

Exhibit No. \_\_\_ CT (RCS-1CT)  
Dockets UE-111048/UG-111049  
Witness: Ralph C. Smith  
Redacted Version

**BEFORE THE  
WASHINGTON STATE UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION,**

**Complainant,**

**v.**

**PUGET SOUND ENERGY, INC.,**

**Respondent.**

**DOCKET UE-111048  
DOCKET UG-111049  
(Consolidated)**

**TESTIMONY OF**

**RALPH C. SMITH**

**ON BEHALF OF**

**WASHINGTON UTILITIES AND TRANSPORTATION  
COMMISSION STAFF**

**December 7, 2011**

**CONFIDENTIAL PER PROTECTIVE ORDER  
Redacted Version**

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## I. INTRODUCTION

**Q. Please state your name and business address.**

A. Ralph C. Smith, 15728 Farmington Road, Livonia, Michigan 48154.

**Q. What is your occupation?**

A. I am a certified public accountant and a senior regulatory utility consultant with the firm Larkin & Associates, PLLC, certified public accountants and regulatory consultants.

**Q. What is your educational background and professional experience?**

A. These are presented in Exhibit No. \_\_\_(RCS-2). This exhibit also summarizes some of my regulatory experience and qualifications.

**Q. On whose behalf are you appearing?**

A. I am appearing on behalf of the Commission Staff.

**Q. Please describe the tasks that you performed related to your testimony in this case.**

A. I reviewed the direct testimony, exhibits, and workpapers of Puget Sound Energy's ("PSE," "Puget" or "Company"), and I prepared data requests and analyzed Company responses to them. I reviewed and analyzed data: (1) to obtain an understanding of the Company's rate filing package as it relates to

1 selected federal income issues in the Company's proposed rate increase and (2) to  
2 formulate an opinion concerning the reasonableness of the Company's proposals  
3 on those selected issues.

4  
5 **Q. What issues will you be addressing in your testimony and what are you**  
6 **recommendations for those issues?**

7 A. My direct testimony discusses Puget's ratemaking proposals concerning the  
8 following areas involving federal income tax issues:

- 9 1) A significant change in tax accounting involving repairs deductions that PSE  
10 applied for and the Internal Revenue Service ("IRS") granted, which has  
11 significantly increased accumulated deferred income tax ("ADIT") and  
12 should therefore reduce rate base, as I recommend.
- 13 2) A related tax accounting method change that PSE made for retirements for  
14 which I recommend also be reflected in rate base as it is known and  
15 measurable and closely related to the repairs deductions tax accounting  
16 change noted above.
- 17 3) The Company's proposal to include a debit balance amount of  
18 approximately \$47.3 million in Account 236, Accrued Taxes Payable, as an  
19 addition to rate base as working capital, which I recommend should be  
20 excluded from the working capital calculation.
- 21 4) The treatment of bonus tax depreciation and tax net operating losses (NOL)  
22 for which I recommend that the rate base (ADIT) and income statement  
23 (Deferred Federal Income Tax Expense) treatment be coordinated, as the

1 same accounting entries typically affect both of these components. The  
2 Company is not incurring or paying current federal income tax expense, so I  
3 recommend that the current federal income tax expense be removed from the  
4 operating income statement and replaced with deferred federal income tax  
5 expense. The Company's proposed rate base treatment of the NOL appears  
6 to be reasonable so I am not recommending an adjustment for that at this  
7 time.

8 5) PSE's proposal to normalize the federal income tax treatment for the  
9 following items with which I agree and recommend be approved:

- 10 a) Capitalized property taxes,
- 11 b) Injuries and damages, and
- 12 c) Bad debts.

13 PSE's original filing contained a proposal for a Deferred Tax Receivable Tracker,  
14 but that proposal has since been withdrawn by the Company.

15  
16 **Q. What test year and rate year are being used in PSE's filing?**

17 A. Puget's request for a rate increase is based on a test year ending December 31,  
18 2010. Staff has used this test year and has assumed a rate year from May 1, 2012  
19 through April 30, 2013.

20  
21 **II. MAJOR TAX ACCOUNTING CHANGE FOR REPAIRS**  
22 **DEDUCTIONS**  
23

24  
25 **Q. What major tax accounting change has PSE applied for and implemented?**

1 A. On December 30, 2008 PSE requested permission from the IRS to change its tax  
2 accounting method for the treatment of repairs.

3  
4 **Q. Was the tax accounting change requested by PSE approved by the Internal  
5 Revenue Service?**

6 A. Yes. The IRS has consented to PSE making the accounting change, i.e., to PSE  
7 changing its income tax accounting for repairs.

8  
9 **Q. Has PSE provided a copy of its application for a change in tax accounting  
10 method?**

11 A. Yes. In response to FEA Data Request 2.03(c) in PSE's 2009 general rate case  
12 ("GRC"), PSE provided a copy of Form 3115, Application for Change in  
13 Accounting Method, and a copy of the executed Consent Agreement dated August  
14 20, 2009. PSE has provided similar information in its current rate case, in  
15 response to Staff Data Request 109.

16  
17 **Q. For what tax year did PSE's change in tax accounting for repairs become  
18 effective?**

19 A. It became effective for tax year 2008, as documented in Attachment A provided in  
20 PSE's response to Staff Data Request 109.

21  
22 **Q. What impact on PSE's Accumulated Deferred Income Tax balance has this  
23 tax accounting change had?**

1 A. In general terms, this change significantly increased ADIT and should therefore  
2 reduce PSE's rate base for the test year and rate year. PSE's response to Public  
3 Counsel Data Request 59 identifies the impact as \$41,414,322 for PSE's electric  
4 utility operations and \$24,564,298 for PSE's gas utility operations.<sup>1</sup> Those  
5 amounts, however, are net of the impact of a related change in tax accounting for  
6 retirements, which I address in a subsequent section of my testimony.

7 The impacts on ADIT from the change in tax accounting for only the  
8 repairs deductions, derived from PSE's filing, are \$41,842,225 for electric utility  
9 operations and \$24,996,849 for gas utility operations. These increases to ADIT  
10 should be reflected for ratemaking purposes in the current PSE general rate case  
11 and should decrease PSE's 2010 test year rate base.

12  
13 **Q. How has this major change in tax accounting method affected PSE?**

14 A. The Company's taxable income decreased as a result of the repairs and  
15 maintenance method change. The decrease in taxable income reduced the  
16 Company's current taxes payable. The Company records a deferred income tax  
17 expense for book/tax timing differences that are normalized. The accounting  
18 entries for the deferred income tax normalization accounting are to debit (charge)  
19 the deferred income tax expense and to credit (increase) the accumulated deferred

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<sup>1</sup> These amounts are the average of monthly averages ("AMA") of ADIT impacts related to the change in tax accounting method for repairs deductions, net of changes for a related tax accounting change implemented by PSE on its 2010 federal income tax return for retirements. I address PSE's changes in tax accounting methods for repairs and retirements in separate sections of this testimony.

1 federal income tax liability. The increase in the Company's accumulated deferred  
2 federal tax liability represents a decrease to rate base.

3  
4 **Q. Is it appropriate for ratemaking purposes that the tax savings resulting from**  
5 **the repairs and maintenance tax accounting method change should be**  
6 **normalized and reflected as a rate base deduction in the current PSE rate**  
7 **case?**

8 A. Yes. A large impact of the tax accounting method change reflects the application  
9 on the Company's 2008 tax return of the new tax accounting method for repairs as  
10 a cumulative adjustment retroactively calculated to include prior years. There is  
11 also a 2009 impact, and a 2010 test year impact. Under the new tax accounting  
12 method for repairs deductions, the repairs deductions will likely continue to  
13 exceed the book expense for repairs, so there should be continuing impacts  
14 through the rate effective period. The annual impact for rate base should be  
15 reflected in the current PSE general rate case at least through December 31, 2010,  
16 the end of the test year. In each year, 2008, 2009 and 2010, the deduction for  
17 repairs under the new tax accounting method was significantly larger than it  
18 would have been under the previous tax accounting method. In 2008, when PSE  
19 originally changed its tax accounting method for repairs, there was also a large  
20 cumulative effect<sup>2</sup> resulting from the change in tax accounting method. For  
21 2008, PSE shows total tax deductions for repairs under the new tax accounting

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<sup>2</sup> The cumulative effect of a change in tax accounting method is referred to by PSE as the §481(a) adjustment. See, e.g., PSE's Exhibit Nos. \_\_\_(MRM-4) and \_\_\_(MRM-5).



