Introduction

Q. Please state your name.

A. My name is Larry O. Martin.

Q. Did you previously offer testimony in this proceeding?

A. Yes, I filed testimony in the Company's direct case.

Purpose and Summary of Testimony

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testimony is to provide support for the Company's recovery of IRS tax settlement expenses. As discussed in my direct testimony, I recommend that tax settlement payments made to the IRS during the test year be placed into rates and recovered over a five-year period. My rebuttal testimony also responds to Staff witness Kermode's proposal regarding the Malin-Midpoint Adjustment.

Tax Settlement Payments

Q. Public Counsel witness Dittmer opposes the Company's recovery of these tax settlement payments. Do you agree with his position?

A. No.

Q. Please explain.

A. Mr. Dittmer states that he opposes the Company's recovery of these expenses on the basis that "many disputed items for which payments were recently made relate to components that would have little or nothing to do with Washington retail operations." This conclusion takes a narrow view of the responsibility of the Company's Washington customers to pay a fair and equitable share of the Company's cost of service. For example, for accounting and financial purposes,

PacifiCorp has been required to accrue reserves to meet tax settlements. Now that the tax liability associated with these amounts has been finally determined, the Company has been required to pay these amounts. Yet these amounts have not been funded by Washington customers. Further, under PacifiCorp's system-wide allocation of taxes, certain Washington-specific taxes -- primarily gross receipts taxes -- have been allocated to other states. Mr. Dittmer's proposal would accept all of the benefits of our existing Company-wide allocation and assume none of the responsibilities.

Q. Mr. Dittmer argues that if Washington were to be responsible for a portion of the current tax payments, that portion should be limited to the portion "that would have been allocated or assigned to the Washington jurisdiction during the period that the tax would have been paid had it been originally known that the liability would ultimately or eventually be due when the tax return was filed." How do you respond to this contention?

A. PacifiCorp allocated the tax settlement payments by applying the average of Washington's Income-Before-Tax ("IBT") divided by total Company IBT to the sum of the tax settlement payments. This approach has been supported by the Commission since 1993. Because the total settlement amounts payable to the IRS are calculated on an entity-level basis, they are not easily allocated on a state by state basis. Therefore, the Company believes that the IBT method is a fair and reasonable approach that accurately reflects Washington's share of the Company's tax settlement expense.

Q. Please describe some of the factors that make it difficult to directly assign certain tax settlement expenses on a state-by-state basis.

A. For example, the amount of the tax settlement payments is affected by items that are calculated only at an entity-level basis which are not identifiable to any particular state, and the fact that the tax liability may be a negotiated settlement that is not identified by state. Because of the complex and sometimes intangible relationship between these factors, and the regular, ongoing basis of these tax settlement payments, it is fair to allocate these expenses system-wide based upon average IBT.

Q. Do you agree with Mr. Dittmer's conclusion that book/tax timing differences that are afforded "explicit or *implicit* tax normalization treatment" (emphasis in original) should be charged against an accumulated Deferred Income Tax reserve account rather than a charge to current year income?

A. Generally, yes. However, I disagree with the suggestion that any amounts be normalized on an *implicit* basis. Unless the Commission has previously *explicitly* provided for normalization of such expenses, they would not have been included in the Company's cost of service and would not have been paid for by ratepayers. Further, this suggests an unfair prejudice against recovery of prudently incurred tax settlement amounts, and directly contradicts Mr. Dittmer's previous assertion that "this Commission has *generally* followed flow through accounting."

Q. Do you agree with Mr. Dittmer's conclusion that "all book/tax timing differences in dispute were afforded tax normalization treatment in the prior 1986 Washington rate case"?

A. No, as stated in the Company's Response to Public Counsel Data Request 18(d), "In PacifiCorp's last litigated rate case in Washington in 1986, the only timing differences that were allowed normalization were method and life differences between book and tax depreciation, the Malin Safe Harbor Lease, and Investment Tax Credits." This data request response is included as Highly Confidential Exhibit No.___(LOM-4).

