EXH. MRM-1T
DOCKETS UE-240004/UG-240005
2024 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-240004** **Docket UG-240005**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

MATTHEW R. MARCELIA

ON BEHALF OF PUGET SOUND ENERGY

FEBRUARY 15, 2024

PUGET SOUND ENERGY

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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" or the "Company") 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 the first exhibit to this prefiled direct testimony, Exh. MRM-2.

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

A. As Director of Tax 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 Chief Financial Officer.

Q. What topics are you covering in your testimony?

A. My prefiled direct testimony will explain:

- Tax incentives in the Inflation Reduction Act (“IRA”) potentially available to utilities like PSE; how PSE plans to leverage tax credits available under the IRA; how these tax benefits will flow back to PSE customers; and the importance of transferability of tax credits and costs associated with such transfers;
- Tax incentives anticipated to be available to the Beaver Creek windfarm project in Montana;
- The impacts of the Tax Cuts and Jobs Act on PSE’s cash flow;
- Impact of the depreciation study for PSE’s gas property on taxes; and
- Mechanics of PSE’s book and tax depreciation projections in the multiyear rate plan.

II. TAX INCENTIVES IN THE INFLATION REDUCTION ACT

A. Overview

Q. What tax incentives in the Inflation Reduction Act of 2022 is PSE expecting to claim?

A. There are two primary incentives—the Production Tax Credit (“PTC”) under Section 45 of the Internal Revenue Code and the Investment Tax Credit (“ITC”) under Section 48 of the Internal Revenue Code. The Inflation Reduction Act (“IRA”) expanded the PTC and the ITC that are available for renewable energy projects and made those credits more generous, potentially, by the introduction of "bonus" credits. In addition, they made those credits transferable, which means that those credits can be sold to a third party. As a result, the PTC and the ITC will be important considerations as the Company looks to satisfy its obligations under Washington's Clean Energy Transformation Act ("CETA").

Q. Please give an overview of how the PTC works.

A. The PTC is a tax credit that is based on a qualifying project's electric production. It is calculated by multiplying the amount of electric output by the applicable credit rate. As a result, the amount of the PTC will vary as the output increases or decreases month over month. For example, a qualifying wind project would calculate its PTC by multiplying its actual output times the applicable credit rate. Since some months will be windier than others, the amount of the PTC will vary. A qualifying wind project is eligible for the PTC based on its output during the first 10 years of its life, starting with the date it is placed in service. Once the wind project's age exceeds 10 years, its generation no longer qualifies for the PTC.

Q. Please give an overview of how the ITC works.

A. In contrast to the PTC, the ITC is calculated based on the eligible cost of the qualifying project, regardless of the output that the project achieves. As a result, the ITC is a one-time credit that is determined on the date that the project is placed in service. The ITC is then passed along to customers over the book life of the asset.

Q. Of these two incentives, which is better for customers?

A. The determination of which benefit will be greatest for customers must be done on a case-by-case basis, based on the facts and circumstances that are unique to each project. But in general, projects that produce a lot of power are more likely to receive greater benefit from the PTC. Projects that have lower production or no production (e.g. storage) are more likely to benefit from the ITC. PSE's due diligence workpapers will evaluate both options to support whichever credit is more appropriate in the circumstances.

B. "Bonus" Credits

Q. The IRA introduced tiers of benefit into the PTC and ITC. Please explain how the tiers work.

A. The IRA made the calculation of the PTC and ITC very complicated by introducing three tiers of "bonus" credits. The new structure for PTCs and ITCs begins with a small base-credit for the PTC of $5.50/MWh and ITC of 6 percent. The real value in the IRA comes from the tiers. But in order to qualify for the bigger benefits, complex requirements must be satisfied. The three "bonus" tiers are (a) the prevailing wage and apprenticeship, (b) domestic content, and (c) energy communities incentives. I will briefly describe each below. Note that the IRS and Treasury are actively issuing guidance on all three, which will provide much needed clarification and specificity that is not available today.

1. Prevailing wage and apprenticeship.

Q. Can you please describe the prevailing wage and apprenticeship incentive?

A. The prevailing wage and apprenticeship incentive is the largest "bonus" and will increase the PTC base rate by plus-$22.00/MWh for a total credit of $27.50/MWh. The ITC base rate increases plus-24 percent to a total credit of 30 percent of eligible costs.

