EXHIBIT NO. ___(MRM-14T)
DOCKET NOS. UE-111048/UG-111049
2011 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-111048** **Docket No. UG-111049**

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

JANUARY 17, 2012

PUGET SOUND ENERGY, INC.

PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF MATTHEW R. MARCELIA

CONTENTS

I. INTRODUCTION 1

II. CONSOLIDATED TAX SAVINGS ADJUSTMENT 2

A. ICNU's Proposed Consolidated Tax Savings Adjustment 2

B. Issues with ICNU's Proposed Consolidated Tax Savings Adjustment 5

1. No Statutory Authority Supports ICNU's Proposed Consolidated Tax Savings Adjustment 6

2. Prior Orders of this Commission Expressly Reject Consolidated Tax Savings Adjustment Proposals 7

3. ICNU's Proposed Consolidated Tax Savings Adjustment Fails the Benefits-Burdens Test and the Cost Causation Tests 14

4. ICNU's Proposed Consolidated Tax Savings Adjustment Harms the Utility 18

5. ICNU's Proposed Consolidated Tax Savings Adjustment is Contrary to PSE's Ring-Fencing Provisions 19

6. ICNU's Proposed Consolidated Tax Savings Adjustment is Ill-Conceived and Will Likely Lead to Prolonged, Litigated Conflict Between Utilities and Stakeholders 23

C. Issues with ICNU's Consolidated Tax Savings Adjustment Calculation 24

1. ICNU's Proposed Consolidated Tax Savings Adjustment Ignores the Importance of Tax Sharing Agreements 24

2. ICNU's "Fair Share" Standard Lacks Objective Merit 26

3. Consolidated Tax Savings Adjustments Have No Impact on Utilities in Other States 27

4. ICNU's Proposed Consolidated Tax Savings Adjustment is an Outlier Within the Industry 28

5. ICNU's Proposed Consolidated Tax Savings Adjustment Will Create an Impermissible Subsidy from Non-Regulated Affiliates to PSE Customers 31

6. Applicability of Consolidated Tax Savings Adjustments to Other Utilities in Washington 31

D. Issues with ICNU's Calculation of the Consolidated Tax Savings Adjustment 32

1. ICNU's Proposed Consolidated Tax Savings Adjustment Violates Tax Laws 32

2. ICNU's Proposed Consolidated Tax Savings Adjustment Ignores Changes to the Consolidated Group 34

3. ICNU's Proposed Consolidated Tax Savings Adjustment Violates the Test Year Concept 36

4. ICNU's Proposed Consolidated Tax Savings Adjustment Ignores the Fact that Every Company had a tax loss in 2010 37

5. ICNU's Proposed Consolidated Tax Savings Adjustment Ignores the Fact that Would Have Yielded a Dramatically Different Result if the Test Year Were 2009 39

6. ICNU's Proposed Consolidated Tax Savings Adjustment Does Not Reflect Actual Tax 40

7. Additional Flaws in ICNU's Proposed Consolidated Tax Savings Adjustment Calculation 41

8. Known and Measurable 43

9. Modifications to ICNU's Proposed Consolidated Tax Savings Adjustment Calculation 44

E. Conclusion on the Proposed Consolidated Tax Savings Adjustment 44

III. TAX REPAIRS AND RETIREMENTS ACCOUNTING METHOD CHANGES 45

IV. ACCOUNTING FOR TAX NET OPERATING LOSSES 56

A. Response to Commission Staff Analysis 56

B. Response to Public Counsel's Analysis...57

V. DEBIT BALANCE IN ACCOUNT 236, ACCRUED FEDERAL INCOME TAXES PAYABLE 59

VI. PROPERTY TAXES 63

VII. LSR PHASE 1..71

A. Ten-Year Amortization Period. 71

B. Normalization of the Treasury Grants. 71

C. Property Taxes on LSR Phase 1 75

VIII. CONCLUSION...76

1 **PUGET SOUND ENERGY, INC.**

2 **PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF**
3 **MATTHEW R. MARCELIA**

4 **I. INTRODUCTION**

5 **Q. Are you the same Matthew R. Marcelia who submitted prefiled direct**
6 **testimony, Exhibit No. ___(MRM-1T), in this proceeding on June 13, 2011,**
7 **on behalf of Puget Sound Energy, Inc. ("PSE")?**

8 A. Yes.

9 **Q. What is the purpose of this prefiled rebuttal testimony?**

10 A. This rebuttal testimony responds to the following:

11 (i) the Prefiled Direct Testimony of Ms. Ellen Blumenthal,
12 Exhibit No. ___(EM-1CT), witness for the Industrial
13 Customers of Northwest Utilities ("ICNU"), with respect to
14 ICNU's proposed consolidated tax savings adjustment;

15 (ii) the Prefiled Direct Testimony of Mr. Ralph C. Smith,
16 Exhibit No. ___CT(RCS-1CT), witness for the
17 Commission Staff of the Washington Utilities and
18 Transportation Commission ("Commission Staff"), with
19 respect to Commission Staff's proposed ratemaking
20 treatment of the repairs and retirement accounting method
21 changes, the treatment of tax net operating losses and the
22 proposal to remove the debit balance from Account 236,
23 Accrued Federal Income Taxes Payable;

24 (iii) the Prefiled Direct Testimony of Ms. Andrea C. Crane,
25 Exhibit No. ___(ACC-1T), witness for the Public Counsel
26 Section of the Washington Attorney General's Office

("Public Counsel"), with respect to Public Counsel's proposed ratemaking treatment of the repairs and retirement accounting method changes and the treatment of tax net operating losses; and

(iv) the Prefiled Direct Testimony of Mr. Rick T. Applegate, Exhibit No. ___T(RTA-1T), witness for Commission Staff, with respect to Public Counsel's proposed ratemaking treatment of property tax expense and proposed adjustment to allow PSE to recover the actual amount of property tax payable for property owned by PSE at the start of the test year.

This prefiled rebuttal testimony concludes with a discussion of issues unique to Phase 1 of the Lower Snake River Wind Project ("LSR Phase 1"), including the recent legislation to eliminate the normalization requirements for the Section 1603 Treasury Grant and the ratemaking treatment of property taxes for the plant.

II. CONSOLIDATED TAX SAVINGS ADJUSTMENT

A. ICNU's Proposed Consolidated Tax Savings Adjustment

Q. What are "Consolidated Tax Savings"?

A. "Consolidated Tax Savings" is the term that ICNU uses to describe a potential effect of filing a consolidated tax return. ICNU asserts that a consolidated group "may have a smaller income tax liability" than it would if each member in the group filed a separate stand-alone tax return. Exhibit No. ___(EB-1CT) at page 2, line 15.

Q. How is it possible that a consolidated group "may have a smaller income tax liability" than it would if each member in the group filed a separate stand-alone tax return?

A. Generally speaking, the sum of each company's separate stand-alone tax calculation will be close to the amount reported in the consolidated return. However, when some members have taxable income and some members have taxable losses, the sum of the taxes payable of the income-producing members will exceed the tax payable by the consolidated group. For example, if three companies, Company A, Company B, and Company C, form consolidated group, ABC, and Companies A and B have taxable income, while Company C has a tax loss, presumably the ABC consolidated group will remit less tax to the Internal Revenue Service ("IRS") than the sum of the taxes payable of Companies A and B if they had filed individually.

In the situations where this is mathematically true, ICNU identifies a "tax savings" or a "tax benefit," which ICNU would attribute to Companies A and B.

Q. In that example, how would ICNU characterize the "tax savings"?

A. ICNU characterizes the "tax savings" as a "tax shield" or a loan to the loss producing Company C from the income producing Companies A and B. ICNU then proceeds to charge loss producing Company C interest on its loan. The imputed interest is used to reduce customer rates for other members of the group.

Q. Please explain ICNU's use of the term "tax shield".

A. The financial community uses the term "tax shield" to describe the *tax deductions* or *losses* which offset other taxable income. In this example, Company C would be the one producing the "tax shield" due to its tax losses and the fact that those losses reduce the income of the ABC consolidated group.

ICNU's use of the term "tax shield" is completely different from the way the financial community would use the term. ICNU uses the term "tax shield" to describe the taxable *income* produced by Companies A and B and how they use that income to consume the loss of Company C. In other words, ICNU is applying the term to income instead of losses or deductions, which is nonsensical because income does not "shield" anything.

Q. In ICNU's proposed consolidated tax savings calculation, does the loss-producing Company C actually remit cash to Companies A and B for the interest payment?

A. No. ICNU's proposed consolidated tax savings calculation does not require loss Company C actually to remit cash to Companies A and B for the interest payment. Indeed, the "interest payment" is a fictional transaction. No cash changes hands. No interest income or expense is recorded for any of the companies. No accounting entries are made. ICNU simply lowers the revenue requirement of one Company if it happens to be a utility based on its hypothetical construct.

1 **Q. How would ICNU's proposed consolidated tax savings adjustment relate to**
2 **PSE?**

3 A. ICNU claims that PSE's inclusion in the consolidated tax return of Puget
4 Holdings LLC ("Puget Holdings") has produced tax benefits and that these
5 benefits should be reflected in PSE's rates. See Exhibit No. ___(EB-1CT) at
6 page 9, line 11, through page 16, line 9.

7 **B. Issues with ICNU's Proposed Consolidated Tax Savings Adjustment**

8 **Q. Is a consolidated tax savings adjustment appropriate?**

9 A. No. A consolidated tax savings adjustment is inappropriate. Each expenditure,
10 whether borne by shareholders or customers, has a potential tax benefit associated
11 with it. The potential tax benefit has value. Tax losses are simply the
12 accumulation of these tax benefits, riding atop of an accumulation of some
13 underlying expenditure. The value of the tax losses is extinguished the moment
14 that they are used to reduce taxable income and become actual tax benefits
15 (i.e., they are no longer potential tax benefits).

16 There can be no dispute that customers have a right to the tax benefit associated
17 with the expenditures for which customers are responsible. The same rights
18 accrue to shareholders when they incur expenditures for which shareholders are
19 responsible.

1 If an asset owned by an affiliate reduces the utility's revenue requirement, that is
2 a clear confiscation and cross-subsidization between the affiliate and the utility.
3 The same confiscation and cross-subsidization occurs when the affiliate's tax
4 benefit is so used. This is the main purpose and effect of ICNU's proposed
5 consolidated tax savings adjustment, and this Commission should continue to
6 reject such proposals for the reasons presented below.

7 **1. No Statutory Authority Supports ICNU's Proposed**
8 **Consolidated Tax Savings Adjustment**

9 **Q. Is there any statutory authority that requires the Commission to adopt**
10 **ICNU's proposed consolidated tax savings adjustment?**

11 A. No. There is no statutory authority that would require the Commission to adopt
12 any consolidated tax savings adjustment, much less one that would require the
13 Commission to adopt a consolidated tax savings adjustment with the errors and
14 inconstancies in ICNU's proposal.

15 **Q. What is the statutory requirement for the recovery of income taxes?**

16 A. There is no specific statutory guidance on the recovery of income taxes from
17 regulated utilities. The provisions of RCW 80.28.010(1) would apply. Rates set
18 for the regulated utilities must be "fair, just, reasonable, and sufficient".

1 **Q. Does ICNU state that its proposed adjustment is similar to the consolidated**
2 **tax savings adjustment that is used in the State of Texas.**

3 A. Yes. ICNU states that its proposed adjustment is similar to the consolidated tax
4 savings adjustment that is used in the State of Texas, which is concerning. First,
5 the Commission is not subject to the laws of Texas. The regulatory scheme in
6 Texas may contain many differences from those in Washington. Second, the
7 Texas legislature enacted an explicit statute requiring a consolidated tax savings
8 adjustment. *See* Texas Public Utility Regulatory Act (PURA) §36.060.
9 Washington has no equivalent law. Third, the Texas Supreme Court ruled in *Pub.*
10 *Utility Commission of Texas v. GTE-Southwest*, 901 S.W.2d 401 (Tex. 1995), that
11 even though a consolidated tax savings adjustment is required under PURA
12 §36.060, the adjustment can be zero.

