EXHIBIT NO. ___(MRM-1T)
DOCKET NO. UE-11___/UG-11___
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-11____** **Docket No. UG-11____**

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

JUNE 13, 2011

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF MATTHEW R. MARCELIA

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1 **PUGET SOUND ENERGY, INC.**

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

4 **I. INTRODUCTION**

5 **Q. Please state your name, business address, and present position with Puget**
6 **Sound Energy, Inc.**

7 A. My name is Matthew R. Marcelia. My business address is 10885 N.E. Fourth
8 Street, Bellevue, WA 98004. I am Director of Taxes for Puget Sound
9 Energy, Inc. ("PSE").

10 **Q. Have you prepared an exhibit describing your education, relevant**
11 **employment experience, and other professional qualifications?**

12 A. Yes, I have. It is Exhibit No. ___(MRM-2).

13 **Q. What are your duties as Director of Taxes for PSE?**

14 A. As Director of Taxes, I have the overall management responsibility for the tax
15 department and direct all aspects of PSE's tax compliance, accounting for taxes,
16 financial reporting of tax, and tax planning. My responsibility includes income
17 taxes as well as state and local taxes. I report directly to the Vice President of
18 Finance and Treasurer.

1 **Q. What is the purpose of this prefiled direct testimony?**

2 A. This prefiled direct testimony presents the following topics:

3 (i) the electric and gas tax pro forma and restating
4 adjustments;

5 (ii) normalization of the tax treatment for

6 (a) capitalized property taxes,

7 (b) injuries and damages, and

8 (c) bad debts;

9 (iii) the treatment of accounting method changes related to
10 taxes;

11 (iv) the impact of bonus depreciation and tax net operating
12 losses; and

13 (v) the pro forma and restating adjustment for property taxes
14 for electric and gas operations.

15 II. RESTATING AND PRO FORMA ADJUSTMENTS FOR 16 FEDERAL INCOME TAXES FOR 17 ELECTRIC AND GAS OPERATIONS

18 A. <u>Methodology for Calculating Federal Income Tax Expense for</u> 19 <u>Electric and Gas Operations</u>

20 **Q. How has PSE generally calculated federal income tax expense for purposes of**
21 **this proceeding?**

22 A. In calculating federal income tax expense for electric and gas operations for
23 purposes of this proceeding, PSE followed this Commission's longstanding

1 principles regarding the segregation of regulated and non-regulated operations.[1]
2 PSE has prepared the tax calculations for this proceeding on a separate company,
3 stand-alone basis. This methodology reflects the tax effect attributable to
4 regulated operations and isolates PSE's customers from the impacts of non-
5 regulated activities.

6 **B. <u>Restating and Pro Forma Adjustments for Federal Income Taxes for</u>**
7 **<u>Electric and Gas Operations</u>**

8 **Q. Please describe the restating adjustment for federal income taxes for electric**
9 **operations.**

10 A. In Exhibit No. ___(JHS-6), at page 6.04, and Exhibit No. ___(MJS-6), at
11 page 6.04, Mr. Story and Mr. Stranik present the pre-tax net operating income or
12 loss from the test year (January 1, 2010, through December 31, 2010) on the first
13 line of the respective exhibits. These amountsreflect tax entries booked during
14 the test year and include tax entries that are not relevant to actual test year
15 revenues and expenses. The restating adjustment for federal income taxes for
16 electric and gas operations adjusts the actual federal income tax expense to the
17 restated level based on the items of income and expense that are included in
18 electric and gas operating income and expenses for the test year. The adjustment
19 for electric operations decreases electric net operating income by $60,471,551.

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[1] The Commission reaffirmed these principles in its order in the general rate filing of Avista Corporation. *See WUTC v. Avista Corp. d/b/a Avista Utils.*, Dockets UE-080416 and UG-080417, Order 08 at ¶¶ 28–34 (Dec. 29, 2008).

1 *See* Exhibit No. ___(JHS-6), at page 6.04, line 20. The adjustment for gas
2 operations decreases gas net operating income by $28,834,101. *See* Exhibit
3 No. ___(MJS-6), at page 6.04, line 20.

4 **Q. Does this adjustment differ from the methodology used in determining**
5 **federal taxes in prior rate filings?**

6 A. No. The methodology is the same. However, PSE moved all tax components
7 associated with interest expense from the Adjustment for Income Taxes into the
8 Tax Benefit of Pro Forma Interest adjustments for electric and gas operations at
9 Exhibit No. ___(JHS-6), at page 6.05, and at Exhibit No. ___(MJS-6), at
10 page 6.05, respectively.

11 **Q. What is the impact of moving the tax benefit on the interest expense from**
12 **this adjustment to the Tax Benefit of Pro Forma Interest adjustment?**

13 A. There is no impact to the revenue requirement.

14 **Q. Has PSE removed the Production Tax Credit and Section 1603 Treasury**
15 **Grants from the restated federal income tax calculations in this proceeding?**

16 A. Yes. PSE has removed the Production Tax Credit ("PTC") and Section 1603
17 Treasury Grants from the restated federal income tax calculations in this
18 proceeding. PSE passes the benefit of these tax savings through to its customers
19 through a separate mechanism that PSE adjusts and files in October of each year.

1 **Q. Did PSE incur cash expenditure for taxes in the test period?**

2 A. No. As indicated in Exhibit No. ___(JHS-6), at page 6.04, line 4, and in Exhibit
3 No. ___(MJS-6), at page 6.04, line 4, PSE is not reporting current taxes, as
4 indicated by the negative amounts which represent a tax benefit. Current taxes
5 represent the amount of tax that is presently owed to the Internal Revenue Service
6 ("IRS").

7 **Q. Does that mean that PSE did not collect amounts from customers for income**
8 **taxes in the test period?**

9 A. No. For example, look at the income taxes associated with elective operations.
10 As shown on Exhibit No. ___(JHS-6), at page 6.04, line 4, PSE is reporting a
11 benefit to customers for current income taxes from electric operations in the
12 amount of $65.7 million. This benefit, however, is more than offset by a charge
13 for net deferred taxes on lines 6 and 7 in the amount of $110.0 million. PSE must
14 pass through almost all of the deferred taxes associated with the $110.0 million to
15 customers under the tax normalization rules as specified in section 168 of the
16 Internal Revenue Code ("IRC").

17 The income taxes that are collected in rates include both current and deferred
18 taxes. Accordingly, the amount of tax expense reflected on Exhibit No. ___(JHS-
19 6), at page 6.04, line 9, is $44.3 million, which nets the current tax benefit with
20 the deferred tax expense.

A similar result occurs for gas operations in Exhibit No. ___(JHS-6), at page 6.04.

Please see Section II.C. below regarding normalization, what a deferred tax is, and the importance of collecting deferred taxes in the proper period.

C. Normalization of the Tax Treatment of Capitalized Property Taxes, Injuries and Damages, and Bad Debts for Electric Operations

Q. Is PSE making other changes to its calculation of restated income taxes related to electric operations?

A. Yes. PSE is changing the accounting treatment from the "flow-through" method to the "normalization" method for the following book/tax timing differences: (i) Capitalized Property Taxes, (ii) the Reserve for Injuries and Damage, and (iii) Reserve for Bad Debts.

