Exhibit No. __(DMF-1T)

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

DOCKET NO. UE-080416

DOCKET NO. UG-080417

REBUTTAL TESTIMONY OF

DON M. FALKNER

REPRESENTING AVISTA CORPORATION

## I. INTRODUCTION

**Q. Please state your name, present position with Avista Corp. and business address.**

A. My name is Don M. Falkner. I am employed by Avista Corp., doing business as Avista Utilities ("Avista" or "Company") and my current position is Assistant Treasurer and Tax Director. My business address is 1411 East Mission Avenue, Spokane, Washington.

**Q. Would you please describe your education and business experience?**

A. I am a 1981 graduate of Washington State University with a Bachelor of Arts Degree in Business Administration, majoring in Accounting. That same year, I sat for and passed the Certified Public Accountant exam. I joined the Company in June of 1981. I have served in various positions within the sections of the Finance Department, including Power Supply Accounting, Subsidiary Accounting, Budget and Forecasting, Plant Accounting, Corporate Accounting and the State and Federal Regulation Department. For the past three years, I have served as the Assistant Treasurer and Tax Director for the Company.

**Q. What is the scope of your rebuttal testimony in this proceeding?**

A. My rebuttal testimony responds to the Public Counsel Section of the Washington State Attorney General's Office (Public Counsel) and the Industrial Customers of Northwest Utilities (ICNU) witness Michael Majoros on the subject of the federal income tax (FIT) adjustments that he has proposed.

**Q. Please summarize your rebuttal testimony with regards to the FIT adjustments.**

A. This rebuttal testimony addresses why the federal income tax adjustments (Nos. 2(E) and 2(G)) that Mr. Majoros proposes on pages 11 through 14 of his direct testimony at Exhibit

No. ___(MJM-4CT) are erroneous and inappropriate for setting rates. In summary, I will address the following:

- Mr. Majoros' calculation is simply inaccurate and significantly overstates the proposed adjustment.
- The proposed adjustments violate jurisdictional cost allocation principles.
- The proposed adjustments may violate the Internal Revenue Code's normalization provisions.
- Regulatory bodies such as the WUTC and FERC have previously rejected this type of adjustment.

**Q. Mr. Majoros provided testimony in the Puget Sound Energy's general rate case (Docket Nos. UE-72300 and UG-72301) regarding similar proposed adjustments relating to federal income taxes. Have you reviewed this testimony?**

A. Yes, I have. I have also reviewed the pre-filed testimony of Puget Sound Energy's rebuttal witness Matthew R. Marcelia on this issue and have reached similar conclusions with respect to the shortcomings of Mr. Majoros' proposed adjustments.

## II. BACKGROUND

**Q. What adjustment has Mr. Majoros proposed to Avista's FIT?**

A. Mr. Majoros has proposed to change the Company's tax rate from the federal statutory rate of 35.0% to an "effective federal tax rate" of 31.0%. The revenue requirement impact of this proposal is summarized as follows:

| | Electric | Natural Gas |
|---|---|---|
| Tax Adjustment | ($3,441,000) | ($3,109,000) |
| Conversion Factor Impact | ($2,122,000) | ($ 379,000) |
| Total Revenue Requirement Adjustment | ($5,563,000) | ($3,488,000) |

**Q. Please describe Avista's present income tax reporting situation.**

A. Avista Corporation, dba Avista Utilities, is a regulated, combination utility that provides electric and natural gas service to customers in Washington, Idaho and Oregon. Avista Capital, Inc. is a wholly owned subsidiary of Avista Corp. and is the parent corporation of Avista Corporation's non-regulated subsidiary investments and operations. As a result, Avista Utilities does not file a separate (or single entity) tax return with the Internal Revenue Service (IRS). Instead, Avista's regulated utility taxable income or loss is included with the taxable income or loss of Avista Corporation's other subsidiaries. In other words, the consolidated Avista Corporation group files one consolidated tax return with the IRS. Although only one tax return is filed for the group, the IRS requires that actual taxable income be computed for each legal entity on a separate company basis.[1] The tax liability of any member of the consolidated group can be determined by multiplying that member's taxable income by the statutory tax rate and then adjusting for any tax credits that the member may have generated.

