BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

PUGET SOUND ENERGY,

Respondent.

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

MATTHEW R. MARCELIA

ON BEHALF OF PUGET SOUND ENERGY

JANUARY 31, 2022
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I. INTRODUCTION

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

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

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

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

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

A. As Director of Taxes and Finance IT Projects, I have the overall management responsibility for the tax department and the financial systems department. I direct all aspects of PSE’s tax compliance, accounting for taxes, financial reporting of tax, and tax planning. My responsibility includes income taxes as well as state and local taxes. In addition, I oversee the impact of IT projects on our financial software and processes. I report directly to the Senior Vice President and Chief Financial Officer.
Q. What topics are you covering in your testimony?

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

II. ACCUMULATED DEFERRED INCOME TAXES

A. Deferred Income Taxes

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

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

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

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

Whenever the tax deduction occurs first, as is the case with a wind farm or a storm, a deferred tax liability (“DTL”) is created. If the book deduction occurs first, a deferred tax asset (“DTA”) is created.
Q. **How is the value of the deferred tax established?**

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

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

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

The net tax effect of a timing difference is zero—it did not raise or lower the company’s tax expense nor did it increase or reduce customers’ cost of service.

This tax treatment matches the book treatment for the storm expenditure as the
company did not record the expenditure nor any additional revenue to cover it in the income statement.

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

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

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

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

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

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

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

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

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

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

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

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

To summarize, the impact on the revenue requirement: there is an increase for storm costs of $1,000, which will offset storm amortization of $1,000; there is an increase in current tax of $210 and a decrease in deferred tax expense of $210; and there is a reversal of DTL in the rate base calculation.
B. Plant-Related Accumulated Deferred Income Taxes

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

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

Q. What does “protected” mean?

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

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IRC §168(i)(9)(A).
In contrast, unprotected differences are those for which the IRS has no similar requirement. Deferred taxes may be provided on unprotected differences, but it is not an IRS requirement.

In PSE’s 2019 general rate case, the Commission ordered that protected-plus ADIT be handled homogenously, which greatly simplifies things. PSE applies the IRS normalization and consistency rules to the entire protected-plus ADIT balance, including EDIT.

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

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

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

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

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

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

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

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

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

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

Q. Why did you divide the property?

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

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

A. PSE projected book depreciation by applying the approved depreciation rates from the last depreciation study against the gross historical cost of the asset to calculate the monthly book depreciation expense. In this proceeding, PSE is requesting approval of a new depreciation study sponsored by Mr. Ned W. Allis in his Prefiled Direct Testimony, Exh. NWA-1T. So, at the time the depreciation rates
from the new depreciation study would become effective starting in January 2023, the new rates are used going forward to calculate monthly depreciation.

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

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

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

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

A. In general, PSE projected book depreciation on NP by applying the approved depreciation rates from the last depreciation study against the future gross cost of the asset to calculate the monthly book depreciation expense. The calculation switches to the new depreciation rate after the effective date of the new depreciation study.
Tax depreciation on the same population was projected by applying the appropriate tax conventions (usually MACRS) against the asset additions.

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

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

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

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4 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.
For additional details on the mechanics that were used to project the EP and NP balances, please see Exh. MRM-3.

D. Special Items

a. Depreciation Study

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

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

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

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

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

A. Yes, because ADIT is generally calculated as the difference between book and tax depreciation, a change to book depreciation will cause a change in the monthly activity recorded to the ADIT balance. Note that the new depreciation rates will
have no effect on the prior, recorded balance of the ADIT. It will only impact monthly ADIT activity recorded after the new depreciation rates take effect.

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

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

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

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

**A.** PSE proposes to move the cost associated with Colstrip Units 3 and 4 to a tracker. Doing so would have the effect of pulling the plant balances out of the calculation of base rates in favor of the tracker rate. Under this approach, PSE would continue to recover the cost of the plant through a depreciation calculation that targets an end-of-life in December 2025. This tracker is discussed in more detail in the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T.
If the book depreciation and rate base are moved to the tracker, the associated tax
calculations need to follow; specifically, the ADIT and EDIT activity would also
need to move to the tracker.

