EXH. MRM-1Tr
DOCKETS UE-190529/UG-190530
UE-190274/UG-190275
2019 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,** **Respondent.**	**Docket UE-190529** **Docket UG-190530 (*Consolidated*)**
In the Matter of the Petition of **PUGET SOUND ENERGY** **For an Order Authorizing Deferral Accounting and Ratemaking Treatment for Short-life IT/Technology Investment**	**Docket UE-190274** **Docket UG-190275 (*Consolidated*)**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

MATTHEW R. MARCELIA

ON BEHALF OF PUGET SOUND ENERGY

REVISED
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PUGET SOUND ENERGY

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Matthew R. Marcelia. I am employed as Director of Tax and Finance IT Projects for Puget Sound Energy ("PSE"). My business address is 355 110th Avenue NE, Bellevue, WA 98004-9734.

Q. Have you prepared an exhibit describing your professional qualifications?

A. Yes, I have. It is Exh. MRM-2.

Q. What is the purpose of your testimony?

A. My testimony will address the Internal Revenue Service ("IRS") normalization requirements related to the excess deferred income taxes ("EDIT") that resulted from the recent change in corporate income tax rates and how PSE is addressing treatment of excess deferred taxes in this filing. Specifically, I address two issues from PSE's 2018 expedited rate filing that the settling parties in that case agreed would be reviewed in this case: (i) ratemaking treatment of EDIT related to non-plant assets (unprotected EDIT); and (ii) the proper accounting and ratemaking treatment of protected-plus EDIT reversals for the period January 1, 2018 through February 28, 2019. The protected-plus EDIT is subject to the IRS normalization and consistency rules that I address in my testimony.

Additionally, my testimony addresses the Financial Transparency and Improvement Program ("FTIP") to redesign, modernize, and simplify PSE's accounting and budgeting systems.

Finally, my testimony addresses calculations in the attrition model used in this case for (i) rate year rate base, (ii) PSE's deferred tax liability, and (iii) income tax expense.

II. EXCESS DEFERRED INCOME TAXES

A. Tax Reform

Q. Please provide a brief overview of the 2017 tax reform legislation.

A. On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA" or "Tax Reform") was signed into law; as a result, the federal income tax structure was significantly modified effective January 1, 2018. Among the most notable changes is a reduction in the federal corporate income tax rate from 35 percent to 21 percent.

Q. What effect did the tax rate change have on PSE?

A. The tax rate change had three effects on PSE: First, it caused PSE to file Dockets UE-180282 and UG-180283 to reduce rates so that customers would benefit from the tax rate change. PSE was the first utility in Washington to lower its customer rates to pass along the benefits of the change in the federal corporate income tax rate from 35 percent to 21 percent – a 40 percent reduction in the tax. The new rates became effective May 1, 2018.

Second, it caused PSE to over-collect from customers during the four months prior to the May 1, 2018 rate change, because of the higher tax rate built into PSE's rates. From January through April of 2018, the income tax reflected in the rates PSE was collecting from customers included federal income tax at 35 percent, rather than the new rate of 21 percent. The return of the over-collected dollars to customers was finalized in Dockets UE-180899 and UG-180900 and commenced on May 1, 2019.

Third, the tax rate change resulting from the TCJA also impacted the deferred income tax assets and liabilities on PSE's balance sheet. Because PSE had a net deferred tax liability ("DTL") when the tax rate was lowered, PSE is in a net EDIT position. In other words, PSE has a net DTL that was established using a 35 percent tax rate, but it will pay the liability to the IRS at a 21 percent tax rate; thus, its net DTL is too large due to the change in the corporate tax rate. In this proceeding, PSE will specifically address the treatment of the EDIT.

Finally, the tax rate change has affected other items that were valued using a tax gross-up such as contributions in aid of construction ("CIAC") and the regulatory liability for production tax credits ("PTC"). These are discussed later in my testimony.

B. Background: Deferred Income Taxes

Q. What are deferred taxes?

A. In general, deferred taxes are created when the time period of the tax deduction for an expenditure differs from the time period of the book deduction for the same expenditure. There are many differences between the accounting rules that FERC and the Washington Utilities and Transportation Commission ("Commission") follow (referred to as the "book treatment") when compared to the rules that the IRS requires taxpayers to follow (referred to as the "tax treatment"). One example is storm expenditures. The tax treatment allows for a tax deduction when the cash is expended for storms. The book treatment allows for the storm expenditure to be captured in a regulatory account on the balance sheet and recovered in the future once it is approved by the Commission. This causes a timing difference.

Another example is the different depreciable lives used to depreciate utility property, plant, and equipment. Generally, the tax life of an asset will be much shorter than the book life.

If the tax deduction occurs first, a DTL is created. If the book deduction occurs first, a deferred tax asset ("DTA") is created.

Q. When will the DTL reverse?

A. The DTL will reverse once the deduction for the storm expenditure is recorded in book income. In that time period, the book deduction will "catch-up" to the tax deduction which, in this example, occurred in an earlier time period.

Q. How is the value of the deferred tax established?

A. When these timing differences are recorded, they are tax effected (i.e. valued) at the enacted tax rate for the period in which the timing difference is expected to reverse. It is future looking based on enacted tax law.

Q. What effect do deferred taxes have on customers?

A. Deferred taxes impact customers in two ways: First, the tax expense that is reflected in cost of service is comprised of two components – (a) current tax expense and (b) deferred tax expense. When a timing difference originates, there is a shift between current tax and deferred tax. For example, if PSE incurs $100 of storm expense, it will claim a current tax deduction worth $35. (Note: I'm using the pre-Tax Reform rate of 35% for this example.) PSE will also record a corresponding increase in deferred tax of $35 in order to slide the benefit of the tax deduction into the same future period where it will record the book deduction for the storm expenditure.

The net tax effect of a timing difference is zero – it did not raise or lower PSE's tax expense nor did it increase or reduce customers' cost of service.

Q. What happens between the origination of the timing difference and its reversal?

A. This brings me to my second point: In between the origination of a timing difference and its reversal, there is a balance sitting in a deferred tax account on PSE's balance sheet. In this example, it would be a DTL in the amount of $35.

The balance is a DTL because the tax deduction occurs prior to the book deduction.

The DTL is used in the rate setting calculation to reduce the rate base upon which PSE's allowed rate of return is applied, thus lowering the revenue requirement.

Q. Why does it make sense to lower the revenue requirement for a DTL?

A. A DTL represents an interest-free loan from the government. Due to the difference between the tax laws and the accounting rules, PSE was able to delay making a payment to the IRS (through accelerating deductions or delaying income). By delaying the timing of the payment, it is as if PSE borrowed money from the government; and best of all, there is no interest expense for this type of borrowing. This benefit is passed on to customers by reducing rate base by the amount of the DTL. A lower rate base translates into a lower revenue requirement.

Q. How does the reversal affect customer rates?

A. Let's step through the process. It is very similar to the impact at origination with one very important difference. The big difference between these entries and those at origination is that there is $100 in the income statement for storm expense. The starting point for all tax calculations is that everything in the income statement (i.e. pre-tax book income) should have a current tax at 35%. But that is not the case for these storm costs because we deducted the expense in an earlier period. As a result, we must remove the current tax expense of $35 and offset it with a

deferred tax expense of $35 – effectively undoing our entries at origination. This entry will also have the effect of removing the DTL from the balance sheet.

The net impact of the reversal entries are as follows: (1) the cost of the storm is recorded in the income statement for $100. (2) The net tax expense of $35 is recorded in the same period as the book expense – which has the effect of matching the tax benefit with the cost of the storm expenditure. (3) The DTL reverses when the timing difference reverses.

To summarize (and oversimplify) the impact on the revenue requirement: there is an increase for storm costs of $100, a decrease for tax expense of $35, and an increase for reversal of DTL in the rate base calculation.

C. Excess Deferred Income Tax Balances

Q. Do all EDIT balances follow the same rules?

A. While the mechanics of calculating EDIT are the same for all deferred taxes, it is important to divide the population into two general categories: (i) non-plant related timing differences in FERC Accounts 190 and 283; and (ii) plant related timing differences in FERC Account 282. The distinction is important because the IRS has rules on how EDIT on plant related balances must be handled – the normalization rules. There is no normalization requirement covering non-plant related balances in FERC Account 190 and FERC Account 283. In contrast, most of the balances in FERC Account 282 are subject to normalization. Each of these categories will be discussed separately below.

1. PSE's Recommendation for the Treatment of Non-Plant Related EDIT in FERC Accounts 190 and 283

Q. What is the balance of the Electric and Gas EDIT in FERC Accounts 190 and 283?

A. The EDIT relating to non-plant differences in FERC Accounts 190 and 283 amounted to $36.0 million for Electric and $2.9 million for Gas at December 31, 2017.

