Exhibit B

PUGET SOUND ENERGY

MEMORANDUM

Date: October 4, 2005

To: Bert Valdman
Kimberly Harris

Cc: John Story

From: Matt Marcelia

Subject: Capitalized Overheads Deducted for Tax

Background

On its 2001 tax return, PSE filed an accounting method change to switch to the simplified service cost method under §263A for allocating mixed service costs (i.e. internal labor and overheads) between self-constructed assets and inventory. Since the IRS considers electricity to be an "inventoriable item", any costs allocated to inventory become deductible immediately as electricity can not be stored. Effectively, the company was able to deduct on its tax returns costs that it would have had to depreciate over a 20-year tax life.

Through September 2005, PSE has claimed net tax benefit of $66.3 million using the simplified service costs method. The amount include in the prior general rate case was $72.6 million. Through normal activity, about $6.3 million has reversed. See Table1.

Table 1: Capitalized Overheads Reported in PSE's Books

	Net Deduction	Tax Effect at 35%	Comments
2002 Sept	186,448,716	65,257,000	Year of change, cumulative benefit to 1986
2002 Dec	19,893,294	6,962,653	normal 2002 activity
2003 Sept	985,000	345,000	YTD 2003 activity
subtotal	207,327,010	72,564,653	amount in GRC
2003 Dec	(4,945,372)	(1,731,000)	normal 2003 activity
2004	4,603,580	1,611,253	normal 2004 activity
2005	(17,480,256)	(6,118,169)	allowed the adjustment to begin reversing on the 2004 tax return, filed in Sept 2005
Grand Total	189,504,962	66,326,737	

IRS Developments

On August 2, 2005, the IRS issued Revenue Ruling 2005-53 and compatible Regulations that will significantly impact utilities who availed themselves of the simplified service cost method. Both pieces of guidance take a more restrictive view of the term "routine and repetitive" than do the current regulations. The Revenue Ruling applies for all prior open tax years. The Regulations are effective for all tax years ending on or after August 2, 2005.

Revenue Ruling 2005-53

To be eligible to use the simplified service cost method, a taxpayer must produce self-constructed assets on a "routine and repetitive" basis. In Revenue Ruling 2005-53 ("RR"), the IRS addresses the circumstances under which a taxpayer will be considered to produce self-constructed assets on a "routine and repetitive" basis. Prior to the RR, the term "routine and repetitive" was determined by looking to the frequency with which similar items were self-constructed. So the construction of substations and the installation of poles, wire, and pipe would qualify for PSE, whereas construction of new generation would not.

In the RR, the IRS has added two new and restrictive elements to the rules which have no basis in prior regulations or revenue rulings. The RR requires that the self-constructed assets be mass-produced (numerous identical goods are manufacture using standardized designs and assembly line techniques) *or* have a high degree of turnover (a tax life of 3 years or less).

To make this change in 2005 and apply it back to 2001, the year in which many utilities switched to the simplified service cost method, is unreasonable. I believe the IRS faces significant hazards of litigation with respect to the RR.

Regulation §§1.263A-1T and 1.263A-2T

With regard to "routine and repetitive", the Regulations mirror the RR except for one change. Where the RR requires *either* mass-production *or* high degree of turnover, the Regulations require *both* mass-production *and* high degree of turnover.

The Regulations go on to provide that taxpayers using an impermissible method (e.g. PSE) can file an automatic method change to adopt a permissible method in 2005. The taxpayer can spread the unfavorable tax impact of the change over its next two tax years (2005 and 2006), without interest or penalty.

Regulations take effect for tax years ending on or after the August 2, 2005 and do not impact prior years.

Under §263A(i), Congress granted the IRS broad authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section..." To successfully challenge the Regulations in court, a taxpayer would need to show that they are arbitrary, capricious, or manifestly contrary to the statutes. This would be extremely difficult to establish. Any legal battle would be long and drawn-out, with little chance of a benefit. At this point, I do not anticipate that taxpayers will be successful in challenging the Regulations.

Impact to PSE in 2005 and 2006

The new RR and Regulations call into question PSE's $72.6 million tax benefit that was included in the last general rate case and our cumulative $66.3 million tax benefit that is currently reflected on the books. As proscribed in the Regulations, PSE would be required to give back the tax benefit prospectively over the next two tax years (2005 and 2006).

Deferred Tax

PSE will begin to reverse the deferred tax prospectively. By the end of 2005, half of the deferred tax will be reversed. The remainder will be reversed throughout 2006, on a monthly basis.

Cash Flow

PSE's next quarterly estimated tax payment is due December 15, 2005. On that date, PSE will remit half of the balance to the IRS, in addition to its normal estimated tax payment. In 2006, PSE will remit one-quarter of the remainder on the following dates: March 15, June 15, September 15, and December 15.

Conclusion

By December 31, 2006, all of the deferred tax will be reversed and remitted to the IRS.