Q. Isn’t the use of a tracker to recover EDIT prohibited by PSE’s 2021 Private
Letter Ruling?  

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

Q. Will the recovery of EDIT in the tracker be subject to the tracker’s true-up
mechanism?

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

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5 PSE received PLR 202142002 in July 2021.
In effect, the Colstrip tracker will monitor and recover the Colstrip activity on a dollar-for-dollar basis. The structure of this tracker will allow for a dollar-for-dollar recovery of the Colstrip EDIT as well.

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

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

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

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

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

(a) If the plant continues in operation, even though PSE cannot participate in that activity from a regulatory perspective, the tax life of the plant will
continue under MACRS, and the ADIT will reverse over a time period which extends beyond 2025.

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

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

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

c. IRS Proration Method

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

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

The IRS regulations draw a distinction between “historical” periods and “future” periods. Those terms, as used by the IRS in this context, refer to the time new rates go into effect relative to the test period. The terms do not relate to whether or not the underlying financial data is actual or estimated. As a result, a historical period is one where the test period occurs before the effective date of the revised rates. A future period is one where the test period occurs after the effective date of the revised rates. In this multiyear rate plan, the rates that are set for 2023, 2024, and 2025 would be considered “future” periods. In contrast, PSE’s normal general
rate case filings (not a multiyear rate plan) are based on historical test years, which meet the IRS definition of a “historical” period so that, in general, the proration method would not apply.

Q. Why does the IRS make this distinction?

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

Q. Please explain the IRS proration method.

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

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

<table>
<thead>
<tr>
<th>Month</th>
<th>Activity</th>
<th>Days in Month</th>
<th>Days in Period</th>
<th>Total Days in Period</th>
<th>IRS ADIT Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-22</td>
<td>1,000,000</td>
<td></td>
<td></td>
<td></td>
<td>1,000,000</td>
</tr>
<tr>
<td>Jan-23</td>
<td>120,000</td>
<td>31</td>
<td>335</td>
<td>365</td>
<td>1,000,000 + 110,137</td>
</tr>
<tr>
<td>Feb-23</td>
<td>120,000</td>
<td>28</td>
<td>307</td>
<td>365</td>
<td>1,110,137</td>
</tr>
<tr>
<td>Mar-23</td>
<td>120,000</td>
<td>31</td>
<td>276</td>
<td>365</td>
<td>1,211,068</td>
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<tr>
<td>Apr-23</td>
<td>120,000</td>
<td>30</td>
<td>246</td>
<td>365</td>
<td>1,301,808</td>
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<tr>
<td>May-23</td>
<td>120,000</td>
<td>31</td>
<td>215</td>
<td>365</td>
<td>1,382,685</td>
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<tr>
<td>Jun-23</td>
<td>120,000</td>
<td>30</td>
<td>185</td>
<td>365</td>
<td>1,453,370</td>
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<tr>
<td>Jul-23</td>
<td>120,000</td>
<td>31</td>
<td>154</td>
<td>365</td>
<td>1,514,192</td>
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<tr>
<td>Aug-23</td>
<td>120,000</td>
<td>31</td>
<td>123</td>
<td>365</td>
<td>1,564,822</td>
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<tr>
<td>Sep-23</td>
<td>120,000</td>
<td>30</td>
<td>93</td>
<td>365</td>
<td>1,605,260</td>
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<tr>
<td>Oct-23</td>
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<td>31</td>
<td>62</td>
<td>365</td>
<td>1,635,836</td>
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<td>120,000</td>
<td>30</td>
<td>32</td>
<td>365</td>
<td>1,656,219</td>
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<td>Dec-23</td>
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<td>31</td>
<td>1</td>
<td>365</td>
<td>1,666,740</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2,440,000</td>
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</table>

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

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

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

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

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

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

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

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

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

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

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

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

**A.** To understand the Commission’s exact request, I have restated Paragraph 43 in its entirety:
According to PSE, violating Normalization Rules could result in the denial of accelerated depreciation for tax purposes, “which provide a substantial offset to PSE’s rate base and would harm customers.” PSE should provide testimony and support for these assertions in its next general rate case filing. Specifically in direct testimony, PSE should identify and quantify the actual benefits that accelerated depreciation confers on ratepayers and provide a “before and after analysis” illustrating the impact of accelerated depreciation on revenue requirement. The Commission’s analysis will benefit from providing non-company parties an opportunity to review this information and offer feedback in responsive testimony. We also require PSE to report in all future general rate cases PP EDIT balances and the amounts returned through base rates for both electric and natural gas. [Footnotes omitted.]