For PTCs, the prevailing wage and apprenticeship incentive requirement must be met for the full construction period and for the full duration of the 10-year PTC period. Pursuant to these requirements, the taxpayer must ensure that any laborers and mechanics employed by it or its contractors and subcontractors are paid prevailing wages during construction and for alteration and repair of the project during construction and for the 10-year production period after the project is placed in service. In addition, qualified apprentices must make up at least 15 percent of total labor hours.[1]

The rule for the prevailing wage and apprenticeship incentive on ITCs is similar to that of PTCs except that the rules apply for the 5-year recapture period, instead of 10-years.[2]

PSE's expectation is that its projects will qualify for the prevailing wage and apprenticeship bonus tier. While this bonus brings a significant amount of

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[1] *See generally* 26 U.S.C. § 45(b)(7)-(8).
[2] *See generally* 26 U.S.C. § 48(a)(10)-(11).

benefit, it does come with an increased compliance and reporting burden. The obligation to meet and report on this requirement extends throughout the 10-year period of the PTC and is not without its own risks and costs to PSE, its contractors, and subcontractors.

2. Domestic content.

Q. Describe the domestic content incentive.

A. The domestic content incentive increases the available credit by 10 percent. For the PTC, that would be an increase of $2.75/MWh, which added to the prevailing wage and apprenticeship incentive would bring the cumulative PTC to $30.25/MWh. For the ITC, the increase is an additional 10 percent, which added to the prevailing wage and apprenticeship incentive would bring the cumulative ITC value to 40 percent of the eligible costs.

To meet the domestic content incentive rules, facilities must be composed of steel, iron, or products manufactured in the U.S. For purposes of these requirements, manufactured products are deemed to be manufactured in the U.S. if 40 percent of the total direct cost of the components of the product are attributable to components mined, produced, or manufactured in the U.S.[3]

Currently, it is unclear which projects will qualify for this bonus. The IRS continues to issue guidance and receive feedback pending the issuance of final rules. It is important to note that, at this time, the current guidance is excessively

[3] *See generally* 26 U.S.C. § 45(b)(9); 26 U.S.C. § 48(a)(12).

onerous and, if finalized, will significantly limit which projects will qualify for the domestic content incentive.

Q. Can you give an example as to why you think that threshold for the domestic content incentive will be hard to achieve?

A. Yes. The proposed rule requires the Company to evaluate the "direct costs" of components used in the project and determine that 40 percent or more of the costs relate to U.S. manufacturing. The "direct costs" is not the price paid for the component. The price paid, which is an obvious and easily audited number, includes the seller's all-in costs: direct, indirect, overheads, marketing, profit, etc. Instead, the "direct cost" is the cost of the manufacturer's direct labor and material to produce the component, without overheads, profit, etc.[4] That number is unknowable to a purchaser. Disclosing such sensitive and proprietary information is not normal and could jeopardize the manufacturer's standing among competitors.

Further, the purchaser (i.e., PSE) needs to maintain records with a level of specificity such that the IRS can conduct an audit of the claim that the project meets the domestic content incentive requirements. It is unclear what level of support the IRS will accept when it comes to the "direct costs" of a manufacturer of a component. It could require the taxpayer who claims the credit to obtain time sheets, payroll information, and internal invoice-level details from the

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[4] *See* IRS Notice 2023-38 (Domestic Content Bonus Credit Guidance under Sections 45, 45Y, 48, and 48E), available at https://www.irs.gov/pub/irs-drop/n-23-38.pdf; *see also* 26 C.F.R. § 1.263A-1(e)(2)(i).

manufacturer in order to support the manufacturer's claim that a component meets the threshold. This is well beyond the construct of a normal contractual relationship between a purchaser and a manufacturer.

If this information is required but cannot be obtained from vendors, a taxpayer is unlikely to have success calculating and sustaining its claim to meet the domestic content incentive threshold.

3. <u>Energy community.</u>

Q. Describe the emergency community incentive.

A. As with the domestic content incentive, the energy community incentive increases the available credit by 10 percent. For the PTC, that would be an increase of $2.75/MWh. For the ITC, the increase is an additional 10 percent.