Q. What is PSE's proposal to reverse the EDIT for these FERC accounts?

A. As further explained in the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T, PSE proposal is to reverse these balances over a four-year period, commencing with the rate year. To that end, see Adjustment 6.26EP for the impact on electric operations and Adjustment 6.26GP for the impact on gas operations.

The IRS imposes no limitations or restrictions on the timing or speed of the reversal of this EDIT.

Q. Going back to your prior example with the storm costs, how would the reversal of EDIT work?

A. In my prior example, PSE had storm costs of $100 with a DTL of $35. If we assume that Tax Reform occurred before the reversal of the DTL, we would need to reconsider the proper valuation of the storm DTL. Since the new tax rate is 21 percent, the interest-free loan from the government will be satisfied with $21,

not the original $35 that we "borrowed." The difference between the DTL that was recorded at $35 and the new value of $21 represents EDIT of $14.

This type of EDIT (unprotected) can be returned to customers over any time period. PSE is holding that balance (the EDIT) in the DTL accounts where it was created, even as the underlying timing difference continues to move.

Q. Can you explain what you mean?

A. Yes, let me further the storm example to illustrate the point. Let's say that the storm timing difference increased from $100 to $300 (an increase of $200) after the tax rate changed. Recall that the original DTL balance was $35. The increase of $200 at 21% would have added $42 to the DTL ($200 x 21% = $42), which would bring the DTL balance to $77 (original balance of $35 + new activity of $42 = $77). As can be seen from this example, the EDIT is still imbedded in the DTL account in the amount of $14. This can be proved by comparing the expected DTL at 21% (timing difference of $300 x 21% = $63) with the actual DTL on the books ($77) and the difference is the EDIT of $14.

So the EDIT is still there in its original amount, awaiting final resolution.

Q. How would PSE's proposal work as it relates to your example?

A. It would have the effect of amortizing the EDIT of $14 over four years on a straight-line basis via monthly entries. The monthly entries would be a debit to the DTL and a credit to FERC Account 411.1 "Provision for deferred income taxes – credit, utility operating income."

In order to simplify the process, we would gather all of the EDIT from the FERC 190 and 283 deferred tax accounts into a EDIT-only DTL account. The administrative burden of trying to amortize the EDIT out of the existing 70 or so deferred accounts would be significant and very difficult to manage. This would allow PSE to amortize the full EDIT balance out of one account for electric and one account for gas.

2. PSE's Recommendation for the Treatment of Plant-Related EDIT in FERC Account 282

Q. Moving on to the plant-related EDIT, what is the balance of the Electric and Gas EDIT in FERC Account 282?

A. The excess deferred income taxes relating to plant differences amounted to $575.7 million for Electric and $239.7 million for Gas at December 31, 2017.

Q. Are there restrictions on the manner in which plant-related EDIT is reversed?

A. Yes. The IRS imposes restrictions on the timing and amount of the reversal of the EDIT under the normalization provisions.

Q. What is PSE's recommendation with respect to the treatment of the plant-related EDIT in FERC Account 282?

A. PSE proposes that the plant-related EDIT be treated in a manner consistent with the Internal Revenue Code normalization requirements and consistency rule in order to avoid a normalization violation. Specifically, as discussed in more detail later in my testimony, the plant-related EDIT should be passed through to

customers no more quickly than over the remaining book life of the underlying assets. Additionally, all of the following items must be treated consistently: depreciation expense, tax expense (including deferred tax expense, of which EDIT is a subcomponent), accumulated deferred taxes on the balance sheet, and rate base. This will allow PSE to comply with the consistency rule as discussed later in my testimony.

D. Normalization of plant related EDIT

1. In General

Q. Please provide an overview of the tax normalization rules.

A. The normalization requirements of the Internal Revenue Code are designed to prohibit the direct or indirect flow-through of accelerated depreciation tax benefits to utility customers. The requirements generally mandate the use of a "normalization method of accounting."[1] The tax laws require certain plant related book/tax timing differences to be normalized. When something is normalized for tax purposes, it means that the deferred tax is recorded on the balance sheet and is factored into the utility's ratemaking.

The normalization requirements were added to the Internal Revenue Code by Congress with the Tax Reform Act of 1969. The normalization rules were enacted in response to concern over the impact on federal revenues from the growing trend towards the "flow-through" of accelerated depreciation tax benefits to

[1] IRC §168(i)(9)(A).

ratepayers. Before normalization, the tax benefits of accelerated depreciation could be passed from the utility to ratepayers (i.e., flowed through) by reducing the federal income tax expense component of cost of service for the accelerated tax depreciation deductions. The reduced cost of service, in turn, lowered the revenue requirements for the utility. Therefore, the tax benefits were not retained by the utility but, instead, were flowed through to ratepayers in the form of lower utility rates. In addition, Congress was concerned about the "double loss" of tax revenue: first, when the utility claimed the accelerated tax deductions; and second, when it received lower tax revenue from regulated utility companies. The combined effect results in the utility's taxable income being lowered twice for the same tax benefit.

A regulated utility is considered to use a normalization method of accounting for public utility property if: (1) it uses the same depreciation method and a depreciation period no shorter than the method and period used for purposes of determining depreciation expense for cost of service and (2) any variation in the federal income tax expense attributable to use of a method of depreciation for ratemaking purposes different from the method used for federal income tax purposes must be adjusted to a reserve account (i.e., credited or debited to a deferred tax asset or liability account). The reserve balance attributable to this adjustment may be treated as a reduction from the rate base or as zero-cost capital.

Q. Isn't tax normalization just a rate making issue, not an accounting issue?

A. Tax normalization is both an accounting and a ratemaking issue. The accounting is very important. After all, the IRS requires a "normalization method of *accounting*."

To see just how important the accounting is, consider Reg. 1.167(l)-1(h), which lays out additional rules for a normalization method of accounting. In fact, the IRS goes so far as to specify some of the debits and credits required.

> *(2) Adjustments to reserve.*
>
> (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account.

That is fairly specific accounting instructions. While the IRS has not laid out all of the debits and credits in the regulations, it clearly requires proper accounting entries.

In fact, when the IRS specified rules to establish compliance with the normalization requirements in Reg. §1.167(l)-1(h)(3) with respect to its operating results and adjustments to a reserve, it refers to the periodic reporting required by the regulatory body. For PSE, that would be its reports to the Commission (e.g. the Commission Basis Report). The IRS requires that the reports PSE files with the Commission comply with the normalization requirements.

The accounting, regulatory reporting, and the ratemaking calculations must comply with the normalization requirements.

Typically, the use of an historical test year makes compliance with normalization very simple as PSE's normal accounting entries capture everything that the IRS requires.

Q. Just to clarify, does PSE's 2018 Commission Basis Report comply with the tax normalization provisions?

A. Yes, it does. It reflects the reversal of EDIT using the average rate assumption method ("ARAM") as required by the IRS.

2. <u>Normalization More Specifically</u>

Q. Can you elaborate on the normalization requirements?

A. Book/tax differences that are subject to the normalization requirement are considered "protected." All other book/tax differences are considered "unprotected." The two primary areas that give rise to protected differences are book/tax differences for depreciation method and life of the asset (commonly referred to as "method/life differences"). PSE records these deferred taxes in FERC Account 282.

Q. Are all normalized differences considered protected?

A. No. Any book/tax difference for which deferred taxes are recorded would be called "normalized." Only the book/tax differences related to plant method and life are subject to normalization protection.[2]

[2] It should be noted that normalization also applies to the investment tax credit, which is not relevant to this testimony. Those rules stem from a different tax statute, not §168(i)(9).

Q. Are all of PSE's deferred taxes in FERC 282 protected?

A. No. Most of PSE's balance in FERC 282 is protected because it relates to accelerated depreciation – mainly bonus depreciation. However, there is a smaller amount that relates primarily to tax repairs[3] which are technically unprotected.

Q. How is PSE currently treating the unprotected balances in FERC 282?

A. PSE normalizes the unprotected balances in FERC 282, just like it treats the protected balances because in PSE's tax software, the balances are not differentiated between protected versus unprotected. Therefore, PSE applies the same rules and logic to both the protected and unprotected balances in FERC Account 282.

Q. Why does PSE normalize both plant protected and unprotected balances?

A. As it relates to the Tax Repairs book/tax difference, PSE normalizes it because the Commission specifically authorized it[4]. As for the other items, they have been normalized for decades. The normalization of the plant-related tax benefits is also

[3] PSE has different units of property ("UOP") for tax purposes relative to book accounting. The tax UOPs are larger than the book UOPs. As a result, expenditures that would be capitalized for book purposes become a deductible repair for tax purposes. A good example would be a pole replacement. One pole is a UOP for book purposes, whereas all of the poles on a circuit are a UOP for tax purposes. Thus, the replacement of one pole would be capitalized for book purposes; while for tax purposes, the replacement of one pole would simply be a deductible repair on the much larger tax UOP. PSE records a deferred tax on the difference.

