Q. Please state your name, business address and present position with PacifiCorp (the Company).

A. My name is Larry O. Martin. My business address is PacifiCorp, 825 N.E. Multnomah, Portland, Oregon 97232, Suite 1900. My present position is Tax Director.

Qualifications

Q. Please briefly describe your education and business experience.

A. I hold Bachelor of Science in Accountancy and Master of Accountancy in Taxation degrees. I have been a Certified Public Accountant since 1987. My business experience includes over five years with the public accounting firm Ernst & Young (f/k/a Ernst & Whinney); ten years as the senior tax executive with JELD-WEN, Inc., a privately-held multi-national manufacturing firm; and over four years as Director of Tax with PacifiCorp. My experience includes all areas of U.S. corporate income taxation including mergers and acquisitions, tax controversy and issues resolution, compliance, planning, financial accounting and reporting for taxes; and property, sales and use, and international taxes.

Q Have you previously testified before this Commission?

A. I filed direct and rebuttal testimony in Docket No. 03-2035-03. In addition, I appeared before the Wyoming and Washington state commissions and have previously been involved in proceedings before the SEC and IRS.

Q. Please describe your present duties.

A. I am responsible for all aspects of the Company’s income tax function including: compliance, accounting, financial and management reporting, issues resolution, and planning.

Purpose of Testimony

Q. What is the purpose of your testimony?

A. I provide testimony in response to the direct testimony of:

- Ronald J. Binz submitted on behalf of AARP;
- Michael L. Arndt and Donna DeRonne submitted on behalf of Committee of Consumer Services (CCS);
- Mary H. Cleveland and David T. Thomson submitted on behalf of Division of Public Utilities (DPU);
- Richard M. Anderson submitted on behalf of Utah Association of Energy Users (UAE); and
- Maurice Brubaker submitted on behalf of Utah Industrial Energy Consumers (UIEC).

Collectively, the intervening parties ("Intervenor" or "Intervenors").

My rebuttal testimony supports recovery of the Company's income tax expense during the test period in this case, computed on a stand-alone basis; and will specifically address the correct regulatory tax treatment for bonus depreciation, the production activity deduction, tax advisory costs, avoided costs, and consolidated tax adjustments raised in Intervenors' pre-filed direct testimony.

Q. Please outline your testimony.

A. My rebuttal testimony first discusses the various proposed tax adjustments to regulatory taxes associated with the consolidated income tax return. Although several different parties have proposed consolidated tax adjustments, each of the four witnesses sponsoring testimony on this issue is proposing a different type of adjustment. For the reasons described in detail below, all of the proposed adjustments are flawed, inconsistent with past commission treatment of the issue and with sound regulatory principles, expose ratepayers to volatile costs and risks and should be rejected. The next part of my testimony addresses issues raised by Ms. Deronne and Mr. Thomson related to bonus depreciation, followed by a discussion of the production activity deduction, tax advisory costs, and the avoided costs M-1.

Consolidated Tax Adjustments

Q. Could you summarize the various consolidated tax adjustments proposed by the Intervenors in this proceeding?

A. Yes. Mr. Binz proposes sharing of consolidated tax benefits based upon an allocation of the tax benefits of losses to gain companies. Mr. Arndt proposes an adjustment based upon an assertion that because of the existence of consolidated "income tax savings", a stand-alone income tax calculation creates phantom income taxes, the payment of which results in an unfair subsidization of non-regulated companies and violates the merger order. While Mr. Brubaker asserts that he is calculating taxes for regulatory purposes on a stand-alone basis with one exception related to interest deductions at PacifiCorp's parent company, Pacificorp Holdings, Inc. (PHI), this is a distinction without any difference. He too proposes an adjustment based on taxes calculated on a consolidated basis. Finally, Dr. Anderson proposes a consolidated tax adjustment because he asserts that the largest benefit Scottish Power brought to the Scottish Power/PacifiCorp merger was the tax benefit. He asserts Utah ratepayers should receive this tax benefit because, he argues, Utah ratepayers lost the opportunity to merge with a better merger partner.

Q. What are the key issues facing the Commission in its determination of the consolidated tax adjustments issue?

A. Although the witnesses have taken several different approaches to their proposed adjustments, there are many technical tax rules, and voluminous testimony, the issue before the Commission is fairly straightforward. None of the consolidated tax adjustment proposals should be adopted because they are inequitable and run counter to long-standing regulatory precedent and past treatment by this Commission. Precedent and past treatment have been adopted to avoid precisely these types of adjustments, which break down the separation of regulated and non-regulated operations, commonly referred to as "ring fencing, which our state commissions have historically and strenuously maintained in an effort to protect ratepayers. All of the proposed adjustments have at least one consistent key element. All of the proposals seek to take the tax benefit from affiliated companies that are associated with losses which have never been paid for by ratepayers, without taking any of the corresponding expenses and risks. This overreaching is particularly egregious in that all of the proposals seek to take the tax benefit associated with the loan that was used to buy the very goodwill that has been specifically ordered to be excluded from rate base by this Commission. Irrespective of the basis for the proposals, they subject the ratepayers to unacceptable risks of future liabilities and volatile rates. The proposed adjustments would confiscate a non-regulated asset without compensation, while excluding the underlying causal cost from rate base.

