EXHIBIT NO. ___(MRM-1T)
DOCKET NO. UE-09___/UG-09___
2009 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-09____** **Docket No. UG-09____**

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

MAY 8, 2009

PUGET SOUND ENERGY, INC.

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PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

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

A. My name is Matthew R. Marcelia. My business address is 10885 N.E. Fourth Street, Bellevue, WA 98004. I am Director of Taxes for Puget Sound Energy, Inc. ("PSE").

Q. Have you prepared an exhibit describing your education, relevant employment experience, and other professional qualifications?

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

Q. What are your duties as Director of Taxes for PSE?

A. As Director of Taxes, I have the overall management responsibility for the tax department and direct all aspects of PSE's tax compliance, accounting for taxes, financial reporting of tax, and tax planning. My responsibility includes income taxes as well as state and local taxes. I report directly to the Vice President of Finance and Treasurer.

Q. What topics are you covering in your testimony?

A. I present the restating adjustment for federal income taxes for

(i) electric operations as set forth in Exhibit No. ___(JHS-4), at page 4.04, and

(ii) gas operations as set forth in Exhibit No. ___(MJS-4), at page 4.04.

I also present the adjustment for tax benefit of pro forma interest for

(i) electric operations as set forth in Exhibit No. ___(JHS-4), at page 4.05, and

(ii) gas operations as set forth in Exhibit No. ___(MJS-4), at page 4.05.

Additionally, I present the adjustment for net interest paid to the Internal Revenue Service ("IRS") for

(i) electric operations as set forth in Exhibit No. ___(JHS-4), at page 4.36, and

(ii) gas operations as set forth in Exhibit No. ___(MJS-4), at page 4.03.

Finally, I present a discussion of the key tax incentives enacted in the American Recovery and Reinvestment Act of 2009.

II. RESTATING AND PRO FORMA ADJUSTMENT FOR FEDERAL INCOME TAXES FOR ELECTRIC AND GAS OPERATIONS

A. Methodology for Calculating Federal Income Tax Expense for Electric and Gas Operations

Q. How has PSE generally calculated federal income tax expense for purposes of this proceeding?

A. In calculating federal income tax expense for electric and gas operations for purposes of this proceeding, PSE followed this Commission's longstanding principles regarding the segregation of regulated and non-regulated operations.[1] PSE has prepared the tax calculations for this proceeding on a separate company, stand-alone basis. This methodology reflects the tax effect attributable to regulated operations and isolates PSE's customers from the impacts of non-regulated activities.

B. Restating Adjustment for Federal Income Taxes for Electric and Gas Operations

Q. Please describe the restating adjustment for federal income taxes for electric and gas operations.

A. Mr. Story and Mr. Stranik present the electric and gas income statements from the

[1] The Commission reaffirmed these principles in its order in the most recent general rate filing of Avista Corporation. *See Wash. Utils. & Transp. Comm'n v. Avista Corp. d/b/a Avista Utils.*, Docket Nos. UE-080416 & UG-080417, Final Order Approving and Adopting Multi-Party Settlement Stipulation and Requiring Compliance Filing, at ¶¶ 28–34 (Dec. 29, 2008).

test year (calendar year 2008) in the first column of their respective exhibits. *See* Exhibit No. ___(JHS-4), at Summary; *see* Exhibit No. ___(MJS-4), at Summary. These income statements reflect tax entries that were booked during the test year that are not relevant to the utility's test year revenues and expenses. The restating adjustment for federal income taxes for electric and gas operations adjusts the actual federal income tax expense to the restated level based on the items of income and expense that are included in electric and gas operating income and expenses for the test year. The adjustment for electric operations decreases net electric operating income by $20,234,048. *See* Exhibit No. ___(JHS-4), at page 4.04. The adjustment for gas operations increases net operating income by $915,758. *See* Exhibit No. ___(MJS-4), at page 4.04.

Q. Has PSE removed the Production Tax Credit from federal income tax calculations in this proceeding?

A. Yes. PSE has removed the Production Tax Credit ("PTC") from federal income tax calculations in this proceeding. PSE passes PTCs through to its customers through a separate mechanism that PSE adjusts and files in October of each year. The PTC mechanism is forward-looking. PSE projects the amount of PTC that will be generated in the following year and then, in the subsequent filing, trues-up the projected PTCs to the actual PTCs generated.