Q. Is PSE proposing to move to "full normalization" of its income taxes?

A. No. PSE is not proposing a move to "full normalization" of its income taxes at this time. The changes proposed by PSE are specific and limited to only these three items and affect no other book/tax timing differences.

Q. Why is PSE making this change?

A. PSE is making this change because there is presently a discrepancy between electric operations and gas operations as to how PSE handles these book/tax differences for rate setting purposes.

1 **Q. How does PSE handle these items for ratemaking in its gas operations and**
2 **electric operations?**

3 A. For gas operations, PSE normalizes capitalized property taxes, injuries and
4 damages, and bad debts. This means that PSE provides deferred taxes on these
5 timing differences.

6 For electric operations, PSE flows-through capitalized property taxes, injuries and
7 damages, and bad debts.

8 **Q. Please explain what is meant by "book/tax timing differences"?**

9 A. Book/tax timing differences (sometimes referred to as "timing differences" or
10 "temporary differences") result whenever a tax deduction occurs in a period that
11 is different from the period of the book deduction. Although there are similarities
12 in the rules governing financial accounting and the rules for income tax reporting,
13 there are many important differences. Many of those differences affect the time
14 period in which revenue and expenses can be recorded, as is the case with the
15 three book/tax timing differences mentioned above.

16 Timing differences give rise to deferred taxes.

17 **Q. What is a deferred tax?**

18 A. A deferred tax is a tax expense or benefit that is certain to occur in a future
19 period. A deferred tax results whenever the tax treatment of an item is
20 accelerated or delayed relative to the book accounting treatment. For financial

1 reporting purposes (and to a certain extent regulatory purposes), companies are
2 required to record deferred taxes on temporary differences. *See* Accounting
3 Standards Codification ("ASC") 740, *Income Taxes* (formerly known as
4 Statement of Financial Accounting Standards ("SFAS") No. 109, *Accounting for*
5 *Income Taxes*) and FERC Part 101 and 201, General Instruction 18,
6 *Comprehensive Interperiod Income Tax Allocation.*

7 **Q. Please explain the difference between "flow-through" and "normalized"**
8 **treatment for ratemaking purposes?**

9 A. The difference between "flow-through" and "normalized" treatment for
10 ratemaking purposes is deferred taxes. Simply put, deferred taxes are *not*
11 recorded under the flow-through method but are recorded under the normalized
12 method.

13 When a tax benefit or expense is flowed-through, today's customers bear the
14 initial tax impact in cost of service, and future customers will bear the reversal of
15 the tax impacts.

16 Keep in mind that we are dealing with temporary difference, so there will always
17 be a complete reversal in a future period. When a tax benefit or expense is
18 normalized, PSE records a deferred tax associated with the book/tax timing
19 difference. By recording a deferred tax, PSE achieves an exact timing match for
20 customers, such that the customer who bears the cost or benefit of the underlying
21 item (for example, a damage claim) also receives the tax effect associated with it.

Normalization (i.e., providing deferred taxes) avoids the inter-generational conflict between today's and tomorrow's customer in that it matches the timing of the tax effect to the timing of the underlying item giving rise to the tax effect.

Q. Can you give an example?

A. Yes. Let me give an example that is similar to the three book/tax differences in question – one in which the tax deduction occurs *after* the book deduction. Assume that a damage claim is made against PSE today for $100. Assuming the other requirements of ASC 450 (formerly known as SFAS 5) for a loss contingency are met, PSE would record an expense of $100 in the income statement. At this point, no tax deduction is permitted under the IRC because PSE has not made a payment for the claim. PSE's tax payable to the IRS will not be reduced by the $100 book expense. Instead, PSE will report $100 of taxable income in excess of its book income and will owe a tax on that income at 35% or $35, in this case.

At this point, it is important to highlight the fact that PSE knows that it will be entitled to a tax deduction at a future date when the underlying claim is paid. In this case, PSE anticipates a tax deduction in the future of $100 – this is a deferred tax, valued at $35 (which is $100 x 35%). A deferred tax is a tax benefit or detriment that is expected in the future and results from a specific, identifiable book/tax timing difference that has already occurred. To record this transaction,

1 deferred taxes need to be decreased (credited) on the income statement and a tax
2 benefit is increased (debited) on the balance sheet.

3 If the book/tax difference for a damage claim is normalized, the future tax
4 deduction (which is a deferred tax benefit) is recorded immediately and offsets
5 the increase in the current tax payable by recording an exactly offsetting amount
6 to a deferred tax account on the balance sheet. This effectively puts the tax
7 deduction into the same accounting period as the underlying expense (in this case,
8 the accrual for the $100 claim).

9 Table 1 below summarizes the normalization treatment. It assumes the claim is
10 made in Year 1 and that the claim is paid in Year 2.

11 **Table 1. Normalization Treatment**

	Year 1	Year 2
Damage Claim Expense	100	0
Current Tax	0	(35)
Deferred Tax	(35)	35
Net Impact to NOI	65	0

12 If the book/tax difference for a damage claim is flowed through, the impact of the
13 tax (an additional cost of $35) is flowed through to current customers in cost of
14 service because the deferred tax has not been recorded. This is the case even
15 though PSE knows that the book/tax timing difference will reverse in the future.
16 As a result, current customers are burdened with paying higher costs or general
17 rates today because they don't receive the future benefit of a tax deduction for the
18 damage claim, whereas future customers will reap the tax benefit when the claim
19 is paid while escaping the burden of the underlying claim.

1 Table 2 below summarizes the flow-through treatment:

2 **Table 2. Flow-Through Treatment**

	Year 1	Year 2
Damage Claim Expense	100	0
Current Tax	0	(35)
Deferred Tax	0	0
Net Impact to NOI	100	(35)
Conversion Factor	.65	.65
Revenue Requirement Impact	154	(54)

3 In this example, customers are better off in Year 2 than they are in Year 1 because
4 Year 1 customers bear the entire cost of the damage claim, whereas Year 2
5 customers reap the entire tax benefit of the damage claim.

6 **Q. Besides the intergenerational conflict discussed above, what other benefit**
7 **exists in normalizing items, such as damage claims?**

8 A. Another benefit to normalizing items like damage claims is that it essentially
9 accelerates the future tax deduction into Year 1 for rate making purposes. Under
10 flow-through treatment, customers must wait until a future year for the tax
11 deduction associated with the damage claim.

12 **1. <u>Capitalized Property Taxes</u>**

13 **Q. Please describe the book/tax difference for capitalized property taxes.**

14 A. For tax purposes, certain costs are required to be capitalized under §263A of the
15 IRC. Property taxes are one such item. PSE is required to capitalize a portion of
16 its overall property tax expenditure for income tax purposes. PSE cannot take a

1 current tax deduction for the portion of property taxes that are capitalized. Once
2 capitalized, these costs become part of PSE's tax basis in the asset. The entire tax
3 basis, including the amount of capitalized property taxes, is depreciated over the
4 tax life of the asset.

