

Exhibit No. ___T (DPK-1T)
Docket No. UE-050684
Witness: Danny P. Kermode

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION
COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PACIFICORP, d/b/a Pacific Power &
Light Company,

Respondent.

DOCKET NO. UE-050684

TESTIMONY OF

DANNY P. KERMODE

STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

RE: PACIFICORP GENERAL RATE CASE

November 3, 2005

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	SCOPE OF TESTIMONY	2
III.	SUMMARY OF TESTIMONY	2
IV.	DISCUSSION.....	3
A.	Adjustment 7.2, Property Taxes	3
B.	Adjustment 7.3, Renewable Energy Tax Credit	9
C.	Adjustment 7.4, IRS Settlement Amortization	10
1.	Retroactive Ratemaking.....	12
2.	Income Tax Expense True-up	16
3.	PacifiCorp’s Adjustment Ignores Additional Income	17
D.	Adjustment 7.5, Malin Midpoint	21
1.	Nature of the Safe Harbor Lease Transaction.....	24
2.	Ratemaking treatment of Malin Midpoint in prior Commission Orders	30
3.	Company Malin Midpoint Adjustment 7.5.....	32
4.	Staff’s Adjustment 7.5	36
5.	Income Tax normalization issues related to the Malin Midpoint Adjustment	38

LIST OF EXHIBITS

- Exhibit No. ___ (DPK-2): Qualifications of Danny P. Kermode
- Exhibit No. ___ (DPK-3): Adjustment 7.2, Property Taxes
- Exhibit No. ___ (DPK-4): Calculation of Adjustment 7.3, Renewable Energy Tax Credit
- Exhibit No. ___ (DPK-5): Internal Revenue Code Section 168(f)(8) - 1981
- Exhibit No. ___ (DPK-6): Excerpt from the Hearing before the Subcommittee on Oversight of the Committee On Ways and Means, House of Representatives, Ninety-Seventh Congress, First Session (December 15, 1981) containing a "Description of Safe Harbor Leasing Provisions Under the Accelerated Cost Recovery System," prepared by The Staff of the Joint Committee on Taxation
- Exhibit No. ___ (DPK-7): Excerpt from the Commission's Fourth Supplemental Order in *WUTC v. Pacific Power & Light Co.*, Cause No. U-82-12 (February 2, 1983), pages 1, 18 and 19
- Exhibit No. ___ (DPK-8): Excerpt from the Commission's Second Supplemental Order in *WUTC v. Pacific Power & Light Co.*, Cause No. U-83-33 (February 9, 1984), pages 1, 16 and 17
- Exhibit No. ___ (DPK-9): Excerpt from the Commission's Fourth Supplemental Order in *WUTC v. Pacific Power & Light Co.*, Cause No. U-86-02 (September 19, 1986), pages 1, 7 and 21
- Exhibit No. ___ (DPK-10): Schedule for the Amortization of the Malin Midpoint Up-Front Cash Payment
- Exhibit No. ___ (DPK-11): PacifiCorp's Response to Staff Data Request No. 151
- Exhibit No. ___ (DPK-12): PacifiCorp's Response to Staff Data Request No. 252

I. INTRODUCTION

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20

Q. Please state your name and business address.

A. My name is Danny P. Kermode. My business address is 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA 98504. My email address is dkermode@wutc.wa.gov.

Q. By whom are you employed and in what capacity?

A. I am employed by the Washington Utilities and Transportation Commission as a Regulatory Analyst.

Q. How long have you been employed by the Commission?

A. I have been employed by the Commission for nine years.

Q. Would you please state your educational and professional background?

A. I graduated in 1982 from Arizona State University in Tempe, Arizona with a Bachelor of Science in Accounting. Later that same year, I attended San Carlos University in the Philippines for postgraduate studies in Economic Analysis and Quantitative Business Analysis. I am a Certified Public Accountant (CPA) and Certified Financial Planner (CFP).

1 In 1992 and 1993, I was a member of the faculty at the National
2 Association of Regulatory Utility Commissioners (NARUC) Annual
3 Regulatory Studies Program held at Michigan State University in East
4 Lansing, Michigan. I taught classes in Financial and Regulatory Accounting
5 Standards and in Deferred Tax Accounting.

6 Exhibit No. ___ (DPK-2) is a resume of my professional and regulatory
7 experience.

8

9

II. SCOPE OF TESTIMONY

10

11 **Q. What is the scope of your testimony?**

12 A. I testify regarding tax related adjustments proposed by Mr. Paul M. Wrigley
13 in his testimony, Exhibit No. ___T (PMW-1T). These adjustments are his
14 Adjustment 7.2, Property Tax Expense; Adjustment 7.3, Renewable Energy
15 Tax Credit; Adjustment 7.4, IRS Settlement Amortization; and Adjustment
16 7.5, Malin Midpoint.

17

18

III. SUMMARY OF TESTIMONY

19

20 **Q. Please summarize your testimony.**

1 A. I present testimony regarding PacifiCorp's adjustment to property tax,
2 Adjustment 7.2, and the adjustment to recognize the effect of the Renewable
3 Energy Tax Credit, Adjustment 7.3. In addition, I address PacifiCorp's
4 Income Tax Settlement Adjustment 7.4 which proposes recovery of Internal
5 Revenue Service (IRS) settlement payments related to prior periods. Finally,
6 I provide testimony regarding the Malin Midpoint Adjustment 7.5, an
7 adjustment that recognizes the 1982 tax-basis sale and leaseback of
8 PacifiCorp's Malin Midpoint transmission line.

9

10 **IV. DISCUSSION**

11

12 **A. Adjustment 7.2, Property Taxes**

13

14 **Q. Did you review PacifiCorp's Property Tax Expense Adjustment 7.2?**

15 A. Yes.

16

17 **Q. Please summarize the Company's adjustment to its property tax expense.**

18 A. The Company's Adjustment 7.2 increases total company test-year property
19 tax expense by \$2,030,301. The Washington portion of this adjustment
20 results in an increase in test-year property tax of \$169,088. *Exhibit No. ____*

1 (PMW-3), Tab 7, page 7.0, column 7.2, line 22. The Company's property tax
2 Adjustment 7.2 is based on estimates the Company made at the end of its
3 fiscal year, the twelve months ended March 2004.

4 The Company's adjustment is actually made-up of three distinct sub-
5 adjustments; a restating adjustment and two projections.

6
7 **Q. Have you prepared an exhibit that summarizes Staff's analysis of property**
8 **taxes?**

9 A. Yes. My Exhibit No. ___ (DPK-3) shows the details of the Company's
10 Adjustment 7.2 in column (a); it shows the details of Staff's Adjustment 7.2 in
11 column (b); and it shows the differences between the Staff and Company
12 adjustments in column (c).

13
14 **Q. Please discuss the three adjustments the Company made in its Adjustment**
15 **7.2.**

16 A. As I mentioned, the details of the Company's adjustment are shown in
17 column (a) of my Exhibit No. ___ (DPK-3). The first adjustment is shown in
18 on line 7: "Reversal of Out-of-Period Adjustment." This is a restating
19 adjustment in which the Company removes two out-of-period accruals it

1 booked during the test year. This adjustment increases total company
2 property taxes by \$1,975,320 as of March 2004, as shown on line 8.

3 The Company's second adjustment is shown on line 11: "Currant
4 Creek Project." This adjustment reflects the Company's projection of the
5 property tax impact of the Currant Creek Generation Project, which is an
6 increase in property tax of \$400,000, again, as of March 2004.

7 The Company's third adjustment is shown on line 12: "Additional
8 Taxes." This adjustment reflects the Company's projection of additional
9 property taxes, and increases total company property tax by another
10 \$1,215,888.