Q. What about subsequent to the 1986 rate case?

A. Subsequent to the 1986 case, the Commission issued an order related to gains on the sale of emission allowances that allowed the amortization of the gains to be normalized. Also the Tax Reform Act of 1986 created tax basis items for CIAC and Avoided Cost, which have been normalized since 1987. See Company's Response to Public Counsel Data Request 18(d), which is included as Highly Confidential Exhibit No. ____(LOM-4).

Q. Do you agree with Mr. Dittmer's conclusion, based upon Company's Response to Public Counsel Data Request 18, that "all timing differences in dispute were afforded normalization treatment"?

A. No. Although the Company's Data Request response might suggest that conclusion, in fact the Company's cost of service developed in 1986 did not include an estimate of expected expense relating to future audit costs. Audit items, as they became known, were booked as an accrued tax liability. Because

the Commission has not yet directed the Company as to the method to account for these expenses, this accrual fund has not been reflected in rates. As a consequence, it has not yet been funded by Washington ratepayers. Therefore, while Mr. Dittmer's statement of the principle is generally correct, under these facts, we reach a different conclusion.

Q. Do you agree with Mr. Dittmer's argument that the Company must demonstrate that it was under-earning during the 1991-98 rate periods in order to be able to recover its tax settlement expenses?

A. No. Whether the Company over-earned or under-earned in previous periods has never been the standard for recovery of costs. Even if that were the standard, which it is not, the Company did not earn its authorized ROE during the 1991-98 rate periods.

Q. Staff witness Kermode states that the costs associated with the tax settlement are "from prior periods and therefore do not reflect an ongoing cost for which current ratepayers should pay." Do you agree?

A. No. The tax liability was finally determined, and therefore incurred, during the test period. The event giving rise to the additional payments is not the original tax year return, but the adjustment proposed and agreed-upon with the taxing authority during the test period. Tax-related settlements with the IRS reflect an ongoing, recurring expense incurred in providing service to the Company's Washington customers. It is appropriate that the Company be able to recover these costs.

Q. Do you agree with Mr. Kermode's statement that it is "obvious" that the events giving rise to the Company's liability for tax settlement payments are the "economic events that took place in the tax year that created the ultimate tax liability"?

A. No. Of course, there would be no audit if there were not economic events occurring during the subject tax year. However, an audit exam and audit appeal are completely separate legal processes, subject to their own procedural rules and appeal rights. The Company's tax liability, if any, is not known for many years. That liability can turn on many factors completely unrelated to the economic events during the tax year, including but not limited to changes in IRS policy, new interpretations of tax law applied retrospectively, and the IRS's willingness, or lack thereof, to pursue certain matters. While the Company has some influence over the economic events occurring during the tax year, the Company has no influence whatsoever over the factors cited above. For this reason, it is appropriate to view the audit as a separate event. Because the amounts due under an audit are not finally determined until some time in the future, the Company believes it appropriate to recover those amounts at that time.

Q. Do you believe that the Company has met its burden with respect to the costs associated with the tax settlement?

A. Yes. In addition to my direct testimony and the Company's response and supplemental response to Staff Data Request No. 124, the Company has provided the parties with detailed information for each adjustment, supporting documents,

and a summary of the adjustments. These data request responses are included as Highly Confidential Exhibit No. ____(LOM-5).

Q. Are there policy implications associated with Staff's approach?

A. Yes. Because the Company does not have an expense for "audit contingency" built into its cost of service, Staff's rejection of the Company's proposal to recover these costs at the time of settlement places the Company in a no-win situation where it is unable to recover these normal, recurring costs associated with providing reliable electricity services to its Washington customers. If Staff insists upon opposing the Company's right to recover tax settlement expenses once they are finally determined and known, as a matter of fairness one would expect Staff to support some sort of an "audit contingency" expense to be built into the Company's cost of service.