Q. Do you agree with the basis for Dr. Anderson's proposal?

A. No. Other significant merger benefits were realized. This issue is addressed in the testimony of Don Furman.

Q. Do you concur with the testimony of Mr. Arndt that the ownership structure of the Company leads to unfair subsidization of unregulated companies and that there are "phantom taxes" due to consolidated income tax savings?

A. No. In fact, the ownership structure of the Company, consolidated tax filings and accounting, and "ring fence" regulatory provisions combine to actually ensure that cross-subsidization of non-regulated entities does not occur.

Q. By way of background, will you please describe a consolidated tax return?

A. Yes. The Internal Revenue Code (IRC) allows affiliated groups of corporations to file consolidated income tax returns on a combined basis rather than requiring each business to file a separate return. In the case of PacifiCorp, the Company normally "contributes" income to the consolidated group for which it pays its appropriate share of taxes. Fiscal year ended March 31, 2002 is an example of a year when PacifiCorp, on a stand-alone basis, incurred a taxable loss and did not contribute income to the consolidated group. It is important to understand that PacifiCorp's taxable income is computed and reported to the IRS on a separate company basis. This separate company computation is not based upon hypothetical taxable income, but rather is based upon the Company's actual stand-alone taxable income. The consolidated entity then adds together the taxable income of each company participating in the return and makes limited adjustments at the consolidated level to calculate the taxes owing the federal government.

Q. Is it common for companies that are eligible to file a consolidated return to elect to do so?

A. Yes. Although filing a consolidated return is "elected" under the IRC, in fact, if corporations meet certain ownership thresholds, the IRS will impose certain limitations on the group irrespective of whether the corporation elects to join in a consolidated tax return. In other words, while the election is voluntary, if the group of corporations chooses not to file a consolidated return, the IRS will nevertheless impose some limitations as if they did. Moreover, many states, including Utah, require "unitary" entities such as PHI to file a consolidated or combined return. Many utilities that are part of a larger holding company system participate in consolidated returns.

Q. What are other reasons that companies participate in consolidated returns?

A. A key reason entities choose to participate in the filing of consolidated tax returns is because of timing differences. It is critical to understanding this issue and the Intervenors' proposed adjustments to understand that total tax expense is made up of two components, current taxes (the return and liability accrual) and deferred taxes (such as net operating losses (NOL), for example) which will become payable at some later date. Filing a consolidated tax return effects the current taxes payable rather than the total income tax expense. In other words, the benefit, if any, of filing consolidated returns is the effect upon the timing of the income tax payment, not the total tax liability. While current taxes owed may be reduced (if there are losses to offset gains); deferred taxes are increased and will ultimately become due. For example, charitable contributions disallowed in prior years due to consolidated taxable income limitations, are carried over to reduce the current tax payable in later years. As another example, excess net operating losses from a prior year may be carried forward to reduce current taxes payable in a subsequent year. With very few exceptions (e.g., percentage depletion), if the filing of a consolidated tax return decreases current taxes owing, it will always increase deferred taxes. In other words, filing a consolidated tax return does not create a permanent benefit. Filing a consolidated return also provides administrative economies of scale in the filing of the tax return, as well as the subsequent resolution of issues upon examination by the IRS.

Q. How are losses treated in the filing of a consolidated return?

A. In a very simple example, when one company with positive income files a consolidated return with another business that has incurred a net loss, the total tax paid by the two firms is reduced, because the net loss of the affiliated business could not otherwise be recognized until later years in which that separate business achieved a profit.

Q. In response to PacifiCorp Discovery Request 9.6, Mr. Arndt asserts that tax losses are not assets of the loss company. Please comment on Mr. Arndt's response.

A. Contrary to Mr. Arndt's statement, the tax benefits of losses represent an asset to the company which generated the losses. FAS 109 dictates the U.S. GAAP treatment of such tax benefits for financial reporting purposes, and states in paragraph 18b., "A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards**."** (Emphasis added.) FAS 109 further states in paragraph 17, "…Deferred taxes shall be determined separately…c. Measure the total deferred tax asset for deductible temporary differences and operating loss carryforwards using the applicable tax rate…" Such assets have value to a company and, for example, if done consistent with requirements of the IRC, this asset can continue with the loss company if it is acquired by another company.

Q. Is the federal income tax paid by PacifiCorp reduced by its participation in the consolidated return?

A. No. Even when a consolidated income tax return is used, each entity's stand-alone tax liability is separately calculated. Accordingly, the Company contributes to the consolidated group its separately calculated share of current income tax.

Q. The Intervenors imply however that there is a distinction between how PacifiCorp filed its return before and after the Scottish Power acquisition. Is that implication correct?

A. No. PacifiCorp joined in filing a U.S. consolidated income tax return prior to the Scottish Power acquisition effective November 30, 1999, and continues to join in the filing of a consolidated return now, after the acquisition. During the test period for this case, PHI is the parent company.

Q. Is Scottish Power in any way included in the U.S. consolidated income tax return?

A. No. Scottish Power income has not been, and is not currently, included in the U.S. consolidated income tax return. Scottish Power has no U.S. income tax liability for which a U.S. tax return would be required.

Q. If the federal income tax owed by PacifiCorp is not reduced, then what are the "savings" from filing a consolidated tax return referred to by Mr. Arndt?

A. The savings are a timing benefit only. Consolidated tax adjustments made in the PHI consolidated return are deferred items and do not permanently minimize tax expense. Since deferred taxes will ultimately be paid, the only benefit to the company is the time value of money on the tax payment deferred. Over time a consolidated tax return and a stand-alone return for a company the size of PHI or PacifiCorp will yield the same result once all the deferrals have reversed.