1 method of \$113,668,259 for electric utility operations and \$65,343,056 for gas  
2 utility operations, with a corresponding tax effect (impact on ADIT) of  
3 \$39,783,891 for electric utility operations and \$22,870,070 for gas utility  
4 operations.<sup>3</sup>

5 Additional repairs deductions in 2009 are shown by PSE to be \$5,434,815  
6 for electric utility operations and \$4,602,203 for gas utility operations.<sup>4</sup> At a 35  
7 percent federal income tax rate, the tax effects (ADIT impact) from these 2009  
8 repairs deductions are \$1.903 million for electric utility operations and \$1.611  
9 million for gas utility operations.

10 PSE's Exhibit Nos. \_\_\_(MRM-4) and \_\_\_(MRM-5) also show net repairs  
11 deductions for 2010 of only \$303,021 for electric utility operations and  
12 \$1,199,508 for gas utility operations.

13 By normalizing the tax savings, similar to what has traditionally been done  
14 for book-tax timing differences related to accelerated tax depreciation, ratepayers  
15 can benefit from the source of funds provided by such tax savings. The  
16 normalization treatment helps assure that all tax savings realized by the method  
17 change will benefit ratepayers by reducing rate base. However, there is no benefit  
18 in the current PSE general rate case under the Company's proposed treatment,  
19 which is to totally exclude all impacts from the repairs deduction on ADIT.  
20

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<sup>3</sup>See, e.g., PSE's Exhibit Nos. \_\_\_(MRM-4) and \_\_\_(MRM-5).

<sup>4</sup>Id.

1 **Q. What impact on rate base does this major tax accounting change have?**

2 A. In general terms, this change **significantly** increases ADIT and reduces the  
3 utility's rate base significantly for test year. As shown on Exhibit \_\_ (RCS-3), the  
4 total tax benefits of PSE's new repairs tax accounting method have amounted to  
5 approximately \$41.842 million for PSE's electric utility operations and \$24.997  
6 million for PSE's gas utility operations, through December 31, 2010, the end of  
7 the test year, but the Company has not reflected any rate base deduction for the  
8 impact of the repairs deductions on ADIT in the current rate case.

9  
10 **Q. Did the Company offset rate base by the full amount of the impact of the**  
11 **income tax savings claimed on its filed tax returns?**

12 A. No. As noted above, in the Company's filing, PSE removed the entire increase to  
13 the ADIT balance in account 282 related to the income tax savings resulting from  
14 the repairs deductions it claimed on its 2008 and 2009 federal income tax returns  
15 and the estimated amount it had identified at the time of its filing for repairs  
16 deductions to be claimed on its 2010 federal income tax returns. As a result of the  
17 Company's attempt to keep the cash flow benefit of all of the repairs deductions  
18 claimed on the Company's tax return for itself, rather than reflect the full amount  
19 of this major tax accounting change for the benefit of ratepayers, the rate base  
20 proposed by the Company is overstated by approximately \$41.842 million for  
21 PSE's electric utility operations and \$24.997 million for PSE's gas utility  
22 operations.

23

1 **Q. Why has PSE chosen not to reflect in this GRC any of the additional ADIT**  
2 **that resulted from the change in tax accounting method for repairs?**

3 A. The ADIT in account 282 related to repairs deductions would normally be  
4 reflected as a reduction to rate base. PSE proposes to not reflect any of the  
5 increase in ADIT on the basis that the IRS has not yet completed an audit of  
6 PSE's deductions for repairs under the new tax accounting method. Accordingly,  
7 PSE removed the tax impact of the repairs deductions from its filing. PSE has  
8 excluded from its proposed rate base the impact of the additional ADIT in account  
9 282 of approximately \$41.842 million for PSE's electric utility operations and  
10 \$24.997 million for PSE's gas utility operations in its determination of rate base.

11  
12 **Q. How did the Company arrive at its conclusion that its treatment of additional**  
13 **ADIT was justified by the absence of a complete IRS audit?**

14 A. The Company reached this conclusion based on its interpretation of the  
15 Commission's Order 11 in the Company's 2009 general rate case.<sup>5</sup>

16  
17 **Q. How was the ratemaking treatment of the change in tax accounting method**  
18 **for repairs deductions addressed in PSE's 2009 general rate case?**

19 A. The Commission's decision in PSE's 2009 general rate case, Dockets UE-090704  
20 and UG-090705, Order 11 at ¶¶ 192-197 (April 2, 2010), addressed the issue as  
21 follows:

---

<sup>5</sup> See, e.g., PSE witness Marcelia's Direct Testimony at pages 18-19.

1 The Federal Executive Agencies (FEA) argue that PSE's electric and  
2 natural gas rates should be adjusted to reflect the implementation of an  
3 IRS ruling allowing the Company to adjust its tax accounting method for  
4 the treatment of repairs. [footnote 6: One of FEA's arguments is that the  
5 IRS also granted Rocky Mountain Power the authorization for the  
6 accounting method at issue and that the Utah Public Service Commission  
7 approved a rate base reduction effective for a test-year ending June 30,  
8 2010. FEA Initial Brief at 8 (citing Exhibit MRM-14 at 4-5). However,  
9 the Utah Public Service Commission's treatment of Rocky Mountain  
10 Power is neither controlling in our jurisdiction nor on point, because that  
11 treatment apparently involves a future test-year that will not conclude until  
12 June of 2010.] FEA argues that the effect of the ruling is to allow the  
13 Company to defer significant additional income taxes that should be  
14 reflected by reducing both electric and natural gas rate base.

15 Mr. Smith testifies for FEA that PSE sought approval from the IRS to  
16 implement the accounting change at issue by letter dated December 30,  
17 2008. The Company does not dispute that it made this request and it  
18 confirms that the IRS granted permission for the accounting method in late  
19 2009. Apparently, the change is reflected in the Company's 2008 tax  
20 return. While the IRS has given its consent for the accounting change, it  
21 has not yet audited and accepted PSE's figures or methodology.  
22 Nonetheless, FEA argues that the increase in accumulated deferred income  
23 taxes (ADIT) is known and measurable and should be reflected as a rate  
24 base reduction in this case. FEA contends that the expenditures for repairs  
25 that are at issue took place during the test year.

26 The Company opposes FEA's proposed adjustment. According to PSE,  
27 the IRS only granted "limited approval for the Company to adopt the  
28 repairs methodology after the close of the test year." The Company points  
29 out that the IRS has not yet audited the Company's implementation of the  
30 methodology. It asserts that its experience with the IRS disallowance of  
31 the simplified service cost method (SSCM) shows why it would be  
32 inappropriate for the ADIT adjustment FEA advocates to be implemented  
33 in this case. In addition it argues that the adjustment would be one-sided  
34 because significant expenditures that occurred after the close of the test-  
35 year have not been included in this rate proceeding.

36 *Commission Determination:* The Company has apparently implemented  
37 the accounting change allowed by the IRS in its 2008 tax return or an  
38 amendment to that return. However, the Company is correct to point out  
39 that the lesson of the SSCM issue demonstrates the risks of recognizing  
40 IRS-allowed accounting changes before they are audited.

41 Additionally, there is the Company's argument that the permissive tax  
42 treatment was not granted until long after the end of the test period. While  
43 the Company has definitely sought to include some adjustments in its

1 favor that reflect events as long as 12 months after the close of the test-  
2 year, the Commission's principles governing pro forma adjustments, and  
3 its decisions in this case, are fashioned to allow such adjustments only in  
4 limited circumstances.