[4] The Commission specifically adopted the Company's normalized treatment of tax repairs in PSE's 2009 general rate case in Dockets UE-090704 and UG-090705, which was laid out in my testimony in that case, Exh. MRM-4T, page 30, lines 13-16. In Order 11, paragraph 197, the Commission said, "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." (Emphasis added).

the best method for sharing the tax benefits of an investment with all generations of customers who benefit from the use of the asset.

Q. How much of the EDIT in FERC 282 balance could be considered unprotected?

A. Of the EDIT of $815.4 million, $33.0 million in Electric and $20.1 million in Gas could be considered unprotected but normalized.

Q. How has the Commission handled the protected and unprotected balances in FERC 282 for other utilities?

A. In recent Cascade and Avista orders,[5] the Commission coined a new term to refer to the comingled balance in FERC Account 282 – "protected-plus." This is an appropriate term that captures the balance well. In its orders, the Commission applied the same treatment to the whole protected-plus balance. This approach has the advantage of being much simpler and easier to implement than an approach that would try to differentiate between protected versus unprotected balances in FERC Account 282. PSE's proposal, discussed below, follows the Commission's approach in those orders.

[5] *See* Dockets UG-170929 and UE-170485/UG-170486.

3. Normalization of EDIT

Q. EDIT is caused by a lowering of the tax rate. Since EDIT is not a method/life difference, why do you think the normalization rules apply?

A. On its face, that statement appears to be true. EDIT is caused by a lowering of the tax rate. In addition, the actual language of §168(i)(9) would appear to support the conclusion that normalization does not apply to EDIT. However, the IRS has concluded otherwise. In Private Letter Ruling ("PLR") 8920025, the IRS declares that normalization *does* apply to EDIT. I will discuss that PLR in more detail later in my testimony. PLR 8920025 is provided as Exh. MRM-3.

Q. Please describe the normalization rules that apply to EDIT.

A. The normalization rules for EDIT have two components. First, the EDIT can be passed through to customers no more quickly than over the remaining book life of the underlying asset. This is achieved by applying ARAM to the amount of the reversal occurring in the period.[6] The statute specifies the mathematical calculation that is required. It has the practical effect of spreading the EDIT over the remaining book life of the underlying assets.

Q. Does PSE have the records that are required to calculate ARAM?

A. Yes, PSE has the vintage records that are required to calculate the ARAM rates.

[6] *See* TCJA of 2017 §13001(d)(1). This provision of the TCJA is taken verbatim from the Tax Reform Act of 1986 ("TRA") §203(e)(1). As a result, there is a high likelihood that the IRS will follow the precedence of TRA when interpreting these provisions of TCJA.

Q. What is the second component of the normalization rules that apply to the reversal of EDIT?

A. In addition to the use of ARAM, taxpayers must also follow the usual normalization provisions of §168(i)(9), the most relevant being the consistency rule of §168(i)(9)(B):

> (B) Use of inconsistent estimates and projections, etc.
>
> (i) In general.
>
> One way in which the requirements of subparagraph (A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).
>
> (ii) Use of inconsistent estimates and projections.
>
> The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

Q. Earlier you mentioned PLR 8920025. Please discuss that ruling.

A. In that ruling, the IRS considered a situation where a plant was transferred out of regulatory accounting. One of the questions at issue was whether the EDIT on that plant, which was created as part of TRA, could still be amortized back to utility customers once the plant was no longer part of rate base. While the issue of regulated versus unregulated assets is not relevant to PSE at this time, the IRS'

comments on the nature of amounts "originally deferred pursuant to a normalization method of accounting" (i.e. EDIT) are instructive.

The ruling has two important parts: First, the IRS concluded that

> [A]mounts which were originally deferred pursuant to a normalization method of accounting remain subject to the normalization rules of sections 167(l) and 168(i)(9) of the Code. Accordingly, all amounts previously deferred under corporate tax rates at 46 percent are part of a "reserve to reflect the deferral of taxes" as described in sections 167(l)(2)(G)(ii) and 168(i)(9)(A)(ii), and become inseparable from the assets which initially gave rise to the deferral.[7]

The amounts that are deferred (i.e. EDIT) remain attached to the underlying assets. They do not take on any unique characteristics of their own. They are anchored to the asset and whatever happens to the asset must therefore happen to the EDIT (e.g. if the asset is transferred to non-regulatory, the EDIT is also transferred; if the asset's book life is extended or shortened, so too is the corresponding EDIT reversal). The EDIT follows the regulatory consequences associated with the underlying property. The EDIT cannot do something that the underlying asset is not doing.

Second, in the PLR, the commission and attorney general claim that the consistency provisions of normalization (§168(i)(9)(B)) do not apply because Congress established a special regulatory treatment for the EDIT (e.g. requires the use of ARAM, which is not part of the normalization provisions under §168(i)(9)). For this, the IRS concludes otherwise. "We [the IRS] also believe that

[7] PLR 8920025 is provided as Exh. MRM-3.

[the Tax Reform Act of 1986] does not override the consistency requirements of sections 167(l) and 168(i)(9)."[8]

In this ruling, the IRS clearly applies normalization (ARAM and consistency) to the EDIT. As a result, PSE's treatment of EDIT must clear both hurdles. Clearing only one of the hurdles will result in a normalization violation.

4. PSE's Experience with the Consistency Rule

Q. Has PSE had any dealings with the IRS regarding normalization and the consistency rule?

A. Yes. Many years ago, it was the normal practice in this state to use the average of the monthly averages ("AMA") technique to calculate rate base in a rate filing and to pair the AMA rate base with the end of period ("EOP") accumulated deferred income tax balances ("ADIT"). Obviously, AMA and EOP are different techniques to measure balances for use in setting rates. In 2006, PSE raised the question of consistency under the normalization provisions. Fortunately, PSE was able to work with the Commission and Staff and used a consistent approach on its next rate filing in 2007 while PSE pursued a PLR with the IRS.

Q. What was the result of PSE's PLR?

A. PSE received PLR 200824001 from the IRS in February 2008 which is provided as Exh. MRM-4. In PSE's PLR, the IRS ruled that the use of AMA rate base with EOP ADIT was inconsistent. However, PSE was not subject to sanction because

[8] Exh. MRM-3.

the violation was inadvertent; and it was never PSE's or the Commission's intent to violate the normalization provisions.

That ruling served to heighten PSE's sensitivity to normalization issues in general and the consistency rule in particular.

Q. Are there additional IRS rulings on the treatment of EDIT related to the 1986 tax reform?

A. Most rulings that refer to EDIT do so in the context of assets being sold or becoming deregulated. Others refer to EDIT related to the investment tax credit.

There is a surprising dearth of guidance around EDIT coming out of the 1986 tax reform. That may be because the net DTLs on the books of utilities in 1986 was much smaller than what we see today. After three decades of modified accelerated cost recovery system ("MACRS") and a decade and a half of bonus depreciation, utilities across the country have enormous DTL balances, which led to enormous EDIT balances. In contrast, the balances in 1986 may have been too small to garner much attention.

Q. Did PSE's regulatory filing for the TRA of 1986 address EDIT?

A. I reviewed PSE's 1987 rate filing as it related to tax reform. While tax reform was clearly discussed and dealt with, I saw no indication in the order that EDIT was even considered. In fact, I did not see EDIT discussed in any of the Commission's orders from that time period.

Q. Are there any other PLRs that you think are relevant to PSE's current EDIT situation?

A. There are a number of IRS rulings on consistency, but only the PLR 8920025 ruling combines consistency with EDIT. However, one of the recent rulings on consistency, PLR 201820~~0~~8010, is of particular interest. It is provided as Exh. MRM-5. In that ruling, the taxpayer enters into a settlement with the IRS, which causes its net operating loss ("NOL") to shrink significantly. The taxpayer uses a historical test year. The settlement occurs in the last month of the historical test year. The taxpayer also uses an AMA methodology such that only about 1/13th of the settlement appears in the rate base calculation. The commission's position is to include the full amount of the settlement as a known and measurable adjustment in the rate base calculation, while leaving all other items of rate base and deferred taxes at AMA. The IRS rules that this is a normalization violation because it violates the consistency principle.

Q. What observations do you have regarding this PLR?

A. I have a few observations: (a) By using the full amount of the settlement on the NOL, the commission essentially moved only the NOL to EOP, while everything else remained at AMA; (b) If the commission had moved all items of rate base and deferred tax to EOP, there would be no consistency issue with using the full impact of the settlement on the NOL; (c) The fact that the settlement was known and measurable appeared to play no role in the IRS determination of consistency; and (d) this situation is very similar to PSE's situation in its last ERF filing with a

June 30, 2018 historical test year where the EDIT reversal is present for only the last six months of the historical test year but not the first six months of the historical test year. I will discuss how we handled normalization in the ERF later in my testimony.

