Exhibit No. ___(LOM-1T)
Docket No. UE-03_____
2003 PP&L Rate Case
Witness: Larry O. Martin

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant, vs. PACIFICORP dba Pacific Power & Light Company, Respondent.	)	Docket No. UE-03______

PACIFICORP

DIRECT TESTIMONY OF LARRY O. MARTIN

December 2003

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, Suite 1900, Portland, Oregon 97232. My present position is Tax Director.

Qualifications

Q. Please briefly describe your education and business experience.

A. I was awarded a Bachelor of Science degree in Accountancy from Brigham Young University in December 1984, and a Masters of Accountancy in Taxation in August 1985, also from Brigham Young University. 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 for JELD-WEN, Inc., a privately-held manufacturing firm; and over three years as Director of Tax with PacifiCorp. My previous 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. 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 to support recovery of the tax settlement payments the Company has made during the test year in this case. My testimony also supports the recovery of costs associated with Internal Revenue Service ("IRS") settlements that will be paid on or before March 31, 2004.

Q. Please outline your testimony.

A. First, I explain how tax costs are currently calculated for ratemaking purposes. I also explain how the Company's accrual for adjustments to income taxes has been funded. Second, I support the Company's request for the Commission to adopt a new ratemaking treatment for in-period IRS tax settlement payments. In this section, I also discuss the timeline and elements of the tax settlement process.

Current Regulatory Treatment of Tax Settlement Payments

Q. How are the Company's tax costs included in its cost of service?

A. Cost of service for the Company currently includes only the estimated tax accrual for the current test period. The Company's ultimate tax liability for the tax year corresponding to that test period will not be known for up to several years, as described below, and thus, is not included. Other tax payments associated with the ultimate tax liability for previous years that are paid in the test period are currently not included. Specifically, tax payments for the test period that will be made after the test year are excluded, as are tax payments related to IRS audits, appeals and/or settlements (referred to collectively herein as "tax settlements") made in the test year but related to prior year tax returns.

Q. Has the Company previously requested regulatory recovery of its tax settlement payments?

A. No.

Q. Please explain the reason for the Company's request in this proceeding.

A. As discussed below, PacifiCorp has incurred tax assessments in the test year in this case that exceed the existing tax accrual. Although PacifiCorp does hold reserves to meet tax settlements, as it is required to do so for accounting and financial reporting purposes, PacifiCorp's existing accrual has not been funded by Washington customers. Therefore, PacifiCorp is now requesting that the Commission permit recovery of the tax settlements paid in the test period and that will be paid on or before March 31, 2004, over a period not to exceed five years.

Q Please explain why you state that the tax contingency accrual has not been funded by Washington customers.

A The Company books a current tax liability, which includes the test period tax liability and a tax liability associated with the audits of prior years. As described in more detail below, this tax liability is adjusted to reflect assessments of the audit and the results of the settlement and appeals process as those events occur. When PacifiCorp makes a rate case filing in Washington, it includes the estimated accruals relating to tax liability for the test period; it does not include the booked amounts for reserves for assessments against the Company resulting from income tax audits. Therefore, these reserves are not and have not been included in the cost of service.

Test Period Tax Settlements

Q. What is the amount of the tax settlement payments made during the test period, and how does the Company propose to recover such amount?

A. The Washington portion of the total tax settlement paid is $5,797,269, as detailed in Mr. Ted Weston's Exhibit No.___(JTW-3), Tab 7, Page 7.7.2. In consideration of the significant amount and the impact on customers, the Company proposes to recover this amount over a period not to exceed five years. Accordingly, the amortization would include an adjustment to increase the current income tax expense by $1,159,454 (one-fifth of the total), with the remaining four-fifths of the amount reflected as an adjustment to the rate base as an accumulated deferred income tax balance to be amortized over the remaining four years.

