EXHIBIT NO. ___(MRM-1CT)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: MATTHEW R. MARCELIA

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, **Complainant,** **v.** **PUGET SOUND ENERGY, INC.,** **Respondent.**	**Docket No. UE-072300** **Docket No. UG-072301**

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF
MATTHEW R. MARCELIA
ON BEHALF OF PUGET SOUND ENERGY, INC.

REDACTED

JULY 3, 2008

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF MATTHEW R. MARCELIA

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1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED REBUTTAL TESTIMONY (CONFIDENTIAL) OF**
3 **MATTHEW R. MARCELIA**

4 **I. INTRODUCTION**

5 **Q. Please state your name, business address, and present position with Puget**
6 **Sound Energy, Inc.**

7 A. My name is Matthew R. Marcelia. I am the Director of Tax at Puget Sound
8 Energy, Inc. ("PSE" or the "Company"). My business address is 10885 N.E.
9 Fourth Street, Bellevue, Washington, 98009.

10 **Q. Have you prepared an exhibit describing your job duties, education, relevant**
11 **employment experience, and other professional qualifications?**

12 A. Yes, I have. It is Exhibit No. ___(MRM-2).

13 **Q. Please summarize the purpose of your rebuttal testimony.**

14 A. My rebuttal testimony addresses the natural gas and electric Federal Income Tax
15 restating adjustments as presented in Mr. Karzmar's and Mr. Story's pro forma
16 and restating adjustments. These adjustments are shown in Exhibit
17 No. ___(KRK-13) at page 13.04 and in Exhibit No. ___(JHS-15) at page 15.04.

18 This rebuttal testimony further addresses why the federal income tax adjustments
19 that Mr. Majoros proposes on page 15 of Exhibit No. ___(MJM-1TC) are

erroneous and inappropriate for setting rates. I also discuss Mr. Majoros' proposed flow-through of taxes associated with storm damage and why this proposal is harmful to customers.

Finally, this rebuttal testimony discusses why the domestic production activities deduction adjustment proposed by Mr. Higgins on page 13 of Exhibit No. ___(KCH-1T) is inappropriate and does not meet Internal Revenue Service ("IRS") standards.

II. ADJUSTMENT NOS. 7(E) AND 3(G) TO FEDERAL INCOME TAXES AS PROPOSED BY MR. MAJOROS ON BEHALF OF PUBLIC COUNSEL

Q. What adjustments has Mr. Majoros proposed to PSE's federal income tax?

A. Mr. Majoros proposed two adjustments to PSE federal income tax. He proposes to (i) change the Company's tax rate from 35.00% to 30.67%, and (ii) flow-through the deferred taxes related to storm damage. I will discuss each item in turn.

A. Proposed Change to the Company's Tax Rate

Q. Please explain PSE's present income tax reporting situation.

A. PSE is a wholly owned subsidiary of Puget Energy, Inc ("Puget Energy"). As a result, PSE does not file a separate (or single entity) tax return with the IRS. Instead, PSE's taxable income or loss is included with the taxable income or loss

1 of Puget Energy and its other subsidiaries. The consolidated Puget Energy group
2 files one consolidated tax return with the IRS. Although only one tax return is
3 filed for the group, the IRS requires that actual taxable income be computed for
4 each legal entity on a separate company basis.[1] The tax liability of any member
5 of the consolidated group can be determined by multiplying that member's
6 taxable income by the statutory tax rate and then adjusting for any tax credits that
7 the member may have generated.

8 **Q. What is PSE's statutory tax rate?**

9 A. PSE's statutory tax rate is 35%.

10 **Q. What is statutory tax rate for the Puget Energy consolidated group?**

11 A. The statutory tax rate for the Puget Energy consolidated group is 35%.

12 **Q. If the Company's statutory rate is 35%, why does Mr. Majoros claim that**
13 **PSE's the rate should be 30.67%?**

14 A. Mr. Majoros claims that he is lowering the tax rate to reflect "the actual tax rate
15 of the consolidated group of which [PSE] is a member". It is a puzzling claim,
16 since the Internal Revenue Code ("IRC") is clear that any taxpayer with an
17 amount of taxable income like that of PSE or the Puget Energy consolidated
18 group must be taxed at a rate of 35%. *See* IRC §11(b). PSE and the Puget

[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.

1 Energy consolidated group have the same tax rate of 35%. Taxpayers are taxed at
2 the rates enacted by Congress. Mr. Majoros' proposed tax rate would require an
3 act of Congress for it to be an appropriate adjustment.

4 Mr. Majoros appears to be confused by the Company's consolidated tax return
5 filing. His concern appears to originate with the fact that within a consolidated
6 tax return, a tax *liability* is not calculated for each separate company (even though
7 taxable *income* is calculated for each separate company). Mr. Majoros uses this
8 startling revelation to state: "In other words, PSE proposes to charge income
9 taxes to its regulated customers at a higher rate that the actual tax rate of the
10 consolidated group of which it is a member." This is an illogical statement and a
11 spurious claim. To calculate the tax *liability* for each company, all Mr. Majoros
12 needs to do is to multiply the taxable *income* of each company by the tax rate (i.e.
13 35%) and the result will be the tax *liability*. The simple reason that this is not
14 done as part of the tax filing is that there is no reason to do it. The IRS treats the
15 consolidated group as one taxpayer and only requires the calculation of one tax –
16 at the consolidated level.