Q. Are there any common themes in the IRS' consistency ruling?

A. I see a couple of common themes running through the IRS' rulings on consistency. First, the IRS is laser focused on all four items being consistent: depreciation expense, tax expense (including deferred tax expense, of which ARAM is a subcomponent), accumulated deferred taxes on the balance sheet, and rate base. They must be treated the same. For example: same population, same time period, same convention, same measurement technique; all must be the same. No exceptions.

Second, the IRS never considers the direction of the consistency infraction. For example, in PSE's PLR, the IRS did not explore whether the infraction was beneficial to the utility versus customers or whether the effect was too quick or not quick enough. Inconsistency is an infraction regardless of the size or direction of the dollars involved.

5. <u>Normalization Violation</u>

Q. What are the consequences of violating the normalization rules?

A. The consequences of not complying with the normalization rules are significant. I mentioned earlier that PSE's treatment of EOP versus AMA treatment of ADIT

caused an inconsistency, but the IRS did not impose sanctions because the violation was inadvertent.

Under the TCJA for a violation related to EDIT, the IRS cannot be so lenient. TCJA §13001(d)(4)[9] adds a new provision that was not present in the TRA of 1986. It requires that the taxpayer's tax be increased by the amount that the utility has passed back to customers beyond what is allowed. It does not appear that the IRS has the ability to permit a taxpayer to correct the infraction without incurring the new penalty as it has in other inconsistency infractions unrelated to EDIT. Note that this new increase in tax appears to have the effect of preventing customers from ever benefitting from EDIT that is passed to customers inappropriately.

In addition to this new penalty, the usual normalization penalties would apply, and the impact would be significant to PSE and its customers. PSE would be prohibited from using accelerated tax depreciation. For example, wind farms are depreciated over five years using MACRS depreciation. If PSE violates the normalization rules, it would be forced to depreciate its wind farms using the same method and life that is used for book purposes (e.g., straight-line over 25 years). This would represent a huge cost increase to PSE and its customers, especially when this effect is extrapolated to all of PSE's depreciable assets.

[9] See Exh. MRM-6 for all of the normalization provisions in the TCJA, including the new provision for additional tax.

As a result, the penalties for EDIT-related violations are larger than other normalization violations.

E. EDIT in the ERF

Q. Why are you discussing the treatment of EDIT in the ERF?

A. The settling parties in the ERF agreed that the proper accounting and ratemaking treatment of protected-plus EDIT reversals for the period January 1, 2018 through February 28, 2019 would be reviewed in this case. My testimony explains that the treatment of the EDIT in the ERF complied with IRS normalization requirements and the consistency rule.

Q. How were the EDIT reflected in the ERF historical test year?

A. The ERF presented an interesting challenge from an EDIT/normalization perspective. The ERF historical test year was from July 1, 2017 through June 30, 2018. The root of the issue was that ERF test year included only six months of ARAM. ARAM on the EDIT did not start until January 1, 2018. Thus, it was present in PSE's actual results of operations only from January through June 2018. The first six months of the ERF historical test year, July 1, 2017 through December 31, 2017, predate tax reform.

Q. Didn't PSE make a simple pro forma adjustment to the ARAM calculation to capture the impact for 12 full months of ARAM in the ERF?

A. No, a simple pro forma adjustment was not an option. As PLR 201820~~08~~010, discussed above, demonstrates, a pro forma adjustment to add or remove deferred

taxes that were not present in the historical test period would violate the consistency rule. To reflect 12 months of ARAM in the period of the historical test year for which it did not exist for the whole 12 months (i.e. July 2017 through December 2017) is not permitted.

A helpful way of looking at this is to consider the mechanics of an example pro forma adjustment. The pro forma adjustment would have pulled in 12 months of ARAM. But the 12 month period of ARAM would cover January 2018 through December 2018. That is the crux of the problem. The time periods do not match with the historical test year. This is clearly illustrated in Table 1 below:

Table 1. ERF Normalization

Consistency Item	Time Period
Rate base	July 2017 – June 2018
ADIT	July 2017 – June 2018
Depreciation expense	July 2017 – June 2018
Tax expense, generally	July 2017 – June 2018
ARAM portion of tax expense	January 2018 – December 2018

As shown above, the ARAM covers the wrong period. Viewing the information in this light helps to illuminate the solution that PSE proposed in the ERF.

Q. How did PSE avoid a consistency violation in the ERF?

A. To avoid consistency issues, PSE developed a multifaceted approach in the ERF. First, PSE started with EOP rate base and ADIT as of June 30, 2018. That locked down the population for all of the following calculations as everything else –

depreciation expense, current and deferred tax expense, and accumulated deferred income taxes must be handled in a consistent manner as the rate base.

Second, PSE extended the book depreciation calculation to cover July 2018 through December 2018 for all assets in place at June 30, 2018. PSE dropped the actual depreciation expense from the period July 2017 to December 2017 (to avoid any double counting of book depreciation). PSE also picked up additional book depreciation from January 2018 through June 2018 for the assets on the books at June 30. The essence of these adjustments to book depreciation result in the assets at June 30 receiving a full 12 months of depreciation at current depreciation rates.

Third, by extending book depreciation through December 2018, we needed to reflect the additional book accumulated depreciation in rate base.

Fourth, these adjustments required corresponding changes to tax expense and ADIT to roll them forward to the balance at December 2018 in a like manner to the book depreciation adjustments.

The key to IRS consistency is to apply the same approach to the same population using the same assumptions. PSE's proposed methodology provided consistent treatment for all aspects of PSE's accounts and cleared the way for the inclusion of the 12-month 2018 ARAM estimate in the ERF.

The updated normalization table would look like Table 2 below:

Table 2. Updated ERF Normalization

Consistency Item	Time Period
Rate base	EOP June 2018, with adjustments to accumulated depreciation
ADIT	EOP June 2018, with adjustments for book and tax depreciation
Depreciation expense	12 months depreciation on all June 2018 assets
Tax expense, generally	12 months tax depreciation on all June 2018 assets
ARAM portion of tax expense	12 months of ARAM on all June 2018 assets

Q. Why was this a reasonable approach?

A. This approach achieved the goal of including the estimate of July through December 2018 ARAM in rates. It complied with the normalization and consistency rules. It avoided the harsh consequences of a violation. It was a workable alternative to using the actual rate base, ADIT, depreciation expense, and tax expense (with only six months of ARAM) from the historical period, which would have meant forgoing the inclusion of a full 12 months of ARAM in rates.

Q. What relevance does PSE's treatment of EDIT in the ERF have on the current general rate case?

A. It highlights the care that was necessary to ensure that the ERF results complied with the IRS normalization and consistency requirements. The particular EDIT

issues raised in the ERF were caused by the desire to include twelve months of EDIT reversals when there were only six months of reversal in the ERF test year.

Even though the results of the ERF settlement were a "black box", the support for the EDIT/ARAM that was used in the settlement complied with the IRS rules.

F. EDIT in this GRC

Q. How are you proposing to treat the return of EDIT in this GRC?

A. Because this GRC has a historical test year and because the historical test year reflects twelve full months of ARAM, PSE proposes to use the values recorded in the test year as the basis for its deferred tax calculation.

Q. Is it necessary to make any adjustments to your EDIT or ARAM numbers?

A. The only adjustments that may be necessary relate to compatibility adjustments to ensure that the rate base, accumulated deferred taxes, book depreciation, and tax expense remain in synch. This is not a new or novel requirement. These types of adjustments are considered in every rate case.

For example, the adjustments to ensure that the depreciation for Colstrip Units 3 and 4 is recovered by the end of 2025 will require special care from a tax normalization perspective as discussed in the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T. PSE needs to ensure that the increase in Colstrip's book depreciation remains in synch (i.e. consistent) with the reversal of Colstrip EDIT using ARAM.

G. Deferral of EDIT

1. Treatment of 2018 Reversal of EDIT from January 1, 2018 to February 28, 2019, the Effective Date of the New ERF Rates.

Q. How has PSE treated the reversal of EDIT that has occurred between January 1, 2018 and February 28, 2019?

A. PSE has been recording reversal of EDIT as part of its deferred tax expense calculation each month. In reality, PSE has been calculating reversing EDIT for decades, but the amounts became much larger beginning January 1, 2018, with the tax rate dropping to 21 percent.

Q. How much reversing EDIT has PSE deferred?

A. PSE has not deferred any reversing EDIT in calculating its deferred tax expense.

Q. Why not?

A. Deferring only the reversing EDIT component of deferred tax expense would result in PSE not using a "normalization method of accounting", as discussed above.

2. Not "more quickly or to a greater extent than the reserve would be reduced under ARAM"

Q. Wouldn't deferral result in passing back the EDIT more slowly than over the book life of the asset?

A. It may result in the EDIT being passed back more slowly but only with respect to the time period while the deferral is growing. In all of the time periods when the

deferral is reversing, the impact of the EDIT recorded in those periods would be greater than if no deferral had been recorded.