III. ADJUSTMENT FOR THE TAX BENEFIT OF PRO FORMA INTEREST

Q. Please describe the adjustment for the tax benefit of pro forma interest.

A. As in prior rate filings, PSE has included an adjustment to capture the tax benefit of pro forma interest for electric and gas operations. This adjustment is sometimes referred to as interest synchronization.

Q. Why is the interest synchronization adjustment necessary?

A. The interest synchronization adjustment matches the tax deduction for interest expense to the new capital structure and interest rate adopted in the rate filing. Because the pro forma interest expense on the new rate base will be different than the interest expense in the test year, the tax deduction for interest expense should be adjusted to reflect the projected interest expense anticipated for the projected rate year rate base.

Q. How has PSE calculated the interest synchronization adjustment?

A. PSE multiplies the projected rate year rate base by the weighted cost of debt that PSE is requesting in this proceeding. The product is the projected interest expense anticipated for the projected rate year rate base. PSE then calculates the difference between the projected interest expense anticipated for the projected rate year rate base and the actual interest expense from the test year. PSE multiplies the difference by the tax rate of 35% to determine the incremental impact on net operating income.

Q. What is the impact of the adjustment for the tax benefit of pro forma interest on electric operations?

A. The adjustment for the tax benefit of pro forma interest on electric operations decreases operating income by $714,135. *See* Exhibit No. ___(JHS-4), at page 4.05.

Q. What is the impact of the adjustment for the tax benefit of pro forma interest on gas operations?

A. The adjustment for the tax benefit of pro forma interest on gas operations decreases operating income by $8,358,141. *See* Exhibit No. ___(MJS-4), at page 4.05.

Q. Compared to prior rate filings, has PSE made changes to the manner in which it has calculated the tax benefit of pro forma interest on electric and gas operations?

A. Yes. Unlike prior rate filings, PSE did not add construction work in progress ("CWIP") to rate base for purposes of calculating the tax benefit of pro forma interest on electric and gas operations.

Q. Why did PSE not add CWIP to rate base for purposes of calculating the tax benefit of pro forma interest on electric and gas operations?

A. PSE did not add CWIP to rate base for purposes of calculating the tax benefit of pro forma interest on electric and gas operations because PSE has not added

CWIP to rate base for any other aspect of the rate filing.

Q. By excluding CWIP from this calculation is the party that is paying the interest getting the tax benefit associated with the interest deduction?

A. Yes. PSE is paying the interest associated with CWIP prior to CWIP being closed to plant in-service, and PSE should receive the tax deduction associated with that interest. The tax deduction for interest expense should flow to the benefit of the party who has the burden of the interest expense because a tax deduction has no existence apart from the underlying expense that gives rise to such deduction. It is inappropriate to assign a tax deduction to a party who does not bear the burden of the underlying cost. Here, PSE's customers do not bear the burden of interest expense associated with CWIP because interest expense associated with CWIP is not being recovered elsewhere in the calculation of the revenue requirement on electric and gas operations.

Q. How does PSE account for interest expense associated with CWIP?

A. For purposes of this discussion, there are two types of construction costs that are recorded in CWIP: those that qualify for the allowance for funds used during construction ("AFUDC") and those that do not qualify.

For expenditures that qualify, PSE determines AFUDC and adds it to the balance of the project in CWIP. AFUDC has two components: debt and equity. The debt component is the relevant component for this discussion.

In addition, there are two AFUDC debt calculations: the AFUDC debt calculation of this Commission and the AFUDC debt calculation of the Federal Energy Regulatory Commission ("FERC"). These two AFUDC debt calculations combine to result in an AFUDC debt calculation that reflects PSE's actual interest rate for the period. In other words, for qualifying projects, the AFUDC debt calculation captures PSE interest expense that is equivalent to what the Commission has approved in the PSE's current rate of return and is associated with those projects. That amount is added (i.e. capitalized) to the CWIP balance of the project.

For expenditures that do not qualify, no amount of interest expense is added to the CWIP balance. An example of this type of project is one that has a short construction period before it is put into service. Thus, customers will never be subject to any burden, cost, or detriment associated with that interest expense.

Q. If AFUDC is capitalized to the CWIP balance, won't customers bear the full burden of that cost?

A. No. The customer is not funding the interest expense on Day 1. The customer bears no cost associated with that interest expense until the CWIP (including its AFUDC) is placed in service and moved in to the plant balances. At that point, the customer begins to bear the burden of the interest expense via the capitalized AFUDC. The customer will bear that burden over the life of the underlying plant in the form of book depreciation. So to the extent customers bear the cost of interest associated with CWIP, they will do so via depreciation and through the rate of return on the net plant balance. At this point in time, when CWIP is in-service and part of ratebase, the customer does receive the tax benefit of the interest deduction through the interest synchronization adjustment.

