

**BEFORE THE WASHINGTON UTILITIES
AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**Docket No. UE-090704
Docket No. UG-090705**

**INITIAL BRIEF ON BEHALF OF
THE FEDERAL EXECUTIVE AGENCIES (REDACTED)**

FEBRUARY 19, 2010

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I. Introduction

On June 22, 2009, this Commission granted the Federal Executive Agencies' ("FEA") petition to become a party to this proceeding. FEA has reviewed the Puget Sound Energy's ("PSE," "Puget" or "Company") testimony, exhibits, and workpapers, issued information requests, and analyzed the Company's responses to them. FEA reviewed and analyzed data (1) to obtain an understanding of PSE's rate filing package as it relates to the selected issues in the Company's proposed rate increase and (2) to formulate an opinion concerning the reasonableness of the Company's proposals on those selected issues.

FEA's analysis focused on the following areas:

1) Wild Horse Expansion Project

a. PSE's inadvertent omission of a test year amount for plant held for future use in computing its proposed pro forma adjustment.

b. PSE's failure to account for and reduce rate base for Accumulated Deferred Income Taxes ("ADIT") related to 2009 bonus tax depreciation that is expected to be generated by the Wild Horse expansion project if the commercial operation date for this projects falls in 2009.

2) American Recovery and Reinvestment Act ("ARRA"), which has introduced additional tax benefits that may be claimed in lieu of the Production Tax Credits.

3) A significant change in tax accounting that PSE applied for and the Internal Revenue Service (“IRS”) granted, which is expected to significantly increase ADIT and should therefore reduce rate base.

4) Pension Expense. PSE’s request for pension expense in two components: First, PSE requests an increased cost for its defined benefit pension cost, which is part of its qualified pension plan. Second, PSE requests expense for a Supplemental Executive Retirement Plan.

II. FEA Recommendations

1. Wild Horse Expansion Project

The Company’s Wild Horse Expansion Project is a 44 MW expansion of the existing 228.6 MW Wild Horse Wind Generating Facility located in Kittitas County, WA. The expansion will install an additional 22 Vestas V80, 2.0 MW wind turbines. PSE confirmed that the project was placed in service on November 9, 2009,¹ and had included the extra wind capacity in its application.²

a. PSE Adjustment for the Wild Hose Expansion Project Should Reflect the Impact of Plant Held For Future Use in computing its proposed pro forma adjustment

¹ PSE Exhibit No. MRM-4T, page 26; and Tr. Vol. VII, p. 470 (Marcelia/PSE).

² PSE Exhibit No. JHS-1T, pp. 19-20.

FEA's recommended that PSE's rate base adjustment for the Wild Horse expansion project should be reduced by \$1,345,461 to account for the test year amount that PSE inadvertently had failed to account for in its proposed pro forma adjustment.³

The Company has corrected this error and incorporated FEA's adjustment in its rebuttal testimony and exhibit.⁴ Consequently, no additional adjustment for this correction is necessary.

b. Rate Base Shall be Reduced for the 2009 Bonus Tax Depreciation Impact on Accumulated Deferred Income Taxes, Related to Placing the Wild Horse Expansion Project into Service in 2009.

FEA recommended that if the Wild Horse expansion project were to become commercially operational in 2009, PSE's rate base should be reduced for approximately \$10.804 million of Accumulated Deferred Income Taxes ("ADIT") related to 2009 bonus tax depreciation that is expected to be generated by the Wild Horse expansion project.⁵ As Company witness Marcelia testified, the Wild Horse expansion project was placed in service on November 9, 2009.⁶ Therefore, the Company agreed with FEA's recommendation and has reflected the \$10.804 million reduction to rate base associated

³ Id.

⁴ PSE Exhibit No. JHS-16, John H. Story, Second Rebuttal Exhibit, Results of Operations, p. 14 of 46, (Page 16.07).

⁵ FEA Exhibit No. RCS-1T, pp. 7-8.