Q. Can you provide an example?

A. Yes. If the first year of ARAM was $100 and it is deferred, the deferral will be spread over two years, beginning in the second year. In Year 2, ARAM for the year would be $100, plus $50 coming from the deferral. With respect to Year 2, the impact of ARAM would be $150, not $100. An impact of $150 would be more than what is allowed under a normalization method of accounting (i.e. it is faster with respect to Year 2 relative to what is provided by the ARAM calculation of $100).

Q. Doesn't the IRS allow taxpayers to use any method to reverse EDIT as long as its excess deferred tax reserve is not reduced "more quickly or to a greater extent than the reserve would be reduced under ARAM"?

A. It is not likely. I have been unable to find any IRS rulings or guidance where the IRS permitted a taxpayer to employ a calculation other than ARAM. The IRS always requires the exact ARAM calculation.[10] There is no variability in the guidance. Thus, despite the often repeated statement by the IRS that reversal of EDIT cannot be done "more quickly or to a greater extent than the reserve would

[10] The only exception is where a taxpayer lacks the records required for the ARAM calculation. In that case, taxpayers can use the Reverse South Georgia Method.

be reduced under ARAM", I have identified no instances of EDIT reversals using a calculation other than ARAM.

Q. Is there any other issue with the deferral concept?

A. Yes. The consistency rule precludes PSE from deferring the 2018 deferred tax expense for reversing EDIT when nothing else is deferred. Deferring only the reversing EDIT portion of deferred tax expense and nothing else would violate consistency.

To apply this to the example I used above, multiple inconsistencies would be created – one in Year 1 when the deferral is created and one in each year that the deferral reverses, e.g. Year 2 and Year 3. It is very unlikely that the IRS would conclude that multiple inconsistencies equate to a valid "normalization method of accounting."

Q. Did PSE attempt to calculate a deferral plan that would comply with the consistency rule?

A. As PSE began to understand the implication of the consistency rule, it became clear that bringing all of the consistency factors into alignment would require an increase in customer rates, due to the adjustments necessary to bring depreciation expense forward to 2018. In addition, as discussed above, it is unclear that the IRS would accept such a deferral, regardless of the direction (beneficial or detrimental to customers). As a result, PSE has not recorded a deferral. Such a speculative deferral that would need to treat depreciation expense consistent with

ARAM and that would increase customer rates seems to be inconsistent with the Commission's policy intent to "ensure those savings [from Tax Reform] will benefit Washington customers."[11] In one sense, those savings did benefit customers by reducing, but not eliminating the need for, the ERF and GRC rate requests.

In short, no deferral has been made. PSE does not propose such a deferral in this filing.

3. A Normalization Method of Accounting

Q. Would it be possible to perform the tax and ratemaking calculations in a manner that follows a normalization method of accounting and then, once those entries have been made, create a deferral?

A. While this construct has the advantage of calculating and recording all balances in a consistent and valid manner from a normalization perspective, any entry that tries to side step the impact of normalization is prohibited.

For example, §168(h)(9)(B)(i) says

> In general. One way in which the requirements of subparagraph (A) [i.e. normalization] are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).

That statement would prohibit an "after-the-fact" deferral even if the utility followed an otherwise valid normalization calculation.

[11] Washington Utilities and Transportation Commission press release, January 8, 2018.

4. Auditor Review

Q. Has PSE's external independent auditor, PricewaterhouseCoopers ("PwC"), reviewed PSE's ARAM calculation and normalization methodology?

A. Yes. In the course of auditing PSE's 2018 financial statements, PwC reviewed two things. (a) PwC reviewed the reversal of EDIT that PSE recorded in its 2018 tax expense for operations and concluded that the amount reported was "not materially misstated."[12] (b) PwC also reviewed PSE's testimony in the ERF and concluded that "the current treatment of the [EDIT in the ERF] appropriately applies the normalization and consistency rules." PwC's full comments on ARAM and normalization are provided as Exh. MRM-7.

H. Other Tax Impacts of TCJA

1. In General

Q. Were there any other impacts of the TCJA on PSE?

A. Yes, there were a handful of other changes in Tax Reform that I will mention briefly.

(a) The bonus depreciation/interest expense tradeoff – Although the TCJA allows for 100% bonus depreciation in certain instances, utilities, like PSE, are prohibited from using the new 100% bonus depreciation rules and are relegated to using the classic MACRS depreciation rules. Its

[12] By way of translation: an auditor's determination that something is "not materially misstated" means that it is correct.

deductions for tax depreciation will be much smaller in the absence of any bonus depreciation. However, PSE's interest expense should remain fully deductible for tax purposes.[13]

(b) Limitation on executive compensation under §162(m) – The TCJA significantly altered the landscape for the deductibility of executive compensation by broadening the rules to cover all forms of compensation and to include privately held corporations. The impact to tax expense from electric and gas operations was small at $0.4 million and $0.2 million, respectively.

(c) Contributions in aid of construction ("CIAC") – PSE's tariffs for electric and gas CIAC were updated to reflect the elimination of bonus depreciation, changes in the law that make essentially all CIAC subject to income tax, and a change to the tax gross-up to reflect the new, lower tax rate of 21%.

(d) Regulatory liability for PTCs – The new, lower tax rate of 21% required a change to items that were valued using a tax gross-up. This precipitated a large change in the Regulatory Liability for PTCs.

[13] A taxpayer permitted to use the 100% bonus depreciation rules may have its interest expense limited to 30% of taxable income before interest, taxes, depreciation, and amortization.

2. Regulatory Liability for PTCs

Q. What do you mean by "Regulatory Liability for PTCs"?

A. I am referring to the balances in general ledger accounts 25300071 and 25400261, collectively "Regulatory Liability for PTCs" ("RLPTC"). In Order 08 in PSE's 2017 general rate case, these accounts were properly identified as the "customer liability". In that filing, the balance was reported on an AMA basis at "approximately $280 million"[14] as of December 31, 2016. The EOP balance, which was not referenced in the 2017 general rate case filing, was $290.8 million.

Q. What was the balance of the underlying PTCs in that filing?

A. The PTC had an AMA balance of $182.8 million as of December 31, 2016 and an EOP balance of $189.0 million.

Q. Please roll-forward the balance of the PTCs and the RLPTC.

A. Table 3, on the following page, shows the balance of the PTCs and the RLPTC from PSE's 2017 general rate case through December 31, 2018.

[14] Order 08 at ¶ 112.

Table 3. PTC Balances and Regulatory Liabilities for PTCs

	A	B	C	D	E	F	G	H	I	J
	Description	SAP Account No.	AMA 12/31/2016 (a)	EOP 12/31/2016	Accrued Monetization in 2017	Tax Reform	EOP 12/31/2017	Actual Monetized on Final 2017 Tax Return	Accrued Utilization in 2018 (b)	EOP 12/31/2018
1	Relevant tax rate		35%	35%	35%	35% => 21%	21%	35%	21%	21%
2	PTCs due from IRS	19000601	182.8	189.0	(1.4)	no change	187.6	(2.8)	(64.6)	121.6
3	Tax Benefit of PTCs at 35%		98.4	101.8	(0.8)			(1.5)		
4	Tax Reform - rate change					(51.1)				
5	Tax Benefit of PTCs at 21%						49.9		(17.2)	32.3
6	Total PTCs with tax benefit		281.2	290.8	(2.2)	(51.1)	237.5	(4.3)	(81.8)	153.9
7	Reg. Liab. For PTC ("RLPTC"	25300071/ 25400261	(281.2)	(290.8)	2.2	51.1	(237.5)	4.3	81.8	(153.9)
8										
9	Montana Fund (monetization)	10800931					-	(4.3)	-	(4.3)
	(a) Dockets UE-170033 & UG-170034 at 41:112, citing Exh. PSE-1JT at 5:17-19.									
	(b) Amounts will be available for ratemaking purposes when monetized on the final 2018 Tax Return									

From Table 3, I would highlight a couple of things: First, during 2017, PSE estimated that it would use about $1.4 million in PTCs, in column E and recorded the impact of that potential usage at 35%. Estimated usage is not the same as "monetization." Monetization did not occur until 2018, in column H, where the actual PTCs used was $2.8 million on the 2017 tax return. The benefit for the monetization on the 2017 tax return was grossed up at 35% because that was the rate in effect for that tax period, even though the tax return was filed after Tax Reform took place.

Second, Tax Reform in column F and row 4, causes a significant drop in the RLPTC – but there is no corresponding movement to the PTC balance on row 2 column F, and the ending PTC balance is $187.6 million in row 2 column G. That is the face value of the tax credits. In valuing a tax credit, there is no need to apply an income tax rate because the tax credit is an "after-tax" value. In other words, PSE's tax credits were $187.6 million when the tax rate was 35%, and they are still $187.6 million when the tax rate is lowered to 21%.

Q. If there was no change to the PTC balance, why would you change the RLPTC?

A. All regulatory assets or liabilities are established at the "pre-tax" value. FERC and GAAP accounting generally prohibit net-of-tax reporting of regulatory accounts (or any other account).