13 ICNU's proposal that the Commission adopt a consolidated tax savings
14 adjustment similar to the one required by Texas law has no merit and should be
15 rejected.

16 **2. Prior Orders of this Commission Expressly Reject**
17 **Consolidated Tax Savings Adjustment Proposals**

18 **Q. Has this Commission addressed consolidated tax savings adjustment**
19 **proposals in past orders?**

20 A. Yes. The Commission has had a number of opportunities over the last decade to
21 address consolidated tax savings adjustments. The consolidated tax savings

adjustments presented ICNU is but the most recent iteration of such an adjustment.

Q. Please describe consolidated tax savings adjustment that have been proposed and considered by this Commission.

A. All consolidated tax savings adjustment that have been proposed and considered by this Commission share a common element—they look to the non-regulated affiliated companies and impute some of the tax losses to the regulated utility. The Commission has resoundingly rejected each and every iteration of such adjustments.

In Docket UE-051090, Commission Staff and Public Counsel proposed a "double leverage" adjustment that would have the effect of imputing the tax deduction associated with interest expense from a holding company to PacifiCorp. The Commission's responded, in part, as follows:

> Nonetheless, after having insulated PacifiCorp and its customers from the risks of leveraged financing at the parent, Staff and Public Counsel seek to secure for customers the cost and tax benefits of that financing. The Company's expert witness argues this may violate the familiar principle in utility law that financial benefits should follow burden of risks. We agree. *If the risks and costs of activities at the parent-level are borne exclusively by shareholders-because customers are insulated from them by the ring fence-then it is fair and appropriate for the shareholders, and not the customers, to receive the benefits that result from those activities.*

1 *WUTC v. PacifiCorp d/b/a Pac. Power & Light Co.*, Docket UE-050684,
2 Order 04 at paragraph 285 (2006) (emphasis added). The Commission clearly
3 rejected the proposal and provided a clear and articulate reason for doing so.

4 In Docket Nos. UE-061546 & UE-060817 (consolidated), ICNU picked up the
5 theme and proposed a variation of the double-leverage adjustment to which the
6 Commission responded, in relevant part, as follows:

> 7 The second key problem is the care taken to separate the financial
> 8 circumstances of PacifiCorp from the other affiliates, including
> 9 MEHC, through "state of the art" ring fencing approved by the
> 10 Commission in the acquisition proceeding. *In this context, it*
> 11 *would be very difficult to justify joining the financial*
> 12 *circumstances of MEHC and PacifiCorp by imputing MEHC debt*
> 13 *costs into PacifiCorp's capital structure.* As the Company and
> 14 Staff argue, this smacks of the very sort of thing we squarely
> 15 rejected in the Company's most recent prior general rate
> 16 proceeding when presented as a "double leverage" adjustment.

17 *WUTC v. PacifiCorp d/b/a Pac. Power & Light Co.*, Dockets UE-061546 & UE-
18 060817 (consolidated), Order 08 ¶ 151 (2007) (emphasis added).

19 Again, the Commission clearly rejects the proposal and states its reason for doing
20 so.

21 In Docket Nos. UE-080416/UG-080417, ICNU and Public Counsel proposed
22 reducing Avista federal income tax rate from 35% to its "effective tax rate" of
23 31% based on a consolidated tax adjustment. In relevant part, the Commission
24 responded as follows:

> 25 Finally, under either circumstance, the CTA [consolidated tax
> 26 adjustment] violates the principle, if not the letter, of our recent

1 decisions establishing "ring-fences" that protect ratepayers from
2 non-regulated activities by declining to pull benefits or burdens
3 from activities "outside the ring-fence" into the regulated business.
4 Not only are we provided no reason to act contrary to our recent
5 precedent in this regard, doing so here could jeopardize the
6 integrity of the rationale for "ring-fencing" and undermine its
7 defensibility if it were attacked. [Paragraph 31.]

8 *WUTC v. Avista Corp., d/b/a Avista Utils.*, Docket Nos. UE-080416/UG-080417,
9 Order 08 at paragraph 151 (2008).

10 The Commission clearly rejected the "effective rate" consolidated tax adjustment.

11 **Q. Has the Commission's response to the various consolidated tax savings**
12 **adjustments varied or evolved over the time?**

13 A. No. Consistently and repeatedly, the Commission has rejected each consolidated
14 tax savings adjustment proposed. The logic for its rejection has been the same—
15 the Commission will not allow activities from "outside the ring-fence" (i.e. non-
16 regulated activities) to be pulled into the regulated business.

17 **Q. Is ICNU's consolidated tax saving adjustment proposal distinguishable from**
18 **consolidated tax saving adjustment proposals previously considered by this**
19 **Commission?**

20 A. No. ICNU's consolidated tax savings adjustment may be better disguised than
21 earlier efforts, but, at its heart, it is the same thing. ICNU's proposal takes the tax
22 losses from the loss members of the consolidated group and imputes that loss as a
23 benefit to the regulated operations of PSE.

1 It is not possible to consider the tax consequences of a cost separate from the
2 underlying cost that gives rise to the tax consequence. The tax impact of a cost
3 forms part of the character of the cost itself. The two are inseparable. There is no
4 basis to separate them.

5 The ICNU proposal is incomplete because it neither considers the underlying cost
6 nor the tax associated with the underlying cost. The ICNU proposal only looks to
7 impute interest on the tax attribute that is associated with the underlying cost
8 while leaving that cost with the non-regulated affiliate.

9 In short, the ICNU proposal ignores the full cycle. The underlying costs, and its
10 tax consequences, belong to the non-regulated affiliate. The imputation of the tax
11 benefit to utility operations would also require the imputation of the costs giving
12 rise to the tax benefit. PSE, and it is PSE's belief that this Commission or any
13 other party, would not support or propose such an adjustment. Using half of such
14 an adjustment (i.e., allocating the benefit but not the cost to the utility) is just as
15 onerous.

16 **Q. Please explain what you mean.**

17 A. Based on the *PacifiCorp* orders, the Commission will not permit the imputation of
18 the debt or the tax deductions associated with the debt from non-regulated
19 subsidiaries into the regulated company. Therefore, the INCU proposal takes a
20 different tack by invoking a different kind of debt—a "loan" that ICNU
21 erroneously refers to as a "tax shield". In this iteration of the "double leverage"

1 arrangement, ICNU never makes any claim to causality between the underlying
2 activity of the loss company and the utility. At least in the "double leverage"
3 situation, parties *claimed* that the imputation of debt was justified because some
4 of the debt was used to accomplish the acquisition of PacifiCorp, a claim rejected
5 by the Commission. The ICNU proposal does not even attempt to make any
6 claim of causation. Instead, ICNU and simply argues that (i) the utility produced
7 taxable income, (ii) at least one unregulated member of the consolidated group
8 produced a taxable loss, and (iii) the utility's customers are somehow entitled to
9 interest on the loss member's tax loss.

10 The ICNU adjustment ignores the actual cause of the tax loss at the non-regulated
11 affiliate. Under the ICNU adjustment, it does not matter if the loss was caused by
12 interest expense, a bad business model, a poor economy, accelerated depreciation,
13 or some other cause. The ICNU proposal just takes the tax loss, which ICNU
14 erroneously refers to as the "tax shield" or loan. Then, the ICNU proposal
15 charges interest on the loan at the utility's allowed rate of return. That interest
16 reduces the utility's revenue requirement.

17 **Q. Why is the ICNU proposal characterized as a "disguised" consolidated tax**
18 **savings adjustment?**

19 A. PSE has characterized the ICNU proposal as "disguised" because ICNU claims
20 that the adjustment complies with prior Commission orders. This statement is not
21 true–the ICNU proposal does not comply with prior Commission orders.

1 ICNU's consolidated tax savings adjustment proposal *appears* to be an interest
2 calculation on a tax number, which is not the tack taken in prior consolidated tax
3 savings adjustments proposed to this Commission. ICNU's consolidated tax
4 savings adjustment is actually a variation of "double leverage". At least under
5 "double leverage", there was actual debt involved; here, it is all hypothetical.
6 There is no actual debt on which to calculate the interest.

7 **Q. Please explain the interest calculation.**

8 A. A company is only entitled to collect interest or rent when it, in fact, makes a loan
9 or a lease, respectively. A company can collect rent only when it has the legal
10 rights to an asset and it permits another party to use that asset. The collection of
11 interest or rent implies that the collector must be compensated for its retained
12 ownership interest in the underlying assets (whether it is money (i.e., the loan
13 principle) or a tangible or intangible asset).

14 This is in stark contrast to PSE's situation in a consolidated tax filing. PSE incurs
15 an actual tax liability that is caused by its regulated operations. PSE makes a cash
16 payment in complete satisfaction of that liability. PSE retains no rights or
17 privileges associated with that payment because PSE has terminated its
18 obligation. The payment cannot be construed as a loan in any regard. There is no
19 loan agreement, there is no interest rate, there is no term or tenor, there is no
20 repayment schedule–there is nothing.

3. ICNU's Proposed Consolidated Tax Savings Adjustment Fails the Benefits-Burdens Test and the Cost Causation Tests

Q. How should the benefit of filing a consolidated tax return be analyzed?

A. The rationale for assigning the benefits of a consolidated tax filing should be based on the principles that make economic and logical sense which is what the benefits-burdens test and the cost causation test attempt to do in a regulatory setting.

The first step would be to consider again the nature of the benefit of consolidation.

Q. Please describe the nature of the consolidated benefit.

A. A consolidated benefit is produced when a loss company incurs a tax loss which it could not use itself (or not use currently) and that tax loss is netted against the taxable income of other members of the consolidated group. The netting can produce a cash benefit by accelerating the timing of the realization of the tax loss but only to the extent that the loss enables the consolidated group to pay less tax currently.

Q. What is necessary to create this cash benefit?

A. The consolidated group must have income producing members and loss producing members. The mere production of taxable income can never, in and of

1 itself, produce a consolidated tax benefit. A member with a tax loss must be
2 present.

3 **Q. In general, should the income producing companies or the loss producing**
4 **company claim the benefit of the accelerated cash flow?**

5 A. The benefit should be allocated to the members that are most responsible for
6 producing the benefit (i.e., the benefits-burdens test).

7 **Q. Is PSE a taxable income producing company or a taxable loss producing**
8 **company in ICNU's consolidated tax savings adjustment analysis?**

9 A. Under ICNU's consolidated tax savings adjustment analysis, PSE is a taxable
10 income producing company. As discussed later in this testimony, however, it is
11 not clear whether PSE is truly an income producing company.

12 **Q. Please explain PSE's contribution to the consolidated tax savings?**

13 A. PSE's only contribution to the consolidated tax savings was its production of
14 taxable income. It must be noted that PSE's production of taxable income would
15 have occurred in the same manner and in the same amount whether or not PSE
16 was part of a consolidated group. Indeed, the recent merger ring-fencing
17 provisions and the tax sharing agreement require this of PSE. PSE's tax position
18 is managed as though PSE were a separate stand-alone entity. By itself, PSE has
19 done nothing to create or cause a consolidated tax benefit to occur. PSE was and
20 is a passive participant. To the extent any benefit is allocated to PSE, it would be

1 an unmerited "windfall" because PSE has incurred no cost associated with the
2 creation of a consolidated tax benefit. As a result, it fails the cost causation test.

3 **Q. Please explain the taxable loss members' contribution to the consolidated tax**
4 **savings?**

5 A. Tax losses do not just happen. They represent the underlying economic activity
6 in which the member is engaged. The loss member has experienced a true change
7 in its economic condition by incurring the loss. To some extent, the loss could
8 have been mitigated. For example, a loss member could have leased assets
9 instead of purchasing them. It could have arranged its affairs in a more "tax-
10 efficient" manner. Perhaps it could have organized (or reorganized) itself along
11 alternative, more tax-efficient lines.

