EXHIBIT NO. MRM-4T
DOCKET NOS. UE-090704/UG-090705
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-090704** **Docket No. UG-090705**

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

DECEMBER 17, 2009

PUGET SOUND ENERGY, INC.

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I. INTRODUCTION

Q. Are you the same Matthew R. Marcelia who provided prefiled direct testimony in these dockets on behalf of Puget Sound Energy, Inc. ("PSE" or "the Company")?

A. Yes. I filed prefiled direct testimony, Exhibit No. MRM-1T and supporting exhibits Exhibit No. MRM-2 and Exhibit No. MRM-3.

Q. What topics are you covering in your rebuttal testimony?

A. I will respond to Public Counsel Witness James R. Dittmer's proposed adjustments to

(i) record a tax benefit associated with the White River sale (Schedule B-4 of Exhibit No. JRD-2C;

(ii) apply the Jackson Prairie sales tax refund against rate base in the test year in Schedule B-2 of Exhibit No. JRD-3C;

(iii) update property tax expense in Schedule C-10 of Exhibit No. JRD-2C;

(iv) remove the §162(m) limitation from electric and gas operations as set forth in Schedule C-11 of Exhibit No. JRD-2C and Exhibit No. JRD-3C; and

(v) flow-through the book/tax difference related to injuries and damages on Schedule C-14 of Exhibit No. JRD-2C.

I also discuss the proposed adjustments of Federal Executive Agency ("FEA") Witness Ralph Smith for bonus depreciation on the Wild Horse Expansion Project and the increase in deferred income tax associated with the Company's new accounting method for the tax treatment of repairs.

Additionally, I will respond to Commission Staff Witness Roland Martin's concerns on the Company's request to include the net interest costs paid to the Internal Revenue Service ("IRS") as set forth in Exhibit No. JHS-16, at page 16.36 and Exhibit No. MJS-14, at page 14.03.

Finally, I will respond to two errors in the testimony of Commission Staff Witness Kathryn Breda at Exhibit No. KHB-2 in regard to deferred taxes and tax normalization.

II. TAX ADJUSTMENTS PROPOSED BY MR. DITTMER ON BEHALF OF PUBLIC COUNSEL

A. The Tax Cost or Benefit of the White River Asset Sale

Q. Did PSE include an estimated tax cost or benefit of the White River asset sale in its original filing?

A. Yes, as explained in PSE's Response to Public Counsel Data Request 439, the Company estimated the income tax associated with the sale of the White River assets at 35% of the estimated proceeds from the sale.

Q. How does Mr. Dittmer propose to modify the company's estimated tax cost of the proceeds from the sale of the White River assets?

A. Mr. Dittmer proposes an adjustment to remove the Company's estimated tax cost and to replace it with a tax loss, causing a reduction to the rate base of $10,824,057 from the Company's original filing.

Q. Is Mr. Dittmer's proposed change appropriate?

A. No. In Order UE-090399, the Commission states

> Puget Sound Energy, Inc., will bring the issue of the application of proceeds from the sale and disposition of all Project proceeds, including the sales of Surplus Property, to the Commission for consideration in the Company's next general rate case after the sale of all Project assets and Surplus Property is completed.

These transactions have not been completed.

Q. How has the Company treated the tax cost or benefit of the sale in its rebuttal filing?

A. The Company removed the tax costs or benefits associated with the White River asset dispositions until all of the transactions have occurred. At this point in time, the final tax gain or loss cannot be determined as the proceeds from the possible sale of Surplus Property can not be estimated. This treatment is consistent with Order UE-090399.

B. **Jackson Prairie Tax Adjustment**

Q. Please briefly describe the Company's sales tax dispute with the Washington Department of Revenue ("DOR") as it relates to the 1999 Jackson Prairie Expansion.

A. In 1999, the Company completed its expansion of the Jackson Prairie facility. In 2004, the Company came under routine audit by the Washington State Department of Revenue ("DOR"). In the audit, the DOR assessed the Company with additional sales tax and interest related to the expansion project. The Company paid the tax and filed a formal appeal. In May 2009, the Company reached a settlement with the DOR and received a refund of a significant amount of the disputed tax, with interest.

Q. How did the Company account for the refund?

A. Upon receipt of the refund in May 2009, the Company accounted for the refund in the same manner in which the original assessment was handled, with the sales tax portion of the refund being applied to capital orders associated with the Jackson Prairie project and the interest portion being applied to interest.

Q. How does Mr. Dittmer propose to treat the refund?

A. Mr. Dittmer proposes to reduce the plant balance for Jackson Prairie reflected in this general rate case by the amount of the refund that relates to plant.

Q. Do you have any other concerns with Mr. Dittmer's proposed adjustment to Jackson Prairie?

A. Yes, Mr. Dittmer proposes to reduce the plant balance of Jackson Prairie by the full amount of the settlement. However, PSE is a one-third owner of the Jackson Prairie facility. As a result, PSE ultimately bore only one-third of the assessment and only one-third of the benefit of the refund. So Mr. Dittmer should not have reduced the plant balance by $740,624. If the Commission determines that any adjustment to plant for this credit received after the test year is warranted, the reduction should not exceed $246,875 (which is one-third of $740,624).

C. <u>Property Tax Expense</u>

Q. Has the Company updated its property tax accrual used in this proceeding?

A. Yes, the Company has updated its property tax accrual for electric and gas operations. The update to property taxes attributable to electric operations results in an increase to net operating income in the amount of $1,390,893 versus a decrease in net operating income in the amount of $1,603,694 in the Company's original filing. The net effect to electric net operating income is an increase of $2,994,587 from PSE's original filing. *See* Exhibit No. JHS-16, page16.15.