11 These three Company adjustments total \$3,591,208, as shown on line
12 15. The Company adds this figure to the Company's actual property tax
13 expense for its fiscal year ended March 2004 (line 4), to derive the Company's
14 test year property tax estimate of \$69,697,000 (line 17). The difference
15 between \$69,697,000 and the total property taxes the Company accrued
16 (\$67,666,699, shown on line 21) is \$2,030,301 (line 23), which is the amount of
17 the Company's adjustment, total company. *See Mr. Wrigley's Exhibit No. ____*
18 *(PMW-3), Tab 7, page 7.2.1.*

1 Multiplying the total company amount of \$2,030,301 by the
2 Washington Allocation Factor (line 25), gives Washington’s share of the
3 Company’s adjustment: \$169,088 (line 27).

4

5 **Q. Is the Company’s Property Tax Expense Adjustment 7.2 appropriate?**

6 A. In part. The Company’s first adjustment is a proper restating adjustment
7 because it corrects the Company’s property tax account balance by removing
8 two amounts that relate to periods prior to the test year. As shown in my
9 Exhibit No. ___ (DPK-3), column (b), line 8, Staff accepts this adjustment.

10 However, the Company’s projections for “Currant Creek Project” and
11 for “Additional Taxes” are not appropriate. As shown on lines 11 and 12 of
12 column (b), Staff does not accept these adjustments.

13

14 **Q. What is the appropriate way to treat the Company’s projections for Currant**
15 **Creek property taxes?**

16 A. The \$400,000 increase in property taxes should be removed because Staff
17 does not include the Currant Creek Power Plant in rate base. Therefore, as
18 shown on line 11, column (b) of my Exhibit No. ___ (DPK-3), Staff makes no
19 adjustment for this item.

20

1 Q. What is the appropriate way to treat the Company's projection for
2 additional property taxes?

3 A. As shown on line 12 of my exhibit, this adjustment should also be removed.
4 In this adjustment, the Company proposes to increase total company
5 property tax by \$1,215,888. According to the Company's Response to Staff
6 Data Request No. 148(a)(4), this adjustment represents "additional tax based
7 on management's judgment." The Company provided no other support for
8 this projection.

9 Because this adjustment is based solely on the judgment of
10 management, and no other supporting computation has been provided, the
11 Company's adjustment fails the "known and measurable" standard for pro
12 forma adjustments, and it should not be allowed.

13

14 Q. Please explain why the Company's projection of additional property taxes
15 is not a proper pro forma adjustment because it is not "known and
16 measurable."

17 A. WAC 480-07-510 specifies that pro forma adjustments "... give effect for the
18 test period to *all known and measurable changes* that are not offset by other
19 factors." (*Emphasis added*). Accordingly, pro forma adjustments are not
20 merely estimates added to test year results. Instead, they are rooted in

1 historical data. Historical test-year data that have been affected by a
2 measurable change may be adjusted to recognize the impact on future
3 revenues or the impact on future costs.

4 For example, the Company could experience a known change in the
5 cost of its insurance premiums. The new insurance costs would be applied
6 to the historical data using the new rates, thus producing a measurable
7 change in costs.

8 In other words, pro forma adjustments are not merely forecasted
9 estimates of future expenses based on someone's "judgment." Accordingly,
10 because the Company's "Additional Taxes" adjustment is based solely on
11 management's judgment, it is not "known and measurable" and it should be
12 rejected by the Commission.

13

14 **Q. What is the proper calculation of Adjustment 7.2?**

15 A. Adjustment 7.2 should be made in the amount of \$34,513, as shown in
16 column (b), line 27, of my Exhibit No. ___ (DPK-3). Staff's Adjustment 7.2
17 uses the same general method the Company used, and includes the
18 Company's restating adjustment to reverse out-of-period accruals (line 7).
19 However, Staff's adjustment does not include the Company's adjustments
20 for "Currant Creek Project" or "Additional Taxes" (lines 11 and 12).

1 Accordingly, Staff's total adjustments are \$1,975,320 (line 15), which
2 translates to an adjustment to Washington of an additional \$34,513 in
3 property taxes (line 27).

4 This is a difference of (\$134,574) compared to the Company's
5 adjustment, as shown in column (c), line 27.

6

7 **B. Adjustment 7.3, Renewable Energy Tax Credit**

8

9 **Q. Please explain the Company's Adjustment 7.3, Renewable Energy Tax**
10 **Credit.**

11 A. PacifiCorp's Adjustment 7.3 recognizes the effect of the Renewable
12 Electricity Production Credit (Renewable Energy Tax Credit) provided for in
13 Section 45 of the Internal Revenue Code on cost of service. The Renewable
14 Energy Tax Credit is available to utilities that construct renewable energy
15 projects. Because it is a tax credit, the Renewable Energy Tax Credit is a
16 direct reduction to income tax expense.

17

18 **Q. Is the Company's proposed adjustment appropriate?**

19 A. Yes. However, the per kilowatt-hour value of the credit has increased from
20 the 1.8 cent per kilowatt-hour used by the Company in its adjustment, to 1.9

1 cent per kilowatt-hour currently. Accordingly, the Company's adjustment
2 needs to be updated.

3

4 **Q. Have you prepared an exhibit explaining Staff's Adjustment 7.3?**

5 A. Yes. My Exhibit No. ___ (DPK-4) describes the details of Staff's Adjustment

6 7.3. The only difference between the Staff and Company calculations is that

7 Staff used the current "Tax Credit Factor" of .019 instead of the former factor

8 of .018. In all other respects, the Staff and Company adjustments are the

9 same. The Commission should accept Staff's calculation because it is more

10 current. The adjustment increases the credit to \$171,091, as shown on line for

11 "Washington Credit" from the \$162,087 amount proposed by the Company.

12

13 **C. Adjustment 7.4, IRS Settlement Amortization**

14

15 **Q. Please explain the Company's Adjustment 7.4, IRS Settlement**

16 **Amortization.**

17 A. The Company Adjustment 7.4 is a proposal by the Company to recover

18 additional taxes the IRS assessed against the Company for eight tax years:

19 1991 through 1998. PacifiCorp attributes \$5,797,266 million of the total

20 \$64,217,849 income tax settlement to Washington.

1 As shown in Mr. Wrigley’s Exhibit No. ___ (PMW-3), Tab 7, page
2 7.4.1, the Company reduces this \$5,797,266 amount by \$1,921,016 for items
3 that are normalized for rate making purposes. The Company then further
4 reduces the Washington attributed tax underpayment by an additional 50%,
5 or \$1,938,125, citing the Settlement Agreement in Docket No. UE-032065.
6 After these reductions, the net amount of prior taxes the Company is
7 requesting is \$1,938,125.

8 The Company’s adjustment amortizes this \$1,938,125 amount over a
9 five-year period. The Company’s adjustment increases test year income tax
10 expense for Washington ratepayers by \$387,625 annually, to pay these prior
11 period taxes. *Exhibit No. ___ (PMW-3), Tab 7, page 7.0, column 7.4, line 23.*

12 The Company is also seeking to earn a return on the unamortized
13 balance. *Id., line 57.* Accordingly, the Company’s adjustment increases rate
14 base by the unamortized amount of \$1,550,500.

15

16 **Q. Is the Company’s proposed ratemaking treatment of these prior period tax**
17 **assessments appropriate?**

18 A. No. The Commission should reject the Company’s Adjustment 7.4, IRS
19 Settlement Amortization, for three independent reasons: (1) The income
20 taxes the Company is requesting to recover are costs related to prior periods.

1 Consequently, the Company’s adjustment constitutes retroactive ratemaking;
2 (2) The Company is in essence requesting that its income tax expense be
3 “trued-up” for the IRS audited years, despite the fact that ratemaking
4 methodology does not allow expense true-ups for prior periods; and (3) The
5 Company’s adjustment is inaccurate because it fails to include the additional
6 income that created the additional income tax.

