BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION,	
Complainant,	
v.	**Docket UE-240004** **Docket UG-240005**
PUGET SOUND ENERGY,	
Respondent.	

SECOND EXHIBIT (NONCONFIDENTIAL) TO THE
PREFILED DIRECT TESTIMONY OF

MATTHEW R. MARCELIA

ON BEHALF OF PUGET SOUND ENERGY

FEBRUARY 15, 2024

PUGET SOUND ENERGY

SECOND EXHIBIT (NONCONFIDENTIAL) TO THE PREFILED
DIRECT TESTIMONY OF MATTHEW R. MARCELIA

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PUGET SOUND ENERGY

**SECOND EXHIBIT (NONCONFIDENTIAL) TO THE PREFILED
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**I.   ADDITIONAL DETAIL ON BOOK AND TAX
DEPRECIATION PROJECTIONS**

A.   Overview

**Q.   Please provide an overview of the process used to project book and tax
depreciation.**

A.   For all assets in the multiyear rate plan, Puget Sound Energy ("PSE") projected

book and tax depreciation on a monthly basis. The book depreciation rates used

were based on the applicable depreciation studies. The tax depreciation rates

were taken from the modified accelerated cost recovery system ("MACRS")

tables. From that activity, PSE calculated the accumulated deferred income tax

("ADIT") activity and excess deferred income tax ("EDIT") activity. The

accumulation of this data provides what is needed to calculate gross rate base and

accumulated depreciation on an average of monthly averages ("AMA") basis and

the ADIT on the IRS proration method for the multiyear rate plan.

Q.   How did PSE go about this effort?

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.

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1   This necessitated branching into two projection methodologies for the assets: (a)

2   the Existing Property ("EP") as of the test year and (b) the New Property ("NP").

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

4   A.   The EP represents all of the assets that were in-service at June 30, 2023. The

5   source data for the EP comes from PSE's plant accounting and tax accounting

6   software. In contrast, the data for the NP comes from PSE's projections and

7   estimates of activity that occurs after June 30, 2023. That data is not part of PSE's

8   book or tax accounting software. Because of that fundamental difference, PSE

9   used different technologies on the EP vs. the NP.

10   **Q.   How did you do this from a technology standpoint?**

11   A.   The process of running all these calculations on existing assets (i.e., assets in

12   service and included in rate base as of the end of the test year June 30, 2023) and

13   future assets on a monthly basis from July 2023 through December 2026

14   generates a significant amount of data. While these calculations are relatively

15   straight-forward, the sheer volume presents challenges which are beyond the

16   capacity of Microsoft Excel. PSE processed these calculations in Alteryx and

17   output the results to Excel for use in the multiyear rate plan.

18   One notable exception to Alteryx was the use of Tax Fixed Assets[1] ("TFA") to

19   calculate the tax deprecation, ADIT, and EDIT activity on existing assets

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[1] TFA is formerly known as PowerTax.

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1   throughout the multiyear rate plan. Given that those assets are in the middle of

2   their useful lives, i.e., part way through their book, tax, and ADIT lives, the most

3   expeditious approach was to roll that system forward for those calculations.

4   **Q.   Can you provide a visual aid for this process, before you get into more**

5   **detail?**

6   A.   Yes, Figure 1 provides an overall flowchart of the process. The process flows

7   from left to right, starting with the June 30, 2023 "Source" data from PowerPlant

8   and TFA and the projections for the new property additions. The next area

9   depicts the addition of "Control" tables to support the calculations that occur in

10   the "Process" column. All calculations are performed in the "Process" column

11   which produces "Outputs" at the level of detail needed to support the multiyear

12   rate plan, which is depicted in the final column.