5 We accordingly reject FEA's adjustment in this case as an inappropriate  
6 pro forma adjustment. The final disposition with the IRS is not known  
7 and the tax impact is in any event subsequent to the test-year. Having  
8 made this determination for purposes of this proceeding, we note that the  
9 Company should implement an increase to ADIT in a future case if the  
10 IRS approves its methodology for treatment of repair costs following an  
11 audit.

12 (Footnotes other than footnote 6 have been omitted.)  
13

14 **Q. In the current PSE rate case, is the ADIT impact from the repairs deductions**  
15 **claimed by PSE on its 2008, 2009 and 2010 federal income tax returns an**  
16 **event subsequent to the test year?**

17 A. No. Clearly, the impacts are from repairs deductions claimed by PSE on its 2008,  
18 2009 and 2010 federal income tax returns affect the 2010 test year ADIT balance  
19 and thus fall within the 2010 test year being used in the current case. The tax  
20 accounting method change occurred initially with the filing of PSE's federal  
21 income tax return in 2009 for tax year 2008. In the context of the current PSE  
22 rate case, this is clearly not an event that occurred subsequent to the 2010 test  
23 year. In fact, the tax accounting method change occurred prior to the 2010 test  
24 year. Additionally, to assure that the repairs deduction impacts in the adjustment  
25 Staff is making are totally within the 2010 test year, the adjustment amount is  
26 based on the 2010 test year "average or monthly averages" amounts calculated by  
27 PSE itself.  
28

1 **Q. Please comment on the criteria suggested in Order 11 that the repairs**  
2 **deductions claimed by PSE must be audited by the IRS before being**  
3 **recognized for ratemaking purposes.**

4 A. Requiring a completed IRS audit before recognizing an income tax expense or the  
5 impact on ADIT from tax deductions claimed on tax returns is not a good criteria  
6 to apply for evaluating utility income tax issues for ratemaking purposes.  
7 Typically, a utility claims income tax expense based on a test year; however, it is  
8 extremely rare that the test year income taxes will have been audited by the IRS  
9 before a rate case is processed. If the requirement of a completed IRS audit were  
10 to be applied consistently, then none of the income tax expense for the test year  
11 would be allowable as an IRS audit is not yet completed. Requiring a completed  
12 IRS audit for income taxes if taken to that level of consistency would essentially  
13 result in no allowance for federal income tax expense in the typical utility rate  
14 case, since IRS audits of test year income taxes are typically not completed during  
15 the time frame in which rate cases are processed.

16 In summary, the suggestion that an IRS audit must be completed before  
17 the effects of claimed tax deductions can be reflected for ratemaking purposes is  
18 ill-advised and should definitely not govern the result for repairs deductions in the  
19 context of the current PSE rate case. As the evidence in the current PSE case  
20 shows, there is sufficient certainty of the deductions for repairs claimed by PSE<sup>6</sup>

---

<sup>6</sup> As will be explained herein, PSE is required under generally accepted financial accounting standards to identify and report any "uncertain" tax positions, yet, in conjunction with those accounting requirements, PSE has not identified any portion of its 2008, 2009 or 2010 repairs deductions as being sufficiently "uncertain" to require the identification and disclosure required by GAAP.

1 and there is a strong connection with the adjustment recommended by Staff to  
2 recognize those tax effects to the 2010 test year being used. Moreover, as I  
3 discuss below, in an order subsequent to Order 11 in the Company's 2009 GRC,  
4 the Commission appears to have rejected a ratemaking criteria that an IRS audit  
5 must be completed before the effects of claimed tax deductions can be reflected  
6 for ratemaking purposes..

7  
8 **Q. Has PSE identified any amounts of repairs deductions claimed on its tax**  
9 **returns for 2008, 2009 or 2010 that PSE expects are likely to be disallowed by**  
10 **the IRS?**

11 A. No. PSE's response to Staff Data Request 140(c) states that: "PSE believes that  
12 its repairs deduction complies with the tax laws and regulations that were  
13 applicable when the deductions were taken." Additionally, PSE has neither  
14 recorded on its books, nor identified any amounts for such repairs deductions that  
15 PSE believes are uncertain.

16  
17 **Q. How is PSE required under generally accepted accounting principles**  
18 **("GAAP") to identify and account for any portions of its repairs deductions**  
19 **(or other tax positions) that are deemed to be "uncertain"?**

20 A. Under Financial Accounting Standards Board ("FASB" Interpretation No. 48  
21 ("FIN 48"), now codified in Accounting Standards Codification ("ASC") 740,  
22 companies are required to evaluate their tax positions for uncertainty and to report  
23 the results of that analysis. FIN 48 requires companies to identify "uncertain" tax

1 positions for financial statement reporting. FIN 48 recognizes that differences in  
2 the interpretation of tax law (i.e. legislation and statutes, legislative intent,  
3 regulations, rulings and case law) exist, and seeks to eliminate any uncertain tax  
4 benefit from the financial statements until the uncertainty associated with the  
5 position has been removed. An uncertainty may be removed by either: (1)  
6 review of the technical merits of the position by the relevant taxing authority, (2)  
7 expiration of the statute of limitations, or (3) law change.

8  
9 **Q. Has PSE accounted for any portion of the repairs deductions it claimed on its**  
10 **federal income tax returns for 2008, 2009 or 2010 as being “uncertain”?**

11 A. No, it has not. PSE’s response to Staff Data Request 130 states specifically that:  
12 “PSE has no uncertain tax positions under FIN 48.”

13  
14 **Q. If none of the repairs deductions claimed on its 2008, 2009 or 2010 federal**  
15 **income tax returns are believed by the Company to be sufficiently**  
16 **“uncertain” to require identification and financial statement reporting, what**  
17 **is the basis for the Company’s removal of the ADIT resulting from the**  
18 **repairs deductions from its determination of rate base?**

19 A. PSE’s removal of the entire amount of ADIT resulting from the repairs deductions  
20 claimed on its 2008, 2009 and 2010 federal income tax returns appears to be  
21 entirely premised upon its interpretation of the Commission’s decision in its last  
22 general rate case, and specifically upon the reference to a completed IRS audit.  
23 PSE seems to be relying exclusively on the fact that an IRS audit has not yet been



1 completed as its only reason in the current case for not reflecting the known and  
2 measureable increase to ADIT and reduction to rate base that has clearly occurred  
3 within the 2010 test year relating to the repairs deduction method change  
4 originally implemented by PSE on its 2008 federal income tax return.  
5 Consequently, the Company's presentation of the rate base impact of this major  
6 tax accounting method change reduced the amount of rate base offset related to all  
7 of the actually filed tax return deductions for repairs, apparently because there is  
8 an uncertainty that has not yet been resolved by a completed IRS audit; however,  
9 as noted above, none of the repairs deductions claimed by PSE were considered  
10 by the Company to be sufficiently "uncertain" to require financial accounting  
11 statement disclosure, under FIN 48. Additionally, the requirement of having a  
12 completed IRS audit of a tax return prior to treating the tax effects of deductions  
13 claimed by a utility as ADIT that reduces utility rate base is not an appropriate  
14 ratemaking criteria and appears to have been specifically rejected by the  
15 Commission in a March 25, 2011 order in Docket UE-100749, a PacifiCorp rate  
16 case.

17  
18 **Q. How has the Commission addressed a similar issue in as rate case subsequent**  
19 **to its Order No. 11 in PSE's last general rate case?**

20 A. In Order 6, dated March 25, 2011 in Docket UE-100749, a PacifiCorp rate case,  
21 the Commission stated as follows at pages 87-89:<sup>7</sup>

---

<sup>7</sup> Footnotes are omitted from the quoted portions of Order 6.

1 *Positions of the Parties.* PacifiCorp proposes to normalize the cumulative  
2 effect of an Internal Revenue Service (IRS) approved change in its income  
3 tax accounting for certain capital assets. The change in tax accounting  
4 allows the Company to expense a cost for income tax purposes, instead of  
5 capitalizing and depreciating it for regulatory purposes.

