**EXHIBIT NO. \_\_\_(MRM-1T)
DOCKET NO. UE-121373
DOCKET NO. UE-121697/UG-121705
DOCKET NO. UE-130137/130138
WITNESS:  MATTHEW R. MARCELIA**

**BEFORE THE**

**WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

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| In the Matter of the Petition of PUGET SOUND ENERGY, INC.For Approval of a Power Purchase Agreement for Acquisition of Coal Transition Power, as Defined in RCW 80.80.010, and the Recovery of Related Acquisition Costs | DOCKET NO. 121373 |
| In the Matter of the Petition of PUGET SOUND ENERGY, INC. and NW ENERGY COALITION For an Order Authorizing PSE to Implement Electric and Natural Gas Decoupling Mechanisms and to Record Accounting Entries Associated with the Mechanisms | DOCKET NOS. UE-121697 and UG-121705 (Consolidated) |
| WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION, Complainant,v.PUGET SOUND ENERGY, INC.,  Respondent. | DOCKET NOS. UE-130137 and UG-130138 (Consolidated) |

**PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF**

**MATTHEW R. MARCELIA
ON BEHALF OF PUGET SOUND ENERGY, INC.**

*In Support of the Multiparty Settlement*

*Re: Coal Transition PPA and other Pending Dockets*

**MAY 8, 2013**

**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY
(NONCONFIDENTIAL) OF** **MATTHEW R. MARCELIA**

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**PUGET SOUND ENERGY, INC.**

**PREFILED REBUTTAL TESTIMONY (NONCONFIDENTIAL) OF MATTHEW R. MARCELIA**

# I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Matthew R. Marcelia. I am employed as Director of Tax for Puget Sound Energy, Inc. ("PSE" or "the Company"). My business address is 10885 NE Fourth Street, Bellevue, WA 98009-9734.

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

A. Yes, I have. It is Exhibit No. \_\_\_(MRM-2).

Q. What is the purpose of your rebuttal testimony?

A. I respond to issues raised in response testimony addressing the property tax tracker and two elements of the Multiparty Settlement—the decoupling K-factor in Docket Nos. UE-131697 and UG-121705 (consolidated) and PSE's proposed Expedited Rate Filing in Docket Nos. UE-130137 and UG-130138 (consolidated) ("ERF"). Specifically, I address the following response testimony and issues:

(i) the Property Tax Tracker;

(ii) the Direct Testimony of James R. Dittmer, Exhibit No. \_\_\_(JRD-1T), on behalf of Public Counsel, with respect to Accumulated Deferred Income Taxes ("ADIT"), the tax Net Operating Loss ("NOL"), and bonus depreciation;

(iii) the Prefiled Direct Testimony of Kevin C. Higgins, Exhibit No. \_\_\_(KCH-1T), on behalf of Kroger and Nucor, with respect to ADIT and the tax NOL; and

(iv) the Response Testimony of Michael P. Gorman, Exhibit No. \_\_\_(MPG-1T), on behalf of the Industrial Customers of Northwest Utilities ("ICNU") with respect to the proper income tax rates to use.

# II. PROPERTY TAX TRACKER

Q. Did the Company include the Property Tax Tracker in the Multiparty Settlement?

A. Yes, the Company included the Property Tax Tracker, Schedule 140, in this filing pursuant to Paragraph 143 of Order 08 in the Company’s last general rate case, Docket Nos. UE-111048 and UG-111049 (consolidated). In that case, the Commission required the Company "to work with Commission Staff and others who may take an interest in the matter to bring forth an agreed mechanism."

Q. Was the mechanism that the Company filed "an agreed mechanism" as the Commission required?

A. Yes, it is. The Company worked with Commission Staff on the mechanism as part of this filing. While both Mr. Dittmer who filed testimony on behalf of Public Counsel and Mr. Higgins who filed testimony on behalf of The Kroger Co. referred to the Property Tax Tracker in their testimonies,[[1]](#footnote-1) none of the intervening parties opposed the tracker. As explained in the Company’s initial filing, the tracker is a very simple mechanism for the collection of actual property taxes – no more, no less.

Q. What actions would you advise the Commission to take in the absence of intervener opposition to the Property Tax Tracker?

A. Due to the clarity in Order 08 and based upon the testimony in this filing, I would urge the Commission to adopt the Property Tax Tracker, Schedule 140, as filed.