Energy communities are areas that (1) have a brownfield site; (2) have or had a certain amount of employment or tax revenues related to the extraction, processing, transport, or storage of coal, oil, or natural gas and have above average unemployment; or (3) are a census tract or adjacent tract in which a coal mine has closed after 1999 or coal-fire generation which has been retired after 2009. The IRS has published data on the census tracks (and adjacent tracks) that qualify, which makes determination fairly straightforward.[5]

[5] *See generally* 26 U.S.C. § 45(B)(11); 26 U.S.C. § 48(a)(14).

If PSE pursues a project in a qualifying census track per the IRS guidance, it will claim the energy community incentive.

4. <u>Interaction of the bonus credits.</u>

Q. How do the bonus credits interact with each other?

A. Each of the bonus credits is determined separately from the others. As indicated above, the rules for each are completely distinct. PSE is anticipating that its projects will qualify for the prevailing wage and apprenticeship incentive in all cases. So, management's analysis starts with the PTC at $27.50/MWh (the rate for 2023) or the ITC at 30 percent. From that base, the domestic content and energy community incentives are considered. If a project qualifies for all three, the PTC rate would be $33.00/MWh; and the ITC rate would be 50 percent.

Note that the PTC rate is adjusted each year for inflation. The numbers above use the rates in effect for 2023. There is no inflation adjustment for the ITC.

<u>C. Passing Benefits to Customers</u>

1. <u>PTCs.</u>

Q. How would the PTC be passed to customers?

A. PSE would continue to use Schedule 95A to pass the PTC to customers as it has in prior years. Once the PTC has been monetized, it is incorporated into Schedule 95A and passed to customers over the next 12 months. PSE will file Schedule 95A after its final tax returns are filed in October each year for rates effective January 1st. PSE will accrue interest on any PTCs that have been monetized but not yet incorporated into Schedule 95A. Interest will stop accruing once PTCs are included in Schedule 95A which includes a return on the PTC balances within the tariff.

2. ITCs.

Q. How would the ITC be passed to customers?

A. Generally, the ITC is subject to the IRS normalization requirements under former §46(f). Those requirements dictate that the ITC be passed back to customers no more quickly than over the book life of the underlying asset via a reduction in tax expense. In addition, no portion of the unamortized balance of the ITC can be used to reduce rate base. The normalization rules also include a number of consistency requirements to ensure that taxpayers apply consistent methodologies and techniques to its ITC and the underlying asset. For reference, these rules are very similar to the normalization rules governing accelerated depreciation.

When normalization is required, PSE will be unable to use Schedule 95A. Instead, PSE will need to reflect the benefit to customers in the same way that customers bear the cost of the project. In other words, the benefit of the ITC will need to be included as a reduction to the rate setting to recover the cost of the asset via a reduction to tax expense. For example, historically, PSE has recovered the cost of its ITC-eligible assets in base rates, and so its ITC has been recovered the same way, in base rates. This is done in order to satisfy the consistency requirements which are part of the IRS normalization regime. Accordingly, if PSE is recovering the underlying asset on a forecast basis,[6] any ITCs that are governed by the normalization provisions will also be forecasted and set in rates and trued-up in the same manner as the underlying asset.

Q. If normalization is not required, how will the ITC be passed to customers?

A. In situations where the ITC is not required to be normalized, PSE will follow the same approach as outlined above for ITCs that are subject to normalization rules. The ITCs will still be amortized over the book life. However, the unamortized balance can be used to reduce the rate base calculation. PSE will reflect these benefits in the same regulatory mechanism that is used to recover the underlying plant investment. For example, if the underlying plant is recovered via the new Clean Generation Resources Rate Adjustment, then the ITC impacts would be included in that mechanism as well. Or, if the asset is recovered in base rates, then the ITC would be reflected in base rates as well. Effectively, customers will receive the benefit as a reduction in the cost of the project.

An example of this would be a storage project. Storage projects are not required to be normalized as provided in the IRA. As a result, the ITC can be amortized over the book life of the asset <u>and</u> the unamortized balance of the ITC can be used to reduce the rate base calculation for the revenue requirement. Both of these

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[6] See Susan Free's prefiled direct testimony, Exh, SEF-1T, for PSE's proposal to recover its investments in utility scale clean generation CETA compliant resources, some of which may be most benefited by ITCs that are subject to IRS normalization rules, in a separate tariff schedule, Schedule 141CGR – Clean Generation Resources Rate Adjustment.

benefits can be reflected in setting the annual rates that are used to recover the cost of the storage project.