**Q. What is the statutory tax rate for Avista Utilities and the Avista Corporation consolidated group?**

[1] When the IRS performs an audit, it actually audits the separate company calculations of taxable income – these are not hypothetical estimations, but actual stand-alone calculations of taxable income.

A. The statutory tax rate for both the Avista Utilities stand-alone and the Avista consolidated group is 35%.

**Q. If the Company's statutory rate is 35%, why does Mr. Majoros claim that the rate Avista should use should be 31.0%?**

A. Mr. Majoros, at page 12, claims that he is reducing FIT expense to reflect "Avista's effective corporate tax rate", which he identifies as a "consolidated tax adjustment." The consolidated tax adjustment is a concept in which the federal income taxes of a regulated utility are reduced by a portion of the tax benefits generated by tax losses, if any, of non-regulated affiliates. In Mr. Majoros' proposal, he allocates a portion of the tax losses of any non-regulated subsidiary companies of Avista Corporation to Avista Utilities based on Avista Utilities' ratio of its positive taxable income to the sum of the positive taxable income of all consolidated entities.

## III. CORRECTION OF COMPUTATIONAL ERRORS IN DERIVATION OF "EFFECTIVE TAX RATE"

**Q. Please explain Mr. Majoros' calculation of his 31.0% effective tax rate.**

A. Mr. Majoros isolated Avista Corporation's subsidiaries that had incurred losses during the years ended 2005 and 2006[2], and then allocated what he calculated as the "utility portion" of those losses to Avista's tax expense for each of those years. Mr. Majoros calculated what he determined to be the "effective tax rate" for each year, and then averaged his computed rates for 2005 and 2006 to determine the average rate for his 2007 adjustment.

**Q. Is Mr. Majoros' calculation of his 31.0% effective tax rate accurate?**

[2] Avista's 2007 Consolidated Tax Return was not completed until mid-September, 2008, and was therefore not available to Public Counsel/ICNU for their adjustment.

A. No, it is not. Even if one were to accept the rationale of Mr. Majoros' method - which the Company does not - he incorrectly applied the full pre-tax impact of those losses as a reduction to Avista's tax expense, rather than the tax effect of the losses. His failure to make this simple, but necessary adjustment produced a significant error in his calculation. Incorrectly applying the entire pre-tax losses, and not the tax impact of the losses, to Avista's tax expense is a fundamental error and creates a serious understatement of his so-called "effective tax rate" of 31.0% computed by Mr. Majoros.

**Q. If you were to otherwise use Mr. Majoros' methodology, but correctly offset Avista's tax expense with the tax effect of the subsidiary losses, what would be the resulting two-year average "effective tax rate"?**

A. The resulting corrected "effective tax rate" using Mr. Majoros' approach would be 34.0% as shown in Exhibit No. ___(DMF-2).

**Q. In addition to computing the wrong "effective tax rate", please explain the other computational error made by Mr. Majoros when deriving his proposed tax adjustments.**

A. Mr. Majoros used the two-year average losses of $4.324 million and allocated this to electric and natural gas results filed in this case to reduce Avista's federal income taxes in this case. Rather than using the entire average pre-tax loss incurred by the subsidiaries, Mr. Majoros should have used the computed tax impact of those losses. As shown in Exhibit ___(DMF-2), the average tax expense on those losses was $1.514 million. In addition, Mr. Majoros then failed to factor in the appropriate allocation between state jurisdictions. Washington's electric and natural gas allocated share of the tax would be $910,717, a significant reduction from the $4.324 million used by Mr. Majoros in his proposed adjustment.

**Q. How does correcting for these computational errors impact the FIT adjustment as proposed by Mr. Majoros?**

A. The corrected electric FIT adjustment would be a net reduction to the revenue requirement of $1.205 million, which is $4.358 million less than the original adjustment proposed by Mr. Majoros. The corrected natural gas FIT adjustment would be a reduction to the revenue requirement of $0.774 million, which is $2.714 million less than the original adjustment proposed by Mr. Majoros. A summary of this information follows:

| | Electric | Natural Gas |
|---|---|---|
| Corrected - Tax Adjustment | ($ 758,000) | ($ 685,000) |
| Corrected - Conversion Factor Impact (1) | ($ 447,000) | ($ 89,000) |
| Corrected - Total Revenue Requirement Adjustment | ($1,205,000) | ($ 774,000) |
| Original Total Revenue Requirement Adjustment | ($5,563,000) | ($3,488,000) |
| Overstatement of Original Adjustment (2) | $4,358,000 | $2,714,000 |

(1) Used to adjust the net operating income by revenue sensitive items, including FIT. Any revision to the FIT would impact the conversion factor applied to all adjustments.
(2) Includes flow through impact of change in FIT rate on all adjustments proposed by Public Counsel and ICNU.

