

**EXH. MRM-1T  
DOCKETS UE-22\_\_\_/UG-22\_\_\_  
2022 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-22\_\_\_**

**Docket UG-22\_\_\_**

**PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF**

**MATTHEW R. MARCELIA**

**ON BEHALF OF PUGET SOUND ENERGY**

**JANUARY 31, 2022**

**PUGET SOUND ENERGY**

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

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**PUGET SOUND ENERGY**

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1 **PUGET SOUND ENERGY**

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

4 **I. INTRODUCTION**

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

7 A. My name is Matthew R. Marcellia and my business address is Puget Sound  
8 Energy, P.O. Box 97034, Bellevue, Washington 98009-9734. I am employed by  
9 Puget Sound Energy (“PSE”) as Director of Tax and Finance IT Projects.

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

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

13 **Q. What are your duties as Director of Tax and Finance IT Projects for PSE?**

14 A. As Director of Taxes and Finance IT Projects, I have the overall management  
15 responsibility for the tax department and the financial systems department. I direct  
16 all aspects of PSE’s tax compliance, accounting for taxes, financial reporting of  
17 tax, and tax planning. My responsibility includes income taxes as well as state and  
18 local taxes. In addition, I oversee the impact of IT projects on our financial  
19 software and processes. I report directly to the Senior Vice President and Chief  
20 Financial Officer.

1 **Q. What topics are you covering in your testimony?**

2 A. My testimony addresses the treatment of accumulated deferred income taxes  
3 (“ADIT”) and excess deferred income taxes (“EDIT”) in the multiyear rate plan,  
4 explaining the method of forecasting book depreciation, tax depreciation, ADIT  
5 activity, and EDIT reversal. In addition, I will address the importance and value  
6 of maintaining a normalization method of accounting for plant-related deferred  
7 income taxes. I will address the restating adjustment for income taxes. Finally, I  
8 will address the expected tax law changes and their likely impact on the multiyear  
9 rate plan.

10 **II. ACCUMULATED DEFERRED INCOME TAXES**

11 **A. Deferred Income Taxes**

12 **Q. Why are you discussing deferred taxes in this filing?**

13 A. I am discussing deferred taxes for three reasons that are relevant to this case. First,  
14 in Order 14 in Dockets UE-190529 and UG-190530, the Washington Utilities and  
15 Transportation Commission (“Commission”) requested that PSE explain the  
16 benefit of deferred income taxes in this case. Second, I explain how PSE has  
17 accounted for deferred taxes on plant-related differences under the Internal  
18 Revenue Service (“IRS”) normalization rules in this filing. Finally, I discuss the  
19 treatment of excess deferred income taxes from the test year and throughout the  
20 multiyear rate plan.

1 **Q. What are deferred income taxes?**

2 A. In general, deferred income taxes are created when the time period of the tax  
3 deduction (or income) for an expenditure differs from the time period of the book  
4 deduction (or income) for the same expenditure. There are many differences  
5 between the accounting rules that FERC and the Commission follow (referred to  
6 as the “book treatment”) when compared to the rules that the IRS requires  
7 taxpayers to follow (referred to as the “tax treatment”). One example is storm  
8 expenditures. The tax treatment allows for a tax deduction when the cash is  
9 expended for storm costs. The book treatment allows for the storm expenditure to  
10 be captured in a regulatory account on the balance sheet and recovered over future  
11 periods after it is approved by the Commission. This causes a timing difference.

12 Another example is the different book and tax lives used to depreciate utility  
13 property, plant, and equipment. Generally, the tax life of an asset will be much  
14 shorter than the book life. A wind farm provides a good example. The tax life is  
15 only five years, using the modified accelerated cost recovery system (“MACRS”)  
16 while the book life is twenty-five years, using straight-line depreciation.

17 Whenever the tax deduction occurs first, as is the case with a wind farm or a  
18 storm, a deferred tax liability (“DTL”) is created. If the book deduction occurs  
19 first, a deferred tax asset (“DTA”) is created.

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

2 A. When these timing differences are recorded, they are tax effected (i.e. valued) at  
3 the enacted tax rate for the period in which the timing difference is expected to  
4 reverse. It is future looking based on enacted tax law. As of the time of this  
5 writing, the current and future tax rate is 21 percent. Thus, deferred taxes are  
6 being recorded today at 21 percent. It should be noted, however, that the tax rate  
7 could change in the near future, as I discuss in more detail below.

8 **Q. What effect do deferred taxes have on customers?**

9 A. Deferred taxes impact customers in two ways: First, the tax expense that is  
10 reflected in cost of service is comprised of two components: (a) current tax  
11 expense and (b) deferred tax expense. When a timing difference originates, there  
12 is a shift between current tax and deferred tax. For example, if the company incurs  
13 \$1,000 of storm expenditures, it will claim a current tax deduction worth \$210 in  
14 that year ( $\$1,000 \times 21\%$  tax rate). The company will also record a corresponding  
15 increase in deferred tax of \$210 in order to shift the benefit of the tax deduction  
16 into the same future period when it will record the book deduction for the storm  
17 expenditure.

18 The net tax effect of a timing difference is zero—it did not raise or lower the  
19 company's tax expense nor did it increase or reduce customers' cost of service.  
20 This tax treatment matches the book treatment for the storm expenditure as the

1 company did not record the expenditure nor any additional revenue to cover it in  
2 the income statement.

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

5 A. In between the origination of a timing difference and its complete reversal, there  
6 is a balance sitting in a deferred tax account on the company's balance sheet. In  
7 the storm example, it would be a DTL in the amount of \$210. The balance is a  
8 DTL because the tax deduction occurs prior to the book deduction.

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

12 **Q. Why does it make sense to lower the rate base for a DTL?**

13 A. A DTL represents an interest-free loan from the government. Due to the  
14 difference between the tax treatment and the book treatment, the company was  
15 able to delay making a payment to the IRS (through accelerating deductions or  
16 delaying income). By delaying the timing of the payment, it is as if the company  
17 borrowed money from the government, and there is no interest expense for this  
18 type of borrowing. This benefit is passed on to customers by reducing rate base by  
19 the amount of the DTL. A lower rate base translates into a lower revenue  
20 requirement. Stated a little differently, the DTL can also be considered a source of



1 cash—by delaying the payment to the IRS, the company has more cash on hand to  
2 meet its cash flow needs.

3 This is demonstrated using the storm example, discussed previously. The  
4 company has \$210 of DTL as an offset to its rate base. If the DTL were not there,  
5 the company would need to incur additional capital (debt or equity) in the same  
6 amount. Doing so would attract a cost to customers in the amount of \$210 times  
7 the weighted average cost of capital. The DTL represents an inexpensive source  
8 of cash flow. In addition, without the DTL, the company’s rate base would  
9 increase, which would further increase customer rates.

10 **Q. When will the DTL reverse?**

11 A. The DTL will reverse once the deduction for the storm expenditure is recorded in  
12 book income. In that time period(s), the book deduction will “catch-up” to the tax  
13 deduction which, in this example, occurred in an earlier time period.

14 **Q. How does the reversal affect customer rates?**

15 A. The reversal of the DTL is very similar to the impact at origination with one very  
16 important difference. The big difference between these entries and those at  
17 origination is that there is \$1,000<sup>1</sup> in the income statement for storm expense and  
18 that storm costs is matched against additional revenue from customers. The  
19 starting point for all tax calculations is to take the amounts in the income

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<sup>1</sup> For simplicity, this example assumes that the Commission allows for the whole storm cost to be deducted in one year (i.e., \$1,000 expense in one year) instead of amortizing it over many years. The end result is the same regardless, but this makes the example simpler.

1 statement (i.e. pre-tax book income, including the storm cost and storm revenue in  
2 this example) and tax them at the current tax rate of 21 percent. Since the  
3 additional revenue will match the storm costs, the pre-tax book income would be  
4 zero. But that is not the case for the tax return because the storm costs were  
5 deducted in an earlier period. As a result, the \$1,000 book expense must be  
6 removed from the current tax calculation in order to prevent the tax deduction  
7 from occurring a second time, which causes current tax to increase by \$210. Then,  
8 the deferred tax expense of \$210 must be applied, effectively offsetting the  
9 increase in current tax and undoing the entries at origination. This entry will also  
10 have the effect of removing the DTL from the balance sheet.