The update to property taxes attributable to gas operations results in a decrease to net operating income in the amount of $1,053,408 versus a decrease in net operating income in the amount of $850,450 in the Company's original filing.

The net effect to gas net operating income is a decrease of $202,958 from PSE's original filing. *See* Exhibit No. MJS-14, page 14.10.

Q. How does the Company calculate its property tax expense?

A. There are three components to the Company's calculation of property taxes. Those three components are the property values, the system ratio, and the levy rates. Each component becomes available at a different time during the year. In fact, it takes 13 to 14 months for all components to become fully available.

Q. What is driving the current change in your pro forma property tax expense?

A. Since the original filing, PSE reached agreement with the DOR on its electric and gas property values. In addition, the system ratios for electric and gas operations were adjusted to actuals. Finally, PSE updated the levy rates. As a result, both electric and gas property tax pro forma adjustments have been updated to capture these changes.

1. The Property Tax Process

Q. Can you describe briefly this 13-14 month cycle?

A. Yes, I have outlined the process in Attachment H to PSE Response to WUTC Data Request 156, which is attached as Exhibit No. MRM-05. In brief, the process begins in January as the Company must determine its best estimate of property tax expense for financial accounting purposes. The initial estimate relies heavily on data from the prior year. The calculation is revised as better information becomes available.

Q. What is the first event that causes the Company to change its calculation?

A. The first event that causes a change in the property tax calculation typically occurs in March or April when the final property tax bills are received related to the prior year. At that point, the Company will know the exact levy rates applicable for the prior year. The prior year levy rates represent new information that must be factored into the calculation of levy rates for the current year.

Q. What is the next event that is likely to change the estimate?

A. In July, the Company usually reaches an agreement with the DOR on the value of the property. Once the value becomes known, the Company updates its calculation to reflect the new information.

Q. After the values are set, what occurs?

A. In December, the Company finds out what the system ratio is for each county.

Q. What is the system ratio?

A. The system ratio is the percentage that is applied to the Company's taxable value in order to reduce the Company's taxable value down to the level of taxation at which all the other members of the particular county are assessed. Since the

Company is appraised every year and the other taxpayers in the county are not appraised every year, the Company is treated differently than other taxpayers. Each county applies a different system ratio to the Company's property in order to equalize the Company's values with the values of other taxpayers in that county.

Q. In December of a given year is the amount of property tax that has been booked during the year known with "certainty" as defined by Commission Staff?

A. In December, the Company has a reasonable estimate of the property tax that has been booked during the year. However, the Company still does not know the final levy rate. The levy rate will not be known until March or April of the following year when the actual tax bills arrive. So the property tax recorded as of December is still an estimate.

Q. For financial reporting, what is the Company's usual method of calculating its property tax?

A. The method described above has been used by the Company for many years. It uses the best information to determine what the property taxes will be. As indicated above, the property tax calculation becomes more accurate over the course of the year. Each event obligates the Company to update its calculations. Generally accepted accounting principals ("GAAP") requires such calculations be estimated and updated as better information is received.

Q. What methodology does the Company use to calculate property taxes in a regulatory proceeding?

A. The Company uses the same process to calculate rate year taxes. The rate year taxes are calculated to reflect what is currently known about the levy rates, property values, and the system ratio.

Q. Is the property tax pro forma adjustment "known and measurable"?

A. Yes. The state allows pro forma adjustments for the test period for "all known and measureable changes that are not offset by other factors". WAC 480-07-510. It is certain that property taxes will be owed in the rate year. It is also certain that the tax paid in the test year is an estimate of the tax that will be paid in the rate year and not a very good estimate at that. In Exhibit No MDF-1T, pages 8 and 9, Mr. Foisy proposes to "return the property tax liability to test year values." Although Mr. Foisy advocates updating the estimate for things that are known, the test year values that he proposes to use are not yet known—they are still an estimate.

Q. What information should be incorporated into the property tax calculation?

A. The new .property tax values and the system ratios are known. The levy rates are estimated based on the best available information. However, the fact that estimates are required as part of an adjustment does not disqualify the adjustment from being known or measurable. The estimates used for property taxes are commonly done and, in fact, required under GAAP. In addition, the property tax pro forma adjustments are not offset by other factors.

Q. Should the Commission continue using the pro forma tax adjustment for property taxes?

A. Absolutely. Doing so is consistent with prior practice and not doing so is inconsistent with measuring revenues and expenses. In this particular instance, electric customers will benefit due to a significant decline in PSE's electric property values.

Q. Besides the property tax updates mentioned above, are there any other changes to the pro forma property tax schedules?

A. Yes, in reexamining the interplay between the different worksheets that support the property tax adjustment at Exhibit No. JHS-16, page 16.15 and those that support the pro forma adjustments on the same exhibit for Hopkins Ridge Infill (page 6), Sumas (page 9), Whitehorn (page 10), and Fredonia (page 33), PSE determined that it had duplicated the removal of property tax expense for the above facilities. The result was that a significant portion of the property tax on these facilities was omitted from PSE's original filing.

The spreadsheets have been updated to accurately capture all of the property taxes. All parties to the proceeding were notified in PSE's First Supplemental Responses to WUTC Staff Data Requests 146, 156, and 158 that this correction was going to be made.