7

8 1. *Retroactive Ratemaking*

9

10 **Q. What is retroactive ratemaking?**

11 A. In general, retroactive ratemaking occurs when a utility recovers costs
12 related to a period or periods prior to the test period. The Commission
13 defined the term in a 2001 Puget Sound Energy case: “Retroactive rate
14 making involves surcharges ... applied to rates which had been previously
15 paid, constituting an additional charge applied after the service was
16 provided or consumed.”¹

17

18 **Q. Does that definition apply to the taxes at issue in PacifiCorp’s Adjustment**
19 **7.4?**

¹ *WUTC v. Puget Sound Energy, Inc.*, Docket No. UE-010410, Order (November 9, 2001) at 2.

1 A. Yes. This is a classic example of retroactive ratemaking. The additional
2 income tax expense that the Company has included in this adjustment
3 applies to the period 1991 through 1998. Had the Company recorded the
4 correct amount of tax during that period, there would be no adjustment in
5 this case.

6 In other words, the \$1.9 million in additional income taxes seeks to
7 recover from Washington ratepayers relate to service the Company provided
8 in 1991 through 1998. These amounts originated in prior periods and they
9 are applicable to the service the Company provided in those prior periods.
10 They are not applicable to the test year in this case.

11 If the Commission allowed recovery of these past costs, that would
12 create in essence a surcharge on current rate payers for service PacifiCorp
13 provided years ago which, by definition, is retroactive ratemaking.

14

15 **Q. What is the problem with retroactive ratemaking?**

16 A. The ratemaking process is prospective, in that it determines the utility's cost
17 to serve its customers at the time rates are set. Retroactive ratemaking
18 contradicts this process. The Indiana commission clearly summarized three
19 reasons why retroactive ratemaking is generally prohibited:

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22

The rule against retroactive ratemaking serves three basic functions, namely: (1) protection of the public by ensuring that current customers will not be required to pay for the past deficits of utilities through their future rates, (2) preventing utilities from employing future rates to protect the financial investment of their stockholders, and (3) requiring utilities to bear losses and enjoy gains depending on their managerial efficiency.²

Q. Have there been cases in which the Commission has allowed costs from prior periods to be recovered in current rates?

A. Yes. The Commission has stated that on “rare occasions,” recovery of past expenses is permitted if it is in the public interest, and it is based on sound regulatory theory.³

The Commission has also stated that expenses justifying such treatment are extraordinary or catastrophic in nature, such as costs associated with storm damage.⁴

The Commission has also addressed recovery of past costs in the context of accounting orders, in which the utility has been allowed to defer costs on its books for later recovery.

² *Re Northern Indiana Public Service Co.*, 157 PUR4th 206, 228 (Indiana PSC 1994).
³ *WUTC v. Puget Sound Power & Light Co.*, Cause No. U-81-41, Sixth Supplemental Order (March 12, 1982) at 19.
⁴ *WUTC v. Puget Sound Power & Light Co.*, Docket Nos. UE-920433, UE-920499 and 921262, Eleventh Supplemental Order (September 231, 1993) at 51.

1 Q. Has the Commission issued an accounting order or other order addressing
2 the prior year income taxes PacifiCorp is seeking to recover in this case?

3 A. No.

4

5 Q. Is the tax settlement at issue here “catastrophic” in nature?

6 A. No.

7

8 Q. Is the tax settlement at issue here “extraordinary” in nature?

9 A. No. This question hits on a key point to the entire adjustment. The tax
10 settlement at issue is made up of large groups of different tax items that span
11 an eight-year period. For example, the additional taxes assessed by the IRS
12 related to adjustments to inventory, adjustments to depletion percentages,
13 and even adjustments for vacation pay.

14 Consequently, the Company’s term “Tax Settlement” is actually an
15 “umbrella” term under which the Company combines a large number of
16 separate and distinct tax adjustments, none of which is extraordinary.

17 In addition, as I mentioned, the tax settlement at issue covers an eight-
18 year period. Accordingly, the tax settlement is not extraordinary for that
19 reason as well.

1 In sum, the Commission should reject Company Adjustment 4.7 as
2 retroactive ratemaking.

3

4 2. *Income Tax Expense True-up*

5

6 **Q. Apart from the issue of retroactive ratemaking, what is the regulatory**
7 **effect of the Company’s request to recover prior-period income tax expense**
8 **for ratemaking purposes?**

9 A. In essence, the Company is requesting that its income tax expense be “trued-
10 up” for the audited years. This would be similar to an expense that has a
11 balancing account, such as a purchased gas cost mechanism in which a utility
12 is permitted to recover its actual cost of gas over time through a sort of
13 “balancing account” deferral and true-up process. This process allows the
14 utility to recover or “true-up,” excess costs it did not collect through tariff
15 rates over a period of time.

16

17 **Q. Is a true-up mechanism appropriate for prior period income taxes?**

18 A. No. First, PacifiCorp is not requesting a true-up mechanism. Second, a true-
19 up mechanism for prior period income taxes would be inconsistent with
20 regulatory theory.

1 **Q. Please explain why it would be inconsistent with regulatory theory to**
2 **allow a true-up of these prior period income taxes?**

3 A. It is in the Company's best interest and the ratepayers' best interest to keep
4 income taxes as low as legally possible. In non-rate case years, the Company
5 benefits by keeping taxes as low as possible. If income taxes were allowed to
6 be trued-up, the Company would have a reduced incentive to keep taxes as
7 low as legally possible, because whatever it did, the actual taxes the
8 Company paid would be collected from the ratepayer.

9 It should also be noted that accounting and legal costs involved in
10 appealing IRS audits are included in a test year to the extent they are
11 incurred in the test year.

12
13 3. *PacifiCorp's Adjustment Ignores Additional Income*

14
15 **Q. Other than the ratemaking principles you have already discussed, are there**
16 **other reasons why the Commission should reject the Company's**
17 **Adjustment 7.4?**

18 A. Yes. The Company's adjustment ignores the additional income that created
19 the additional income tax for which the Company is seeking recovery. The

1 result is a mismatch of income taxes with the income that generated those
2 income taxes.

3

4 **Q. Please explain this additional income concept.**

5 A. Income tax is a unique category of expense. Contrary to other expenses,
6 income tax expense is created only as an effect of another, independent,
7 expense or revenue item. That is to say, income taxes exist only as a result of
8 other financial transactions.

9 For example, assume a company increases its sales and its revenues
10 increase by \$100,000, and all other things remain constant, the company will
11 incur an income tax expense of \$35,000, assuming a 35% tax rate. On the
12 other hand, if the same company incurred additional *expenses* of \$100,000, its
13 income tax expense would decrease by \$35,000. It is only because of these
14 other independent transactions (additional sales revenues or additional
15 expenses) that the related income taxes are incurred or reduced.

16

17 **Q. How does this concept apply to PacifiCorp's Adjustment 7.4?**

18 A. As shown in Mr. Wrigley's Exhibit No. ___ (PMW-3), Tab 7, page 7.4.1, the
19 Company has allocated a total of \$1.9 million of additional income taxes to
20 be recovered from Washington rate payers over five years. However,

1 PacifiCorp fails to add any additional revenue or decrease any expenses
2 associated with these additional income taxes.

3 In other words, to incur \$1.9 million of additional income taxes at a
4 35% tax rate, the Company must have recognized additional revenues or
5 decrease expenses (or some combination both) that resulted in \$5.5 million⁵
6 of additional income. The \$1.9 million in additional income taxes can not
7 “stand alone,” as the Company proposes in its adjustment. Income taxes are
8 taxes on “something;” they can not exist in a void. However, that is precisely
9 what the Company’s proposal is requesting: the recovery of income taxes as
10 a stand-alone expense.

11

12 **Q. Assuming away the other reasons you have provided for rejecting**
13 **Adjustment 7.4, what would PacifiCorp have to do to properly match the**
14 **additional income tax expense it is requesting?**

15 A. PacifiCorp would have to also amortize \$5.5 million of the prior-period
16 income related to the additional taxes, over eight years, the same period as
17 the settlement income taxes were incurred. This would result in \$692,188 of
18 additional revenue recognized in test year Results from Operations.