17 In fact, it is the Company's common practice to make this exact calculation to
18 determine each subsidiary's separate tax liability. However, those calculations
19 are not submitted to the IRS as part of the Company's tax filings because it is not
20 required. In the case of the Puget Energy consolidated group, such calculations
21 are simple, straight-forward, and non-controversial. I have supplied them as
22 Exhibit No. ___(MRM-3).

1 **Q. Please explain Mr. Majoros' application of "effective tax rate".**

2 A. Mr. Majoros' application of the term "effective tax rate" is uncommon. Most
3 people are familiar with term "effective tax rate" in the context of financial
4 reporting. Every company that files a financial statement with the SEC is
5 required to disclose its "effective tax rate" in the footnotes of its financial
6 statements. For example, PSE's effective tax rate can be seen in Footnote 13,
7 *Income taxes,* of its 2006 10K. In the context of financial reporting, the term
8 "effective tax rate" is calculated as a percentage by dividing the *tax expense* by
9 the *pre-tax book income* to which it is associated. A company is required to
10 reconcile the effective tax rate to the statutory rate in its 10K filings. The
11 Company's case, the difference is primarily attributable to flow-through and to
12 tax credits.

13 In a regulatory setting, the term is used frequently to measure the regulatory *tax*
14 *expense* compared to the regulatory *pre-tax Net Operating Income ("NOI")* to
15 which it relates. For example, *see* Exhibit No.___(MRM-5), which is Public
16 Counsel Data Request No. 671 and the Company's response thereto. In that Data
17 Request, Public Counsel and the Company clearly lay out the mathematical
18 formula to calculate the Company's "effective tax rate". There is no difference
19 between the Company's formula and Public Counsel's. Both use *pre-tax NOI* and

1 *tax expense.*[2]

2 The point is that the term "effective tax rate" typically compares *tax expense*
3 relative to a *pre-tax book income*. That is how the Company uses the term and
4 that is how Public Counsel uses the term in its data request. That is not how Mr.
5 Majoros uses the term. His application of the term is much different. He would
6 use the term to compare *tax paid* with *taxable income.* This is at odds with
7 common parlance and financial accounting nomenclature.

8 **Q. Why does this matter?**

9 A. It matters because Mr. Majoros uses familiar terminology to introduce a radical,
10 foreign concept into the Company's tax calculation. He has calculated a
11 meaningless "tax rate" that is completely unusable and unsuitable for determining
12 tax expense for ratemaking.

13 **Q. In general, what tax rate should be used in setting customer rates?**

14 A. When the Company calculates its tax expense for ratemaking purposes, it uses a
15 tax rate of 35%, as that is the Company's statutory (and marginal) tax rate. This
16 should not be misunderstood to mean that the Company's tax expense will be
17 35% of pre-tax NOI. Pre-tax NOI must be adjusted for a number of items,
18 primarily the reversal of prior year's flow-through. The Company's calculation

[2] As stated in PSE's Response to Public Counsel Data Request No. 671, it is important to populate the equation with correct numbers in order to calculate the correct effective tax rate. *See* Exhibit No.___(MRM-5).

for electric operations can be seen at Exhibit No. ___ (JHS-15) at page 15.04. After considering these adjustments, the Company's tax expense will no longer be 35% of pre-tax NOI. It may be higher or lower.

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.

Q. Is Mr. Majoros' testimony consistent with the calculation he performs in Exhibit No. ___(MJM-5C)?

A. Mr. Majoros states one concept in his testimony and applies a different method in Exhibit No. ___ (MJM-5C) when he performs a calculation. Both his testimony and his calculations contain inconsistencies and errors. I will address each, in turn, beginning with his testimony.

Q. What concerns have you identified in Mr. Majoros' testimony?

A. As stated above, PSE and the Puget Energy consolidated group are taxed at the same rate. So Mr. Majoros' claim that "PSE proposes to charge income taxes to its regulated customers at a higher rate than the actual tax rate of the consolidated group" is factually false. PSE and the Puget Energy consolidated group are both taxed at 35%.

Q. Is there anything else of concern to you in Mr. Majoros' testimony?

A. Yes. Mr. Majoros makes the statement: "In my opinion, the Commission should

1 base PSE's income tax expenses on the actual amount of taxes paid principle."
2 Exhibit No. ___ (MJM-1TC) at page 16, line 15. This statement should be met
3 with extreme caution and skepticism. As Mr. Majoros may or may not be aware,
4 the IRS has its own "principles" (a.k.a. §168(i)(9)) on what regulated taxpayers
5 like PSE may or may not include in tax expense, deferred tax, and the rate base.
6 His statement, on its face, would violate all of it. It is a well established fact that
7 regulated taxpayers may use accelerated tax depreciation (e.g., MACRS) only if
8 they follow a normalization method of accounting. IRC §168(i)(9). Simply
9 stated, a normalization method of accounting requires a taxpayer to record
10 deferred taxes for the benefit it derives from accelerated tax depreciation. The
11 IRC further requires that taxpayers consistently apply estimates or projections to
12 tax expense, depreciation expense, the reserve for deferred taxes, and the rate
13 base in determining regulated rates. Mr. Majoros' proposed method, as he states
14 it, would require PSE to record "tax expenses on the actual amount of taxes paid
15 principle". The "actual amount of taxes paid" does not allow for deferred taxes,
16 which are required by the IRC under the normalization rules. His method would
17 result in a normalization violation.

