

Exhibit ___ T (DPK-1T)
Docket UE-061546
Witness: Danny P. Kermode

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION

Complainant,

vs.

PACIFICORP dba Pacific Power & Light
Company,

Respondent.

DOCKET UE-061546

In the Matter of the Petition of

PACIFIC POWER & LIGHT COMPANY

For an Accounting Order Approving Deferral
of Certain Costs Related to the MidAmerican
Energy Holdings Company Transition.

DOCKET UE-060817

TESTIMONY OF

DANNY P. KERMODE

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

February 16, 2007

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	SCOPE OF TESTIMONY	2
III.	SUMMARY OF TESTIMONY	4
IV.	DISCUSSION	5
A.	Uncontested Adjustments	5
1.	Adjustment 7.1, Interest True-up	5
2.	Adjustment 7.2, Utah Gross Receipts Tax	5
3.	Adjustment 7.3, Deferred Tax Balance Reclassification	6
4.	Adjustment 7.4, Malin-Midpoint	6
5.	Adjustment 7.5, Flow-Through Deferred Tax.....	7
6.	Adjustment 7.7, Year-End Deferred Tax Adjustment	7
7.	Adjustment 7.8, Renewable Energy Tax Credit	8
8.	Adjustment 7.9, Low Income Tax Credit	8
B.	Contested Adjustment	9
1.	Adjustment 7.6, IRS Settlement Amortization	9
a.	Retroactive ratemaking	11
b.	Income tax expense true-up	15
c.	Adjustment for income tax normalization	17
d.	PacifiCorp's adjustment ignores additional income	18
e.	Conclusions	22

1 I. INTRODUCTION

2
3 Q. Please state your name and business address.

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

7
8 Q. By whom are you employed and in what capacity?

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

11
12 Q. How long have you been employed by the Commission?

13 A. I have been employed by the Commission for ten years.

14
15 Q. Would you please describe your educational background?

16 A. I graduated in 1982 from Arizona State University in Tempe, Arizona with a
17 Bachelor of Science in Accounting. Later that same year, I attended San Carlos
18 University in the Philippines for postgraduate studies in economic analysis and
19 quantitative business analysis. I am licensed in Washington as Certified Public
20 Accountant (CPA).

21 In 1992 and 1993, I was a member of the faculty at the National Association
22 of Regulatory Utility Commissioners (NARUC) Annual Regulatory Studies Program

1 held at Michigan State University in East Lansing, Michigan. I taught classes in
2 Financial and Regulatory Accounting Standards and in Deferred Tax Accounting.

3 In 2002, I published an article in Journal of the American Water Works
4 Association titled *Contributions in Aid of Construction: IRS Final Regulations*
5 (2002). I later published an article in the National Regulatory Research Institute's
6 Journal of Applied Regulation titled *Regulatory Provision of Income Taxes for S*
7 *Corporations and Other Nontaxable Business Forms* (2004).

8
9 **Q. Please discuss your professional background.**

10 A. I am a financial professional with a CPA and 20 plus years' experience that includes
11 experience in private practice, industry and government. I spent ten years as a CPA
12 in private practice in Phoenix, Arizona, from 1983 to 1993, where I was an expert
13 witness in a number of utility cases before the Arizona Corporation Commission, the
14 State's public utility regulatory body.

15 From 1994 to 1996, I was the controller for the Rocky Mountain Institute, a
16 large internationally-recognized non-profit organization that conducts research and
17 performs services in the energy field. Since 1996, I have been employed by the
18 Washington Utilities and Transportation Commission ("the Commission") as a
19 Regulatory Analyst.

20 Since my employment at the Commission, I have testified in numerous cases
21 including testifying in the two most recent PacifiCorp general rate cases, Docket UE-
22 032065 and Docket UE-050684. I testified on income tax issues in the 2001 rate
23 case involving Olympic Pipeline Company, Docket TO-011472. I also filed

1 testimony in three water company general rate cases, American Water Resources,
2 Docket UW-980258; Rainier View Water Co., Inc, Docket UW-010877; and
3 Marbello Water Company, Docket UW-041181.