This overstatement of the FIT adjustment, based on computational errors alone, is significant and is otherwise described in the testimony of Company witnesses Mr. Norwood and Ms. Andrews.

**Q. Has the 2007 Consolidated Federal Income Tax Return been prepared for Avista?**

A. Yes, the Federal tax return was completed in mid-September, 2008.

**Q. What does the 2007 Federal tax return show?**

A. Only one subsidiary of the Avista Consolidated group had a loss in 2007 of approximately $350,000. This compares to the losses used in Mr. Majoros' FIT adjustment calculation of $7.7 million in 2005 and $3.9 million in 2006.

**Q. How does this impact the FIT adjustments proposed by Mr. Majoros?**

A. Using Mr. Majoros' methodology as applied to the 2007 tax return (although Avista does not accept this methodology as an acceptable or rational method), and correcting for the computational errors described above, the tax impact of the portion of $350,000 loss allocable to electric operations would be approximately $29,000 and allocable to natural gas operations would be approximately $26,000.[3]

The balance of my testimony will explain why the conceptual approach of Mr. Majoros is otherwise unsupportable, even if one were to correct for these errors discussed above.

## IV. PUBLIC COUNSEL/ICNU MISAPPLY THE CONCEPT OF "EFFECTIVE TAX RATE"

**Q. Please explain Mr. Majoros' use of the term "effective tax rate".**

A. Mr. Majoros' application of the term "effective tax rate" is unconventional in this context. The most familiar use of the term "effective tax rate" is in the context of financial reporting. Every company that files a financial statement with the SEC is required to disclose its "effective tax rate." For example, Avista's effective tax rate can be seen in Management's Discussion and Analysis of Financial Condition and Results of Operations on page 33 of its 2007 10K. In the context of financial reporting, the term "effective tax rate" is calculated as a

[3] These amounts were computed using only 2007 information, since Avista's test year in this case was 2007. The total adjustment of $55,000 was computed as follows: $350,000 (tax loss) * 75% (utility portion) * 35% (Federal statutory tax rate) * 60.17% (Washington's share).

percentage by dividing the *tax expense* by the *pre-tax book income* to which it is associated. A company is required to reconcile the effective tax rate to the statutory rate in its 10K filings. For the Company, the difference is primarily attributable to flow-through items, such as depreciation on pre-1981 property, and tax credits, discussed further below.

In a regulatory setting, the term is used frequently to measure the regulatory *tax expense* compared to the regulatory *pre-tax Net Operating Income ("NOI")* to which it relates. That is the typical usage of the term and is how the Company uses the term. That, however, is not how Mr. Majoros uses the term. He would use the term to compare *tax on the regulated income adjusted for subsidiaries with losses* with the *utility income.* This misrepresents common financial terminology and accounting nomenclature.

**Q. Why does this matter?**

A. It matters because Mr. Majoros misuses familiar terminology – i.e. "effective tax rate" – to introduce a wholly unsupportable concept into the Company's tax calculation. He has calculated a meaningless "tax rate" that should have no application in determining tax expense for ratemaking.

**Q. Please explain and describe what tax rate should be used in setting customer rates?**

A. When the Company calculates its tax expense for ratemaking purposes, it uses a tax rate of 35%, as that is the Company's statutory (and marginal) tax rate. This should not be misunderstood to mean that the Company's tax expense will be 35% of pre-tax NOI. Pre-tax NOI must still be adjusted for a number of items, primarily the reversal of prior year's flow-through and

tax credits. After considering these adjustments, the Company's tax expense will no longer be 35% of pre-tax NOI. It may be higher or lower.

However, none of this has any impact on the fact that the Company is taxed at a rate of 35% and that 35% is the appropriate tax rate to use in determining tax expense for ratemaking.