Q. Is the stand-alone calculation of PacifiCorp's tax liability contained within the Company's filing consistent with the calculation and regulatory treatment of income taxes in past Utah rate cases?

A. Yes. Both before and after the merger with Scottish Power, the Commission calculated PacifiCorp's income taxes on a stand-alone basis. Principles for regulatory recovery of tax expense recognize that the Company would benefit from reduced current tax cash requirements to the extent of deferred taxes, absent an adjustment. Removal of this potential benefit to a company for deferred taxes is accomplished by requiring a reduction to rate base for the accumulated deferred tax liability.

Q. Intervenors point out that in the merger order the Commission expressly reserved the consolidated tax issue for consideration in a future rate case. How do you understand this stipulated reservation?

A. It is true that a number of the parties, including the Company, stipulated in the merger proceeding that consideration of a proposed adjustment related to potential tax savings should be left to a later rate case. However, in doing so, the Company and other parties specifically reserved all factual as well as legal arguments and objections to such proposals in later cases. One specific objection was that stand-alone tax calculations had previously been used by the Commission and therefore, any party challenging such calculation would have to satisfy their burden of proof to warrant a change from Commission precedent. Leaving open the opportunity to consider the issue does not mean that an adjustment is warranted or appropriate.

Q. Has such a showing been made in this case?

A. No. For the reasons described in greater detail below, Intervenors have offered no compelling reasons to depart from long-standing Commission precedent of calculating income taxes on a stand-alone basis. Instead, they have proposed adjustments that would create substantial risk to ratepayers and violate other important regulatory principles.

Q. Before turning specifically to the proposals of the various Intervenors, do you have any general comments regarding Mr. Arndt's proposed adjustment?

A. Yes. At page 17, lines 12-17, Mr. Arndt asserts that PacifiCorp has not provided forecasted consolidated federal income tax information for the test period because the Company does not do such forecasts. This statement is not correct. In fact, PacifiCorp has provided projected, consolidated federal income tax information in response to UIEC 8.6, a response that was also provided (as updated) to the Committee in response to CCS Data Request 35.2. If the Committee had asked us for this information prior to the filing of their testimony, it would have been provided to them. Mr. Arndt's failure to investigate this issue prior to filing his testimony leads him to conclude that the Commission should adopt his adjustment using 2001-2003 fiscal tax year information. In fact, the Company's response to UIEC 8.6 shows that the future taxes are expected to be different than those on which Mr. Arndt's proposed adjustment is based.

Q. The proposals of Mr. Arndt and Mr. Binz seem to be based on a similar premise although the calculations and the rationales are somewhat distinct. Each argues that consolidated tax benefits are the result of the existence of both loss and gain companies and that gain companies should therefore receive their respective share of any tax benefit. Do you agree that this is a reasonable approach?

A. No. Such an approach would violate the states commission's merger order requirements to keep regulated and non-regulated activities functionally separated.

Q. Why is it important to separate PacifiCorp from its non-regulated affiliates?

A. The state utility commissions that regulate PacifiCorp have gone to great lengths to ensure adequate separation between PacifiCorp and its non-regulated affiliates in order to protect ratepayers. For example, during the merger, the Idaho, Washington and Wyoming commissions specifically ordered the Company to separate out non-utility businesses from PacifiCorp and to put into place “ring fence” provisions for the diversified activities. (Idaho Merger Stipulation at ¶ 33, Wyoming Merger Stipulation at ¶ 20; Washington Merger Stipulation at ¶ 27.) In addition, in approving the merger, this Commission placed particular emphasis on merger stipulation provisions designed to keep PacifiCorp separate from other Scottish Power nonregulated activities.

PacifiCorp has taken steps, encouraged and approved by its commissions, to maintain separation of its utility operations for the benefit of ratepayers. In 2001, PacifiCorp sought approval from FERC and other state utility commission for which it was required to do so to insert PHI into the holding company structure and move PPM and other non-regulated companies to a position of being affiliates of PacifiCorp rather than a subsidiary. The FERC and the commissions approved the reorganization.

Even prior to the merger, the Company had also consistently made an interest synchronization adjustment in its general rate case filings to remove the portion of actual interest paid to fund rate base not allowed into rates.

Q. Is this careful separation between the utility and its non-regulated affiliates consistent with Intervenors’ proposed adjustments?

A. No. The Intervenors’ adjustments disregard the functional separation between these separate companies that this Commission and others have carefully maintained and would expose ratepayers to greater risks and more volatile rates. Ignoring the separate business functions, risks, expenses and revenues, Intervenors simply reach out to capture the benefit of the losses generated by the non-regulated entities. Moreover, the proposed adjustments disregard other well-known cost-causation principles that this Commission has embraced.

Q. **Please explain what you mean by regulatory cost-causation principles.**

A. Long-standing regulatory principles establish that a Company's rates are "just and reasonable" when they are cost-justified. In determining whether rates are cost-justified, a commission looks for a causal link between the service the company provides ratepayers and the expenses the company incurs to provide that service. The Intervenors' proposed adjustments totally disregard this regulatory principle by seeking to assign to ratepayers the tax benefits of losses generated by affiliated companies when the shareholders or affiliates, not the ratepayers, have paid the expenses associated with generating those losses.