6 The IRS allowed PacifiCorp to adopt the “repairs deduction” method of  
7 accounting starting January 1, 2008. However, it appears that the  
8 Company also recognized the “repairs deduction” retroactively for the  
9 years 1999 to 2007. With that in mind, the Company also proposes that its  
10 adjustment be considered “non-final” in nature and requests that the  
11 \$14,463,685 reduction to rate base be “adjusted if necessary after the  
12 Service [IRS] has completed its examination.

13 Recognizing the impact of the change in its income tax accounting on its  
14 regulatory books, the Company recognized a deferred tax to account for  
15 the related book-tax timing difference. The timing difference is caused by  
16 the rapid recovery afforded by the repairs deduction for tax purposes and  
17 the slower depreciation for regulatory purposes. The increase in  
18 accumulated deferred taxes using average of monthly averages reduces the  
19 Company’s revenue requirement by \$1.7 million.

20 Staff agrees with the adjustment, but asserts that the Company’s  
21 recognition of the rate base impact reflects only half of the impact to  
22 accumulated deferred income tax. Staff proposes a \$28,927,930 deferred  
23 tax deduction from rate base thereby decreasing the Company’s revenue  
24 requirement by \$3.5 million.

25 In rebuttal testimony, PacifiCorp argues that deferred taxes are a source of  
26 interest-free funds that can be used to support of rate base investment.  
27 However, it contends that a utility cannot use the funds until it realizes the  
28 benefit. In this case, the Company argues it did not realize the benefit of  
29 the repairs deduction until it filed its income tax return in September 2009.  
30 The Company argues that the deferred tax amount was properly recorded  
31 in 2009, but Staff improperly characterizes it as a prior year adjustment.

32 *Commission Decision.* The parties do not dispute that PacifiCorp is  
33 expensing certain repair costs that it previously capitalized for tax  
34 purposes. Because the Company creates a book-tax difference by  
35 continuing to capitalize these costs, the parties also agree that the amount  
36 should be normalized. **Therefore, the sole issue is the timing of**  
37 **recognition and magnitude of the impact on rate base.** The Company  
38 contends that it did not receive the benefit of the repairs deduction until it  
39 filed its federal income tax return in September 2009, so it reduces rate  
40 base by \$14,463,685. Staff, on the other hand, calculates the full impact  
41 of the tax accounting change during the entire test year and reduces rate  
42 base by \$28,927,370.

1           **PacifiCorp argues that the Commission denied an adjustment in the**  
2           **2009 Puget Sound Energy (PSE) rate case that is identical to the**  
3           **adjustment Staff proposed here. The Company’s reliance on that case**  
4           **is misplaced. In the PSE case, we rejected the argument that *no***  
5           **adjustment could be made to rate base until after an IRS audit**  
6           **because the amount was not known and measurable.** Here, according  
7           to the Company, the accumulated deferred income tax liability balance as  
8           of December 31, 2009, is \$28,927,370. Thus, the amount is both known  
9           and measurable. In addition, the IRS allowed the tax treatment in the PSE  
10          case long after the end of the test year. Here, in sharp contrast, the IRS  
11          allowed the tax treatment *during* the test year.

12          We conclude that Staff is correct and we should accept its adjustment to  
13          reduce rate base by \$28,927,370, which reflects the impact of the full year  
14          of the change. The repairs deduction is an ongoing difference in  
15          accounting that will be in effect for the same period as the rates set in this  
16          proceeding. The change is known and measurable. Accordingly, it is  
17          reasonable to normalize and reflect the impact as if it were in effect for the  
18          entire period. The impact of this adjustment reduces the revenue  
19          requirement by \$1,822,309 in addition to the \$1.7 million the Company  
20          has already recognized. (Emphasis added.)

21  
22                 As noted in the Commission’s PacifiCorp order, “the sole issue is the  
23          timing of recognition and magnitude of the impact on rate base.” Moreover, the  
24          focus is on whether an adjustment is “known and measurable”, not the timing of  
25          an IRS audit.

26                 As in that PacifiCorp rate case, and in the current PSE rate case, the ADIT  
27          impact from the new tax accounting method for repairs is both known and  
28          measurable in the test year. Indeed, PSE had to specifically *remove* those  
29          amounts in its filing in its attempt to *not* reflect the related ADIT balances.  
30          Thus, there is no valid reason remaining to *not* reflect the known and measurable  
31          impact of the repairs deductions taken by PSE as a reduction to rate base in the  
32          current PSE rate case and the 2010 test year being used to determine PSE’s  
33          revenue requirement.

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**Q. Has the Company benefitted from the repairs deductions it took on the filed tax returns?**

A. Yes. The Company has claimed the deductions for repairs under the changed tax accounting method on the consolidated tax returns that are filed by its parent company. The repairs deductions also appear on the “separate return” calculations that are made for PSE.

**Q. Should the Company be allowed to earn a full rate base return, grossed up for income taxes, on the rate base that has effectively been funded by the tax savings related to the repairs deductions?**

A. No. The tax savings realized by deducting repairs under the new tax accounting method for repairs on the Company’s (and its parent company’s) tax returns commenced with the 2008 federal income tax return and represent a source of funds to the Company, similar to a grant (or an interest bearing loan) from the federal and state government. Additionally, the build-up of ADIT balances is funded by ratepayer payments to the utility in rates based on a revenue requirement that has included deferred income tax expense.

**Q. What do you recommend in the current PSE rate case?**

A. PSE’s ADIT balance should be increased to reflect the full impact of the change in tax accounting method for repairs, and rate base should be reduced accordingly. As shown on Exhibit No. \_\_\_(RCS-3), an adjustment should be made to reduce

1 PSE's proposed rate base by *at least* \$41.842 million for PSE's electric utility  
2 operations and \$24.997 million for PSE's gas utility operations to reflect the  
3 impact of repairs deductions for 2008, 2009 and 2010 under the new tax  
4 accounting method.

5  
6 **Q. Why do you recommend that PSE's rate base should be reduced by "at least"**  
7 **those amounts?**

8 A. I recommend that PSE's rate base should be reduced by "at least" those amounts  
9 because PSE's filing appears to have understated the tax effect of the repairs  
10 deductions claimed on the 2010 federal income tax return. PSE's general rate  
11 case filing was based on estimated amounts of repairs deductions for 2010. The  
12 federal income tax return for 2010 has now been filed,<sup>8</sup> and the actual repairs  
13 deductions claimed on that 2010 tax return should now be known. If the 2010  
14 repairs deduction amounts and their relationship to PSE's electric and gas utility  
15 test year ADIT balances can be adequately identified, this adjustment should be  
16 updated in order to fully reflect the impact on the test year of the repairs  
17 deductions through the end of the test year.

18  
19 **III. TAX ACCOUNTING METHOD CHANGE FOR**  
20 **RETIREMENTS**

21  
22  
23 **Q. Please discuss PSE's tax accounting method change for retirements.**

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<sup>8</sup> Selected pages from the 2010 consolidated federal income tax return in which PSE participates were provided as CONFIDENTIAL Attachment A to PSE's response to ICNU Data Request 3.01.