As stated above, Avista Utilities and the Avista Corporation consolidated group are taxed at the same rate. So Mr. Majoros' claim, at page 12, that "Avista ratepayers pay taxes to Avista Corporation at a higher rate than Avista Corporation pays to the federal government" is, on it face, factually inaccurate. Avista Utilities and the Avista Corporation consolidated group are both taxed at 35%.

**Q. Can you simply summarize Mr. Majoros' calculation on Exhibit No. ___(MJM-6)?**

A. Yes. Mr. Majoros has separated all of the subsidiaries in the consolidated tax return into entities with positive taxable income and entities with negative taxable income. He then allocates a portion of the negative taxable income to Avista and claims that Avista should charge utility customers less tax.

**Q. Is this a valid methodology for determining tax liability for multiple entities?**

A. No, not at all. I have many concerns with that approach. First, it is an arbitrary carving up of the consolidated group for purposes of ratemaking. The IRS requires consolidated taxpayers to report their results by legal entity. When considering tax expense from a ratemaking perspective, the operative unit of analysis is not a legal entity, but regulated vs. non-regulated.

Accordingly, Mr. Majoros has commingled the separate risks, rewards, revenues, and expenses of the regulated and non-regulated groups. In doing so, he has disregarded the cost-

causation principle. Generally, rates are considered to be "just and fair" when they are cost-justified. To establish cost-justification, the Commission commonly looks for a causal link between the service provided and the expense the Company incurs to provide the service. The tax is calculated as the result of some underlying activity. A tax cannot and does not exist in isolation. A tax is applied to something. If that "something" is a regulated activity, that "something" is part of the benefits or costs of the regulated activity, and the tax impact falls on customers. If that "something" is a non-regulated activity, that "something" is part of the benefits or costs of the non-regulated activity, and the tax impact does not fall on customers. Mr. Majoros violates the principle of cost-causation by attempting to shift only the tax without reflecting on the nature of the underlying activity that is the subject of the tax.

Second, it is a true observation that some legal entities in the Avista Corporation consolidated group reported taxable income while others reported taxable losses. Mr. Majoros provides no explanation, however, as to why customers should enjoy lower tax expense when a non-regulated legal entity reports a tax loss but bear no additional tax expense when the same non-regulated entity reports taxable income. A simple illustration will make this point:

Consider specifically the situation of Advanced Manufacturing and Development, Inc., dba METALfx ("METALfx"), a non-regulated entity owned (82.95%) by Pentzer Corporation, which is a wholly owned subsidiary of Avista Capital. In 2005, METALfx reported a loss of $0.7 million and in 2006, reported a net income of $0.6 million. Mr. Majoros believes that METALfx's loss in 2005 should be shared with the regulated customers. However, he completely ignores the net income in 2006, which almost completely offsets the loss in 2005. Under the tax laws, METALfx is able to carry tax losses back two years and forward 20 years to offset its taxable gains. It would

seem that fairness and logic would require that he likewise allocate a portion of the net income to customers if he is truly interested in allocating some of the loss. But Mr. Majoros inconsistently applies his methodology. Moreover, he fails to explain why the customers should be impacted by anything METALfx has done, regardless of whether its activities resulted in gain or loss.

Third, like all businesses, the earnings of Avista Corporation's subsidiaries fluctuate each year. In many cases, the businesses that operated at a loss in one year will operate with net income the subsequent year. In fact, the four subsidiaries that operated with taxable losses of approximately $7.7 million in 2005 operated with taxable net income in 2006 of $4.9 million. Mr. Majoros' methodology completely ignores these results.

Fourth, under Mr. Majoros' calculation, any legal entity that reports a tax loss should share that tax loss with every other legal entity that has a tax gain. He again ignores completely whether or not the tax loss is a result of regulated or non-regulated activities. As such, his analysis causes an inappropriate cross-subsidy between regulated and non-regulated activities.

Finally, it is interesting to note that in the two years covered in Mr. Majoros' Exhibit No. ___(MJM-6), both the regulated and the non-regulated group reported positive taxable income which begs the question of why Mr. Majoros would allocate any loss to customers.