12 **Q. Does this suggest that loss members could eliminate their tax losses?**

13 A. No. This does not suggest that the loss member could have eliminated its tax
14 losses or even that it should have avoided tax losses. The fact is that it did not
15 need to due to the fact that other members of group did produce taxable income.
16 However, the loss company has control over these decisions in a way that PSE
17 does not. This would support the notion that the benefit of consolidation should
18 fall to the members that produced the tax loss.

19 To ignore this reality is to presume that the loss company has no other means
20 available to it to realize its tax losses other than through consolidation. This is

1 false. Tax net operating losses from non-regulated members are valuable assets
2 around which tax planning and special transactions can be structured. Net
3 operating losses can be realized through a myriad of possible transactions limited
4 only by the provisions of the Internal Revenue Code.

5 ICNU's proposed consolidated tax savings adjustment erroneously renders non-
6 regulated members incapable of any other means of realizing their tax losses apart
7 from filing a consolidated tax return.

8 **Q. Based on PSE's analysis of the income-producing members relative to the**
9 **loss producing member, who is most responsible for the benefits of**
10 **consolidation?**

11 A. The tax loss companies are the ones most responsible for the benefits that are
12 realized by filing a consolidated return. As a result, they should be allocated the
13 benefits of the tax reduction, in addition to any time value associated with the tax
14 reduction. PSE is a bystander, and its actions are not influenced by economic
15 fortunes or misfortunes of the other members of the consolidated group.

16 If PSE is not responsible for the tax benefit, its customers should not receive
17 interest income on the benefit anymore than they should pay for the cost that
18 created the tax benefit.

1 **Q. How would you characterize this discussion in terms of the benefits-burden**
2 **test and the causation test?**

3 A. PSE bears no economic or theoretical burden in creating its contribution to the tax
4 savings. As a result, it should bear no benefit in the event that a tax benefit
5 materializes in a non-regulated member nor should it receive any interest on such
6 tax benefit.

7 The consolidated tax savings adjustment proposed by ICNU fails the benefits-
8 burden test and the cost causation test, and the Commission should reject the
9 proposal.

10 **4. ICNU's Proposed Consolidated Tax Savings Adjustment**
11 **Harms the Utility**

12 **Q. Does ICNU's proposed consolidated tax savings adjustment harm the utility?**

13 A. Yes. The consolidated tax savings adjustment has one goal—to lower PSE's
14 revenue requirement. It tries to achieve this goal by attributing tax benefits from
15 non-regulated members to the benefit of PSE when, in fact, no causation exists for
16 this result.

17 The proposed consolidated tax savings adjustment would deprive the shareholders
18 of a significant portion of the loss mitigation that they are entitled to under the tax
19 laws by inappropriately attributing those benefits to customers.

1 **Q. Does any cash change hands as a result of the consolidated tax savings**
2 **adjustment?**

3 A. No. As stated above, the consolidated tax savings adjustment is a fictional
4 transaction. The interest that the proposed consolidated tax savings adjustment
5 calculates does not result in a physical cash transfer. However, shareholders will
6 suffer the full effect of the transfer as they will be forced to fund utility operations
7 to the extent that their non-utility operations suffer a tax loss. Thus, shareholders
8 suffer a perverse double loss. First, their non-regulated entities incurred an actual
9 tax loss as a result of their operations. Second, as a result of those losses,
10 shareholders incurred a reduced return from their presumably profitable utility.

11 **5. ICNU's Proposed Consolidated Tax Savings Adjustment is**
12 **Contrary to PSE's Ring-Fencing Provisions**

13 **Q. Please describe what is meant by the term ring-fencing?**

14 A. Ring-fencing involves the financial and corporate structuring of a company so
15 that its exposure to the potential claims from the creditors of affiliated entities,
16 particularly in bankruptcy, is mitigated. This is achieved, in part, by requiring
17 that any transaction between affiliates occur on terms that are the same as the
18 terms available to unrelated, third-party market participants. If an arrangement
19 with affiliates were more favorable or less favorable than market, the ring fencing
20 defense would be weakened.

1 **Q. Does PSE have ring-fencing provisions in place?**

2 A. Yes. PSE's ring-fencing provisions were discussed by the Commission in Docket
3 No. U-072375, and those provisions were prerequisite to the Commission's
4 approval of the merger consummated in February 2009.

5 **Q. How has the Commission characterized PSE's ring-fencing provisions?**

6 A. In Docket No. U-072375, the Commission stated as follows with respect to PSE's
7 ring-fencing provisions:

8 Third, Public Counsel and our dissenting colleague ignore the
9 extensive ring-fencing provisions in the Settlement, acknowledged
10 by Public Counsel's own principal witness as *state of the art*.
11 These ring-fencing provisions protect PSE from the risks inherent
12 in Puget Holdings' taking on debt that will be on the books of
13 Puget Energy, not the books of PSE, and ensure that PSE's
14 ratepayers do not bear the risks attributable to this debt. The new
15 owners will bear the full risks of their investment, both the debt
16 and equity components, in return for the opportunity to achieve a
17 higher internal rate of return at the Puget Holdings level *without*
18 *affecting at all the rates paid by PSE's ratepayers*. . . .

19 *In the Matter of the Joint Application of Puget Holdings LLC & Puget Sound*
20 *Energy, Inc., For an Order Authorizing Proposed Transaction,* Docket U-072375,
21 Order 08 at paragraph 20 (2008) (emphasis added).

22 The Commission's order continues as follows:

23 The ring fencing is *more comprehensive and stronger* than any
24 previously approved by the Commission. [Emphasis added.]

25 *Id*. at paragraph 143.

> There are comprehensive ring-fencing provisions that protect customers from financial distress either associated with the purchase's financing or distress at other companies affiliated with the purchaser.

Id. at paragraph 272.

> Taken together, these commitments and conditions we [the Commission] impose on the Settlement are *more protective of customers and the public interest, more far-reaching, and at least as enforceable as any prior similar transaction in memory*. [Emphasis added.]

Id. at paragraph 273.

From the statements quoted above, the Commission appears to value these provisions and is satisfied that they are robust enough to accomplish their intended purpose. In addition, the Commission's intent was that new owners bear the full risk of their investment "without affecting *at all* the rates paid by PSE's ratepayers".

Q. What do PSE's ring fencing provisions have to do with the consolidated tax savings adjustment proposed by ICNU?

A. It is illogical to require strict ring-fencing provisions on PSE and contravene those same provisions by lowering PSE's revenue requirement because a non-regulated affiliate generated a tax loss. The very nature of PSE's "state of the art" ring-fencing provisions ensures that customers pay only the expenditures related to regulated operations—nothing more and nothing less. This would include interest income or interest expense associated with regulatory operations.

In contrast, the very nature of the proposed consolidated tax savings adjustment is antithetical to ring-fencing. By definition and by computational mechanics, the proposed consolidated tax savings adjustment looks beyond the utility to non-regulated operations and places an unmerited claim on the assets of non-regulated members and ignores the underlying cost.

Q. Are the terms of the proposed consolidated tax savings adjustment consistent with arms-length terms?

A. No. The Internal Revenue Code requires the allocation of taxes based on separate company calculations. To this end, most companies with written tax sharing agreements amplify these provisions and further layout the computational requirements to achieve this end. When it comes to the allocation of tax losses, most tax sharing agreements fall into one of two camps: subsidiaries are compensated for their tax losses when the consolidated group utilized the tax loss, or, in the alternative, the loss subsidiary is compensated for its tax loss when it produces taxable income. Allocation of income taxes based on separate company calculations is the norm.

Q. How do companies allocate the time value of the tax savings?

A. Because the proposed consolidated tax savings adjustment concept is unfair, companies do not use them and there is no allocation of the time value of the tax savings. No loss company would willingly agree to make an interest payment to

1 an income producing company. Doing so would only add additional loss (and
2 insult) to the loss company's economic setback.

3 **Q. Would the proposed consolidated tax savings adjustment weaken the ring-**
4 **fencing provisions?**

5 A. The proposed consolidated tax savings adjustment would weaken the ring-fencing
6 provisions because its very terms do not represent an arms-length transaction.
7 Moreover, the proposed consolidated tax savings adjustment is contrary to the
8 Commission's final order in Docket U-072375.

9 As discussed above, the Commission should reject the proposed consolidated tax
10 savings adjustment because it is inconsistent with the ring-fencing provisions that
11 have already been demonstrated to ensure rate payers bear only the benefits and
12 burdens of utility operations.

13 **6. ICNU's Proposed Consolidated Tax Savings Adjustment is Ill-**
14 **Conceived and Will Likely Lead to Prolonged, Litigated**
15 **Conflict Between Utilities and Stakeholders**

16 **Q. Are you aware of the consolidated tax adjustment passed by the Oregon**
17 **legislature?**

18 A. Yes. In 2006, Oregon's legislature adopted "SB 408," which was an ill-
19 conceived attempt to pass the benefits of consolidated taxes to utility customers.
20 The law, and the rules enacted to implement the law, were complex,
21 controversial, and subject to gaming by the parties.

Q. Did SB 408 achieve its intended results?

A. No. SB 408 was a complete failure. Everyone was unhappy—the utilities, the customers, and the Oregon Public Utilities Commission. Ultimately, the Oregon legislature repealed the statute in 2011. Like SB 408, ICNU's proposed consolidated tax savings adjustment is ill-conceived and will likely lead to prolonged, litigated conflict between utilities and stakeholders.

C. Issues with ICNU's Consolidated Tax Savings Adjustment Calculation

Q. Are there any specific issues in ICNU's prefiled response testimony that cause concern?

A. Yes. ICNU makes a number of statements that are alarming and must be challenged.

1. ICNU's Proposed Consolidated Tax Savings Adjustment Ignores the Importance of Tax Sharing Agreements

Q. How are tax sharing agreements typically used by members of an affiliated group?

A. ICNU's prefiled response testimony asserts that it is "unaware of any rate case in which the terms of a tax sharing agreement influenced the computation of a consolidated tax savings adjustment." Exhibit No. ___(EB-1CT) at page 4, lines 20-21.

1 On first reading, this may seem like a significant statement and a justification for
2 ignoring a tax sharing agreement. However, a few things must be considered
3 about this statement.

4 First, the statement is limited by the "awareness" of ICNU and its witness. The
5 Commission should be wary of setting ratemaking policy based on the awareness
6 or unawareness of ICNU or its consultant.

7 Second, ICNU mentions that Texas uses this type of consolidated tax adjustment.
8 However, its knowledge is limited to a sample size of one state. ICNU's
9 Responses to PSE Data Request No. 023 and 024 confirms as much: "Ms.
10 Blumenthal has not researched the specific calculations used by other states."
11 Please see Exhibit No. ___(MRM-15) for copies of INCU's Responses to PSE
12 Data Request No. 023 and 024.

13 It would be more accurate to say that commissions in states with consolidated tax
14 savings adjustments adopt them in direct contradiction to the tax sharing
15 agreement adopted by the utility and its consolidated affiliates. As mentioned
16 earlier, the proposed consolidated tax savings adjustment is an economic fiction
17 and would never be entered into voluntarily by willing parties. Where
18 consolidated tax savings adjustments exist, they have been implanted by brute
19 force.

20 Finally, due to the nature of a consolidated tax savings adjustment and the fact
21 that they do not represent economic reality, ICNU's statement is essentially a

tautology. It would be instructive to view the same statement in the opposite, which could be composed roughly as follows: "I am unaware of any rate case in which the terms of a tax sharing agreement conflicted with the computation of taxes, except where a regulator imposes a consolidated tax savings adjustment." This statement is just as much a tautology as ICNU's statement, but it would represent vastly more utilities as only a few states have consolidated tax savings adjustments.

2. ICNU's "Fair Share" Standard Lacks Objective Merit

Q. What standard does ICNU invoke to support its proposed consolidated tax savings adjustment?

A. ICNU's testimony mentions the term "fair share" nine times in seventeen pages. Curiously, ICNU does not define this term apart from what can be inferred from the mathematics of its computation. The challenge is that the definition of "fair share" is subjective.