11 The net impact of the reversal entries are as follows: (1) the cost of the storm is  
12 recorded in the income statement for \$1,000, offset by additional revenue of the  
13 same amount; (2) The current tax expense of \$210 is recorded in the same period  
14 as the book expense and is offset by the deferred tax of the same amount, which  
15 has the effect of matching the tax benefit of the deduction for the storm  
16 expenditure with the customers who provided the additional revenue; (3) The  
17 DTL reverses when the timing difference reverses (i.e., as the regulatory asset  
18 reverses).

19 To summarize, the impact on the revenue requirement: there is an increase for  
20 storm costs of \$1,000, which will offset storm amortization of \$1,000; there is an  
21 increase in current tax of \$210 and a decrease in deferred tax expense of \$210;  
22 and there is a reversal of DTL in the rate base calculation.

1 **B. Plant-Related Accumulated Deferred Income Taxes**

2 **Q. Turning now to deferred taxes on plant-related timing differences, what does**  
3 **the term “protected-plus” mean with regard to plant-related ADIT?**

4 A. The use of the term “protected-plus” when referring to ADIT or EDIT is a short-  
5 hand way of referring to the ADIT or EDIT on plant-related timing differences  
6 recorded in FERC Account 282. It includes plant-related timing differences that  
7 are protected and unprotected.

8 **Q. What does “protected” mean?**

9 A. Plant-related protected differences are those which are subject to the  
10 normalization and consistency requirement of section 168(i)(9) of the Internal  
11 Revenue Code (“IRC”). The normalization and consistency rules are designed to  
12 prohibit the direct or indirect flow-through of accelerated depreciation tax benefits  
13 to utility company ratepayers. The requirements generally mandate the use of a  
14 “normalization method of accounting.”<sup>2</sup> The tax laws require certain plant-related  
15 book/tax timing differences to be normalized. When something is normalized for  
16 tax purposes, it means that deferred taxes are recorded on the balance sheet and  
17 are factored into the company’s ratemaking.

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<sup>2</sup> IRC §168(i)(9)(A).

1 In contrast, unprotected differences are those for which the IRS has no similar  
2 requirement. Deferred taxes may be provided on unprotected differences, but it is  
3 not an IRS requirement.

4 In PSE's 2019 general rate case, the Commission ordered that protected-plus  
5 ADIT be handled homogenously, which greatly simplifies things.<sup>3</sup> PSE applies  
6 the IRS normalization and consistency rules to the entire protected-plus ADIT  
7 balance, including EDIT.

8 **Q. At the end of the test year, what is the ADIT balance?**

9 A. The ADIT balance in FERC Account 282, including EDIT, was \$1.3 billion for  
10 electric and \$598.2 million for gas. The total ADIT was \$1.9 billion. Those  
11 numbers include EDIT (before gross-up).

12 **Q. At the end of the test year, what is the EDIT balance?**

13 A. The remaining balance of EDIT as of June 30, 2021 for protected-plus differences  
14 (in FERC Account 282) was \$497.8 million for electric and \$219.0 million for  
15 gas, before gross-up.

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<sup>3</sup> Docket UE-190529 and UG-190530, Order 14, ¶ 39: "We agree with PSE and Staff that separating protected and unprotected plant-related EDIT is unnecessary. Separating those amounts would be unduly burdensome and would provide little, if any, benefit to ratepayers."

1 **Q. How did PSE apply the normalization rules in calculating plant-related**  
2 **ADIT and EDIT in the test year?**

3 A. The normalization rules are complex. But PSE has tried to carefully follow the  
4 IRS normalization and consistency rules throughout this filing by confirming that  
5 the tax calculations were consistent with the book calculations. The tax  
6 calculations need to follow the book calculations and match according to  
7 projection methodologies, technique, and time period.

8 To be more specific, each time period needs to be considered separately in  
9 discussing the ADIT and EDIT activity.

10 First, the test year: PSE reported the actual ADIT and EDIT activity that it  
11 recorded during that time period. This was a relatively straightforward exercise.  
12 In calculating the tax adjustments utilized by Ms. Susan E. Free in her Exh. SEF-6  
13 (in Adjustment 6.04) for electric and Exh. SEF-11 (in Adjustment 11.04) for gas,  
14 the EDIT calculations are based on the underlying actual calculations from the  
15 last six months of tax year 2020 and the first six months of tax year 2021. PSE  
16 was careful to match the time period for the ADIT (and EDIT) with the book  
17 depreciation, tax expense, and rate base calculations. This follows the same  
18 process that PSE has used in its prior general rate case filings.

1 **C. Projections of Plant-Related Accumulated Deferred Income Taxes**

2 **Q. How did PSE apply the normalization rules in calculating plant-related**  
3 **ADIT and EDIT in the years following the test year?**

4 A. For the pro forma period and each of the periods throughout the multiyear rate  
5 plan, PSE has to incorporate forecasted activity across its plant-related rate base.  
6 This necessitated branching into two projection methodologies for the assets: (a)  
7 the Existing Property (“EP”) as of the test year and (b) the New Property (“NP”).

8 **Q. Why did you divide the property?**

9 A. The EP represents all of the assets that were in-service at June 30, 2021. The  
10 source data for the EP comes from PSE’s plant accounting and tax accounting  
11 software. In contrast, the data for the NP comes from PSE’s projections and  
12 estimates of activity that occurs after June 30, 2021. That data is not part of PSE’s  
13 book or tax accounting software.

14 **Q. How did you project book depreciation, tax depreciation, and ADIT on the**  
15 **EP?**

16 A. PSE projected book depreciation by applying the approved depreciation rates from  
17 the last depreciation study against the gross historical cost of the asset to calculate  
18 the monthly book depreciation expense. In this proceeding, PSE is requesting  
19 approval of a new depreciation study sponsored by Mr. Ned W. Allis in his  
20 Prefiled Direct Testimony, Exh. NWA-1T. So, at the time the depreciation rates

1 from the new depreciation study would become effective starting in January 2023,  
2 the new rates are used going forward to calculate monthly depreciation.

3 To project the tax depreciation and ADIT, PSE rolled forward the activity in its  
4 PowerTax software to determine the tax depreciation and ADIT, including EDIT,  
5 activity in the future periods.

6 **Q. How did you handle retirements?**

7 A. Book and tax retirements were projected using a three-year average of actual  
8 activity from 2018 through 2020. Nonrecurring activity was eliminated from the  
9 analysis (e.g., the Colstrip Units 1 and 2 shutdown, the sale of water heaters, etc.)  
10 to create a retirement model by month and by vintage. A further refinement was  
11 made with respect to AMR retirements to replace the historical activity with  
12 PSE's projected replacement plan for those assets. The retirement model was  
13 applied against the EP for both book and tax purposes in projecting activity post-  
14 June 30, 2021.

15 **Q. How did you project book depreciation, tax depreciation, and ADIT on the**  
16 **NP?**

17 A. In general, PSE projected book depreciation on NP by applying the approved  
18 depreciation rates from the last depreciation study against the future gross cost of  
19 the asset to calculate the monthly book depreciation expense. The calculation  
20 switches to the new depreciation rate after the effective date of the new  
21 depreciation study.

1 Tax depreciation on the same population was projected by applying the  
2 appropriate tax conventions (usually MACRS) against the asset additions.

3 PSE calculated the monthly difference between the book depreciation and the tax  
4 depreciation. This difference was multiplied by the current federal tax rate to  
5 calculate the monthly movement in the ADIT. There is no EDIT on the NP as all  
6 these assets are placed in service after the enactment of the Tax Cuts and Jobs Act  
7 (“TCJA”).

8 **Q. With respect to the NP, how did PSE account for the fact that, often, the**  
9 **book and tax cost basis can differ?**

10 A. It is often the case that the book and tax cost basis differ due to differences in the  
11 capitalization rules for each. One example would be the repairs deduction,<sup>4</sup> which  
12 is allowed for tax purposes. The overall impact of these difference result in a  
13 smaller tax basis relative to the book basis, which causes the ADIT balance to  
14 increase. To capture this in the analysis, the basis differences were projected using  
15 a three-year average of actual activity from 2018 through 2020, similar to the  
16 approach used with retirements.

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<sup>4</sup> 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 which 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, whereas all of the poles on a circuit are a UOP for tax. Thus, the replacement of one pole would be capitalized for book; while for tax, 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.