⁵ \$5,537,500 additional income = \$1,938,125 million income tax divided by 35% tax rate.

1 Using an amortization period of eight years, instead of the five years
2 the Company has requested, reduces the proposed annual recovery from
3 \$387,625 to \$242,266.

4 The matching of the additional revenues combined with the proposed
5 income tax settlement expense would result in a reduced revenue
6 requirement of \$449,922.

7

8 **Q. Please summarize Staff’s recommendation regarding the Company’s IRS**
9 **Settlement Amortization Adjustment 7.4.**

10 **A.** The Commission should reject the IRS Settlement Amortization Adjustment.
11 The Company’s adjustment relates to expenses and revenues that are outside
12 the test year, and they do not reflect an ongoing cost of operations.
13 Including the tax settlement amounts would constitute retroactive
14 ratemaking. The Company seeks recovery of what is in fact a myriad of
15 different costs with different dynamics and accounting implications, all
16 grouped under the heading “tax settlement.” These are ordinary items
17 companies typically experience.

18 Ratemaking does not and should not provide, in effect, a “true-up”
19 mechanism for prior years’ income taxes, because doing so would remove

1 incentives of the Company to keep its income taxes as low as legally
2 permitted.

3 Finally, income tax expense is dependent on revenues or other
4 expenses. It can not exist by itself. If the Commission chooses to include the
5 out of period tax expenses, it should impute the corresponding taxed
6 income. If the ratepayers are expected to carry the burden of the income tax,
7 they should receive the benefit of related income.

8 If an adjustment is made, the expense and the related income should
9 be amortized over eight years, which was the period that created the
10 expense; not the five years proposed by the Company.

11

12 **D. Adjustment 7.4, Malin Midpoint**

13

14 **Q. What does "Malin Midpoint" refer to?**

15 A. Malin Midpoint is the name of a PacifiCorp transmission line that is 446
16 miles long, that goes between Malin, Oregon, near the California border, and
17 Midpoint, Idaho. The transmission line went into service in 1981.

18

1 **Q. What is the nature of the Malin Midpoint Adjustment?**

2 A. The Malin Midpoint Adjustment is an adjustment that addresses the
3 ratemaking impacts of a tax-basis sale and lease-back transaction involving
4 that transmission line.

5

6 **Q. Please describe that transaction.**

7 A. In 1981, PacifiCorp, then known as Pacific Power and Light Company,
8 entered into an agreement with Amoco to create, for Federal income tax
9 purposes only, a sale and leaseback of the Malin Midpoint transmission line.
10 The transaction was entered into under Section 168(f)(8) of the Internal
11 Revenue Code. These transactions are commonly called “safe harbor leases.”
12 My Exhibit No. ___ (DPK-5) contains a copy of the version of Section
13 168(f)(8) as it was enacted in 1981.

14 As far as tax law is concerned, PacifiCorp “sold” the transmission line
15 to Amoco at PacifiCorp’s tax basis of \$145,938,000, for which Amoco paid
16 PacifiCorp a \$44 million up-front cash payment for the purchase of the Malin
17 Midpoint utility plant. That \$44 million up-front cash payment equaled the
18 present value of the tax benefits Amoco expected to receive from the
19 transaction, at the time the transaction occurred. Amoco became the nominal

1 owner of the property and became eligible for the ACRS depreciation and
2 the investment tax credit.

3 Under the provisions of Section 168(f)(8), Amoco then “leased” the
4 plant back to PacifiCorp. As long as the provisions of Section 168(f)(8) are
5 followed, the law provides a “safe harbor” from the transaction being
6 characterized as anything but a sale and leaseback for tax purposes. As the
7 Staff of the Congressional Joint Committee on Taxation stated: “Because the
8 leasing provision was intended to be only a transferability provision, many
9 of the transactions that will be characterized as a lease under the safe harbor
10 will have no business purpose other than to transfer tax benefits.”⁶

11 This tax-basis only transaction enabled Amoco to enjoy the tax
12 benefits associated with the Malin Midpoint plant, namely, tax-basis
13 accelerated depreciation and the investment tax credit.

14
15 **Q. Historically, how has the Commission treated this transaction for**
16 **ratemaking purposes?**

⁶ Exhibit No. ___ (DPK-6) at page 4: “*Description of Safe Harbor Leasing Provisions Under the Accelerated Cost Recovery System*,” prepared by The Staff of the Joint Committee on Taxation. This description is contained in document entitled “Hearing before the Subcommittee on Oversight of the Committee On Ways and Means, House of Representatives, Ninety-Seventh Congress, First Session (December 15, 1981).” Exhibit No. ___ (DPK-6) is an excerpt from that document.

1 A. The Commission has consistently ordered that the \$44 million payment
2 PacifiCorp received from Amoco be amortized above the line over a thirty-
3 year period, with the unamortized portion deducted from rate base.

4 **Q. What are the issues regarding the Malin Midpoint transaction in this case?**

5 A. The issues regarding the Malin Midpoint sale and lease-back transaction are:

6 1) Is the Company's method for treating the \$44 million consistent with the
7 Commission's method?; and 2) Does the Commission's method violate the
8 normalization requirements of the Internal Revenue Code?

9

10 1. *Nature of the Safe Harbor Lease Transaction*

11

12 **Q. Please describe the context in which the Malin Midpoint sale and**
13 **leaseback arrangement came about.**

14 A. In the Economic Recover Tax Act of 1981 (ERTA), Congress added section
15 168(f)(8) to the Internal Revenue Code (Title 26 U.S.C.), which allowed
16 special tax treatment of transactions involving sale and leaseback of long-
17 term assets. As I mentioned, these leases were called "safe harbor leases."

18

1 **Q. Did PacifiCorp actually sell the transmission line to Amoco?**

2 A. No. It is important to note here that the Section 168(f)(8) “safe harbor” sale
3 and leaseback transaction is tax basis only. Under the “safe harbor”
4 provided in the Tax Code, there was no requirement that a company actually
5 “sell” its asset to the future “lessor.”

6 Accordingly, PacifiCorp did not actually sell the Malin Midpoint
7 transmission line to Amoco; PacifiCorp remained the legal owner of the line.

8

9 **Q. Please describe the specifics of the Amoco/PacifiCorp safe harbor lease**
10 **transaction.**

11 A. In December 1981, PacifiCorp and Amoco reached an agreement under
12 Section 168(f)(8), in which they agreed to create for tax purposes, a sale and
13 leaseback of the Malin Midpoint property. Amoco then paid PacifiCorp \$44
14 million in cash as an initial up-front cash payment on the “purchase” of the
15 Malin Midpoint property.

16 No further transactions have actually taken place between the two
17 parties since that initial \$44 million cash up-front cash payment paid by
18 Amoco. Instead, under Section 168(f)(8), PacifiCorp is assumed for tax
19 purposes to pay “rent” payments, and Amoco is assumed for tax purposes to

1 be making payments to PacifiCorp on a note payable financing the purchase
2 of the property.

3 The imputed loan payments from Amoco are set at the same payment
4 amount as the imputed lease payments from PacifiCorp. This allows the two
5 payments to offset each other. In addition, the lease period and the loan
6 period are also set to be the same. Accordingly, there is no need for any
7 more funds to be exchanged between PacifiCorp and Amoco.

8

9 **Q. You testified that PacifiCorp did not actually sell the Malin Midpoint**
10 **plant to Amoco. Did PacifiCorp transfer any ownership interest of Malin**
11 **Midpoint whatsoever to Amoco?**

12 A. No.

13

14 **Q. Please describe the details of the cash payment paid by Amoco to**
15 **PacifiCorp as part of the Section 168(f)(8) safe harbor lease.**

16 A. In December 1981, Amoco paid \$43,869,000 in cash to PacifiCorp, in order to
17 qualify for the special leasing treatment allowed under Section 168(f)(8). As I
18 explained, this \$44 million payment represents the up-front cash payment by
19 Amoco for the tax-basis-only “purchase” of the Malin Midpoint property.