Q. **Could the Commission adopt the Intervenors' proposals without violating the cost-causation principle?**

A. No. As currently proposed, the Intervenors' adjustments inequitably take all or most of the benefit of the tax losses and none of the corresponding burdens or business risk. In other words, if the Intervenors' adjustments were adopted, the shareholders or affiliates would absorb all of the costs, and the ratepayers would receive the related tax benefits. However, if the Commission permitted the Company to include the expenses of the non-regulated companies associated with generating the losses and the amount of the losses in the Company's revenue requirement, than it might be equitable and consistent to share the tax benefits associated with the losses with ratepayers.

Q. Are you advocating such a result?

A. No. The Company believes that the Commission's current policy to carefully separate regulated and non-regulated operations and expenses is fair and consistent with regulatory principles and regulation and best protects ratepayers. If the Commission were to include non-regulated costs and tax benefits in setting utility rates, it would presumably have a duty to examine the reasonableness of the parent corporation's decisions that have an effect on the tax position of the non-utility affiliates. This would greatly expand the oversight of the Commission, while it nevertheless lacks jurisdiction over regulating the affiliates' operations. This could lead to volatile utility rates that would rise or fall inversely with affiliate earnings. While the Intervenors' methods find a benefit in the current years, when loss companies begin to generate a profit, these methods would begin raising the rates of ratepayers. I will discuss these increased risks in greater detail later in my testimony.

Q. Mr. Brubaker asserts that the basis for his adjustment is the financing structure used in the Scottish Power/PacifiCorp merger. His adjustment would take the tax benefits associated with the deductions of just one affiliate (PHI) to reduce the PacifiCorp tax calculation for regulatory purposes. Does this limitation change any of the previous testimony?

A. No. This proposal equally violates cost causation principles and runs afoul of the requirements of separation from the merger order. Just as in the case of the other affiliates in the corporate group, the tax losses at PHI were created by expenses (interest paid on the loan associated with the acquisition adjustment) never borne by ratepayers, indeed, the losses are created by expenses this Commission has insisted will never be borne by ratepayers.

Q. Can the Commission adopt Mr. Brubaker's proposal without violating or compromising the stand-alone tax computation?

A. No, by virtue of his adjustments, his proposed computation is no longer a stand-alone computation. Although Mr. Brubaker makes a novel assertion that stand-alone computations can be preserved while simultaneously adjusting for the tax benefit of an affiliate's interest expense, this position is without merit. The tax benefit at issue arises from an entity's losses. For purposes of determining these losses, interest expense is no different than any other cash expense incurred in the operations.

Q. How did Scottish Power acquire PacifiCorp and when was it completed?

A. Scottish Power established a U.S. holding company, NA General Partnership (NAGP) to acquire and hold PacifiCorp shares, which previous to the acquisition were publicly traded. As NAGP's shares were not publicly traded, Scottish Power's publicly-traded shares were used in exchange for PacifiCorp shares in a type "B" reorganization under IRC §368. Scottish Power then transferred this equity stock ownership in PacifiCorp to NAGP in exchange for debt and equity in NAGP totaling $6.6 billion. Upon conclusion of the transaction on November 30, 1999, NAGP owned all of the outstanding shares of PacifiCorp.

Q. What changes have occurred in the U.S. structure since the acquisition?

A. Corporate reorganizations were approved by FERC and state utility commissions in order to meet merger commitments discussed above with the express purpose of creating better ringfencing between regulated and non-regulated affiliates. After these reorganizations, PHI became the parent company when NAGP was merged into PHI effective December 1, 2003.

Q. You mentioned that ratepayers have never and, according to Commission order, should never finance the costs associated with the acquisition adjustment. What do you mean by the acquisition adjustment and how is it related to the deductions at the PHI level?

A. As explained in detail in testimony filed by the Company and other parties in the merger proceeding, when Scottish Power merged with PacifiCorp, it bought the equity at PacifiCorp and paid more than net book value for those assets. The amount paid above the net book value of the assets is referred to as an acquisition premium, acquisition adjustment or goodwill. This goodwill is recorded on the financial books and records at PHI, not at PacifiCorp. In the merger order, the Commission ordered that the goodwill could not be included in rate base for ratemaking purposes and that ratepayers should not pay the costs associated with the goodwill. In compliance with that order, PacifiCorp has never attempted to recover any of the goodwill premium from ratepayers. The loan at PHI, which creates the interest deductions that Mr. Brubaker would apply to the calculations of PacifiCorp’s taxes for ratemaking purposes, was used to acquire the goodwill associated with the merger which is on the books of PHI. Mr. Brubaker’s one-sided adjustment takes the tax benefits associated with the interest deductions for the loan that services the goodwill asset but would not take the costs which create the tax benefits, e.g. the goodwill. This adjustment blatantly violates regulatory cost-causation principles. For consistency, Mr. Brubaker should also propose that goodwill be included in the rate base at PacifiCorp to make the adjustment evenhanded. However, such a proposal would be directly counter to the merger order.

Q. But isn't the tax benefit associated with the loan at PHI permanent as Intervenors appear to assert and therefore different from the adjustment proposed by Mr. Arndt and Mr. Binz?

A. That is absolutely false. As I discussed above, the interest deductions at PHI create a NOL, which as cited above from FAS 109, is a deferred tax item. Not surprisingly, Intervenors' proposed adjustments make no provision for compensating PHI (or any other non-regulated loss company) for the loss of this future benefit. If the adjustment by Mr. Arndt and Mr. Binz is adopted, PacifiCorp's current taxes would be artificially reduced, but its deferred taxes would be increased by an equal amount. Later, the current cash flow benefit will become an increased tax payment when the NOL reverses. Also not surprisingly, Intervenors' proposed adjustments make no provision for this future increased expense.