4 I filed testimony regarding income taxes in the Verizon Northwest, Inc.
5 general rate case, Docket UT-040788. Most recently, I provided testimony opposing
6 a request for a special surcharge by Iliad Water Services, Inc., Docket UW-060343.

7
8 **II. SCOPE OF TESTIMONY**

9
10 **Q. What is the scope of your testimony?**

11 A. I testify regarding the nine tax-related adjustments proposed by PacifiCorp witness
12 Mr. Paul M. Wrigley in his direct testimony, Exhibit ___ (PMW-1T). These
13 adjustments are: Adjustment 7.1, Interest True-up;
14 Adjustment 7.2, Utah Gross Receipts Tax Adjustment;
15 Adjustment 7.3, Deferred Tax Balance Reclassification;
16 Adjustment 7.4, Malin Midpoint Adjustment;
17 Adjustment 7.5, Flow-Through of Deferred Tax;
18 Adjustment 7.6, IRS Settlement Amortization;
19 Adjustment 7.7, Year-end Deferred Tax Adjustment;
20 Adjustment 7.8, Renewable Energy Tax Credit; and
21 Adjustment 7.9, the Low Income Tax Credit
22

1 III. SUMMARY OF TESTIMONY

2
3 Q. Please summarize your testimony.

4 A. I conducted a detailed review of each of the nine tax-related adjustments in the above
5 list. I confirmed that eight of these adjustments are either appropriate, require minor
6 corrections with which the Company has agreed, or reflect use of different numbers
7 driven by other changes or adjustments, such as rate base, that do not reflect a
8 dispute regarding the underlying tax issue.

9 Consequently, the following adjustments are uncontested: Adjustments 7.1,
10 7.2, 7.3, 7.4, 7.5, 7.7, 7.8 and 7.9. I will briefly describe each of these adjustments in
11 my testimony.

12 The single contested tax-related adjustment is Adjustment 7.6, IRS
13 Settlement Amortization. In this adjustment, the Company seeks to place in current
14 rates, federal income taxes attributable to prior years. For several reasons, including
15 retroactive ratemaking, this adjustment is inappropriate and the Commission should
16 reject it.

1
2
3 **IV. DISCUSSION**

4
5 **A. Uncontested Adjustments**

6
7 *1. Adjustment 7.1, Interest True-up*

8 **Q. Please describe PacifiCorp's Interest True-up Adjustment 7.1.**

9 A. This adjustment, also known as interest synchronization, synchronizes the interest
10 expense used to compute income tax, with the interest provided through the cost of
11 capital return computation. The Company multiplied the weighted cost of debt by its
12 proposed Washington rate base amount, to compute the synchronized interest
13 expense.

14 **Q. Is the Company's adjustment appropriate?**

15 A. Yes, as to method. The difference between the Company's and Staff's adjustments
16 is attributable to the use of different rate base amounts, and a different debt ratio.
17 Other Staff witnesses address those differences.

18
19 *2. Adjustment 7.2, Utah Gross Receipts Tax*

20
21 **Q. Please describe the Company's Adjustment 7.2, related to the Utah Gross**
22 **Receipts Tax.**

1 A. This adjustment appropriately removes amounts associated with the now
2 discontinued Utah Gross Receipts Tax. In 2006, Utah repealed this gross receipts tax
3 as it applied to PacifiCorp. This adjustment removes \$300,000, the amount of this
4 tax included in Washington allocated costs.

5
6 3. *Adjustment 7.3, Deferred Tax Balance Reclassification*
7

8 **Q. Please describe the Company's Adjustment 7.3, Deferred Tax Balance**
9 **Reclassification.**

10 A. Adjustment 7.3 re-allocates the ending deferred tax balance for existing plant, based
11 on the Company's Power Tax model. The adjustment reduces rate base by \$16,435.
12 The adjustment recognizes the allocation of the deferred tax balance from an
13 allocated balance to a situs balance. This adjustment is consistent with the Western
14 Control Area cost allocation methodology supported by Staff.
15

16 4. *Adjustment 7.4, Malin-Midpoint*
17

18 **Q. Please describe the Company's Adjustment 7.4, Malin-Midpoint**

19 A. The Company's Adjustment 7.4 recognizes the sale of tax benefits in 1981 using a
20 safe harbor lease. Though the Tax Code provision for safe harbor leasing is now
21 repealed, this adjustment recognizes that the Company received a \$43 million up-
22 front payment. The Commission has ordered the Company to amortize this cash
23 receipt over thirty years, with a rate based reduction for the unamortized balance.