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1   **Figure 1: Flowchart of the Process to Project Book and Tax Depreciation**
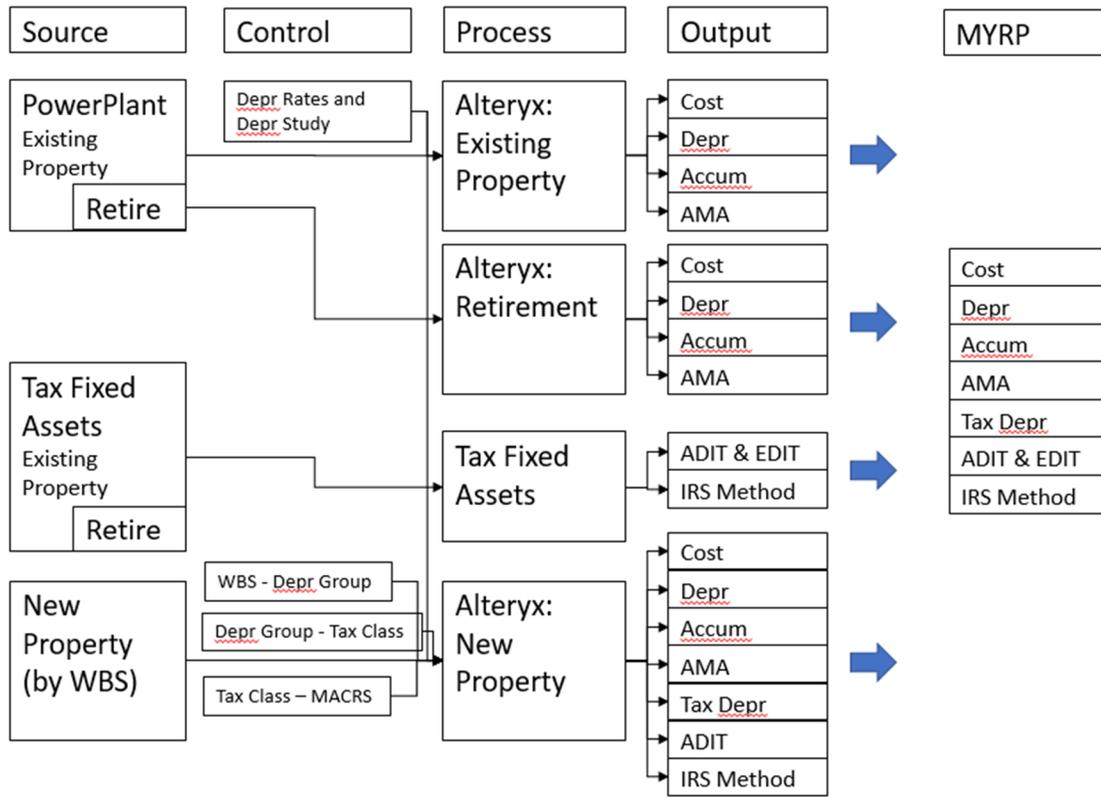
3   **B.   Projections for Existing Property ("EP")**

4   **Q.   Please elaborate on the process for EP.**

5   A.   For the EP, PSE extracted book data from PowerPlant for all assets in service at

6   June 30, 2023. This data included primarily the original cost, accumulated

7   depreciation, and depreciation rate. From this data, PSE projected book

8   depreciation and accumulated depreciation on a monthly basis.

9   The book depreciation that was calculated became an input to TFA in order to

10   compare the projected book deprecation with the projected tax deprecation to

11   establish the projected movement in ADIT. This also determined the movement

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1	in EDIT within TFA. One of the strengths of the TFA system is its ability to
2	calculate and control the movement in deferred taxes, especially the application of
3	the average rate assumption method ("ARAM") to the reversal of EDIT. This
4	approach allowed PSE to use standard TFA reports to see the tax and ADIT
5	results for the EP.

6 **Q.   Does this approach comply with the IRS normalization requirements?**

7 A.   Yes, it does. The book depreciation projection is used (a) for cost of service, (b)

8 in accumulated depreciation and rate base, and (c) in calculating ADIT and EDIT

9 activity. Tax depreciation is calculated on the same assets and for the same time

10 periods that are used for book depreciation.