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

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

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

A. When a regulated utility avails itself of the benefits of accelerated tax depreciation, the tax laws require that it follow a normalization method of accounting.\(^7\) The normalization requirement is designed to prohibit the direct or

\(^7\) IRC §168(i)(9)(A).
indirect flow-through of accelerated depreciation tax benefits to utility
customers. A regulated utility is considered to use a normalization method of
accounting for its public utility property if: (1) it uses the same depreciation
method and a depreciation period no shorter than the method and period used for
purposes of determining depreciation expense for cost of service and (2) any
variation in the federal income tax expense attributable to use of a method of
depreciation for ratemaking purposes different from the method used for federal
income tax purposes must be adjusted to a reserve account (i.e., credited or
debited to an ADIT account). The reserve balance attributable to this adjustment
may be treated as a reduction from the rate base or as zero-cost capital.

Q. Please summarize how PSE complies with these rules.

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

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8 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.
Q. What would happen to PSE if it failed to use a normalization method of accounting?

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

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

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

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9 IRC §168(i)(9)(C).
use book depreciation. That change in tax accounting method would cause the
reversal of the ADIT of $1.9 billion.

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

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

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

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

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

\textsuperscript{10} 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.
presently regulated at 51.5 percent debt to 48.5 percent equity. At June 30, PSE’s outstanding debt stood at $4.5 billion. Therefore, if PSE borrowed an additional $1.9 billion, it would see its debt load increase by 42 percent to $6.5 billion, and its debt versus equity ratio deteriorate to 60.1 percent debt and 39.9 percent equity.

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

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

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

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

A. First, customers would see higher rates due to the reversal of ADIT of $1.9 billion. Rate base would increase $1.9 billion. At a weighted average cost of capital (“WACC”) of 7.39 percent, this change alone increases rates by $140 million per year. Second, customers would see higher rates due to PSE’s higher debt levels with third party lenders as interest expense would increase. Third, customers would see higher rates due to PSE being subject to higher interest rates on its debt, due in part to having a lower credit rating. Fourth, customers would likely see higher rates due to an increase in the rate of return on equity due to PSE becoming a more risky investment opportunity for equity investors. Fifth,
customers would see higher rates due to additional interest and penalties the IRS would assess on the violation. In summary, a normalization violation must be avoided as the consequences are catastrophic to PSE and its customers.

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

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

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

Example: One asset with a cost of $10,000. Book life is ten years, straight-line. Tax life is five years, MACRS. Asset is placed in service January 1st of Year 1. Debt is 51.5 percent and equity is 48.5 percent. The debt rate is 5.5 percent. The equity rate is 9.4 percent. The WACC is 7.39 percent. The tax rate is 21 percent. Finally, assume that there are no other costs or revenue sources. With this data, a simple revenue requirement for this one-asset utility can be determined.

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

<table>
<thead>
<tr>
<th>Table 2: Book vs. Tax Depreciation Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Row</td>
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<tr>
<td>-----------</td>
</tr>
<tr>
<td>1</td>
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<td>6</td>
</tr>
<tr>
<td>7</td>
</tr>
</tbody>
</table>
Table 3 shows an expanded analysis to include the revenue requirement, net income, and rate base, all of which are beneficially impacted by the presence of the accelerated tax depreciation. The benefit is achieved by virtue of the treatment of the annual deferred tax expense and the ADIT, which are highlighted in Table 2.

From Table 3, a few points should be highlighted:

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

Second, the Interest Expense on Line 3 is lower due to part of the invested capital coming from the IRS in the form of the ADIT, which results in less debt outstanding.
Third, Total Income Tax Expense on Line 8 of $220 includes the impact of the annual deferred tax expense (Line 7) of $210, which is the book/tax depreciation difference.

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

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

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

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

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

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

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

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

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

<table>
<thead>
<tr>
<th>Table 6: Select Comparison between Tables 3 and 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Row</td>
</tr>
<tr>
<td>-------------</td>
</tr>
<tr>
<td>1</td>
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<tr>
<td>2</td>
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<tr>
<td>3</td>
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<tr>
<td>4</td>
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<tr>
<td>5</td>
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<tr>
<td>6</td>
</tr>
</tbody>
</table>

Table 6 shows that in every year, the Revenue Requirement is smaller when accelerated tax depreciation is used. See Line 3. As expected, the benefit grows with the growth of ADIT and then declines as ADIT declines.
Similarly with Rate Base, it is *smaller* in every year by the amount of the ADIT.