Q. What was the effect of this correction?

A. As a result of the correction, the property tax expense attributable to each plant and included in the overall adjusted results of operations for this rebuttal filing by applying the corrections to page 16.15 increased as follows:

Hopkins Ridge Infill property tax increase of $88,507

Sumas property tax increase of $140,740

Whitehorn property tax increase of $71,610

Fredonia property tax increase of $179,053

2. Mr. Dittmer's Electric Pro Forma

Q. Mr. Dittmer also proposed adjustments to PSE’s original pro forma property tax adjustment. Do you have any concerns with Mr. Dittmer’s proposal?

A. Yes. I have reviewed Mr. Dittmer’s adjustment property tax pro forma at Exhibit No. JRD-2C, Schedule C-10-Electric and Exhibit No. JRD-3C, Schedule C-10-Gas.

I would recommend that the Commission reject Mr. Dittmer’s property tax pro forma adjustments for both electric and gas operations. Mr. Dittmer’s adjustment contains a number of inaccuracies which I will address.

Q. What adjustment should Mr. Dittmer make to his calculation of Montana property taxes for electric?

A. Mr. Dittmer's calculation of PSE's Montana property tax fails to include the property tax which PSE paid on a small amount of locally assessed property. He must include an additional $11,304 in his calculation to account for the locally assessed property in Montana.

Q. What adjustment should Mr. Dittmer make to his calculation of Oregon property taxes for electric?

A. Mr. Dittmer's calculation of PSE's Oregon property tax fails to capture the slightly lower Oregon value. As a result, his tax calculation is too high. Instead of a tax of $682,879 that he calculates on Line 12, Column (d), of Schedule C-10-Electric, he should have a tax of $672,895, which lowers the tax by $9,984.

Q. What adjustment should Mr. Dittmer make to the Washington property taxes for electric?

A. Mr. Dittmer updated Line 2, column b, to report the final Washington property value. However, he did not make a corresponding change to his estimate of the levy rate on Line 8, column b. Instead, he left the levy rate unadjusted. He continues using a levy rate estimate of 10.08.

Q. What justification does Mr. Dittmer give for his failure to adjust the levy rate?

A. His failure to adjust the levy rate is puzzling. Instead of modifying the levy rate, he continues to use PSE's old and, now, outdated estimate of the levy rate. And in doing so, he claims to be using a "conservative" estimate. I would agree that there was a time when that estimate of the levy rate was conservative. However, that time has passed. In the face of new information, I would not characterize the outdated levy rate as "conservative". It is inaccurate.

Q. How are levy rates set?

A. Levy rates are set by each taxing jurisdiction. A levy rate is simply a fraction. The numerator is the taxing jurisdiction's budget and the denominator is the taxable value of all property within that jurisdiction. So, in general, the levy rate is a function of two things: (a) the amount of tax revenue that needs to be raised (e.g. the jurisdiction's budget for that expenditure) and (b) the taxable value of all property within the jurisdiction.

Based on this simple equation, two observations can be made. The relative movement between a jurisdiction's budget and property values will have a significant effect on the levy rate. If property values are rising, there will generally be downward pressure on the levy rates. Conversely, if property values are falling, there will be upward pressure on the levy rates.

In Washington, there are limitations on the budget increases, unless voters approve otherwise. As a result, the most volatile element of the levy rate calculation is property values.

Q. How does new construction impact the levy rates?

A. New construction has the effect of increasing property values in two ways. First, new construction can increase the quantity of structures on the tax rolls. Second, new construction brings newer property onto the tax rolls. As the jurisdiction's budget gets spread over more property, each individual parcel bears less of the tax burden (i.e. the levy rate trends downward). The basic math described above still applies. As the denominator expands relative to the numerator, the product decreases (i.e. the levy rate declines).

Q. How does Mr. Dittmer account for the effect of property values in his estimate of the levy rate?

A. He acknowledges the basic dynamics of the levy rate that I described above. However, he does nothing to quantify or measure the impact. He sidesteps the issue and states the he has "applied the property tax levy rates utilized by PSE in developing its pro forma property tax expense". Exhibit No. JRD-1CT, page 72, lines 9-10. This is a misleading claim. In making it, he appears to have accepted PSE's levy rate estimate. This is not so. PSE's levy rate estimate in its original pro forma adjustment was based on very different assumptions for property values. He has not used PSE's current estimate of the levy rate. As explained above, property values effect levy rates.

Q. What is PSE's levy rate for electric operations?

A. PSE's uses a levy rate of 10.2.

Q. What information does PSE point to in favor of modifying its initial levy rate?

A. There are a number of factors that inform PSE's modification of its levy rate. But the leading factor is the significant decline in PSE's property values. PSE's electric property values are down 16.6% over the prior year even with its significant capital expenditures during the year. PSE has more taxable property than last year and its values have declined.

Second, property values are down across the board. It is not only PSE that has seen its values fall. Most homeowners are seeing their values drop. In addition, foreclosure filings are up, which is another indicator that values have dropped.

Third, new construction has fallen considerably. As Mr. Valdman indicated in his testimony at Exhibit No. BAV-1T, page 13, PSE continues to experience decreases in new customer additions. Also on page 50, Mr. Valdman cites the decline in permits for new single family homes and duplex/twin homes dropped in 2009. Economic data such as this indicates that new property will be coming on-line at much lower levels than we have experienced in the past. A dearth of new property tends to put upward pressure on levy rates.

Q. Where does this information lead PSE in its evaluation of levy rates?

PSE looked at the data and determined that the original levy rate estimate did not capture the current economic conditions. As a result, PSE reevaluated the levy estimate and determined that a four-year average would be the appropriate method to capture the economic data in the levy rate.