3. Other non-tax benefits.

Q. How does PSE plan to pass other non-tax benefits to customers?

A. As discussed in the Prefiled Direct Testimony of John Mannetti, Exh. JM-1CT, PSE is pursuing a number of other benefits, incentives, and grants from a host of federal and state opportunities. As PSE receives those incentives, it plans to reflect them in Schedule 95A. Those incentives will influence the annual tariff rate for that Schedule.

For example, hypothetically, if PSE receives a grant associated with one of its generation projects, PSE would include the grant in Schedule 95A and return it to customers over the appropriate and approved timeline. If the grant is related to a generation asset, it is likely that it would be returned to customers ratably over the book life of the asset.[7]

Recognizing that each incentive may have a different profile, it seems appropriate to pool the incentives in one place (e.g. Schedule 95A) and give each incentive

[7] This is consistent with the methodology approved by the WUTC in 2013 for Section 1603 Treasury Grants on PSE's hydro projects. *See In the Matter of the Petition of Puget Sound Energy, Inc., for an Accounting Order Authorizing Accounting Treatment Related to Payments for Major Maintenance Activities*, Docket UE-130583, Order 02; *WUTC v. Puget Sound Energy*, Docket UE-130617, Order 06; *In the Matter of the Petition of Puget Sound Energy, for an Order Authorizing the Sale of the Water Rights and Associated Assets of the Electron Hydroelectric Project in Accordance with WAC 480-143 and RCW 80.12*, Docket UE-131099, Order 02; and *In the Matter of the Petition of Puget Sound Energy, for an Order Authorizing the Sale of Interests in the Development Assets Required for the Construction and Operation of Phase II of the Lower Snake River Wind Facility*, Docket UE-131230, Order 02, Final Order Approving and Adopting Settlement Agreement (October 23, 2013), ¶¶ 19, 28-31.

the appropriate reversal pattern without the need to maintain incentives in multiple different rate schedules. With minor modification, Schedule 95A can be expanded beyond the more limited tax focus that it has today. Please see the Prefiled Direct Testimony of Susan E. Free, Exh. SEF-1T, for additional discussion.

D. Transferability of Tax Credits

Q. Please explain how transferability works for the PTC and the ITC.

A. Transferability is of critical importance to PSE and its customers. It allows a taxpayer like PSE to transfer (i.e. sell) its PTCs or ITCs to unrelated third parties for cash. The big benefit here is that PSE has an alternative path to monetize its tax credits. Without transferability, PSE's only option to monetize its tax credits would be to generate taxable income in large enough quantities so that it could use its credits on its own tax returns.

Q. Do you anticipate that PSE will not have enough taxable income to use its tax credits?

A. Yes. That is a very likely result.

Q. Please explain.

A. Renewable energy projects come with tax-lives that are significantly shorter than the book life. For example, a wind farm has a tax recovery period of 5 years using the Modified Accelerated Cost Recovery System ("MACRS") versus a book recovery over 25 years straight-line. That means each new project comes with a large amount of tax depreciation – so much that it will severely depress taxable income, as one project is built after another. PSE's path towards CETA compliance means that its taxable income will be depressed for a long time and that it will not be able to utilize all of its tax credits for many years if it must rely solely on its own taxable income.

Q. How does transferability solve that problem?

A. With transferability, PSE can sell those credits in the year they are created or shortly thereafter – monetizing them relatively quickly and thus, making them available to include in customer rates on a timely basis.

Q. Who would purchase PSE's tax credits?

A. First, no purchasers have been identified at this time. A purchaser will only be necessary once PSE does not have enough taxable income to use its own credits.

Second, a purchaser could be any unrelated third party. Most likely, PSE will be able to sells its tax credits to a large corporation that has, or is expecting to have, a large tax liability. In general, any corporation that falls into that category could be a potential purchaser.

Third, once a tax credit has been generated, its sale (if there is going to be one) must be reported on the tax return which covers the year in which the credit has been generated. So for example, if a tax credit is generated in Year 1, PSE could sell it to a purchaser any time before PSE files its tax return for Year 1, which would have an extended due date of October of Year 2. The sale of a credit must be reported on the Year 1 tax return because the tax credit was generated in Year 1. A credit cannot be sold after the tax return for Year 1 has been filed.