18 **Q. What are the consequences of violating the normalization rules?**

19 A. The consequences of not complying with the normalization rules would be
20 significant to PSE and its customers. The Company would be prohibited from
21 using accelerated tax depreciation in all of its forms, including bonus
22 depreciation. For example, PSE currently depreciates its wind farms over 5 years

using Modified Accelerated Cost Recovery System ("MARCS") depreciation. If PSE violates the normalization rules, it would be forced to depreciate its wind farms using the same method and life that is used for book purposes (e.g., straight-line over 25 years). This would represent a huge cost increase to PSE and its customers, especially when this effect is extrapolated to all of the Company's depreciable assets.

Q. Please continue with you review of Mr. Majoros' testimony.

A. Mr. Marjoros proposed methodology would introduce tremendous volatility into customer rates. The "actual amount of taxes paid principle" does not allow for deferred taxes. The resulting volatility is clearly discernable in his Exhibit No. ___(MJM-5C) at line 2, columns 3, 6, and 9. Mr. Majoros believes that PSE (as listed on line 2 of Exhibit No. ___(MJM-5C)) should have recovered only the tax on $73.8 million of taxable income in 2004, the tax on $386.6 million taxable income in 2005, and the tax on $203.0 million taxable income in 2006. In other words, his stated methodology would subject the utility customers in 2005 to a rate increase of $109.5 million (to cover PSE's increase taxable income between 2005 over 2004 at a tax rate of 35%). Customers in 2006 would have seen their rates fall by $64.3 million, as the taxable income in 2006 declined from the 2005 level.

Q. What is the cause of this volatility?

A. Taxable income and the "actual taxes paid principle" are inherently volatile

1 calculations and prone to significant swings. The primary cause of these swings
2 is normally captured by deferred taxes. There are two components to tax
3 expense: current taxes and deferred taxes. Deferred taxes offset the swing in
4 current taxes. By properly reflecting deferred taxes, customers are treated to a
5 much more stable tax expense that fairly and accurately matches the tax expense
6 to the income and expense of utility operations. Management believes such rate
7 volatility is unacceptable and contrary to sound ratemaking principles.

8 **Q. Are there any additional areas of concern in Mr. Majoros' testimony?**

9 A. Yes. In his testimony, Mr. Majoros misstates the amount of federal income tax
10 for electric as $123.3 million (Exhibit No. ___ (MJM-1TC) at page 16, line 8).
11 The $123.3 million is actually the "Taxes Other Than Income Tax" amount from
12 line 29 of Exhibit No.___(JHS-11) at the summary page. The correct amount of
13 federal income tax noted in the Company's supplemental filing was $18.7 million.
14 *See* Exhibit No. ___(JHS-11) at the summary page, line 30.

15 Furthermore, I would note that Mr. Majoros created a different methodology
16 when he attempts to recalculate the tax rate in Exhibit No. ___(MJM-5C) which
17 varies from what he describes in his testimony.

18 **Q. Can you simply summarize Mr. Majoros' calculation on Exhibit**
19 **No. ___(MJM-5C)?**

20 A. Yes. Mr. Majoros, while claiming to change the tax expense to reflect the actual
21 tax paid, has done nothing of the sort. Very simply, he has separated all of the

1 subsidiaries in the consolidated tax return into entities with positive taxable
2 income and entities with negative taxable income. He then allocates a portion of
3 the negative taxable income to PSE and claims that PSE should pay less tax.

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

5 A. No, I have many concerns with that approach.

6 First, it is a nonsensical carving up of the consolidated group for purposes of
7 ratemaking. The IRS requires consolidated taxpayers to report their results by
8 legal entity. When considering tax expense from a ratemaking perspective, the
9 operative unit of analysis is not a legal entity, but regulated vs. non-regulated. By
10 failing to do this elementary step, Mr. Majoros has allocated a portion of the
11 regulated taxable losses from Rainier Receivables, Inc. ("Rainier Receivables")
12 and from PSE Funding, Inc. ("PSE Funding") to non-regulated companies. This
13 is completely improper – as 100% of the tax losses from Rainier Receivables and
14 PSE Funding must be attributed to regulated operations. Any other result would
15 be inappropriate and result in customers providing a subsidy to the non-regulated
16 members of the consolidated group. By my estimation, he proposes to allocate
17 14% of the tax losses from Rainier Receivables and PSE Funding to non-
18 regulated companies.

19 Mr. Majoros has commingled the separate risks, rewards, revenues, and expenses
20 of the regulated and non-regulated groups. In doing so, he has disregarded the
21 cost-causation principle. Generally, rates are considered to be "just and fair"

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

12 Second, it is a true observation to state that some legal entities in the Puget
13 Energy consolidated group reported taxable income while others reported taxable
14 losses. Mr. Majoros provides no explanation as to why customers should enjoy
15 lower tax expense when a non-regulated legal entity reports a tax loss but bear no
16 additional tax expense when the same non-regulated entity reports taxable
17 income.

18 Consider specifically the situation of B&H Maintenance and Construction
19 ("B&H"), a non-regulated entity wholly owned by InfrastruX. *See* Exhibit
20 No. ___(MJM-5C) at line 22. In 2004, 2005, and 2006, B&H reported the follow
21 results: [REDACTED], and [REDACTED],
22 respectively. Over the three-year period, B&H reported a [REDACTED].