Malin-Midpoint Safe Harbor Lease Adjustment

Q. What is the issue with respect to the Malin Midpoint Safe Harbor Lease?

A. PacifiCorp in 1982 sold to an independent third party the tax benefits of the accelerated depreciation and the Investment Tax Credits associated with the transmission line referred to as Malin-Midpoint. This was a "safe harbor" Sale and Leaseback transaction under Section 168(f)(8) of the Internal Revenue Code. The ratemaking issue concerns the treatment to be accorded the $43 million the Company received in the safe harbor transaction.

Q. Do you agree with Mr. Kermode that no transfer of tax benefits actually occurred with the Malin-Midpoint Safe Harbor Lease?

A. No. A Safe Harbor Lease agreement under section 168(f)(8) had to be entered

into by PacifiCorp and the third party, otherwise no cash would have ever been received by PacifiCorp.

Q. What did PacifiCorp give up in exchange for this cash from the third party?

A. As described above, PacifiCorp sold tax depreciation benefits and Investment Tax Credits to the third party. It should be noted that under the Internal Revenue Service rules for Safe Harbor Lease transactions, a link must be established between the types of items sold and the cash received. The normalization treatment for the items sold therefore determines the normalization treatment of the cash received. Without this link determining the normalization treatment, the IRS will not recognize the transaction as a Safe Harbor Lease.

Q. Please explain the normalization treatment.

A. The normalization treatment for the tax depreciation benefits must follow the normalization requirements for the Accelerated Cost Recovery System (ACRS). Under these requirements, the difference between the accelerated tax timing and method depreciation and the timing and method depreciation for financial purposes must be normalized. The normalization treatment for the Investment Tax Credits must follow the normalization requirements for investment tax credits, which are prescribed in IRS Code Section 46(f).

Q. Is Mr. Kermode's explanation of Code Section 46(f) correct?

A. Yes. Section 46(f)(1) or Option 1 requires a rate base reduction for the unamortized ITC balance with no amortization included in cost of service. Section 46(f)(2) or Option 2 requires the cost of service to be reduced by that amortization with no reduction to rate base for the unamortized balance.

PacifiCorp is an Option 1 Company.

Q. Do you agree with Mr. Kermode's recommendation for an adjustment?

A. No. Based on the underlying policy issued in the IRS Private Letter Ruling to which Mr. Kermode refers, the amortization included in cost of service must be reduced for the amount related to the Investment Tax Credit. Otherwise the Company is clearly violating normalization. The Commission order in the Company's 1986 rate case, Cause No. U-86-02, recognized this as well by reducing the amortization from $244,000 to $174,000.

Q. Do you agree with Mr. Kermode that the IRS Private Letter Ruling does not apply because the accounting is different and the Commission does not recognize the source of the proceeds?

A. No. We agree that the Commission's accounting order in the Private Letter Ruling relied upon by Mr. Kermode is different from Mr. Kermode's proposal. However, in the Private Letter Ruling, the IRS concluded that the Safe Harbor Lease was null and void not because of the accounting, but because under the 46(f)(2) rules the proposal included a reduction to rate base which was enough to cause a violation of normalization. This is a clear indication from the IRS that any part of any Commission's proposal that would violate the normalization requirements under either the ACRS requirements or the ITC requirements would be a violation of normalization. The IRS held that in order for the transaction to qualify as a Safe Harbor Lease, the cash sale proceeds must be accounted for under the same normalization treatment as the underlying tax benefits transferred.

Q. Do you have an alternative proposal?

A. Yes. The Company accepts the rate base reduction, except for the year end balance since the Washington Commission treatment of tax is year end and this balance represents proceeds from the sale of tax benefits. The amortization to be recognized in cost of service should be the $174,000 which excludes the ITC portion in order to avoid violation of normalization.

Q. Does this conclude your rebuttal testimony?

A. Yes.