Q. You assert that the Intervenors' proposed adjustments run counter to the provisions of the merger order. Mr. Arndt claims the opposite is true; that in fact calculating taxes on a stand-alone basis violates the merger order by causing PacifiCorp ratepayers to indirectly subsidize non-regulated operations and/or pay for the acquisition premium. Is his analysis sound?

A. No, and in fact, Mr. Arndt's calculation results in non-regulated operations subsidizing the regulated operations – a property taking. Simply put, tax expense is the result of a math equation. Tax expense or benefit is always a percentage of some other operational income or expense item. For a dollar of revenue, 35 cents of tax is incurred. For a dollar of eligible expense, 35 cents of tax benefit is earned. The tax cannot be separated from its underlying source or cause. In this case, there is no tax benefit without incurring the expense related thereto. Calculating taxes on a stand-alone basis ensures that the tax expense or benefit remains with the entity which earned the revenue or incurred the expense.

Q. How would Mr. Arndt's proposal result in a property taking?

A. As mentioned previously, the tax benefit related to the interest deduction of a non-regulated entity is an asset of that entity. Adopting Mr. Arndt's proposal, or that of the other Intervenors irrespective of the basis for their position, would mean the Company would take the asset of a non-regulated entity without compensation. The asset is permanently assigned to the gain companies because none of the Intervenors has proposed an adjustment in subsequent years for PacifiCorp to "pay back" the tax benefit it used to the loss company when that loss company could use that benefit in later years. That results in a taking. Conversely, if the Intervenors do not really intend that the tax benefit be permanently assigned from year to year, then mechanisms would need to be put into place for gain companies to "pay back" losses to loss companies when they can be used in subsequent years. This would result in volatile customers rates and mismatches between generations of ratepayers.

Q. Are the proposed adjustments a workable solution?

A. No. Intervenors are proposing to take a tax benefit without any cost to the Company, leaving the non-regulated entity treated unfairly. Absent compensation to the non-regulated entity, such an action would create a liability to the non-regulated entity when it later has taxable income against which it would otherwise offset its losses. In accounting terms, the proposed adjustment is out of balance (in other words, a credit to the loss entity with no corresponding debit).

Q. The SEC recently reviewed this issue. How does that review relate to this case?

A. The SEC recently reviewed the same issue as raised in this proceeding. While the regulatory oversight of the SEC is different than that of the state commissions, their analysis offers some useful information to this case.

Q. Specifically what was the purpose of the SEC review?

A. The purpose of the SEC review was to ensure compliance under the Public Utilities Holding Company Act of 1935 (PUHCA). This Act specifically requires the SEC to investigate and guard against holding companies taking advantage of their subsidiary companies. As part of this review, the SEC Staff reviewed the tax sharing agreement and tax cash flows. The SEC found that the current tax sharing agreement met their requirements and was consistent with this regulatory charge.

Q. What is the conclusion of the SEC regarding tax payments to PHI?

A. PHI and its U.S. affiliates are making tax payments within the group in the same fashion as done prior to the SEC PUHCA review. The focus of the SEC is on cash tax payments, not the total tax expense. The SEC PUCHA review resulted in no change to total tax expense. PUHCA rules recognize that a legitimate, non-abusive use of funds at a public utility holding company is payment of interest expense on acquisition indebtedness. Accordingly, the SEC has allowed PHI to retain cash tax payments in order to satisfy PHI's liability for the acquisition of PacifiCorp. Pursuant to SEC rules, the SEC had to have found that the debt had a relationship to the acquisition or the SEC would not have permitted this particular feature of the tax allocation agreement to remain.

Q. Mr. Arndt refers to the tax sharing agreement at PacifiCorp as a document designed to "enrich the non-regulated companies at the expense of PacifiCorp's captive ratepayers." Please respond.

A. This allegation is completely false. The SEC PUHCA Staff were complying with their mandate to enforce the provisions of PUHCA, and in the case of taxes, this includes Rule 45. Rule 45 provides the conditions, definitions, requirements and reporting required of affiliated companies subject to the provisions of PUHCA, which includes PHI and its affiliates. Rule 45(c) was adopted under Section 12 of PUHCA to regulate tax allocation agreements because they could involve implicit loans, extensions of credit or indemnities[1] and because they had been used by holding companies to exploit utility companies through the misallocation of consolidated tax return benefits.[2] The SEC reviewed, provided input and

[1] *Adoption of Amendment to Rule Governing Allocation of Consolidated Income Taxes Among Member Companies of Registered Holding Company Systems, Rule U-45(b)(6),* Holding Co. Act Release No. 12776 (January 12, 1955).

[2] *Allocation of Consolidated Federal Income Tax Liability By Registered Holding Companies and their Subsidiaries*, Holding Co. Act Release No. 21767 (October 29, 1980) ("Rule 45(c) Proposing Release").

ultimately found that the tax allocation agreement effective April 1, 2004 was consistent with its statutory charge.