In order to establish the rate-making value of an after-tax amount, like the production tax credit, the after-tax item must be grossed up by one minus the tax rate.

In times past when the PTCs were created, the proper accounting was to take the face value of the PTCs and gross them up by the 0.65 (which is 1 – 35%) because the tax rate back then was 35%, with the impact visible on row 3 of Table 3. Over time, this caused the PTCs of $189 million to become the RLPTC with a value of $290 million. Stated a little differently, $290 million represented the amount of revenue reduction[15] that customers would see on their energy bills as PSE was able to utilize its $189 million in PTCs on its tax returns. Reducing revenue by $290 million ensures that $189 million benefit of the PTCs flows to customers.

See this example for how the calculation works:

Revenue reduction	($290)
Income tax benefit at 35%	$101
PTC utilized	$189
Net Income	- 0 -

Q. How does your example change when the rate drops to 21%?

A. (For simplicity, I'll ignore the $1.4 million in activity in 2017 for this example.) When the rate drops, the gross-up needs to be adjusted to reflect the actual amount that must be passed back to customers. PSE must reevaluate the PTC of

[15] In this example, I'm using a revenue account to represent the value going to customers. It could be presented as an expense reduction or as an offset to an asset on the balance sheet.

$189 million under the gross-up equation by taking the face value of the PTCs and gross them up by the 0.79 (which is 1 – 21%) because the new tax rate is 21%. The RLPTC has a new value of $239 million.

Here's the proof that the new value is the correct value and will result in the full value of the PTCs flowing to the benefit of customers.

Revenue reduction	($239)
Income tax benefit at 21%	$50
PTC utilized	$189
Net Income	- 0 -

As a result of Tax Reform, the RLPTC is reduced by $51 million.

Q. What would happen if the RLPTC was left at its original value and was not adjusted for Tax Reform?

A. If the balance of the RLPTC is not altered for Tax Reform, it will be recorded at the wrong balance and will overstate the value of the customer liability.

Here's the impact if the value of the RLPTC is not changed.

Revenue reduction – no change	($290)
Income tax benefit at 21%	$61
PTC utilized	$189
Net Income/(Loss)	($40)

The result is not zero. The RLPTC needs to be restated to reflect the new tax rate.

Q. Does the decrease in value mean that customers will receive less than the full value of the PTCs?

A. No. Customers will still receive 100% of the value of the PTCs. The value of the RLPTC has declined due to Tax Reform, but customers will receive all of the PTCs, grossed up to the new tax rate.

Q. Is there anything else you'd like to mention about Table 3?

A. Yes. Row 9 of Table 3 shows the funding for the Montana Transition Fund. Pursuant to Order 08, paragraph 112, in PSE's 2017 general rate case, there is a clear priority to the application of the monetized value of PTCs. The first $5 million goes to the Montana Transition Fund. On PSE's 2017 tax return, the monetized value for customers was $4.3 million ($2.8 million in PTC + gross up at 35% of $1.5 million). PSE will contribute the additional $.7 million when additional PTCs are monetized on future tax returns.

3. Impact of Tax Reform on Cash Flows

Q. Has Tax Reform had any impact on PSE's net cash flows?

A. Yes, Tax Reform has affected net cash flows. The primary impact results from the loss of bonus depreciation.

a. Impact of Loss of Bonus Depreciation

Q. Please explain how bonus depreciation impacts net cash flow.

A. Under Tax Reform, utilities, like PSE, are no long able to use bonus depreciation. For utilities, the only accelerated depreciation that is available is the classic

MACRS depreciation rates. While MACRS tax depreciation is still accelerated when compared to the normal book depreciation rates, it does not offer the significant benefit that PSE has been accustomed to since 2001 when bonus depreciation was first introduced.

In fact, the impact of this change on PSE's deferred taxes has been significant. For example, in 2017, PSE's tax depreciation was about $297 million larger than its book depreciation. At 35%, this translates into tax savings (i.e. a tax-free loan from the U.S. government) of about $104 million. 2017 was typical of what PSE has experienced with bonus depreciation over the years – tax depreciation exceeding book depreciation by hundreds of millions of dollars each year. PSE's estimate for 2018 is radically different. Instead of tax depreciation exceeding book depreciation, book depreciation is now exceeding tax depreciation by about $39 million for 2018. At 21%, that translates into tax costs (i.e. a tax payment) of about $8 million. The swing from 2017 to 2018 (caused by Tax Reform) is having an impact on PSE's cash flow.

Q. But aren't there other book/tax timing differences that counteract the effect of losing bonus depreciation?

A. No, not really. Depreciation, in the bonus-era, has been one directional and significantly beneficial to customer rates and PSE's cash flow. It is now gone. There are many other book/tax timing differences. But those were not impacted by Tax Reform to the extent that depreciation was. Generally, those book/tax differences have been much smaller than depreciation and have "danced around"

meaning that they are likely to flip from positive to negative from year-to-year. The character of those has not changed under Tax Reform.

b. Impact of Reversing EDIT

Q. What effect does reversing EDIT have on cash flows?

A. Reversing EDIT, regardless of which FERC account it is attributable to (FERC Account 190, 282, or 283), is effectively a use of cash. It is being passed back to customers in the form of lower rates, which means less cash inflows to PSE. The impact is more subtle than the impact of bonus depreciation because the EDIT is already a net liability on PSE's books – in the form of a net DTL. The cash outflow for the reversal of the EDIT is "paid" to customers, whereas the reversal of the pre-Tax Reform DTL would have been paid to the IRS. As it is passed back to customers, PSE will be swapping out its interest-free loan from the U.S. government and will need to "re-finance" with a combination of additional debt or equity. Note that the cash outflow is the same amount in each case – only the payee is different. This highlights another element of the ARAM methodology – it is designed to ensure that the utility's cash outflow from reversing DTLs is the same before and after the Tax Reform. For the Account 282 balances, the reversal (and thereby, the cash impact) will be the same pre- and post-Tax Reform.

Q. Will the reversal of the EDIT in FERC Accounts 190 and 283 also be cash neutral pre- and post-Tax Reform?

A. Since there is no tax normalization requirement for the EDIT in FERC Accounts 190 and 283, there is no need or requirement to achieve cash neutrality pre- and

post-Tax Reform. In that case, other concerns come into play as further explained in the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T.

c. Summary

Q. Please summarize the impact of Tax Reform on cash flows.

A. Table 4, below, summarizes the magnitude of the effect of Tax Reform on cash flow.

Table 4. Summary of the Magnitude of the Effect of Tax Reform on PSE Cash Flow

	Description	2018 Estimated/ GRC	2017 Actual	Difference
1	Tax vs. Book Depreciation Exp.	(39.0)	297.2	(336.2)
2	Tax Rate	21%	35%	
3	Tax Impact of loss of bonus on Cash	(8.2)	104.0	(112.2)
4	Rate base offset impact (a)			5.3
5				(106.9)

(a) $112.2 million in DFIT × 9.8% ROE × 48.5% = $5.3 million

While the impact of Tax Reform has been very beneficial for customers, it is adversely impacting PSE's net cash flows. PSE's cash flows from operations impact its capital structure and its credit rating. This is discussed in the Prefiled Direct Testimony of Daniel A. Doyle, Exh. DAD-1T.

III. THE FINANCIAL TRANSPARENCY AND IMPROVEMENT PROGRAM

A. Overview of FTIP and the Need for FTIP

Q. Please describe FTIP.

A. FTIP is a redesign, modernization, and simplification of PSE's accounting, budgeting, and forecasting systems, processes, and tools. There are two phases, which I refer to as FTIP 1 and FTIP 2.

Q. Describe your role.

A. For FTIP 1, I was a member of the Steering Committee. For FTIP 2, I was the Sponsoring Director and was responsible for day-to-day operations of implementing the program. Both phases of FTIP are described later in my testimony.

Q. Describe the need for FTIP.

A. There were a number of reasons PSE needed to implement FTIP. The main reasons were as follows:

- PSE implemented SAP's accounting platform ("ECC") in 1998. Over time, the 20-year-old original installation became outdated and burdensome to maintain.
- PSE needed to eliminate the customizations built into the initial SAP implementation to simplify and make more cost effective other strategic investments, including Integrated Work Management and future projects on the SAP platform.
- Prior to FTIP, PSE operated and maintained four separate budget systems that worked well individually but did not efficiently and consistently support a corporate-wide financial view of PSE.

- Given the separate budget systems described above, budgeting and forecasting activities and processes were more complicated, time consuming, less transparent, and less efficient to operate and maintain than a single centralized system.

- Many components of budgeting and forecasting were performed in "off system" spreadsheets or databases that were inefficient to operate and maintain and were subject to error, which intensified the need for non-value adding and time-consuming quality controls.

- Inefficient and difficult data mining and analysis delayed decision making.

- Certain "behind the scenes" allocation processes within SAP called assessments[16] hindered and obfuscated cost flows and transparency into spending patterns.