**Q. Did Mr. Majoros, in fact, identify a cross-subsidy?**

A. Mr. Majoros claims to have identified a cross-subsidy, but no cross-subsidy exists. The non-regulated group is *paying* tax at a rate of 33.5% in 2005 and 34.9% in 2006 while the regulated group is *paying* tax at 31.5% and 32.6%, respectively. Mr. Majoros states that "Avista's approach causes ratepayers to subsidize Avista's non-regulated subsidiaries." (Exhibit

No. ___(MJM-4CT) at page 12, line 16). His statement is incorrect. Absolutely no cross subsidy has, in fact, occurred under the Company's methodology.

**Q. Why is the regulated group's effective tax rate lower than the non-regulated group?**

A. The regulated group has tax credits available to it that the non-regulated group does not have. Tax credits play a crucial part in determining the amount of taxes *paid*, as they reduce the cash payment that is remitted to the government. Mr. Majoros did not factor in tax credits.

**Q. What tax credits did you include in your analysis?**

A. I included the actual credits that appeared in the tax returns. In 2005 and 2006, the primary tax credits came from the Production Tax Credit (PTC), which the regulated group receives from the generation of power at its Kettle Falls Generating Station and its Cabinet Gorge Hydro Facility. These tax credits were included in the Company's filed case and reflected in the proposed revenue requirement, and can be found in Company witness Ms. Andrews' electric Federal Income Tax workpapers at page $P_7$.

**Q. What is the impact of removing the tax credits from the calculation?**

A. If tax credits are removed from the analysis, the tax rate for the regulated group would be 35%. The only reason their actual tax rate dips below 35% is due to the presence of tax credits. If the tax credits are removed, the regulated group returns to 35%, which is the tax rate the Company has historically used.

## V. MR. MAJOROS' ANALYSIS MAY VIOLATE THE IRS' NORMALIZATION RULES

**Q. Do you have any other concerns with Mr. Majoros' analysis of the tax rate?**

A. Yes. Mr. Majoros applies his revised tax rate on Exhibit No. ___(MJM-4) at page 10 of 22 and recalculates tax expense. Despite his attempt at removing the effects of accelerated tax depreciation from the tax expense calculation, which is different than his proposal in the Puget case, he still may have violated the normalization provisions of the Internal Revenue Code (IRC) on at least two counts. The normalization provisions require a regulated taxpayer to apply consistent assumptions for tax expense, depreciation expense, the reserve for deferred taxes, and for rate base. Mr. Majoros calculates an adjustment for tax expense only. He has made no adjustment to the reserve for deferred taxes.

The normalization provisions also require a regulated taxpayer to record deferred taxes based on the difference between depreciation for ratemaking and depreciation for tax purposes. That difference is multiplied by the statutory tax rate. Mr. Majoros' methodology introduces the tax losses and supposed "tax savings" from the non-regulated entities into the calculation. This potentially violates the provisions of Regulation §1.167(l)-1(h)(2) which provide that the deferred tax can be adjusted only for differences related to book and tax depreciation methods. This Regulation precludes the Company from making adjustments related to the tax losses or supposed "tax savings" of non-regulated companies.

In addition to the potential violation of federal tax normalization rules, the Company has always tried to exercise great care to assign to customers only the tax expense associated with burdens and benefits of the regulated activities. To do otherwise would impose upon customers some burden or benefit from the non-regulated entities that are not associated with utility operations, and this should not be permitted. The Company and the Commission must ensure that benefits and costs borne by customers are appropriately attributable to regulated activities in the

same way that we must assure that cost of unregulated activities are borne only by the non-regulated entity. Activities and events that occur outside of the regulated group must not impact customers negatively or positively.

**Q. Why did you say that the adjustment proposed by Mr. Majoros "might" be a violation of IRS normalization rules?**

A. The IRS code is very complex, and sometimes open to interpretation. In his attempt to reduce regulated income tax expense by using losses from non-regulated entities that have no relation to Avista's utility services, Mr. Majoros' proposal has the potential to improperly allocate tax benefits of accelerated depreciation between the Company and customers. If the Commission were to accept what Mr. Majoros is proposing, there is no question that the Company would be forced to request an official determination from the IRS through a Private Letter Ruling, and begin a long administrative process for a flawed tax adjustment that has been proposed and rejected before, as I will outline below.