1 A. As described in PSE witness Marcelia's Direct Testimony at pages 19-20, PSE  
2 has changed its tax accounting method for retirements. PSE filed the method  
3 change in March 2010 to be included in PSE's 2010 federal income tax return.  
4 This method change is a companion to the tax accounting method change for  
5 repairs deductions. PSE provided its Form 3115 for the tax accounting method  
6 for retirements as Attachment B to PSE's response to Staff Data Request 109.  
7 The change in tax accounting method for repairs that PSE applied for and used on  
8 its 2008 and subsequent federal income tax returns was based on the creation of  
9 different units of property ("UOP") for income tax purposes. Prior to that tax  
10 accounting method change, the UOP were similar or identical for book and tax  
11 purposes. With the tax accounting method change, generally the tax UOP are  
12 now larger than the book UOP. The UOP affects how PSE records retirements  
13 for book and tax purposes. If a UOP is replaced, that is treated as a retirement,  
14 and affects the amount of plant investment and accumulated depreciation. If  
15 something less than a UOP is repaired or replaced, that cost is treated as a repairs  
16 deduction for income tax purposes, and as a maintenance expense for book  
17 purposes. The use of larger UOP for income tax purposes has the result of  
18 decreasing the retirements for tax purposes. The change in tax accounting for  
19 retirements that PSE filed in March 2010 and reflected on its 2010 federal income  
20 tax return brings the tax UOP for retirements into alignment with the tax UOP for  
21 repairs.  
22

1 **Q. How did PSE treat the tax accounting change for retirements in its general**  
2 **rate case filing?**

3 A. PSE's response to Staff Data Request 109 states that: "... pursuant to paragraph  
4 197 of the [Order 11] in Docket Nos. UE-090704 and UG-090705, PSE did not  
5 include the tax method change in this proceeding." PSE witness Marcelia's direct  
6 testimony, at page 20, indicates that PSE has removed all impacts from that tax  
7 accounting method change from its general rate case filing in their entirety. He  
8 claims that is consistent with the 2009 general rate case Order 11 and the  
9 treatment of the repairs method change.

10  
11 **Q. Is PSE's reliance upon Order 11 from the 2009 general rate case misplaced?**

12 A. Yes. As noted above, the Commission's subsequent Order 6 in PacifiCorp's  
13 general rate case clarified the PSE 2009 Order and stated as follows:

14 PacifiCorp argues that the Commission denied an adjustment in the 2009  
15 Puget Sound Energy (PSE) rate case that is identical to the adjustment  
16 Staff proposed here. The Company's reliance on that case is misplaced.  
17 **In the PSE case, we rejected the argument that no adjustment could**  
18 **be made to rate base until after an IRS audit because the amount was**  
19 **not known and measurable.<sup>9</sup>**

20 (Emphasis supplied.)

21 Here, the amount of ADIT resulting from the tax accounting method change for  
22 retirements is known and measureable, and should therefore be reflected for  
23 ratemaking purposes, just as the impact of the tax accounting method change for  
24 repairs should be.

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<sup>9</sup> Docket UE-100749, Order 6, at page 89.

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**Q. What impact does reflecting the tax accounting method change for retirements have on PSE's rate base?**

A. As shown on Exhibit \_\_\_(RCS-3), using information derived from PSE Exhibit No. \_\_ (MRM-7), the impact on ADIT for the 2010 test year for the tax accounting change for retirements is to reduce the impact on ADIT resulting from the repairs tax accounting change. The tax accounting method change for retirements reduces PSE's ADIT by approximately \$428,000 for electric utility operations and by \$433,000 for gas utility operations. In other words, while the repairs tax accounting method change substantially increased PSE's ADIT, the retirements tax accounting method change moderately reduces PSE's ADIT.

**Q. What is the net impact on PSE's ADIT for electric and gas utility operations from the combined impacts of the tax accounting method changes for repairs and retirements?**

A. The net impact on PSE's ADIT for electric and gas utility operations from the combined impacts of the tax accounting method changes for repairs and retirements is to increase ADIT and reduce PSE's electric utility rate base by \$41.414 million and gas utility rate base by \$24.564 million, as shown on Exhibit No. \_\_\_(RCS-3) and summarized below:



Increase (Reduction) to ADIT/Reduction (Increase) to Rate Base  
From Tax Accounting Method Changes for Repairs and Retirements

	Electric	Gas	Total
Account 282 Repairs	\$ 41,842,225	\$ 24,996,849	\$ 66,839,074
Account 282 Retirements	\$ (427,903)	\$ (432,551)	\$ (860,454)
Total Repairs/Retirements	\$ 41,414,322	\$ 24,564,298	\$ 65,978,620

**IV. BONUS TAX DEPRECIATION AND NET OPERATING  
LOSS CARRYFORWARDS**

**Q. Please discuss the bonus tax depreciation deductions that are available to PSE.**

**A.** On December 17, 2010, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. That Act provides for 100 percent depreciation bonus for qualifying capital investments placed in service after September 8, 2010 through December 31, 2011. For equipment placed in service after December 31, 2011 and through December 31, 2012, the bill provides for 50 percent bonus tax depreciation. The Small Business Jobs Act of 2010, which contained a 50 percent depreciation bonus, still applies to purchases made between January 1, 2010 and September 7, 2010.

In summary:

- Bonus tax depreciation helps businesses that buy new equipment cut their tax bill.
- The bonus tax depreciation applies, among other things, to purchases of tangible personal property (including construction, mining, forestry, and agricultural equipment) with a MACRS recovery period of 20 years or less.
- To qualify, the equipment must have been purchased and placed in service.
- The bonus tax depreciation applies to new equipment only.

- 1 • This bonus tax depreciation is allowed for both regular and alternative
- 2 minimum tax purposes.
- 3 • The bonus tax depreciation is discretionary; the taxpayer need not claim the
- 4 depreciation bonus.
- 5 • The tax depreciation bonus will expire at the end of 2012.
- 6 • For 2011, the tax depreciation bonus is 100 percent for qualifying property.
- 7

8 **Q. What are the implications of bonus tax depreciation for a regulated utility,**  
9 **such as PSE?**

10 A. For a regulated utility, such as PSE, that normalizes its federal income tax  
11 expense related to tax depreciation, the bonus federal income tax depreciation  
12 should reduce current federal income tax expense. There are also related impacts  
13 on deferred income tax expense and ADIT. Deferred federal income tax expense  
14 and ADIT, which is a rate base offset, are each increased by similar amounts. In  
15 general, the increase to deferred federal income tax expense and the increase to  
16 ADIT are the result of the same journal entries. In situations where the utility has  
17 adequate positive taxable income to fully utilize the deductions, for income  
18 statement purposes, the impacts on current and deferred income tax expense will  
19 generally offset each other, and there should be no net effect. For rate base,  
20 however, the substantially increased ADIT, which is non-investor supplied cost-  
21 free capital, provides a significant reduction.

22  
23 **Q. How does a federal income tax net operating loss (“NOL”) occur?**

1 A. A NOL is created in any year in which the aggregate income reported on a  
2 taxpayer's tax return is exceeded by the aggregate deductions claimed on that  
3 return.

4  
5 **Q. In general, is it possible to relate specific deductions to the Company's**  
6 **NOLs?**

7 A. In the context of the current rate case, PSE has made a reasonable presentation  
8 that its NOLs relate to the Company's claiming bonus tax depreciation in 2009  
9 and 2010. In order to relate specific deductions to the Company's NOLs, there  
10 would have to be deduction ordering rules. As a general matter, the tax law  
11 contains no ordering rules for deductions. Thus, for most purposes, it does not  
12 relate an NOL to any specific deductions. Consequently, as a general matter, it is  
13 typically impossible to relate any specific deductions to the Company's NOLs for  
14 2009 and 2010.

15 However, Treasury Regulation §1.167(l)-1(h)(1)(iii), which contains rules  
16 pertaining to normalization that govern the amount of deferred taxes that can be  
17 used to determine rate base, describes a "with and without" accelerated  
18 depreciation calculation that is similar to the calculation "with and without" bonus  
19 tax depreciation presented by PSE witness Marcellia. Using that type of "with and  
20 without" calculation, PSE has reasonably demonstrated that its NOLs can be  
21 attributed to bonus depreciation in 2009 and 2010. Put another way, without

1 bonus depreciation in 2009 and 2010, PSE would not have reported tax losses in  
2 either year.<sup>10</sup>

3  
4 **Q. What federal income tax NOLs has PSE recently experienced?**

5 A. PSE witness Marcelia's direct testimony at page 30 indicates that the Company  
6 had an NOL of \$92.4 million on its 2009 federal income tax return and expects an  
7 NOL of \$190.0 million on its 2010 federal income tax return.

