

Docket No. 04-035-42  
David T. Thomson  
Exhibit No. DPU 6.0R  
January 14, 2005

**BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH**

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In the Matter of the Application of	:	
PacifiCorp for Approval of its Proposed	:	
Electric Service Schedules and Electric	:	Docket No. 04-035-42
Service Regulations	:	Revenue Requirement Filing
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**REBUTTAL DIRECT TESTIMONY**

**OF**

**DAVID T. THOMSON**  
**STATE OF UTAH**  
**DIVISION OF PUBLIC UTILITIES**

**JANUARY 14, 2005**

1 **Q. Please state your name and business address for the record.**

2 A. David T. Thomson. My business address is Heber M. Wells Building 4<sup>th</sup> Floor,  
3 160 East 300 South, Salt Lake City, Utah 84114-6751.

4 **Q. For which party will you be offering rebuttal testimony in this case?**

5 A. I will be offering testimony on behalf of the Utah Division of Public Utilities  
6 (Division).

7 **Q. Please describe your position and duties with the Division?**

8 A. I am a Utility Analyst II. Among other things, I serve as an in-house consultant  
9 on issues concerning the terms, conditions and prices of utility service; industry  
10 and utility trends and issues; and regulatory form, compliance and practice  
11 relating to public utilities. I examine public utility financial data for  
12 determination of rates; review applications for rate increases; conduct research,  
13 examine, analyze, organize, document and establish regulatory positions on a  
14 variety of regulatory matters; review operations reports and evaluate compliance  
15 with laws and regulations, etc.; testify in hearings before the Public Service  
16 Commission; assist in analysis of testimony and case preparation; and participate  
17 in settlement conferences, etc.

18 **Q. What is the purpose of your rebuttal testimony?**

19 A. The purpose of my rebuttal testimony is to explain the withdrawal of my  
20 adjustment 6.4 that reduced contract services in account 593 for costs associated  
21 with the major winter storm outage in December of 2003. The original proposed  
22 adjustment was to the revenue requirement filing of PacifiCorp submitted to the

1 Utah Public Service Commission (UPSC) on August 4, 2004 under Docket  
2 Number 04-035-42.

3 **Q. Why are you withdrawing your adjustment 6.4?**

4 A. I am withdrawing my adjustment based on additional information received since  
5 the Division filed its direct testimony that indicated that basically PacifiCorp had  
6 already done this adjustment and so my adjustment was not required.

7 **Q. Do you have anything else that you would like to discuss during this**  
8 **testimony?**

9 A. Yes. I will outline in general terms the Commission's past policy regarding the  
10 computation of federal income taxes for ratemaking purposes for utility members  
11 of a consolidated group and highlight some cases from other jurisdictions that  
12 relate to this matter.

13 **Q. What is the stand-alone or separate-entity concept of ratemaking?**

14 A. The stand-alone concept holds that a utility's cost of service should be determined  
15 as if the utility were a separate or stand-alone company so that the utility's  
16 ratepayers do not bear the burden of costs or losses attributable to an affiliate.  
17 Accordingly, for ratemaking purposes, the utility's cost of service takes into  
18 consideration only those expenses incurred by the utility in providing service to  
19 its customers. Under this method, regulators have sought to segregate the  
20 regulated utility from its affiliates, and to determine the operational and capital  
21 cost specifically attributable to the utility's jurisdictional activities.

22 **Q. How does this stand-alone concept apply to income tax expense?**

1 A. Because income tax is a recoverable expense, it is important that the tax reflects  
2 the utility's revenues, credits and losses. The income tax becomes more  
3 complicated when the utility files a consolidated tax return with its parent and  
4 affiliates. Generally, each company participating in the consolidated filing  
5 prepares a return that indicates its tax liability, if any. The returns are then  
6 compiled or consolidated so that the taxes and losses of the various companies  
7 offset one another. The consolidated return, then, indicates the amount of tax due  
8 from these companies as a group.

9 The stand-alone method holds that when utility's taxes are filed using a  
10 consolidated return, the income tax expense paid by the utility ratepayers should  
11 be determined as if the utility filed its taxes separately. This approach ensures  
12 that any benefits or burdens that result from the utility's operations accrue to its  
13 ratepayers and insulates those ratepayers from the benefits, burdens and risks  
14 associated with the operations of affiliated companies.

15 **Q. Is there authoritative support for treating a regulated utility as a stand-alone**  
16 **entity for income tax purposes?**

17 A. Yes. According to Accounting for Public Utilities, §7.08 (3), (Mathew Bender,  
18 Release No. 21A, December 2004):

19 [t]he only approach that is consistent with standard ratemaking  
20 principles that prohibit cross-subsidization between utility and  
21 non-utility activities is to put the regulated operation on a 'stand-  
22 alone' basis and to assign the full tax burden to the tax gain source  
23 and a tax benefit to the tax loss source. The basic theory is that the  
24 regulated costs should not be affected by the results from  
25 nonregulated operations.  
26

1           That same source, at §17.04 (3), states, “a ‘stand alone’ method (as opposed to  
2 a consolidated effective tax rate method) for computing the income tax expense  
3 component of cost of service is the proper and equitable method to be followed  
4 for ratemaking purposes.”

