Exhibit ___T (DPK-4T)
Dockets UE-061546/UE-060817
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

CROSS-ANSWERING TESTIMONY OF

Danny P. Kermode

STAFF OF WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

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II. DISCUSSION

A. Background

1. How PacifiCorp pays federal income taxes

Q. Does PacifiCorp file a separate federal income tax return?

A. No, PacifiCorp does not file a separate corporate tax return. Berkshire Hathaway, Inc., PacifiCorp's ultimate parent corporation, combines the results of all of the subsidiaries in its corporate tree, including MEHC and PacifiCorp, and files a consolidated federal income tax return. PacifiCorp is simply one of the companies on that corporate tree that contributes to Berkshire Hathaway's final consolidated tax return.

Q. Please provide a general description of Berkshire Hathaway.

A. Berkshire Hathaway is a large holding company that owns subsidiaries engaged not just in utility operations, but in various other business activities. For example, one of the companies included in Berkshire Hathaway's corporate tree includes GEICO, which is one of the largest automobile insurers in the United States. Other subsidiaries include General Re and Berkshire Hathaway Reinsurance Group, two of the largest re-insurers in the world, as well as Benjamin Moore, which sells paints and wall coverings, plus many other companies, including Sees Candies. *Berkshire Hathaway, Inc., 2005 Annual Report, page 1.*

At the end of September 2006, Berkshire Hathaway had total assets of $240 billion. *Berkshire Hathaway Inc.'s SEC Form 10-Q (September 30, 2006) at 2.* By contrast, PacifiCorp's Washington electric plant is only $ 637.7 million, after depreciation and amortization. *Staff witness Mr. Schooley's Exhibit ___ (TES-2), page 1 of 23.*

2. *Calculation of federal income taxes in ratemaking*

Q. How does the Commission normally calculate federal income taxes for ratemaking purposes?

A. In my experience, the Commission normally calculates federal income taxes for ratemaking purposes in a manner consistent with Staff's calculation in this case, which is shown in Mr. Schooley's Exhibit ___ (TES-2), page 2 of 23.

The calculation is based on the utility's adjusted regulatory income. "Adjusted regulatory income" is the utility's test-year income derived on a regulatory accounting basis, adjusted for any expenses that are recognized differently under income tax accounting. These adjustments are commonly referred to as "Schedule M" adjustments.

However, these Schedule M adjustments to regulatory income do not include differences in the tax basis/regulatory basis timing differences in depreciation expense, because the Internal Revenue Code requires these differences to be normalized.

The bottom line is that this method states federal income tax expense for ratemaking purposes for a utility on a pro forma, stand-alone basis.

B. ICNU's Income Tax Expense Adjustment

Q. In its adjustment, did ICNU use the same regulatory approach to calculating federal income taxes as you just described?

A. Yes, with one significant exception. Page 1 of Mr. Gorman's Exhibit ___ (MPG-4) is ICNU's income tax calculation. Mr. Gorman correctly adjusts for Schedule M items, as shown on lines 14 and 15, and he is correct in not adjusting for deferred taxes or depreciation expense timing differences. This is consistent with the approach I just described.

The only difference between the Commission's usual approach and ICNU's approach is that Mr. Gorman imputes $5,469,271 in interest from MEHC, which is shown on line 17, column 2, of his Exhibit ___ (MPG-4). Obviously, this significantly reduces PacifiCorp's federal income tax expense.

Q. What does ICNU say is the intent of this adjustment?

A. According to Mr. Gorman, the intent of this adjustment is to reflect "an amount equal to the [income] tax expense likely paid to government taxing authorities." *Direct Testimony of Michael P. Gorman, Exhibit ___ (MPG-1T) at 2:2-3.*

Q. Does ICNU's adjustment in fact reflect an amount likely paid to government taxing authorities?

A. No.

Q. Please explain why not.

A. It is very complex to calculate PacifiCorp's share of the actual amount of income taxes that Berkshire Hathaway, PacifiCorp's ultimate parent corporation, will pay. ICNU elected to focus only on MEHC and on only one tax deduction: interest. ICNU made no attempt to calculate the amount income taxes Berkshire Hathaway would actually pay to government taxing authorities.

ICNU intentionally failed to account for this complexity. As Mr. Gorman admits: "Moving further up the affiliate corporate structure [from MEHC] significantly complicates the issue and I did not perform that adjustment." *Direct Testimony of Michael P. Gorman, Exhibit ___ (MPG-1T) at 4:2-3.*

Indeed, calculating the actual taxes Berkshire Hathaway pays to governmental authorities depends on the amount of operating gains and losses from all companies in the Berkshire Hathaway "corporate tree." Again, ICNU intentionally failed to recognize the impact of such gains and losses. Again, as Mr. Gorman admits: "My proposed adjustment does not reduce income tax collections from PacifiCorp's retail ratepayers based on operating losses at other affiliate companies." *Direct Testimony of Michael P. Gorman, Exhibit ___ (MPG-1T) at 5:4-5.*

Therefore, ICNU is simply wrong when it claims that its income tax adjustment will adjust PacifiCorp's income tax expense to approximately what will be "likely paid to government taxing units."

Q. Could PacifiCorp's rates be higher if ICNU's "actual taxes paid" approach is accepted instead of Staff's approach?

A. Yes. If Berkshire Hathaway's actual federal income tax payment was allocated in part to PacifiCorp, it is conceivable that PacifiCorp ratepayers would pay higher income taxes through rates because other companies in the Berkshire Hathaway's corporate tree may pay high amounts of income taxes. This is because some companies in that tree are very profitable. In addition, the way some of those companies are taxed can lead to high tax payments. For example, insurance companies pay income tax on changes in unearned premium reserves. *See Leonard Saul Goodman, The Process of Ratemaking, (1998) at 710.* This is yet another reason why the Commission should reject ICNU's "taxes to actual" theory.

C. Double-Leverage Issue

Q. Is there another aspect of this issue the Commission should consider?

A. Yes. ICNU's Income Tax Expense Adjustment is simply an uncompleted form of a "double-leverage" adjustment. In other words, ICNU's proposal is equivalent to imputing the debt/equity structure of MEHC onto the equity component of PacifiCorp's capital structure, then computing the synchronized interest based on the new weighted cost of debt. For example, the additional interest of $5.469 million derived in Mr. Gorman's Exhibit ___ (MPG-4) is the same amount of interest that would result from a double-leveraged capital structure.

Q. Did the Commission rule on the double leverage issue in the 2005 Rate Case?

A. Yes. The Commission rejected a double leverage approach for PacifiCorp in that case. *Docket UE-050684, Order 04 (April 17, 2006) at 104-105.*

Q. Did Staff support a double-leverage adjustment in the 2005 Rate Case?

A. Yes.

Q. Does Staff still believe such an analysis has merit?

A. Yes. However, Staff decided not to contest that issue in this case.

Q. Is it appropriate for another party to raise the double-leverage issue in this case?

A. Yes. However, ICNU is not explicitly raising a double-leverage issue. Instead, ICNU has mischaracterized its use of double leverage as a "taxes to actual" issue. In my opinion, that is neither accurate nor appropriate. If ICNU wants to address the double-leverage issue, it should do so directly.

Q. What is Staff's recommendation regarding ICNU's Income Tax Expense Adjustment?

A. The Commission should reject ICNU's Income Tax Expense Adjustment.

Q. Does this conclude your cross-answering testimony?

A. Yes.