Q. Is there a cost to sell tax credits?

A. Yes, PSE will incur additional costs in order to sell its tax credits. I will divide the discussion of costs into two categories: (a) the discount on the sales transaction and (b) the direct transaction costs to consummate a sale.

1. <u>The discount.</u>

Q. Please explain the discount.

A. In order to complete the sale of a tax credit, the credit must be offered for sale for an amount that is less than its face value. For example, if PSE has a tax credit of $100, it would be able to sell it to a purchaser for, say, $93 – incurring a discount of $7 dollars.

Q. Why can't PSE sell a $100 tax credit for $100?

A. Simply put: There is no reason for a purchaser to go through the complications of a transaction if it receives no economic benefit in the exchange. If the credit were offered for $100, the purchaser would skip the transaction entirely and make a simple cash payment directly to the IRS to satisfy its tax liability. The discount is present to induce the purchaser into the transaction.

Q. How will the discount be determined?

A. The discount will be determined by the market conditions when PSE places its tax credits for sale. The market for federal PTCs and ITCs is at the earliest stages but is developing quickly. PSE understands that transactions are occurring in the $0.92 to $0.93 range per $1.00 of tax credit[8], with the hope that the market will continue creeping upwards as buyers and sellers gain more experience and transactions become more standardized.

Q. In a sales transaction, who bears the cost of the discount?

A. If PSE lacks sufficient taxable income to use its tax credits, it will need to engage in the transferability market, and the Company, as the seller, will bear the cost of the discount rather than the buyer. The cost of any discount will reduce the cash available for PSE to pass along to customers in Schedule 95A.

Q. Is there an alternative to incurring a discount?

A. There is an alternative, but it is not a good one. The alternative is for PSE to hold its tax credits until it has taxable income with which to utilize them. In this case, a customer may need to wait a decade or more before that happens – which represents a very significant degradation in the present value of the credit, well in excess of an immediate discount encountered in a transaction.

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[8] Norton Rose Fulbright, *Project Finance NewsWire, Off to the Races* at 9 (June 2023), available at www.projectfinance.law/media/5830/pfnw-june-2023.pdf.

For example, the net present value ("NPV") of selling a tax credit for $0.93 per $1.00 of nominal value is $0.93. However, the NPV of waiting 10 years[9] to get $1.00 of benefit on PSE's tax return is about $0.46. Clearly, incurring the discount is a vastly more economic option for PSE and customers.

2. <u>The direct transaction costs.</u>

Q. Explain what direct transaction costs are involved in selling tax credits.

A. In order to complete a transaction, buyers and sellers need to engage in a significant amount of due diligence before agreeing to a transaction. These are the direct transactions costs, sometimes called closing costs. It includes things like transaction fees or broker's fees, tax opinions, review/audit by accounting firms, documentation costs, platform fees, and, in some cases, tax insurance. In short, the seller must engage a host of third-party professionals to complete a transaction. This is above and beyond the day-to-day gathering, storing, and reporting of normal tax, accounting, legal, and human resources information that is required to construct and operate a renewable generation resource.

Q. How would PSE pay for these costs?

A. These costs would be paid for out of the proceeds from the sale of the credit. This will reduce the cash available to return to customers under Schedule 95A.

[9] The use of 10 years is a very pertinent example for PSE. In its last experience with PTCs from Hopkins Ridge and Wild Horse, PSE was unable to use the PTC it generated in 2007 until 2017, once its tax net operating losses had been utilized. As PSE pursues compliance with CETA, its investment plans will likely extend through 2045 which indicates that the depression of taxable income could last a long time and delay its use of tax credits.

III. BEAVER CREEK TAX INCENTIVES

A. Federal Incentives

Q. The Company has included the Beaver Creek project in this filing. What IRA benefits does the Company expect from that project?

A. The Beaver Creek project ("Beaver Creek") is a utility-scale windfarm located in Stillwater County, Montana. Please see the Prefiled Direct Testimony of Colin P. Crowley, Exh. CPC-1HCT, for more information regarding the Beaver Creek project. Under the provisions of the IRA, Beaver Creek would be eligible for either the PTC or the ITC. Based on our analysis, the PTC will provide the most benefit on this project.