5 **Q. What effect will normalizing this book/tax difference have on electric**
6 **operations going forward?**

7 A. By normalizing the capitalized property taxes, PSE will provide deferred taxes
8 associated with this book/tax difference. In general terms, this will have the
9 effect of increasing net operating income by reducing the amount of tax expense
10 in cost of service.

11 **Q. How is PSE handling the historical build-up of capitalized property taxes**
12 **that were flowed-through in the past?**

13 A. The historical build-up of capitalized property taxes will reverse over the
14 remaining tax life of the assets to which it relates. The balance is embedded in
15 the tax basis of those assets as a flow-through item. No special action needs to be
16 taken for the reversal to occur because it is captured as flow-through tax
17 depreciation. The reversal is already occurring and will continue to occur.
18 Indeed, it is reflected in the proceeding. All flow-through depreciation, of which
19 capitalized property taxes are but one part, is reflected in the book/tax difference

1 labeled "Plant Depreciation – Flow Through" in the workpapers supporting
2 Exhibit No. ___(JHS-6), at page 6.04.

3 **Q. What is the amount of the accumulated balance?**

4 A. The accumulated balance is approximately $10,149,285, which represents a tax
5 benefit of $3,552,250. The annual reversal will occur over many years and the
6 amount will vary as retirements occur and depreciation rates change. The annual
7 reversal amount is approximately $449,008 which represents a tax benefit of
8 $157,153.

9 **Q. How are capitalized property taxes recorded for gas operations?**

10 A. Capitalized property taxes are normalized for gas operations. By normalizing
11 capitalized property taxes for electric operations, PSE's treatment will be the
12 same for both gas and electric operations.

13 **2. <u>Reserve for Bad Debts</u>**

14 **Q. Please describe the book/tax difference for the reserve for bad debts.**

15 A. For tax purposes, the reserve for bad debts cannot be deducted for income tax
16 purposes until the debt has been written off. For tax purposes, the establishment
17 of a reserve is generally not sufficient to claim a tax deduction.

1 **Q. What effect will normalizing this book/tax difference have on electric**
2 **operations going forward?**

3 A. By providing deferred taxes on the book/tax difference for bad debts, electric
4 operating income will generally increase by reducing the amount of tax expense
5 in cost of service.

6 **Q. How will electric operating income be increased by this change?**

7 A. Electric operating income will be increased because the book deduction precedes
8 the tax deduction associated with bad debts. By recording the deferred tax, the
9 tax benefit for the future tax deduction which was delayed under the flow-through
10 method will be matched to the timing of the expense for accounting and
11 ratemaking purposes. Thus, the tax benefit of the future tax deduction will be
12 accelerated into the period in which the bad debt expense is recorded, even
13 through the actual tax deduction can not be taken on the tax return until the bad
14 debt is written off.

15 **Q. What is the accumulated balance that was flowed-through in prior periods**
16 **and how is PSE going to reverse it?**

17 A. The gross accumulated balance as of January 1, 2010, was $5,895,758. PSE will
18 be reversing the accumulated balance over two years, starting with this filing.
19 Thus, the amount amortized would be $2,947,879 per year and would lower tax
20 expense by $1,031,758 (which is $2,947,879 x 35%) per year.

1 **Q. Is the reversing flow through reflected in this filing?**

2 A. Yes, a flow through tax deduction of $2,947,879 has been included in this filing.
3 The effect of this deduction is to reduce tax expense by $1,031,758 (which is
4 $2,947,879 x 35%).

5 **Q. How are Bad Debts recorded for gas operations?**

6 A. Bad debts are normalized for gas operations. By normalizing bad debts for
7 electric operations, the Company's treatment will be the same for both gas and
8 electric operations.

9 **3. Reserve for Injuries and Damages.**

10 **Q. Please describe the book/tax difference for the reserve for injuries and**
11 **damages.**

12 A. The reserve for injuries and damages can not be deducted for income tax purposes
13 until the claims have been paid.

14 **Q. What effect will normalizing this book/tax difference have on electric**
15 **operations going forward?**

16 A. By providing deferred taxes on the book/tax difference for injuries and damages,
17 electric operating income will, generally, increase by reducing the amount of tax
18 expense in cost of service.

1 **Q. How will electric operating income be increase by this change?**

2 A. Electric operating income will be increased because the book deduction precedes
3 the tax deduction associated with injuries and damages, in some cases by years.
4 By recording the deferred tax, the tax benefit for the future tax deduction which
5 was delayed under the flow-through method will be matched to the timing of the
6 expense for accounting and ratemaking purposes. Thus the tax benefit of the
7 future tax deduction will be accelerated into the period in which the injuries and
8 damages expense is recorded, even through the actual tax deduction can not be
9 taken on the tax return until the claim is paid.

10 **Q. What is the accumulated balance that was flowed-through in prior periods**
11 **and how is PSE going to reverse it?**

12 A. The gross accumulated balance as of January 1, 2010, was $300,000. PSE will be
13 reversing the accumulated balance over two years, starting with this filing. Thus,
14 the amount amortized would be $150,000 per year and would lower tax expense
15 by $52,500 (which is $150,000 x 35%) per year.

16 **Q. Is the reversing flow through reflected in this filing?**

17 A. Yes. PSE has included a flow-through tax deduction of $150,000 in this filing.
18 The effect of this deduction is to reduce tax expense by $52,500 (which is
19 $150,000 x 35%).

1 **Q. How are injuries and damages recorded for gas operations?**

2 A. Injuries and damages are normalized for gas operations. By normalizing injuries
3 and damages for electric operations, PSE's treatment will be the same for both
4 gas and electric operations.

5 **4. <u>Comparison of the Normalization Method vs. the Flow-</u>**
6 **<u>Through Method</u>**

7 **Q. Has PSE prepared an exhibit to compare the normalization method to the**
8 **flow-through method for these three book/tax difference?**

9 A. Yes. Please see Exhibit No. ___(MRM-3) for a comparison of the impact of the
10 normalization method and the impact of the flow-through method. The
11 normalization method results in an increase to electric net operating income in the
12 amount of $2,428,998 by lowering tax expense.

13 **III. TAX ACCOUNTING METHOD CHANGES**

14 **A. <u>Tax Repairs Method Change</u>**

15 **Q. Please briefly describe the accounting method for tax repairs?**

16 A. PSE recently changed its tax method of accounting for repairs.
17 *See, e.g., WUTC v. Puget Sound Energy, Inc.*, Dockets UE-090704 and UG-
18 090705, Order 11 at ¶¶ 192-197 (Apr. 2, 2010) (the "<u>2009 GRC Final Order</u>").

1 By way of background, PSE requested permission from the IRS to change its
2 accounting method for the treatment of tax repairs. The change affects taxes. It
3 has no effect on the book characterization of an expenditure as a repair or capital
4 item. The new tax method allows PSE to adopt different units of property
5 ("UOP") for tax purposes than the UOPs used for book purposes. In general, the
6 UOPs for tax purposes will be larger than those for book purposes. By using
7 larger UOPs for tax, more of PSE's expenditures will qualify as an immediate tax
8 deduction.