Q. Does the proposed consolidated tax savings adjustment result in a sharing of the benefits of filing a consolidated return?

A. No, not really. Under the proposed consolidated tax savings adjustments, ICNU divides all of the members and former members into taxable income-producing companies (i.e., the winners) and taxable loss-producing companies (i.e., the losers). ICNU then allocates all of the tax benefit to the winners. The losers get

nothing, in spite of the fact that they have incurred the detriment that gives rise to the tax benefit. This cannot be considered "sharing" as the term is commonly used. For example, if I were to share my lunch with you and you ate all of it, then you turned around and charged me interest on the value of my lunch because you ate it faster than I could have eaten it, that is not "sharing" under any definition. However, that is ICNU's proposed consolidated tax savings adjustment.

The Commission should reject the consolidated tax savings adjustments based on ICNU's "fair share" standard, which is an undefined, incongruous, and fictional standard.

3. Consolidated Tax Savings Adjustments Have No Impact on Utilities in Other States

Q. Is ICNU's claim true that consolidated tax savings adjustments have no impact on utilities in other states?

A. In its testimony, ICNU makes the following statement:

> There is no evidence that consolidated tax savings adjustments have had any impact, either positive or negative, on the utilities in these states.

Exhibit No. ___(EB-1CT) at page 13, lines 6 and 7.

A simple thought experiment will suffice to refute the point: Does the consolidated tax savings adjustment change the revenue requirement or not? Certainly, it would. Does the revenue requirement have any impact on a utility?

Certainly, it does. Therefore, the consolidated tax savings adjustment will unquestionably have an impact on the utility. Additionally, as discussed above, the consolidated tax savings adjustment could have an impact on PSE and its customers by weakening the ring-fencing provisions that currently protects customers from risks of the unregulated affiliated companies.

In addition, ICNU's statement must be viewed in the light of INCU's Responses to PSE Data Request No. 023 and 024, provided as Exhibit No. ___(MRM-15). ICNU has apparently not researched any state other that Texas, which could account for ICNU's failure to find any evidence, either positive or negative.

The Commission should reject the consolidated tax savings adjustment because it will have an unfavorable impact on the utility, its customers, and its shareholders.

4. ICNU's Proposed Consolidated Tax Savings Adjustment is an Outlier Within the Industry

Q. How common are consolidated tax savings adjustments?

A. Consolidated tax adjustments are not common. PSE is only aware of a handful of states that deviate from the widely-used stand-alone method that is currently employed by this Commission.

The methodology proposed by ICNU is an even further outlier because it is, at most, used in a small subset of the states that do a consolidated tax savings adjustment. Of the states that do a consolidated tax adjustment, each state is

1 unique. As an example, ICNU uses Texas as its model but has varied from the
2 Texas model.

3 **Q. How do most states determine income taxes?**

4 A. Most states follow the stand-alone method because it reflects the tax cost directly
5 associated with the level of income or loss resulting from utility operations, it
6 avoids commingling of utility and non-utility operations, and it is consistent with
7 longstanding and well reasoned regulatory principles that allow the utility to
8 recover the costs associated with providing regulated services and protects
9 ratepayers from the financial impact of non-regulated operations.

10 **Q. What is the position of the Federal Energy Regulatory Commission**
11 **("FERC") on consolidated tax savings adjustment?**

12 A. FERC has repeatedly endorsed the use of the stand-alone method and has rejected
13 the use of consolidated tax savings adjustments since 1973. In *Florida Gas*
14 *Transmission Company,* FPC Op. No. 611-A (1973), the Federal Power
15 Commission (the predecessor to FERC) ruled that tax savings from losses of non-
16 regulated affiliates cannot be used to reduce the rates set for regulated operations,
17 either in cost of service or in rate base.

18 **Q. Is this Commission bound by the FERC decision?**

19 A. No. This Commission is not bound by FERC's decisions or policies except to the
20 extent that this Commission has expressly adopted a particular FERC decision or

1 policy. FERC has an established well-reasoned position on consolidated tax
2 savings adjustment, which should not be contravened lightly. In addition, all
3 prior rulings of this Commission have been consistent with FERC's position on
4 consolidated tax savings adjustments.

5 **Q. How are taxes allocated under Generally Accepted Accounting Principles**
6 **("GAAP")?**

7 A. Under ASC 740 (formerly FAS 109), Accounting for Income Taxes, when
8 separate financial statements are issued by members of a consolidated group, the
9 income taxes must be allocated among the members of the consolidated group. A
10 method that allocates current and deferred tax expense to members of the group as
11 if it were a separate taxpayer is consistent with the principles of ASC 740. In
12 fact, it is specifically cited as an acceptable method, ACS 740-10-30-27.

13 On the other hand, a method that allocates no current or deferred tax expense to a
14 member of the group that has taxable income because the consolidated group has
15 no current or deferred tax expense is inconsistent with the principles of ACS 740.
16 *See* ACS 740-10-30-28. As a result, the use of a consolidated tax savings
17 adjustment would be inconsistent with the principles of ACS 740.

18 In sum, the Commission should reject ICNU's proposed consolidated tax savings
19 adjustment because it is not commonly accepted ratemaking, it is contrary to
20 FERC regulatory accounting, and it is inconsistent with GAAP.

5. ICNU's Proposed Consolidated Tax Savings Adjustment Will Create an Impermissible Subsidy from Non-Regulated Affiliates to PSE Customers

Q. How does PSE respond to the following claim: "Essentially, without a consolidated tax adjustment, ratepayers will subsidize Puget Holding's non-regulated operations"? Exhibit No. ___(EB-1CT) at page 14, lines 3-4.

A. ICNU's claim is untrue. Indeed, the exact opposite is true. First, the proposed consolidated tax savings adjustment will create an impermissible subsidy from the non-regulated affiliates to PSE customers. Second, PSE's customers are not entitled to benefits associated with affiliates outside of the ring-fencing. Third, as explain below, PSE has generally had tax losses since it became a member of the Puget Holdings consolidated group, so could not possible have loaned any "tax benefit" to any other member of the Puget Holdings group.

6. Applicability of Consolidated Tax Savings Adjustments to Other Utilities in Washington

Q. Could other utilities in Washington calculate a consolidated tax saving adjustment like the one proposed by ICNU?

A. PSE does not believe that other utilities in Washington could calculate a consolidated tax savings adjustment like the one proposed by ICNU. For example, in Dockets UE-061546 and UE-060817 (consolidated), Order 08, the Commission explains in paragraph 150 that PacifiCorp is part of the Berkshire Hathaway consolidated group. Furthermore, PacifiCorp is but "one of 500

1 affiliated companies included in Berkshire Hathaway's corporate family".
2 Although PSE is comprised of a much smaller number of entities (34 by ICNU's
3 count, but only 6 in reality), it would be inappropriate to adopt a policy with
4 which only a few smaller utilities might be able to comply.

5 **D. Issues with ICNU's Calculation of the Consolidated Tax Savings**
6 **Adjustment**

7 **1. ICNU's Proposed Consolidated Tax Savings Adjustment**
8 **Violates Tax Laws**

9 **Q. Does the proposed consolidated tax savings adjustment violate the tax laws?**

10 A. ICNU asked the following question in its direct testimony:

11 **Q. Does the calculation emulate the tax laws?**

12 A. The calculation uses information from the consolidated tax
13 returns prepared in compliance with the tax laws and filed
14 with the IRS. The calculation is designed to reflect the
15 economic benefit of the loan by the utility to its loss
16 affiliates over time. Continuing losses indicate that a
17 member of the consolidated group has been unable to offset
18 its own losses with its own income.

19 Exhibit No. ___(EB-1CT) at page 8, line 23, through page 9, line 4. This type of
20 reasoning pervades ICNU's consolidated tax savings adjustment analysis and is a
21 non sequitur. The fact that ICNU pulls numbers from the tax return is absolutely
22 no indication that its calculation "emulates the tax laws". Drawing numbers from
23 the tax returns does not substantiate the validity of the calculations in which those
24 numbers are used. In fact, the proposed consolidated tax savings adjustment

1 clearly violates the provisions of §172 of the Internal Revenue Code ("IRC") to
2 cite but one example.

3 **Q. What are the applicable federal tax law requirements for tax losses?**

4 A. Federal tax law allows losses to offset income within a consolidated tax return.
5 Those losses are first used to offset income arising in the current year. If current
6 year losses exceed current year income, a net operating loss is created that can be
7 applied to offset the taxable income in other tax years. Generally speaking, tax
8 losses can be carried back two years and carried forward twenty years. *See* IRC
9 §172(b)(1).

10 **Q. How does the proposed consolidated tax savings adjustment calculation**
11 **reflect IRC §172?**

12 A. ICNU's proposed consolidated tax savings adjustment ignores the
13 carryback/carryforward limitations of IRC §172. The calculation allows taxable
14 income from *any of the 10 years* included in the calculation to offset *any tax loss*.
15 This is not possible under current tax law. A tax loss in 2010 can only offset
16 taxable income in 2008 or 2009. If there was taxable income prior to 2008, it
17 would not matter because the tax loss carryback period is limited to two years.
18 ICNU's calculation, however, would allow the tax loss from 2010 to offset
19 taxable income as far back as 2001. Moreover, ICNU stated in its testimony that
20 it would use twenty years of tax data, which would only compound the error.

2. ICNU's Proposed Consolidated Tax Savings Adjustment Ignores Changes to the Consolidated Group

Q. How does the proposed consolidated tax savings adjustment calculation reflect changes in ownership?

A. ICNU's proposed consolidated tax savings adjustment calculation ignores changes in ownership: "I also included all companies because, over time, companies may be sold, change their names, or go out of business." Exhibit No. ___(EB-1CT) at page 11, lines 18-19.

Q. Under the IRC, can the Puget Holdings consolidated group benefit from the tax losses of members who are no longer part of the group?

A. No. The Puget Holdings consolidate group cannot legally derive any tax benefit from a company that is not part of its consolidated tax return.

Q. Can you give an example?

A. Yes. ICNU's calculation includes the tax loss from Snoqualmie River Hydro from 2001. Snoqualmie River Hydro ceased to exist in 2001, yet its tax loss is presumed to benefit PSE's ratepayers in the 2010 test year. The 2001 consolidated tax loss (of which Snoqualmie River Hydro was a very small part) was carryback for cash following the completion of the 2001 tax return. There is no carryforward.

1 **Q. What is the implication of this calculation for Snoqualmie River Hydro?**

2 A. ICNU's calculation will effectively double count the 2001 loss from Snoqualmie
3 River Hydro. The loss was collected from the IRS in cash about ten years ago
4 (for which ICNU makes no offsetting adjustment), and ICNU will use the loss
5 again in 2010 to impute an imaginary benefit to PSE's rate payers. Tax losses
6 that are utilized in a carryback cannot be used again in a carryforward.

7 **Q. How has ICNU treated the InfrastruX subsidiaries that were sold in 2006?**

8 A. ICNU has included all of the InfrastruX subsidiaries that were sold in 2006.

9 **Q. Can any of their taxable gains or losses be used by the Puget Holdings**
10 **consolidated tax group?**

11 A. No, not in accordance with the IRC. Those companies were sold when PSE was
12 part of a different consolidated group. Their taxable income or losses are of no
13 effect to PSE or the Puget Holdings consolidated group going forward.

14 By ignoring changes to the consolidated group (namely, the departure of members
15 or PSE's changing consolidated groups), ICNU's consolidated tax savings
16 adjustment violates the provisions of the IRC.