# III. INCOME TAX ISSUES WITH RESPECT TO THE DECOUPLING K FACTOR AND EXPEDITED RATE FILING

## A. Response to Public Counsel Witness Mr. Dittmer

Q. Please respond to Mr. Dittmer's claims that PSE’s analysis fails to "consider the mitigating impact of significant growth in the Accumulated Deferred Income Tax balance … that can reasonably be expected to occur over the term of the rate plan." Exhibit No. \_\_\_(JRD-1T), page 25, lines 12-15.

A. I have several concerns with Mr. Dittmer's statement, as discussed in more detail below. First, it is not clear on what Mr. Dittmer bases his expectation that there will be significant growth in ADIT. Second, the exclusion of deferred taxes is acceptable when establishing the proper K-factor.

Q. On what does Mr. Dittmer base his "reasonable expectation" that there will be significant growth in ADIT?

A. Mr. Dittmer does not specifically cite the source of his expectations.

Q. On what does Mr. Dittmer base his conclusion of "significant growth" in ADIT?

A. Mr. Dittmer introduces Exhibit No. \_\_\_(JRD-6C), which is PSE’s Response to Public Counsel Data Request No. 32, and apparently relies on this response to support his conclusion of "significant growth" in ADIT. However, that data response simply breaks down the value of the NOL at June 30, 2012, between electric and gas operations. It provides no insight into the breakdown between electric production versus electric non-production, which is the subject of this rate filing. In addition, the speculative numbers provided in part (b) of the response concerning the possible reversal of the NOL are Company-wide values. Those values cannot be split between electric and gas operations (as noted in the data response). Furthermore, they cannot be allocated between production and non-production. Mr. Dittmer commits a simple but major error in assuming that the entire NOL relates to property that is the subject of this filing. The speculative NOL reversals are predicated on Company-wide estimates of taxable income – which includes much beyond the scope of this filing.

Q. Does Mr. Dittmer cite any other evidence of the "significant growth" in ADIT?

A. No. Beyond his errant use of the possible reversal of the NOL, Mr. Dittmer does not cite any evidence to show that the change in the future ADIT will be significant.

Q. Why do you say that the exclusion of deferred taxes is acceptable?

A. First, when the property-related ADIT is allocated to non-production activities, which is what the K factor addresses, the impact is not significant. As evidenced in the Prefiled Rebuttal Testimony of Katherine J. Barnard, Exhibit No. \_\_\_(KJB-11T), the inclusion of ADIT, properly allocated to non-production assets, would not change the proposed K-factor for electric or gas operations. This analysis directly controverts Mr. Dittmer’s unsubstantiated testimony at Exhibit No. \_\_\_(JRD-1T), page 34, lines 14-20, where he speculates about the "probable significant growth" in ADIT.

Q. Are there other reasons for excluding the ADIT?

A. Yes, the movement in the ADIT is unpredictable and ultimately unknowable, especially the subset of ADIT which is relevant to this filing.

Q. Please provide an overview of ADIT as it relates to this proceeding.

A. The ADIT that is the focus of the discussion in this case is the balance of all of the historical book/tax difference related to non-production property for which deferred taxes have been provided. That balance is reflected on the Company’s balance sheet as a Deferred Tax Liability. In a general rate case, the ADIT liability would be a reduction in the rate base calculation. This filing is unlike a general rate case in that the rate base analysis is but one data point in establishing the K-factor.

Q. What is the driving force behind ADIT and the NOL?

A. By far, the number one factor behind ADIT and the NOL is bonus depreciation. In general, it has been the Company’s experience that when bonus depreciation has been available, the Company has experienced a tax loss (i.e., an NOL).

Q. What do you mean by "bonus depreciation"?

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

**Q. What impact has bonus depreciation had on PSE in the past?**

A. Large deductions for bonus depreciation in prior years have put PSE in a tax NOL position. The practical implication of an NOL carryforward is that the tax benefits of some deductions will be delayed until a future tax year. In the case of PSE, the Company has claimed tax deductions (e.g., bonus depreciation) for which it has not received a cash benefit. Under normal circumstances, a tax deduction will have the effect of reducing the taxpayer’s cash outlay for taxes – in essence, deferring a tax payment until a later tax year. That is not so when the tax deduction only serves to create an NOL carryforward. An NOL carryforward is similar to a tax receivable from the IRS, except that it can only be used on future tax returns and it will likely take some time (i.e., years) to recover.