1 For additional details on the mechanics that were used to project the EP and NP  
2 balances, please see Exh. MRM-3.

3 **D. Special Items**

4 **a. Depreciation Study**

5 **Q. What effect does the depreciation study have on the projection of book**  
6 **depreciation?**

7 A. The depreciation study is anticipated to have an effective date of January 1, 2023.  
8 As a result, many book depreciation groups (“DeprGroups”) will see their  
9 depreciation rate updated as of that date. For additional background, book  
10 depreciation is generally calculated monthly by multiplying the original cost of  
11 the asset by the depreciation rate associated with that asset’s DeprGroup.  
12 Whenever the depreciation rate changes, PSE will begin to recover the cost of the  
13 asset more quickly or more slowly than before.

14 **Q. Will the depreciation study have any effect on the projection of tax**  
15 **depreciation?**

16 A. No. Tax depreciation is not impacted by the depreciation study.

17 **Q. Will the depreciation study have any effect on ADIT?**

18 A. Yes, because ADIT is generally calculated as the difference between book and tax  
19 depreciation, a change to book depreciation will cause a change in the monthly  
20 activity recorded to the ADIT balance. Note that the new depreciation rates will

1 have no effect on the prior, recorded balance of the ADIT. It will only impact  
2 monthly ADIT activity recorded after the new depreciation rates take effect.

3 **Q. Will the depreciation study have any effect on EDIT reversal?**

4 Yes, it will because the EDIT reversal is linked to the book life of the asset under  
5 the average rate assumption method (“ARAM”). Therefore, if book depreciation  
6 expense increases (i.e., the expected book life becomes shorter), EDIT reversal  
7 will also accelerate. If the book depreciation expense decreases (i.e., the expected  
8 book life becomes longer), the EDIT reversal will also slow down. The EDIT  
9 reversal period is tied to the book life of the asset. Book life of the asset  
10 determines the book depreciation rate. They are linked together.

11 **b. Colstrip Units 3 and 4 Tracker**

12 **Q. How does PSE handle the ADIT and EDIT for Colstrip Units 3 and 4 in the**  
13 **multiyear rate plan?**

14 A. PSE proposes to move the cost associated with Colstrip Units 3 and 4 to a tracker.  
15 Doing so would have the effect of pulling the plant balances out of the calculation  
16 of base rates in favor of the tracker rate. Under this approach, PSE would continue  
17 to recover the cost of the plant through a depreciation calculation that targets an  
18 end-of-life in December 2025. This tracker is discussed in more detail in the  
19 Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T.

1 If the book depreciation and rate base are moved to the tracker, the associated tax  
2 calculations need to follow; specifically, the ADIT and EDIT activity would also  
3 need to move to the tracker.

4 **Q. Isn't the use of a tracker to recover EDIT prohibited by PSE's 2021 Private**  
5 **Letter Ruling?**<sup>5</sup>

6 A. No. The IRS rules will allow for the recovery of EDIT in a tracker, but only as  
7 long as the other items to which the consistency rule applies are recovered in the  
8 same mechanism (e.g., the same tracker) and updated concurrently at any time the  
9 tracker is adjusted. The Colstrip tracker will include the Colstrip rate base and  
10 depreciation expense, and so it must also include the Colstrip tax depreciation,  
11 ADIT, and EDIT reversals.

12 **Q. Will the recovery of EDIT in the tracker be subject to the trackers true-up**  
13 **mechanism?**

14 A. Yes. It is PSE's expectation that the tracker will update annually. The consistency  
15 rule will require that PSE apply the same regulatory conventions to the EDIT as it  
16 applies to the other items for which consistency is required. As a result, the same  
17 true-up calculation must also be applied to the EDIT activity as is applied to the  
18 depreciation expense, tax expense, ADIT, and rate base.

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<sup>5</sup> PSE received PLR 202142002 in July 2021.

1 In effect, the Colstrip tracker will monitor and recover the Colstrip activity on a  
2 dollar-for-dollar basis. The structure of this tracker will allow for a dollar-for-  
3 dollar recovery of the Colstrip EDIT as well.

4 **Q. Will the EDIT balance for Colstrip Units 3 and 4 go to zero by 2025?**

5 A. Yes, it is targeted to go to zero by 2025. The EDIT recovery is tied to the book  
6 depreciation of the original plant balance, which is targeted to end-of-life in 2025.  
7 The EDIT will follow the book depreciation. However, if something happens to  
8 accelerate or decelerate the book depreciation of the plant balance, the EDIT will  
9 also accelerate or decelerate.

10 **Q. Will the ADIT balance for Colstrip Units 3 and 4 go to zero by 2025?**

11 A. There is not a simple, straightforward answer to this. As I alluded to above,  
12 changing the book recovery period (e.g., full book recovery by 2025) does not  
13 translate into a change in the tax MACRS recovery period. As a result, the ADIT  
14 is not expected to be completed by 2025.

15 The ADIT is sensitive to two factors: the book life and the tax life. The book life  
16 can be altered at the discretion of the regulator. The tax life cannot. In general, the  
17 tax life for Colstrip assets has been 20 year MACRS for each vintage. The  
18 ultimate reversal period for the ADIT will depend on the activity that transpires  
19 before the end of 2025. Below are a few examples:

20 (a) If the plant continues in operation, even though PSE cannot participate in  
21 that activity from a regulatory perspective, the tax life of the plant will

1 continue under MACRS, and the ADIT will reverse over a time period  
2 which extends beyond 2025.

3 (b) If the plant were to be shut down on or before 2025, the ADIT would be  
4 reversed to zero as part of the tax gain/loss on the abandonment, along the  
5 lines of the process PSE followed for Colstrip Units 1 and 2.

6 (c) If PSE were to sell the plant on or before 2025, the ADIT would be  
7 reversed to zero as part of the tax gain/loss calculation for the sale.

8 For purposes of this filing, PSE has assumed that the tax life will continue under  
9 MACRS (i.e., option (a)), which will cause the ADIT to extend beyond 2025,  
10 while still being fully reversed within the tracker.

11 **c. IRS Proration Method**

12 **Q. Does the IRS have any different or unique normalization rules that would**  
13 **apply to this filing?**

14 A. Yes, the IRS normalization rules will require the application of the IRS proration  
15 method to determine the amount of ADIT that is used to reduce rate base in  
16 setting rates for “future” periods.

17 The IRS regulations draw a distinction between “historical” periods and “future”  
18 periods. Those terms, as used by the IRS in this context, refer to the time new  
19 rates go into effect relative to the test period. The terms do not relate to whether  
20 or not the underlying financial data is actual or estimated. As a result, a historical  
21 period is one where the test period occurs *before* the effective date of the revised  
22 rates. A future period is one where the test period occurs *after* the effective date of  
23 the revised rates. In this multiyear rate plan, the rates that are set for 2023, 2024,  
24 and 2025 would be considered “future” periods. In contrast, PSE’s normal general

1 rate case filings (not a multiyear rate plan) are based on historical test years,  
2 which meet the IRS definition of a “historical” period so that, in general, the  
3 proration method would not apply.

4 **Q. Why does the IRS make this distinction?**

5 A. The regulations make this distinction because the IRS was concerned about  
6 taxpayers using future, projected deferred taxes (which have not been recorded  
7 yet, because the future has not yet happened) to reduce rate base and thus reduce  
8 rates. In other words, the inclusion of a deferred tax in setting rates prior to being  
9 recorded or recognized in the accounting records was a concern. To address this  
10 concern, the IRS requires the use of the proration methodology whenever deferred  
11 taxes in “future” periods are used to set rates.

12 **Q. Please explain the IRS proration method.**

13 A. The IRS proration method is presented in Treasury Regulation §1.167(l)-  
14 1(h)(6)(ii):

15 If solely a future period is used for such determination, the  
16 amount of the reserve account [i.e. ADIT] for the period is  
17 the amount of the reserve at the beginning of the period and  
18 a pro rata portion of the amount of any projected increase  
19 to be credited or decrease to be charged to the account  
20 during such period. [...] The pro rata portion of any increase  
21 to be credited or decrease to be charged during a future  
22 period (or the future portion of a part-historical and part-  
23 future period) shall be determined by multiplying any such  
24 increase or decrease by a fraction, the numerator of which  
25 is the number of days remaining in the period at the time  
26 such increase or decrease is to be accrued, and the

denominator of which is the total number of days in the period (or future portion).

The IRS proration method is a number-of-days method, as the deferred tax activity is weighted by the number of days it is on the books divided by the total number of days in the period. Table 1 shows an example of an ADIT with a beginning balance of \$1 million and monthly activity of \$120,000.