3. ICNU's Proposed Consolidated Tax Savings Adjustment Violates the Test Year Concept

Q. Is ICNU's utilization of a ten-year window appropriate for ratemaking in Washington?

A. No. ICNU's utilization of a ten-year window is inappropriate for ratemaking in Washington. Rates are set based on the income and expenditures that occur in a historical test year. In this filing, the test year covered 2010. Items of income and expense that occurred outside of the test year are generally ignored. There are limited circumstances in which the Commission permits a pro forma adjustment. In such circumstances, the income tax impact is reflected in the pro forma adjustment. There are no situations in which an out-of-period income tax adjustment would be made apart from an adjustment to the underlying activity. To do so creates a mismatch between taxes and the underlying income or expense.

Q. How many years of data are used to develop the amount of debt incurred by PSE as part of the weighted average cost of capital?

A. The debt outstanding during the test year is analyzed on an average-of-monthly-average basis. To that evaluation, adjustments are made for various known and measurable changes. The average debt outstanding for the last ten years is not analyzed to determine the amount of the debt in order to determine the appropriate interest expense the company can recover.

1 **Q. If the test year is the focus of the debt analysis on which rates are set, why**
2 **would you analyze ten years of data to determine the imputed interest on a**
3 **hypothetical tax benefit loan?**

4 A. Logically, the determination of debt and interest expense should bear some
5 correlation to the determination of money lent and interest income. A ten-year
6 analysis is clearly inconsistent with the determination of interest expense and the
7 concept of a historical test year.

8 The Commission should dismiss the proposed consolidated tax savings
9 adjustment because it violates the historical test year standard employed in
10 Washington.

11 **4. ICNU's Proposed Consolidated Tax Savings Adjustment**
12 **Ignores the Fact that Every Company had a tax loss in 2010**

13 **Q. Is PSE a taxable income- or loss-producing company since joining the Puget**
14 **Holdings consolidated group?**

15 A. PSE is a tax loss-producing company since joining the Puget Holdings
16 consolidated group. As explained in my prefiled direct testimony, PSE had tax
17 losses in 2009 and 2010.

1 **Q. Did every company in the Puget Holdings consolidated return incur a tax**
2 **loss in 2010?**

3 A. Yes. PSE had a tax loss in 2010, as did each and every other member of the
4 Puget Holdings consolidated group.

5 **Q. If every member of the Puget Holdings consolidated group has a loss, how**
6 **much taxable income was "shielded" from tax in 2010?**

7 A. None. Since every member had a loss in 2010, no one had any taxable income
8 which was capable of "shielding" the tax loss of another member.

9 **Q. What was the value of the "tax shield" in 2010?**

10 A. Zero, because there was no tax shield. The interest on the "tax shield" would also
11 be zero.

12 **Q. How does ICNU reflect the fact that all subsidiaries reported a tax loss in**
13 **2010?**

14 A. ICNU's calculation violates the tax rules for net operating loss carrybacks. In
15 ICNU's calculation, *any tax loss can offset any taxable income*. So the 2010 tax
16 losses offset the taxable income of affiliates (including the income of PSE) from
17 2002 through 2007.

1 **Q. Can the 2010 losses be carried back to 2002 and 2007?**

2 A. No. As discussed above, IRC §172(b)(1) limits net operating loss carrybacks to
3 two years. There can be no offset.

4 **<u>5. ICNU's Proposed Consolidated Tax Savings Adjustment</u>**
5 **<u>Ignores the Fact that Would Have Yielded a Dramatically</u>**
6 **<u>Different Result if the Test Year Were 2009</u>**

7 **Q. If 2009 had been the test year, how would the calculation have been**
8 **different?**

9 A. In 2009, only one non-regulated member of the consolidated return reported
10 taxable income. All of the other members reported a tax loss, including PSE. In
11 situations were PSE has a tax loss and at least one other member has taxable
12 income, ICNU's consolidated tax savings adjustment will result in PSE's
13 customers *paying* for those tax benefits because the calculation should result in a
14 negative adjustment to revenue requirement. This outcome is unacceptable and
15 likely would fail to receive the support of any party. The Commission should
16 reject the proposed consolidated tax savings adjustment.

6. ICNU's Proposed Consolidated Tax Savings Adjustment Does Not Reflect Actual Tax

Q. Does ICNU's proposed consolidated tax savings adjustment look at the actual tax?

A. No. ICNU's calculation looks at taxable income or loss, not the actual tax. Although ICNU multiplies taxable income or loss by 35%, the result is not the tax paid or saved.

Q. What is missing from the calculation?

A. Tax credits, like the production tax credit, do not factor into ICNU's analysis. The alternative minimum tax ("AMT") is also noticeably absent from ICNU's consolidated tax savings adjustment. Both will affect the amount of taxes paid.

Q. What is the importance of ignoring AMT and tax credits?

A. First, it reinforces the point that ICNUs' calculation violates the tax code. Second, once PSE begins generating taxable income, much of that income will be offset by production tax credits ("PTCs"). To the extent that PSE taxable income is offset by PTCs, that taxable income is not available to "shield" the tax losses of an affiliate. The proposed consolidated tax savings adjustment would effectively double count PSE taxable income: once when it is offset by PTCs and again when it offsets the loss of an affiliate. Third, Schedule 95A would have to be modified in an attempt to mitigate the double counting of PSE's taxable income.

1 **Q. By ignoring AMT and tax credits, what does ICNU's "tax savings" actually**
2 **represent?**

3 A. ICNU's "tax savings" actually represents an arbitrary calculation designed
4 loosely around ICNU's definition of "tax shield" that has the sole intent of
5 lowering the revenue requirement. It fails to actually look at tax savings.

6 This contrasts sharply with PSE's tax sharing agreement, which considers tax
7 credits and AMT, thereby ensuring that customers are only burdened with taxes
8 applicable to utility operations.

9 **7. Additional Flaws in ICNU's Proposed Consolidated Tax**
10 **Savings Adjustment Calculation**

11 **Q. Are there any other errors in ICNU's consolidated tax savings adjustment**
12 **calculation?**

13 A. Yes. PSE has reproduced ICNU's calculations as Exhibit No. ___(MRM-16C).
14 The only change made to ICNU's original calculation is to add column references
15 to aid in this discussion. In column N, the total taxable income for PSE, on line 2,
16 is $100 million. However, PSE's "loan amount" in column N, line 41 is
17 $261 million. This is not impossible, illogical, and unreasonable. PSE cannot
18 "loan" that which it does not have.

1 **Q. What occurs on Line 46 of the proposed consolidated tax savings**
2 **adjustment?**

3 A. On Line 46 of the proposed consolidated tax savings adjustment, ICNU grosses
4 up the "Puget's tax savings" by "one minus the tax rate", or 65%.

5 **Q. Should the tax savings be grossed up?**

6 A. It is impossible to say because it depends on what the "tax savings" is supposed to
7 represent. If it represents interest on the presumed loan, then it is equivalent to
8 interest income and should not be grossed up. However, if it represents a
9 modification to tax expense, it should be grossed up.

10 **Q. What does ICNU believe the "tax savings" to be?**

11 A. ICNU claims to be calculating interest on the presumed loan. However, the fact
12 that ICNU grosses up the "interest" is contradictory to treating it as "interest".
13 Interest is not subject to gross up.

14 If ICNU is calculating a modification to tax expense, this could raise additional
15 concerns around normalization because the rules require consistency in the
16 treatment of tax expense, deferred taxes, and rate base.

1 **8. Known and Measurable**

2 **Q. Is the amount of the proposed consolidated tax savings adjustment known**
3 **and measurable during the test year?**

4 A. No. The amount of the proposed consolidated tax savings adjustment is not
5 known and measurable during the test year. The value of the implied loan cannot
6 be known until the tax return is filed. ICNU used the actual filed tax data in
7 calculating its consolidated tax savings adjustment. This data were not known
8 until the middle of September. Fortunately for ICNU, the filing date of this rate
9 case allowed it to pull in the actual 2010 tax return data, but that is unlikely to be
10 the case with all rate case filings and was not possible as of the date of PSE's
11 initial filing.

12 **Q. Is the proposed consolidated tax savings adjustment a retroactive**
13 **calculation?**

14 A. Yes. ICNU looks back ten years and uses that data to calculate the rate that will
15 apply in the rate year. The proposed consolidated tax savings adjustment is
16 fundamentally a retroactive calculation.

17 In recent years, there has been a significant amount of volatility in federal income
18 tax calculations as Congress has enacted legislation with provisions that have had
19 a major impact on taxes. There is no guarantee that such tax legislation will be
20 extended or enacted in future years.

1 **9. Modifications to ICNU's Proposed Consolidated Tax Savings**
2 **Adjustment Calculation**

3 **Q. Has PSE made any adjustments to ICNU's proposed consolidated tax savings**
4 **adjustment calculation?**

5 A. No. ICNU's proposed consolidated tax savings adjustment calculation violates so
6 many established principles of taxation and regulation that it cannot be and is not
7 capable of being rescued. There is no adjustment that could salvage the proposed
8 consolidated tax savings adjustment calculation to make it plausible.

9 **E. Conclusion on the Proposed Consolidated Tax Savings Adjustment**

10 **Q. Please summarize PSE's review of the proposed consolidated tax savings**
11 **adjustment.**

12 A. The Commission should reject the proposed consolidated tax savings adjustment
13 for the reasons cited above. The proposed consolidated tax savings adjustment is
14 not reflective of the utility's tax situation, is based on a hypothetical loan analysis
15 that is derived from information that is neither relevant nor timely, and violates all
16 prior Commission orders on this subject.

III. TAX REPAIRS AND RETIREMENTS ACCOUNTING METHOD CHANGES

Q. Please summarize Commission Staff's testimony as it relates to the tax repairs and retirement accounting method changes.

A. Commission Staff argues that PSE should include the impact of its repairs and retirements method change in rate base in direct defiance of Order 11 in PSE's last general rate proceeding and Order 06 in PacifiCorp's last general rate proceeding.

Q. What did the Commission rule in Order 11 from PSE's last general rate proceeding?

A. The Commission ruled as follows in Order 11 from PSE's last general rate proceeding:

> Having made this determination for purposes of this proceeding, we note that the Company should implement an increase to ADIT in a future case *if the IRS approves its methodology for treatment of repair costs following an audit*.

WUTC v. Puget Sound Energy, Inc., Dockets UE-090704 & UG-090705, Order 11 at paragraph 197 (2010) (emphasis added).

The Commission reached this conclusion based on the record in that case, which continues to be true as the facts have not changed:

> However, the Company is correct to point out that the lesson of the SSCM issue demonstrates the risks of recognizing IRS-allowed accounting changes before they are audited.

1 *Id.* at paragraph 194.

2 **Q. What is Commission Staff's objection to Order 11 from PSE's prior general**
3 **rate proceeding?**

4 A. Commission Staff objects to the requirement that an audit be completed prior to
5 recognizing the benefit in ratemaking.

6 **Q. Is the completion of an IRS audit a good standard for ratemaking purposes?**

7 A. Generally speaking, it is not a good standard to employ in the normal course of
8 business with common, recurring book/tax difference. However, the repairs and
9 retirement accounting method changes did not occur in the normal course of
10 business. These accounting method changes are usual book/tax differences.
11 Consider what PSE has done under this method change: it has changed its units
12 of property for tax purposes. That is a significant change. The calculations are
13 extremely complex, requiring an accumulation of many untested assumptions and
14 estimates.

15 The Commission recognized this in carving out a unique treatment for the
16 accounting method change for ratemaking purposes.

17 **Q. On what did the Commission base its decision?**

18 A. The Commission's decision was informed, in large part, by PSE's experience
19 with the Simplified Service Cost Method change that PSE adopted on its 2001 tax
20 return.

In the way of background, PSE was able to deduct much more of its overhead costs for tax purposes relative to book purposes. The result of the Simplified Service Cost Method was tax deductions of an equivalent amount to what PSE is seeing with the repairs method change. When the IRS performed its audit, the exam team disallowed the entire method change. PSE appealed and successfully reinstated about 85 percent of the original deduction. The IRS, however, adopted new rules that required PSE to return to its prior method of calculating overheads.

Over the course of six years and after significant controversy with the IRS, the Simplified Service Cost Method was gone, leaving PSE with a charge for interest expense associated with the timing of the tax payments.