1 [REDACTED]

2 Mr. Majoros believes that B&H's [REDACTED] in 2004 and 2006 should be shared
3 with the regulated customers. However, he completely ignores the [REDACTED] in
4 [REDACTED] in 2005, which completely offsets the [REDACTED] in 2004 and 2006.
5 Under the tax laws, B&H is able to carry tax losses back two years and forward
6 20 years to offset its taxable gains. It would seem that fairness and logic would
7 require that he likewise allocate a portion of the [REDACTED] to customers if he is
8 truly keen on allocating some of the [REDACTED]. But Mr. Majoros inconsistently
9 applies his analysis in order to manipulate a result to his liking. Mr. Majoros fails
10 to explain why the customers should be impacted by anything B&H has done,
11 regardless of whether its activities resulted in gain or loss.

12 Third, consider the same point from a different angle. Management of the
13 regulated company chose to place some regulated activities in PSE Funding, a
14 separate legal entity. Management expected PSE Funding to generate losses for
15 book and tax purposes; but for legal and accounting reasons, management decided
16 that customers would be well served by structuring the regulated operations in
17 more than one legal entity. The fact that PSE Funding does report losses does not
18 imply that management should have pursued some other legal structure. The
19 losses of PSE Funding remain fully attributable to regulated operations regardless
20 of legal entity in which they fall.

21 By the same count, the management of InfrastruX could have chosen some other
22 arrangement of its legal structure, by which they could have eliminated the tax

1 losses reported by some or all of its subsidiaries. But management at InfrastruX
2 did not choose to do so. In no way should InfrastruX's choice of legal entity
3 structure have any impact on the tax properly attributable to regulated operations
4 or imply that somehow a tax loss incurred by one of InfrastruX's legal entities
5 should be shared with PSE's customers.

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

11 Fourth, Puget Energy sold InfrastruX, along with all of its legal entities, in May
12 2006. Those legal entities are gone. Mr. Majoros should have accounted for this
13 fact in performing his analysis. It is customary in rate proceedings to adjust for
14 known and measurable items, of which the sale of InfrastruX would be one. The
15 sale of InfrastruX eliminates the possibility that the Puget Energy consolidated
16 tax group will report any future taxable income or losses related to the InfrastruX
17 legal entities.

18 Fifth, Puget Energy reported a [REDACTED] on the sale of
19 InfrastruX in 2006. If Mr. Majoros were to consistently apply his methodology,
20 customers would owe tax on this sale. If he allocates a portion of the tax losses
21 from the InfrastruX entities to customers, he would need to offset it with a portion
22 of the taxable income. Please note that the InfrastruX group [REDACTED]

1 ████████ – over the years included in his analysis. The InfrastruX
2 group reported a ████████ in 2004, a ████████
3 in 2005, and a ████████ in 2006 – for a ████████.

4 Sixth, it is interesting to note that in every year covered in Mr. Majoros' Exhibit
5 No. ___(MJM-5C), both the regulated and the non-regulated group reported
6 positive taxable income – which begs the question of why Mr. Majoros would
7 allocate any loss to customers.

8 Seventh, Exhibit No. ___(MJM-5C) contains an error on line 1, column 2. The
9 Loss from Puget Energy should be $1,987,811 – not $987,811. Mr. Majoros
10 dropped $1 million of loss from his analysis.

11 Finally, Mr. Majoros claims in his testimony that "the Commission should base
12 PSE's income tax expenses on the actual amount of taxes paid principle." Mr.
13 Majoros' calculation in Exhibit No. ___(MJM-5C) completely fails in this regard.
14 He never calculates the "actual amount of taxes paid" and yet that is the principle
15 he wants the Commission to apply. I have calculated the "actual amount of taxes
16 paid", applying Mr. Majoros' principles as best as can be determined from his
17 very brief testimony on this topic. I have modified Mr. Majoros' Exhibit
18 No. ___(MJM-5C). *See* Exhibit No. ___(MRM-4).

19 **Q. If the "actual amount of taxes paid" is calculated, what does it show?**

20 A. It shows that the regulated group is paying tax at a *lower* tax rate than that of the

REDACTED

1 consolidated group of which it is a member. *See* Exhibit No. ___ (MRM-4). This
2 is in direct contradiction to Mr. Majoros' testimony (Exhibit No. ___(MJM-1TC)
3 at page 16, line 10). He claims that "PSE proposes to charge income tax to its
4 regulated customers at a *higher* rate than that of the consolidated group of which
5 it is a member." (emphasis added) This is not true.

6 **Q. Did Mr. Majoros also identify a cross-subsidy?**

7 A. Mr. Majoros claims to have identified a cross-subsidy, but no cross-subsidy
8 exists. The non-regulated group is *paying* tax at a rate of 35% in 2005 and 2006
9 while the regulated group is *paying* tax at 34.8% and 31.4%, respectively. Mr.
10 Majoros states that "[t]his is an obvious cross-subsidy." (Exhibit No. ___(MJM-
11 1TC) at page 16, line 15). His statement is incorrect. Absolutely no cross
12 subsidy has occurred in fact or in appearance under the Company's methodology.

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

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

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

20 A. I included the actual credits that appeared in the tax returns. In 2004, the main

1 credit resulted from the payment of minimum tax in an earlier year. In 2005 and
2 2006, the primary tax credits came from the Production Tax Credit, which the
3 regulated group receives from the generation of power at its two wind farms.

4 **Q. Is it appropriate to consider tax credits in your analysis?**

5 A. It is not truly *my* analysis. I am trying to make Mr. Majoros' calculation do what
6 he has stated it is supposed to do. He recommends using the "actual amount of
7 taxes paid" method. In calculating the amount of taxes paid, tax credits must be
8 reflected. If Mr. Majoros were to amend his proposed methodology to the "actual
9 amount of taxes paid not considering tax credits" method, then I would remove
10 the tax credits.