1 In this filing, the Company reduced the historical \$43.5 million deferred gain
2 to \$39.6 million. This recognizes the effect of the repurchase of a leased substation,
3 which in turn reduced the annual amortization of the safe harbor lease proceeds.

4 The Company's Adjustment 7.4 is consistent with how the Commission
5 resolved the Malin-Midpoint issue in Order 04 in the last PacifiCorp rate case,
6 Docket UE-050684 ("2005 Rate Case").

7
8 5. *Adjustment 7.5, Flow-Through Deferred Tax*

9
10 **Q. Please describe the Company's Adjustment 7.5, Flow-Through Deferred Tax**
11 **Adjustment.**

12 A. Adjustment 7.5 adjusts to flow-through accounting all tax timing differences
13 between book and tax depreciation that are not related to the asset life or
14 depreciation method. For example, the adjustment removes all non-plant associated
15 Accumulated Deferred Income Taxes and reduces the deferred income tax expense.
16 This adjustment properly flows-through to the ratepayer the tax benefits of tax items
17 that the Internal Revenue Code does not require to be normalized.

18
19 6. *Adjustment 7.7, Year-End Deferred Tax Adjustment*

20
21 **Q. Please describe the Company's Adjustment 7.7, Year-End Deferred Tax**
22 **Adjustment.**

1 A. In Adjustment 7.7, the Company adjusts the average deferred tax deduction and the
2 Deferred Investment Tax Credit to a year-end balance. The year-end balance is
3 consistent with the Commission's policy to provide ratepayers the maximum benefits
4 of deferred taxes that are allowed by the Tax Code.¹

5

6 7. *Adjustment 7.8, Renewable Energy Tax Credit*

7

8 **Q. Please describe the Company's Adjustment 7.8, Renewable Energy Tax Credit**
9 **Adjustment.**

10 A. Adjustment 7.8 is an adjustment for the Renewable Energy Tax Credit ("Tax
11 Credit"). The Tax Credit is a financial incentive provided by Congress for utilities to
12 develop renewable energy facilities. In June 2006, the Internal Revenue Service
13 published Notice 2006-51, setting the latest inflation adjustment factor for 2006 at
14 1.9 cents per KWh produced by qualified energy resources.

15 Adjustment 7.8 recognizes the current inflation adjustment factor, and it
16 reduces Washington allocated income taxes by \$629,057.

17

18 8. *Adjustment 7.9, Low Income Tax Credit*

19

20 **Q. Please describe the Company's Adjustment 7.9, Low Income Tax Credit.**

¹ E.g., *Utilities & Transp. Comm'n v. Wash. Natural Gas Co.*, Cause U-79-15, Second Supplemental Order (September 25, 1979) at 5-6.

1 A. RCW 82.16.0497 allows PacifiCorp to take a credit against the state Public Utility
2 Tax in the form of the Low Income Tax Credit. Adjustment 7.9 correctly recognizes
3 the increase in the Company's allowed Low Income Tax Credit by \$36,669 for 2007.

4
5 **B. Contested Adjustment**

6
7 *1. Adjustment 7.6, IRS Settlement Amortization*

8
9 **Q. Please describe the Company's Adjustment 7.6, IRS Settlement Amortization.**

10 A. In Adjustment 7.6, the Company seeks to recover from Washington ratepayers
11 federal income tax amounts that were assessed by the Internal Revenue Service
12 (IRS) relating to eight historic tax years: 1991 through 1998.