⁶ Exhibit MRM-4T, p. 26 and Tr. Vol. VII at 470:15-18 (Marcelia).

with the bonus depreciation for the Wild Horse Project in its rebuttal testimony.⁷

Consequently, no additional adjustment is necessary.

2. PSE has adequately explained how it has addressed the impacts of the American Recovery and Reinvestment Act (“ARRA”)

The American Jobs Creation Act of 2004 enacted §199 of the Internal Revenue Code, to provide for a new tax deduction, phased in through 2009, related to income attributable to Domestic Production Activities. The §199 deduction is an “add on” deduction, as it does not require additional economic expenditures or outlays by the taxpayer; it therefore has the effect of a tax credit or tax reduction.⁸ Because of this feature, the §199 deduction is sometimes referred to as the Production Tax Credit.⁹

PSE has availed itself of this tax benefit, which PSE refers to as Production Tax Credits (“PTC”). PSE recognizes that the Wild Horse expansion project is expected to produce PTCs. However, in its original filing in this proceeding, PSE had not reflected such PTCs in computing its retail electric revenue requirement deficiency of \$148.148 million.¹⁰ PSE’s response to FEA data request 1.34(e) states that: “PTCs are passed

⁷ PSE Exhibit No.MRM-4T, p.26 and PSE Exhibit No.JHS-16, p. 14 of 46, (Page 16.07), Exhibit No. JHS-4 p. 4.07, and Tr. Vol. VII, pages 471-473 (Marcelia/PSE).

⁸ For accounting purposes, the benefit of the §199 deduction will be presented in financial statements as a special charge, similar to the treatment of a tax credit. *See, e.g.*, FASB Staff Position No. FAS 109-1.

⁹ FEA Exhibit No. RCS-1T, pp. 8-9.

¹⁰ PSE Exhibit No. JHS-1T, p. 2: “This increase does not reflect an additional production tax credit (“PTC”) associated with the wind turbines being constructed at the Wild Horse Wind Project.”

through to customers under Schedule 95A and are not included in general rate case filings.”¹¹

The ARRA has introduced other tax options that may be more beneficial to some taxpayers than the Production Tax Credits. In response to FEA data request 1.34(e) and (f), PSE has indicated that the ARRA introduced additional benefits that may be claimed in lieu of the PTC, namely, the possibility to elect investment tax credit (“ITC”) or cash grants from the U.S. Treasury. PSE indicated in Exhibit No. MRM-12 that it would update its Wild Horse expansion project analysis to identify which option (PTC, ITC or cash grants) is most beneficial to ratepayers. In its direct testimony, FEA recommended that various options for tax benefits under the ARRA be reviewed from the perspective of minimizing the cost of the Wild Horse expansion project to ratepayers. This should include a review of PSE’s analysis of such tax benefits, as described in the Company’s response to FEA data request 1.34(f).¹²

According to the Company witness Marcellia during hearings, PSE has completed its evaluation as to which is most beneficial to ratepayers. PSE filed for a treasury grant on December 22, 2009. The Commission issued an order in Docket UE-091570¹³ on December 10, 2009 articulating that the benefit would be passed back to customers through Production Tax Credit (PTC) Tracker (Schedule 95A). The Company also stated

¹¹ FEA Exhibit No. RCS-1T, p.10.

¹² FEA Exhibit No. RCS-1T, pp.10-11.

¹³ The Petition of Puget Sound Energy, Inc., for an Accounting Order Regarding the Treatment of U. S. Treasury Grant to be Received Under Section 1603 of the ARRA, WUTC Docket UE-091570, Order 01, December 2009.

it provided analysis and calculations supporting its position in that docket.¹⁴ FEA is satisfied with the Company's explanation of this issue and it is therefore not advocating an adjustment for this matter in PSE's base rate case.