Q. What happens with respect to electric and gas expenditures that do not qualify for AFUDC?

A. For expenditures that do not qualify for AFUDC, no interest has been added to the CWIP balance. Thus, when the CWIP balance is placed in service and moved to plant, it carries no burden for the interest that was incurred while the assets were in CWIP. Book depreciation is completely free of any interest component for that particular in-service plant. In addition, PSE recovers none of that interest expense incurred during construction from customers in rates – either as a component of depreciation or as interest expense. As a result, customers should receive no benefit from the tax deductions for the interest expense associated with that CWIP balance.

Q. Would it be appropriate to include CWIP in the interest synchronization calculation if the Commission were to allow the inclusion of CWIP in rate base?

A. Yes. If the Commission were to allow the inclusion of CWIP in rate base, then it would be appropriate to include that CWIP in the interest synchronization calculation because customers would then bear the burden of interest expense associated with that CWIP. Symmetry, however, requires the removal of CWIP from the interest synchronization calculation if CWIP is not included in rates.

Q. What is the impact of excluding CWIP from rate base for purposes of calculating the tax benefit of pro forma interest on electric and gas operations?

A. The new method decreases operating income from electric operations by $1,728,152 when compared to the prior method. I have included the calculation of the tax benefit of pro forma interest using the methodology from the prior rate filing as a workpaper to Exhibit No. ___(JHS-4) at page 4.05.

The new method decreases operating income from gas operations by $670,939 when compared to the prior method. I have included the calculation of the tax benefit of pro forma interest using the methodology from the prior rate filing as a workpaper to Exhibit No. ___(MJS-4) at page 4.05.

IV. INTEREST PAID TO THE IRS

Q. Please describe the adjustment for net interest paid to the IRS.

A. On November 5, 2008, PSE filed an accounting petition with the Commission in Docket No. U-082012 that requested an order to defer and recover (i) interest due the IRS for tax years 2001 to 2006 and (ii) carrying costs incurred in connection with the interest due. The accounting petition has not come before the Commission as of the filing date for this general rate case proceeding.

Q. What adjustments gave rise to the interest that is payable the IRS for tax years 2001 to 2006?

A. On its 2001 tax return, PSE adopted the simplified service cost method of accounting for tax purposes under section 263A of the Internal Revenue Code. The simplified service cost method of accounting permits companies to deduct costs related to capitalized labor and overheads that otherwise they would have to capitalize.

The simplified service cost method resulted in tax deductions that ultimately totaled $204 million over tax years 2001 through 2003, for a tax benefit of $71.4 million (59.1% related to electric and 40.9% related to gas).

Q. How did PSE account for the tax benefits derived from the simplified service cost method?

A. PSE recorded deferred taxes on the tax benefits related to the simplified service cost method. In other words, PSE recorded a deferred tax liability for the full benefit of the simplified service cost method of tax accounting.

Q. How were deferred taxes on simplified service cost method treated in previous rate proceedings?

A. In previous rate proceedings, deferred taxes on simplified service cost method reduced PSE's rate base.

Q. Did the IRS audit PSE adoption and utilization of the simplified service cost method?

A. Yes. The IRS audited PSE's adoption and utilization of the simplified service cost method. The IRS audit team, with direction from the IRS national office, disallowed all of the tax deductions associated with PSE's adoption and utilization of the simplified service cost method.

Q. How did PSE respond to this IRS disallowance?

A. PSE evaluated the merits of the IRS position and concluded that the IRS position was inappropriate because the tax law permitted the tax deductions during the periods in which PSE claimed them. PSE subsequently filed a formal protest with the IRS appeals office.

Q. Did PSE prevail in its appeal of the disallowance of all of the tax deductions associated with PSE's adoption and utilization of the simplified service cost method?

A. No. However, PSE was successful in reaching a settlement with the IRS appeals office. In reaching a settlement, PSE succeeded in retaining approximately 85% of its original tax deductions. The settlement, however, required PSE to make an interest payment to the IRS.

Q. What was the outcome of the settlement?

A. For the tax year 2001, the settlement required PSE to make a tax payment, including the payment of interest on the back taxes. For tax years 2002–2006, however, PSE received tax refunds (including interest on the tax refunds) from the IRS. Unfortunately, the interest received on the refunds was not sufficient to offset the interest paid on the tax payment. Please see Exhibit No. ___(MRM-3) for a table that presents the comparison of original tax returns with the final IRS settlement.