In light of this experience, the Commission issued Order 11, which PSE has followed in this case.

Q. What did the Commission rule in Order 06 from PacifiCorp's prior general rate proceeding?

A. In relevant part, Order 06 differentiates between PacifiCorp and PSE:

> In the PSE case, we rejected the argument that no adjustment could be made to rate base until after an IRS audit because the amount was not known and measurable. Here, according to the Company [PacifiCorp], the accumulated deferred income tax liability balance as of December 31, 2009 is $28,927,370. Thus, the amount is both known and measurable.

WUTC v. PacifiCorp d/b/a Pac. & Light Co., Docket UE-100749, Order 06 at paragraph 260 (2011).

1 The distinction that the Commission makes is clear. PacifiCorp's amount was
2 known and measurable, whereas PSE's amount was not and will not be known
3 and measurable until the IRS completes its audit.

4 **Q. Is the amount of PSE's repair and retirement method change known and**
5 **measurable?**

6 A. No. The amount is an estimate and will remain an estimate until the IRS
7 completes its audit.

8 **Q. Has PSE recorded the amounts of its estimate in its books and records for**
9 **tax purposes?**

10 A. Yes. The fact that PSE recorded the amounts of the method change in its books
11 and records for tax purposes, however, does not ensure that the amount is known
12 and measurable, according to the Commission's use of those terms.

13 **Q. Has PSE claimed tax deductions in its 2008, 2009, and 2010 tax returns?**

14 A. Yes. Contrary to Commission Staff's testimony on uncertainty, the inclusion of
15 those deductions in three tax returns does not lower the risk when the issue is
16 reviewed in an IRS audit. If anything, the risk to PSE is greater today than when
17 the change was first made because the accumulated deduction is larger. Compare
18 this with PSE's experience with the Simplified Service Cost Method change. In
19 that case, PSE had included the Simplified Service Cost Method in four tax
20 returns prior to being audited. The IRS exam team still disallowed the entire

1 Simplified Service Cost Method deduction. Even though a significant amount of
2 the deduction was reinstated upon appeal, PSE was subject to an interest charge
3 as a result.

4 **Q. Does PSE consider the repairs and retirement method changes to be**
5 **"uncertain" under the terms of FIN 48?**

6 A. PSE has no reserves under FIN 48 related to repairs and retirement method
7 changes.

8 **Q. Does PSE's lack of a reserve under the terms of FIN 48 mean that the**
9 **amount if known and measurable?**

10 A. No. There is no relationship between FIN 48 and the "known and measurable"
11 standard. They are different and unrelated concepts. Indeed, PSE does not have
12 any reserves under FIN 48 for anything, and this does not mean that every item
13 recorded in PSE's books and records is "known and measurable".

14 **Q. Did PSE record any tax reserves for Simplified Service Cost Method?**

15 A. When Simplified Service Cost Method was under audit, PSE did not provide a
16 reserve under FIN 48 (or its predecessor guidance). PSE believed that the
17 deductions it claimed under Simplified Service Cost Method were appropriate
18 under the tax laws, regulations, and court cases in effect at the time the deductions
19 were claimed and did not provide any tax reserves associated with it.

1 **Q. What was the result of the Simplified Service Cost Method after audit?**

2 A. As discussed above, the IRS disallowed the entire deduction in audit. PSE
3 appealed and about 85 percent of the deductions that PSE claimed were restored.

4 **Q. Does the absence of a tax reserve under FIN 48 mean that PSE has reached a**
5 **final determination with the IRS?**

6 A. No.

7 **Q. Does the absence of a tax reserve under FIN 48 mean that PSE will prevail**
8 **on the issue with the IRS?**

9 A. No.

10 **Q. What does FIN 48 require?**

11 A. FIN 48 requires the use of a two-step approach for recognizing and measuring tax
12 positions taken or to be taken in a tax return. First, a tax position must have at
13 least a more likely than not chance of being sustained based on the technical
14 merits, if challenged by the taxing authorities and taken by management to the
15 court of last resort. Second, a tax position that meets the recognition threshold
16 should be measured at the largest amount that has a greater than 50.0% likelihood
17 of being sustained.

1 Tax positions that meet this threshold can be recorded in the financial statements
2 and no "FIN 48" reserve is required. Tax positions that fail to meet this threshold
3 require a reserve.

4 **Q. How does the FIN 48 standard compare with other accounting standards**
5 **used for recognizing non-tax assets and liabilities?**

6 A. The FIN 48 standard varies significantly relative to the accounting standards for
7 recognizing and measuring non-tax assets and liabilities. For example, to record
8 an asset that is unrelated to income taxes requires a much higher level of
9 certainty. The guidance generally uses the term "highly probable," which is
10 interpreted to mean that the event being recorded is believed to have an 80% to
11 90% certainty of occurring. This language is not used in FIN 48 as it requires the
12 more likely than not standard which is 51%.

13 The accounting guidance to record a liability that is unrelated to income taxes, by
14 contrast, is much more lenient, requiring only awareness of the claim and the
15 ability to estimate it.

16 **Q. What does the absence of a reserve under FIN 48 mean?**

17 A. It means that management believes that PSE's tax positions pass the recognition
18 and measurement standards of FIN 48. PSE only includes tax positions in it
19 federal income tax return which it believes to be correct. PSE does not include
20 speculative adjustments in its tax return. The tax return includes only items that

1 management believes to be legitimate, accurate tax deductions. With respect to
2 PSE's experience with the Simplified Service Cost Method change, management
3 believed that its position was correct and fought the IRS in appeals. PSE's
4 position was partially upheld, but the IRS prevailed when they changed the rules.

5 PSE is prepared to defend its tax returns. There is no certainty, however, that
6 PSE will prevail. The tax laws, regulation, and court cases are an extremely
7 complex and convoluted body of law. Reasonable people can reach different
8 conclusions based on the same facts. With the Simplified Service Cost Method
9 change, although management was successful in appeals, the issue was lost when
10 the IRS changed the rules and required taxpayers, like PSE, to return to their prior
11 method of calculating overhead costs. Disputes with the IRS can take years to
12 resolve.

13 **Q. Will the deferred tax balances reported in 2010 be lower in the rate year?**

14 A. Almost certainly, they will. The IRS audit is likely to be completed in 2012. It
15 would be extremely uncharacteristic for the IRS to conclude that the deductions
16 PSE claimed for its repairs and retirement method changes should be larger.
17 Thus, the IRS will probably calculate a smaller deduction—how they made their
18 calculation is likely to be a point of considerable contention. The outcome of the
19 audit, however, is unknown at this time. As a result, the deferred tax liability
20 associated with the repairs and retirement method change is not known and
21 measurable.

1 **Q. Has the IRS issued any additional guidance on the repairs method change?**

2 A. Yes. In August 2011 (subsequent to PSE's filing this case), the IRS issued
3 Revenue Procedure 2011-43. In Revenue Procedure 2011-43, the IRS describes
4 the "safe harbor" provisions for the repairs deduction for electric transmission and
5 electric distribution property. Taxpayers who follow the safe harbor have some
6 assurance that their accounting method will be upheld upon IRS audit.

7 **Q. Does PSE's repair method change comply with the safe harbor in Revenue**
8 **Procedure 2011-43?**

9 A. No. PSE's accounting method does not comply with the safe harbor in Revenue
10 Procedure 2011-43. First, the safe harbor covers only electric transmission and
11 distribution. PSE's accounting method covers not only electric transmission and
12 distribution but also electric generation and gas distribution. Second, the safe
13 harbor method uses units of property that are smaller than those adopted by PSE
14 which would lower the benefit received. Third, the safe harbor method employs a
15 number of other computational differences which will produce a different result
16 when compared to PSE's repairs methodology.

17 **Q. Does PSE plan to follow the safe harbor?**

18 A. Generally speaking, PSE prefers to follow the IRS safe harbors. Doing so adds a
19 level of certainty to PSE's tax positions. Failing to meet a safe harbor, however,
20 does not automatically mean that a taxpayer's position will be reversed in audit.

1 **Q. What effect will Revenue Procedure 2011-43 have on PSE's repairs method**
2 **change?**

3 A. The impact of Revenue Procedure 2011-43 is not known at this time. For PSE to
4 take advantage of the safe harbor provision, PSE will need to recalculate the
5 entire repairs and retirement method changes for electric transmission and
6 distribution. This evaluation will be undertaken in 2012.

7 **Q. Do any of PSE's other deferred taxes balances fail the "known and**
8 **measurable" standard?**

9 A. No. PSE considers all of its other deferred tax balance to meet the known and
10 measurable standard. In PSE's opinion, the only deferred tax balances that fail
11 that standard relate to the repairs and retirement method changes, due to their
12 being based on an unaudited accounting method change with the IRS and the
13 unique nature of the calculation. As a result, all of PSE other deferred tax balance
14 are reflected in ratemaking, consistent with historical practices.

15 **Q. Is PSE's reliance on Order 11 misplaced?**

16 A. No. PSE's reliance on Order 11 is not misplaced. The IRS audit has not been
17 completed. There is new guidance which only addresses electric transmission and
18 distribution, and PSE's methodology is outside the safe harbor provisions of that
19 guidance. PacifiCorp's Order 06 distinguished PacifiCorp from PSE and did not
20 overrule Order 11. PSE is still awaiting a final determination with the IRS. As a

1 result, PSE is in the same position it was in when Order 11 was issued—the only
2 difference being that more dollars are at stake and if anything, the risk is higher
3 now than when Order 11 was issued.

4 **Q. What is the basis for Public Counsel's objection to PSE's treatment of the**
5 **repairs and retirement method changes?**

6 A. Public Counsel "understands the reluctance of the Commission to reflect the
7 change in the Company's last rate case". Exhibit No. ___(ACC-1T) at page 30,
8 lines 17-18. However, Public Counsel believes that this reluctance has been
9 overcome by the fact that PSE has placed the repairs estimate in three tax returns.
10 The use of an estimate three times does not make it known and measurable. In
11 addition, Public Counsel, like Commission Staff, cites PacifiCorp Order 06. Like
12 Commission Staff, Public Counsel fails to appreciate that the Commission
13 distinguishes PSE from PacifiCorp and reiterates the fact that PSE's repairs
14 deduction will not be known until PSE has a "final disposition with the IRS".

15 **Q. How should the Commission rule on the treatment of repairs and retirement**
16 **method changes?**

17 A. PSE's full expectation is that the Commission will rule consistent with Order 11
18 and Order 06 and state that the PSE does not have a final agreement with the IRS
19 and that the amount of the repairs and retirement method changes are based on a
20 myriad of assumptions and estimates that have not been approved by the IRS and
21 are not known and measurable. The Simplified Service Cost Method experience

1 is a prime example of how this has played out in the past. Only when the
2 amounts become known and measurable following the completion of the IRS
3 audit should PSE include the deferred tax liability in rate base.

4 Commission Staff's and Public Counsel's adjustments should be rejected as
5 inappropriate.

6 IV. ACCOUNTING FOR TAX NET OPERATING LOSSES

7 A. Response to Commission Staff Analysis

8 **Q. Does Commission Staff propose any adjustment to PSE accounting for tax**
9 **net operating losses?**

10 A. No. Commission Staff accepts PSE's accounting for tax net operating losses.
11 Commission Staff, however, cites an example of the accounting treatment
12 proposed by a "general consensus" at the National Association of Regulatory
13 Utility Commissioners ("NARUC") meeting in October 2011. Based on
14 Commission Staff's description of the accounting, PSE thought it would be
15 helpful to clarify its accounting treatment.

16 When PSE records a tax net operating loss, the entry is a debit to FERC
17 account 190 (accumulated deferred income tax on the balance sheet) and to credit
18 FERC account 411 (deferred tax expense on the income statement). In this way,
19 customers bear only the burden of deferred taxes in cost of service for which a tax
20 benefit has been claimed.