3. Rate Base Should Be Reduced for the Impact on Accumulated Deferred Income Taxes related to a Major Tax Accounting Change

PSE applied for a significant change in tax accounting during the 2008 test year that the Internal Revenue Service ("IRS") granted,¹⁵ which is expected to significantly increase ADIT and should therefore reduce rate base.¹⁶

On December 30, 2008, which was during the test year, PSE requested permission to change its tax accounting method for the treatment of repairs.¹⁷ The tax accounting change requested by PSE was approved by the Internal Revenue Service and was described in PSE's response to FEA data request 2.03(d). The IRS has consented to PSE making the accounting change, i.e., changing its income tax accounting for repairs, but the IRS has not approved the numbers or PSE's methodology.¹⁸ PSE's methodology and numbers are subject to adjustment by the IRS upon audit.¹⁹

¹⁴ Tr. Vol. VII at 479:9 - 481: 9 (Marcelia/PSE).

¹⁵ Tr. Vol. VII at 484:23 – 485:4 (Marcelia/PSE).

¹⁶ FEA Exhibit No. RCS-1T, pp.11, 13.

¹⁷ Exhibit No. MRM-15C and Tr. Vol. VII at 470:6-9, 485:1-12 (Marcelia/PSE) and FEA Exhibit No. RCS-1T, p. 11.

¹⁸ FEA Cross Exhibit No. MRM-15C.

¹⁹ FEA Exhibit No. RCS-1T, p. 11, Tr. Vol. VII at 487:21 – 488:5 (Marcelia/PSE), and FEA Cross Exhibit No. MRM-15C.

This issue involving a major change to a utility's tax accounting method was raised in two recent electric utility rate cases (beyond the current PSE rate case).²⁰ The factual backgrounds of the Rocky Mountain Power proceeding in Utah Dockets 09-035-23 and 09-035-03 are quite similar. On December 30, 2008, both PSE and Rocky Mountain Power requested permission from the IRS to change their tax accounting method for the treatment of repairs. The IRS accepted both companies' accounting change requests in the latter part of 2009. The change in accounting method is now reflected in both companies' 2008 Federal income tax returns.²¹ Neither company's calculations or repairs deduction amounts reported in their 2008 Federal income tax returns have yet been audited by the IRS.²²

In its December 8, 2009 order the Utah Public Service Commission approved the stipulation in which the parties agreed that the 2009 general rate case of Rocky Mountain Power be updated to reflect the repairs deduction taken in the company's 2008 Federal income tax return and the estimate of repairs deduction from January 1, 2009 to June 30, 2010 consistent with the test year ended June 30, 2010.²³ This Commission should likewise recognize the ratemaking impact on ADIT and rate base resulting from the tax accounting changes for the treatment of repairs reported by PSE in its amended 2008

²⁰ FEA Exhibit No. RCS-1T, p.13. In the Matter of the Division of Public Utilities' Review and Audit of Rocky Mountain Power's Deferred Tax Normalization Method, Docket No. 09-035-03, and Potomac Electric Company Rate Case, Case No. 1076.

²¹ Tr. Vol. VII, p. 492 (Marcelia/PSE) and FEA Cross Exhibit MRM-14, p. 9.

²² FEA Cross Exhibits MRM-14, pp. 9-10 and MRM-15C, pp. 3-4; Tr. Vol. VII, p. 492; and Exhibit No. MRM-4T, p. 27.

²³ FEA Cross Exhibit No. MRM-14, pp.4-5.