Q. Please explain the nature of the tax settlement payments.

A. The tax settlement payments for which the Company is seeking recovery in this case relate to the exam and appeal of the 1991-93 audit and the exam of the 1994-98 audit. Payments related to these tax settlements were made during the test period. There is an additional payment expected during the period ended March 31, 2004 related to the appeal of the 1994-98 audit.

Q. Why is there a discrepancy between cost of service taxes and the tax settlement amounts?

A. As described above, the Company's tax liability for ratemaking purposes is based on the estimated accrual booked during the test period. Booked adjustments to the liability made at a later time associated with tax settlement payments are currently disallowed in the cost of service in future filings. However, the tax estimate used for ratemaking purposes is not the ultimate tax liability of the Company.

Q. Does this mean the booked tax expense used for ratemaking purposes is based upon estimates?

A. Yes. Exhibit No.___(LOM-2), Life Cycle of A Tax Year, illustrates the book, tax and regulatory treatment of tax costs of the Company over the period of time before the filing of a tax return through the assessment of the ultimate tax liability. Estimates of the ultimate tax liability for a specific tax year are made throughout the entire life cycle of that tax year. Based upon the quarterly estimated tax liability required for U.S. GAAP purposes, estimates are first made prior to the conclusion of a tax year based upon the business activity occurring in each quarter. Subsequent events, such as the filing of an extension of time for the filing of the return, and the filing of the return itself, provide opportunities for revision of the previous estimates. At the time of the events, the book provision is adjusted to reflect the additional precision that can be achieved because the Company has more time to fully analyze the details of the accounting during the fiscal year.

Q. Does the filing of the return establish the ultimate tax liability for a specific tax year?

A. No. Filing the return represents the Company's best estimate of the tax liability at that point in time, given the time constraints under which the return must be completed and filed. Subsequent to filing the return, the IRS and state taxing authorities audit the return. Upon conclusion of the IRS audit, the Company decides which issues to appeal, either administratively within the IRS or through the courts. Estimates continue to be made throughout this process, and a final determination of the tax liability for a given tax year is only made upon conclusion of litigation or when the Company no longer pursues an adjustment.

Q. How does the IRS audit affect the tax accrual?

A. In the course of its audit, the IRS will issue a Notice of Proposed Adjustment ("NOPA") for each adjustment the IRS believes should be made to taxable income. As these NOPAs are issued, the Company reviews the merits of the IRS' position, which may include proposed adjustments such as carry-over items from different time periods, differing interpretations of tax law, new interpretations of tax law applied retrospectively and other items. The Company determines whether to concede to the IRS position, provide additional information in support of the Company's position, negotiate the settlement of the specific issue as part of concluding the entire audit, or to appeal the issue upon completion of the audit. The tax accrual will be adjusted either up or down as the NOPAs are received, and based upon the Company's assessment of the issue, as needed to accurately state the tax liability on the books. As shown in Exhibit No.___(LOM-2), conclusion of the federal and state audits is normally completed only several years after the end of the fiscal year under examination.

Q. How is the tax accrual affected if adjustments are appealed by the Company?

A. Estimates continue to be revised throughout either an administrative appeal or litigation, based upon concessions made by either party. Again, Exhibit No.___(LOM-2) shows that on average, appeals are concluded only several years after the end of the subject fiscal year.

Q. When does the tax liability become final for a specific tax year?

A. The tax liability for a specific tax year becomes final when either the taxing authority or the courts establish a deficiency, and the Company decides not to pursue further appeals, or further appeal is unavailable. Alternatively, the Company and the taxing authority may settle the appeal at any point throughout the process. Although the tax liability may be a negotiated settlement, it is at that time that the tax liability for a given year is conclusive.