5 **Q.   What are the additional ratemaking principles that support the stand-alone**  
6 **method as it applies to income tax expense?**

7 A.   Representatives of Coopers and Lybrand testified on this issue before the  
8 Subcommittee on Select Revenue Measures – Hearing on Treatment of  
9 Consolidated Tax Savings under IRC Normalization Requirements on September  
10 11, 1991. The following is excerpts from that testimony:

11           Rates should be set to reflect the costs of the entity’s regulated  
12 operations. In a rate proceeding, rates are based on the utility’s  
13 own revenues, costs and rate base for a given test year. Regulated  
14 costs should not be affected by the results from nonregulated  
15 operations. If ratepayers are held responsible for costs, they are  
16 entitled to the tax benefits associated with the costs. If ratepayers  
17 do not bear the costs, they are not entitled to the tax benefits  
18 associated with the costs.

19  
20           Over the years, the FERC has modified the underlying rationale for  
21 its support of the stand-alone method to the current “benefits and  
22 burdens” standard, which it initially set out in Southern California  
23 Edison Co., 595 F.P.C. 2167 (1977). Using this standard, the  
24 benefits of consolidated tax savings are given to ratepayers (via  
25 reduction in the regulated affiliated tax expense) if the ratepayers  
26 bear the burden of paying the deductible expenses that generated  
27 the savings.

28  
29           It helps to remember where utilities get the money to finance their  
30 diversification: not from ratepayer funds, but from their own  
31 shareholders. These investors bear all the risk, and should the  
32 business lose money in the start-up stage, sound tax policy dictates  
33 that they be the ones to benefit from these tax losses.

34

1 **Q. Has the UPSC or the Division previously addressed the issue of consolidated**  
2 **versus stand-alone tax liability?**

3 A. Yes. Although I have not comprehensively reviewed all of the cases and  
4 materials on this topic, I will review the decisions and materials of which I am  
5 aware.

6 In Docket No. 84-035-02 dated October 1, 1985, Utah Power and Light  
7 Company sought authorization for the formation and financing of a non-regulated  
8 subsidiary. Adopting the Division's recommendation, the Commission required  
9 the company to "fund the subsidiary entirely from investor supplied capital and  
10 authorize income taxes on a 'stand-alone' basis."

11 In UPSC Docket No. 95-057-02 (June 9, 1995), the Division, through its  
12 witness Wesley D. Huntsman, reiterated the Division's position during the  
13 Questar formation case that regulatory income tax expense is to be based on  
14 income, tax rates and tax credits directly related to the distribution utility.

15 In August 23, 1995, Foote, Passey, Griffin and Company issued a "Report on  
16 Study of Federal and State Income Tax Policies and Calculations for Mountain  
17 Fuel Supply Company, PacifiCorp, and US West Communications, Inc." They  
18 were hired by the Division to study the federal and state income tax policies and  
19 calculations of the above-mentioned utilities. On page 34 of their report, they  
20 said, "Based upon our review of utility practices in this and other states, we  
21 concur with that position." (That regulatory income tax expense should be based  
22 on income, tax rates, and tax credits directly related to the distribution utility, i.e.  
23 on a stand-alone basis).

1 **Q. Has PacifiCorp adopted the Commission’s policy to determine federal and**  
2 **state income tax on a stand-alone basis?**

3 A. Yes. They have been using it for many years. It is my understanding that other  
4 Utah utilities also use the stand-alone approach.

5 **Q. Do you know if other State Commissions and Regulators having jurisdiction**  
6 **over PacifiCorp have adopted the stand-alone method and, if so, who are**  
7 **they?**

8 A. Oregon and Wyoming have adopted the stand-alone method. There may be  
9 others, but these are the ones I am familiar with on the matter of stand-alone  
10 income tax expense. Also, of note, Nevada has adopted a stand-alone regulation,  
11 although I recognize that PacifiCorp has no operations in Nevada.

12 As stated above in UPSC Docket No. 84-035-02, stand-alone tax methodology  
13 is one of a number of ways various state commissions have insulated the  
14 ratepayers from detrimental aspects affiliated entities, such as large initial or  
15 continual operating losses, defaults on debt, litigation, natural catastrophes, etc. In  
16 Docket UM 814 of the Oregon Public Utility Commission, the commission,  
17 created a “wall” between a utility and its parent and other subsidiaries and  
18 affiliates. Wyoming, in a stipulation, required PacifiCorp to instigate “ring fence  
19 provisions” to strengthen the separation of the utility from its affiliates which that  
20 commission had carefully maintained in the past.