11 **C.   Projections for New Property ("NP")**

12 **Q.   Please elaborate on the process for NP?**

13 A.   The projections for the NP are derived from PSE's projection for the projects it

14 expects to pursue. The Prefiled Direct Testimony of Joshua A. Kensok, Exh.

15 JAK-1T, discusses the process for tracking budgets and actuals for formally

16 approved projects. To use this data, it must be converted from the project-level to

17 the depreciation group ("DeprGroup") level.[2] It is not uncommon for a project at

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[2] The DeprGroup can also be used to determine the FERC account.

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1   the work breakdown structure ("WBS")[3] level to encompass assets falling under

2   various DeprGroups.

3   Based on historical activity and other information, PSE created a control file to

4   translate the WBS project-level data to the appropriate DeprGroup(s).

5   When a project is placed in service, book depreciation begins using the half-

6   month convention. The depreciation rate comes from the same depreciation data

7   extracted from PowerPlant that is used for the EP, discussed above.

8   Because this is new property, the tax depreciation and ADIT activity can be

9   calculated outside of TFA using the MACRS tables and follows the standard tax

10   conventions of half-year depreciation in the first year. The difference between

11   book and tax depreciation is used to calculate the ADIT activity. These

12   calculations are performed on a monthly basis.

13 **Q.**   **With respect to the NP, how did PSE account for the fact that, often, the**

14   **book and tax cost basis can differ?**

15 A.   Further refinement was made to account for the different cost basis between book

16   and tax. There are differing capitalization rules between book (FERC) and tax

17   (IRS) accounting which often, but not always, permit the tax basis of an asset to

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[3] At PSE, the project-level is often referred to as the work breakdown structure ("WBS"). Generally, each project has a unique WBS number. The WBS is the data element within SAP which is used to track projects and budgets.

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1 be smaller than the book basis. One example of this is tax repairs[4], which allows

2 for an upfront tax deduction of some costs, while those same costs must be

3 capitalized for book purposes. An opposing example would be contributions in

4 aid of construction, which reduces the capitalized cost for book purposes but for

5 tax purposes is treated as taxable income when received and an increase to

6 capitalized cost. The overall impact of all basis differences results in a smaller

7 tax basis which has the effect of increasing the ADIT balance. PSE projected the

8 basis difference by using a three-year average of the actual activity in TFA from

9 2020 through 2023, similar to the approach used for projected retirements,

10 discussed below.

11 There is no EDIT with respect to the NP as it is new property placed in service

12 following passage of the Tax Cuts and Jobs Act.

13 To determine the correct tax depreciation by DeprGroup, PSE extracted the book

14 to tax mapping table from TFA. This allowed the matching of the correct tax

15 deprecation rates with each DeprGroup.

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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.

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D.   Retirements

Q.   What did you do with asset retirements after the test year?

A.   PSE created an asset retirement model based on the actual book and tax

retirements recorded in 2020, 2021, and 2022. From that activity, a number of

non-recurring retirements were removed (e.g. Colstrip, the sale of water heaters,

etc.) to create a retirement model by DeprGroup, 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

same adjustments were made to both book and tax retirements.

For the book retirements, PSE treated them as if they were negative additions that

went into service on the date of the retirement. Negative depreciation was

calculated from that point onward. The impact of the negative addition and the

negative depreciation was netted against the EP to create the "after-retirement"

results reported in the multiyear rate plan for the EP.

For the tax retirements, PSE recorded the modeled retirements in TFA. Once

recorded, TFA applies the tax retirement against the tax basis of the tax assets in

order to calculate the correct tax depreciation and ADIT activity for each tax year.

The impact of tax retirements are then available in standard TFA reports for EP.

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E.   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, 2025. 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 – in this case, PSE expects to recover some of the gas property more quickly.

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.

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

2   Yes, it will because the EDIT reversal is linked to the book life of the asset under

3   the average rate assumption method ("ARAM"). Therefore, if book depreciation

4   expense increases (i.e., the expected book life becomes shorter), EDIT reversal

5   will also accelerate. If the book depreciation expense decreases (i.e., the expected

6   book life becomes longer), the EDIT reversal will also slow down. The EDIT

7   reversal period is tied to the book life of the asset. Book life of the asset

8   determines the book depreciation rate. They are linked together.