9 **Q. When was this method change filed?**

10 A. PSE included this method change in its 2008 tax return, which PSE filed in
11 September 2009.

12 **Q. How has PSE treated the repairs/UOP accounting method change in this**
13 **filing?**

14 A. In the 2009 GRC Final Order, the Commission's instructions on the ratemaking
15 treatment for this accounting method are clear and unambiguous:

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

20 2009 GRC Final Order at ¶ 197.

Since the IRS has not yet audited the new method, PSE has not implemented an increase to ADIT. In other words, PSE has removed the tax impact of the new method from this filing, pursuant to the Commission's instructions.

Q. With respect to the repairs accounting method, has anything changed since the issuance of the 2009 GRC Final Order?

A. No. The IRS has not issued guidance for electric or gas utilities, although the IRS is supposedly close to issuing guidance for electric utilities. PSE is under IRS audit, and the repairs method change is under review. The audit, however, has not yet been completed.

Q. What is the net amount of the adjustment for the test year?

A. Please see Exhibit No. ___(MRM-4) and Exhibit No. ___(MRM-5) for the monthly balance for the test year for electric and gas operations, respectively. The full impact of the method change has been removed from this filing as required by the 2009 GRC Final Order.

B. Tax Retirements Method Change

Q. Please briefly describe the new accounting method for tax retirements?

A. PSE changed its tax method of accounting for retirements. This method change is a companion to the method change for tax repairs, mentioned above. As discussed above, the change for tax repairs resulted in the creation of different UOPs for book and tax purposes. Generally, the tax UOPs are larger than the

1 book UOPs. PSE's accounting method change for tax retirements applies the new
2 tax UOPs to the tax retirement calculation. Larger UOPs will have the effect of
3 decreasing the retirements for tax purposes. This change was necessary to bring
4 the tax UOPs for retirements in to alignment with the tax UOPs for repairs.

5 **Q. When did PSE file this method change?**

6 A. PSE filed the method change in March 2010, to be included in PSE's 2010 federal
7 income tax return.

8 **Q. How has PSE treated the tax retirements accounting method change in this**
9 **filing?**

10 A. PSE treated the tax retirement method change in the same manner as it treated the
11 tax repairs method change. It has been removed from this filing in its entirety.
12 This treatment is consistent with the 2009 GRC Final Order and the treatment of
13 the repairs method change.

14 **Q. What is the net amount of the adjustment for the test year?**

15 A. The expected impact of the method change is reflected in Exhibit No. ___(MRM-
16 6), which calculates the monthly balance for the test year for electric and gas
17 operations.

1 **C. <u>Methodology to Remove These Method Changes from This Filing</u>**

2 **Q. Please describe the methodology that PSE used to remove these tax**
3 **accounting method changes from this rate filing.**

4 A. PSE has removed the tax repairs and retirements method changes from this filing.
5 Please see Exhibit No. ___(MRM-7) for a reproduction of the workpapers
6 supporting Exhibit No. ___(JHS-3), Exhibit No. ___(JHS-4), Exhibit
7 No. ___(MJS-3), and Exhibit No. ___(MJS-4) that illustrate this removal. As
8 reflected in Exhibit No. ___(MRM-7), PSE breaks out the impact of the method
9 changes from the totals in tax accounts 19000433 (NOL Carryforward),
10 23600033 (Federal Income Taxes Payable), 28200002 (DFIT Gas Plant), and
11 28200121 (DFIT Electric Plant) and tracks these dollars in new sub-accounts.
12 Please see Exhibit No. ___(MRM-4), Exhibit No. ___(MRM-5), and Exhibit
13 No. ___(MRM-6) for the impact of this change. The removal is performed on a
14 month-by-month basis and, as shown on Exhibit No. ____(MRM-7), line 64, the
15 net impact after the transfer to the new accounts is the same as the total shown on
16 line 7 for the old accounts.

17 **Q. Did PSE transfer these balances to the new accounts?**

18 A. Yes. PSE transferred the balances in May of 2011 so that they could be tracked.
19 It is not possible to reopen PSE's financial statements for this type of adjustment
20 so that it is reflected each month. Please see Exhibit No. ___(MRM-7) for the
21 changes to the accounts on a monthly basis, and please see Exhibit No. ___(JHS-

3), pages 3.03, 3.04, 3.06 and 3.08, and Exhibit No. ___(MJS-3), pages 3.03, 3.04, 3.06 and 3.08 for the impact of the changes.

Q. What is the result produced by these exhibits?

A. The results produced by these exhibits are actual account balances that do not reflect the effects of the repairs and retirements method changes.

IV. BONUS DEPRECIATION AND NET OPERATING LOSS CARRYFORWARDS

A. Overview

Q. Please provide an overview of this section.

A. This Section IV discusses the impact of bonus depreciation and the resulting tax net operating losses that it has created for PSE. This Section IV provides a discussion and related computations at the level of the combination utility, as opposed to discussing electric and gas operations separately. Once the analysis for the combination utility is complete, this Section IV demonstrates how the results impact electric and gas operations.

B. Bonus Depreciation

Q. What is bonus depreciation?

A. Bonus depreciation is a special provision of the tax depreciation rules. It allows taxpayers, like PSE, to deduct a "bonus" amount of depreciation in the tax year in

which a qualifying asset is placed in service. In addition to the "bonus" amount, taxpayers can claim normal depreciation on the remainder of the tax basis after removing the bonus amount. Essentially, bonus depreciation accelerates a large amount of tax depreciation into the asset's first year.

Q. How is bonus depreciation accounted for?

A. Bonus depreciation is accounted for just like any other amount of tax depreciation. To the extent that bonus depreciation and normal depreciation exceed book depreciation, a deferred tax liability is created. The tax effect of bonus depreciation is recorded to the plant-related deferred tax liability in the year the asset is placed in service.

Q. Was bonus depreciation available during the test year?

A. Bonus depreciation did not become available until September of the test year. On September 27, 2010, the Small Business Jobs Act of 2010 was enacted. The Small Business Jobs Act of 2010 contained a number of provisions that were intended to stimulate the economy. One of those provisions was 50% bonus depreciation, which Congress made retroactive to January 1, 2010 and extended to December 31, 2010.

Q. Please explain how 50% bonus depreciation works.

A. Assume an asset that cost $1,000 has a tax life of 5 years, using Modified Accelerated Cost Recovery System ("MACRS") with a half-year convention.

1 Under the normal MACRS rules, this asset would be eligible for tax depreciation
2 in Year 1 of $200 (the product of the original cost of $1,000 and the depreciation
3 rate of 20%). If the asset is eligible for 50% bonus depreciation, however, the tax
4 deprecation in Year 1 would be $600 (a "bonus" of $500, which is 50% of $1,000
5 tax basis, plus normal MACRS on the remaining $500 tax basis in the amount of
6 $100, which is the product of the remaining original cost of $500 and the
7 depreciation rate of 20%). As shown in this example, bonus depreciation
8 significantly accelerates the amount of tax depreciation that can be claimed on
9 qualifying assets.