20 That amount equals the present value of the tax benefits Amoco expected to

1 realize from the Malin Midpoint sale and leaseback, at the time Amoco
2 entered into the transaction.

3

4 **Q. Does the \$44 million represent an actual transfer of tax benefits from**
5 **PacifiCorp to Amoco?**

6 A. No. The Section 168(f)(8) sale and leaseback simply allowed Amoco to enjoy
7 the tax benefits of the Malin Midpoint property, by deeming Amoco owner
8 of the Malin Midpoint property and allowing Amoco to depreciate the
9 “purchased” assets and take the investment tax credits associated with the
10 plant as the deemed owner. The \$44 million was merely a negotiated
11 amount. That up-front cash payment represents Amoco’s estimate of the tax
12 savings Amoco expected to realize; it does not represent the tax savings
13 Amoco actually realized over time.

14 In other words, the Tax Code allowed Amoco to depreciate the plant
15 and take investment tax credit for tax purposes, because Section 168(f)(8)
16 treated the Malin Midpoint assets as if they had been sold to Amoco by
17 PacifiCorp. Amoco paid PacifiCorp the present value of the estimated tax
18 benefits that Amoco assumed at the time of the payment it would receive as
19 a result of the transaction.

20

1 **Q. What were some of the key assumptions Amoco made in determining**
2 **what amount it would pay to PacifiCorp?**

3 A. One of the key assumptions Amoco used to compute the cash payment
4 amount was a 46% tax rate, the top corporate tax rate at the time of the
5 transaction. Amoco also assumed a 12.11% discount rate in computing the
6 present value. This discount rate is also a matter of judgment and entails
7 risk. That is, Amoco expected to earn 12.11% on the up-front cash payment
8 during the period between the time the up-front cash payment was made
9 and the time Amoco was able to take the depreciation deductions and
10 investment tax credit.

11 In short, Amoco paid \$44 million to PacifiCorp in 1981, and expected
12 in return \$67 million of tax benefit over the 30-year life of the property.

13
14 **Q. Did Amoco's 46% tax rate assumption turn out to be correct?**

15 A. No. The Tax Reform Act of 1986 lowered the corporate rate from the 46% to
16 34%. Congress changed the corporate tax rate again in 1993, raising it to
17 35%.

18
19 **Q. Did those tax rate changes change the tax benefits Amoco actually received**
20 **from the sale and leaseback transaction?**

1 A. Yes. I estimate that the tax rate changes caused Amoco to actually lose some
2 \$2 million in tax benefits from what it had estimated when it paid the \$44
3 million in cash to PacifiCorp in 1981.

4

5 **Q. Did PacifiCorp have to pay back any of the \$44 million to Amoco because**
6 **Amoco's tax benefits were different than expected?**

7 A. No.

8

9 **Q. What is the significance of this fact?**

10 A. This demonstrates the fact that the \$44 million payment Amoco made to
11 PacifiCorp was merely a negotiated amount based on certain assumptions,
12 including expected tax rates. The \$44 million does not, and did not,
13 represent the actual value of tax benefits associated with the Malin Midpoint
14 plant. It was simply the up-front cash payment on the purchase of the utility
15 plant. Amoco assumed certain risks of ownership, including possible
16 changes in the tax rate.

17

1 2. *Ratemaking treatment of Malin Midpoint in prior Commission Orders*

2

3 **Q. Have you reviewed how the Commission has treated the \$44 million**
4 **PacifiCorp received from the Malin Midpoint transaction for ratemaking**
5 **purposes?**

6 A. Yes.

7

8 **Q. What did you find?**

9 A. I found that in the three prior rate case orders involving PacifiCorp in which
10 the Commission has addressed the issue, the Commission has amortized the
11 \$44 million over the life of the related assets.

12 The first order to address the issue was in Cause Nos. U-82-12 and U-
13 82-35. At pages 18-19 of the Commission's Fourth Supplemental Order in
14 that case (February 2, 1983), the Commission described Staff's proposed
15 treatment as follows:

16 [Staff proposes] to amortize the cash receipts over the life of
17 the related assets...

18

19 On page 19 of that Order, the Commission accepted Staff's
20 adjustment. An excerpted copy of this order is my Exhibit No. ____
21 (DPK-7).

1 The next case was Cause No. U-83-33. On page 17 of the
2 Commission's Second Supplemental Order in that case (February 9, 1984),
3 the Commission again described and accepted Staff's proposed treatment for
4 the \$44 million:

5 The Commission staff proposed the same treatment
6 proposed by it in Cause Nos. U-82-12/U-82-35. Commission
7 staff witness Willard Kessel treated the cash received in the
8 sale as a rate base reduction and proposed to amortize the
9 net amount received of \$43,574,000 over the life of the
10 related asset, which he calculated to be 30 years to be
11 consistent with the book life of the Malin/Midpoint line. ...
12 As it did in Cause Nos. U-82-12/U-82-35, the Commission
13 accepts the Commission staff's proposal.

14
15 An excerpted copy of the Commission's Second Supplemental Order
16 is my Exhibit No. ____ (DPK-8).

17 The third case was Cause No. U-86-02, PacifiCorp's last litigated
18 general rate case in Washington. Once again, the Commission addressed the
19 Malin Midpoint issue by deducting the unamortized balance of the \$44
20 million cash receipts from rate base, as shown on page 21 of its Second
21 Supplemental Order (September 19, 1986). This adjustment was proposed by
22 PacifiCorp and was the same adjustment as Staff proposed. An excerpted
23 copy of the Commission's Second Supplemental Order is my Exhibit No. ____
24 (DPK-9).

25

1 **Q. How would you characterize the Commission’s treatment of the effect of**
2 **the Malin Midpoint cash receipts on the Company’s results of operations**
3 **for ratemaking purposes?**

4 A. The Commission has been consistent. The amortization of \$44 million
5 dollars over thirty years produces an annual amortization of \$1,452,000 per
6 year, total company.

7 The only complicating factor associated with the amortization
8 originated in the Commission’s Order in Cause No. U-86-02. Staff in that
9 case reduced the amount of amortization by an imputed amount assumed to
10 be associated with the Investment Tax Credit, which resulted in a lesser
11 amount being amortized. I discuss this complexity later in my testimony.

12
13 3. *Company Malin Midpoint Adjustment 7.5*

14
15 **Q. Has the Company proposed an adjustment for the Malin Midpoint**
16 **transaction?**

17 A. Yes. The Company offers as one of its tax adjustments Adjustment 7.5,
18 entitled “Malin Midpoint.” The details of the adjustment are shown in Mr.
19 Wrigley’s Exhibit No. ___ (PMW-3), Tab 7, page 7.5.

20

1 **Q. Did you review the Company's Malin Midpoint Adjustment 7.5?**

2 A. Yes.

3

4 **Q. Please summarize the Company's Adjustment 7.5.**

5 A. As shown in Mr. Wrigley's Exhibit No. ___ (PMW-3), Tab 7, page 7.5, the
6 Company Adjustment 7.5 for the Malin Midpoint transaction is reflected in
7 five separate adjustments. One adjustment is to the test year expenses; three
8 adjustments are to rate base; and one adjustment is made to account for a
9 Schedule M income tax item.

10 The combined effect of these five adjustments, when allocated to
11 Washington using the Company's proposed methodology, is to increase
12 operating expenses by \$156,972 and increases rate base by \$582,787, as
13 shown on Exhibit No. ___ (PMW-3), Tab 7, page 7.0, column 7.5, lines 30 and
14 57.