See Line 7.

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

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

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

A. The ADIT balance is the key. Anything that increases the ADIT balance more quickly or that permits the balance to be outstanding longer will be beneficial to customers. For example, a wind farm has a five year tax life and a twenty-five year book life. The ADIT for that will reach its apex in the sixth tax year and slowly unwind over the next nineteen years. That benefit to customers will be greater than the one identified in the tables above where the difference is only five years for tax versus ten years for book. Another example would be bonus depreciation where 50 percent of the cost could be deducted in the first year; that caused an immediate, large increase in the ADIT from day one over the normal MACRS increase.
The change in interest rates or equity rates also have an impact. In general, higher rates make the ADIT more valuable as the interest savings will be larger. However, on a NPV basis, the benefit of that, while still present, is muted.

In its workpapers, PSE has provided a working model to allow additional examination of the impact of various combinations of factors.\textsuperscript{11}

Q. How would you extrapolate the value of accelerated tax deprecation to PSE’s customers based on June 30 balances?

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

c. Additional Comments

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

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

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

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

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

<p>| Table 7: Book vs. Tax Depreciation Difference - Flow Through |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|</p>
<table>
<thead>
<tr>
<th>Row</th>
<th>Year</th>
<th>Book Depr Rate</th>
<th>Book Depreciation</th>
<th>Tax Depr Rate</th>
<th>Tax Depreciation</th>
<th>Annual Book/Tax Diff</th>
<th>Annual Def Inc Tax</th>
<th>ADIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>10.00%</td>
<td>1,000</td>
<td>20.00%</td>
<td>2,000</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>2</td>
<td>10.00%</td>
<td>1,000</td>
<td>32.00%</td>
<td>3,200</td>
<td>(2,200)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>3</td>
<td>3</td>
<td>10.00%</td>
<td>1,000</td>
<td>19.20%</td>
<td>1,920</td>
<td>(920)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>4</td>
<td>4</td>
<td>10.00%</td>
<td>1,000</td>
<td>11.52%</td>
<td>1,152</td>
<td>(152)</td>
<td>-</td>
<td>-</td>
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<td>5</td>
<td>5</td>
<td>10.00%</td>
<td>1,000</td>
<td>11.52%</td>
<td>1,152</td>
<td>(152)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>6</td>
<td>6</td>
<td>10.00%</td>
<td>1,000</td>
<td>5.76%</td>
<td>576</td>
<td>424</td>
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</tr>
<tr>
<td>7</td>
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<td>10.00%</td>
<td>1,000</td>
<td>-</td>
<td>-</td>
<td>1,000</td>
<td>1,000</td>
<td>-</td>
</tr>
<tr>
<td>8</td>
<td>8</td>
<td>10.00%</td>
<td>1,000</td>
<td>-</td>
<td>-</td>
<td>1,000</td>
<td>1,000</td>
<td>-</td>
</tr>
</tbody>
</table>

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

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12 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.
year MACRS. The difference between Table 2 and Table 7 is that no deferred tax is recorded in Table 7 for the book/tax timing difference. In flow through accounting, the deferred tax is not recorded. Without recording the deferred tax, the impact of the current tax is all that remains. In the rate setting context, the current tax expense or benefit will flow into the Revenue Requirement as a detriment or a benefit depending on whether or not the book/tax difference is growing or declining.