Federal income tax return. Despite the Company's objections to this recommendation,²⁴ the repairs at issue occurred during the test year and the effects of the repairs under the changed tax accounting methodology are sufficiently known and measurable to be reported by the Company in its recently amended 2008 tax return.²⁵

FEA therefore recommends that the Commission reduce test year rate base for the impact on ADIT due to this major tax accounting change. PSE agreed that the tax accounting change has an equal and offsetting impact on current income tax expense and deferred income tax expense.²⁶ The ADIT balance reflected by PSE in its rate increase application should be increased to reflect the impact of this tax accounting change consistent with the information provided by PSE in response to FEA data request 2.03.²⁷ Accordingly, electric rate base should be reduced by *****Begin Confidential***** *****End Confidential*****, and gas rate base should be reduced by *****Begin Confidential***** *****End Confidential***** for a total reduction of *****Begin Confidential***** *****End Confidential*****.²⁸

²⁴ Tr. Vol. VII, pp. 518-519 (Marcelia/PSE). As for the Company's claim that the relevant event at issue is IRS approval of the tax accounting change request, which occurred after the end of the test year, the Company concedes that it has made ratemaking adjustments for other events occurring after the end of the test year. See Tr. Vol. VII, pp 494-495 (Marcelia/PSE).

²⁵The Company has testified that its 2008 Federal tax return corresponds to period covered by the 2008 test year. See, Tr. Vol. VII, p. 492 (Marcelia/PSE).

²⁶ Tr. Vol VII at 488:6-12 (Marcelia/PSE).

²⁷ FEA Cross Exhibit No. MRM-15C and FEA Exhibit No. RCS-1T, p.13.

²⁸ Exhibit No. MRM-16C.

4. Pension Expense.

PSE's request for pension expense has two components: First, an increased cost for its defined benefit pension cost, which is part of its qualified pension plan. Second, the expense for a Supplemental Executive Retirement Plan. PSE recommends a pension expense of approximately \$3.7 million for electric and 2.0 million for gas.²⁹ This does not include PSE's requested expense for its Supplemental Executive Retirement Plan, which FEA addresses separately, below.

a. **The Expense Allowance For Defined Benefit Pension Cost Should Be Based on a Four-Year Average of the FAS 87 Amounts**

The Company states that its adjustment restates the test year to reflect cash contributions to the Company's qualified retirement fund. It also indicates that, in previous general rate cases, the Commission has used the average of four years of contributions to determine the amount that is to be included in operating expense. PSE's request is based upon an average of four years ending September 2009, including estimates which PSE indicates will be adjusted to actual during the course of the proceeding. PSE has allocated its pension contribution to O&M based on wage distributions and then allocated between electric and gas based on its labor benefit assessment distribution allocation.³⁰

In 1993 this Commission issued its Eleventh Supplemental Order in Puget Sound Power & Light Company's ("PSP&L") 1992 rate increase proceeding in consolidated

²⁹ FEA Exhibit No. RCS-1T, pp. 3, 14.

³⁰ PSE Exhibit No. JHS-1T, pp. 41-42 .

Dockets UE-920433, UE-920499 and UE-921262. In that order, the Commission determined the appropriate ratemaking treatment for postretirement benefits other than pensions (“PBOPs”). Up until that proceeding, PSP&L had been using a cash basis of accounting for PBOPs but eventually realized that they were too costly to continue funding and that the cash basis of accounting had made them appear to be affordable when in fact they were not.³¹ The Commission in that order also made an adjustment to expense to reflect that PSP&L should have made a change to its PBOPs program at an earlier date in response to concerns of escalating costs for such benefits and to limit exposure to such escalating costs. Finally, the Commission adopted an accrual method to account for PBOPs for ratemaking purposes rather than recognizing those costs on a cash basis.³²

Similar concerns underlie FEA’s recommendation in this proceeding regarding the Company’s defined benefit pension plans. For many years, including the years 1999-2002 and 2004-2007, the Company did not make any contributions,³³ making the programs appear very affordable during those years due to cash basis accounting. Continuing to utilize a cash basis for the ratemaking recognition of the cost of providing a qualified defined benefit pension plan would cause this cost to be significantly higher in the current PSE rate case than it has been in recent years.³⁴ In addition, FEA witness Smith testified that the range of company cash contributions in any given year can be

³¹ 147 PUR 4th 80 (1993), WUTC v. PSP&L Co., Docket Nos. UE-920433, UE-920499, and UE-921262, Eleventh Supplemental Order, mimeo page 56.

