

**BEFORE THE  
WASHINGTON UTILITIES & TRANSPORTATION COMMISSION**

In the Matter of the Petition of

PUGET SOUND ENERGY, INC.

For an Accounting Order Authorizing Deferral  
and Recovery of Costs Associated with  
Increased Capital Borrowings Necessary to  
Remit Deferred Taxes

Docket No. UE-051527

Docket No. UG-051528

PETITION OF  
PUGET SOUND ENERGY, INC.  
FOR AN ACCOUNTING ORDER

**I. INTRODUCTION**

1. In accordance with WAC 480-07-370(b), and because of the Internal Revenue Service's ("IRS") issuance of its Revenue Ruling 2005-53 and new Regulations sections 1.263A-1T and 1.263A-2T on August 2, 2005, Puget Sound Energy, Inc. ("PSE" or the "Company") respectfully petitions the Commission for an order that authorizes the deferral of costs (using the Company's allowed net of tax rate of return (currently 7.01%)) associated with increased capital borrowings necessary to remit the \$72 million that was treated as a reduction to rate base in the Commission's Order No. 06: Final Order Rejecting Tariff Sheets; Authorizing and Requiring Compliance Filing; Requiring Subsequent Filing in Docket Nos. UG-040640, UE-040641, UE-

031471 and UE-032043 (the "Order"). PSE has already incurred increased capital costs associated with payment of a portion of the \$72 million prior to November 1, 2005; therefore, PSE requests that the Commission issue the requested order by November 1, 2005, so that interest can begin accruing on costs already incurred.

2. PSE is engaged in the business of providing electric and gas service within the State of Washington as a public service company, and is subject to the regulatory authority of the Commission as to its retail rates, service, facilities and practices. Its full name and mailing address are:

Puget Sound Energy, Inc.  
Attn: John H. Story,  
Director, Cost & Regulation  
P.O. Box 97034  
Bellevue, Washington 98009-9734

3. Rules and statutes that may be brought at issue in this Petition include RCW 80.01.040, RCW 80.28.020, and WAC 480-07-370(b).

## II. BACKGROUND

4. The issue giving rise to this proposed tariff revision was addressed in PSE's last general rate case, Docket Nos. UG-040640 *et al.*, in particular in the prefiled direct testimony of Mr. James Russell, the rebuttal testimony of Mr. John Story, and in the Order at paragraphs 156-159. The Commission determined that it was premature to issue a ruling on the dispute at that time. However, events subsequent to the Order now make it appropriate for the Commission to grant PSE's accounting petition as proposed in this filing.

5. The Company created a deferred tax balance to take advantage of a tax deduction proposed by Deloitte & Touche (“Deloitte”). Deloitte advised the Company that, based on Deloitte's research and informal discussions with the IRS, the rules that were adopted as a result of the 1986 Tax Act for the allocation of internal labor and overhead between self-constructed assets and products held for sale would also apply to utility companies. Deloitte developed a methodology for reviewing a company's capitalization policy to determine whether a company could allocate more costs to energy production and less to self-constructed assets. This allocation methodology would only apply for income tax purposes and would not affect capitalization for accounting purposes.

6. Based on Deloitte's analysis of PSE's books and records, Deloitte determined that application of its methodology would enable the Company to deduct a one-time catch-up adjustment of approximately \$163 million and take a current deduction of \$23 million on the Company's 2001 tax return (which was filed in the fall of 2002). In addition, the Company applied Deloitte's methodology to deduct approximately \$21 million for calendar years 2002 and 2003.

7. In Docket UG-040640 *et al.*, the Commission Staff proposed to reduce PSE's test year rate base for electric operations by \$42.9 million and natural gas operations by \$29.7 million for the deferred tax balances related to this new method of determining overhead deductions that would previously have been capitalized. The Company agreed that such an adjustment could be appropriate, provided that if any such deductions were subsequently disallowed by the Internal Revenue Service (“IRS”), which was then investigating the method,

the Company would then be able to immediately adjust rates to recover any revenue loss, including any assessed interest that might result from such disallowance.

8. In the Order, the Commission declined to prejudge this issue. However, the Commission recognized that it would be appropriate for the Company to file for rate treatment in the event that this tax deduction was disallowed:

There is yet one additional dispute that we must resolve in this connection. The Company asks the Commission to pre-approve an adjustment to rates in the event that the Internal Revenue Service reverses the tax benefit of \$72 million that both Staff and PSE have treated as a reduction to rate base. PSE also asks the Commission to include any IRS assessed interest that might result from such a disallowance.