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

<table>
<thead>
<tr>
<th>Row</th>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
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<tr>
<td>1</td>
<td>Revenue Requirement</td>
<td>2,060</td>
<td>1,594</td>
<td>1,787</td>
<td>1,843</td>
<td>1,696</td>
<td>1,702</td>
<td>1,708</td>
<td>1,560</td>
<td>1,413</td>
<td>1,266</td>
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<tr>
<td>2</td>
<td>Book Depreciation</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>3</td>
<td>Interest Expense</td>
<td>(255)</td>
<td>(227)</td>
<td>(198)</td>
<td>(170)</td>
<td>(142)</td>
<td>(113)</td>
<td>(85)</td>
<td>(57)</td>
<td>(28)</td>
<td>0</td>
</tr>
<tr>
<td>4</td>
<td>Pretax Net Income</td>
<td>805</td>
<td>367</td>
<td>588</td>
<td>674</td>
<td>555</td>
<td>589</td>
<td>623</td>
<td>504</td>
<td>395</td>
<td>266</td>
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<tr>
<td>5</td>
<td>Income Tax Expense</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>6</td>
<td>Current</td>
<td>(41)</td>
<td>(385)</td>
<td>(70)</td>
<td>110</td>
<td>85</td>
<td>213</td>
<td>341</td>
<td>316</td>
<td>291</td>
<td>266</td>
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<tr>
<td>7</td>
<td>Deferred</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>8</td>
<td>Total Income Tax Exp</td>
<td>(41)</td>
<td>(385)</td>
<td>(70)</td>
<td>110</td>
<td>85</td>
<td>213</td>
<td>341</td>
<td>316</td>
<td>291</td>
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<td>9</td>
<td>Net Income</td>
<td>846</td>
<td>752</td>
<td>658</td>
<td>564</td>
<td>470</td>
<td>376</td>
<td>282</td>
<td>188</td>
<td>94</td>
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<td>Effective Tax Rate</td>
<td>-5.1%</td>
<td>-104.9%</td>
<td>-11.8%</td>
<td>16.3%</td>
<td>15.2%</td>
<td>36.1%</td>
<td>54.7%</td>
<td>62.7%</td>
<td>75.6%</td>
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<td></td>
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</tr>
<tr>
<td>12</td>
<td>Plant</td>
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<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
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<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>13</td>
<td>Accumulated Depr.</td>
<td>(1,000)</td>
<td>(2,000)</td>
<td>(3,000)</td>
<td>(4,000)</td>
<td>(5,000)</td>
<td>(6,000)</td>
<td>(7,000)</td>
<td>(8,000)</td>
<td>(9,000)</td>
<td>(10,000)</td>
</tr>
<tr>
<td>14</td>
<td>ADIT</td>
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<td>0</td>
<td>0</td>
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<td>0</td>
<td>0</td>
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</tr>
<tr>
<td>15</td>
<td>Net Rate Base</td>
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<td>6,000</td>
<td>5,000</td>
<td>4,000</td>
<td>3,000</td>
<td>2,000</td>
<td>1,000</td>
<td>0</td>
</tr>
</tbody>
</table>

In this example, in Year 1, there is no deferred tax on Line 7. That “missing” deferred tax of $210 is grossed up and applied to reduce the Revenue Requirement.
Requirement. In this way, the benefit of accelerated tax depreciation is flowed through to customers in Year 1 in the form of lower rates. However, in the latter years, the situation reverses and those customers face a higher Revenue Requirements as no tax deductions remain.

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

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

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

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

Q. Can you provide a summary response to the Commission’s request in Paragraph 43?

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

III. TAX LAW CHANGES

A. Potential Tax Law Changes During the Multiyear Rate Plan

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

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

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

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

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

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

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

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13 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.
Third, PSE would file to change the Schedule 141Z tariffs for electric and gas. Schedule 141Z is returning the unprotected EDIT from FERC Accounts 190 and 283 to customers over three years. PSE expects to net the unreturned balance against the new EDIT calculation for deferred taxes in FERC Accounts 190 and 283.

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

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

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

A. The multiyear rate plan has been filed using a tax rate of 21 percent. If the tax rate changes, PSE would need to update its filing to calculate a new revenue requirement that would capture the higher income taxes and lower EDIT reversals. The projected ADIT reported in net rate base would also change.
B. The TCJA Had a Negative Impact on PSE’s Cash Flow

Q. When the TCJA was enacted, PSE saw a negative impact to its cash flow.

Can you quantify the impact?

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

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

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

In fact, the impact of this change on PSE’s deferred taxes has been significant. For example, in 2017, PSE’s tax depreciation was about $297 million larger than its book depreciation. At 35 percent, this translates into tax savings (i.e., a tax-free loan from the U.S. government) of about $104 million. The year 2017 was typical of what PSE has experienced with bonus depreciation over the years—tax depreciation exceeding book depreciation by hundreds of millions of dollars each year. PSE’s experience for 2018 was radically different. Instead of tax depreciation exceeding book depreciation, book depreciation exceeded tax depreciation by about $177 million for 2018. At 21 percent, that translates into tax
costs (i.e., a tax payment) of about $37 million. The difference between 2017 and 2018 is summarized in Table 11.