Q. How predictable have the bonus depreciation rules been?

A. The tax laws surrounding bonus depreciation have been extremely unpredictable. In the Second Exhibit to my Prefiled Rebuttal Testimony, Exhibit No. \_\_\_(MRM-3), I lay out the history of bonus depreciation legislation. This exhibit highlights the unpredictability of the primary cause of the Company’s growth in property-related ADIT and tax NOLs. As indicated in Exhibit No. \_\_\_(MRM-3), bonus depreciation has been in effect for every year since 2008. However, the legislation giving rise to bonus depreciation is typically enacted **after** the start of the year for which bonus depreciation is effective. This causes an interesting problem. It prevents taxpayers, including PSE, from incorporating bonus depreciation into their capital spending plans.

Whenever Congress reauthorizes bonus depreciation, PSE’s tax picture looks significantly different than prior to the rule change. However, no one can reasonably predict what Congress will do based on the history displayed in Exhibit No. \_\_\_(MRM-3). The year 2009 provides a prime example of this uncertainty. In that year, Congress did not grant bonus depreciation until September 27, 2009 and made it retroactive back to January 1,2009. There is no way to plan for this. A few months later, in mid-December, Congress enacted, for the first time ever, 100 percent bonus depreciation, effective September 9, 2009, which **predated** the enactment of the initial law for bonus depreciation for 2009.

No one knows with any level of certainty what is going to happen with bonus depreciation or what the bonus rate will be. The evidence shows that it is not uncommon for the rules to change well after the year has started.

Only one time in the last six years has the rule for bonus depreciation been known one year ahead of time – that was in 2012.

Based on this history, I do not see a basis for Mr. Dittmer’s "reasonable expectation" that the NOL will, in fact, reverse over the course of the rate plan as he claims.

Q. How does the Company forecast its ADIT and NOL?

A. The Company forecasts its ADIT and NOL in a mechanical fashion based on the tax laws that are in effect at the time of the projection. The Company makes no attempt to divine the tea leaves. As a result, the Company provides significant disclaimers around such estimates so that the reader understands the uncertainty and unpredictability that is imbedded in the tax numbers.

Q. How does the Company account for ADIT and NOLs?

A. For regulatory purposes, the Company accounts for its NOL as an offset to its plant-related ADIT. This treatment was validated and confirmed in the Company’s last general rate case.[[2]](#footnote-2) This treatment, which remains as appropriate now as it was then, recognizes the fact that the Company has not received the full cash flow benefit of the tax savings associated with bonus depreciation.

Q. On page 35, lines 17-20, of Exhibit No. \_\_(JRD-1T), Mr. Dittmer states that "PSE’s available 'regulatory' ADIT balance" will continue to grow and that he "expect[s] this growth to be significant." What does Mr. Dittmer mean by "available 'regulatory' ADIT balance"?

A. Mr. Dittmer does not offer an explanation or definition of this phrase. However, there are a couple of rules that must be followed when addressing plant-related ADIT and one of the most important rules to follow is the tax normalization provisions of the Internal Revenue Code ("IRC") §168(i)(9) and Treasury Regulation §1.167(l)-1(h).

Q. Why are you bringing up the tax normalization rules?

A. I raise the tax normalization rules because Mr. Dittmer has characterized the ADIT balance as "available." It is not truly "available" as I understand that term. The plant-related ADIT balances are required by the Internal Revenue Code if the Company is to avoid severe sanctions. In that sense, the ADIT balance is not "available".

Q. What do you think Mr. Dittmer means by the term "'regulatory'ADIT"?

A. He does not define the term, but I assume he means the subset of ADIT that applies to this rate filing as opposed to the entire ADIT that would appear in a general rate case, for example.

Q. Mr. Dittmer expects the growth in ADIT to be significant. Why?

A. I suspect this belief stems from the conflation of the subset of ADIT relevant to this filing with all ADIT. It further appears that he may be under the mistaken belief that all of the potentially reversing NOL would be attributable to the subset of ADIT relevant to this filing, which is most certainly not the case as I explained above.

Q. When will the NOL reverse?

A. No one knows when the NOL will reverse. It depends on the future of the bonus depreciation provisions. If the bonus depreciation provisions were allowed to expire and if the Company’s taxable income actually increases, the NOL could potentially reverse in two or three years. However, if Congress continues to extend those provisions for the next six years as it has for the last six years, it would be unlikely that the NOL would reverse.

 Further complicating the matter, whenever the NOL is used, that usage would need to be appropriately allocated to the non-production rate base. In other words, all NOL usage would **not** be attributable to or applicable to this filing, as I discussed above.