11 **Q. If you remove tax credits from the calculation, what happens?**

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

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

17 A. Yes. Mr. Majoros applies his revised tax rate on Exhibit No. ___(MJM-4) at page
18 12 of 23 and recalculates tax expense. In doing so, he has violated the
19 normalization provisions of the IRC on at least two counts. First, the
20 normalization provisions require a regulated taxpayer to apply consistent

1 assumptions for tax expense, depreciation expense, the reserve for deferred taxes,
2 and for rate base. IRC§168(i)(9)(B). Mr. Majoros calculates an adjustment for
3 tax expense only. He has made no adjustment to the reserve for deferred taxes.
4 This is an impermissible inconsistency and would be a normalization violation.

5 Second, the normalization provisions require a regulated taxpayer to record
6 deferred taxes based on the difference between depreciation for ratemaking and
7 depreciation for tax purposes. That difference is multiplied by the statutory tax
8 rate. Mr. Majoros' methodology introduces the tax losses and supposed "tax
9 savings" from the non-regulated entities into the calculation. This violates the
10 provisions of Regulation §1.167(l)-1(h)(2) which provide that the deferred tax can
11 be adjusted only for differences related to book and tax depreciation methods.
12 This Regulation precludes the Company from making adjustments related to the
13 tax losses or supposed "tax savings" of non-regulated companies. Adjusting the
14 tax expense or the deferred tax reserve for this item would be a normalization
15 violation.

16 Not only does Mr. Majoros commingle regulatory activities with non-regulatory
17 activities, he also commingles electric operations with gas operations. In his
18 calculation, electric operations and gas operations are combined when he derives
19 one tax rate. Electric and gas operations have unique tax profiles. The Company
20 calculates tax adjustments for each separately in order to preserve the proper cost-
21 causation. For example, only electric customers should receive the benefit of the
22 PTC or bear the cost of reversing flow-through. It would be inappropriate for gas

1 customers to bear any burden or benefit that is caused by electric operations.

2 Furthermore, the Company exercises great care to assign to customers only the
3 tax expense associated with burdens and benefits of the regulated activities. To
4 do otherwise would impose upon customers some burden or benefit from the non-
5 regulated entities and should not be permitted. Mr. Majoros' methodology, in
6 whatever form he ultimately decides to pursue, is designed to subsidize customers
7 at the expense of the non-regulated entities. The Commission must ensure that
8 benefits and costs borne by customers are appropriately attributable to regulated
9 activities. Activities and events that occur outside of the regulated group must
10 not impact customers negatively or positively.

11 **Q. How has the Company calculated taxes for the test year?**

12 A. The Company starts with the twelve months ended September 30, 2007 income
13 statement. As this income statement consists of three months of 2006 and nine
14 months of 2007, the taxes shown include estimates associated with the full twelve
15 months of each of these years. The Federal Income Tax restating adjustment as
16 presented in Mr. Karzmar's and Mr. Story's pro forma and restating adjustments
17 shown in Exhibit No. ___(KRK-13), page 13.04 and Exhibit No. ___(JHS-15) at
18 page 15.04, and the equivalent schedules in prefiled direct and supplemental,
19 adjust the test year so that all the taxes are based on what actually occurred in the
20 twelve months of the test year. For each proforma and restating adjustment that
21 has a tax impact, the taxes are calculated at the 35% statutory rate so that the test
22 year maintains its appropriate tax burden.

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

A. Historically, the Commission has been very concerned to protect customers from intentional and unintentional commingling of regulatory and non-regulatory activities in ratemaking. Mr. Majoros ignores this. 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 PSE, and violates the normalization provisions of the IRC. The Commission should reject Mr. Majoros' tax rate adjustment.

B. Proposed Flow-Through Adjustment for Storm Damages

Q. Please summarize the Company's current book accounting treatment related to storms.

A. When certain storms occur, the Commission allows the Company to accumulate the O&M costs associated with that storm in a regulatory asset account. The Company does not record an expense related to those costs immediately. The Commission typically reviews the regulatory account at a future ratemaking proceeding and allows the Company to recover some appropriate portion of those costs in future rates. The Company will begin to amortize the regulatory asset once the Commission has allowed it to be recovered in rates. Thus, the Company's accounting will match the additional revenue that results from higher rate with the increase expense, which results from the amortization of the

1 regulatory asset.

2 **Q. Please summarize the Company's current tax treatment related to storms.**

3 A. The O&M costs that are accumulated in the regulatory account represent actual
4 cash expenditures incurred by the Company. These costs are deductible
5 immediately for tax purposes. So the Company deducts these costs on its tax
6 return when they are incurred.

7 **Q. How does the Company account for difference between the book and tax**
8 **treatment of storms?**

9 A. The Company provides a deferred tax to cover the difference between the book
10 and tax treatments of storms. The deferred tax is recorded on a storm-by-storm
11 basis. To provide a deferred tax is referred to as "normalization". To not provide
12 a deferred tax is referred to as "flow-through", or sometimes "flow-thru".

13 **Q. What is a deferred tax?**

14 A. A deferred tax is a tax expense or benefit that is certain to occur in a future
15 period. Companies are required to record deferred taxes on temporary differences.
16 *See* Statement of Financial Accounting Standards No. 109, *Accounting for Income*
17 *Taxes,* ("FAS 109") and FERC Part 101 and 201, General Instruction 18,
18 *Comprehensive Interperiod Income Tax Allocation.* Temporary differences
19 (sometimes referred to as "timing differences") result whenever a tax deduction
20 occurs in a period that is different from the period of the book deduction. For

1 example, storms create a temporary difference because the tax deduction typically
2 occurs in Year 1, while the amortization expense would occur in Years 2 through
3 4. In this example, a deferred tax liability would be created in Year 1, would
4 begin reversing in Years 2, and would be fully reversed at the end of Year 4.