Q. Do you have an exhibit to support you calculation?

A. Yes, Exhibit No. MRM-6 shows the prior four years of PSE's electric values and levy rates. As the exhibit indicates, PSE's electric values in Column (b) have dropped to a level that falls between the 2006 value on Line 3 and the 2007 value on Line 4. Using a four-year average on the levy rate results in a levy rate of 10.2 on Line 8, which likewise falls between the 2006 levy on Line 3, column (c) and the 2007 levy on Line 4.

Q. Other than the levy rate, does Mr. Dittmer need to make any other adjustments to his Washington property tax calculation for electric?

A. Yes, he has recorded the wrong amount for locally assessed electric property in Washington on Line 15 of Schedule C-10-Electric. He recorded $226,523. The correct amount would be $325,000 which is a change of $98,477.

Q. Does Mr. Dittmer's property tax pro forma require any additional adjustments?

A. Yes, one final adjustment is necessary. Mr. Dittmer needs to capture PSE's First Supplemental Responses to WUTC Staff Data Requests 146, 156, and 158. Without these adjustments, his pro forma adjustment suffers from the same mathematical error that PSE's initial property tax pro forma adjustment had, namely the interplay between the double removal of the property tax expense for Hopkins Ridge Infill (Adj 6), Sumas (Adj 9), Whitehorn (Adj 10), and Fredonia (Adj 33) at Exhibit No. JHS-16.

Q. Please summarize your modifications of Mr. Dittmer's property tax proforma for electric operations?

A. Certainly. Mr. Dittmer's electric property tax proforma requires the following adjustments:

1. Increase Montana tax by $11,403 for locally assessed property

2. Lower Oregon tax by $9,984 for lower value.

3. Use actual system ratios. Decrease Washington tax by $81,784.

4. Use a proper levy rate that reflects the declining property values. Increase Washington tax by $239,071.

5. Correct the locally assessed tax in Washington. Increase tax by $98,477.

6. Adjust his schedules to avoid double removal of property tax on Hopkins Ridge Infill, Sumas, Whitehorn, and Fredonia. I quantified the impact of these changes in my discussion of the PSE's correction, above.

3. Mr. Dittmer's Gas Pro Forma

Q. Did you also review Mr. Dittmer's gas proforma adjustment for property taxes?

A. Yes. I have reviewed Mr. Dittmer's property tax pro forma at Exhibit No. JRD-3C, Schedule C-10-Gas. Mr. Dittmer's adjustment contains a number of inaccuracies that also must be addressed.

Q. What adjustment should Mr. Dittmer make to his calculation of property taxes for gas operations?

A. Mr. Dittmer needs to increase the gas system ratio in his calculation of the gas property taxes. The actual number is known and it is 97.46%, not 96.84% that he uses.

Q. What does Mr. Dittmer use for his gas levy rate?

A. He uses 10.156. As discussed above, this is an inappropriate levy rate. With falling property values and an economic downturn, his levy rate does not adequately reflect the upward pressure that exists on levy rates.

Q. What is PSE's gas levy rate?

A. PSE's levy rate is 10.3. As with the electric levy rate, PSE is using a four-year average as the best estimate of the levy rate. *See* Exhibit No. MRM-06, Lines 11 – 22.

I would note that PSE's gas values did not decline like electric values did. The gas decline was offset by the capital expenditures during the year and resulted in a slight increase in values over the prior year level. However, the impacts and concerns that surrounded PSE's analysis of the electric levy rate are applicable to the gas levy rate as the underlying assets for both gas and electric operations exist in the same economic environment of falling property values.

Q. Do you have any other adjustments to Mr. Dittmer gas pro forma?

A. I have one final adjustment: He only recorded the locally assessed property at $32,201 instead of $40,000 which is PSE's estimate. He does not explain the change. PSE's value should be used.

Q. What effect would these adjustments have on Mr. Dittmer's pro forma?

A. It would increase Mr. Dittmer's gas pro forma tax adjustment by $247,659 and decrease his net operating income by $160,978.

D. Section 162(m) Limitation

Q. What is the §162(m) limitation?

A. Section 162(m) of the Internal Revenue Code ("IRC") limits to $1 million the amount of compensation that a company may deduct from taxable income for certain key employees. Compensation in excess of $1 million is generally not deductible.

Q. What was the amount of the limitation in the test year?

A. The limitation that was allocated to electric and gas operations for the test year was $594,209 for electric calculation of taxable income and $320,804 for gas calculation of taxable income. The impact of net operating income for electric was $207,973 decrease to net operating income and for gas was $112,281 decrease to net operating income.

Q. To whose compensation does the limitation relate?

A. The limitation relates only to the compensation of the Company's CEO.

Q. Will the limitation apply in the rate year?

A. The limitation under §162(m) will not apply to PSE in future years as the Company no longer has publicly traded stock. As a result, the Company has removed the effect of the limitation from its tax expense for electric and gas operations. The effect of this is to increase net operating income by $207,973 for electric and $112,281 for gas.

E. Tax Normalization Accounting: Tax Treatment of the Reserve for Injuries and Damages

Q. What gives rise to the book/tax difference for Injuries and Damages?

A. For book purposes, PSE's reserve for injuries and damages is governed by Statement of Financial Accounting Standards ("SFAS") 5 "Accounting for Contingencies". According to SFAS 5, a liability is recorded when it is probable to occur and can be reasonably estimated. The federal income tax treatment is controlled by IRC §162. Under §162, PSE takes a tax deduction for injuries and damages when the related claim is actually paid. As a result of the differing guidance (SFAS 5 versus §162), the same expense could be recorded in different time periods for book and tax purposes. The timing difference is referred to as a "book/tax timing difference".