Q. Please summarize your testimony addressing Mr. Dittmer’s concern over ADIT.

A. Mr. Dittmer’s claim of significant ADIT growth based on the reversal of the NOL is flawed. Ms. Barnard has demonstrated, to the contrary, that the inclusion of ADIT and NOL would not have changed the Company’s request for rate relief in this filing. The movement in the ADIT and NOL is unpredictable based on tax laws which change almost annually. PSE cannot predict with any level of certainty how and when the NOL will reverse. The inclusion of the ADIT and NOL in the factors used to establish the Multiparty Settlement would greatly complicate this and all future filings (as is evidenced by this very testimony).

## B. Response to Kroger Witness Mr. Higgins

Q. Mr. Higgins states that the rate base in 2011 was "skewed upward" due to the presence of the NOL. Exhibit No. \_\_\_(KCH-1T), page 10, line 7. Please explain this.

A. As I mentioned above, the NOL represents tax deductions for which the Company has not yet receive the full cash benefit in its tax payments. Order 8, paragraph 179-180, confirms and explains this rate making treatment. It is misleading to describe this as a "skewing" of rate base, when in fact, the inclusion of the NOL is necessary to accurately reflect reality.

 In addition, this treatment is consistent with and required by the tax normalization provisions of the IRC.

Q. Would the K factor be lower if the NOL had not existed?

A. As I mentioned earlier, Ms. Barnard has demonstrated that the presence or absence of the ADIT and NOL would not have changed the rate request in this filing.

Q. Do you have any other comments on Mr. Higgins testimony?

A. One minor point. On page 10, line 12, of his testimony, Mr. Higgins states that "depreciation deductions" can be carried forward for up to twenty years. Mr. Higgins misspeaks. It is NOLs that can be carried forward as he describes, not "depreciation deductions".

## C. Response to ICNU Witness Mr. Gorman

Q. ICNU Witness Mr. Gorman thinks the Company should use a tax rate of 35 percent for this filing. Do you agree?

A. The statutory tax rate is 35 percent. PSE has used that rate consistently throughout this filing. However, it is important to distinguish between when the statutory tax rate should be used and when the effective tax rate should be used. The effective tax rate for this filing is 36 percent.

Q. When should the statutory tax rate be used?

A. The statutory rate should be used whenever the income tax impact of a specific item is being evaluated, assuming that the item has a tax impact. For example, bonus depreciation impacts tax expense/benefit at the rate of 35 percent. It is a timing difference for which deferred taxes are provided (i.e., it is normalized). However, there are some items for which there is no tax impact. An example of this would be permanent items or items that are subject to flow through rate treatment.

**Q. How is a permanent or flow through item treated?**

A. Permanent items have no tax impact – meaning they are removed from the tax calculation when a tax return is filed. An example would be 50 percent of meals and entertainment expenses or the amortization of Treasury Grants. Both of these items are excluded from the tax return.

Flow through items have the same impact as permanent items but for a different reason. Flow through items are timing differences for which no deferred taxes are provided. An example would be AFUDC. By omitting the deferred tax, AFUDC impacts tax expense as if it were a permanent item. However, AFUDC will impact tax expense twice – once when it originates (it will be a benefit to tax expense) and again when it reverses through book depreciation expense (it will be a charge to tax expense).

Permanent and flow through items essentially have a tax rate of zero, even though the statutory rate is 35 percent.

Q. How is the effective tax rate calculated?

A. The effective tax rate is calculated by taking the tax expense and dividing it by the related pre-tax income. The effective rate should be used to calculate tax expense when pre-tax income is the starting point. If the statutory rate were used, the effect of the permanent and flow through items would be eliminated. That would not be appropriate as the Company is entitled to recover those amounts in the rate making process.

Q. Has the Company adequately explained how the 36 percent effective rate was determined?

A. Yes, the workpapers supporting Exhibit No. \_\_\_(KJB-5) in the ERF docket demonstrate this calculation. In addition, these calculations were reiterated in PSE’s Response to Public Counsel Data Request No. 017.

Q. Which tax rate should the Company use?

A. The effective tax rate is the appropriate rate to use in this filing as that is the rate which captures the impact of permanent and flow through items.

# IV. CONCLUSION

Q. Does this conclude your prefiled rebuttal testimony?

A. Yes.

1. See Exhibit No. \_\_(JRD-1T) page 12, line 23, through page 13, line 2, and Exhibit No. \_\_(KCH-1T), page 9, lines 8 through 10. [↑](#footnote-ref-1)
2. *See WUTC v. Puget Sound Energy, Inc.,* Docket UE-111048 and UG-111049, Order 08 ¶¶ 177-184 (May 7, 2012). [↑](#footnote-ref-2)