5 **Q. What effect do deferred taxes have on tax expense?**

6 A. There are two components of "tax expense": current tax expense and deferred tax
7 expense. So to continue with my storm example: In Year 1, current tax expense
8 drops because the Company claims a deduction on its tax return for the whole
9 storm amount. However, deferred tax expense increases by the same amount to
10 reflect the fact that the Company will owe more tax over the next three years
11 (Years 2 through 4), which is the amortization period approved in prior
12 proceedings. The result is that there is no net "tax expense" on the income
13 statement in Year 1, as amounts in current and deferred tax expense offset. Note
14 that it is completely appropriate to show no net tax expense because none of the
15 storm costs has been posted to storm amortization expense – it is sitting in a
16 regulatory assets account, awaiting a Commission order.

17 Then in Years 2 through 4, the costs will run through storm amortization expense.
18 There will be no current tax deduction in Years 2 through 4 because the Company
19 already claimed the deduction in Year 1. In Year 2 through 4, there will be a
20 reduction in deferred tax expense to capture the fact that the deferred tax liability
21 created in Year 1 is reversing.

1 As this example illustrates, a deferred tax is essential to matching the tax
2 deduction (which is a tax benefit) with the period to which the book amortization
3 is deducted.

4 **Q. What would happen if no deferred tax was provided (i.e., if the storm was**
5 **flowed-through)?**

6 A. If no deferred tax were provided, the deferred tax expense would be zero in Years
7 1 through 4. The only entries that would be entered into the books would be
8 related to the current tax.

9 If no deferred tax were recorded in Year 1, the Company would appear to reap a
10 tax "windfall" – a current tax deduction for storm costs.[3] Then in Years 2 through
11 4, the situation turns ugly as the tax "windfall" turns into a tax "shortfall". In
12 those years, the Company is recording storm amortization expense but appears to
13 be receiving no tax deduction associated with the storm costs – this is because the
14 full tax deduction was claimed in Year 1. Deferred taxes smooth the "windfall"
15 and "shortfall" and match the net tax expense with the storm amortization to
16 which it relates.

17 By their vary nature temporary differences are temporary. To create the illusion
18 of "windfalls", which will always be followed by "shortfalls", represents a less
19 than optimal ratemaking convention. By recording a deferred tax for temporary

[3] No amortization expense has yet been recorded and no provision has been made to account for the future tax that will result.

1 differences, the Company properly accounts for the future reversal of the
2 deduction. It is a known and measurable item. Failure to account for deferred
3 taxes could cause misleading results from utility operations.

4 **Q. How do customers benefit from the provision of deferred taxes (i.e.,**
5 **normalization)?**

6 A. Customers see the following benefits from normalization. First, through
7 normalization, the Company allocates the proper annual costs to the customer
8 who is receiving utility services during that annual period. Customers change
9 over time. It would be inappropriate for a new customer to arrive in Year 2 and
10 be burden by the cost of the storm amortization expense and at the same time
11 receive no tax benefit related to storm costs. This would violate cost-causation
12 and the benefits and burdens principles – the benefit of the tax deduction should
13 attached to the customers who pay for the storm costs.

14 By applying flow-through to storms, Mr. Majoros causes a shift in cost from early
15 (e.g., Year 1) customers to later (e.g., Years 2 through 4) customers. Note that
16 later customers will see their cost of service increase while receiving no service
17 related benefits for their higher utility costs. Mr. Majoros provides no
18 justification for his preference for current customers over later customers.

19 Second, the creation of a deferred tax liability is appropriate to reflect the future
20 tax payments which will be required as the tax benefits reverse. Accrual
21 accounting requires companies to record a reserve when they know that a liability

1 has been incurred. Since temporary differences must reverse, deferred tax
2 liabilities should be recorded and accrued through cost of service.

3 Third, normalization results in lower rates for customers. When the tax benefit of
4 the storm deduction is matched to the same period as the amortization of the
5 storm costs, there is no direct effect on customer rates due to taxes. By failing to
6 record deferred income taxes (i.e. flow-through), customer rates must increase in
7 the later years. However, customer rates do not increase for only the cost of the
8 tax. Instead, they increase by the cost of the tax, plus the tax on the cost of the
9 tax. So the cost to customers ratchets up. For example, with a tax rate of 35%,
10 rates must go up $1.54 in order to cover $1 of the reversing tax benefit. When
11 deferred taxes are provided, there is no tax on tax impact.

12 **Q. How does Mr. Majoros justify his flow-through adjustment?**

13 A. Mr. Majoros states that "there is no legal requirement to normalize these tax
14 benefits." He is technically correct on this point. However, this logic is
15 insufficient to justify his actions. Legality is not the issue. The issue is fairness
16 to customers over the underlying storm cost recovery period. Besides, whatever
17 validity his logic has, it is equally legitimate in reverse, i.e., "there is no legal
18 requirement to *flow-through* these tax benefits" and, I would add, "there are many
19 equitable reasons not to."