The Company states that the IRS is currently undertaking a review of all utilities that have taken this tax deduction and will not soon complete that review. The result is not predictable. Staff argues that this means it is premature to grant PSE's request for pre-approval of an automatic rate adjustment that also includes IRS assessed interest.

PSE argues that it is neither fair nor reasonable to include the benefits of this deduction (which is still contingent) in current rates while reserving for a future ruling – and presumably a potential disallowance argument – what should be a straightforward statement of the Commission's commitment to permit recovery of these funds if the Company is ultimately required to pay them to the Federal government.

We cannot lawfully prejudge future rates. However, we do find it appropriate to recognize in principle that if the IRS successfully challenges in court the adjustment PSE and other utilities have taken, and requires future repayment of the current benefits taken, presumably with interest, PSE should file an accounting petition asking for appropriate treatment of any back taxes and interest assessed.

Order at ¶¶ 156-159 (footnotes omitted).

9. On August 2, 2005, the IRS issued Revenue Ruling 2005-53 and new Regulations sections 1.263A-1T and 1.263A-2T, copies of which are attached as Exhibit A to this Petition. These rulings and regulations effectively make the method applied by PSE and other utilities impermissible and require utilities that took related tax benefits to repay the benefits over tax years 2005 and 2006. Therefore, PSE must repay the deferred taxes over tax years 2005 and 2006.

10. PSE has already remitted \$6,237,916 to the IRS and plans to remit the balance (\$66,326,737) as follows:

- (i) PSE will remit one-half of the \$66,326,737 balance (approximately \$33.2 million) in December 2005; and
- (ii) PSE will remit the remaining one-half of the \$66,326,737 balance (approximately \$33.2 million) in four quarterly installments (approximately \$8.3 million each) in the Company's quarterly tax payments on March 15, June 15, September 15, and December 15, 2006.

Attached as Exhibit B to this Petition is a memorandum from Matt Marcellia, Director, Tax, to Vice Presidents Bert Valdman and Kimberly Harris, dated October 4, 2005, regarding Capitalized Overheads Deducted for Tax, that provides additional background and PSE's proposed repayment plan.

11. Paragraph 159 of the Order states:

We cannot lawfully prejudge future rates. However, we do find it appropriate to recognize in principle that if the IRS successfully challenges in court the adjustment PSE and other utilities have taken, and requires future repayment of the current benefits taken, presumably with interest, PSE should file an accounting petition asking for appropriate treatment of any back taxes and interest assessed.

As discussed above, the IRS has now issued a new Revenue Ruling and regulations regarding the deductibility of internal labor and overheads. As the IRS has the authority to make this type of change, a court challenge would most likely be prolonged, without a very high probability of success, and PSE would still be required to make the reversal payments over the next two years to avoid interest charges and potential penalties for underpayment of federal taxes. Even if PSE were to prevail in a court challenge, the tax turn around associated with this deduction would have likely occurred so no benefit would be achieved.

12. To make these tax payments, PSE must increase its capital borrowings. However, because PSE's rate base was reduced by these deferred taxes in the 2004 general rate case, PSE is not earning its carrying costs on such capital. Given the change in the revenue ruling and the regulations, which are a matter of public record, and the fact that the underlying issue has already been litigated before this Commission, PSE believed that it is appropriate to address this issue through revised tariff sheets. PSE made that proposal in Docket Nos. UE-051527 and UG-051528. In subsequent discussions with Commission Staff and other stakeholders, the Company learned that others would be more comfortable with accounting deferral treatment of such costs rather than have immediate tariff sheet revisions.

13. PSE, therefore, seeks in this filing to establish a deferred account that will accumulate the cost (using the Company's allowed net of tax rate of return (currently 7.01%)) associated with these capital borrowings based on the date the payments are made. PSE is also seeking in its accounting petition the Commission's approval of the recovery of the amount in the deferred account in its rates. PSE's proposal for the timing of recovery of the amounts in the

deferral account (e.g. whether over one year or some other time period) and the method of such recovery (e.g. in rate schedules or through a surcharge rider) will be included in the Company's next general rate case to be filed in February 2006, and can be addressed by the Commission in that proceeding.

14. In the event the Commission approves this Petition, PSE will withdraw its proposed tariff revisions filed in Docket Nos. UE-051527 and UG-051528. PSE's proposed Accounting Order submitted with this Petition includes that condition as part of the Commission's approval.