Q. Are there any risks associated with adopting the Intervenors' proposed adjustments?

A. Yes. In the previous proceedings in various jurisdictions, PacifiCorp has sought recovery of audit payments made to the IRS dealing with prior tax years. Parties have argued that because taxes are calculated on a stand-alone basis actual payments to the IRS and later audit payments are irrelevant. Whatever merits there may be to that argument, if the Commission were to adopt any of the Intervenors' proposed tax adjustments, the factual basis for that position would no longer be true. Indeed, if taxes were set for regulatory purposes with specific reference to taxes actually paid to the federal and/or state governments and specific tax deductions of other affiliates, then what actually happens with respect to actual tax payments is entirely relevant to utility ratemaking. In this case, the ultimate benefit, if any, of the various losses of the non-regulated affiliates is not yet known. The Intervenors' adjustments are based only on the filing of the tax return and do not take into the account the subsequent adjustments to the returns (and hence, to the losses) which will occur when the IRS audits the tax years included in his computations. The ultimate liability for these tax years will not be known for several years. If the Commission were to take the benefit of these losses now in setting rates, and the IRS were to later take some or all of the same deduction away, customers should be subject to payments in later years in connection with those IRS audit adjustments. In addition to injecting great potential volatility into the ratemaking process, these types of later adjustments would create intergenerational mismatches among customers. Moreover, unlike other areas of intervenor testimony, the fact that these tax benefits are far from certain to continue (given the audit is not complete) appears to impose no impediments to seeking to take the benefits.

Q. Have other Commissions considered and rejected similar type of consolidated tax adjustments?

A. Yes. Mr. Binz proposed the same type of consolidated tax adjustment in the Company's Wyoming general rate case earlier this year. Mr. Arndt's adjustment is similar in the calculation methodology to Mr. Binz's adjustment. The Wyoming Public Service Commission rejected the proposed adjustment. In addition, the Oregon Public Utility Commission was faced with a request for investigation filed by a ratepayer related to upstream tax savings in the PGE/Enron corporate structure. The Commission denied the petition for investigation in Order 03-214, on April 10, 2003. In the Staff Memorandum (incorporated by reference into the Oregon commission's order), Oregon Staff recognized the very same cost causation principles I discussed above: "If PGE's rates were set in a manner that captured some of Enron's tax losses, PGE's rates would also have needed to reflect the expenses that created those tax savings, and customers would be worse off. Staff's counsel advised that it would be difficult for the OPUC to justify picking and choosing which of Enron's revenues and expenses—including tax savings—to include for purposes of setting Oregon customers' rates. Moreover, such an approach may lead to confiscatory rates."

Incredibly, Intervenors' proposed adjustments in this case ignore this fundamental cost causation premise and seek to take either all or some of the tax benefits and none of the corresponding expenses.

Q. Are there other risks associated with the proposed consolidated tax adjustments?

A. Yes. There is a greatly increased risk of rate volatility, not just from later potential audit payments but also on a year-to-year basis. As an actual example, in recent years, a loss company in the PHI group had a loss in excess of $21 million; the next year, the same company had a loss of only about $2 million. All other things remaining equal, PacifiCorp would have reason to come back to this Commission and file for an increase in rates because the $19 million change to the computation would increase PacifiCorp's tax expense. This is true even though nothing had changed with respect to how services were provided to ratepayers or in the expense of actual services provided to ratepayers.

Q. Would the proposed tax adjustments also potentially increase the regulatory burden?

A. Yes. Non-regulated entities can make decisions that may or may not be in the best interest of ratepayers that will have a direct impact on the calculation under Intervenors' proposed methodology; yet this Commission has no regulatory oversight over those decisions. Nevertheless, in order to ensure that a reasonable level of loss is shared with PacifiCorp, initially the auditors, and eventually the Commission, would need to review the expenses and associated losses to ensure the accuracy of the actual numbers. For example, if an affiliate had a loan that generated tax losses, auditors might choose to investigate whether the loan had a reasonable interest expense associated with it. This would greatly expand the auditing and monitoring function of the Commission without any corresponding increase in jurisdiction or oversight to affect those decisions.

In addition, tax losses and gains and loss and gain companies would need to be tracked over the historical period used in the adjustment (e.g. here, a 3-year average) in order to set up mechanisms to "pay back" tax benefits associated with losses to loss companies when those amounts could be used in later years. This tracking would need to be done for all companies taking part in the regulated return because PacifiCorp could be a loss company (as it was in FY2002) to which tax payments would be due by other nonregulated companies in subsequent years.

Even if a true-up was not made on an annual basis, tracking would still need to take place so that ultimately the tax loss asset could be repaid to the loss company when it becomes necessary. For example, if a non-regulated affiliate had tax losses several years in a row (the benefit of which were assigned to PacifiCorp and/or other gain companies), and that non-regulated affiliate was later sold to a third party, that third party would also generally be buying the tax loss assets of the non-regulated affiliate. At the time of the sale, the gain companies who took the benefit of the losses over time would need to pay back this tax benefit prior to the conclusion of the sale.

Q. What conclusions do you draw from the foregoing discussion?

A. Stand-alone tax calculations are the best way to mitigate risk and rate volatility for customers. Moreover, stand-alone tax calculations provide the Commission the best mechanism to insulate ratepayers from audit adjustments, penalties and interest payments from the IRS in later years. For these reasons, the Commission should reject the tax adjustments proposed by Messrs. Arndt, Binz, and Brubaker and Dr. Anderson.