³² Id., mimeo p. 57.

³³ PSE Exhibit No. TMH-1T, p. 19.

³⁴ FEA Exhibit No. RCS-1T, p. 23.

very broad. If the ratemaking allowance for qualified pension expense is based on actual contributions, there is a risk that the amount contributed will be subject to possible manipulation by management for purposes of deriving an expense allowance in a rate case.³⁵

FEA recommends that the allowance for pension expense in the current PSE rate case be limited to the average annual net periodic pension costs determined pursuant to FAS 87 for the four year period ending December 31, 2008, as allocated to expense, and between PSE's electric and gas operations.³⁶ A four-year average should be used because the use of such an average appears to be consistent with Commission practice and helps smooth out or "normalize" the expense allowance for ratemaking purposes.³⁷

FEA also urges this Commission to have PSE evaluate whether it should continue to provide defined benefit pension plans.³⁸ As the recent economic turmoil has demonstrated, a defined benefit plan can require radical increases in funding during periods of poor investment performance. Many other companies have discontinued defined benefit pension plans in favor of other alternatives such as Defined Contribution Plan. Basing a ratemaking allowance for pension costs on plan funding contributions, which are up to utility management and can span a range as wide as \$60 million or more,

³⁵ FEA Exhibit No. RCS-1T, p. 18.

³⁶ FEA Exhibit No. RCS-1T, pp. 23-24.

³⁷ FEA Exhibit No. RCS-1T and Tr. Vol. VI, p. 354 (Stranik/PSE).

³⁸ FEA Exhibit No. RCS-1T, pp. 18-20.

could deter the Company from making reforms to its pension plans that would reduce cost.³⁹

b. PSE's Expense for a Supplemental Executive Retirement Plan ("SERP") Should Be Removed

The SERP is a non-qualified plan and provides supplemental retirement benefits for select executives.⁴⁰

FEA recommends removing PSE's requested expense for the SERP, which is shown on FEA Exhibit (RCS-4). This adjustment reduces O&M expense by approximately \$2.139 million for electric and \$1.155 million for gas, respectively. This adjustment increases PSE's net operating income for electric and gas operations by approximately \$1.390 million and \$751,000, respectively.⁴¹

Public Counsel's Witness James Dittmer also recommended removing PSE's Expense for SERP. He cited the following reasons supporting his recommendation:

- (1) Such highly paid employees are already entitled to "normal" retirement benefits pursuant to the "qualified" retirement plan offered,
- (2) The plan is expensive to offer given that it is not tax efficient like the qualified plan, and

³⁹ Id., p. 19.

⁴⁰ Tr. Vol. VII at 416:1-4 (Hunt/PSE).

⁴¹ FEA Exhibit No. RCS-1T, p.28, and FEA Exhibit No. RCS-4.

(3) The fact that other Washington utilities are either no longer offering the benefit or do not seek rate recovery of such costs.⁴²

In addition, as discussed in FEA's testimony, utility SERP expense has been disallowed in other recent rate cases.⁴³

⁴² PC Exhibit No.JRD-1T, pp. 60-61.

⁴³ FEA Exhibit No.RCS-1T, pp. 26-28. The Arizona Corporation Commission has issued several decisions in which it denied rate recovery for SERP expenses. See 258 PUR 4th 353 (2007) Re Arizona Public Service Company, 247 PUR 4th 243 (2006) In Re Southwest Gas Corp., 2008 WL 2332953 (Ariz Corp Comm Decision 70360, May 27, 2008) In the Matter of the Application of UNS Electric, and 2007 WL 4731250 (Ariz Corp Comm Decision 70011, November 27, 2007) Re UNS Gas, Inc.

CONCLUSION

For the reasons set forth above, FEA urges this Commission to adopt its recommendations on the matters addressed in its testimony and brief.

Respectfully submitted,

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