13 As shown in Mr. Wrigley's Exhibit ___ (PMW-4), Tab 7, page 7.6.1, this
14 adjustment relates to a Company settlement with the IRS, in which the Company
15 agreed to pay an additional \$64,217,849 in federal income taxes. The Company
16 computes Washington's allocated share as \$5,797,266. In its adjustment, the
17 Company reduces this amount by 50 percent, or \$2,898,633. This amount is further
18 reduced to reflect an unamortized balance of \$1,159,454 (rate base) and a test year
19 expense amount of \$579,726. *Exhibit ___ (PMW-4), Tab 7, page 7.6.*

20 The Company says the 50 percent reduction and the amortization are "in
21 accordance with the Settlement Agreement adopted by the Commission in Docket
22 UE-032065." *Mr. Wrigley's direct testimony, Exhibit ___ (PMW-1T) at 18:14-16.*

1 **Q. Does the Settlement Agreement the Commission approved in Docket UE-032065**
2 **require the treatment proposed by PacifiCorp in this docket?**

3 A. No. According to page 10, Paragraph 14f of the Settlement Agreement the
4 Commission approved in that docket: “no Party shall be deemed to have approved,
5 admitted or consented to the facts principles, methods or theories employed in
6 arriving at the terms of this Settlement Agreement, nor shall any Party be deemed to
7 have agreed that any provision of this Agreement is appropriate for resolving issues
8 in any other proceeding.” That Agreement was signed by PacifiCorp, Staff and the
9 Natural Resources Defense Council.

10
11 **Q. Is the Company’s proposed ratemaking treatment of these prior period tax**
12 **assessments appropriate?**

13 A. No. The Commission should reject the Company’s Adjustment 7.6 for four
14 independent reasons: (1) The income taxes the Company is requesting to recover are
15 costs related to prior periods. Consequently, the Company’s adjustment constitutes
16 retroactive ratemaking; (2) The Company is in essence requesting that its income tax
17 expense be “trued-up” for the IRS audited years, despite the fact that ratemaking
18 methodology does not allow expense true-ups for prior periods; (3) The Company’s
19 adjustment fails to reduce the proposed adjustment by the items that are normalized
20 for rate making purposes; and (4) The Company’s adjustment is inaccurate because it
21 fails to include the additional income that created the additional income tax.

1 **Q. Did Staff present similar testimony on this issue in the 2005 Rate Case, Docket**
2 **UE-050684?**

3 A. Yes. Staff made many of these same arguments in that case. However, the
4 Commission did not resolve this issue in its order in that case.

5

6 **a. Retroactive ratemaking**

7

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

9 A. In general, retroactive ratemaking occurs when a utility recovers costs related to a
10 period or periods prior to the test period. The Commission defined the term in a
11 2001 Puget Sound Energy case: "Retroactive rate making involves surcharges ...
12 applied to rates which had been previously paid, constituting an additional charge
13 applied after the service was provided or consumed."²

14

15 **Q. Does that definition apply to the taxes at issue in PacifiCorp's Adjustment 7.4?**

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

20

21 In other words, the additional income taxes the Company seeks to recover
from Washington ratepayers relate to service the Company provided in 1991 through

1 1998. These amounts originated in prior periods and they are applicable to the
2 service the Company provided in those prior periods. They are not applicable to the
3 test year in this case.

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

7
8 **Q. What is the problem with retroactive ratemaking?**

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

13 The rule against retroactive ratemaking serves three basic
14 functions, namely:

- 15 (1) protection of the public by ensuring that current customers will
16 not be required to pay for the past deficits of utilities through their
17 future rates,
18 (2) preventing utilities from employing future rates to protect the
19 financial investment of their stockholders, and
20 (3) requiring utilities to bear losses and enjoy gains depending on
21 their managerial efficiency.³

22
23
24 **Q. Have there been cases in which the Commission has allowed costs from prior**
25 **periods to be recovered in current rates?**

² *Utilities & Transp. Comm'n v. Puget Sound Energy, Inc.*, Docket UE-010410, Order Denying Petition to Amend Accounting Order (November 9, 2001) at 2.

³ *Re Northern Indiana Public Service Co.*, 157 PUR4th 206, 228 (Indiana PSC 1994).

1 A. Yes. The Commission has stated that on “rare occasions,” recovery of past expenses
2 is permitted if the public interest requires it, and it is based on sound regulatory
3 theory.⁴ The Commission has also stated that such treatment may be appropriate if
4 the expenses are extraordinary or catastrophic in nature, such as costs associated with
5 storm damage.⁵

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

9

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

12 A. No.

13

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

15 A. No.

16

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

18 A. No. The tax settlement at issue addressed large groups of many different tax items
19 that span an eight-year period. For example, the taxes assessed by the IRS relate to
20 adjustments to inventory, adjustments to depletion percentages, and even

⁴ *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.*, Cause U-81-41, Sixth Supplemental Order (March 12, 1982) at 19.