1 **Q. Have you identified any problems with Mr. Majoros' calculation of the flow-**
2 **through amount?**

3 A. Yes. In the event the Commission opts to flow-through some or all of the storm
4 costs, I have the following concerns. In his calculation, he has flowed through the
5 entire book-tax difference related to storm costs in one period. It is inappropriate
6 to flow-through the entire amount in one period. Significant storms, like that
7 reflected in the test year, are not common or recurring in nature. Flowing-through
8 the entire amount in one period will leave the Company short on cash to make the
9 tax payment in Year 2. All other things being equal, the Company may need to
10 file for a rate increase in order to raise the cash necessary to make those tax
11 payments which begin in Year 2. *See* Exhibit No.___(JHS-19), which shows the
12 need for a $55.9 million rate increase in Year 2. Historically, the Commission has
13 granted the Company relatively short amortization periods over which to recover
14 storm costs. Short amortization periods tend to highlight the short-sightedness of
15 the flow-through treatment advocated by Mr. Majoros.

16 **Q. What is your recommendation to the Commission on Mr. Majoros storm**
17 **adjustment?**

18 A. The Commission should continue with its current tax methodology of normalizing
19 storm costs.

20 **Q. Do you have any additional concerns with Mr. Majoros' overall analysis?**

21 A. Yes. Exhibit No. ___(MJM-4) at page 12, Schedule 4 of PC Adjustment

Nos. 7(E) and 3(G) contains an error on line 18. Mr. Majoros has his signs backwards on his electric and gas adjustments. The electric adjustment should be positive $2,977,019 and the gas adjustment should be negative $1,293,262.

III. DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

Q. Briefly describe the Domestic Production Activities Deduction.

A. IRC §199 allows a taxpayer that performs manufacturing activities within the United States to claim a "§199 deduction". That deduction is calculated by multiplying the taxable income that is generated from the qualifying production or manufacturing activities by the applicable percentage. In 2006, the applicable percentage was 3%. In 2007 through 2009, it is 6%. In 2010 and beyond, the applicable percentage is 9%.

Q. Are there any limitations on the amount of deduction that a taxpayer can claim?

A. Yes, there are three limits:

(i) The deduction is limited by the amount of taxable income that the taxpayer derives from the qualifying activities. If there is no taxable income from qualifying activities, there is no deduction.

(ii) The deduction is limited to 50% of W-2 wages that are properly allocated to qualifying activities.

(iii) The deduction is limited by the taxpayer's overall taxable income, without regard to the deduction.

1 Any preliminary §199 deduction in excess of these limitations is completely
2 eliminated.

3 **Q. Does PSE perform any activities that would qualify for the §199 deduction?**

4 A. Yes, PSE generates electricity. The generation of electricity is a qualifying
5 activity. PSE participates in no other qualifying activities.

6 **Q. If PSE engages in only one qualifying activity, the generation of electricity,**
7 **how do you determine the taxable income that is attributable exclusively to**
8 **that activity?**

9 A. IRC §199, the regulations, and the IRS' published guidance set forth detailed and
10 complex rules that must be followed in order to assure that the allocation method
11 used to allocate taxable income between qualifying and non-qualifying activities
12 is appropriate. In addition, Edison Electric Institute Taxation Committee
13 ("EEITC") developed a set of guidelines to assist utilities in the application of the
14 rules. PSE's calculation follows the EEITC guidelines.

15 **Q. Can you briefly describe the steps you follow in making your allocation?**

16 A. Yes. It is important to keep in mind that the goal of this process is to determine
17 the *taxable* income from only generation activities. The initial step requires the
18 Company to determine the amount of *book* income that is attributable to electric
19 operations. For this, we look to the Company's regulatory filings (e.g., the FERC
20 Form 1). The book income from electric operations is then allocated between

1 generation and non-generation on the basis of the net book value of generation
2 and non-generation plant. The next step requires the Company to allocate each
3 book-tax difference between generation and non-generation. This step of the
4 process will effectively convert the *book* income from generation into *taxable*
5 income from generation.

6 If that analysis results in a positive taxable income, we would continue the
7 process and multiply the positive taxable income by the applicable percentage.
8 The final two steps would be to apply the W-2 limitation and the overall taxable
9 income limitation.

10 The result would be the §199 deduction that PSE can claim on its tax return.

11 **Q. Did PSE include any benefit from the §199 deduction in its GRC filing?**

12 A. No. As Mr. Higgins' rightly observed in his testimony (Exhibit No. ___(KCH-
13 1T) at page 14, line 18), PSE did not include any benefit from the §199 deduction.

14 **Q. Why not?**

15 A. The Company performed a detailed calculation of its §199 deduction for inclusion
16 in its 2006 federal income tax return. That calculation shows that the Company
17 had a tax loss from its electric generation activities for 2006. Furthermore, in the
18 preparation of its 2007 tax provision (the 2007 tax return has not yet been
19 prepared), the Company estimated that it had another taxable loss from generating
20 activities. In neither year did the Company pass the first limitation that I

mentioned above.

Q. How is it that PSE has a taxable loss from generating activities when it is reporting positive taxable income overall?

A. The primary reason that PSE is reporting a tax loss from generation activities relates to the addition of the two wind farms: Hopkins Ridge and Wild Horse. Wind farms are a significant capital expenditure that benefit from accelerated tax depreciation using the five-year MACRS tax depreciation rates. Accelerated tax depreciation has the effect of greatly suppressing the Company's taxable income from generation during the first five years of a wind farm's life. Accelerated tax depreciation has caused the Company to incur tax losses from generating activities.

Although accelerated tax depreciation on the two wind farms is significant enough to cause a tax loss from generating activities, it is not large enough to cause PSE to report an overall tax loss.