**Table 1: IRS Proration Method Example**

Month	Activity	Days in Month	Days in Period	Total Days in Period	Increment	IRS ADIT Balance
Dec-22	1,000,000					1,000,000
Jan-23	120,000	31	335	365	110,137	1,110,137
Feb-23	120,000	28	307	365	100,932	1,211,068
Mar-23	120,000	31	276	365	90,740	1,301,808
Apr-23	120,000	30	246	365	80,877	1,382,685
May-23	120,000	31	215	365	70,685	1,453,370
Jun-23	120,000	30	185	365	60,822	1,514,192
Jul-23	120,000	31	154	365	50,630	1,564,822
Aug-23	120,000	31	123	365	40,438	1,605,260
Sep-23	120,000	30	93	365	30,575	1,635,836
Oct-23	120,000	31	62	365	20,384	1,656,219
Nov-23	120,000	30	32	365	10,521	1,666,740
Dec-23	120,000	31	1	365	329	1,667,068
	2,440,000	365			667,068	1,667,068

There are two points to note: First, the result is not much different than using the average of monthly averages (“AMA”). In the example above, the AMA for the same fact pattern would be \$1,720,000, which would be a difference of about \$53,000 (AMA of \$1,720,000 less IRS of \$1,667,068).

Second, the IRS proration method must be used whenever a taxpayer’s rate setting falls within the definition of a “future” period. The IRS will not permit the

1 use of any other method than its own, regardless of the economic impact, positive  
2 or negative.

3 **Q. Doesn't the use of the IRS proration method cause an inconsistency if you**  
4 **use AMA for all other components of the normalization calculation?**

5 A. Yes, it does. Clearly, the two techniques are different and, therefore, not  
6 consistent. However, the IRS requires this treatment, regardless of any other  
7 techniques used in "future" periods. I would characterize the requirement to use  
8 the IRS proration method as an exception to the consistency rule.

9 **Q. Has PSE ever used the IRS proration method in the past?**

10 A. Yes, PSE has used the process in the past on those relatively infrequent situations  
11 where it has pro formed new property into the rate year.<sup>6</sup> But the multiyear rate  
12 plan is the first time PSE has used the IRS proration method on a large scale for  
13 all plant-related deferred taxes.

14 **Q. How does the calculation work when the rates for multiple years are being**  
15 **calculated, such as when PSE is calculating ADIT for 2023, 2024, and 2025?**

16 A. As a starting point for the calculation of any deferred taxes, PSE starts with the  
17 difference between the book and tax activity for each month and multiplies that  
18 by the income tax rate, which yields the monthly increase or decrease to the

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<sup>6</sup> For example, in Ms. Free's testimony from the 2019 general rate case, Dockets UE-190529/UG-19030 Exh. SEF-1Tr at 52:10-12 where she discusses a pro forma adjustment for AMI which triggers these rules from Treasury Regulation §1.167(l)-(1)(h).



1 beginning ADIT balance. This baseline analysis must be done for each month  
2 from the end of the test year, starting July 2021, throughout the last month of the  
3 multiyear rate plan, December 2025, including the effects of asset additions and  
4 retirements. Once those monthly calculations are complete, the rate setting  
5 calculations can begin for rate base, using AMA, and ADIT, using the IRS  
6 proration method.

7 In the multiyear rate plan, the underlying rate base activity is run through the  
8 AMA routine to establish an average balance for which rates will be set. A  
9 separate AMA calculation is performed for each year in the multiyear rate plan. In  
10 the same way, PSE has performed a separate IRS proration calculation for each  
11 year in the multiyear rate plan, with the number of days resetting for each new  
12 rate year.

13 As an interesting side note to the IRS proration method, 2024 is a leap year and  
14 has 366 days. As a result, the denominator for the IRS proration method is 366 in  
15 2024, instead of the more common 365 days used in 2023 and 2025.

16 **E. Normalization Benefit to Customers and PSE**

17 **Q. Please respond to Paragraph 43 of Order 14 from PSE’s last general rate**  
18 **case in which the Commission requested additional “testimony and support”**  
19 **for the proposition that the normalization rules confer a benefit to customers.**

20 A. To understand the Commission’s exact request, I have restated Paragraph 43 in its  
21 entirety:

1 According to PSE, violating Normalization Rules could  
2 result in the denial of accelerated depreciation for tax  
3 purposes, “which provide a substantial offset to PSE’s rate  
4 base and would harm customers.” PSE should provide  
5 testimony and support for these assertions in its next  
6 general rate case filing. Specifically in direct testimony,  
7 PSE should identify and quantify the actual benefits that  
8 accelerated depreciation confers on ratepayers and provide  
9 a “before and after analysis” illustrating the impact of  
10 accelerated depreciation on revenue requirement. The  
11 Commission’s analysis will benefit from providing non-  
12 company parties an opportunity to review this information  
13 and offer feedback in responsive testimony. We also  
14 require PSE to report in all future general rate cases PP  
15 EDIT balances and the amounts returned through base rates  
16 for both electric and natural gas. [Footnotes omitted.]

17 The Commission’s request has a couple of parts. First, I will address the IRS  
18 Normalization requirement for PSE’s ADIT balance on plant-related timing  
19 differences. Then, I will look at a “before and after” analysis. Additionally to  
20 directly address the final sentence of paragraph 43, I have stated the protected-  
21 plus EDIT balances as of the test year in my testimony above and no protected-  
22 plus EDIT amounts have been returned through base rates as of June 30, 2021.

23 **a. Customers benefit from PSE’s compliance with the IRS**  
24 **normalization rules required for accelerated tax depreciation**

25 **Q. Please discuss the IRS normalization requirement and what benefit it has to**  
26 **customers.**

27 A. When a regulated utility avails itself of the benefits of accelerated tax  
28 depreciation, the tax laws require that it follow a normalization method of  
29 accounting.<sup>7</sup> The normalization requirement is designed to prohibit the direct or

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<sup>7</sup> IRC §168(i)(9)(A).

1 indirect flow-through of accelerated depreciation tax benefits to utility  
2 customers.<sup>8</sup> A regulated utility is considered to use a normalization method of  
3 accounting for its public utility property if: (1) it uses the same depreciation  
4 method and a depreciation period no shorter than the method and period used for  
5 purposes of determining depreciation expense for cost of service and (2) any  
6 variation in the federal income tax expense attributable to use of a method of  
7 depreciation for ratemaking purposes different from the method used for federal  
8 income tax purposes must be adjusted to a reserve account (i.e., credited or  
9 debited to an ADIT account). The reserve balance attributable to this adjustment  
10 may be treated as a reduction from the rate base or as zero-cost capital.

11 **Q. Please summarize how PSE complies with these rules.**

12 A. PSE's utility property is subject to accelerated tax depreciation (e.g., MACRS)  
13 and is thus subject to the normalization rules. PSE records the difference between  
14 accelerated tax depreciation and book depreciation to its ADIT accounts in FERC  
15 Account 282 at the statutory tax rate. The balances in FERC Account 282 are  
16 used to reduce the rate base whenever customer rates are set or adjusted by the  
17 Commission.

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<sup>8</sup> For additional historical context on the normalization rules, see UE-190529-30, Exh. MRM-1Tr 11:17 – 12:11 and Exh. DAD-7T 27:1 – 29:2, which have been provided as Exh. MRM-4 in this case.

1 **Q. What would happen to PSE if it failed to use a normalization method of**  
2 **accounting?**

3 A. The context for PSE's comments which the Commission's points to in Paragraph  
4 43 was PSE's concerns over a potential violation of the normalization rules. If a  
5 regulated utility, like PSE, fails to maintain a normalization method of  
6 accounting, it will lose its ability to benefit from accelerated tax depreciation.  
7 Such a failure will cause its tax depreciation methodology to revert to the  
8 depreciation methodology used in setting rates,<sup>9</sup> which is generally straight-line  
9 over the estimated useful life of the asset. The change in tax accounting method  
10 will cause its deferred tax liability for the difference between book and tax  
11 depreciation to reverse and become a current tax payable (i.e., a tax liability to the  
12 IRS in the year of change).

13 **Q. What would that mean to PSE and its customers?**

14 A. At a high level, PSE's protected-plus ADIT balance in FERC Account 282 is a  
15 net \$1.9 billion DTL as of June 30, 2021. Consistent with the IRS rules, PSE  
16 treats that \$1.9 billion as a reduction to rate base when rates are set.  
17 If PSE were to lose the ADIT of \$1.9 billion due to a normalization violation,  
18 PSE would be prohibited from using accelerated tax depreciation and required to

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<sup>9</sup> IRC §168(i)(9)(C).