10 **Q. Did Congress enact any other bonus deprecation laws during the test year?**

11 A. Yes. On December 17, 2010, the Tax Relief, Unemployment Insurance
12 Reauthorization, and Job Creation Act of 2010 was enacted. It contained two
13 bonus depreciation components. One allows bonus depreciation of 100% for
14 qualifying assets that go into service between September 9, 2010, and
15 December 31, 2011. The other provision allows bonus depreciation of 50% for
16 qualifying assets placed in service through December 31, 2012.

17 **Q. How does 100% bonus depreciation work?**

18 A. Again, assume an asset that costs $1,000 has a tax life of 5 years, using MACRS
19 with a half-year convention. If the asset is eligible for 100% bonus depreciation,
20 tax depreciation in Year 1 would be $1,000 – the entire tax cost would be

1 deducted in the first year. There would be no additional depreciation on this asset
2 in Years 2 through 6.

3 **Q. Did PSE reflect the impact of the two new bonus depreciation laws in this**
4 **filing?**

5 A. Yes. PSE reflected the impact of the two new bonus depreciation laws in this
6 filing.

7 **Q. In general, what impact does bonus depreciation have on PSE?**

8 A. In general, bonus depreciation has a significant tax effect on PSE. First, being
9 able to deduct 50% (or more) of an asset's costs in the first year creates a large
10 amount of tax deductions, which PSE uses to offset taxable income. Being able
11 to accelerate those deductions into the first year creates a timing benefit in that it
12 reduces the amount of tax PSE needs to pay. Second, it allows PSE to maximize
13 deferred taxes as a source of funds or cash flow.

14 **Q. What effect is bonus depreciation expected to have relevant to the test year?**

15 A. PSE expects that bonus depreciation will have a significant impact relevant to the
16 test year. As a result of the tax provisions included in the legislation mentioned
17 above, PSE and its customers will benefit from 50% bonus and 100% bonus
18 during the test year. Although the 2010 tax return has not been filed, PSE
19 estimates that bonus depreciation will cause a net operating loss for the tax year.

1 **C. Net Operating Loss (“NOL”) Carryforwards**

2 **Q. Can the expected 2010 NOL be carried back for a refund of prior year taxes?**

3 A. The IRS rules allow NOLs to be carried back two years and carried forward
4 twenty years. PSE has no opportunity for carryback because it did not have
5 taxable income in the prior two years. Therefore, any 2010 tax loss must be
6 carried forward.

7 **Q. What happens when an NOL is carried forward?**

8 A. The IRS has numerous rules regarding NOLs. In general, an NOL carryforward
9 is treated as an additional tax deduction on a future tax return. As a result, an
10 NOL carryforward can reduce the amount of tax due on a future tax return, but it
11 cannot reduce the amount of tax below zero.

12 A taxpayer has 20 years in which to use an NOL carryforward. If the NOL can
13 not be used within that period, it will expire.

14 **Q. What is the practical implication of an NOL carryforward?**

15 A. The practical implication of an NOL carryforward is that the tax benefits of some
16 deductions will be delayed until a future tax year. PSE has claimed tax
17 deductions (e.g., bonus depreciation) for which PSE has not received a cash
18 benefit. Under normal circumstances, a tax deduction will have the effect of
19 reducing the taxpayer’s cash outlay for taxes (i.e., deferring a tax payment until a
20 later tax year). That is not so when the tax deduction only serves to create an

1 NOL carryforward. An NOL carryforward is similar to a tax receivable from the
2 IRS, except that it can only be used on future tax returns and it will likely take
3 some time (i.e. years) to recover.

4 **Q. What is the extent of PSE's NOL carryforwards?**

5 A. PSE currently has two NOLs carryforwards: from 2009, $92.4 million (actual)
6 and from 2010, $190.9 million (estimated) for a total NOL carryforward of
7 $283.3 million (which is $99.2 million tax effected). Please see Exhibit
8 No. ___(MRM-8) for calculations of these two NOL carryforwards.

9 **Q. Has PSE removed the effect of the repairs and retirements method changes**
10 **discussed above from the NOL balances?**

11 A. Yes. PSE removed the effect of the repairs and retirements method changes
12 discussed above from the NOL balances. Please see Exhibit No. ___(MRM-7),
13 discussed above. The NOL carryforward shown in account 19000433 on Exhibit
14 No. ____(MRM-7), line 55, is the NOL deferred tax asset without the repairs and
15 retirements method changes.

16 **Q. How and when are PSE's NOL carryforwards accounted for on the books?**

17 A. PSE accounts for its NOL carryforward as a deferred tax asset. The deferred tax
18 asset reduces the overall net deferred tax liability on PSE's books. PSE records
19 the NOL at the same time that it records the deferred taxes for bonus depreciation.
20 In 2010, for example, PSE did not record a deferred tax liability for bonus

1 depreciation until September because that was the month in which the tax laws
2 changed. Bonus depreciation caused PSE to anticipate an NOL for the year,
3 which in turn caused PSE to record a deferred tax asset for the estimated
4 2010 NOL in September.

5 **D. <u>Discussion of Deferred Taxes and Revenue Requirement</u>**

6 **Q. What effect do deferred taxes have on the revenue requirement?**

7 A. In general, deferred tax liabilities reduce the revenue requirement because they
8 are subtracted from rate base, whereas deferred tax assets increase the revenue
9 requirement because they are added to rate base. This is similar to any other asset
10 or liability on the balance sheet for which PSE is allowed to earn a return.

11 **Q. What effect does the deferred tax liability for plant have on plant-related**
12 **rate base?**

13 A. The deferred tax liability for plant-related book/tax differences is treated as a
14 reduction to plant-related rate base, thereby lowering the revenue requirement.

15 **Q. Why does PSE reduce plant-related rate base by the deferred tax liability?**

16 A. PSE reduces plant-related rate base by the deferred tax liability to pass the benefit
17 of the deferred taxes along to customers. This methodology perfectly matches the
18 tax benefit with the recovery of the underlying expenditure that gives rise to the
19 tax benefit. The theory behind this treatment is that the deferred tax liability
20 represents the deferral of a tax payment–in essence, an interest-free loan from the

1 federal government to the Company. If a utility avails itself of this cost-free
2 capital, it cannot earn a return on plant acquired by the cost-free capital.

3 **Q. How does this methodology apply when an NOL carryforward is involved?**

4 A. As discussed above, recording an NOL indicates that PSE has claimed tax
5 deductions in excess of the amount that defers a tax payment. If no deferral of a
6 tax payment occurred, then PSE did not avail itself of cost-free capital. In other
7 words, there is no tax benefit to pass along customers via a rate base reduction
8 because the tax benefit has been delayed.

9 **Q. If no tax deferral has occurred, what effect will that have on the plant-**
10 **related deferred tax liability that reduces rate base?**

11 A. If no tax deferral has occurred, the plant-related deferred tax liability that reduces
12 rate base must be reduced by the amount of the deferred tax assets for the NOL
13 carryforward. In other words (using a simplistic rate base calculation to illustrate
14 the point), the rate base would be calculated as (a) the cost of plant, less plant
15 depreciation, (b) less the net plant-related deferred tax liability, (c) plus the
16 deferred tax assets for the NOL carryforward. In this calculation, the deferred
17 taxes that are captured in the plant-related rate base calculation will reflect the
18 amount of taxes that have been deferred (i.e., the amount of zero cost capital
19 received by PSE).