Q. How did PSE conclude that the PTC would be more valuable than the ITC?

A. As indicated in the Seventh Exhibit to the Prefiled Direct Testimony of Colin Crowley, Exh. CPC-8HC, the PTC is expected to provide the most benefit to customers on Beaver Creek. The tax normalization rules apply to the ITC for which Beaver Creek is eligible, which significantly reduces its economic benefit to customers. The PTC is the clear choice.

Q. Which "bonus" credits will Beaver Creek qualify for?

A. Beaver Creek is expected to qualify for the prevailing wage and apprenticeship incentive.

Beaver Creek might also qualify for the domestic content incentive, but it is uncertain at this time. The IRS has proposed stringent rules that the steel and other components must meet in order to qualify. Achieving the domestic content incentive will be challenging under the current rules, as I discussed above. PSE will continue to monitor the development of the rules and will claim the domestic content incentive if Beaver Creek can qualify. However, at this time, the domestic content incentive is not part of Beaver Creek's economics.

Beaver Creek will not qualify for the energy community incentive. It lies in a census track that is outside of those listed in the IRS guidance. No energy community incentive has been included for the project.

B. State Incentives

Q. Are there other incentives that Beaver Creek qualifies for outside of the IRA?

A. Yes, the Beaver Creek project will receive a property tax abatement from Stillwater County. The abatement will reduce the local levies on Beaver Creek to 25 percent of what they would normally be for Years 1 through 5. After that, the abatement will step up by 15 percent straightline each year until Year 10 when the project will be assessed at 100 percent of its value. Property taxes are collected separately through Schedule 140 – Property Tax Tracker which will be the rate schedule through which the property tax abatement will be incorporated in rates.

Q. Since Beaver Creek is a CETA resource, will it qualify for the sales tax incentive under CETA?

A. The sales tax incentive under CETA only applies to Washington sales taxes. Beaver Creek is in Montana and not subject to Washington sales taxes. Montana does not presently have a sales tax, which means that the Project is free of any sales tax.

Q. In general, can you please elaborate on the sales tax incentive under CETA for which future CETA compliance projects may be eligible?

A. As part of the CETA, the Washington legislature included a reduction in sales tax for qualifying machinery and equipment that is "used directly in the generation of electricity" or the labor and services rendered to install such equipment.[10] Businesses that comply with the requirements of the statute are eligible for a reduction of 50, 75 or 100 percent of the sales tax paid, depending on the level of qualification that the project can achieve. The reduction in the sales tax can be claimed only after the tax has been paid. The refund occurs after the equipment has been purchased.

Q. How would the sales tax refund be reflected in customer rates?

A. Any sales tax that is paid on the qualifying machinery and equipment for projects in Washington would be reflected in the capitalized cost of the project. If a sales

[10] *See* RCW 82.08.962.

tax refund is received, the refund would be applied to the capital cost of the project – thus, lowering the cost of the project to customers and resulting in lower customer rates.

Q. Would PSE include the refund in Schedule 95A?

A. No. The expected benefit of the refunds will be included in PSE's expected capital costs of qualifying projects. When the refunds are received, the benefit will be applied directly against the capital cost of the project, so that the amount of the project that is placed in service will be automatically net of the benefit of the refund.

IV. CASH IMPACT OF THE TCJA

A. The Tax Cuts and Jobs Act ("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 explain why that is?

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

Under the TCJA, utilities, like PSE, are no longer able to use bonus depreciation. For utilities, the only accelerated depreciation that is available is the classic modified accelerated cost recovery system 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 had 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 under the TCJA 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 1.

Table 1 - Impact of Tax Reform on Cash Flows related to Deferred Taxes				
in millions (negative numbers are a use of cash)				
	A	**B**	**C**	**D**
	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) $141.3 million in DFIT x 9.4% ROE x 48.5% equity = $6.4 million			

Table 1 shows the impact for just one year – 2018. But this was not just a one-year phenomenon. It remains a continuing issue. The overall accumulated deferred income tax ("ADIT") balance has been in decline since the TCJA took effect in 2018. The main cause has been the loss of bonus depreciation. But the lower tax rate and the excess deferred income tax ("EDIT") reversals have also played a part. Table 2 shows the average annual decline in PSE's plant-related ADIT balance in FERC Account 282, an average of $41 million per year. Note that the ADIT balances in Table 2 include the protected-plus EDIT that is being reversed using the average rate assumption method ("ARAM").