1 use book depreciation. That change in tax accounting method would cause the  
2 reversal of the ADIT of \$1.9 billion.

3 **Q. Can you explain how the reversal of ADIT would work?**

4 A. If the IRS forces PSE off of the use of accelerated tax depreciation due to a fault  
5 in its normalization method of accounting, PSE would need to reverse all vestiges  
6 of its prior benefits of accelerated tax depreciation. In essence, all of those prior  
7 tax depreciation deductions in excess of book depreciation would reverse in the  
8 current year.<sup>10</sup> That would be many years of accelerated tax depreciation in excess  
9 of book depreciation reversing all at once, increasing taxes payable by \$1.9  
10 billion.

11 Further, since PSE would not have been making estimated tax payments with the  
12 foreknowledge that it would have normalization violation, it would be  
13 significantly underpaid in its current year estimated taxes and be subject to  
14 additional interest and penalties on the underpayment.

15 **Q. Where would PSE come up with the cash to make a payment to the IRS of**  
16 **\$1.9 billion, plus interest and penalties?**

17 A. Setting aside the catastrophic nature of such a request, for this hypothetical, I will  
18 just assume that it is viable to finance this payment. PSE's debt versus equity is

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<sup>10</sup> IRC §481(a) allows a taxpayer to spread an unfavorable accounting method change over three tax years. But that exception only applies to adjustments "initiated by the taxpayer." Although it is unclear, it seems likely that the IRS would view an accounting method change caused by a normalization violation to be an involuntary change and not one "initiated by the taxpayer," thus making the three-year spread unavailable.

1 presently regulated at 51.5 percent debt to 48.5 percent equity. At June 30, PSE's  
2 outstanding debt stood at \$4.5 billion. Therefore, if PSE borrowed an additional  
3 \$1.9 billion, it would see its debt load increase by 42 percent to \$6.5 billion, and  
4 its debt versus equity ratio deteriorate to 60.1 percent debt and 39.9 percent  
5 equity.

6 With equity falling below 44 percent, PSE would lose its ability to pay dividends.

7 A change of this magnitude would certainly lead to an increase in PSE's risk  
8 profile in the credit markets. This would cause S&P and Moody's to re-evaluate  
9 and lower their credit rating on PSE's debt.

10 A change to PSE's credit rating will increase the interest rate at which PSE can  
11 borrow money.

12 **Q. Can you summarize the effects that a violation would have on customers?**

13 A. First, customers would see higher rates due to the reversal of ADIT of \$1.9  
14 billion. Rate base would increase \$1.9 billion. At a weighted average cost of  
15 capital ("WACC") of 7.39 percent, this change alone increases rates by \$140  
16 million per year. Second, customers would see higher rates due to PSE's higher  
17 debt levels with third party lenders as interest expense would increase. Third,  
18 customers would see higher rates due to PSE being subject to higher interest rates  
19 on its debt, due in part to having a lower credit rating. Fourth, customers would  
20 likely see higher rates due to an increase in the rate of return on equity due to PSE  
21 becoming a more risky investment opportunity for equity investors. Fifth,

1 customers would see higher rates due to additional interest and penalties the IRS  
2 would assess on the violation. In summary, a normalization violation must be  
3 avoided as the consequences are catastrophic to PSE and its customers.

4 **b. Before and after analysis of the impact of accelerated**  
5 **depreciation on revenue requirement**

6 **Q. Please respond to the Commission’s request that PSE “identify and quantify**  
7 **the actual benefits that accelerated depreciation confers on ratepayers and**  
8 **provide a ‘before and after analysis’ illustrating the impact of accelerated**  
9 **depreciation on revenue requirement.”**

10 A. In response to this request, I will use an example of one asset in order to illustrate  
11 and quantify the impacts of accelerated tax depreciation. These principles can be  
12 extrapolated more broadly once the foundation has been laid for how it works.

13 Example: One asset with a cost of \$10,000. Book life is ten years, straight-line.

14 Tax life is five years, MACRS. Asset is placed in service January 1st of Year 1.

15 Debt is 51.5 percent and equity is 48.5 percent. The debt rate is 5.5 percent. The  
16 equity rate is 9.4 percent. The WACC is 7.39 percent. The tax rate is 21 percent.

17 Finally, assume that there are no other costs or revenue sources. With this data, a  
18 simple revenue requirement for this one-asset utility can be determined.

19 The heart of this analysis is captured in the following table. The tax recovery of  
20 the cost of the asset occurs more quickly than the book recovery of the same cost.

Table 2: Book vs. Tax Depreciation Difference											
Row	Year	1	2	3	4	5	6	7	8	9	10
1	Book Depr Rate	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
2	Book Depreciation	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
3											
4	Tax Depr Rate	20.00%	32.00%	19.20%	11.52%	11.52%	5.76%				
5	Tax Depreciation	2,000	3,200	1,920	1,152	1,152	576				
6	Annual Book/Tax Diff	(1,000)	(2,200)	(920)	(152)	(152)	424	1,000	1,000	1,000	1,000
7	Annual Def Inc Tax	(210)	(462)	(193)	(32)	(32)	89	210	210	210	210
8	ADIT	(210)	(672)	(865)	(897)	(929)	(840)	(630)	(420)	(210)	-

Line 6 shows the annual book/tax difference. The tax, accounting, and rate making treatment of that difference will convey a benefit to customers that cannot be achieved apart from accelerated tax depreciation as explained below.

Before getting more deeply into the numbers, below is how it works.

In Year 1, the company's tax deduction in this example will be \$1,000 more than its book depreciation. As a result, the company will pay \$210 less to the IRS than it would have paid in the absence of accelerated tax deduction (Line 7). By using the IRS as a cost-free source of capital, the company requires less invested capital, both debt and equity. By incurring less debt, interest expense is smaller. By recording the ADIT as a reduction to rate base, the rate base is smaller, which also lowers the revenue requirement.

Things will continue in this vein until Year 6. In Year 6, the story changes. Tax depreciation becomes *less* than book depreciation. Basically, the IRS starts getting its money back. Even so, the company has received the benefit of using the IRS' money which it will repay over Year 6 through Year 10, and there is no interest charges.



1 Table 3 shows an expanded analysis to include the revenue requirement, net  
 2 income, and rate base, all of which are beneficially impacted by the presence of  
 3 the accelerated tax depreciation. The benefit is achieved by virtue of the treatment  
 4 of the annual deferred tax expense and the ADIT, which are highlighted in Table  
 5 2.

<b>Table 3: Revenue Requirement, Net Income, and Rate Base</b>											
Row	Year	1	2	3	4	5	6	7	8	9	10
1	<b>Revenue Requirement</b>	2,295	2,080	1,904	1,752	1,600	1,466	1,349	1,233	1,116	1,000
2	Book Depreciation	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
3	Interest Expense	(249)	(208)	(174)	(145)	(115)	(90)	(67)	(45)	(22)	0
4	Pretax Net Income	1,046	872	730	607	484	376	282	188	94	0
5	Income Tax Expense:										
6	Current	10	(279)	(40)	96	70	168	269	249	230	210
7	Deferred	210	462	193	32	32	(89)	(210)	(210)	(210)	(210)
8	Total Income Tax Exp	220	183	153	128	102	79	59	39	20	0
9	<b>Net Income</b>	<b>826</b>	<b>689</b>	<b>577</b>	<b>480</b>	<b>383</b>	<b>297</b>	<b>223</b>	<b>149</b>	<b>74</b>	<b>0</b>
10	Effective Tax Rate	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	0.0%
11											
12	<b>Rate Base:</b>										
13	Plant	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
14	Accumulated Depr.	(1,000)	(2,000)	(3,000)	(4,000)	(5,000)	(6,000)	(7,000)	(8,000)	(9,000)	(10,000)
15	ADIT	(210)	(672)	(865)	(897)	(929)	(840)	(630)	(420)	(210)	0
16	<b>Net Rate Base</b>	<b>8,790</b>	<b>7,328</b>	<b>6,135</b>	<b>5,103</b>	<b>4,071</b>	<b>3,160</b>	<b>2,370</b>	<b>1,580</b>	<b>790</b>	<b>0</b>
17	Actual ROE	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	0.00%

7 From Table 3, a few points should be highlighted:

8 First, the Revenue Requirement (Line 1) is a result that is pegged to achieve the  
 9 allowed return on equity (Line 17). For example, the Year 1 Revenue  
 10 Requirement is \$2,295. That level of revenue allows the company to recover its  
 11 book depreciation, interest expense, income taxes, and achieve the targeted return  
 12 on equity on Net Rate Base consistent with the authorized rate of return.