⁵ *Utilities & Transp. Comm'n v. Puget Sound Power & Light Co.*, Dockets UE-920433, UE-920499 and 921262, Eleventh Supplemental Order (September 21, 1993) at 51.

1 adjustments for vacation pay, just to name a few. There are 117 separate tax
2 adjustments in 1998 alone. In other words, this adjustment involves no single, large,
3 extraordinary item.

4
5 **Q. Does the fact that these taxes are being amortized in the test year make them a**
6 **“current” expense, and thus recoverable?**

7 A. No. The year when expenses are amortized does not make them a current expense.
8 The taxes at issue here were current expenses in 1991 through 1998, *i.e.*, the tax year
9 in which the liability arose. In the accrual method of accounting, a liability and the
10 related expenses are recognized in the year of the transaction, not when the tax is
11 paid, or when the amortization occurs. For example, an inadvertent error that
12 misstates the taxability of an individual transaction does not somehow defer, for
13 regulatory purposes, to a later period the recognition of the tax amount, when the tax
14 on that transaction is finally paid.

15
16 **Q. Would a settlement agreement with the IRS during the test period create a**
17 **current test-period expense?**

18 A. No. The focus needs to be on when the economic events took place that created the
19 ultimate tax liability, not when an agreement with the taxing authority occurred, or
20 when the tax ultimately might have been paid.

21
22 **Q. When does the taxpayer pay an assessment for underpayment, and what does**
23 **the payment include?**

1 A. In general, a tax assessment is paid at the time the taxpayer and the IRS agree with
2 proposed changes. The taxpayer pays the additional tax owed and the interest on the
3 additional tax computed. It is instructive to note that the interest is generally from
4 the due date of the prior year tax return to the date of the payment. This clearly
5 highlights the fact that the IRS recognizes that the tax payment is related to the prior
6 period and it is not a current tax payment. If it was a current tax payment, no interest
7 would accrue.

8 In sum, Adjustment 7.6 constitutes retroactive ratemaking because it includes
9 in the test year a tax expense attributable to 1991-1998, and requires ratepayers to
10 pay for that out of period expense.

11
12 **b. Income tax expense true-up**

13
14 **Q. Apart from the issue of retroactive ratemaking, what is the regulatory effect of**
15 **the Company's request to recover prior-period income tax expense for**
16 **ratemaking purposes?**

17 A. In essence, the Company is requesting that its income tax expense be "trued-up" for
18 the IRS audited years 1991-1998. This would be similar to an expense that has a
19 balancing account, such as a purchased gas cost mechanism, in which a utility is
20 permitted to recover its actual cost of gas over time through a "balancing account"
21 deferral and true-up process. This process allows the utility to recover, or "true-up,"
22 excess costs it did not collect through tariff rates over a period of time.

1 **Q. Has the Commission approved a true-up mechanism for prior period income**
2 **taxes for PacifiCorp?**

3 A. No.

4
5 **Q. Is a true-up mechanism appropriate for prior period income taxes?**

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

9
10 **Q. Please explain why it would be inconsistent with regulatory theory to allow a**
11 **true-up of these prior period income taxes.**

12 A. It is in the Company's and the ratepayers' best interest to keep income taxes as low
13 as legally possible. The Company does so by configuring its taxable transactions
14 and events to result in the lowest tax. If income taxes were allowed to be trued-up,
15 the Company would have a reduced incentive to keep taxes as low as legally
16 possible, because the actual taxes the Company paid would be collected from the
17 ratepayer regardless whether the tax could have legally been lower.

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

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c. Adjustment for income tax normalization

Q. Have you reviewed each of the IRS adjustments that are contained in the tax settlement?

A. Yes.

Q. Why is such an adjustment-by-adjustment review helpful?

A. It is important for the analyst to understand the type of adjustments included in the IRS adjustments. Though all the IRS audit adjustments affect expenses allowed for income taxes, not all IRS audit adjustments affect regulatory expenses.