8  
9 **Q. How have the NOLs impacted PSE's ability to obtain tax savings benefits**  
10 **from the bonus tax depreciation?**

11 A. PSE witness Marcelia's direct testimony at page 30 claims that the entire NOL in  
12 each year, 2009 and 2010, is attributable to bonus tax depreciation. He reaches  
13 this conclusion by simply comparing the amount of bonus depreciation claimed  
14 for each year with the NOL. Because the bonus depreciation exceeded the total  
15 NOL for each year, 2009 and 2010, PSE takes the position that the NOL is thus  
16 solely attributable to bonus tax depreciation.

17  
18 **Q. How have the NOLs impacted PSE's calculation of income tax expense for**  
19 **purposes of the current GRC?**

20 A. Because of the NOLs, PSE is not claiming any current federal income tax  
21 expense. PSE is claiming the full amount of deferred federal income tax expense

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<sup>10</sup>See also PSE's response to Staff Data Request 179.

1 related to the book/tax timing differences that are normalized. Thus, PSE is  
2 claiming amounts for deferred federal income tax expense for which it has not yet  
3 obtained any tax reduction benefit, i.e., it is claiming deferred income tax expense  
4 related to the NOL.

5  
6 **Q. How have the NOLs impacted PSE's calculation of the ADIT balances that**  
7 **are deducted from rate base in the current GRC?**

8 A. PSE has identified an NOL for utility operations from its 2009 tax return of \$92.4  
9 million and an estimated NOL for 2010 of \$190.9 million, for a total NOL carry  
10 forward of \$283.3 million (\$99.2 million tax effected).<sup>11</sup> PSE allocated \$157.7  
11 million of the NOL to electric utility operations and \$125.6 million to gas utility  
12 operations.<sup>12</sup> PSE removed the effect of the repairs and retirements method  
13 changes discussed above from these NOL balances.<sup>13</sup> The NOL carry forward  
14 shown in account 19000433 on PSE's Exhibit No. \_\_\_(MRM-7), line 55,<sup>14</sup> is the  
15 NOL deferred tax asset without any impacts from the repairs and retirements tax  
16 accounting method changes.<sup>15</sup> PSE has thus increased rate base for electric and  
17 gas utility operations by a combined amount of \$41.742 million.

18  

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<sup>11</sup> See, e.g., PSE Exhibit No. \_\_\_(MRM-1T)at pages 27 and 30, and Exhibit Nos. \_\_\_(MRM-7) and \_\_\_(MRM-8).

<sup>12</sup> Id.

<sup>13</sup> Id at page 27.

<sup>14</sup> The \$41.742 million amount is from account 19000433 on PSE's Exhibit No. \_\_\_(MRM-7), page 2, line 55, column P.

<sup>15</sup>Exhibit No. \_\_\_(MRM-1T) at page 27.

1 **Q. How has PSE addressed for ratemaking purposes bonus depreciation on**  
2 **major new additions, such as the Lower Snake River wind project, for which**  
3 **PSE has requested pro forma rate base treatment?**

4 A. PSE has reflected in its pro forma rate base adjustment for the Lower Snake River  
5 wind project, the full impact of bonus tax depreciation.<sup>16</sup>  
6

7 **Q. How does the issue of the impact of repairs deductions interact with the**  
8 **amount of ADIT that PSE has identified as resulting from the portions of**  
9 **2009 and 2010 bonus tax depreciation that resulted in the NOLs?**

10 A. Normally, there would be a close interrelationship between the repairs deductions  
11 and bonus tax depreciation because both affect the tax basis of the asset. Repairs  
12 that are deducted do not become part of the tax basis of the asset. Bonus  
13 depreciation is typically computed on the tax basis of the asset. Thus, repairs that  
14 are not deducted would typically become part of the tax basis of the asset and, if  
15 related to qualifying property, would generate bonus tax depreciation. However,  
16 PSE's rate case presentation appears to have effectively isolated the impact of its  
17 2008, 2009 and 2010 repairs deductions and PSE proposes to remove those  
18 known and measurable impacts from its 2010 test year AMA rate base balances  
19 for ADIT on the basis that an IRS audit of those tax years has not yet been  
20 completed. As explained above, Staff recommends that these known and  
21 measurable impacts on ADIT resulting from PSE's repairs deductions be reflected

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<sup>16</sup> See, e.g., PSE's workpaper details for PSE adjustment 13.02, Lower Snake River, which includes a pro forma rate base deduction of approximately \$67.874 million.

1 as rate base deductions in the current PSE rate case using the 2010 AMA amounts  
2 identified by PSE.

3  
4 **Q. Did PSE accurately estimate the amount of its 2010 federal income tax net**  
5 **operating loss?**

6 A. No. Exhibit No. \_\_ (MRM-1T), at pages 27 and 30, and Exhibit No. \_\_ (MRM-8)  
7 estimated the 2010 net operating loss to be \$190.945 million. Confidential  
8 information provided in PSE's response to ICNU Data Request 3.01, which  
9 contains selected pages from the 2010 consolidated federal income tax return filed  
10 on September 15, 2011 in which PSE participates, shows that for 2010 PSE had  
11 taxable income of [REDACTED], i.e., a net operating loss of that  
12 amount. Staff has asked PSE in discovery to provide updated information  
13 consistent with the actual 2010 NOL. It may be appropriate to update the rate  
14 base impact of the 2010 NOL to reflect PSE's actual 2010 NOL in lieu of the  
15 estimated 2010 NOL amount used by PSE. An adjustment to reflect this has not  
16 been made at this time, but could be addressed, if necessary, at a later stage of this  
17 proceeding.

18  
19 **Q. Has guidance on the ratemaking treatment for NOLs attributable to bonus**  
20 **tax depreciation been provided at a NARUC accounting committee meeting?**

21 A. Yes. A presentation at an October 2011 NARUC accounting committee meeting  
22 by a representative from KPMG provided an illustration of a utility with an NOL

1 and the related accounting and ratemaking implications. I have attached that  
2 illustrative example as Exhibit \_\_\_(RCS-4).

3  
4 **Q. Please explain that illustrative example.**

5 A. A presentation made by a representative of KPMG and the discussion that  
6 followed resulted in a proposed treatment of the deferred taxes related to the  
7 difference between book and tax depreciation (bonus plus other accelerated tax  
8 depreciation.) The general consensus was, to the extent that net operating losses  
9 prevented a utility from fully using the benefit of the bonus/accelerated  
10 depreciation deductions during a rate effective period, ratepayers should not have  
11 to pay the full deferred tax expense. The treatment proposed is to “reverse” the  
12 portion of the deferred tax expense related to the net operating loss carry-forward  
13 and place it into a “deferred tax asset.” In accounting terms, this would entail an  
14 entry to debit ADIT in account 190 and to credit deferred federal income tax  
15 expense in the accounting period for the impact of the NOL that is expected to be  
16 usable to reduce future income tax expense. The deferred tax asset is, then, to be  
17 used (i.e., amortized to expense) as the utility is able to use the NOLs to offset  
18 future income tax expense. The basic principle is that ratepayers should pay  
19 deferred income taxes only to the extent that the utility is receiving the benefit of  
20 the tax depreciation deduction. This deferred tax asset would be created to the  
21 extent that the utility is reasonably assured of using the NOL. It should be noted  
22 that this illustrative example is very simplistic and reflects the use of a year-end  
23 rate base, not the test year average used by PSE. Additionally, the example does



1 not consider post-test year adjustments that impact ADIT, such as PSE's proposed  
2 adjustment for the Lower Snake River wind project.

3  
4 **Q. What are the ratemaking implications of the NOL carry forward situation?**

5 A. The ratemaking implications are that the "deferred tax asset" must be coordinated  
6 with the utility's claim for deferred income tax expense.