- Routine patches and upgrades were more risky and costly to implement due to the customizations built into the original design of the financial systems.

- The accounting system was based on FERC-centric work order numbers, requiring FERC accounting knowledge and decision making throughout the organization.

- Over time, the account structure accumulated over 3,000 cost elements and 2,000 labor activity rates, which increased complexity and reduced transparency.

- The organization inconsistently used key data fields and governance structures within the financial module of SAP.

In short, the accounting software solution that PSE implemented in the late 1990s, which worked well for so many years, needed to be rethought and refreshed in order to meet the current and future needs of PSE and its customers.

[16] In SAP, an assessment is a process whereby the system will allocate the expenditures in a cost center to work orders. In general, the process is a convenient way to allocate costs. However, it has a significant drawback in that if your work order receives an assessment, it is very difficult and time consuming to reverse engineer the process to determine why your work order was assessed that dollar amount in that month. Managers who were on the receiving end of an assessment found the process unpredictable and quite frustrating from a budgeting, forecasting, and accountability perspective.

In light of these needs, PSE management established its objective to redesign PSE's budgeting process, tools, accounting structure, reporting, and financial accountabilities in order to:

- Evolve PSE's financial systems from one that primarily meets accounting requirements to one that also keeps track of expenditures in a manner that more transparently reflects the way PSE manages its business and the work that it performs;
- Reduce the work on budgeting, accounting, and reporting—and get more value out of it;
- Improve the financial information available to management to allow for better decision making.

The need and vision for the project were articulated in the August 14, 2014 whitepaper at Exh. MRM-8.

B. The Scope and Implementation of FTIP

Q. What was the scope of FTIP?

A. As PSE entered the Design Phase[17] of the project, the project team gained more clarity on the specific scope that would be necessary to achieve the objectives discussed above. That initial scope was extensive. At a high level, it called for a major change in the cost flow model, replacement of the income statement architecture, establishing a newer and more enlightened governance model over key data elements, simplifying and standardizing key data elements, installation

[17] PSE's project management process utilizes a Project Lifecycle/Phase Gate Model, which includes five phases: Initiation, Planning, Design, Execution and Close-out. Each phase includes deliverables and activities that allow the project to progress through each phase by way of phase gate approvals.

of the Budget Planning and Consolidation ("BPC") budgeting tool, installation of the FERC module, migration to Simple Finance, migration to the SAP Hana platform, and installation of SAP's Fiori[18] apps. The established timeline required completion of this work in time to open the books in January 2017 on the new platform – giving PSE a clean break from the old in 2016 and ushering in the new for 2017.

Q. Describe how PSE kept management informed during this project.

A. The FTIP project followed PSE's project management guidelines. Those guidelines require a review of the project at each Phase Gate. At the end of the Design Phase in early 2016, management evaluated the project as it prepared to move from the Design to Execution Phase. As originally designed, the cost had increased. Implementation risk had increased. Schedule risk had increased. Technology risk had increased. In addition, extensive organizational change management would be required, given the level of change proposed.

Q. Did PSE reevaluate the planned implementation of FTIP in light of these risks?

A. Yes. At this point, management initiated a mini-redesign phase to divide the program into two parts, which would address the risks while preserving the benefits. Each part would continue to have two tracks within it, a budget track and an accounting track. For FTIP 1, the focus of the budget track became the

[18] SAP Fiori Apps are a collection of standard business applications within SAP featuring a customized and more intuitive user experience for some elements of the SAP landscape.

installation of the BPC module without user enhancements. The focus of the accounting track was to make the changes necessary to support the budgeting tool, i.e. change the cost flow model[19] and simplify and standardize key data elements. Everything else was moved to FTIP 2 – FERC, income statement, user enhancements in BPC, Simple Finance, etc.

In Exhibit MRM-9, I walk through growth in the original FTIP design and show how it was redesigned into the smaller and more manageable FTIP 1.

Q. Please describe the Design Phase and scope of FTIP 2.

A. In May 2017, FTIP 2 went through its own Design Phase. Its scope included all of the de-scoped items from FTIP 1, with the exception of Simple Finance and the Fiori apps, and added the Trintech Cadency reconciliation tool.

The Corporate Spending Authorization ("CSA") for the FTIP 2 Design Phase is included as Exh. MRM-10.

Q. When were the FTIP phases completed?

A. FTIP 1 was completed on time and placed in service in January 2017. This allowed PSE to make a clean break between 2016 and 2017. FTIP 2 was completed and placed in service in May 2018.

[19] The cost flow model controls how costs make their way through the accounting system, from the origination of the expenditure through to its final resting place on the financial or regulatory chart of accounts.

Q. Were there significant changes to the scope, schedule, or budget of FTIP?

A. No. Once each project completed its Design Phase, there were no significant changes to the scope, schedule, or budget. The overall project costs were $73.8 million, which is consistent with the projects overall budget.

C. Alternatives Considered

Q. Describe the alternatives evaluated and how the FTIP solution was chosen.

A. There were three primary options that PSE considered. The first was to install a single budgeting solution without making any changes to the accounting system (SAP's ECC module). This option was extremely unpalatable. Any budget system under this scenario would have required extensive customization in an attempt to replicate the customizations that were in place in the accounting system. While a project of this nature may have been technically possible, PSE would have been doubling-down on the accounting customizations that were proving so problematic in terms of simplicity, transparency, and accountability by forcing similar customizations into a new budgeting solution. This would not have achieved the objectives for the project nor would it have met the needs of the organization.

The second alternative was to install a budgeting solution, make some modifications to the existing accounting system, but not address the issue of work order numbering and FERC accounting, discussed further below. This option would have provided PSE with a partial solution. The budgeting tool would have

required extra customizations. The accounting system would have been improved to a limited extent by removing some assessment cycles. The biggest drawback to this option was the level of customizations that remained in the accounting system (ECC) – the income statement would continue to be derived from work orders, and those work orders would need to have the FERC number in them, which would require manual creation. This arrangement, while possible, would have significantly hindered future development on the SAP platform, especially in the enterprise asset management space (Integrated Work Management).

The third option, which PSE adopted, was to install a budgeting solution and to bring the accounting system into a standard configuration. This arrangement met all of the criteria. PSE would install one budgeting tool without undue customization which would be used across the whole organization. The accounting system would be brought into a standardized SAP configuration. The cost flow model would be streamlined and simple. Assessments would be nearly eliminated. The move to the FERC module would enable PSE to use natural work order numbering regardless of the FERC classification. Future projects in the SAP landscape could move forward without the accounting system dictating excessive complexity and customizations.

Q. How did PSE decide on SAP's BPC tool as its budgeting solution?

A. PSE considered three budgeting solutions: SAP's BPC solution, SAP's PPM solution, and PowerPlan's budgeting solution. PSE focused on these three products because of (a) their capabilities in budgeting capital projects, (b) both

platforms (SAP and PowerPlan) are already deeply embedded in PSE's IT landscape, and (c) both offered fairly seamless integration. Other third-party applications were not considered as the complexity and uncertainty of introducing another vendor and new processes into the landscape carried additional costs and risks beyond what PSE was willing to take on. One of PSE's guiding principles for IT projects is to leverage existing technology assets and maximize their use. In addition, both SAP and PowerPlan are respected market leaders in the utility industry.

In the end, the BPC solution was selected. Implementation of the PPM solution would have significantly expanded the scope, schedule, and budget for the project and taken us down a path that was beyond the stated objectives of the project. The PowerPlan solution offered seamless integration for capital projects but was undifferentiated with respect to operations and maintenance expense. In addition, it was projected to be more costly overall.

Q. Did PSE consider changing its accounting system and using something other than SAP?

A. No. SAP is PSE's enterprise resource planning platform ("ERP"). SAP's accounting module (ECC) is the heart of that system. To swap out the accounting module would have completely disrupted the entire platform. Far from improving or simplifying the system, it would have moved the organization in the opposite direction. Other functions performed within SAP would have required a complete

retrofit[20] with custom interfaces that would complicate the landscape and lead to higher overall cost of ownership.

Q. Did PSE consider upgrading to the current version of SAP?

A. Yes, PSE evaluated moving from Classic GL to a newer version, either Simple Finance or S/4. Ultimately, PSE identified no compelling benefits justifying the move and decided to remain on Classic GL. During this time, SAP announced that it would continue to support Classic GL through 2025. In addition, very few utilities had moved to either Simple Finance or S/4, and PSE was not interested in being a pioneer.

As a consequence of the decision to not pursue Simple Finance or S/4, we reevaluated the Fiori Apps that were available for Classic GL and concluded that there was not enough value to justify the effort to implement them.

D. Cost and Description of the FTIP Subphases

Q. What was the cost of each sub-phase of the project?

A. The following is a summary of the cost of the project by the four sub-phases.

The cost for FTIP 1 – Budgeting was $21.5 million. In this sub-phase, PSE installed BPC, which was a new module that was added to SAP. BPC integrates with PSE's existing SAP technology footprint and IT support structure. BPC established a common platform for budgeting across the organization and allowed

[20] Including PSE's entire billing and human resource systems.