1 **Q. If PSE had not availed itself of the benefits of bonus depreciation, would PSE**
2 **have an NOL carryforward?**

3 A. No. Without bonus depreciation in 2009 or 2010, PSE would not have reported
4 tax losses. In fact, PSE would have reported taxable income and would have been
5 required to make tax payments.

6 Table 3 below summarizes the impact of bonus depreciation on taxable income:

7 **Table 3. Impact of Bonus Depreciation on**
8 **Taxable Income**

(in millions)	NOL	Bonus depreciation included in NOL	Taxable income with bonus depreciation removed
2009 tax return	(92.4)	(247.0)	154.6
2010 estimate	(190.9)	(299.4)	108.5

9 **E. <u>Impact of the NOL Carryforward on PSE's Electric and Gas</u>**
10 **<u>Operations</u>**

11 **Q. What effect does the foregoing analysis have on PSE's electric and gas**
12 **operations?**

13 A. The foregoing analysis was performed at the combined utility level. Please see
14 Exhibit No. ___(MRM-8) for an allocation of the NOL between PSE's electric
15 and gas operations. PSE allocated $157.7 million of the NOL to electric
16 operations and $125.6 million of the NOL to gas operations. PSE has based this
17 allocation on the relative contributions of electric and gas operations to the NOL.

1 **Q. Do these amounts reflect any bonus depreciation for Phase 1 of the Lower**
2 **Snake River Wind Project ("<u>LSR Phase 1</u>")?**

3 A. No. LSR Phase 1 has not been completed at this time. Therefore, there is nothing
4 reflected on PSE's books for bonus depreciation for that project. In other words,
5 LSR Phase 1 has not affected any of the amounts reflected above. Deferred taxes
6 and NOL carryforwards, however, are relevant to LSR Phase 1 because some
7 portion of its bonus depreciation will likely contribute to an NOL carryforward as
8 discussed in the Prefiled Direct Testimony of Mr. John Story, Exhibit
9 No. ___(JHS-1T).

10 **V. TAX AND INTEREST EXPENSE SYNCHRONIZATION**

11 **Q. Please describe the adjustment for the tax benefit of pro forma interest.**

12 A. As in prior rate filings, PSE has included an adjustment to capture the tax benefit
13 of pro forma interest for electric and gas operations. This adjustment is
14 sometimes referred to as interest synchronization.

15 **Q. Why is this adjustment necessary?**

16 A. The interest synchronization adjustment is required to match-up the tax deduction
17 for interest expense with the new capital structure and interest rate adopted in this
18 rate filing. Because the pro forma interest expense on the new rate base will be
19 different than the interest expense in the test year, the tax deduction for interest

1 expense should be adjusted to reflect the projected interest expense anticipated for
2 the projected rate year rate base.

3 **Q. What is the impact of the adjustment for the tax benefit of pro forma interest**
4 **on electric operations?**

5 A. The adjustment for the tax benefit of pro forma interest on electric operations
6 increases operating income by $55,619,944. *See* Exhibit No. ___(JHS-6), at
7 page 6.05.

8 **Q. What is the impact of the adjustment for the tax benefit of pro forma interest**
9 **on gas operations?**

10 A. The adjustment for the tax benefit of pro forma interest on gas operations
11 increases operating income by $18,505,185. *See* Exhibit No. ___(MJS-6), at
12 page 6.05.

13 **Q. How has PSE calculated the interest synchronization adjustment?**

14 A. PSE multiplies the projected rate year rate base by the weighted cost of debt that
15 PSE is requesting in this proceeding. The product is the projected interest
16 expense anticipated for the projected rate year rate base. That interest expense is
17 entitled to a tax deduction at 35%, which is reflected in the adjustment.

1 **Q. Compared to prior rate filings, has PSE made changes to the manner in**
2 **which it has shown the calculation of the tax benefit of pro forma interest on**
3 **electric and gas operations?**

4 A. PSE's calculation of the tax benefit of pro forma interest in this filing is the same
5 as the calculation in PSE's last general rate case, Dockets UE-090704 and UG-
6 090705 (the "2009 GRC"). In this proceeding the entire tax benefit for interest
7 expense is reported in this adjustment. In the 2009 GRC, PSE split the tax benefit
8 between the income tax adjustment and interest synchronization adjustment.
9 Moving the entire tax benefit of interest expense into the interest synchronization
10 adjustment has no impact on the revenue requirement.

11 ## VI. PRO FORMA AND RESTATING ADJUSTMENT FOR
12 ## PROPERTY TAXES

13 ### A. Effect on Electric and Gas Net Operating Income

14 **Q. What is this effect of the property tax pro forma and restating adjustment**
15 **for electric and gas operations?**

16 A. The property tax pro forma and restating adjustment causes electric net operating
17 income to decrease by $3,359,921. *See* Exhibit No. ___(JHS-6), at page 6.11.
18 The adjustment for gas operations causes gas net operating income to decrease by
19 $1,668,296. *See* Exhibit No. ___(MJS-6), at page 6.11.

1 **Q. What is the intent of these adjustments?**

2 A. These adjustments are necessary to convert the property tax expense that has been
3 recorded in the financial accounting records to the property tax expense that is
4 appropriate for the test period.

5 **Q. What method did PSE use to calculate the property tax adjustment in this**
6 **filing?**

7 A. PSE used the same methodology that it has used over the last 30 years or so to
8 calculate the property tax expense associated with the assets owned in the test
9 period.

10 **B. <u>Property Taxes in General</u>**

11 **Q. Please describe the lien date and what occurs on the lien date?**

12 A. One of the most important concepts in property taxation is that of the lien date.
13 The lien date is the date on which the taxing authorities attach a tax lien on all of
14 the taxable property which is owned by the taxpayer. In the tax jurisdictions in
15 which PSE operates, the lien date is January 1 of the assessment year. The tax
16 lien attaches to all taxable property that PSE owns on January 1. In effect, the tax
17 lien attaches to all taxable property that PSE owned during the previous calendar
18 year. The taxes paid on this property as of the lien date are paid in the year
19 following the lien date.

1 **Q. What happens if PSE acquires property after the lien date?**

2 A. Property acquired after the lien date (i.e., after January 1) is not included or
3 reflected in the property tax associated with the January 1 lien date. The new
4 property would be included in the property tax cycle for the next year and would
5 be reflected in the January 1 lien date of the next year and would be paid in the
6 third year.

7 **Q. What is the amount of the liability that attaches to the property on the lien**
8 **date?**

9 A. On the lien date, the amount of the liability is unknown as the taxing authorities
10 have not yet determined the amount. Notwithstanding the unknown amount, a
11 liability has been created and is attached to the property.

12 **Q. Please describe how property taxes are calculated?**

13 A. The property tax expense is the product of three components: (i) the assessed
14 value, (ii) the system ratio, and (iii) the levy rates. The result is the property tax
15 liability for the property that was owned at January 1 of the assessment year.

