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~~ the Wild Horse deferred tax errors but, unfortunately, introduced new errors into the calculation of the Baker Relicense.

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) uses 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.