Table 2 - ADIT Movement since TCJA							
in millions (negative numbers are a use of cash)							
	2017	2018	2019	2020	2021	2022	2023 est.
Electric	1,384.3	1,353.7	1,298.8	1,278.8	1,244.1	1,215.0	1,166.2
Gas	579.2	578.3	576.1	577.3	578.7	578.3	565.7
Common	70.8	66.8	68.9	68.5	70.5	62.0	54.2
ADIT	2,034.3	1,998.7	1,943.7	1,924.6	1,893.3	1,855.3	1,786.2
Decline		(35.6)	(55.0)	(19.1)	(31.3)	(37.9)	(69.2)
Average							(41.4)

This trend stands in stark contrast to the trend in the pre-TCJA era, in which PSE's ADIT balance was *growing* at an average of $102 million per year. Table 3 below shows this growth pre-TCJA.

Table 3 - ADIT Movement pre-TCJA				
in millions (negative numbers are a use of cash)				
	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				101.8

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, per the average shown in Table 3), it has become a use of cash flow (minus $41 million, per the average shown in Table 2). This reversal is averaging a net loss of $143 million per year. In addition to the plant-related ADIT, PSE returned the unprotected EDIT of $38.9 million to customers over three years in the amount of $13 million per year in 2020, 2021, and 2022. Together, these bring the annual impact of the TCJA to about $156 million per year in lower cash flow for the Company. 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-1T.

Q. Can you summarize how the TCJA impacts PSE's cash flows?

A. Table 4 below summarizes the average annual impact of TCJA on PSE's cash flows.

Table 4 - Summary of the Imact of TCJA on Cash Flows		
in millions (negative numbers are a use of cash)		
	A	**B**
	Description	Annual Impact
1	Prior to TCJA, plant-related deferred taxes were a source of cash flow which is now gone (Table 3)	(101.8)
2	After TCJA, there is no bonus deprecition and plant-related ADIT, which includes the return of EDIT, is reversing (Table 2)	(41.4)
3	Return of the unprotected EDIT(a)	(13.0)
4	Estimated cash impact from TCJA	(156.2)
	(a) Completed in 2022	

V. OTHER TAX ITEMS

A. Impact of Depreciation Study for Gas Property on Income Taxes

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

A. The depreciation study performed for PSE's gas assets ("Depreciation Study") estimates the annual depreciation accruals related to gas plants in service for financial and ratemaking purposes and to determine appropriate average service lives and net salvage percentages for each plant account. The Depreciation Study is anticipated to have an effective date that coincides with the rate effective date for the first rate year in this proceeding in January 2025. As a result, many gas depreciation groups will see their depreciation rate updated as of that date. Whenever the depreciation rate changes, PSE will begin to recover the cost of the asset more quickly or more slowly than before; and in the case of this Depreciation Study, the Study will accelerate the recovery of the gas property. Please see the Prefiled Direct Testimony of Ned W. Allis, Exh. NWA-1T, for more details regarding the Depreciation Study.

Q. Will the Depreciation Study have any effect on PSE's 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, the Depreciation Study will affect the EDIT reversal, because the EDIT reversal is linked to the book life of the asset under 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 book life of the asset determines the book depreciation rate. They are linked together.

Q. Have you included the impact of the Depreciation Study in your projected ADIT balances and EDIT reversals?

Yes, as of January 1, 2025, PSE's projection of book depreciation, ADIT, and EDIT reversal reflect the new depreciation rates for the gas property.

B. Mechanics of PSE's Book and Tax Depreciation Projections

Q. Can you provide additional information on your projections for book and tax depreciation and ADIT in the multiyear rate plan?

A. By way of overview, PSE followed the same approach in this filing as it did in the last multiyear rate plan. At the highest level, PSE rolled forward its existing plant as of June 30, 2023. To that property, PSE added its projected capital additions. Then, on a monthly basis, it calculated its book depreciation, accumulated reserve, tax depreciation, deferred taxes, and average of monthly averages balances as necessary to support this filing. For a more complete discussion of the process, please see the second exhibit to this prefiled direct testimony, Exh. MRM-3.

VI. CONCLUSION

Q. Does that conclude your prefiled direct testimony?

A. Yes, it does.