Based on PSE's limited understanding of the "general consensus," PSE's accounting for tax net operating losses would likely be consistent with NARUC's approach.

B. Response to Public Counsel's Analysis

Q. Please explain Public Counsel's request to adjust income tax expense for the tax net operating loss?

A. Public Counsel fails to understand how tax expense is actually recorded. As a result, Public Counsel's testimony is contrary to the discussion of tax net operating losses in PSE's and Commission Staff's testimony.

For PSE to record a tax net operating loss, the FERC account 190 Net Operating Loss must be debited. The offset to the debit is a credit to FERC account 411, Income Tax Expense. A credit to tax expense *lowers* the tax expense which is reflected in cost of service. So, the adjustment Public Counsel seeks from the Commission has already been reflected by the very fact that a tax net operating loss has been recorded on PSE's books. *See* Exhibit No. ___(ACC-1T) at page 27, lines 14-17.

Q. Does the current tax methodology used for ratemaking purposes *not* consider when taxes are actually paid by PSE?

A. Public Counsel is incorrect in its claim that "the current tax methodology used for ratemaking purposes does not consider when taxes are actually paid by the

1 Company". Exhibit No. ___(ACC-1T) at page 27, lines 18-19. The tax expense
2 or benefit reflected in ratemaking includes current and deferred taxes. Current
3 taxes generally capture the amount payable or receivable from the IRS, while the
4 deferred taxes represent the amount of benefit or cost delayed into future tax
5 periods. In other words, current ratemaking does consider when taxes are actually
6 paid because it captures current and deferred taxes.

7 **Q. Should PSE's deferred tax related to the net operating loss offset PSE's**
8 **deferred taxes on plant related rate base?**

9 A. Yes. Again, Public Counsel's testimony is contrary to the testimony presented by
10 PSE and Commission Staff. For example, Commission Staff states that the
11 Company "has made a reasonable presentation that its NOLs related to the
12 Company's claiming bonus tax depreciation in 2009 and 2010." Exhibit
13 No. ___(RCS-1CT) at page 25, lines 7-9. In addition, if PSE were to account for
14 the net operating losses in a different matter, it would run afoul of the
15 normalization provisions of IRC §1.167(l)-1(h). The normalization provisions
16 govern the recording of deferred taxes on plant related item. Included in the
17 normalization provisions are requirements around net operating losses that are
18 caused by deductions associated with plant related items. In PSE's case, that
19 would include the deferred taxes associated with bonus depreciation.

20 Public Counsel's proposed adjustment would be illogical and contrary to the
21 normalization provisions of the IRC, and the Commission should reject it.

1
2
V. DEBIT BALANCE IN ACCOUNT 236, ACCRUED FEDERAL INCOME TAXES PAYABLE

3 **Q. Please describe Commission Staff's proposed adjustment to the debit balance**
4 **in Account 236?**

5 A. Commission Staff proposes to remove the debit balance from Account 236,
6 Accrued Federal Income Taxes Payable.[1] Commission Staff concludes that it is
7 unusual to have a large debit balance in that account and that the large debit
8 balance no longer exists.

9 **Q. Please explain why there is a large debit balance in Account 236 at the end of**
10 **the test year.**

11 A. There is a large debit balance in Account 236 at the end of the test year because
12 PSE was expecting a large cash refund from the IRS as a result of the tax losses
13 PSE sustained in its 2009 tax return. Part of that loss was carried back two years
14 for a refund. The remainder was carried forward and resulted in the tax net
15 operating loss carryforward. The portion of the 2009 tax loss that was refunded
16 was recorded to Account 236 as a debit balance, essentially reversing the prior
17 accumulation of taxes payable which were originally recorded to Account 236.
18 The debit in Account 236 is essentially a receivable from the IRS which is
19 removed once the cash has been received.

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[1] The term "Account 236" is used in this testimony to refer exclusively to Federal Income Taxes Payable. FERC Account 236 is a broader tax payable heading which includes a number of other tax payable accounts which are not at issue here.

1 **Q. Has PSE collected the cash refund from the IRS to which the debit balance**
2 **relates?**

3 A. Yes. In January 2011, PSE received a cash refund.

4 **Q. How should the debit balance be treated for ratemaking purposes?**

5 A. Account 236 is included in working capital. Cash is also included in working
6 capital. So whether the refund is included in Account 236 or in some other
7 balance sheet account, it should be included in working capital.

8 Many of the accounts in working capital fluctuate significantly month over
9 month, yet remain part of the working capital analysis. The same should be true
10 for Account 236.

11 **Q. Please explain Commission Staff's concern expressed in Commission Staff's**
12 **Response to PSE Data Request No. 003.**

13 A. In Commission Staff's Response to PSE Data Request No. 003, a copy of which
14 is provided as Exhibit No. ___(MRM-17), Commission Staff explains its
15 expectation of the offsetting debit to its credit entry to Account 236. Commission
16 Staff apparently believes that the credit would be posted to Temporary Cash
17 Investments (Account 136).

18 This highlights Commission Staff's misunderstanding, which PSE tried to correct
19 on the conference call to which he makes reference. Temporary Cash
20 Investments are included in non-operating. However, that is not where the offset

1 to Account 236 would have been posted. It would have been posted to cash
2 (FERC Account 131). From there, it was reinvested back into the utility, as
3 happens with any cash received—it would have been spent on needs of the
4 business: O&M, capital projects, interest payments, etc. all of which are reflected
5 in utility operations in some manner. No matter what the use, one would expect it
6 to have a similar impact on working capital relative to the impact of the debit
7 balance in Account 236.

8 **Q. In Commission Staff's Response to PSE Data Request No. 003, reproduced in**
9 **Exhibit No. ___(MRM-17), Commission Staff complains that PSE has not yet**
10 **provided Commission Staff with the complete details of the journal entry.**
11 **Please explain.**

12 A. First, PSE provided Commission Staff with everything requested. Second, the
13 balance in Account 236 is composed of many entries occurring over the course of
14 the test year, not just one entry as implied. Third, in order to ensure that PSE was
15 responsive to Commission Staff's needs, PSE held a conference call with
16 Commission Staff's witness on November 22, 2011. It is unclear what additional
17 details Commission Staff would like PSE to produce.

18 **Q. Is it *uncommon* for PSE to have a large debit balance in Account 236?**

19 A. No, it is not. Account 236 may end up with a debit balance whenever PSE has a
20 tax overpayment or is expecting a cash refund, whenever it is recovering a tax
21 that was originally posted to Account 236. A brief review of the ending balance

1 from SAP in Account 236 from 2006 – 2010 shows the following year-end
2 balances: $20.1 million debit, $37.9 million debit, $15.7 million debit, $98.1
3 million debit, and $60.7 million debit. From this data, PSE would conclude that it
4 is not uncommon for PSE to report a debit balance in Account 236.

5 It should be noted that Commission Staff never asked PSE whether or not it was
6 common for Account 236 to have a debit balance. Instead, Commission Staff
7 simply stated that it was "not common" in its testimony.

8 As Commission Staff has already acknowledged that net operating losses are an
9 offset against deferred taxes in rate base, and this is part of that net operating loss
10 calculation, PSE would request that the Commission reject Commission Staff's
11 proposed adjustment to Account 236.

12 **Q. Does Commission Staff propose any changes to PSE's current income tax**
13 **expense?**

14 A. Yes. Commission Staff proposes to reclassify all of PSE's current tax expense to
15 deferred tax expense.

16 **Q. Is this adjustment appropriate?**

17 A. No. FERC Account 409, Income Taxes, receives debit and credit entries
18 depending on whether a company is in a tax refund or tax payable situation. The
19 Uniform System of Accounts, which PSE must follow, provides instructions for
20 both positive and negative balances to be recorded in this account. In setting rates

1 in a general rate proceeding, only a subset of PSE's activity is evaluated, not the
2 entire book income or taxable income. In addition, certain adjustments are made
3 for setting rates. For example in this proceeding, PSE proposed approximately
4 eighteen modifications to the SAP balances in the test year. *See* Exhibit
5 No. ___(JHS-4) for a complete list. To the extent that any of these modification
6 impact income taxes, that income tax impact is reflected in current income tax
7 expense/benefit. The impact is appropriately recorded to current income tax
8 expense or benefit (as compared to deferred income tax expense or benefit)
9 because it is unknown whether PSE will report taxable income or loss when it
10 files a tax return with *all* items of income and expense in the rate year. It is a
11 little perplexing that Commission Staff would have the Commission get involved
12 in the detail of specifying how tax-related journal entries should be recorded on
13 the Company's books.

14 As a result, PSE requests that the Commission not have the Company reclassify
15 its current income tax expense to deferred income tax expense in this proceeding.

16 VI. PROPERTY TAXES

17 **Q. Please summarize Commission Staff's testimony with respect to property**
18 **taxes.**

19 A. Commission Staff's testimony states as follows with respect to property taxes:

> 20 PSE seeks to recover property tax expenses by estimating the
> 21 amount it expects to pay for property owned *at the end* of the test
> 22 year. I recommend that the Commission reject this request and

instead allow the Company to recover the actual amount of property tax payable for property owned by PSE *at the start of* the test year.

Exhibit No. ___(RTA-1T) at page 12, lines 16-20.

This statement captures the essence of Commission's Staff's position versus that of PSE.

Q. Did the Commission rule on this topic in PSE's last general rate proceeding?

A. Yes, it did. The Commission's order, however, did not address the taxation of property acquired after the lien date (i.e., the property acquired on January 1 through December 31 of the test year). As a result, PSE has raised it in this case.

Q. How does Commission Staff justify its adjustment to property taxes?

A. Commission Staff states that its proposed adjustment "matches revenue requirement with the actual cash outlays PSE must make as a result of owning and operating its property during the test year." Exhibit No. ___(RTA-1T) at page 14, lines 8-10. Commission Staff further claims that "no additional revenue than what is provided in [his] adjustment is necessary to support the Company's property tax obligations during the test year." *Id*. at page 14, lines 12-14.

Q. Is Commission Staff's justification adequate or accurate?

A. No. Commission Staff provides no explanation of why a cash basis for property taxes is appropriate for setting rates.

Q. Is the cash basis the proper basis for determining property taxes?

A. No. PSE reports its revenues and expenses (including property taxes) on the accrual method of accounting, as required by GAAP and FERC. *See* FERC's General Instruction 11 of the Uniform System of Accounts. In fact, the accrual basis is used to record many items, including but not limited to accounts payable, customer revenues, bad debt expense, and payroll. Other than allowing cash payments for pension costs because the Commission does not accept the accounting standards pension estimation methodology, the cash basis accounting is not a relevant standard that either PSE or this Commission has adopted in setting general rates. It should be noted that over time the accounting standard methodology and the cash payments for pensions will equal each other as long as one method is used consistently in setting rates. This is not true of Commission Staff's property tax proposal.

Q. Does Commission Staff's adjustment place PSE on cash method?

A. No. The property tax expense used by Commission Staff is NOT the actual tax paid in the test year. In fact, not one dollar of the tax calculated by Commission Staff was paid in the test year. Commission Staff has completely failed to apply its own cash-basis standard.

Q. What does Commission Staff's adjustment do?

A. Commission Staff claims that Exhibit No. ___(MRM-13) represents that actual cash paid during the test year, which it does not. Exhibit No. ___(MRM-13) represents the amount of cash that will be paid during 2011 (not the test year) for the assets owned *at the end of 2009*. This can be clearly seen by examining the "Tax Cycle Year 2010" in Exhibit No. ___(MRM-11). The actual tax payments made in the test year covered the 2009 tax cycle and relate to the property PSE owned as of the January 1, 2009, lien date. Those taxes are not relevant to items of income and expense in the 2010 test year.

Q. Has PSE identified other problems with Commission Staff's adjustment?

A. Yes. Given that Commission Staff's adjustment fails to determine the "actual cash outlays" for the test year, the adjustment cannot possibly satisfy its own definition of the matching principle in which Commission Staff attempts to match the "actual cash outlays" with the revenue requirement.