9   **F.   EDIT Reversals**

10 **Q.   Can you explain how the EDIT reversal will work in the multiyear rate plan?**

11 A.   The reversal pattern for the plant-related timing difference will continue to follow

12   the ARAM for EDIT reversal, consistent with Order 14 from PSE's 2019 general

13   rate case.[5] For the historical test year ending June 30, 2023, the historical EDIT

14   reversal that was recorded for that period is presented in PSE's Tax Adjustments

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[5] *See WUTC v. Puget Sound Energy*, Dockets UE-190529 and UG-190530, Order 14; *In the Matter of the Petition of Puget Sound Energy For an Order Authorizing Deferral Accounting and Ratemaking Treatment for Short-life IT/Technology Investment*, Dockets UE-190274 and UG-190275, Order 11; *In the Matter of the Petition of Puget Sound Energy For an Order Authorizing Deferred Accounting associated with Federal Tax Act on Puget Sound Energy's Cost of Service*, Dockets UE-171225 and UG-171226; *In the Matter of the Petition of Puget Sound Energy For an Order Authorizing the Accounting Treatment of Costs of Liquidated Damages*, Dockets UE-190991 and UG-190992, Order 09; *In the Mater of the Petition of Puget Sound Energy For an Order Authorizing Accounting for Tracking of Revenues Subject to PSE's Private Letter Ruling Requesting a Decision on the Proper Ratemaking Treatment of Protected Excess Deferred Income Taxes*, Dockets UE-200843 and UG-200844, Order 01, Consolidating Dockets; Granting Petition; Amending Final Orders (September 28, 2021).

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1   in the Prefiled Direct Testimony of Susan E. Free's Testimony, Exh. SEF-1T,

2   Section IX.A.d (discussing Adjustment Nos. 6.04 and 11.04 – Federal Income

3   Tax).

4   From this starting point, the EDIT reversal is determined for each period, the pro

5   forma period, the gap year, and multiyear rate plan, years 2025 and 2026. In each

6   period, the book depreciation that has been calculated for that period has been

7   posted into TFA. When matched against the tax deprecation on the assets, the

8   ADIT and EDIT activity is determined.

9   In short, the EDIT reversal will be matched with the book depreciation. When the

10   book depreciation rates change (e.g. due to the depreciation study that is being

11   requested in this case and which is sponsored in the Prefiled Direct Testimony of

12   Ned W. Allis, Exh. NWA-1T), the EDIT reversal will change in a like manner.

13   **G.   IRS Proration Method**

14   **Q.   Does the IRS have any different or unique normalization rules that would**

15   **apply to this filing?**

16   A.   Yes, the IRS normalization rules will require the application of the IRS proration

17   method to determine the amount of ADIT that is used to reduce rate base in

18   setting rates for "future" periods.

19   The IRS regulations draw a distinction between "historical" periods and "future"

20   periods. Those terms, as used by the IRS in this context, refer to the time new

21   rates go into effect relative to the test period. The terms do not relate to whether

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1 or not the underlying financial data is actual or estimated. As a result, a historical

2 period is one where the test period occurs *before* the effective date of the revised

3 rates. A future period is one where the test period occurs *after* the effective date of

4 the revised rates. In this multiyear rate plan, the rates that are set for 2025 and

5 2026 would be considered "future" periods. In contrast, PSE's normal general rate

6 case filings (not a multiyear rate plan) are based on historical test years, which

7 meet the IRS definition of a "historical" period so that, in general, the proration

8 method would not apply.

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

10 A.   The regulations make this distinction because the IRS was concerned about

11 taxpayers using future, projected deferred taxes (which have not been recorded

12 yet, because the future has not yet happened) to reduce rate base and thus reduce

13 rates. In other words, the inclusion of a deferred tax in setting rates prior to being

14 recorded or recognized in the accounting records was a concern. To address this

15 concern, the IRS requires the use of the proration methodology whenever deferred

16 taxes in "future" periods are used to set rates.