### **III. PROPOSED ACCOUNTING & RATEMAKING TREATMENT**

15. The Company proposes to defer, to FERC Account No. 182.3, Other Regulatory Assets, the increased capital borrowings necessary to remit the \$72 million that was treated as a reduction to rate base in the Order.

16. Exhibit C to this Petition shows the proposed calculation and accounting deferral associated with this Petition. Rows 5 through 10 of Exhibit C show the date of remittance to the IRS for the \$72,564,653 of deferred taxes. (The November 1, 2005, date shown on row 5 is based on the requested date of the order and not the actual date of remittance, which was earlier.) Rows 18 through 35 of Exhibit C show actual calculation of the monthly deferrals associated with the capital costs.

17. To illustrate the calculation, row 18 of Exhibit C shows the calculation for November 2005. In that month, the Company would calculate the recovery of capital costs at its

currently authorized net of tax rate of return (7.01%) multiplied by the already-paid \$6,237,916 remittance to the IRS. This calculation provides a capital deferral amount of \$35,941. This capital deferral amount is then divided by the conversion factor for federal income taxes, which results in a monthly deferral of November 2005 of \$55,293.

18. The accounting entries associated with the November 2005 deferrals are shown on rows 39 through 44 of Exhibit C. As shown on line 42, the Company would credit the income statement \$55,293 and debit the regulatory asset \$55,293. In addition, the Company would make a tax entry on the income statement to account for the tax effect of the income booked of \$55,293. The net impact of these entries is the \$35,941 capital recovery amount required to make the Company whole for its increased capital costs.

19. Rows 19 and 20 of Exhibit C show the calculation for December 2005. In that month, the Company would calculate the recovery of capital costs at its currently authorized net of tax rate of return multiplied by the already-paid \$6,237,916 remittance to the IRS. In addition, the Company would calculate the capital cost recovery of the remittance of \$33,163,369 that will be made on December 15, 2005. This calculation provides a capital deferral amount of \$139,045 (the sum in the capital deferral column of rows 19 and 20). This capital deferral amount is then divided by the conversion factor for federal income taxes, which results in a monthly deferral of \$213,916 (the sum in the monthly deferral column of rows 19 and 20) for December 2005.

20. The accounting entries associated with the December 2005 deferrals are shown on rows 46 through 56 of Exhibit C. As shown on line 49, the Company would credit the income statement \$213,916 and debit the regulatory asset \$213,916. In addition, the Company would



make a tax entry on the income statement to account for the tax effect of the income booked of \$213,916. The net impact of these entries is the \$74,871 capital recovery amount required to make the Company whole for its increased capital costs.

21. In addition to the entry for December 2005 described in paragraph 20 of this Petition, the Company would also book the carrying costs associated with the total of the capital deferrals for the previous month(s). In December 2005, this would require a credit to the income statement of \$329 and a debit to the balance sheet of \$329, as shown on line 54. In addition, the Company would make a tax entry on the income statement to account for the tax effect of the income booked of \$329. The net impact of these entries is the \$214 capital recovery amount required to make the Company whole for its increased capital costs.

22. As also shown on Exhibit C, the total amount to be deferred through calendar year 2006 pursuant to this Petition and the proposed order is the sum of the two monthly deferral columns, as shown on row 37, which is \$6,203,655 (\$6,020,144 + \$183,511).

23. The Company also requests that the Commission permit the Company to continue booking the carrying costs of the capital deferrals until such time that the Company has fully recovered such costs from customers. For example, if the recovery were to be done over one year, the Company would continue to accrue carrying costs of the capital deferrals in calendar year 2007 based on the declining balance in the deferral account as the customers reimburse the Company for these costs.

24. PSE submits that the foregoing accounting and ratemaking treatment is reasonable and in the public interest and should be approved. Due to the manner in which rates are

calculated, the treatment proposed in this Petition for recovery of these capital costs will result in a savings to customers of approximately \$4 million over the tariff revision method originally proposed by the Company in Docket Nos. UE-051527 and UG-051528. However, the deferral and recovery method proposed in this petition would still make the Company whole with respect to recovery of these costs.

#### **IV. PRAYER FOR RELIEF**

25. Based on the foregoing, PSE respectfully requests that the Commission issue an Accounting Order in the form attached as Exhibit D.

DATED this 19th day of October 2005.

**PERKINS COIE LLP**

  
By \_\_\_\_\_

Kirstin S. Dodge, WSBA #22039  
Attorneys for Puget Sound Energy, Inc.