13 Second, the Interest Expense on Line 3 is lower due to part of the invested capital  
 14 coming from the IRS in the form of the ADIT, which results in less debt  
 15 outstanding.

1 Third, Total Income Tax Expense on Line 8 of \$220 includes the impact of the  
2 annual deferred tax expense (Line 7) of \$210, which is the book/tax depreciation  
3 difference.

4 Fourth, Total Income Tax Expense on Line 8 also results in an effective tax rate  
5 of 21 percent (Line 10). This is proof that the tax expense is perfectly shaped to  
6 the book income that is used to set customer rates. In other words, the revenue  
7 and costs that are used to set the revenue requirement over the life of the activity  
8 are burdened with an income tax of 21 percent in each year. This achieves  
9 generational fairness between rate payers from year to year, which is one  
10 hallmark of a well-designed regulatory scheme.

11 Fifth, Net Rate Base calculation on Line 16 is reduced by the outstanding balance  
12 of the ADIT as required by the normalization rules, which leads to a lower  
13 revenue requirement.

14 This analysis is a simplistic calculation that represents what is occurring in PSE's  
15 tax, accounting, and rate setting treatment of the accelerated tax depreciation.

16 **Q. Can you explain what would happen if PSE did not avail itself of accelerated**  
17 **depreciation?**

18 A. Yes. As with the prior example, let's begin by looking at book versus tax  
19 depreciation. When accelerated tax depreciation is not present, there is no  
20 book/tax difference to calculate nor is there any ADIT.

Table 4: Book vs. Tax Depreciation Difference											
Row	Year	1	2	3	4	5	6	7	8	9	10
1	Book Depr Rate	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
2	Book Depreciation	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
3											
4	Tax Depr Rate	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
5	Tax Depreciation	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
6	Annual Book/Tax Diff	-	-	-	-	-	-	-	-	-	-
7	Annual Def Inc Tax	-	-	-	-	-	-	-	-	-	-
8	ADIT	-	-	-	-	-	-	-	-	-	-

Without the creation of any deferred tax, the company is not able to use the IRS's money as a source of capital. All capital for the investment in the asset must come from the investors in the form of debt and equity.

The table below recasts the activity in Table 3 with one significant difference: No deferred tax is recorded on Line 7 because book and tax depreciation are equal.

This means that there is no ADIT on Line 15 to reduce Net Rate Base.

Table 5: Revenue Requirement, Net Income, and Rate Base without Accelerated Tax Depreciation											
Row	Year	1	2	3	4	5	6	7	8	9	10
1	<b>Revenue Requirement</b>	2,326	2,178	2,031	1,884	1,737	1,589	1,442	1,295	1,147	1,000
2	Book Depreciation	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
3	Interest Expense	(255)	(227)	(198)	(170)	(142)	(113)	(85)	(57)	(28)	0
4	Pretax Net Income	1,071	952	833	714	595	476	357	238	119	0
5	Income Tax Expense:										
6	Current	225	200	175	150	125	100	75	50	25	0
7	Deferred	0	0	0	0	0	0	0	0	0	0
8	Total Income Tax Exp	225	200	175	150	125	100	75	50	25	0
9	<b>Net Income</b>	846	752	658	564	470	376	282	188	94	0
10	Effective Tax Rate	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	0.0%
11											
12	<b>Rate Base:</b>										
13	Plant	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
14	Accumulated Depr.	(1,000)	(2,000)	(3,000)	(4,000)	(5,000)	(6,000)	(7,000)	(8,000)	(9,000)	(10,000)
15	ADIT	0	0	0	0	0	0	0	0	0	0
16	<b>Net Rate Base</b>	9,000	8,000	7,000	6,000	5,000	4,000	3,000	2,000	1,000	0
17	Actual ROE	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	0.00%

In this hypothetical situation, the Revenue Requirement in every year will be higher than in the prior example, for the following reasons:

First, Interest Expense is higher on Line 3 because additional debt is required to fund the investment.

1 Second, Total Income Tax Expense on Line 8 is higher. On an overall basis, tax  
 2 expense will be higher due to a higher revenue requirement on a larger rate base.  
 3 Note that the Current tax on Line 6 is much larger than shown in Table 3 in the  
 4 early years, indicating a much larger tax payable to the IRS in the absence of  
 5 accelerated tax depreciation. But this situation reverses in the later years as the  
 6 book/tax difference in Table 3 reverses.

7 Third, the Effective Tax Rate remains at 21 percent, so the rate design is sound;  
 8 but as mentioned above, the Total Income Tax Expense is higher.

9 Fourth, the Net Rate Base on Line 16 is larger due to the absence of the ADIT.  
 10 This pushes up the Revenue Requirement as additional revenue is required to  
 11 achieve the targeted return on equity of 9.4 percent.

12 Table 6 shows a select comparison between using accelerated tax depreciation  
 13 (Table 3) and not using it (Table 5).

Table 6: Select Comparison between Tables 3 and 5											
Row	Year	1	2	3	4	5	6	7	8	9	10
1	Table 3 Revenue	2,295	2,079	1,904	1,752	1,600	1,465	1,349	1,233	1,116	1,000
2	Table 5 Revenue	2,326	2,178	2,031	1,884	1,736	1,589	1,442	1,295	1,147	1,000
3	Difference	(31)	(99)	(127)	(132)	(137)	(124)	(93)	(62)	(31)	0
4											
5	Table 3 Rate Base	8,790	7,328	6,135	5,103	4,071	3,160	2,370	1,580	790	0
6	Table 5 Rate Base	9,000	8,000	7,000	6,000	5,000	4,000	3,000	2,000	1,000	0
7	Difference	(210)	(672)	(865)	(897)	(929)	(840)	(630)	(420)	(210)	0

15 Table 6 shows that *in every year*, the Revenue Requirement is smaller when  
 16 accelerated tax depreciation is used. See Line 3. As expected, the benefit grows  
 17 with the growth of ADIT and then declines as ADIT declines.

1 Similarly with Rate Base, it is *smaller* in every year by the amount of the ADIT.  
2 See Line 7.

3 **Q. How does this look on a net present value basis?**

4 A. There is a benefit to customers and PSE on a net present value (“NPV”) basis. In  
5 this example, the NPV of the Revenue Requirement in Table 3 is \$11,463 versus  
6 the NPV of the Revenue Requirement in Table 5 of \$12,064 for a lower NPV by  
7 \$601. In this example, the savings that ADIT provides to customers over the life  
8 of the asset is 5.24 percent (\$601 divided by \$11,463).

9 **Q. How sensitive is the analysis to various factors?**

10 A. The ADIT balance is the key. Anything that increases the ADIT balance more  
11 quickly or that permits the balance to be outstanding longer will be beneficial to  
12 customers. For example, a wind farm has a five year tax life and a twenty-five  
13 year book life. The ADIT for that will reach its apex in the sixth tax year and  
14 slowly unwind over the next nineteen years. That benefit to customers will be  
15 greater than the one identified in the tables above where the difference is only five  
16 years for tax versus ten years for book. Another example would be bonus  
17 depreciation where 50 percent of the cost could be deducted in the first year; that  
18 caused an immediate, large increase in the ADIT from day one over the normal  
19 MACRS increase.

1 The change in interest rates or equity rates also have an impact. In general, higher  
2 rates make the ADIT more valuable as the interest savings will be larger.

3 However, on a NPV basis, the benefit of that, while still present, is muted.

4 In its workpapers, PSE has provided a working model to allow additional  
5 examination of the impact of various combinations of factors.<sup>11</sup>

6 **Q. How would you extrapolate the value of accelerated tax depreciation to PSE's**  
7 **customers based on June 30 balances?**

8 A. The example above shows that for each individual investment PSE makes,  
9 accelerated tax depreciation and ADIT are a good thing and result in lower cost to  
10 customers when compared to no accelerated tax depreciation. What is true for the  
11 one asset in the example is equally true for the population of PSE's assets. Putting  
12 a precise number on this benefit for PSE's customers is a challenging proposition.  
13 A simplistic, but valid, approach is to look at the ADIT balance of \$1.9 billion.  
14 The ADIT balance provides customers with an annual benefit of approximately  
15 \$141 million (\$1.9 billion at WACC of 7.39 percent).