16 **Q. When does each component of the property tax calculation become**
17 **available?**

18 A. Each component becomes available at a different time. From start to finish, the
19 process can run from January 1 of the assessment year (Year 1) through April of
20 the following year (Year 2) – a total of 16 months. The process is even longer if

the tax payments are factored in, as the tax payments occur on April 30 and October 31 of Year 2. Please see Exhibit No. ___(MRM-9) for an illustration of the property tax timeline that shows when each component of the property tax calculation becomes available. Exhibit No. ___(MRM-9) highlights how the property tax cycle from one year spills over into the property tax cycle of the next year, and, at certain times of the year, two cycles are running concurrently.

Q. Please explain Exhibit No. ___(MRM-9)?

A. Exhibit No. ___(MRM-9) presents a property tax timeline. The timeline shows, visually, how the property tax cycle for Year 1 extends well beyond the end of Calendar Year 1.

By looking at January 1 of Year 2, it is clear that there are two property tax cycles underway: The Year 1 cycle continues through April when the levy rates become available and the calculations can be completed. Then the tax payments can be made in April and October of Year 2. At the same time, Year 2 starts off a new cycle with the advent of the January 1st lien date for Year 2.

Throughout the Year 1 and Year 2 property tax cycles, the main components and their approximate timing are as follows:

Lien date – January 1 Year 1
Unit value – End of July Year 1
System ratio – December Year 1
Levy rate – April Year 2
Payment 1 due date – April 30 Year 2
Payment 2 due date – October 31, Year 2

1 On January 1 of Year 2, the same cycle begins anew for Year 2 and will run
2 through Year 3.

3 **Q. Please describe the property tax cycle and what PSE does at each stage?**

4 A. The property tax cycle begins on January 1 of the assessment year (Year 1)
5 because PSE must determine its best estimate of property tax expense for
6 financial accounting purposes. The initial estimate relies heavily on data and
7 estimates from the prior year. PSE revises the calculation as better information
8 becomes available throughout the remainder of the cycle.

9 For any given cycle, one of the first events is that the levy rates for the prior cycle
10 will become available. The prior year levy rates represent new information that
11 must be factored into the calculation of levy rates for the current year, even
12 though the new data for the levy rates relates to the prior year property tax. PSE
13 typically uses a multiyear average to estimate the expected levy rate.

14 **Q. How does the unit value become available in July?**

15 A. Around the end of July, the Washington State Department of Revenue
16 (the "Department of Revenue") completes its evaluation of the value of property
17 that PSE owned on January 1 of Year 1. Once the value has been set, PSE
18 updates its tax calculation to reflect the new values.

1 **Q. How does the system ratio become available in December?**

2 A. In December, the Department of Revenue provides PSE with the unit value
3 allocated to each county, along with the system ratios for each county. Based on
4 this new information, PSE updates it property tax estimate.

5 **Q. What is the system ratio?**

6 A. The system ratio is the percentage that is applied to PSE's taxable value to reduce
7 PSE's taxable value down to the level of taxation at which all the other members
8 of the particular county are assessed. Because PSE is appraised every year and
9 other taxpayers in the county are not appraised every year, PSE is treated
10 differently than other taxpayers. Each county applies a different system ratio
11 (sometimes referred to as an equalization ratio) to PSE's property to equalize
12 PSE's values with the values of other taxpayers in that county.

13 **Q. As of the end of Year 1, has PSE recorded the actual property tax that will be**
14 **due associated with the assets owned on January 1?**

15 A. At year end, PSE has recorded a reasonable estimate of the property tax expense
16 that it anticipates to pay for the assets it owned on January 1 of Year 1. The final
17 levy rates, however, are not yet available. The levy rate will not be provided until
18 March or April of the following year when the actual tax bills arrive. As a result,
19 the annual property tax expense recorded at year end remains an estimate of the
20 final amount.

1 **Q. How do the levy rates become available for the Year 1 tax cycle in March or**
2 **April of Year 2?**

3 A. The actual tax bills begin arriving in March and April of Year 2 for the property
4 that PSE owned as of January 1 of Year 1. As those bills arrive, PSE can
5 determine the final amount of property tax that is due to the counties and can
6 update its levy rate to the actual value.

7 **C. Ratemaking Issues Related to Property Taxes**

8 **Q. Please explain Exhibit No. ___(MRM-10)?**

9 A. Exhibit No. ___(MRM-10) builds off of Exhibit No. ___(MRM-9) and layers in
10 the concept of a test year. In this proceeding, the test year is concurrent with
11 calendar year 2010 (i.e., January 1, 2010, through December 31, 2010). The test
12 year is a twelve-month period. In the context of a property tax calculation, using
13 a twelve-month period is problematic because a complete property tax calculation
14 takes about sixteen months. The issue this raises, specifically in Exhibit
15 No. ___(MRM-10), is that the property tax expense associated with Year 1 is not
16 finalized until 3 or 4 months into the property tax cycle for Year 2. Year 2 is
17 entirely estimated based on the available information from Year 1, which is itself
18 an estimate.

1 **Q. What is the importance of the lien date?**

2 A. As stated above, the lien date is the effective date of the property tax liability.
3 Property acquire after the lien date is not included in the tax calculation
4 associated with that lien date.

5 **Q. What is the significance of this?**

6 A. The property tax expense that appears in the accounting records is deficient for
7 ratemaking purposes because it only captures the property taxes on property that
8 was owned on the January 1 lien date. For ratemaking purposes, this filing must
9 capture the property tax associated with all property that is owned during the test
10 year, even if it was acquire after the lien date of January 1, 2010.

11 The property tax that is recovered in this proceeding must match the assets to
12 which the test year relates. A property tax that captures only property owned on
13 the first day of the test year will not meet the definition of matching costs
14 associated with benefits.

15 **Q. In this filing, how much property has been added since the lien date of**
16 **January 1, 2010?**

17 A. Please see Exhibit No. ___(MRM-11) for an illustration of the net asset additions
18 from the lien date of January 1, 2010, through the last day of the test year of
19 December 31, 2010.

The net additions through December 31, 2010 (the end of the test year) result in $495.9 million of new plant which is not reflected in the property tax associated with the January 1, 2010 lien date. The breakdown between electric and gas is as follows: (i) net plant additions of $448.6 million for electric and (ii) net plant additions $47.3 million for gas.

Q. Should the tax associated with property acquired after the lien date but before the end of the test year be included in this proceeding?

A. Yes. The tax associated with property acquired after the lien date but before the end of the test year should be included in this proceeding. For example, the Commission stated as follows in the 2009 GRC Order, although not specifically referring to property taxes.

> These [adjustments] are allowed to revise or update expenses, revenues, and rate base so long as there is a mechanism ensuring, and evidence establishing, that these adjustments do not disturb test year relationships.
>
> Thus, in Washington, we use a modified historic test year approach. We start with audited results from a recent 12 month period, but we modify those results to reflect changes that substantial evidence, timely presented, shows have occurred during the pendency of a rate case, or will occur in the rate year that begins at the conclusion of the proceeding. […] This approach reduces regulatory lag without burdening ratepayers with unnecessary costs determined on the basis of the more speculative future test year approach to ratemaking that is used in some jurisdictions.