7  
8 **Q. Please summarize your recommendations concerning the ratemaking**  
9 **treatment of the impacts on income tax expense and ADIT related to bonus**  
10 **tax depreciation.**

11 A. PSE's filing for the 2010 test year appears to appropriately reflect the AMA for  
12 the impact of all of the bonus tax depreciation that PSE was able to use on its  
13 2009 tax return and the estimated amount for the 2010 tax return that PSE  
14 recorded during the 2010 test year.<sup>17</sup> Additionally, PSE has reflected the full  
15 impacts of bonus tax depreciation for pro forma additions to rate base, such as the  
16 Lower Snake River project.<sup>18</sup> In the context of the current PSE rate case, the  
17 Company's treatment of bonus tax depreciation impacts on ADIT appear to be  
18 reasonable. Consequently, I am not proposing an adjustment for the ADIT rate  
19 base balances relating to bonus tax depreciation or the NOL impact on ADIT.

---

<sup>17</sup> PSE's response to Staff Data Request 187 provides a "roll forward" of the Company's December 2010 balances to agree with the 2010 NOL shown on PSE's federal income tax return for 2010.

<sup>18</sup> See, e.g., PSE adjustment 13.02, which includes a rate base deduction for Deferred Taxes of \$67.874 million.

1 In terms of its presentation of federal income tax expense, given the NOL  
2 situation,<sup>19</sup> PSE's claim for current federal income taxes should be zeroed out and  
3 all federal income tax expense should be treated as deferred income tax expense.  
4 This should not cause a change in total income tax expense, and would entail a  
5 shifting from current to deferred income tax expense for presentation purposes.  
6  
7

8 **V. DEBIT BALANCE IN ACCOUNT 236, ACCRUED**  
9 **FEDERAL INCOME TAXES PAYABLE**  
10

11 **Q. As a result of your investigation into PSE's proposed ratemaking treatment**  
12 **of the tax impact of repairs deductions and Staff's investigation into PSE's**  
13 **proposed working capital allowance calculation, what issue has arisen with**  
14 **respect to Account 236, Accrued Federal Income Taxes Payable?**

15 A. As a result of those investigations, it was determined that, after its repairs  
16 adjustment to ADIT, PSE had a debit balance in account 23600033, Accrued  
17 Federal Income Taxes Payable, of \$47,312,650, on a 2010 AMA basis.<sup>20</sup>  
18 Furthermore, Staff determined that PSE had effectively included that account 236  
19 debit balance item in rate base as part of PSE's claim for working capital.  
20

21 **Q. How should account 236 be treated for ratemaking purposes?**

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<sup>19</sup> An NOL situation generally means that the company has no current income tax liability and is not currently paying federal income taxes.

<sup>20</sup> The \$47.3 million amount is for PSE's electric and gas utility operations combined.

1 A. The \$47.3 million debit balance that PSE had in account 236 on average during  
2 the 2010 test year should be removed from rate base for the following reasons:  
3 (1) it is unusual to have a large debit balance in this account; typically, account  
4 236, which is a current liability account, will have a credit balance, reflecting that  
5 there is a liability to make a payment for current income taxes; and (2) the large  
6 debit balance in account 236 no longer exists on a going-forward basis; most if  
7 not all of the large debit balance in this account was reversed by PSE in January  
8 or February 2011, shortly after the end of the test year. Consequently, the large  
9 debit balance in account 236 is not only abnormal for that account, but was also a  
10 temporary situation that occurred in the 2010 test year. PSE does not have a large  
11 debit balance in that liability account on a going forward basis. On a going  
12 forward basis, the balance in account 236 would normally be a credit showing  
13 taxes payable, but PSE is in a NOL carry-forward situation, and is not paying  
14 federal income taxes, so a representative going forward balance for account 236  
15 for ratemaking purposes should be zero. Therefore, I recommend that the \$47.3  
16 million account 236 debit balance item be removed from PSE's rate base.  
17 Accordingly, Staff is removing the \$47.3 million from PSE's claim for working  
18 capital.

19 **VI. PSE'S PROPOSAL TO NORMALIZE THE FEDERAL**  
20 **INCOME TAX TREATMENT FOR THREE BOOK-TAX**  
21 **TIMING DIFFERENCES THAT HAVE TRADITIONALLY**  
22 **BEEN TREATED AS FLOW THROUGH ITEMS FOR PSE'S**  
23 **ELECTRIC UTILITY OPERATIONS**

24

1 **Q. To what three book-tax timing differences has PSE proposed to apply tax**  
2 **normalization treatment for its electric operations in the current general rate**  
3 **case?**

4 A. PSE proposes to apply tax normalization treatment to the following three items:

- 5 1) Capitalized property taxes,  
6 2) Injuries and damages, and  
7 3) Bad debts.

8  
9 **Q. How have the book-tax timing differences for these three items been treated**  
10 **in prior PSE general rate cases?**

11 A. The book-tax timing differences for these three items been treated as flow-  
12 through items in prior general rate cases for PSE's electric utility operations.

13  
14 **Q. What is PSE's stated reason for proposing to change the ratemaking**  
15 **treatment for these three book-tax timing differences in the current general**  
16 **rate case?**

17 A. PSE witness Marcellia's Direct Testimony at page 6 states that:

18 PSE is making this change because there is presently a discrepancy  
19 between electric operations and gas operations as to how PSE handles  
20 these book/tax differences for ratemaking purposes.

21  
22 **Q. Will you be addressing each of the three book/tax timing differences**  
23 **individually?**

1 A. Yes. In the following sub-sections of my testimony, I address each of the three  
2 book/tax timing differences individually.

3

4 **A. Capitalized property taxes**

5

6 **Q. Please discuss PSE's proposal to change from flow-through to normalization**  
7 **for book/tax timing differences related to capitalized property taxes.**

8 A. PSE witness Marcelia discusses this Company proposal at pages 11-13 of his  
9 Direct Testimony. Basically, PSE is required to capitalize a portion of its overall  
10 property tax expenditure for income tax purposes. Once capitalized, those  
11 property taxes become part of PSE's tax basis in the asset, which is depreciated  
12 over the tax life of the asset. PSE proposes to normalize the book/tax timing  
13 difference related to property taxes. By normalizing the capitalized property  
14 taxes, PSE will provide deferred taxes associated with the book/tax difference. In  
15 the current PSE case and generally this will have the effect of increasing net  
16 operating income by reducing the amount of income tax expense in the cost of  
17 service.

18

19 **Q. What impact on electric operations does the Company show that its proposed**  
20 **change to apply a normalization treatment will have on PSE's claim for**  
21 **federal income tax expense in the current PSE general rate case?**

1 A. According to PSE's calculations, normalizing capitalized property taxes would  
2 decreases federal income tax expense for PSE's electric operations by \$851,587,  
3 as shown on PSE witness Marcelia's Exhibit No. \_\_ (MRM-3).

4  
5 **Q. What impact does the Company's proposed change to apply a normalization**  
6 **treatment have on PSE's claim for federal income tax expense in periods**  
7 **beyond the current general rate case?**

8 A. That is not known at this point. However, normalizing a book/tax timing  
9 difference where the book deduction would typically occur before the tax  
10 deduction, in general, should result in lower federal income tax for ratemaking  
11 purposes in years when the book expense amount exceeds the tax deduction  
12 amount. Over a sufficiently long period of time, the book and tax deduction  
13 amounts should be approximately equal.

14  
15 **Q. What impact would changing the ratemaking treatment of flowing through**  
16 **the impact of book/tax timing differences related to capitalized property**  
17 **taxes be for PSE's gas distribution utility operations in the current general**  
18 **rate case?**

19 A. It would increase the gas utility income tax expense by \$102,673, as stated in  
20 response to Staff Data Request 112.

21  
22 **Q. What is your recommendation regarding the ratemaking treatment for**  
23 **federal income taxes relating to capitalized property taxes?**

1 A. PSE's proposal to normalize federal income taxes relating to capitalized property  
2 taxes is reasonable and should be adopted.