Bonus Depreciation

Q. In Ms. DeRonne's testimony she proposes that an adjustment be made to the 2006 test year accumulated deferred income tax for amounts expended through December 31, 2004 on assets placed in service prior to December 31, 2005 to reflect bonus depreciation available under two statutes enacted in 2002 and 2003. Please explain bonus depreciation.

A. Bonus depreciation was enacted as an incentive for new capital investments. It provides for additional depreciation deductions in the year an asset is placed in service if it meets statutory requirements, generally meaning property with a class life equal to or less than 20 years. As an exception to the normal sunset date of December 31, 2004 for this provision, Congress allowed costs incurred on or before December 31, 2004 to be included in the deduction to the extent the asset was placed in service on or before December 31, 2005. This was done to take into account capital improvements in process during 2004 but which are not completed until 2005. Bonus depreciation is not available for capital expenditures beyond December 31, 2004.

Q. Why wasn't this adjustment included in the original submission for this case?

A. The computation of the deduction was complex. Although work had begun at the time of the Company's filing, it had not been completed.

Q. Is it appropriate for bonus tax depreciation to be included in the computation of the accumulated deferred income tax liability for the test period?

A. Yes. Bonus tax depreciation is another form of accelerated tax depreciation allowable on certain asset additions. The additional depreciation increases the Company's deferred tax liability.

Q. Is the bonus depreciation allowance for ratemaking purposes prohibited by Internal Revenue Code (IRC) normalization restrictions?

A. No. Normalization under the IRC requires that accelerated tax deductions attributable to life and method differences be allowed in rates no more rapidly than allowed under the tax laws. Additionally, book basis differences are not restricted under IRC normalization rules. As bonus depreciation represents a method difference, the full deduction is allowable for ratemaking purposes, up to the amount determined for tax return purposes.

Q. How will the tax effect of bonus depreciation affect rate base in the test period?

A. Bonus depreciation increases the deferred tax liability. Accordingly, this deduction will further reduce rate base in the test period. Because the bonus depreciation deduction is entirely related to a method difference, the full impact of the bonus deduction will reduce rate base.

Q. What is the appropriate amount of the bonus depreciation deduction, tax effect, revenue requirement and rate base adjustment for the test period?

A. The Company has made an estimate of the amount expended through December 31, 2004 for assets that will be placed in service prior to December 31, 2005, thereby qualifying for bonus depreciation. Based upon this estimate, the enhanced depreciation deduction on such asset additions was taken in fiscal year ending March 31, 2005 and in the test period ending March 31, 2006. The Company's total tax expense for the test period remains unaffected (although current and deferred portions may change). The additional bonus depreciation amount is $64.321 million on total Company basis. This figure was provided in the Company's response to Data Request CCS 24.14.

Q. Do you have any other comments regarding the proposed adjustment for bonus tax depreciation?

A. Yes. To put it simply, the calculation of the amount of bonus tax depreciation that the Company is eligible for is based on two factors (1) the amount of capital dollars actually spent in CY04 and (2) a forecast of the projects that will be completed and placed into service in CY05 on which capital dollars were spent in CY04. Notably, CY04 actual capital spend used to calculate that part of this adjustment includes 9 months of FY05. Likewise, CY05 plant in service projections used in the adjustment includes 9 months of the test year in this case, FY06. The Company's calculation of the proposed adjustment assumes that the amount of plant to be placed into service in CY05 is consistent with the calculations used in the case for other purposes for the test period (e.g. calculating rate base additions). Accordingly, if the Commission were to adopt the other adjustments proposed by Ms. Deronne and other witnesses to reduce projected plant in service additions to rate base because capital spending is slightly under budget for the first six months of FY05 (or part of CY04), this proposed adjustment will also need to be reduced accordingly. The Committee cannot have it both ways; in other words, they cannot seek the entire tax benefit associated with CY05 plant additions on the one hand, while simultaneously reducing the expense that created the tax benefit over that same period.

Production Activity Deduction

Q. Both Mr. Thomson (DPU) and Ms. DeRonne (CCS) have identified the newly enacted deduction for production activities as a potential reduction to the Company's federal income tax expense. What is this deduction?

A. The recent tax legislation codified the *Deduction for Production Activities* in IRC §199 ("production activity deduction"). This provision allows for a deduction against qualified production activities. Qualified production activities include the generation of electricity (but not distribution, transmission, etc.). The deduction for the test period is equal to three percent of the taxable income from generation activities. It is likely that, on a stand-alone basis, the deduction will be available to the Company for its electric generation operations.

Q. Why was the deduction not included in the income tax computations filed in this rate case?

A. At the time of filing the rate case, the deduction had not yet been enacted. In addition, because the deduction was added to the Act late in the legislative process, there was little or no information available on how the deduction would be computed. At that time, the deduction was not identifiable.

Q. Do you agree that enough information is now known to include the deduction in this case as proposed by Ms. Deronne and Mr. Thomson?

A. As stated in the testimony of Mr. Thomson, to date, the IRS has issued very little guidance as to how to interpret and determine the basis for the deduction. That being said, as with other tax matters, corporate tax consultants and professionals are working their way through these issues during this tax season. Subject to the very important caveats discussed below, I believe that the Company's tax department can, exercising its professional judgment with input from qualified consultants, now calculate a reasonable forecast of the amount of the deduction. Like other parts of this case, this forecast requires the company experts to analyze and make calculations based on the information now known, reasonable forecasts of inputs and on their professional experience.

Q. Mr. Thomson provided an estimate of the deduction. Ms. Deronne did not provide an estimate but proposed that the Commission order PacifiCorp to do one. What is your calculation of the proposed deduction?