15

16 **Q. What does the Company testify is the basis for these adjustments?**

17 A. The Company testifies that the Commission ordered the "gain" (the \$44
18 million cash payment PacifiCorp received) to be amortized over a thirty-year
19 period with "associated rate base treatment." *Exhibit No. ___T (PMW-1T) at*
20 *21, lines 11-12.*

1 Q. Is the Company's testimony correct?

2 A. Yes. Mr. Wrigley correctly states in his testimony that the Commission
3 ordered the \$44 million dollars to be amortized over a thirty-year period,
4 with the associated rate base treatment.

5

6 Q. Is the Company's Adjustment 7.5 consistent with that testimony and the
7 Commission-ordered treatment?

8 A. No. The Company's five adjustments contained in Adjustment 7.5 bear no
9 resemblance to the treatment the Commission ordered. The Commission-
10 ordered amortization of the \$44 million cash payment should result in a
11 reduction in total expenses, not an increase of \$156,972, as reflected in the
12 Company's adjustment. In addition, the rate base treatment ordered by the
13 Commission should result in a decrease in rate base, not the \$582,787
14 increase proposed by the Company.

15 In short, the Company's proposed Adjustment 7.5 is inconsistent with
16 prior Commission orders on Malin Midpoint.

17

1 **Q. How would you describe the method proposed by the Company?**

2 A. The Company is proposing a method that imputes income tax effects of the
3 fictional sale and leaseback transaction and creates deferred taxes for
4 regulatory and rate making purposes.

5

6 **Q. In its prior orders, has the Commission addressed the method PacifiCorp
7 proposes in this case?**

8 A. Yes. On page 17 of the Commission's Second Supplemental Order in Cause
9 No. U-83-33, the Commission acknowledged the Company's "rent/interest
10 timing difference" method. *Exhibit No. ___ (DPK-8) at page 17.*

11

12 **Q. Did the Commission accept the Company's method?**

13 A. No. The Commission did not accept the "rent/interest timing difference"
14 method the Company advanced in Cause No. U-83-33. Apparently, that is
15 the same methodology the Company is once again proposing in this case.

16

17 **Q. Should the Commission accept the Company's Adjustment 7.5?**

18 A. No. The Commission should reject Company Adjustment 7.5. It is
19 inconsistent with the treatment the Commission has ordered on three

1 separate occasions. Moreover, it imposes imputed costs on the ratepayers of
2 the tax basis safe harbor lease transaction.

3

4 4. *Staff's Adjustment 7.5*

5

6 **Q. Please explain Staff's Adjustment 7.5, related to the \$44 million cash
7 PacifiCorp received from the Malin Midpoint transaction.**

8 A. Staff Adjustment 7.5 applies the same ratemaking treatment to the cash
9 receipts that the Commission previously ordered in Cause Nos. U-82-12 and
10 U-82-35, in Cause No. U-83-33, and again in Cause No. U-86-02.

11

12 **Q. Have you prepared an Exhibit describing Staff's Adjustment 7.5?**

13 A. Yes. Please refer to my Exhibit No. ____ (DPK-10).

14

15 **Q. Please explain that exhibit.**

16 A. As shown on that exhibit, Staff took the net proceeds of the sale (line 7), and
17 divided by 30 years to derive the annual amortization amount of \$1,452,000
18 (footnote (1)). The general divisional-pacific allocation factor is then applied
19 to the total amount, resulting in a Washington amortization of \$244,000 (line
20 42.

1 **Q. Please explain how Staff's Malin Midpoint rate base adjustment is**
2 **calculated.**

3 A. The average total company, test year balance of the unamortized balance of
4 \$9,804,000 is computed on lines 35 and 36 in Exhibit No. ____ (DPK-10). The
5 Divisional Generation - Pacific allocation factor is then applied to the average
6 balance amount, which results in a deduction of \$1,644,000 from the
7 Company's Washington rate base (line 41).

8

9 **Q. Did you check the accuracy of the rate base calculation in Staff's**
10 **adjustment?**

11 A. Yes. I checked the accuracy of this calculation by comparing the amount of
12 the deduction from rate base the Commission used in Cause No. U-86-02, to
13 the amount shown in my exhibit. The amount deducted from rate base in
14 that earlier case, \$6,064,000, Exhibit No. ____ (DPK-9), Order page 21, is
15 essentially the same as the 1986 amount of \$6,089,000 computed in column
16 (e), line 12 of my Exhibit No. ____ (DPK-10), with less than a half of one
17 percent difference between the two amounts. This shows my calculation in
18 this case is reasonably accurate.

19

1 **Q. Please summarize Staff's recommendation for the Malin Midpoint**
2 **Adjustment 7.5.**

3 A. Staff's Adjustment 7.5 is consistent with prior Commission orders, it is
4 accurate, and it should be accepted.

5 The Company's Adjustment 7.5 proposes a \$582,787 increase in rate
6 base, and an increase in operating expenses of \$156,972. This adjustment
7 defies logic. The unamortized amount of \$44 million over thirty years
8 should, consistent with prior Commission orders, still reduce rate base, and
9 the amortization of the gain should still decrease operating expenses.

10 Therefore, PacifiCorp's adjustment is not consistent with prior orders
11 of this Commission and it should be rejected. The Company has provided
12 no reason why the Commission's approach should be different than it was
13 when it first decided this issue over twenty-years ago.

14

15 5. *Income Tax normalization issues related to the Malin Midpoint Adjustment*

16

17 **Q. What is income tax normalization?**

18 A. In brief, for regulatory purposes, regulated utilities record depreciation on a
19 straight line basis. Under straight line depreciation, an equal amount of
20 depreciation is recorded each year over the life of an asset.

1 However, for federal income tax purposes, the utility is allowed to
2 take accelerated depreciation for that asset. That is, the utility computes its
3 federal income taxes using a rate of depreciation that allows for a faster
4 recovery of its investment, which results in a larger depreciation expense for
5 a shorter period.

6 The result is a difference between taxes for “book” purposes and taxes
7 for “federal income tax” purposes. “Normalization” accounting addresses
8 how this tax timing difference is recognized on the Company’s books.

9

10 **Q. How does tax normalization apply to regulated public utilities?**

11 A. As it applies to regulated public utilities, income tax normalization requires
12 any income tax computation for rate making purposes to include, as an
13 expense, the regulatory basis depreciation expense (*i.e.*, based on straight line
14 depreciation) and to recognize the regulatory basis treatment of any
15 investment tax credits.

16 In other words, the net income that is used to compute the utility’s
17 income tax expense must include the effect of the regulatory depreciation
18 expense, and not the utility’s tax-basis depreciation expense.

19 This creates a temporary difference between the income taxes the
20 utility actually pays, and the amount the utility recognizes as an expense for

1 ratemaking purposes. The accounting for this difference is called “deferred
2 accounting.” The difference between federal income taxes computed using
3 straight line depreciation for regulatory purposes and federal income taxes
4 computed using accelerated depreciation is deferred and amortized over the
5 life of the asset. At the end of the regulatory life of the asset, the difference
6 equals zero.

7 Under the Internal Revenue Code, the utility would lose the ability to
8 use accelerated depreciation for tax purposes if regulators “flowed-through”
9 to rate payers the tax savings associated with the utility’s use of accelerated
10 depreciation in computing federal income tax.

11

12 **Q. Is normalization also required for the investment tax credit?**

13 A. Yes. The Internal Revenue Code also requires investment tax credit to be
14 normalized. Rates must be set based on a deferred accounting treatment of
15 the credit. For example, assume a utility uses the investment tax credit in
16 year one, which then reduces the income tax paid in the same year. For
17 ratemaking purposes, the investment tax credit is recognized over the life of
18 the plant that the investment tax credit helped finance.

19 In the case of PacifiCorp, the deferred ITC is deducted from its rate
20 base, but it is not amortized into the cost of service for normalization

1 purposes, because the investment tax credit as recognized as a source of zero
2 cost capital.