2009 GRC Final Order at ¶ 22 and 23 (footnotes omitted).

1 As discussed earlier, the additional plant added during the test year will
2 have an impact on property tax. Not reflecting this impact will disturb test
3 year relationships because the property tax recorded in the test year is
4 based on property from 2009, not 2010.

5 **D. PSE's Property Tax Calculation Used in This Filing**

6 **Q. How has PSE calculated its property tax adjustments in this filing?**

7 A. Please see Exhibit No. ___(MRM-12) for a reproduction of PSE's property tax
8 calculation. In Exhibit No. ___(MRM-12), PSE has followed its longstanding
9 practice to update the test year property tax expense to its most recent property
10 tax calculation for the current year.

11 This calculation looks to the lien date of January 1, 2011, which captures all
12 assets owned on the last day of the test year, December 31, 2010. PSE uses
13 reasonable estimates to produce PSE's expected property tax expense.

14 **Q. How does PSE calculate property tax expense for accounting purposes?**

15 A. PSE calculates its property tax expense for accounting purposes in the same
16 manner it is using in this filing. PSE uses the best information available to
17 determine what the property taxes will be. As indicated above, the property tax
18 calculation becomes more accurate over the course of the year as more factors
19 become available. Generally Accepted Accounting Principles ("GAAP") require

updates to these calculations as PSE receives better information throughout the year.

Q. Are PSE's financial statements audited by an independent accounting firm?

A. Yes. PSE's financial statements are audited on an annual basis by an independent accounting firm. The accounting firm attests that PSE's financial statements conform to GAAP in all material respects. Over the course of an audit, the accounting firm will review, among other things, the property tax calculation and methodology.

Q. Does this methodology differ from what the Commission used in the 2009 GRC Final Order?

A. Yes. This methodology is different from what the Commission used in the 2009 GRC Final Order.

E. A Property Tax Calculation that is Consistent with the 2009 GRC Final Order

Q. Has PSE prepared a property tax calculation that is consistent with the 2009 GRC Final Order?

A. Yes. Please see Exhibit No. ___(MRM-13) for a property tax calculation that is consistent with the 2009 GRC Final Order.

1 **Q. What are the shortcomings of this calculation?**

2 A. Exhibit No. ___(MRM-13) is an erroneous estimate of the property taxes
3 associated with the test year.

4 **Q. Why is Exhibit No. ___(MRM-13) an "estimate" of the property taxes**
5 **associated with the test year if all of the numbers, including the total taxes**
6 **paid on line 20, are actual, final values?**

7 A. Although the amounts reported on Exhibit No. ___(MRM-13) are actual, final
8 values, they represent an improper estimate of the property taxes associated with
9 the test year for two reasons.

10 First, the amounts reported on Exhibit No. ___(MRM-13) are based on the wrong
11 lien date. The methodology is calculating tax for the assets owned on January 1,
12 2010, or in effect, assets owned as of December 31, 2009. In other words, the
13 amounts reported on Exhibit No. ___(MRM-13) fail to include any assets added
14 in the test year. PSE's net property increased 7.5% during the test year, and the
15 calculation should reflect a lien date that falls on the last day of the test year in
16 order to capture the tax on the new property.

17 Second, the methodology used to produce Exhibit No. ___(MRM-13) violates the
18 matching principle. It fails to match the costs in the test year with the assets
19 owned in the test year. Although the property tax reflected in Exhibit
20 No. ___(MRM-13) was revealed over the course of the test year, the revelation of

1 the costs over the period of the test year should not be confused with the fact that
2 the tax is unrelated to the assets that were added during the test year.

3 **Q. What is the problem with using an estimate for ratemaking purposes?**

4 A. WAC 480-07-510 allows adjustments to the test period for "all known and
5 measureable changes that are not offset by other factors". In the 2009 GRC, the
6 Commission defined the term "measurable" as follows:

7 This means the amount typically cannot be an estimate, a
8 projection, the product of a budget forecast, or some similar
9 exercise of judgment – even informed judgment – concerning
10 future revenue, expense, or rate base.

11 2009 GRC Final Order at ¶ 26.

12 **Q. How has the Commission applied this definition to property taxes?**

13 A. Perhaps the Commission's clearest exposition of the "measurable" standard to
14 property tax expense occurred in the 2009 general rate case order for Avista
15 Corporation:

16 Property taxes are an annual expense that is consistently known
17 and must be planned for every year. However, the exact amount of
18 these taxes remains unmeasurable until the taxing authorities
19 announce rates and property valuations for any given tax year. It
20 is wholly appropriate to pro form new tax rates and assessments
21 once they become measurable.

22 *WUTC v. Avista Corporation d/b/a Avista Utils.*, Dockets UE-090134, et al.,
23 Order 10 at ¶ 154 (Dec. 22, 2009).

1 In applying this standard in the 2009 GRC Final Order, however, the Commission
2 rejected PSE's attempt to bring in the newest assessed values, which were
3 "measurable" under the Commissions definition of the term, and accepted
4 Commission Staff's recommendation, which did not comply with the
5 Commission's guidance.

6 So the prospective application of the Commission's estimation methodology for
7 property taxes is unclear at this time.

8 **Q. Has the Commission's explanation and application of the "measurable"**
9 **standard addressed property acquired after the lien date?**

10 A. No. To PSE's knowledge, the Commission has not yet addressed the treatment of
11 property added after the lien date. The Commission's focus has been on utilizing
12 the values and levy rates that become known in the test year to determine the
13 property tax expense that is applicable to the test year, without recognizing that
14 this methodology fails to match the costs in the test year with the assets owned in
15 the test year. Missing from the discussion about actual test year numbers is the
16 fact that those numbers relate only to the property owned on the first day of the
17 test year – the lien date, which in this proceeding is January 1, 2010.

1 **F.** **PSE's Proposal for Calculating Property Tax in this Proceeding**

2 **Q.** **Does PSE present a proposal for calculating property tax in this proceeding?**

3 A. Yes. The property tax calculation presented on Exhibit No. ___(MRM-12)
4 represents a reasonable estimate of the property tax due. PSE will update the
5 estimate as information becomes available throughout this proceeding. This
6 estimate is consistent with PSE's filings over the past thirty years or so and has
7 been accepted in the past. Finally, it accounts for property taxes on all property
8 owned by PSE during the test year.

9 The property tax calculation presented on Exhibit No. ___(MRM-12) contrasts
10 with the estimate calculated on Exhibit No. ___(MRM-13). As discussed above,
11 the estimate calculated on Exhibit No. ___(MRM-13) fails to match the costs in
12 the test year with the assets owned in the test year. Specifically, it fails to tax
13 7.5% of PSE's known and measurable taxable property.

14 PSE's goal in calculating property tax expense in this filing is to recover the
15 actual tax—no more and no less. The amount of property tax is ultimately outside
16 of PSE's control. In fact, the tax is set by state and local taxing authorities. If the
17 Commission is concerned about the mechanics of the estimate, it would be
18 possible to treat property taxes akin to the treatment of municipal taxes, as a pass-
19 through on a rider.

1 **VII. CONCLUSION**

2 **Q. Does this conclude your prefiled direct testimony?**

3 A. Yes.