Q. What is the Company's present treatment for the book/tax timing differences related to the Reserve for Injuries and Damages?

A. Electric and gas operations have divergent accounting/ratemaking practices for the treatment of the book/tax difference for the Reserve for Injuries and Damages. The divergent practice predates the merger of Puget Sound Power & Light Co. with Washington Natural Gas in 1997. For electric operations (formerly Puget Sound Power & Light Co.), the tax benefit or detriment of the book/tax difference was flowed through to customers. For gas operations (formerly Washington Natural Gas), the tax benefit or detriment of the book/tax difference was normalized.

Q. What is the difference between flow through and normalized ratemaking treatment?

A. The difference is deferred taxes. When a tax benefit or expense is flowed through, today's customers bear the initial tax impact in cost of service, while future customers will bear the reversal of the tax impact. When a tax benefit or expense is normalized, the Company records a deferred tax associated with the book/tax timing difference. By recording a deferred tax, the Company achieves an exact timing match, such that the customer who bears the cost or benefit of the underlying item (in this case, an injury or damage claim) also bears the tax effect associated with it. Normalization (i.e. providing deferred taxes) avoids the inter-generational conflict between today's versus tomorrow's customers in that it matches the timing of the tax effect to the timing of the underlying item.

Q. Can you give an example?

A. Yes. Assume that a claim is made against PSE today for $100. Assuming the other requirements of SFAS 5 are met, the Company would record an expense of $100 in the income statement. At this point, no tax deduction is permitted under §162 since no payment has been made. The Company's tax payable to the IRS will not be reduced by the $100 book expense; instead the Company will report $100 of taxable income in excess of its book income and will owe a tax on that income at 35% or $35, in this case.

However, the Company also knows that it will be entitled to a tax deduction at a future date when the underlying claim is paid. So the Company anticipates a tax deduction in the future of $35 – this is a deferred tax. A deferred tax is a tax benefit or detriment that is expected in the future and it results from book/tax timing differences.

Because this book/tax difference is normalized for gas operations, the future tax deduction (which is a deferred tax benefit) is recorded immediately and thereby offsets the increase in the current tax payable. This effectively puts the tax deduction into the same accounting period as the accrual for the underlying expense (in this case, the accrual for the $100 claim).

For electric operations, the impact of the tax (an additional cost of $35) is flowed through to customers in cost of service because the deferred tax is not recorded. This is the case even though the Company knows that the book/tax timing difference will reverse in the future. As a result, the current customers are hit with paying more tax expense (because they don't receive the benefit of a tax deduction for injury claim), whereas future customers will reap a tax benefit but escape the burden of the underlying claim. This fundamental inequity is inherent whenever flow through treatment is used.

Q. What do you propose to do about this inequity?

A. The Company proposes to begin normalizing the book/tax timing difference for the Reserve for Injuries and Damages in determining the tax expense for electric operations as of the test year. This would eliminate the divergent practices between electric and gas operations.

Q. What effect would this have on tax expense from electric operations during the test year?

A. During the test year, the book/tax timing difference for injuries and damages increased $2,050,000. At 35%, this caused tax expense to increase by $717,500. Normalizing the tax treatment of injuries and damages would decrease tax expense by $717,500, thereby increasing electric net operating income.

Q. If the Company begins normalizing injuries and damages, what would happen to the accumulated build-up which was flowed through in prior periods?

A. The accumulated flow through build-up would be flowed through to customers as that portion of the reserve reversed. If an item originated as flow through, it must be reversed as flow through.

Q. What is the accumulated balance for injuries and damages?

A. If normalization begins in the test year, the accumulated flow through balance is

$500,000 (the tax effected balance is $175,000, which is 35% of $500,000). The balance would be flowed through to customers as those claims are paid.

Q. Does Public Counsel support this change?

A. Public Counsel's witness, Mr. Dittmer, has expressed support for such an adjustment although he did not formally calculate the adjustment in his testimony. *See* Exhibit No. JRD-1CT at page 85.

Q. What is the net dollar impact of this change in methodology?

A. The change has an impact of $717,500 increase to electric net operating income and is included in the Company's tax calculation at Exhibit No. JHS-16, page 16.04.

III. TAX ADJUSTMENTS PROPOSED BY MR. SMITH ON BEHALF OF FEA

A. Update to Wild Horse Expansion Project for Bonus Depreciation

Q. Please describe the adjustment for the Wild Horse Expansion Project that FEA Witness Ralph Smith proposes.

A. Mr. Smith proposes that if the Wild Horse Expansion Project becomes commercially operational in 2009, PSE's rate base should be reduced for approximately $10.804 million of deferred taxes related to 2009 bonus tax depreciation that is expected to be generated by the Wild Horse Expansion Project.

Q. Do you agree with Mr. Smith's proposed adjustment?

A. Yes. In Exhibit No. JHS-16, page 16.07, the Company has updated its tax depreciation calculations to capture bonus depreciation for the Wild Horse Expansion Project. Fifty-percent bonus depreciation is available to the project as the project was placed into service on November 9, 2009. Bonus depreciation was not included in the initial filing. However, it was included in the Company's Supplemental filing dated September 28, 2009. As indicated in PSE's Response to FEA Data Request 01.44, the Company has updating its filing to reflect the impact of bonus depreciation. See Exhibit No. JHS-16, page 16.07 for the rebuttal update that also reflects bonus depreciation.