More importantly, Commission Staff's characterization of the matching principle is erroneous for other reasons. The matching principle is not an attempt to match the cash outlays with revenues. It stands for the proposition of matching *expenses* with the *revenues* that they generate. If PSE earns revenue based on the plant it owns, its property taxes expense should be based on those same assets—it should not exclude assets acquired during the test year because they are new, as

1 Commission Staff proposes. Those assets will generate property tax in the rate
2 year that should match up with the revenue they generate.

3 **Q. How does Commission Staff address the fact that Exhibit No. ___(MRM-13)**
4 **is an estimate of property tax expense?**

5 A. Commission Staff does not challenge the statement or attempt to refute it.

6 **Q. Are the amounts shown in Exhibit No. ___(MRM-13) known and**
7 **measurable?**

8 A. No. The amounts shown in Exhibit No. ___(MRM-13) are known and
9 measurable for calendar year 2009 and not the test year—2010. As stated above,
10 Exhibit No. ___(MRM-13) represents an *estimate* of the property taxes associated
11 with the 2010 test year.

12 There is no way around the fact that property taxes are going to be estimated.
13 The only question is which estimate the Commission should use. PSE is
14 proposing a better estimate (see Exhibit No. ___(MRM-12)) and one that has
15 been used by this Commission in setting rates for years prior to PSE's 2009
16 general rate case.

17 Exhibit No. ___(MRM-13) does not include tax on all of the assets that PSE owns
18 in the test year; therefore, it is an estimate and a bad one. Commission Staff
19 ignores the matching principle associated with the assets that are in rate base
20 being matched with the costs that they generate.

1 Commission Staff ignores the fact that PSE's adjustment for property taxes is
2 described as a "pro forma and restating adjustment". This means that it is a future
3 looking adjustment in that it matches the costs associated with the assets included
4 in this proceeding.

5 **Q. How has the Commission historically ruled on the issue of property taxes?**

6 A. Until PSE's last general rate case, the Commission and Commission Staff had
7 always supported PSE's adjustment methodology for property taxes. That
8 adjustment was calculated following the same methodology as Exhibit
9 No. ___(MRM-12).

10 **Q. What is the practical result of Commission Staff's adjustment?**

11 A. The practical result of Commission Staff's adjustment is that 7.5 percent of PSE's
12 property will be free of property taxes for ratemaking purposes. This is the
13 property that PSE acquired during the test year. Unfortunately, the State
14 Department of Revenue will not be so generous as to forego this assessment, and
15 contrary to Commission Staff's adjustment, PSE will pay property taxes on
16 100 percent of the property owned *during* 2010.

17 This is inappropriate and would grant rate payers an unacceptable subsidy by
18 relieving them of an expenditure that they have an obligation to cover through
19 general rates.

Q. Please compare the property tax calculation with the repairs and retirement method changes.

A. It makes for an interesting comparison because Commission Staff is proposing incongruent arguments for these two items.

First, as mentioned earlier, the repairs and retirement method changes are extremely complex calculations requiring hundreds of assumptions and estimates. This is a dramatic contrast to the property tax calculation, which is composed of only three variables, two of those are already known with only the levy rate estimated.

Commission Staff claims that the repairs and retirements method change is known and measurable simply because it is recorded in PSE's books and records (regardless of the estimates involved) while at the same time Commission Staff claim that property taxes are not known and measureable regardless of being recorded in PSE's books and records because there are estimates involved.

Second, PSE has no FIN 48 reserve for repairs and retirements. Therefore, Commission Staff concludes that the amount is known and measurable. PSE, however, has no FIN 48 reserve for its income tax deduction for property taxes – yet Commission Staff concludes that it is not known and measureable. If FIN 48 is the standard (which it should not be), the Commission Staff has failed.

1 Finally, the repairs and retirement method changes will require an IRS audit to
2 achieve certainty (as seen with the Simplified Service Cost Method change). By
3 contrast, the simple property tax calculation is revealed over a 16 month period
4 and is always being updated. Yet, Commission Staff claims the repairs and
5 retirement method changes are known and measurable while the simple property
6 tax calculation is not known and measureable.

7 **Q. What is PSE's suggestion to the Commission?**

8 A. The Commission should accept PSE's property tax adjustment as presented in
9 Exhibit No. ___(MRM-12) because PSE's proposal is principled, consistently
10 applied, and satisfies the matching principle.

11 **Q. How are municipal taxes recovered in rates?**

12 A. They are recovered under their own tariff.

13 **Q. Could property taxes be handled in a similar fashion?**

14 A. Yes. If the Commission is concerned that the Company may "over collect" on its
15 property taxes, a similar type of rate treatment could be used for property taxes as
16 is used for municipal taxes. The Commission could accept the Company's
17 methodology, which properly matches benefits, and costs but order the Company
18 to move these taxes to a separate tariff in its next general rate case. In this way,
19 the Company can ensure that the property tax expense is borne by the customers
20 who benefit from the property.

VII. LSR PHASE 1

A. Ten-Year Amortization Period.

Q. What amortization period did PSE assume for the Section 1603 Treasury Grants for LSR Phase 1?

A. PSE assumed a 10-year amortization period, which is consistent with the period used for the Section 1603 Treasury Grants that PSE received for the Wind Horse Expansion Project.

When PSE receives the Section 1603 Treasury Grant for LSR Phase 1, it will update Schedule 95A. At that time, PSE will provide all of the support and documentation necessary to substantiate the revision to the tariff.

B. Normalization of the Treasury Grants.

Q. Please provide some background on the normalization requirements of the Section 1603 Treasury Grants.

A. The American Recovery and Reinvestment Act of 2009 (the "ARRA" or the "Stimulus") was passed in February 2009. Section 1603 of the Stimulus allows a Treasury Grant of 30% of the eligible cost of a qualifying renewable investment. For example, a wind farm would be a qualifying investment. Congress's intent in enacting section 1603 was to stimulate investment in renewable energy. However, in drafting the new law, Congress instructed the U.S. Treasury to

1 "apply rules similar to the rules of section 50 of the Internal Revenue Code".
2 ARRA §1603(f).

3 Section 50 of the IRC can be described as a "catch-all". It provides numerous
4 administrative provisions on the taxation of the investment tax credit ("ITC"),
5 including such things as recapture provisions and required tax basis adjustments.
6 PSE identified one such provision as being potentially problematic: IRC
7 section 50(d)(2), which invoked the ITC normalization provisions. Generally, the
8 ITC normalization provisions decrease the value of benefit that can be passed on
9 to customers by restricting the ratemaking treatment of the unamortized balance
10 of the ITC.

11 At the time, PSE believed that Congress's invocation of the ITC normalization
12 rules was an unintended consequence of its citation to Section 50 and antithetical
13 to concept of a stimulus plan. The ITC normalization rules would have the effect
14 of significantly reducing the value of the Section 1603 Treasury Grants to PSE's
15 customers by restricting the regulatory treatment of the unamortized balance of
16 such grants.

17 In May 2009, PSE and its representative met with tax normalization teams from
18 the IRS and U.S. Treasury to explain why tax normalization would be

1 inappropriate for section 1603 Treasury Grants. This meeting was held prior to
2 the issuance of the Treasury Guidance[2] which ultimately occurred in July 2009.

3 Unfortunately, when the Treasury issued the Guidance in July, it expressly
4 required ITC-style normalization of the Section 1603 Treasury Grants, contrary to
5 PSE's wishes but well within Treasury's authority. *See* Part VIII (F) of the
6 Treasury Guidance.

7 PSE continued to believe that normalizing Section 1603 Treasury Grants was
8 inappropriate and not beneficial to customers. So, PSE began a legislative effort
9 to expressly prevent the normalization of Section 1603 Treasury Grants.

10 **Q. Did PSE's efforts yield any results?**

11 A. Yes. PSE's efforts were absolutely successful, even if it took a full thirty-three
12 months from the time the Stimulus was enacted. Various members of Congress
13 supported PSE's position and introduced corrections into twelve separate pieces
14 of legislation. On December 31, 2011, PSE's correction was signed into law as
15 Section 1096 of the National Defense Authorization Act of 2012.

16 Legislative victories of this magnitude do not "just happen". They are the result
17 of the persistent, tireless effort of numerous dedicated individuals within PSE. In
18 addition, such efforts are not without monetary costs. The cost of this effort was

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[2] Officially titled as follows: Payments for Specified Energy Property in Lieu of Tax Credits under the American Recovery and Reinvestment Act of 2009, US Treasury Department, Office of the Fiscal Assistant Secretary, July 2009/Revised March 2010/Revised April 2011.

1 significant and extended beyond the dollars involved in the effort. Indeed, PSE's
2 federal legislative team mustered a coalition of Washington State elected officials
3 from both sides of the aisle to work collaboratively to support PSE's customers.

4 This was a situation were PSE saw Congress and the U.S. Treasury invoking the
5 normalization provision in a situation where normalization did not belong. PSE
6 selflessly rose to the challenge and ultimately got the correction across the finish
7 line. Congress finally arrived at the right answer, the same answer that PSE
8 explained to U.S. Treasury and IRS officials at the May 2009 meeting.

9 **Q. What does this mean?**

10 A. It means that Section 1603 Treasury Grants become a much more valuable
11 reduction to customer rates. Technically, this change will allow PSE to reduce
12 the rate base calculation by the unamortized portion of the Section 1603 Treasury
13 Grants. Prior to the law change, the normalization rules prevented this treatment.
14 Now customers will enjoy not only the amortization but a rate base offset
15 associated with the unamortized balance.

16 **Q. How will customers receive this benefit that PSE just won?**

17 A. This benefit will completely flow to customers. Section 1603 Treasury Grants are
18 not part of general rates and, consequently, not part of this general rate case.
19 They are rightly reflected in a tracker, as the balance of the benefit changes over
20 time. The Commission has already approved this treatment. The Section 1603

1 Treasury Grants and the newly won rate base offset will be reflected in Tariff
2 95A, when that Tariff is next updated.

3 **C. Property Taxes on LSR Phase 1**

4 **Q. Has PSE reviewed Commission Staff's pro forma adjustment for LSR**
5 **Phase 1?**

6 A. Yes. In its pro forma adjustment for LSR Phase 1, Commission Staff prevents
7 PSE from recovering the property taxes on LSR Phase 1. Commission Staff
8 believes that PSE should be on the cash basis for property taxes. Importantly,
9 Commission Staff does not dispute that LSR Phase 1 will be subject to property
10 taxes.

11 **Q. Does Commission Staff propose the cash basis of accounting for other items**
12 **in the pro forma adjustment for LSR Phase 1?**

13 A. No. For example, Commission Staff would allow the recovery of contractual
14 obligations that have not yet been paid or accrued. Further, Commission Staff
15 would allow the recovery of depreciation expense, which just so happens to be a
16 significant estimate based on the estimated life of an asset, its removal cost, and
17 its salvage value – hardly a known and measurable amount. The property tax
18 calculation for LSR Phase 1 is simple by comparison and requires no estimate of
19 removal costs, which may or may not occur decades in the future.

1 Commission Staff signals out property taxes for its misguided application of cash
2 basis accounting. In doing so, Commission Staff prevents PSE from recovering a
3 known cost. If a pro forma adjustment is allowed for LSR Phase 1, it must reflect
4 the costs associated with the assets included in rate base. Failure to do so will
5 violate the matching principle. Mr. Martin also compounds this by ignoring that
6 property taxes are allowed to be deferred under RCW 80.80.060. The legislature
7 specifically allows taxes related to renewable projects to be deferred.

8 **Q. Does PSE have an alternative proposal?**

9 A. Yes. If the Commission were to direct PSE to establish a property tax tracker, the
10 property taxes on LSR Phase 1 would become part of that analysis and could be
11 removed from the LSR Phase 1 pro forma adjustment.

12 **VIII. CONCLUSION**

13 **Q. Does this conclude your prefiled rebuttal testimony?**

14 A. Yes.