3  
4 **B. Injuries and Damages**

5  
6 **Q. Please discuss PSE's proposal to change from flow-through to normalization  
7 for book/tax timing differences related to injuries and damages.**

8 A. PSE witness Marcellia discusses this Company proposal at pages 15-17 of his  
9 Direct Testimony. The reserve for injuries and damages cannot be deducted for  
10 income tax purposes until the claims are paid. PSE proposes to normalize the  
11 book/tax timing difference related to injuries and damages. By normalizing this,  
12 PSE will provide deferred taxes associated with the book/tax difference. In the  
13 current PSE case and generally this will have the effect of increasing net  
14 operating income by reducing the amount of income tax expense in the cost of  
15 service.

16  
17 **Q. What impact on PSE's electric operations does the Company's proposed  
18 change to apply a normalization treatment have on PSE's claim for federal  
19 income tax expense in the current PSE general rate case?**

20 A. According to PSE's calculations, normalizing the reserve for injuries and  
21 damages would decrease federal income tax expense for PSE's electric operations  
22 by \$52,500, as shown on PSE witness Marcellia's Exhibit No. \_\_ (MRM-3).  
23 Normalizing the timing book/tax timing difference will generally reduce the

1 amount of tax expense in the cost of service, and in effect, increase electric  
2 operating income. The book deduction precedes the tax deduction. Recording the  
3 deferred tax will match the tax benefit of the future tax deduction to the timing of  
4 the expense for accounting and ratemaking purposes. Even though the actual tax  
5 deduction cannot be taken on the tax return until the claim is paid, the tax benefit  
6 will be in the period in which the injuries and damages expense is recorded.  
7

8 **Q. What impact does the Company's proposed change to apply a normalization**  
9 **treatment have on PSE's claim for federal income tax expense in periods**  
10 **beyond the current general rate cases?**

11 A. As with capitalized property taxes, that is not known at this point. However,  
12 normalizing a book/tax timing difference where the book deduction would  
13 typically occur before the tax deduction, in general, should result in lower federal  
14 income tax for ratemaking purposes in years when the book expense amount  
15 exceeds the tax deduction amount. Over a sufficiently long period of time, the  
16 book and tax deduction amounts should be approximately equal.  
17

18 **Q. What impact would changing the ratemaking treatment of flowing through**  
19 **the impact of book/tax timing differences related to injuries and damages be**  
20 **for PSE's gas distribution utility operations in the current general rate case?**

21 A. The response to Staff Data Request 112 reflected no impact to the ratemaking  
22 treatment of injuries and damages for PSE's gas distribution utility operations.  
23



1 **Q. What is your recommendation regarding the ratemaking treatment for**  
2 **federal income taxes relating to injuries and damages?**

3 A. PSE's proposal to normalize federal income taxes relating to injuries and damages  
4 is reasonable and should be adopted.

5  
6 **C. Bad Debts**

7  
8 **Q. Please discuss PSE's proposal to change from flow-through to normalization**  
9 **for book/tax timing differences related to bad debts.**

10 A. PSE witness Marcellia discusses this Company proposal at pages 13-15 of his  
11 Direct Testimony. The reserve for bad debts cannot be deducted for income tax  
12 purposes until the uncollectible accounts have been written off. PSE proposes to  
13 normalize the book/tax timing difference related to bad debts. By normalizing  
14 this, PSE will provide deferred taxes associated with the book/tax difference. In  
15 the current PSE case and generally this will have the effect of increasing net  
16 operating income by reducing the amount of income tax expense in the cost of  
17 service.

18  
19 **Q. What impact on PSE's electric operations does the Company's proposed**  
20 **change to apply a normalization treatment have on PSE's claim for federal**  
21 **income tax expense in the current PSE general rate case?**

22 A. According to PSE's calculations, normalizing bad debts would decrease federal  
23 income tax expense for PSE's electric operations by \$1,524,912, as shown on

1 PSE witness Marcelia's Exhibit No. \_\_ (MRM-3). Deferred taxes provided by PSE  
2 will reduce the amount of tax expense in cost of service, which will increase  
3 electric operating income. The recording of the deferred tax will match the tax  
4 benefit of the future tax deduction with the recording of the bad debt expense,  
5 even though the actual tax deduction cannot be taken until the bad debt is written  
6 off.

7  
8 **Q. What impact does the Company's proposed change to apply a normalization**  
9 **treatment have on PSE's claim for federal income tax expense in periods**  
10 **beyond the current general rate case?**

11 A. That is not known at this point. However, normalizing a book/tax timing  
12 difference where the book deduction would typically occur before the tax  
13 deduction, in general, should result in lower federal income tax for ratemaking  
14 purposes in years when the book expense amount exceeds the tax deduction  
15 amount. Over a sufficiently long period of time, the book and tax deduction  
16 amounts should be approximately equal.

17  
18 **Q. What impact would changing the ratemaking treatment of flowing through**  
19 **the impact of book/tax timing differences related to bad debts be for PSE's**  
20 **gas distribution utility operations in the current GRC?**

21 A. It would increase the gas utility income tax expense by \$483,075, as stated in  
22 response to Staff Data Request 112.

1 **Q. What is your recommendation regarding the ratemaking treatment for**  
2 **federal income taxes relating to bad debts?**

3 A. PSE's proposal to normalize federal income taxes relating to bad debts is  
4 reasonable and should be adopted.  
5

6 **VII. SUMMARY OF RECOMMENDATIONS ON INCOME TAX**  
7 **ISSUES**

8  
9 **Q. Please summarize your recommendations on income tax issues.**

10 A. My recommendations on income tax issues are as follows:

11 1) A significant change in tax accounting involving repairs deductions that PSE  
12 applied for and the IRS granted, has significantly increased ADIT. The  
13 adjustment to ADIT for the tax accounting change for repairs is known and  
14 measureable in the 2010 test year and should therefore reduce rate base. Net  
15 of the impacts of a related tax accounting change for retirements, PSE's  
16 electric and gas utility rate base should be reduced by the following amounts  
17 for this known and measurable adjustment:

Increase (Reduction) to ADIT/Reduction (Increase) to Rate Base From Tax Accounting Method Changes for Repairs and Retirements			
	Electric	Gas	Total
Account 282 Repairs	\$ 41,842,225	\$24,996,849	\$ 66,839,074
Account 282 Retirements	\$ (427,903)	\$ (432,551)	\$ (860,454)
Total Repairs/Retirements	\$ 41,414,322	\$24,564,298	\$ 65,978,620

18  
19 2) The Company's proposal to include a debit balance amount of  
20 approximately \$47.3 million in Account 236, Accrued Taxes Payable, as an

1 addition to rate base as working capital, should be rejected. The \$47.3  
2 million should be removed from rate base because it is abnormal for  
3 Account 236 to have a large debit balance, and the \$47.3 million debit  
4 balance that PSE had in that account during the 2010 test year was largely  
5 reversed in January and February of 2011 and therefore no longer exists on a  
6 going forward basis. A zero balance for Account 236 should be used for  
7 working capital.

8 3) PSE's proposed treatment of bonus tax depreciation and tax net operating  
9 losses is generally reasonable and no adjustments to rate base in addition to  
10 the above two items are recommended at this time. PSE's filing used an  
11 estimated amount for its 2010 NOL which was larger than the actual NOL  
12 reflected on PSE's 2010 tax return; consequently, it may be appropriate to  
13 update the rate base impact of the NOL by replacing PSE's estimated  
14 amount with the actual 2010 NOL at a later point during this proceeding.  
15 PSE is not paying or incurring current federal income tax expense. PSE's  
16 current federal income tax expense should therefore be removed. PSE is  
17 incurring deferred federal income tax expense. The adjustments to reduce  
18 current federal income tax expense to zero for ratemaking purposes and to  
19 reflect an equal adjustment for deferred federal income tax expense are  
20 reflected in Staff's presentation. Because of PSE's NOL carry-forward, the  
21 allowance for income taxes in Staff's recommended revenue increase is  
22 treated as an increase to deferred income tax expense.

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8

- 4) PSE's proposal to normalize the federal income tax treatment for the following items in the current rate case should be granted:
  - a) Capitalized property taxes
  - b) Injuries and damages, and
  - c) Bad debts.

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

A. Yes, it does.