B. Change in Tax Method of Accounting for Repairs

Q. Do you agree with Mr. Smith's proposal (Exhibit No. RCS-1CT at pages 11-13) that PSE's deferred tax balance be substantially increased to reflect PSE's requested permission to change its tax accounting method for the treatment of repairs?

A. No. As discussed in more detail below, the change in tax accounting methodology has not been audited by the IRS and should not be pro formed into this case.

Q. Please briefly describe the new accounting method?

A. On December 30, 2008, the Company requested permission from the IRS to change its accounting method for the treatment of tax repairs. The change impacts taxes. It has no effect on the book characterization of an expenditure as a repair or capital item. The new tax method allows the Company to adopt different units of property ("UOP") for tax purposes. In general, the UOPs for tax purposes will be larger than those for book purposes. For example, for book purposes, one pole is a UOP. If one pole is replaced, the expenditure is capitalized. For tax purposes, the UOP would be the electric circuit which includes a number of poles, lines, and other equipment. If one pole is replaced, it would be a tax deductible repair, not a capital item. By using larger UOPs for tax, more of the Company's expenditures will qualify as an immediate tax deduction.

Q. Did the IRS approve the accounting method change?

A. Yes, on August 20, 2009, PSE received notice that the IRS had accepted the Company's new method. On September 15, 2009, PSE signed the consent letter and the new method became effective.

Q. What does it mean when the IRS approves a method change?

A. The IRS approval is an important but limited approval. It is important because the Company could not have made the change without it. However, it is limited because the IRS explicitly does not approve of the numerical calculations, the Company's interpretation of the applicable laws or guidance, or the underlying methodology. The IRS approval only indicates that the Company is eligible to adopt the new method. The IRS has not bound itself in any way in terms of proposing adjustments to the calculation in future audits. Indeed, as happened with adoption of the Simplified Service Cost Method discussed more fully below, the IRS can disallow deductions in later periods, even though approval of the accounting method has been obtained.

Q. How does the Company propose to account for this benefit?

A. The Company will continue to follow its established method of accounting for book/tax differences for tax repairs. The Company has been availing itself of a scaled down version of this tax treatment since 2003. The current method change will expand the use of this method. The Company plans to continue its existing accounting treatment which is to normalize the timing difference and record deferred taxes. As with all plant-related deferred taxes, the deferred tax will be used to decrease the plant-related rate base when future rates are set.

Q. What effect does the method change have on the test year?

A. The method change occurred after the test year and has not been reflected in the Company's filing as the Company's calculation has not been audited by the IRS.

Q. What is the appropriate treatment of the method change in this general rate case?

A. Mr. Smith, in Exhibit No. RCS-1CT at page 13, requests that the deferred tax be pro formed into the rate base analysis in this filing. That would be inappropriate. The method change was granted after the close of the test year and it still has not been audited by the IRS. As such, it should not be pro formed into the rate case. The proposed adjustment is also one sided in that the Company has incurred substantial capital expenditures since the close of the test year that are not included in this rate proceeding. Those capital expenditures, in part, are offset by the additional deferred tax. In order to include a pro forma adjustment, the statute permits an adjustment to the test period for "known and measurable changes that are not offset by other factors". WAC 480-07-510. The additional deferred tax related to the method change is clearly offset and vastly overwhelmed by other factors, namely capital expenditures of nearly $700 million dollars since the close of the test year.

While the capital expenditures and the additional deferred tax appear to be known with equal certainty, the additional deferred tax is less certain in that it has not yet undergone the scrutiny of an IRS exam.

C. <u>Interplay between §199 Deduction and the American Recovery and Reinvestment Act ("ARRA")</u>

Q. Do you need to make any clarifications to Mr. Smith's testimony related to §199 and the ARRA?

A. Yes, Mr. Smith testimony (Exhibit No. RCS-1CT, pages 8 and 9) confuses two unrelated tax benefits. The first benefit is the §199 deduction. IRC §199 allows a taxpayer that performs manufacturing activities within the United States to claim a "§199 deduction". That deduction is calculated by multiplying the taxable income that is generated from the qualifying production or manufacturing activities by the applicable percentage. In 2008 and 2009, it is 6%. In 2010 and beyond, the applicable percentage is 9%. A number of limitations apply and their operation has precluded PSE from claiming a benefit under §199.

Mr. Smith incorrectly characterizes the §199 *deduction* as a tax credit or tax rate reduction. It is not a tax credit or a tax rate reduction. Although Mr. Smith cites FASB Staff Position ("FSP") FAS 109-1 in support of his proposition (Exhibit No. RCS-1CT, page 9, footnote 1), FSP FAS 109-1 clearly rejects the notion of the §199 *deduction* as a tax rate reduction, and no where does it contemplate treatment of §199 as a tax credit.

Mr. Smith follows-up this statement with the comment that "the §199 deduction is sometimes referred to as the Production Tax Credit." This is untrue. The §199 deduction should never be referred to as the Production Tax Credit ("PTC") because they are completely different tax benefits and have significantly different characteristics.

Then in reference to the §199 deduction, he states that "PSE has availed itself of this tax benefit, which PSE refers to as Production Tax Credits (PTC)". Exhibit No. RCS-1CT, page 9. This is inaccurate and misleading. PSE has availed itself of PTCs under §45 of the IRC – which is a true production tax credit and not related in any way to §199. In fact, there is no way to derive PTC from §199. PSE has been precluded from benefiting from the §199 deduction due to the various limitations that apply to that deduction, which are wholly different than that of §45.