For example, adjustments to tax-basis depreciation expense may be related to a tax basis depreciation *method*, or the *life* of an asset. Depreciation expense related to method or asset lives are normalized. That is, deferred taxes are recognized on the regulatory books for any differences between tax basis and regulatory basis. Therefore, any change in the tax basis depreciation does not affect income tax expense, but rather it affects the accumulated deferred tax balance.

Consequently, these normalized amounts need to be removed from the calculation of income tax expense in Adjustment 7.6, if that adjustment is accepted.

Q. Have you prepared an exhibit removing these normalized items?

A. Yes. I show this in my Exhibit ___ (DPK-2).

1 **Q. Please describe Exhibit ___ (DPK-2).**

2 A. My exhibit takes the computation provided by the Company in Exhibit ___ (PMW-
3 4), Tab 7, page 7.6.1, and reduces the Washington allocated amount by \$1,921,016,
4 resulting in a corrected annual amortization amount of \$387,625.

5
6 **Q. Does PacifiCorp concur in this removal of normalized items?**

7 A. Yes. PacifiCorp confirmed that it inadvertently omitted a reduction for normalized
8 items. Staff and Company also agree that the \$1,921,016 amount is correct. The
9 Commission should make this adjustment if it rejects Staff's other arguments and
10 accepts Company Adjustment 7.6.

11

12 **d. PacifiCorp's adjustment ignores additional income**

13

14 **Q. Other than the ratemaking principles you have already discussed, are there**
15 **other reasons why the Commission should reject the Company's Adjustment**
16 **7.6?**

17 A. Yes. The Company's adjustment is incomplete because it ignores the additional
18 income that created the additional income tax the Company now wants ratepayers to
19 pay. The result is a mismatch of income taxes with the income that generated those
20 income taxes.

21

1 **Q. Please explain this matching concept.**

2 A. Income tax is a unique category of expense. Unlike other expenses, income tax
3 expense is created only as an effect of another independent expense or revenue item.
4 In other words, income taxes exist only as a result of other financial transactions.

5 For example, assume a company increases its *revenues* by \$100,000, and,
6 with all other things remaining constant, the company incurs an income tax expense
7 of \$35,000, assuming a 35% tax rate. On the other hand, if the same company
8 incurred additional *expenses* of \$100,000, its income tax expense would decrease by
9 \$35,000. This shows that it is only because of additional revenues or additional
10 expenses, *i.e.*, independent transactions, that additional income taxes are incurred or
11 reduced.

12

13 **Q. How does this concept apply to PacifiCorp's Adjustment 7.6?**

14 A. As shown in Mr. Wrigley's Exhibit ___ (PMW-4), Tab 7, page 7.6.1, the Company
15 has allocated a total of \$579,727 of additional income taxes to be recovered annually
16 from Washington rate payers until 2008. However, PacifiCorp fails to add any
17 additional revenue or decrease any expenses associated with these additional income
18 taxes.

19 In its exhibit, the Company shows that it originally allocated \$5.8 million of
20 additional income taxes to Washington.⁶ However, in order for the Company to
21 incur \$5.8 million in additional income taxes, the Company must have had additional

⁶ The \$5.8 million was further reduced by 50% and amortized into rates over a five year period.

1 revenues or decreased expenses (or some combination of both) that resulted in \$16.6
2 million⁷ of additional taxable income! In other words, the \$5.8 million in additional
3 income taxes can not “stand alone,” as the Company proposes in its adjustment.

4 In short, income taxes are taxes on “something;” they can not exist in a void.
5 However, that is precisely the Company’s proposal: to recover income taxes as a
6 stand-alone expense.

7 A basic principle of accounting is to match revenues with the expenses that
8 gave rise to those revenues. If the Commission adopts the Company’s adjustment, it
9 must impute the additional revenues associated with the Company requested income
10 tax expense to be consistent with this principle. The stand-alone income tax in the
11 Company’s Adjustment 7.6 violates this principle.