Q. Does this mean it is not possible to identify all taxes relating to a fiscal year until some time afterwards?

A. Yes, it is typical that all taxes due for a particular year are not paid until several years have passed.

Q. Why does the Company believe it is reasonable to recover in-period tax settlement payments?

A. Tax settlements, although ongoing, are not known and measurable until the deficiency is ultimately assessed by the taxing authority. Thus, recovery for such payments is more appropriately sought when the deficiency is assessed, and the level of the payment is therefore known and measurable, than in a prior period. As a result, the appropriate time for the Company to recover the tax settlement payments as reasonable, known and measurable costs is when those assessments are paid in a test year. Also, the event giving rise to the tax settlement payments does not occur until the deficiency is assessed. Thus, consistent with ratemaking principles, recovery for those payments should be sought in a test period which includes the event, *i.e.* the assessment of deficiency and payment.

Q. Are test-period payments for tax settlements out-of-period costs?

A. No. The event giving rise to the additional payments is not the original tax year return, but the adjustment proposed and agreed-upon with the appropriate taxing authority during the test period. Although the original return is the source for current adjustments, the adjustments are separate from the original return and arise as a result of IRS and state taxing authority audit activity during the test period. Financial and regulatory rules share a common principle that an amount must be known and measurable in order for an accrual to be made. Rejecting these tax settlement payments as out-of-period costs would place the Company in a no-win situation in which Commission policies would preclude the recovery of normal, reasonable expenses.

Q. Are the adjustments by taxing authorities, and the resulting tax settlement payments, ongoing?

A. Yes. The Company has been identified by the IRS as a taxpayer included in the Large and Mid-Size Business ("LMSB") audit program (formerly Coordinated Examination Program, or "large-case" program). As a taxpayer in this program, the Company is audited by the IRS for every tax year. Given the breadth of scope, intensity, and time invested in the IRS audit (ten man-years were devoted to the 1994-98 audit), adjustments to the returns are a virtual certainty. All states in which the Company operates have laws which require agreed-upon federal adjustments to be reported to the states, and the adjusted tax to be paid.

Q. Why is it appropriate to view adjustments by the taxing authorities as arising from current audit activity rather than the original tax return?

A. As stated above, the Company is subject to audit for every tax year. Thus, this is an ongoing expense that can properly be matched with the year in which the audit activity takes place and concludes. Similar treatment is afforded to other like transactions. For example, an installment note received upon the sale of an asset is treated as a separate asset from the property. The note is booked at its original face value. The note is classified as current or non-current on the balance sheet based upon its term rather than the original life of the asset. Valuation of the note is based upon its collectibility, even if the note contains provisions to repossess the original asset. Although the original asset gave rise to the note, the note is treated entirely separate from the asset.

Proposed Regulatory Treatment

Q. What is the Company's proposal for allowance of tax settlement payments?

A. The Company requests that it be permitted to recover tax settlement payments made during the test period as an adjustment in the current case, amortized over a reasonable period of time not to exceed five years.

Q. On a going forward basis, are there alternative regulatory treatments to recovery of in-period tax settlement payments in general rate cases that the Commission could adopt?

A. Yes. The Commission could establish a tax contingency included in cost-of-service to account for future adjustments to tax estimates and tax settlement costs.

Q. Is the Company proposing such a tax contingency at this time?

A. No. If there is sufficient interest, PacifiCorp is agreeable to working with other parties to this case to develop a proposal to present to the Commission at a later time.

Q. Please summarize the key points of your testimony.

A. Permitting recovery of tax settlement payments is consistent with traditional regulatory principles because the payments were actually made in the test period and are therefore, known and measurable. The Company is subject to audit for each tax year and deficiency assessments take place many years after the end of the tax year. The Company's customers have not funded the Company's tax reserves. Because tax settlement payments are an on-going, normal and reasonable business expense, it is reasonable to permit recovery of these costs. Given the magnitude of the costs and the potential impact on customers, the Company requests that the Commission permit recovery of tax settlement payments made during the test period as an adjustment in the current case amortized over a reasonable period of time not to exceed five years.

Q. Does this conclude your testimony?

A. Yes.