16 **c. Additional Comments**

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<sup>11</sup> See workpaper New-PSE-WP-MRM-1T-ADIT-Tax-22-GRC-01-2022.xlsx, tab "Plant ADIT Model".

1 **Q. Before leaving this topic, is there anything else to add?**

2 A. The Commission did not reference flow through accounting in Paragraph 43, but  
3 it may be helpful to discuss it and compare it with the two scenarios discussed  
4 above.

5 **Q. Please explain how flow through accounting would work in the example**  
6 **above.**

7 A. Flow through accounting represents a situation where accelerated depreciation is  
8 used but the deferred taxes are not recorded. For purposes of this example, I will  
9 apply flow through accounting to the full difference between book and tax  
10 depreciation to highlight the mechanics of the calculations and to show the most  
11 beneficial scenario in favor of flow through accounting.<sup>12</sup>

12 As with the examples above, we begin with a review of the difference between  
13 book and tax depreciation.

Row	Year	1	2	3	4	5	6	7	8	9	10
1	Book Depr Rate	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
2	Book Depreciation	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
3											
4	Tax Depr Rate	20.00%	32.00%	19.20%	11.52%	11.52%	5.76%				
5	Tax Depreciation	2,000	3,200	1,920	1,152	1,152	576	-	-	-	-
6	Annual Book/Tax Diff	(1,000)	(2,200)	(920)	(152)	(152)	424	1,000	1,000	1,000	1,000
7	Annual Def Inc Tax	-	-	-	-	-	-	-	-	-	-
8	ADIT	-	-	-	-	-	-	-	-	-	-

15 Table 7 shows the difference between book depreciation, which is recovered on a  
16 straight-line basis over ten years and tax depreciation which is recorded over five-

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<sup>12</sup> The IRS normalization rules would not allow flow through accounting to apply to the full difference between book and tax depreciation. However, doing the analysis this way will create the most benefit possible under flow through accounting for comparison against the other approaches.

1 year MACRS. The difference between Table 2 and Table 7 is that no deferred tax  
 2 is recorded in Table 7 for the book/tax timing difference. In flow through  
 3 accounting, the deferred tax is not recorded. Without recording the deferred tax,  
 4 the impact of the current tax is all that remains. In the rate setting context, the  
 5 current tax expense or benefit will flow into the Revenue Requirement as a  
 6 detriment or a benefit depending on whether or not the book/tax difference is  
 7 growing or declining.

8 In Table 8, the Revenue Requirement (Line 1) reflects this reality. It is lower  
 9 while the timing difference is increasing, but higher when it reverses. In isolation,  
 10 the increase and decrease would be offsetting across all years. However, that is  
 11 not the case. The Revenue Requirement is harmed across the whole life of the  
 12 investment because the rate base is higher in every year due to the “missing”  
 13 ADIT (Line 15 is zero).

Table 8: Revenue Requirement, Net Income, and Rate Base - Flow Through											
Row	Year	1	2	3	4	5	6	7	8	9	10
1	<b>Revenue Requirement</b>	2,060	1,594	1,787	1,843	1,696	1,702	1,708	1,560	1,413	1,266
2	Book Depreciation	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
3	Interest Expense	(255)	(227)	(198)	(170)	(142)	(113)	(85)	(57)	(28)	0
4	Pretax Net Income	805	367	588	674	555	589	623	504	385	266
5	Income Tax Expense:										
6	Current	(41)	(385)	(70)	110	85	213	341	316	291	266
7	Deferred	0	0	0	0	0	0	0	0	0	0
8	Total Income Tax Exp	(41)	(385)	(70)	110	85	213	341	316	291	266
9	<b>Net Income</b>	846	752	658	564	470	376	282	188	94	0
10	Effective Tax Rate	-5.1%	-104.9%	-11.8%	16.3%	15.2%	36.1%	54.7%	62.7%	75.6%	0.0%
11											
12	<b>Rate Base:</b>										
13	Plant	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
14	Accumulated Depr.	(1,000)	(2,000)	(3,000)	(4,000)	(5,000)	(6,000)	(7,000)	(8,000)	(9,000)	(10,000)
15	ADIT	0	0	0	0	0	0	0	0	0	0
16	<b>Net Rate Base</b>	9,000	8,000	7,000	6,000	5,000	4,000	3,000	2,000	1,000	0
17	Actual ROE	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	9.40%	0.00%

15 In this example, in Year 1, there is no deferred tax on Line 7. That “missing”  
 16 deferred tax of \$210 is grossed up and applied to reduce the Revenue



1 Requirement. In this way, the benefit of accelerated tax depreciation is flowed  
2 through to customers in Year 1 in the form of lower rates. However, in the latter  
3 years, the situation reverses and those customers face a higher Revenue  
4 Requirements as no tax deductions remain.

5 It is very illuminating to consider the effective tax rate (Line 10). It shows a very  
6 unfortunate situation. Customers in the first few years receive a windfall by  
7 claiming *all* the benefit of accelerated tax depreciation. This may seem like a  
8 great deal—customers win at the IRS’s expense. But that’s not the case. Instead,  
9 customers in the early years win at the expense of customers in the later years.  
10 The effective tax rate in later years is well in excess of 21 percent. Customers in  
11 those years are burdened with more than their share of the costs of the investment  
12 as they have been robbed of any tax deduction associated with the part of the  
13 investment for which they are paying. These fluctuations in the effective tax rate  
14 represent a mismatch in rate-making treatment between the customers who pay  
15 for the asset and get the entire tax benefit and those who pay for the asset without  
16 any tax benefits. This is a hallmark of a poor rate-making scheme where costs and  
17 benefits are not matched to the same period.

18 **Q. Can you compare the normalized treatment against the flow through**  
19 **treatment?**

20 A. Yes. The generational inequity in the flow through approach to setting rates  
21 becomes clearer in Table 9, below, which compares the normalized treatment  
22 from Table 3 with the flow through treatment of Table 8.

Row	Year	1	2	3	4	5	6	7	8	9	10
1	Table 3 Revenue Norm.	2,295	2,080	1,904	1,752	1,600	1,466	1,349	1,233	1,116	1,000
2	Table 8 Revenue FT	2,060	1,594	1,787	1,843	1,696	1,702	1,708	1,560	1,413	1,266
3	Difference	235	486	117	(92)	(96)	(236)	(359)	(328)	(297)	(266)
4											
5	Table 3 Rate Base Norm.	8,790	7,328	6,135	5,103	4,071	3,160	2,370	1,580	790	0
6	Table 8 Rate Base FT	9,000	8,000	7,000	6,000	5,000	4,000	3,000	2,000	1,000	0
7	Difference	(210)	(672)	(865)	(897)	(929)	(840)	(630)	(420)	(210)	0
8											
9	Table 3 Effective Tax Rate	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	0.0%
10	Table 8 Effective Tax Rate	-5.1%	-104.9%	-11.8%	16.3%	15.2%	36.1%	54.7%	62.7%	75.6%	0.0%
11	Difference	26.1%	125.9%	32.8%	4.7%	5.8%	-15.1%	-33.7%	-41.7%	-54.6%	0.0%

As mentioned before, the Revenue Requirement for normalized treatment (Line 1) is higher in the first few years. But in Year 4 and thereafter, things change as those customers are faced with higher bills in every year.

The rate base is lower under normalization (Line 7) by the amount of the “missing” ADIT. This translates into more costs for customers in the flow through methodology.

**Q. Are the generational inequities inherent in the flow through methodology justified in order to lower customer rates?**

A. No. Table 10 demonstrates that overall, the flow through methodology does not lower customer rates.

Row	Year	Total	NPV
1	Table 3 Revenue - Normalized	15,793	11,463
2	Table 5 Revenue - Book=Tax	16,629	12,064
3	Table 8 Revenue - Flow through	16,629	11,708

Table 10 shows the cumulative Revenue Requirement for the full ten year recovery period of the asset for each scenario. It shows that the normalized treatment results in the lowest Revenue Requirement, by a significant margin.

1 Table 10 further shows that the normalized treatment results in the lowest NPV.  
2 This is significant as it demonstrates that the inequitable conference of benefits on  
3 earlier customers is more than offset by the cost that future customers must bear.

4 **Q. Can you provide a summary response to the Commission's request in**  
5 **Paragraph 43?**

6 A. I would summarize the response as follows: ADIT is good and more ADIT is  
7 better. There is nothing better for customers than borrowing money from the  
8 government at no cost. This analysis shows that accelerated tax depreciation and  
9 the normalized regulatory treatment are beneficial to customers, result in the fair  
10 matching of tax benefits to the customers who bear the burden of the underlying  
11 investment, and result in a lower Revenue Requirement.