Q. Have you reviewed Mr. Higgins' response testimony as it relates to the Domestic Production Activities Deduction?

A. Yes, I have reviewed his testimony on the domestic production activities deduction and Exhibit No. ___(KCH-2) in which he calculates a §199 deduction for PSE in the amount of $7,070,802.

1 **Q. Does Mr. Higgins's analysis comply with IRC §199 and the Regulations**
2 **issued there under?**

3 A. No, Mr. Higgins' analysis falls short of what the law requires. His approach is
4 too simplistic to accurately reflect what the law requires. Unfortunately,
5 Congress and the IRS did not promulgate simple rules for §199. The rules require
6 taxpayers to perform detailed calculations. Those calculations result in a tax loss
7 from generating activities.

8 **Q. Can you point to any specific errors in Mr. Higgins' analysis?**

9 A. Yes. Mr. Higgins' analysis contains several errors:

10 First, on line 7 of Kroger Exhibit No. ___(KCH-2), Mr. Higgins calculates Net
11 Operating Income (excluding FIT and DFIT) as derived from Exhibit
12 No. ___(JHS-11) at the summary page. I do not believe that this is an appropriate
13 starting point for estimating the §199 deduction. The §199 deduction is the result
14 of a tax calculation and so must be calculated from the best estimate of actual tax
15 return data. In order to calculate a meaningful estimate of taxable income, a
16 taxpayer must begin with the most likely pretax book income (or NOI) that would
17 form the basis of an actual tax filing – where all items of income and expense
18 have been set to the same time period. So for Mr. Higgins to begin the
19 calculation with pretax NOI for ratemaking is problematic as pretax NOI for
20 ratemaking is determined on a wholly different basis than taxable income in the
21 tax return. Pretax NOI that is used in a ratemaking represents an impermissible

1 comingling of historical and future data – which would never be permissible in an
2 actual tax filing. The resulting estimate of taxable income from such a starting
3 point would be unreliable.

4 Second, on line 10 of Kroger Exhibit No. ___(KCH-2), Mr. Higgins attempts to
5 convert book NOI into taxable income. He calculates an increase in the amount
6 of $34,948,316 for "Other Pro Forma Income Adjustments". This adjustment
7 covers only the pro forma adjustments for flow-through and permanent items tax
8 items. His error is that by only grabbing the flow-through and permanent items,
9 Mr. Higgins fails to remove or deduct any of the pro forma normalized items tax
10 items. The normalized items would lower taxable income by $262,987,353. As a
11 result, I would suggest revising line 10 to $228,039,037 (which nets the increase
12 to taxable income of $34,948,316 with a decrease to taxable income of
13 $262,987,353).

14 Third, on line 12 of Kroger Exhibit No. ___(KCH-2) needs to be revised
15 downward to reflect the adjustment in No.2, above. This would make Mr.
16 Higgins' estimate of taxable income from electric operations equal to
17 $25,830,985 after removing $262,987,353 of pro forma normalized deductions.

18 Fourth, on line 14 of Kroger Exhibit No. ___(KCH-2), Mr. Higgins allocates his
19 taxable income between qualifying generating activities and other non-qualifying
20 activities using a simple one-step process. He looks to Exhibit No. ___(JHS-6)
21 and compares the 2007 PCA-related NOI of $71.6 million with the Total 2007
22 PCA-related NOI of $175.6 million and concludes that 40.8% taxable income

1 must come from qualifying activities. This analysis is problematic on a couple of
2 counts. By looking to PCA-related NOI, Mr. Higgins has included a significant
3 amount of unqualified activities in his percentage. For example, PCA-related
4 NOI includes purchased power, wheeling, and some transmission and
5 distribution—all of which are excluded activities.

6 In addition, Mr. Higgins' methodology has the effect of allocating taxable income
7 ratably. The IRS requires that taxpayers specifically allocate 100% of those items
8 that can be identified directly with the qualifying activity. Only items that can not
9 be directly identified should be allocated ratably. Mr. Higgins' analysis ignores
10 this requirement and effectively allocates too much taxable income to qualifying
11 activities. (For example, Mr. Higgins has only allocated 40.8% of tax
12 depreciation on the wind farms to qualifying activities, while the IRS requires
13 100% allocation to qualifying activities.)

14 **Q. Have you be able to use Mr. Higgins' analysis to calculate a revised,**
15 **corrected amount?**

16 A. No. The errors in Mr. Higgins' analysis are too profound to allow for a slight
17 modification and expect it to yield the correct amount.

18 However, although I do not claim that this would result in the correct amount, I
19 would point out that if Mr. Higgins would make only one adjustment to capture
20 100% of the tax depreciation on the wind farms, instead of only 40.8%, his
21 revised qualifying taxable income number (which I recalculated in my third point

above (i.e., $25,830,985)) would be reduced an additional $51.7 million and result in a tax loss from qualifying activities. A tax loss from qualifying activities would result in no benefit from the §199 deduction.

There are many other adjustments to consider in order to calculate the correct tax loss, but the point is that the result is a tax loss – which is consistent with the Company's experience under §199.

Q. What is your recommendation to the Commission on this matter?

A. For the reasons that I have outline above, I would respectfully recommend that the Commission set aside Mr. Higgins' analysis of the Domestic Production Activities Deduction as his analysis does not represent a legitimate estimation of the §199 deduction.

IV. CONCLUSION

Q. Does that conclude your prefiled rebuttal testimony?

A. Yes.