3

4 **Q. Please explain your understanding of the Company's position regarding**
5 **income tax normalization requirements and the Commission's method for**
6 **treating the Malin Midpoint transaction?**

7 A. As I understand it, the Company believes the Commission's method violates
8 the Internal Revenue Code's normalization requirements. In the Company's
9 Response to Staff Data Request No. 151 (a), which is my Exhibit No. ____
10 (DPK-11), the Company admits that its Adjustment 7.5 is not consistent "in
11 some respects" with the Commission's orders in Cause Nos. U-82-12/U-82-35
12 and Cause No. U-83-33. The Company states the Commission's method
13 would "invalidate the favorable tax treatment of this safe harbor lease
14 transaction...." and "...to follow the methodology of U-83-33 would violate
15 ... [Internal Revenue Code] normalization accounting requirement."

16

17 **Q. What is the basis for the Company's position?**

18 A. As shown in same Data Request Response, the Company argues that its
19 receipt of the \$44 million cash payment amounted to "accelerated recovery"
20 by the Company of the tax benefits associated with Malin Midpoint, and

1 therefore, this was equivalent to PacifiCorp's use of the investment tax credit
2 and depreciation. Consequently, according to the Company, "The cash
3 amount received by PacifiCorp from Amoco ... was for investment tax credits
4 and depreciation benefits ...is equivalent to the use, by PacifiCorp, of those
5 accelerated tax benefits." *Exhibit No. ___ (DPK-11), page 1.*

6 Essentially what the Company is saying is the \$44 million must be
7 normalized using the same rules that would apply as if that \$44 million was
8 the actual plant subject to investment tax credit and accelerated depreciation.

9
10 **Q. In your opinion, does the Commission's method for treating the cash**
11 **PacifiCorp received in the Malin Midpoint tax transaction violate the**
12 **normalization requirements of the Internal Revenue Code?**

13 A. No.

14
15 **Q. Please explain the basis for your opinion.**

16 A. The Company's argument relies on the premise that the cash received by
17 PacifiCorp was solely for investment tax credits and depreciation benefits.
18 That is not correct. As I stated earlier in my testimony, the \$44 million in
19 cash PacifiCorp received was simply Amoco's up-front cash payment to

1 PacifiCorp for the tax-basis purchase of the Malin Midpoint transmission
2 lines; it was not a purchase of tax benefits.

3 A *result* of the sale and leaseback transaction was the ability of Amoco
4 to take tax benefits associated with the Malin Midpoint property. However,
5 nowhere in Section 168(f)(8) is there any statement that the transaction is a
6 sale of tax benefits. Rather, Section 168(f)(8) discusses leases of property.

7 In other words, the Company is attempting to impute a result of the
8 transaction, as if it were the transaction itself. That is not appropriate. The
9 Malin Midpoint transaction is a tax-basis sale and leaseback of a
10 transmission line, not a sale and leaseback of tax benefits.

11 This is reflected in the terms of the transaction itself. As I explained
12 earlier, the \$44 million cash payment from Amoco to PacifiCorp was simply
13 an agreed-upon amount equal to Amoco's present value estimate of tax
14 benefits that Amoco expected to receive. That cash payment was not a *quid*
15 *pro quo* purchase and sale of the tax benefits themselves.

16 In short, the Company's argument rests on the assumption that the
17 cash payment was the purchase of tax benefits, which is not the case.

18 Indeed, the opening of the Treasury's temporary regulations clearly stated
19 that Safe Harbor Lease transaction were to be treated as a type of lease:

1 If all the requirements ... are met, then the agreement shall
2 be treated as a lease, and the party characterized as the
3 lessor shall be treated as the owner of the property. In such
4 case, the lessor shall be deemed to have entered into the
5 lease in the course of carrying on a trade or business and
6 shall be allowed accelerated cost recovery system (ARCS)
7 deductions under section 168 and the investment tax credit
8 under section 39 with respect to the leased property.
9

10 *IRS Regulation § 5c.168(f)(8)-1(a) Special rules for leases. 46 FR 51907*
11

12 **Q. Has PacifiCorp raised any other normalization issues associated with the**
13 **Commission's method of treating the Malin Midpoint transaction?**

14 A. Yes. In PacifiCorp's Response to Staff Data Request No. 252, which is my
15 Exhibit No. ___ (DPK-12), the Company argues that the Commission's
16 method violates the normalization requirements related to the safe-harbor
17 leasing provisions of Tax Code Section 168(f)(8).

18 In its Response, the Company cites Section 168(f)(8)(D), now repealed,
19 which restricts qualified leased property to, among other things, public
20 utility property that is normalized for rate making purposes. The Company
21 argues that if public utility property is leased under the Section 168(f)(8) sale
22 and leaseback arrangement, and if that property is not normalized for rate
23 making purposes, the public utility property would not longer be eligible for
24 the safe-harbor provisions of 168(f)(8).
25

1 **Q. In your opinion, does the \$44 million PacifiCorp received in the safe**
2 **harbor lease transaction constitute public utility property under the Tax**
3 **Code?**

4 A. No. The term “public utility property” is defined in Section 46(f)(5) of the
5 Internal Revenue Code as:

6 ...property used predominantly in the trade or business of the
7 furnishing or sale of (i) steam through a local distribution system or
8 (ii) the transportation of gas or steam by pipeline, if the rates for
9 such furnishings or sale are established or approved by a
10 governmental unit, agency, instrumentality, or commission
11 described in subsection (c)(3)(B).

12
13 Clearly, cash is not “public utility property” as contemplated by this
14 definition.

15
16 **Q. Assuming the \$44 million cash payment PacifiCorp received from Amoco**
17 **should be normalized, what would be the effects of that treatment?**

18 A. There would be no effect from the normalization of the cash receipts because
19 the Company is amortizing the \$44 million over the same period for tax
20 purposes as it is being amortized using the Commission’s method. In other
21 words, because both methods amortize the same amount into the Company’s
22 results of operations, there is no difference in the income tax impact.

23

1 **Q. How does the Federal Energy Regulatory Commission (FERC) treat the**
2 **proceeds a utility receives from a safe harbor sale and leaseback**
3 **transaction?**

4 A. It is my understanding that the FERC uses the same method the Commission
5 uses. In a case involving Arizona Public Service Company (APS), FERC
6 ordered the utility to amortize safe harbor lease proceeds as a credit to the
7 cost of service over the economic life of property, and that the unamortized
8 balance should be deducted from rate base. In that case, the FERC
9 Administrative Law Judge, and then FERC rejected the utility's argument
10 that this treatment violated Section 168(f)(8) of the Internal Revenue Code.
11 The Ninth Circuit Court of Appeals affirmed the FERC decision.⁷

12
13 **Q. Has FERC dealt with any other aspects of the way in which utilities treat**
14 **safe harbor leased utility property?**

15 A. Yes. In 1995, FERC was again asked to address the proper accounting for the
16 proceeds of a safe harbor lease transaction. Interestingly, it was PacifiCorp
17 who requested the accounting treatment, this time regarding Unit No. 4 of
18 the Cholla power plant, which the Company had purchased from APS. In

⁷ *Re Arizona Public Service Co.*, Opinion No. 193, 25 FERC ¶ 61,092, at page 61,309, *order on rehearing*, Opinion No. 193-A, 25 FERC ¶ 61,393, at pp. 61,870-71 (1983), *affirmed sub nom. Papago Tribal Utility Authority v. FERC*, 773 F.2d 1056, 1062-65 (9th Cir. 1985), *cert. denied*, 475 U.S. 1515 (1986).

1 1981, the Cholla plant was “sold” by APS to General Electric Company in a
2 safe harbor lease transaction. In 1991, APS, in a true asset transfer, sold the
3 property to PacifiCorp.

4 PacifiCorp requested FERC approval to treat the unamortized
5 “depreciation–related” proceeds from a safe harbor transaction as
6 accumulated deferred income taxes. According to PacifiCorp, those
7 proceeds “amounted to an accelerated recovery of tax benefits.”⁸ The FERC
8 denied PacifiCorp’s request.