12
13 **Q. Assuming away the other reasons you have provided for rejecting Adjustment**
14 **7.6, what would PacifiCorp have to do to properly match the additional income**
15 **tax expense it is requesting?**

16 **A.** PacifiCorp must impute revenue into its test year data equal in the amount that
17 produces the same income tax it is requesting from Washington tax payers.

18
19 **Q. Have you prepared an exhibit describing the calculation of the imputed**
20 **revenue?**

21 **A.** Yes. It is my Exhibit ____ (DPK-3).

⁷ \$16,563,617 additional net income = \$5,797,266 income tax divided by 35% tax rate.

1 **Q. Please describe your exhibit.**

2 A. On line 2 of my Exhibit ___ (DPK-3), I show the total IRS settlement amount shown
3 in Mr. Wrigley's Exhibit ___ (PMW-4), Tab 7, page 7.6.1. On line 3, I reduce the
4 Washington allocated amount by the IRS adjustments that reflect normalized items.
5 The result on line 4 represents the adjusted IRS settlement amount proposed by the
6 Company, adjusted for normalized items, or \$3.876 million.

7 To compute the amount of additional revenue required to incur the \$3.876
8 million of additional income taxes, I divide the \$3.876 million by 35%, the effective
9 tax rate. As shown on line 6, the Company would need \$11.075 million of additional
10 taxable income to incur \$3.876 million of additional income taxes.

11 Consistent with the Company's approach, I multiply this additional income
12 by 50%. As shown on line 9, the total imputed revenue required to match the
13 requested income tax is \$5.538 million. Amortized over five years, the annual
14 amount is \$1.107 million.

15
16 **Q. If revenues properly match the Company's IRS settlement income tax expense,**
17 **what is the impact on revenue requirements?**

18 A. When the imputed revenue is correctly matched with the amortized IRS settlement
19 amount requested by the Company, the overall revenue requirement decreases by
20 \$719,875, as shown on line 15 of my Exhibit ___ (DPK-3). This decrease correctly
21 captures the additional revenues or reduced expenses the Company earned or
22 incurred, respectively, in prior periods that caused it to have an increased income tax
23 expense.

1 **Q. Under your imputed revenue calculation, are you suggesting that there is an**
2 **actual increase in revenue or decrease in an expense in the tax year when the**
3 **IRS makes an adjustment?**

4 A. No. I am not suggesting that there is a change in the actual revenue or expense for
5 that tax year. I am simply highlighting one of the many problems with the
6 Company's case: PacifiCorp is requesting ratepayers to pay income tax on something
7 that occurred outside the test year. If the Commission finds it appropriate for the
8 ratepayer to carry that burden, then it is also just as appropriate that the ratepayer
9 receive the related benefit.

10

11 **e. Conclusions**

12

13 **Q. Please summarize Staff's conclusions regarding the Company's IRS Settlement**
14 **Amortization Adjustment 7.6.**

15 A. The Commission should reject the IRS Settlement Amortization Adjustment. The
16 Company's adjustment relates to expenses and revenues that are outside the test year,
17 and it does not reflect an ongoing cost of operations.

18 Including the tax settlement amounts would constitute retroactive ratemaking.

19 The Company seeks recovery of what is in fact a myriad of different expenses, all
20 with different dynamics and accounting implications, and all grouped under the
21 broad heading "tax settlement."

1 Ratemaking does not and should not provide, in effect, a “true-up”
2 mechanism for prior years’ income taxes. Doing so would remove incentives of the
3 Company to keep its income taxes as low as legally permitted.

4 The Company’s adjustment includes many individual adjustments to
5 depreciation which are normalized. Consequently, they have no direct effect on the
6 cost of service. Therefore, if the Commission approves Adjustment 7.6, the impact
7 of these depreciation adjustments must be removed.

8 Furthermore, if the Commission chooses to include the out-of-period tax
9 expenses, it should impute the corresponding taxable income. Income tax expense is
10 dependent on revenues or other expenses. It can not exist by itself. If the ratepayers
11 are expected to carry the burden of the income tax, they should receive the benefit of
12 related income.

13 Finally, if the Company’s Adjustment 7.6 is accepted by the Commission, the
14 expense and the related income should be amortized over eight years, which was the
15 period that created the expense; not the five years proposed by the Company.

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

18 **A. Yes.**