<table>
<thead>
<tr>
<th align="left">Table 11 - Impact of Tax Reform on Cash Flows related to Deferred Taxes</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td align="left">Description</td>
<td>2018 Actual</td>
<td>2017 Actual</td>
<td>Difference</td>
<td></td>
</tr>
<tr>
<td align="left">1 Tax vs. Book Depreciation Exp</td>
<td>(177.5)</td>
<td>297.2</td>
<td>(474.7)</td>
<td></td>
</tr>
<tr>
<td align="left">2 Tax Rate</td>
<td>21%</td>
<td>35%</td>
<td></td>
<td></td>
</tr>
<tr>
<td align="left">3 Cash impact of loss of bonus depr</td>
<td>(37.3)</td>
<td>104.0</td>
<td>(141.3)</td>
<td></td>
</tr>
<tr>
<td align="left">4 Impact on ratebase (a)</td>
<td></td>
<td></td>
<td>6.4</td>
<td></td>
</tr>
<tr>
<td align="left">5 Net cash impact of Tax Reform</td>
<td></td>
<td></td>
<td>(134.9)</td>
<td></td>
</tr>
</tbody>
</table>

(a) $112.2 million in DFIT x 9.4% ROE x 48.5% equity = $6.4 million

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

<table>
<thead>
<tr>
<th>Table 12 - ADIT Movement since TCJA</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021 Est</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electric</td>
<td>1,384.3</td>
<td>1,353.7</td>
<td>1,298.8</td>
<td>1,278.8</td>
<td>1,251.1</td>
</tr>
<tr>
<td>Gas</td>
<td>579.2</td>
<td>578.3</td>
<td>576.1</td>
<td>577.3</td>
<td>579.4</td>
</tr>
<tr>
<td>Common</td>
<td>70.8</td>
<td>66.8</td>
<td>68.9</td>
<td>68.5</td>
<td>66.3</td>
</tr>
<tr>
<td>ADIT</td>
<td>2,034.3</td>
<td>1,998.7</td>
<td>1,943.7</td>
<td>1,924.6</td>
<td>1,896.7</td>
</tr>
<tr>
<td>Decline</td>
<td>(35.6)</td>
<td>(55.0)</td>
<td>(19.1)</td>
<td>(27.8)</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(34.4)</td>
</tr>
</tbody>
</table>

In contrast to the pre-TCJA era, PSE ADIT balance was growing at an average of $102 million per year. See Table 13.
While the impacts of TCJA have been very beneficial to customers, it continues to adversely impact PSE’s net cash flows. Instead of ADIT being a positive source of cash flow (plus $102 million), it has become a use of cash flow (minus $34 million). This reversal is averaging $136 million per year. In addition to the plant-related ADIT, PSE is returning the unprotected EDIT of $38.9 million to customers over three years in the amount of $13 million per year. Together, these brings the annual impact of TCJA to about $149 million per year in lower cash flow. PSE’s cash flows from operations impact its capital structure and its credit ratings. This is discussed in the Prefiled Direct Testimony of Cara G. Peterman, Exh. CGP-1CT.

Q. How do you foresee the potential tax law changes impacting PSE’s cash flows?

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

<table>
<thead>
<tr>
<th>Table 13 - ADIT Movement pre-TCJA</th>
<th>in millions (negative numbers are a use of cash)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
</tr>
<tr>
<td>Electric</td>
<td>1,206.7</td>
</tr>
<tr>
<td>Gas</td>
<td>479.2</td>
</tr>
<tr>
<td>Common</td>
<td>43.2</td>
</tr>
<tr>
<td>ADIT</td>
<td>1,729.1</td>
</tr>
<tr>
<td>Decline</td>
<td>68.5</td>
</tr>
<tr>
<td>Average</td>
<td></td>
</tr>
</tbody>
</table>
movement, even at a slightly higher tax rate, will not do much to impact the picture that PSE has experienced post-TCJA.

IV. CONCLUSION

Q. Does that conclude your prefiled direct testimony?

A. Yes, it does.