Agenda Date: October 26, 2005
Item Numbers: A2 and A3

Dockets: **UE-051527 and UG-051528**
Company Name: Puget Sound Energy

Staff: James M. Russell, Energy Accounting Manager
Roland Martin, Regulatory Analyst

Recommendation:

Issue an Order approving the accounting treatment sought by Puget Sound Energy (PSE or Company) in its Petition filed October 19, 2005, in Docket UE-051527 and Docket UG-051528 conditioned upon the Company's withdrawal of its proposed tariff filings in these dockets.

Background:

On October 5, 2005, Puget Sound Energy (PSE or Company) filed tariff revisions proposing to increase electric revenues by $5,839,185 (0.4%) and natural gas revenues by $4,182,029 (0.6%) on an LSN basis to become effective November 1, 2005. After discussions with Staff and other parties, PSE agreed to file a Petition for an Accounting Order in these same dockets replacing the tariff revision sought in the original filings.

Original Tariff Filings:

PSE's original tariff revisions sought to increase rates as a result of a recent decision by the Internal Revenue Service (IRS). The decision will require accelerated repayment by PSE of a $72 million deferred tax balance which had been treated as a rate base reduction in PSE's last general rate case, Dockets UE-040640 and UG-040641 (Order No. 6). In that case, the $72 million rate base adjustment was not at issue. However, in Mr. John Story's rebuttal testimony on behalf of PSE he argued that, "The Company agrees that such an adjustment could be appropriate, provided that if any such deductions are subsequently disallowed by the Internal Revenue Service, the Company will then be able to immediately adjust rates to recover any revenue loss, including any assessed interest…" Staff argued in brief that it was "premature for the Commission to grant pre-approval of an automatic rate adjustment that also includes IRS assessed interest." In other words, Staff's position was that the Commission should withhold any determination absent the effect of an adverse IRS ruling and should judge any future proposal on its own merits.

The Commission wrote in its Order No. 6 at paragraph 159:

> "We cannot lawfully prejudge future rates. However, we do find it appropriate to recognize in principle that if the IRS successfully challenges in court the adjustment PSE and other utilities have taken, and requires future repayment of the current benefits taken, presumably with interest, PSE should file an accounting petition asking for appropriate treatment of any back taxes and interest assessed."

PSE did not originally file an accounting petition as prescribed by the Commission's Order. It filed an immediate rate change as proposed by Mr. Story in his rebuttal testimony. In its original cover letter PSE stated that it, "notes that it is unclear from the Order whether the Commission contemplated PSE to file proposed tariff revisions as one manner of handling a reversal of the new tax method."

Staff discussed with the Company its opinion that the tariff proposals were not only unfair, but that they did not comply with the Commission's Order requiring an accounting petition to resolve any adverse ruling by the IRS on this issue. PSE's rate increase proposals are unfair because PSE received a major portion of these tax benefits in September 2002, a full two and a half years before these benefits were ever passed on to PSE's customers through the rate base reduction implemented in UE-040640. Through PSE's proposed tariff revisions the impact of this tax deduction would be removed from customers rates a full year before all the benefits are scheduled to be paid back.

Under the IRS's decision PSE will be required to pay back the remaining $66 million deferred tax balance over the 2005 and 2006 tax years. PSE states that it will pay back the first half ($33 million) on December 15, 2005, and the remaining half over equal quarterly payments on March 15, June 15, September 15, and December 15, 2006. An accounting solution as contemplated and required by the Commission's Order provides a fair way to handle these repayments.

Proposed Accounting Petition:

After discussions with Staff concerning the appropriate means of addressing the tax repayment issue PSE filed a Petition for an Accounting Order in these dockets on October 19, 2005, to track the financing costs associated with repayment of these Federal income taxes. Through the accounting mechanism, PSE proposes to defer the costs at PSE's net of tax rate of return (currently 7.01%). PSE has already repaid approximately $6 million of the total $72 million liability and is proposing to begin deferring the costs associated with that repayment on November 1, 2005.

Through this accounting mechanism the rate of return requirement on the deferred tax repayments can be tracked as they are paid back to the IRS over the coming year. This deferred accounting will provide PSE with interest income to exactly match the timing and offset the cost of financing these repayments. These deferred financing costs, which will amount to approximately $6 million by the end of December 2006, will then be addressed by the Commission through PSE's scheduled 2006 general rate case.

Conclusion:

Staff recommends that the Commission issue an Order approving the accounting treatment sought by Puget Sound Energy in its Petition filed October 19, 2005, in Dockets UE-051527 and UG-051528, conditional upon the Company's withdrawal of its proposed tariff filings in these dockets.