The interest for the tax years 2001 through 2005 reflected in Exhibit No. ___(MRM-3) represent actual cash payments or receipts. The amount of interest shown for 2006 is an estimate and has not yet been received.

Q. How does PSE propose to recover the net interest paid to the IRS?

A. PSE proposes to amortize the net interest over a period of 24 months, which would decrease electric net operating income by $1,471,578 as set forth in Exhibit No. ___(JHS-4), at page 4.36 and decrease gas net operating income by $1,018,402 as set forth in Exhibit No. ___(MJS-4), at page 4.03.

Q. Is it appropriate for PSE to recover from customers the net interest paid to the IRS?

A. Yes. Although this is a unique adjustment, it is consistent with the Commission's treatment of PSE's adoption of the simplified service cost method. In determining the proper rate making treatment of the simplified service cost method, the Commission acknowledged PSE's concern that the IRS could possibility challenge its adoption. To that end, the Commission stated as follows:

> We cannot lawfully prejudge future rates. However, we do find it appropriate to recognize in principle that if the IRS successfully challenges in court the adjustment PSE and other utilities have taken, and requires future repayment of the current benefits taken, presumably with interest, PSE should file an accounting petition asking for appropriate treatment of any back taxes and interest assessed.[2]

PSE's proposed treatment of the net interest paid to the IRS is consistent with the Commission's past instructions.

V. AMERICAN RECOVERY AND REINVESTMENT ACT

Q. Please provide the Commission with an overview of the American Recovery and Reinvestment Act of 2009.

A. The American Recovery and Reinvestment Act of 2009 (the "Act") was enacted on February 17, 2009. The Act extends and expands a number of valuable tax incentives including, for the first time, the possibility of receiving cash grants for qualifying renewable projects.

Q. Please explain the main tax incentives included in the Act that are of potential interest to PSE.

A. The main tax incentives in the Act that are of potential interest to PSE include the following:

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[2] *Wash. Utils. & Transp. Comm'n v. Puget Sound Energy, Inc.*, Docket Nos. UG-040640, *et al.*, Order No. 06: Final Order Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing; Requiring Subsequent Filing, at ¶ 159 (Feb. 18, 2005).

(a) Extension of the PTCs – The Act extends the PTCs to include qualifying wind facilities that are placed in service on or before December 31, 2012. This represents a two year extension for qualifying wind projects.

(b) Election to Convert the PTC to an ITC – The Act allows taxpayers to make an irrevocable election to claim an investment tax credit ("ITC") on qualifying facilities instead of the PTC. By way of comparison, the PTC is determined based on the amount of energy the wind farm produces (i.e., a production-based credit). The ITC is a cost/investment-based credit. Taxpayers can claim the ITC on 30% of the cost of a qualifying facility. The election is available through 2012.

(c) Conversion of the ITC to a Cash Grant – Although ITCs have existed since the 1970s and PTCs have existed since the 1990s, the potential to convert an ITC to a cash grant from the U.S. Treasury is new for 2009 and 2010. Section 1603 of the Act allows taxpayers to forego ITC and to claim a cash grant from the U.S. Treasury in the amount that would have been claimed under the ITC. The cash grant is available for qualifying facilities that are (i) placed in service in 2009 or 2010 or (ii) placed in service after 2010, if construction commences in 2009 or 2010. The U.S. Treasury has not yet issued guidance on the cash grant. Some very important details remain unclear. Representatives from PSE will be meeting with the IRS and U.S. Treasury in early May to discuss some of the particulars. The goal of the meeting will be to support and encourage the U.S. Treasury in issuing guidance that is attentive to and sympathetic to the needs and unique perspective of PSE, as a regulated utility. As the U.S. Treasury issues guidance, the decisions that they make will have a significant effect on the value that PSE and its customers see from the cash grant program.

(d) Bonus Depreciation – The Act extended 50% bonus depreciation to qualifying property that is placed in service in 2009. There were no modifications to the bonus depreciation methodology, other than providing for a one-year extension. In general, qualifying property includes property that is depreciated under the modified accelerated cost recovery system (MACRS) and has a tax life of 20 years or less.

Q. How have these tax incentives been reflected in PSE's rate filing?

A. These tax incentives effect future plant additions. To the extent that future plant qualifies for one or more of the incentives mentioned, that benefit will be reflected in future rate proceedings.

VI. CONCLUSION

Q. Does this conclude your direct testimony?

A. Yes.