Furthermore, Mr. Smith's proposals are moot in any regard as the Commission has already approved a methodology in Docket No. UE-050870 to capture this benefit for customers in the event that the Company does qualify.

IV. TAX ADJUSTMENTS PROPOSED BY COMMISSION STAFF

A. Interest Paid to the IRS

Q. Do you agree with Commission Staff's rejection of the recovery in rates of the net interest PSE paid to the IRS in connection with the tax benefits from the simplified service cost method of accounting?

A. No. As discussed in my prefiled direct testimony and in more detail below, PSE's customers benefited from this tax methodology and the interest should be recovered over a two-year period.

Q. What adjustments gave rise to the interest that is payable to 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 IRC. 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.

As discussed as a possibility earlier with the repairs adjustment, the IRS disallowed PSE's deduction upon audit and PSE appealed. PSE reached a settlement with the IRS. As a result of the settlement, PSE had to pay interest to the IRS.

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

A. PSE recorded deferred taxes on 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 PSE's 2004 general rate case, Docket UG-040640 *et al*., deferred taxes on simplified service cost method reduced PSE's rate base. This treatment was addressed in particular in the prefiled direct testimony of Mr. James Russell, the rebuttal testimony of Mr. John Story, and in the Order at paragraphs 156-159.

Q. What was the Company's concern in the 2004 general rate case?

A. In Docket UG-040640 *et al.*, the Commission Staff proposed to reduce PSE's test year rate base for the deferred tax balances related to this new method of determining overhead deductions that previously would have been capitalized. The Company agreed that such an adjustment could be appropriate, provided that if any such deductions were subsequently disallowed by the IRS, which was then investigating the method, the Company would then be able to immediately adjust rates to recover any revenue loss, including any assessed interest that might result from such disallowance.

Q. How did the Commission rule?

A. In Order No. 6, the Commission declined to prejudge this issue. However, the Commission recognized that it would be appropriate for the Company to file for rate treatment in the event that this tax deduction was disallowed:

> There is yet one additional dispute that we must resolve in this connection. The Company asks the Commission to pre-approve an adjustment to rates in the event that the Internal Revenue Service reverses the tax benefit of $72 million that both Staff and PSE have treated as a reduction to rate base. PSE also asks the Commission to *include any IRS assessed interest* that might result from such a disallowance.
>
> The Company states that the IRS is currently undertaking a review of all utilities that have taken this tax deduction and will not soon complete that review. The result is not predictable. Staff argues that this means it is premature to grant PSE's request for pre-approval of an automatic rate adjustment that also includes IRS assessed interest.
>
> PSE argues that it is neither fair nor reasonable to include the benefits of this deduction (which is still contingent) in current rates while reserving for a future ruling – and presumably a potential disallowance argument – what should be a straightforward statement of the Commission's commitment to permit recovery of these funds if the Company is ultimately required to pay them to the Federal government.
>
> 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*.

Order No. 6 at ¶¶ 156-159 (footnotes omitted and emphasis added)

Q. Has PSE filed an accounting petition asking for appropriate treatment?

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. That accounting petition has not come before the Commission.

Q. How does PSE propose to recover the net interest paid to the IRS in this rate filing?

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-16, at page 16.36 and decrease gas net operating income by $1,018,402 as set forth in Exhibit No. MJS-14, at page 14.03.

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

A. Yes. Recovery of the interest cost paid to the IRS was contemplated by the Commission in its initial 2004 order to reduce PSE's rate base by the deferred tax on the simplified service cost method. 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 possibly challenge its adoption, including the interest that might be incurred.

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

Q. Did customers benefit from the reduction of simplified service cost method deferred taxes from rate base?

A. Contrary to Mr. Martin's testimony (Exhibit No. RCM-1T at page 12, lines 7 through 9), customers unequivocally and absolutely benefited from the Company's adoption of the simplified service cost method, even though some of the benefits had to be repaid at a later date.

In Docket No. UE-051527, et al, the Company originally filed for a revision to the filed tariffs to reflect the removal of this benefit from rates. Upon discussion with Commission Staff it was agreed that the Company would withdraw the revision of tariffs and file an Accounting Petition that would track the costs associated with repaying the IRS. As the order in that docket recognizes:

> On October 5, 2005, Puget Sound Energy (PSE or Company) filed tariff revisions proposing to increase electric revenues by $5,839,185 (0.4%) and natural gas revenues by $4,182,029 (0.6%) on an LSN basis to become effective November 1, 2005. Subsequently, on October 19, 2005, Puget Sound Energy filed a petition seeking an Accounting Order under WAC 480-07-370(b)(i) in these same Dockets.
>
> In its Petition PSE is requesting accounting and ratemaking treatment for the financing costs associated with the early repayment of deferred Federal income taxes in the amount of $72

> million that was treated as a rate base reduction in the company's last general rate case, Docket UG-040640, UE-040641, UE-031471 and UE-032043, Order No. 6 (the Order).

This change in the original request had the affect of extending the benefits being received by the customer.

As a result of the order, PSE withdrew its proposed revisions to the tariffs as outlined in PSE's letter to the Commission dated October 26, 2005 and provided as Exhibit No. MRM-7.