**Q. What are the consequences of violating the IRS's "normalization" rules?**

A. Violation of the rules on accelerated tax depreciation normalization requirements could result in the denial by the IRS of the Company's ability to claim accelerated tax depreciation on any of its public utility property as long as the violation continued. As a result, the Company would not be able to claim accelerated depreciation on any of its remaining production, transmission, distribution or other plant that remained subject to cost-based regulation, resulting in negative impacts on the Company's results of operations, financial condition and cash flows. The tax benefits of accelerated tax depreciation are provided to customers through a reduction to rate base (deferred taxes).

## VI. FERC AND STATE COMMISSIONS (INCLUDING THE WUTC) HAVE REJECTED SUCH PROPOSALS

**Q. What has FERC's position been on this issue?**

A. The Federal Energy Regulatory Commission abandoned the consolidated return method over 20 years ago.[4/5] In FERC's Opinion No. 173, at page 06, dated June 22, 1983 (Columbia Gas Transmission Corporation, Docket No. RP75-106-006), it stated that "the tax allowance should be equal to the tax on the profit the ratepayer will contribute to the company. In short, the tax allowance should be equal to the tax on the company's allowed rate of return." The FERC also went on to state that as a result of the differences in calculating the earnings due the company and the determination of taxable income, "the Commission has found that the taxes the company pays to the Internal Revenue Service is not a reliable guide, even as a starting point, for determining a company's tax allowance." (Id. at 06) In reiterating the use of the "stand-alone income tax method" the FERC stated, "when an expense is not included in the cost of service (because the company did not incur that expense in providing service), the deduction created by that expense is not allocated to the ratepayers." (Id. at 07)

**Q. Has this Commission also provided recent guidance on this issue?**

A. Yes it has. In its 2007 Order WUTC v. PacifiCorp, the Commission rejected a

[4] *Re Columbia Gulf Transmission Co.*, 23 FERC ¶ 61,396, Opinion 173 (1983) (rejecting the consolidated tax return method of calculating income taxes, and adopting a "stand-alone" method). The same day, FERC adopted the stand alone method for electric utilities. *Re Potomac Edison Co.*, 23 FERC ¶ 61,398, Opinion 163A (1983).

[5] Some state commissions still use the consolidated return method in some form (*e.g., Re West. Mass. Electric Co.*, 114 PUR 4th 1, 25 (Mass. DPU 1990)). Others have declined to use that method on policy grounds (*Re Potomac Elec. Power Co.*, 124 PUR 4th 1, 22-24 (Md. PSC 1991), or constitutional grounds (*e.g., Re Income Tax Expense for Rate-making Purposes*, 59 PUR 4th 576, 586-87 (Cal. PUC 1984): "We see no public interest that is served by making utility rates a function of profits or losses in non-utility affiliates, as would result from the consolidated

Consolidated Tax Adjustment (CTA) that was somewhat similar in scope to the proposed adjustment in this case. (Case No. UE-061546) In the PacifiCorp case, the Industrial Customers of Northwest Utilities (ICNU) proposed a CTA which imposed interest expense from the parent company onto the utility, which on its own, had no interest expense. In its decision Order No. 08, at para:(s) 152 & 153, the WUTC concluded:

> "(w)e note finally that what ICNU proposes here is tantamount to asking for a tax-true-up. True-up mechanisms, a form of single issue ratemaking, are not generally favored in utility ratemaking. We reject ICNU's proposed adjustment to reduce income tax as unsupportable."

## VII. CONCLUSION

**Q. What is your recommendation to the Commission with respect to Mr. Majoros' tax rate adjustment?**

A. The Commission has been very concerned to protect customers from intentional and unintentional commingling of regulatory and non-regulatory activities in ratemaking. Mr. Majoros' recommendations introduce this commingling through the misuse and faulty application of an "effective tax rate." His proposed adjustment to the Company's tax rate is inequitable, inconsistent with sound ratemaking principles, ignores the actual statutory tax rate that applies to Avista, and potentially violates the normalization provisions of the IRC. The Commission should reject Mr. Majoros' tax rate adjustment in its entirety.

**Q. Does that conclude your prefiled rebuttal testimony?**

A. Yes, it does.

---

return method. Further, we are persuaded that a tax loss is an asset that would be taken either without compensation and without due process of law, or with compensation but for no useful purpose.").