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

18 A.   The IRS proration method is presented in Treasury Regulation §1.167(l)-

19 1(h)(6)(ii):

20 If solely a future period is used for such determination, the amount
21 of the reserve account [i.e. ADIT] for the period is the amount of the
22 reserve at the beginning of the period and a pro rata portion of the
23 amount of any projected increase to be credited or decrease to be
24 charged to the account during such period. [...] The pro rata portion

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1 of any increase to be credited or decrease to be charged during a
2 future period (or the future portion of a part-historical and part-
3 future period) shall be determined by multiplying any such increase
4 or decrease by a fraction, the numerator of which is the number of
5 days remaining in the period at the time such increase or decrease is
6 to be accrued, and the denominator of which is the total number of
7 days in the period (or future portion).

8 The IRS proration method is a number-of-days method, as the deferred tax

9 activity is weighted by the number of days it is on the books divided by the total

10 number of days in the period. Table 1 shows an example of an ADIT with a

11 beginning balance of $1 million and monthly activity of $120,000.

12 **Table 1: IRS Proration Method Example**

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

13

14 There are two points to note: First, the result is not much different than using the

15 average of monthly averages ("AMA"). In the example above, the AMA for the

16 same fact pattern would be $1,720,000 which would be a difference of about

17 $53,000 (AMA of $1,720,000 less IRS of $1,667,068).

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1   Second, the IRS proration method must be used whenever a taxpayer's rate

2   setting falls within the definition of a "future" period. The IRS will not permit the

3   use of any other method than its own, regardless of the economic impact, positive

4   or negative.

5   **Q.   Doesn't the use of the IRS proration method cause an inconsistency if you**

6   **use AMA for all other components of the normalization calculation?**

7   A.   Yes, it does. Clearly, the two techniques are different and, therefore, not

8   consistent. However, the IRS requires this treatment, regardless of any other

9   techniques used in "future" periods. I would characterize the requirement to use

10   the IRS proration method as an exception to the consistency rule.

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

12 A.   Yes, PSE used the process in the last multiyear rate plan and on those relatively

13   infrequent situations where it has pro formed new property into the rate year.[6] But

14   the prior multiyear rate plan was the first time PSE has used the IRS proration

15   method on a large scale for all plant-related deferred taxes.

16 **Q.   How does the calculation work when the rates for multiple years are being**

17 **calculated, such as when PSE is calculating ADIT for 2025 and 2026?**

18 A.   As a starting point for the calculation of any deferred taxes, PSE starts with the

19   difference between the book and tax activity for each month and multiplies that

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[6] For example, in Susan Free's prefiled direct testimony from PSE's 2019 general rate case, Dockets UE-190529/UG-19030, Exh. SEF-1Tr at 52:10-12, Mr. Free discusses a pro forma adjustment for AMI which triggers these rules from Treasury Regulation §1.167(l)-(1)(h).

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1	by the income tax rate, which yields the monthly increase or decrease to the
2	beginning ADIT balance. This baseline analysis must be done for each month
3	from the end of the test year, starting July 2023, throughout the last month of the
4	multiyear rate plan, December 2026, including the effects of asset additions and
5	retirements. Once those monthly calculations are complete, the rate setting
6	calculations can begin for rate base, using AMA, and ADIT, using the IRS
7	proration method.
8	In the multiyear rate plan, the underlying rate base activity is run through the
9	AMA routine to establish an average balance for which rates will be set. A
10	separate AMA calculation is performed for each year in the multiyear rate plan. In
11	the same way, PSE has performed a separate IRS proration calculation for each
12	year in the multiyear rate plan, with the number of days resetting for each new
13	rate year.

II. CONCLUSION

15 **Q. Does that conclude your additional explanation for the book and tax**
16 **depreciation projection?**

17 A. Yes, it does.