9
10 **Q. What was the amount of the \$44 million Malin Midpoint cash payment**
11 **that was amortized in the Company’s results of operations in the 1986 rate**
12 **case, Cause No. U-86-02?**

13 A. The total adjustment in the 1986 case for the Malin Midpoint transaction was
14 \$196,000 as shown on Page 7 of the Commission’s Second Supplemental
15 Order in that case, which is the second page of my Exhibit No. ___ (DPK-9).
16 This \$196,000 adjustment amount equaled the amortized amount for the
17 Malin Midpoint of \$174,000, plus a \$22,000 adjustment for the tax effect of
18 the tax-basis rent and interest timing difference.

⁸ Re *PacifiCorp*, Docket No. AC91-110-001, Order Denying Rehearing, 81 FERC ¶ 61,225 at page 61,952 (1997).

1 **Q. Staff is recommending \$244,000 be amortized into the results of operations**
2 **in this case. Please explain the \$48,000 difference between that amount**
3 **and the \$196,000 amount of the adjustment in Cause No. U-86-02.**

4 A. The \$48,000 difference is the result of: 1) removing the \$22,000 tax effect of
5 additional expense related to the rent and interest timing difference of the
6 sale and leaseback transaction; and 2) a \$50,000 increase in the amortization
7 amount due to the recognition of the additional amortization that was
8 removed in Cause No. U-86-02, which was assumed to be associated with the
9 Company's investment tax credit.

10

11 **Q. Please explain why the \$22,000 rent and interest timing difference is not**
12 **included in Staff Adjustment 7.5.**

13 A. This rent and interest timing difference reflects a tax-basis only transaction.
14 As I stated above, the rent payments to Amoco and the debt payments from
15 Amoco to PacifiCorp are tax-law fiction. The term "rent" and "interest"
16 timing difference can be confused with the income tax concept used for
17 normalization that is also termed a "timing difference." When discussing
18 "timing differences" related to normalization, that term refers to transactions
19 that are recognized for regulatory purposes at a different time than the same
20 transaction is recognized for income tax purposes.

1 The “timing difference” referred to in the term “rent and interest time
2 difference” refers to the timing difference created by the income tax basis
3 “rent” payment made by PacifiCorp, which is an expense for tax purposes,
4 and the interest income the Company receives from Amoco for the tax-basis
5 debt. This rent and interest timing difference is, for regulatory purposes, a
6 permanent difference. The rent payments and interest income will never be
7 included in the regulatory results because they represent the financial results
8 of a tax-basis imaginary sale and leaseback.

9 In other words, neither the “rent” payments nor the interest income
10 will ever be recognized for any other purposes but income taxes. Therefore,
11 the \$22,000 recognized in Cause No. U-86-02 should not be included in the
12 regulatory results of operations used to set rates.

13
14 **Q. Why have you have included \$50,000 of additional amortization that was
15 not included in Cause No. U-86-02?**

16 **A.** At the time of the 1986 rate case, Cause No. U-86-02, Staff recommended not
17 including \$50,000 of the amortization because there was a newly-released
18 Internal Revenue Service Private Letter Ruling (PLR 8537063) that discussed
19 the regulatory treatment of “net proceeds” from the sale in a safe harbor

1 lease transaction. This ruling specifically addressed the regulatory treatment
2 of the deferred investment tax credit.

3 I have reviewed that Private Letter Ruling and it is my opinion that
4 the Commission may include the additional amount. Therefore, I have
5 increased the amortization to the original thirty-year amortization amount,
6 without reduction.

7

8 **Q. Please briefly discuss that Private Letter Ruling.**

9 A. The Private Letter Ruling had been requested by an unidentified regulated
10 public utility. That company had elected to recognize its investment tax
11 credits by amortizing them into the cost of service, rather than reducing its
12 rate base, as is the case of PacifiCorp. The company's election to amortize
13 prohibits the reduction of rate base for any deferred ITC balances. In other
14 words, any reduction of rate base related to the deferred investment tax
15 credit would violate normalization requirements.

16 The Private Letter Ruling stated that because the state commission's
17 temporary order reduced the petitioning company's rate base by sales
18 proceeds representing credits investment tax credits, the company would fail
19 to satisfy the conditions of section 46(f), and therefore the property would
20 not be qualified leased property. In other words, the company would not

1 qualify for the investment tax credit and would be required to reverse the
2 sale and leaseback.

3

4 **Q. Should that Private Letter Ruling affect the Commission's method of**
5 **treating the Malin Midpoint safe harbor lease?**

6 A. No, for several reasons. First, that Private Letter Ruling assumed that the
7 "sale proceeds" were comprised of the sold investment tax credits. If that
8 assumption was correct in that case, it is not correct in this case. The Malin
9 Midpoint transaction was a sale and leaseback transaction under Section of
10 168, which is entitled: "Special Rule for Leases." Section 168 (f)(8)(E)
11 requires a "minimum investment" by the lessor. The cash PacifiCorp
12 received was an up-front cash payment for the tax-basis purchase of the
13 Malin Midpoint property, establishing the required minimum investment.
14 This confirms the Malin Midpoint transaction was and is a sale and leaseback
15 transaction involving a transmission line. It was not a sale of investment tax
16 credits.

17 Second, the Private Letter Ruling was based on additional wording
18 added to Section 168(f)(8)(D) by the 1982 Technical Corrections Act:

19 Under regulations prescribed by the Secretary, public utility
20 property shall not be treated as qualified leased property
21 unless the requirements of rules similar to the rules of

1 subsection (e)(3) of this section and 46(f) are met with
2 respect to such property.⁹
3
4

5 However, to my knowledge, no regulations were ever issued.

6 Third, a private letter ruling applies to a specific taxpayer using that
7 taxpayer's specific set of facts. A private letter ruling cannot be used or cited
8 as precedent. The IRS can revoke or modify a private letter ruling by, among
9 other methods, issuing a revenue ruling or procedure, or by regulations. *See*
10 *Section 11 of the IRS Revenue Procedure 2005-1.*

11 Finally, the Private Letter Ruling takes a position contrary to the
12 treatment FERC required in the matter involving Arizona Public Service
13 Company, which I discussed earlier. As FERC has observed, the Ninth
14 Circuit Court of Appeals decision affirming FERC's treatment of the safe
15 harbor lease in that case post-dated the private letter ruling.¹⁰ The FERC has
16 also observed that reliance on that Private Letter ruling was "misplaced."¹¹
17 The FERC noted that the Private Letter Ruling itself stated it "may not be
18 cited or relied on as precedent [and] is directed only to the taxpayer who
19 requested it."¹² According to the FERC: "If the ruling is not even binding on

⁹ *Technical Corrections Act of 1982*, 1983-1 C.B. 451, 453.

¹⁰ *Re PacifiCorp*, Docket No. AC91-110-001, Order Denying Rehearing, 81 FERC ¶ 61,225 at page 61,952 (1997).

¹¹ *Re Lear Petroleum Corporation*, Opinion No. 294, 42 FERC ¶ 61,015, 1988 WL 243522, *12 (1988).

¹² *Id.*, quoting the Private Letter Ruling itself.

1 the agency which issued it, it cannot serve as grounds for overturning
2 another agency's precedent which was affirmed by a federal court of
3 appeals."¹³

4

5 **Q. In your opinion, do prior Commission orders regarding Malin Midpoint**
6 **violate normalization requirements under either section 168 or section 46**
7 **of the Internal Revenue Code?**

8 A. No.

9

10 **Q. In your opinion, is there anything in prior Commission orders on Malin**
11 **Midpoint or in the current Staff Adjustment 7.5 that would make the**
12 **Malin Midpoint property non-qualified leased property under Section**
13 **168(f)(8)?**

14 A. No.

15

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

17 A. Yes.

¹³ *Id.*