### 12 III. TAX LAW CHANGES

13 **A. Potential Tax Law Changes During the Multiyear Rate Plan**

14 **Q. What are the tax law changes impacting 2021 and beyond?**

15 A. At the time of this writing, new tax law has not been enacted. The early  
16 expectation was that the corporate income tax rate would increase to 28 percent;  
17 and over time it appeared that a lower corporate income tax rate of 25 percent  
18 might be enacted. As of this filing, no law has been passed to change the  
19 corporate income tax rate. PSE is primarily concerned with an increase in the  
20 corporate income tax rate.

1 **Q. How does the tax rate increase impact PSE?**

2 A. In general, an increase in the corporate tax rate will have the effect of reducing,  
3 but not eliminating, PSE's plant-related EDIT balance. Much of PSE's ADIT  
4 balance was accumulated during years when the corporate tax rate was 35  
5 percent. Starting in 2018, new layers were being added at 21 percent. Over the  
6 years, the changing corporate income tax rate has caused the ADIT balance to  
7 become a stew of differing tax rates. Today's EDIT balances are based on the  
8 current tax rate of 21 percent. If the corporate rate increases to 25 percent, the  
9 EDIT balance would be recalculated, and a portion of it would evaporate. As a  
10 rough calculation, that might translate into EDIT declining by 29 percent.<sup>13</sup>

11 **Q. From a regulatory standpoint, how will PSE handle a tax rate increase?**

12 A. PSE would follow the same process that was followed for TCJA. More  
13 specifically, there are a number aspects to the tax rate change.

14 First, PSE would immediately file an accounting petition seeking deferral of the  
15 increase in tax expense. This would include setting up tracking accounts to  
16 capture the under-collection of higher income taxes in current rates.

17 Second, PSE would file for new rates to reflect the increase in tax expense.

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<sup>13</sup> The current EDIT is based on a rate change from 35 percent to 21 percent which is a drop of 14. If the rate goes up to 25 percent, that is an increase of 4. One could roughly calculate the percentage decrease in EDIT as follows: 4 divided by 14 equals 29 percent.

1 Third, PSE would file to change the Schedule 141Z tariffs for electric and gas.  
2 Schedule 141Z is returning the unprotected EDIT from FERC Accounts 190 and  
3 283 to customers over three years. PSE expects to net the unreturned balance  
4 against the new EDIT calculation for deferred taxes in FERC Accounts 190 and  
5 283.

6 Fourth, in order to follow the normalization and consistency rules for the plant-  
7 related EDIT, the EDIT that is built into rates cannot be updated apart from the  
8 book depreciation, tax expense, rate base, and ADIT. As a result, the EDIT  
9 impacts would need to be rolled into the rate making in the multiyear rate plan.

10 Fifth, the Electric Schedule 87, Income Tax Rider, and the Gas Rule 28, Income  
11 Tax Rider, would both require adjustment to reflect the new income tax rate.

12 **Q. How would a tax rate increase impact the multiyear rate plan?**

13 A. The multiyear rate plan has been filed using a tax rate of 21 percent. If the tax rate  
14 changes, PSE would need to update its filing to calculate a new revenue  
15 requirement that would capture the higher income taxes and lower EDIT  
16 reversals. The projected ADIT reported in net rate base would also change.

1 **B. The TCJA Had a Negative Impact on PSE's Cash Flow**

2 **Q. When the TCJA was enacted, PSE saw a negative impact to its cash flow.**  
3 **Can you quantify the impact?**

4 A. The TCJA negatively impacted cash flows primarily as a result of the loss of  
5 bonus depreciation.

6 **Q. Please explain how bonus depreciation impacts net cash flows.**

7 A. Under TCJA, utilities, like PSE, are no longer able to use bonus depreciation. For  
8 utilities, the only accelerated depreciation that is available is the classic MACRS  
9 depreciation rates. While MACRS tax depreciation is still accelerated when  
10 compared to the normal book depreciation rates, it does not offer the significant  
11 benefit that PSE has been accustomed to under the bonus regime.

12 In fact, the impact of this change on PSE's deferred taxes has been significant.  
13 For example, in 2017, PSE's tax depreciation was about \$297 million larger than  
14 its book depreciation. At 35 percent, this translates into tax savings (i.e., a tax-free  
15 loan from the U.S. government) of about \$104 million. The year 2017 was typical  
16 of what PSE has experienced with bonus depreciation over the years—tax  
17 depreciation exceeding book depreciation by hundreds of millions of dollars each  
18 year. PSE's experience for 2018 was radically different. Instead of tax  
19 depreciation exceeding book depreciation, book depreciation exceeded tax  
20 depreciation by about \$177 million for 2018. At 21 percent, that translates into tax

1 costs (i.e., a tax payment) of about \$37 million. The difference between 2017 and  
 2 2018 is summarized in Table 11.

<b>Table 11 - Impact of Tax Reform on Cash Flows related to Deferred Taxes</b>				
<i>in millions (negative numbers are a use of cash)</i>				
	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>
	Description	2018 Actual	2017 Actual	Difference
1	Tax vs. Book Depreciation Exp	(177.5)	297.2	(474.7)
2	Tax Rate	21%	35%	
3	Cash impact of loss of bonus depr	(37.3)	104.0	(141.3)
4	Impact on ratebase (a)			6.4
5	Net cash impact of Tax Reform			(134.9)
	(a) \$112.2 million in DFIT x 9.4% ROE x 48.5% equity = \$6.4 million			

4 This was not just a one-year phenomena. The overall ADIT balance has been in  
 5 decline since TCJA took effect. The main cause has been the loss of bonus  
 6 depreciation. But the lower tax rate and the EDIT reversals have also played a  
 7 part. Table 12 shows the average annual decline in PSE’s plant-related ADIT  
 8 balance in FERC Account 282, an average of \$34 million per year.

<b>Table 12 - ADIT Movement since TCJA</b>					
<i>in millions (negative numbers are a use of cash)</i>					
	2017	2018	2019	2020	2021 Est
Electric	1,384.3	1,353.7	1,298.8	1,278.8	1,251.1
Gas	579.2	578.3	576.1	577.3	579.4
Common	70.8	66.8	68.9	68.5	66.3
ADIT	2,034.3	1,998.7	1,943.7	1,924.6	1,896.7
Decline		(35.6)	(55.0)	(19.1)	(27.8)
Average					(34.4)

10 In contrast to the pre-TCJA era, PSE ADIT balance was growing at an average of  
 11 \$102 million per year. See Table 13.

<b>Table 13 - ADIT Movement pre-TCJA</b>				
<i>in millions (negative numbers are a use of cash)</i>				
	2014	2015	2016	2017
Electric	1,206.7	1,252.5	1,309.4	1,384.3
Gas	479.2	501.5	533.7	579.2
Common	43.2	43.6	49.3	70.8
ADIT	1,729.1	1,797.5	1,892.4	2,034.3
Decline		68.5	94.9	141.9
Average				<u>101.8</u>

2 While the impacts of TCJA have been very beneficial to customers, it continues to  
3 adversely impact PSE's net cash flows. Instead of ADIT being a positive source  
4 of cash flow (plus \$102 million), it has become a use of cash flow (minus \$34  
5 million). This reversal is averaging \$136 million per year. In addition to the plant-  
6 related ADIT, PSE is returning the unprotected EDIT of \$38.9 million to  
7 customers over three years in the amount of \$13 million per year. Together, these  
8 brings the annual impact of TCJA to about \$149 million per year in lower cash  
9 flow. PSE's cash flows from operations impact its capital structure and its credit  
10 ratings. This is discussed in the Prefiled Direct Testimony of Cara G. Peterman,  
11 Exh. CGP-1CT.

12 **Q. How do you foresee the potential tax law changes impacting PSE's cash**  
13 **flows?**

14 A. The primary cause for the negative cash flow result in the TCJA was the loss of  
15 bonus depreciation. There are no proposals under consideration that would allow  
16 utilities to use bonus depreciation. As a result, PSE's book depreciation expense is  
17 still likely to exceed its tax depreciation going forward. And recording that



1

movement, even at a slightly higher tax rate, will not do much to impact the

2

picture that PSE has experienced post-TCJA.

3

#### **IV. CONCLUSION**

4

**Q. Does that conclude your prefled direct testimony?**

5

A. Yes, it does.