PSE to centralize around one budget system. As a result, we eliminated the side spreadsheets and databases, and we eliminated the small legacy systems, Cognos and Pace, that were used by some groups.

The cost for the FTIP 1 – Accounting was $18.3 million. The installation of BPC would have been completely ineffective without changes to the SAP accounting module, ECC. The most important change to ECC was the alteration to PSE's costs flows, which simplified the path that expenditures flow through the accounting system. It required that PSE redesign and standardize the usage of such data elements as SAP's work breakdown structures ("WBS"), cost centers, cost elements, and labor activity rates. These data elements had to be simplified and standardized across PSE. For example, we reduced the number of labor activity rates from about 2,000 to 150 by introducing standard labor rates. Similarly, we reduced the number of cost elements from over 3,000 to 500. In short, we made dramatic changes to ECC putting it on the path toward simplification and clarity.

The cost for the FTIP 2 – Budgeting was $8.0 million. In this phase, we automated a number of cumbersome functions, such as adding, removing, and transferring employees among cost centers. We simplified our labor planning for capital projects, added drill-through functionality to assist in researching variances, added detailed tabs to the budgeting forms, and added predictive text to make input easier. We also added better budget to actual reporting. The new

functionality greatly improved the usability of the BPC solution beyond that offered at the time of original installation.

The cost for FTIP 2 – Accounting was $26.0 million. As part of this phase of the project, PSE installed the SAP FERC module. This module allows PSE to do its FERC reporting from within the system and to generate PSE's income statement using the reporting embedded in the restructured WBS, as changed in FTIP 1. One of the major customizations instituted back in 1998 was to use the SAP order numbers as the basis for the FERC income statement whereby the FERC account was embedded in the mask for all order numbers, even those used by field operations – a group that is largely supported by contract labor. The old arrangement required (a) field operations to have an understanding of FERC accounting and (b) each order number to have the FERC order number embedded in its first four digits. By shifting the income statement to the WBS and allowing the FERC reporting to be derived from the FERC module rather than from manually created orders containing a FERC hierarchical structure, PSE can now use standard SAP techniques to automatically create orders and continue to successfully report its results on a FERC basis. Additionally, future projects within the SAP landscape will build on this new capability for which FTIP laid the groundwork. Additionally, FTIP 2 – Accounting included a normal maintenance upgrade to the PowerPlan software in addition to re-architecting it to receive the new data stream from SAP, which allowed the software to process activity from multiple FERC accounts that are charged to the same capital order. Finally, PSE installed the Trintech Cadency software for reconciling account

balances. It allowed PSE to move away from spreadsheets and centralize our account reconciliation process into a single tool

E. FTIP Provides Benefits to PSE and Its Customers

Q. Describe the benefits of the project.

A. In evaluating the benefits of FTIP, all of the sub-parts are inextricably linked. The budget benefits could never have been achieved without the compatible changes to the accounting system. Table 5, below, sets forth a summary of the annual benefits:

Table 5. Summary of Annual Benefits

Benefit	Metric	Baseline	Target	Cash Savings	Avoidance
Reduction of construction support costs	Construction support overhead	$128.0M	$113.0M	$15.0M	
Avoidance of construction support costs		$12.0M	$0.0M		$12.0M
Reduction in number of employees in the Budget department	# of FTE in Budget	26	19	$1.0M	
Total cash benefit				**$16.0M**	**$12.0M**
All benefit (incl. cost avoidance)				**$28.0M**	

PSE has already seen the benefit in terms of a reduction in employees working in the Budget department and a reduction in the construction support costs. These savings began in 2017 and are included in the test year in this case. These benefits present a cash-on-cash payback of about 4.6 years or an all-in payback of about 2.6 years. These annual savings do not include the other FTIP benefits.

Q. Has PSE pro formed in the benefits from FTIP?

A. No. The benefits in Table 5 began in 2017. They are reflected in the operating results in the 2018 test year and do not need to be pro formed in to the results.

Q. Are there other benefits resulting from FTIP?

A. The benefits listed above do not capture the full impact of the financial transformation that the project provides. There are many benefits that will not show up directly in the numbers, including:

- Better transparency into the numbers leads to better resource allocation and quicker decision making.
- A common budget platform allows for clear visibility and accountability down to the cost center manager level.
- Future upgrades and service packs can be installed more quickly and with less risk

In addition, the accounting platform is now ready for the future. By moving the accounting architecture to a standard SAP methodology and by removing the FERC account number from PSE's order structure, PSE has paved the way for future technologies that are more directly customer facing. For example, FTIP laid the foundation for PSE's Integrated Work Management, which is transforming how PSE performs work for customers – from first contact, to order creation, to work assignment, to job completion, to project billing.

FTIP also lowers PSE's accounting, reporting, budgeting, and technology risk, improves PSE's accountability model, allows for more efficient and better decision making, and paves the way for future improvements.

IV. ATTRITION ANALYSES

Q. Did you assist in preparing the attrition analyses presented in this case?

A. Yes. I provided assistance with respect to the following calculations in the attrition analyses: (i) rate year rate base and depreciation expense, (ii) DTL used in the rate base calculation, and (iii) income tax expense. The attrition analyses and adjustment is described in more detail in the Prefiled Direct Testimony of Ronald J. Amen, Exh. RJA-1T.

Q. How were rate year rate base and depreciation expense calculated in the attrition analyses?

A. The attrition growth factors by functional class developed by Black and Veatch were used to grow the EOP gross plant presented on page 1 in column "c" in Exh. SEF-4E and Exh. SEF-4G to the rate year. The balances were then converted to an AMA basis. The same attrition growth factors were used to grow book depreciation expense by functional class, which, in turn, drove the movement in accumulated depreciation on the balance sheet. A few asset groups (e.g. AMI, GTZ, CRM[21], and Colstrip) were handled differently, as their growth or lack thereof were anomalous relative to the populations where they would normally reside, thus it would not be appropriate to apply the same attrition growth factors to them as were applied to the rest of the population. As a result, those groups had their rate year amounts determined separately in a manner that was more

[21] Acronyms stand for Advanced Metering Infrastructure, Get to Zero and gas Cost Recovery Mechanism.

specific to their circumstances. For AMI and GTZ, PSE's rate year revenue projections and capital projections were used. For CRM, because these amounts are recovered in a separate mechanism, the rate year amounts were left at the same level as was in the test year so as not to impact the trending. For Colstrip, depreciation expense that is included in the restated results of operations was removed in order to not overstate the attrition results in the rate year, as discussed in the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T.

Once the numbers for 2020 and 2021 were escalated, the results were converted to AMA using 8/12th of 2020 activity and 4/12th of 2021 activity.

This exercise yielded the movement in gross plant, depreciation expense, and accumulated depreciation that were used for the attrition analyses.

Q. How was the DTL calculated in the attrition analyses?

A. The DTL used in the rate base calculation was calculated in accordance with the IRS normalization and consistency principles. The movement in the DTL was calculated based on the movement in gross plant, accumulated depreciation, and depreciation expense, referred to above. Tax depreciation was calculated for each forecasted year using the same capital additions used in gross plant. The resulting difference between book depreciation and tax depreciation caused movement in the DTL balances.

Once the deferred taxes were calculated for 2020 and 2021, the results were converted to AMA using 8/12th of 2020 activity and 4/12th of 2021 activity, following the IRS normalization technique.

Q. How was income tax expense calculated in the attrition analyses?

A. To calculate income tax expense, we focused on the key drivers of tax expense: (a) the statutory rate of 21%, (b) plant related activity including reversal of excess deferred income taxes ("EDIT"), (c) the tax benefit of interest expense, and (d) a small amount of "other." Each of these drivers is discussed below:

(a) Statutory rate. The statutory rate is 21%. That rate was applied to the rate year pre-tax net operating income.

(b) Plant related activity. Plant related activity consists mainly of reversing flow-through and reversing EDIT. The impact of this activity was projected out to the rate year and the impact was included in the tax expense calculated for the rate year.

(c) Tax benefit of interest expense. This is the usual adjustment which puts the tax benefit of the interest expense into the revenue requirement. It is calculated as the requested weighted average cost of debt of 2.87% times rate base to determine the portion of interest that is funding rate base multiplied by the statutory tax rate of 21%. It's a benefit because interest is a deduction from taxable income and it makes tax expense smaller.

(d) Other. The "other" category looks at the test year tax expense for any impacts that were not be captured in (b) or (c) above. Once the amount is calculated, the amount is also applied to the rate year tax expense under the premise that similar items will be present in the rate year.

The result of this process is a rate year tax expense that is matched to the activity on the attrition rate year balance sheet and income statement.

V. CONCLUSION

Q. Does this conclude your prefiled direct testimony?

A. Yes.