21 **Q. Sometimes the tax savings from the filing of a consolidated tax return are**  
22 **substantial enough that the consolidated group is required to pay little or no**  
23 **income tax. Some have argued that a utility paying no income taxes due to**

1           **consolidated savings should have its income tax expense for ratemaking**  
2           **under the stand-alone method adjusted for this consolidated tax savings.**  
3           **Has this question been addressed by jurisdictions in which PacifiCorp**  
4           **conducts business?**

5    A.    Yes. The Oregon and Wyoming commissions have addressed this question. In  
6           Order #03-214 (April of 2003), the Oregon Commission denied a request to open  
7           an investigation and order Portland General Electric (PGE) to refund funds  
8           collected to pay income tax. PGE had paid taxes on a stand-alone basis but the  
9           consolidation group had not paid taxes. The petition for investigation was denied.

10           The commission accepted the findings of its staff on the matter. The staff  
11           findings were that PGE made its federal and state income tax payments to its  
12           parent (Enron) while on a consolidated basis, and directly to the proper taxing  
13           authorities while on an unconsolidated basis. Hence, there was no substance to  
14           the argument that PGE collected amounts for payment of income taxes that it did  
15           not use for that purpose. Commission staff cited PGE's FERC Form 1 showing  
16           that income taxes were being shown as paid in that filing.

17           The Oregon staff reiterated, and the Oregon Commission agreed, that income  
18           taxes were calculated using PGE's net operating income. The tax effects of the  
19           parent's other operations are ignored for purposes of setting rates (stand-alone).

20           The Wyoming Public Service Commission in Docket #20000-ER-03-198  
21           addressed the same question as it related to PacifiCorp. In that Docket, parties  
22           argued that the filing of a consolidated tax return had saved the consolidated  
23           group a substantial amount of taxes, yet PacifiCorp had filed its case using the



1 stand-alone method and the taxes had been computed on a 35% tax rate. The  
2 parties proposed to adjust the utility's income tax expense to reflect the tax  
3 savings. These parties pointed out that regulatory commissions in Pennsylvania,  
4 New Jersey and West Virginia required such consolidated tax savings  
5 adjustments.

6 In Wyoming, PacifiCorp argued that: (1) it had taken steps, encouraged by the  
7 Wyoming Commission, to maintain separation of its utility operations for the  
8 benefit of ratepayers, (2) by using the stand-alone method it was adhering to the  
9 cost causation principle of ratemaking and (3) it believed that if the adjustment  
10 was accepted, shareholders would be assigned the risks and that ratepayers would  
11 be assigned the benefits, resulting in one-sided cross subsidization having nothing  
12 to do with risk/benefit.

13 The Wyoming Commission rejected the proposed adjustment stating:

14 It is contrary to our past treatment of the issue; and it would begin  
15 breaking down the separation of the utility from its "ring fence  
16 provisions," the stipulation contained a number of provisions  
17 preventing the assertion of bars to the jurisdiction of the  
18 Commission to examine affiliate transactions. The goal of these  
19 provisions was not to bring regulated affiliates into the gambit of  
20 Commission regulations but to allow the Commission to satisfy  
21 itself that affiliate transactions did not negatively impact the utility  
22 or its ratepayers.  
23

24 **Q. What is your opinion as to the results of the Oregon and Wyoming cases**  
25 **discussed above?**

26 A. It seems to me that the commissions in these cases held to the principle of stand-  
27 alone methodology in the setting of rates for income taxes even though other  
28 jurisdictions had shown they had the authority to adjust rates for consolidated tax

1 savings. It appears that tax savings was not enough of a factor for the Oregon and  
2 Wyoming commissions to override, or violate so to speak, the generally accepted  
3 method of stand-alone rate setting. It appears to me that these regulators felt that  
4 such cross subsidization would diminish or weaken past efforts to segregate  
5 affiliated and subsidiary activities so that subsidiary activities would not have a  
6 detrimental impact on regulated activities.

7 **Q. Before concluding your testimony do you have anything else you would like**  
8 **to add to this testimony?**

9 A. Yes. In this case, there is an argument that circumstances warrant a departure  
10 from the stand-alone approach. At issue here is the interest on a loan transaction  
11 between the holding company and Scottish Power, which effectively offsets  
12 PacifiCorp's tax liability (and, presumably, the tax liability of any other profitable  
13 affiliate). I would like to emphasize that the stand-alone method, with its basic  
14 theory that regulated income tax expense should not be affected by the results  
15 from nonregulated operations, precludes the Commission from considering *any*  
16 offset in the consolidated tax filing that arises from the operations of the parent or  
17 other subsidiaries, whether it was a peculiar one time transaction or situation, a  
18 normal or reoccurring transaction or operation or otherwise. Under the stand-  
19 alone method, the utility is treated as a separate entity and consolidated tax  
20 activity or computations which arise outside of the separate utility entity, are  
21 irrelevant and accordingly ignored.

22 In other words, if the Utah Commission accepts the argument put forth by  
23 some parties in this case to adjust, for ratemaking purposes, PacifiCorp's tax

1 liability due to the consolidated tax savings, the Commission must explicitly set  
2 aside the rate-making principle of treating PacifiCorp as a stand-alone entity.

3 **Q. Does this conclude your testimony?**

4 A. Yes.