A. Based upon regulatory taxable income for the Company's generation activity using the best available information, the forecasted amount of the deduction on a total company basis is $2,493,000 and the tax effect thereof is $872,550. I recommend that the Commission adopt this calculation of the forecasted deduction subject to two caveats.

Q. You mentioned that there are caveats to your recommendation that the Commission adopt the adjustment to include this deduction. What are the caveats?

A. First, this deduction should not be allowed to the extent that a "consolidated tax adjustment" of any type as proposed by various Intervenors is allowed in this case. Due to production activity losses outside of PacifiCorp, it is expected that the production activity deduction will be zero on a consolidated tax return basis. In other words, the Company realizes a tax deduction computed on a stand-alone basis that is otherwise unavailable on a consolidated basis. For purposes of this item, the consolidated tax adjustment would work to the detriment of ratepayers. Consistent application of any proposed consolidated tax adjustments, if ultimately adopted, would dictate that this deduction be eliminated. Second, this deduction is based upon revenues requested in this case. Accordingly, computation of the amount of the deduction will need to be revised if the Commission determines taxes should be calculated for regulatory purposes on a stand-alone basis and there are any adjustments to the Company's revenues as filed.

Tax Advisory Costs

Q. Ms. DeRonne (CCS) proposes an adjustment to reduce tax advisory service costs to the forecasted amount. Do you agree with this adjustment?

A. Yes. The Company's tax advisory service costs are forecasted to be $3,040,000 in the test period.

Q. Ms. DeRonne further proposes elimination of the full amount of tax advisory service costs if the consolidated tax savings adjustment proposed by Mr. Arndt is not adopted based upon the premise, "If Utah ratepayers do not receive the benefit of the tax advisory services being provided, they should not be included in rates." Do you agree with this proposal?

A. Although I agree with the premise, Ms. Deronne's testimony comes to the wrong conclusion. The tax advisory service costs forecasted for the Company are in fact PacifiCorp's portion of the total costs and are not related to consolidated-level tax work. Tax services directly attributable to a non-regulated entity are in fact billed directly to that entity. Services which apply to the entire U.S. group and which cannot be segregated are charged to the respective entities using the three-factor formula. The service costs included in this forecasted amount are, in fact, forecasted for the very kind of compliance related work included in this case for which Ms. Deronne would readily take the associated tax benefits (e.g. bonus depreciation, production activity deduction, etc.). Accordingly, Utah ratepayers are receiving the benefit of these tax advisory services and these costs should be included in rates.

Avoided Costs M-1

Q. Ms. DeRonne asserts that avoided costs should be eliminated from the case unless the Company provides an explanation and an adequate justification for the item. Should the avoided costs M-1 be eliminated from this case?

A. No. Such an elimination would violate normalization because it would return to ratepayers the avoided costs basis adjustment more rapidly than what is permitted by tax rules.

Q. Please explain the avoided costs M-1.

A. The 1986 Tax Reform Act adopted an avoided cost interest computation for tax purposes to be used in lieu of the debt AFUDC recorded per books. The tax law codified under IRC §263A capitalizes the financing cost of self-constructed assets, resulting in higher taxable income on the return. The computation determines a ratio based on the Company's interest expense over long-term and interest-bearing liability balances. This rate is then applied to an adjusted annual CWIP amount that reflects self-constructed assets. The CWIP base includes self-constructed assets with a class life of 20 years or more, property with an estimated production period exceeding 2 years and property with an estimated production period exceeding one year with an estimated cost of at least $1,000,000.

AFUDC is the book entry of capitalized interest, which is reversed for tax purposes. This reversal decreases taxable income and decreases the tax basis in the property. Avoided cost is the tax entry which increases current taxable income and increases the tax basis in the property. The net of the two different methods of capitalizing interest creates a current book-tax difference to taxable income. The difference in property basis is recovered through tax depreciation. The depreciation on the AFUDC basis difference is not protected by the IRS normalization requirements, but depreciation on the avoided cost basis difference is protected by the IRS normalization requirements.

Should the avoided costs Schedule M addition be included in the Company's filing?

A. Yes. The increase projected for the test period is related to the increases in capital additions required to meet demands, as proposed in this case. The avoided costs M-1 are not a new item and the treatment in this filing is the same as past practice.

Q. Please summarize your testimony.

A. The Commission has historically taken great care to carefully separate PacifiCorp from its non-regulated affiliates in order to protect ratepayers from potential, significant subsequent liabilities, from risk of non-regulated operations losses, and from risk of rate volatility. The Intervenors' proposed adjustments for consolidated tax savings in the various forms ignores this careful separation and imposes great risks onto ratepayers. Moreover, these proposals are inequitable and inconsistent with long-standing regulatory ratemaking principles and practice. The Commission should reject the Intervenors' proposed adjustments for consolidated tax adjustments. The deferred tax liability should be adjusted for bonus depreciation, but the amount may need to be adjusted based upon capital expenditures ultimately allowed in this rate case. The production activity deduction should also be taken in determination of federal income tax expense in this case to the extent that the proposed consolidated tax savings adjustments are not adopted. Tax advisory service costs should be reduced as indicated and should be allowed in this rate case. Consistent with past practice and legal requirements, avoided costs should continue to be accepted as an M-1 adjustment for computing income taxes.

Q. Does this conclude your testimony?

A. Yes.