1,000	656	(256)	344	(134)	(390)	135
10	1,000	655	(255)	345	(135)	(390)	-
	10,000	10,000	(3,900)	-0-	-0-	(3,900)	4,506

* Note: Assumptions and analysis for illustrative purposes.

Income tax deduction for customers' rates (book tax) based on straight-line depreciation.
 Income tax deduction for utility's tax filings (current tax) based on accelerated depreciation.
 Over the life of the asset, the tax deduction is the same.
 During the life of the asset, customers receive the value of the accumulated deferred taxes
 as a reduction to rate base and required return.

ATTACHMENT B

**Excerpts from
Accounting for Public Utilities
Matthew Bender & Company, Inc.
Publication 016, Release 21, October 2004**

Section 7.08[3]:

“It is not uncommon for a regulated utility to have subsidiary operations that produce tax losses which, on a consolidated tax return, offset taxable income from utility operations. . . The only approach that is consistent with standard ratemaking principles that prohibit cross-subsidization between utility and non-utility activities is to put the regulated operations on a ‘stand-alone’ basis and to assign the full tax burden to the taxable gain source and a tax benefit to the tax loss source. The basic theory is that the regulated costs should not be affected by the results from nonregulated operations.”

Section 17.04[2]:

“Income tax normalization is consistent with a fundamental principle of the cost of service approach to ratemaking; the principle that consumers should bear only costs for which they are responsible. Under this principle, there is a well-reasoned, and widely recognized, postulate that taxes follow the events they give rise to. Thus, if ratepayers are held responsible for costs, they are entitled to the tax benefits associated with the costs. If ratepayers do not bear the costs, they are not entitled to the tax benefits associated with the costs.

“Regulators have long used a ratemaking procedure that explicitly embraces this principle. The procedure is to identify utility activities (revenues and costs) and compute taxes directly related to the utility activities.

“Non-utility operations involve financial risks that are different from a utility’s regulated operations. When these risks are not borne by the ratepayers, it is unfair to make use of the business losses generated in those nonregulated entities to reduce the utility’s cost in determining the rates to be charged for utility services. By the same token, when a company’s nonjurisdictional activities are profitable, the ratepayers have no right to share in those profits, but neither are they required to pay any of the income taxes that arise as a result of those profits. Thus, a “stand alone” method (as opposed to a consolidated effective tax rate method) for computing the income tax expense component of cost of service is the proper and equitable method to be followed for ratemaking purposes.”

ATTACHMENT C

**STAND-ALONE METHOD OF CALCULATING INCOME TAXES
Simplified Example**

Income taxes included in rates are calculated based on the revenues, expenses and rate base the Commission determines are adequate to provide the utility an opportunity to earn a reasonable rate of return.

Simplified example of a ratemaking tax calculation:

\$521,190	Rate Base
8.0%	Reasonable Rate of Return
\$ 41,695	Required Net Operating Income (\$521,190 multiplied by 8.0%)
\$360,897	Operating Revenues
-232,942	Book Expenses other than Depreciation
- 35,583	Book Depreciation
<u>- 23,693</u>	Interest Expense (Rate Base multiplied by weighted cost of debt)
\$ 68,679	Regular Taxable Income
4,533	State Income Tax (\$68,679 multiplied by 6.6% Oregon SIT rate)
<u>22,451</u>	Federal Income Tax (\$68,679 minus 4,533, multiplied by 35% FIT rate)
\$ 41,695	Net Operating Income

The calculation above shows “book” taxes used for ratemaking purposes. For “tax” (filing) purposes, IRC and Oregon regulations allow for certain timing and other differences from the book tax computation in calculating taxable income and current tax liability. The taxes related to these timing differences are called “deferred taxes.” Book and ratemaking tax expense includes both current taxes and deferred taxes. The calculation of both federal and state taxes also includes tax credits, as applicable.