Q. Can you estimate that amount of benefit customers received?

A. Yes, in the 2004 general rate case, electric and gas rates were reduced by lowering of the rate base by $72 million. Using PSE's authorized rate of return of 7.01% and grossing up the result for revenue sensitive taxes (a gross-up factor of 62%), demonstrates that electric and gas customers were receiving in excess of $8 million of benefit annually. Mr. Martin estimates a similar benefit in Exhibit No. RCM-3, lines 3 and 4.

It is important to keep in mind that PSE initially recorded the deferred taxes from the simplified service cost method in September 2002. Thus customers received a number of years of benefit. According to ratemaking principles, customers are deemed to benefit from the deferred tax from the time it is recorded on the Company's books (September 2002). The theory is that this benefit to customers offsets other costs which customers should rightly bear, for example capital expenditures that the Company has incurred. It is offsetting adjustments, such as this deferred tax, which could enable a company to operate for longer periods of time between rate cases.

Q. Didn't the Commission already issue an accounting order which allowed PSE to defer and ultimately recover the costs of repaying the deferred taxes?

A. In Order UE-051527 and UG-051528, discussed earlier, the Commission allowed PSE to defer the carrying costs associated with the repayment of the deferred taxes. This deferral did not erase the fact that customers had already received significant benefits from the simplified service cost method change. The deferral simply slowed the flow of the benefits to customers as the benefit was being repaid.

Q. How are deferred taxes usually treated for ratemaking purposes?

A. For ratemaking purpose, plant-related deferred taxes are used to reduce rate base under the theory that they represent a source of zero-cost capital. Accordingly, because the Company incurs no cost associated with the deferred tax, the Company should not be allowed to earn a return on that portion of invested capital. However, in some unique situations, that deferred tax does have a cost associated with it. In those situations, it is appropriate for the Company to recover that cost.

This it precisely what the Company is requesting in this case. The cost that the Company seeks to recover is the cost paid to the IRS. In this situation, there is a cost associated with the use of the deferred tax, as the Company advised could be the case and as the Commission acknowledged in its 2004 order.

Q. How does the cost paid to the IRS compare to the benefit customers received?

A. It is clear that the interest paid to the IRS is considerably less than the benefit derived by customers. The interest cost to the IRS was $6,905,776 in total, whereas customers received benefits in excess of $8 million per year prior to recapture of any costs associated with repaying the IRS and benefits in excess of the costs after the payments began. From a cost/benefit analysis, the use of the simplified service cost method was a clear benefit to customers even though it proved to be short-lived.

Q. Please summarize the Company's proposal to recover this cost?

A. As outlined in the Company's original filing, and reaffirmed here, PSE is proposing to recover the cost paid to the IRS over a period of 24 months, which would decrease electric net operating income by $1,471,578 and decrease ratebase by $1,323,561 as set forth in Exhibit No. JHS-16, at page 16.36 and decrease gas net operating income by $1,018,402 and decrease ratebase by 915,968 as set forth in Exhibit No. MJS-14, at page 14.03.

PSE submits that the foregoing accounting and ratemaking treatment is fair and reasonable and the customers still received a net benefit that was passed through to them.

B. Normalization Errors

Q. Have you reviewed Ms. Breda's calculation of deferred income taxes associated with the Wild Horse expansion at Exhibit No. KHB-2, page 2.14 and 2.18?

A. Yes, I have. Ms. Breda's calculation of deferred income taxes in Commission Staff's original and updated filing contains errors that would trigger a normalization violation if it were left uncorrected. Ms. Breda updated her calculations on December 11, 2009 as to some deferred tax errors but, unfortunately, introduced new errors into the calculation.

Q. Please describe the errors?

A. Ms. Breda's calculations of deferred taxes on the Wild Horse Expansion (page 2.14) and on the Baker Relicense (page 2.18) use an impermissible calculation methodology to determine the deferred tax. The deferred tax is used to reduce rate base in the rate year.

Because this error impacts deferred taxes, it is absolutely critical that it be corrected.

Q. What would happen if the error were left uncorrected?

A. If the errors were not corrected, it would cause PSE to violate the normalization provisions of the IRC.

Q. Please briefly describe the normalization provisions and how these errors would violate those provisions.

A. The normalization requirements of the IRC §168(i)(9) prohibit the direct or indirect flow-through of accelerated depreciation tax benefits to utility company ratepayers more quickly than ratably over the book life of the asset. The IRS has issued strict guidance concerning this requirement whenever future periods are involved (i.e. the rate year). In this case, those provisions are relevant to the Wild Horse Expansion and the Baker Relicense pro forma adjustments.

Treasury Regulation §1.167(l)-1(h)(6)(ii) requires that the amount of the deferred tax used in setting rates cannot exceed the amount of deferred tax at the beginning of the period, plus a *pro rata portion* of the amount that increases or decreases the deferred tax over the period.

In this case, Ms. Breda used the deferred tax at the beginning of the period and increased it by the *full amount* of the increase in deferred tax over the rate year. This is not allowed.

Q. What is the effect of a normalization violation?

A. A normalization violation results in the loss of accelerated depreciation tax deductions for its public utility property. This would include the loss of MACRS and bonus depreciation. A utility that can not avail itself of accelerated depreciation must depreciate its property for federal income tax purposes based on the same method and period used for ratemaking purposes (i.e., straight-line method over the book life).

Q. What would you suggest in this situation?

A. I would strongly urge the Commission to reject Ms. Breda's adjustment on Wild Horse Expanse and Baker Relicensing.

V. CONCLUSION

Q. Does this conclude your rebuttal testimony?

A. Yes.