EXH. MRM-1T
DOCKETS UE-18___/UG-18___
2018 PSE EXPEDITED RATE FILING
WITNESS: MATTHEW R. MARCELIA

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of: **PUGET SOUND ENERGY** **Expedited Rate Filing**	**Docket UE-18____** **Docket UG-18____**

PREFILED DIRECT TESTIMONY (NONCONFIDENTIAL) OF

MATTHEW R. MARCELIA

ON BEHALF OF PUGET SOUND ENERGY

NOVEMBER 7, 2018

PUGET SOUND ENERGY

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PUGET SOUND ENERGY

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Matthew R. Marcelia. I am employed as Director of Tax and Finance IT Projects for Puget Sound Energy ("PSE" or "the Company"). My business address is 355 110th Avenue NE, Bellevue, WA 98009-9734.

Q. Have you prepared an exhibit describing your professional qualifications?

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

Q. What is the purpose of your testimony?

A. My testimony will address the Internal Revenue Service ("IRS") normalization requirements related to the excess deferred income taxes ("EDIT") that resulted from the recent change in corporate income tax rates and how PSE is addressing treatment of excess deferred taxes in this filing. In addition, I will explain the purpose and benefits of the Financial Transparency and Improvement Program ("FTIP").

II. EXCESS DEFERRED INCOME TAXES

A. Tax Reform

Q. Please provide a brief overview of the 2017 Tax Reform legislation.

A. On December 22, 2017, the Tax Cuts and Jobs Act ("TCJA" or "Tax Reform") was signed into law; as a result, the federal income tax structure was significantly modified effective January 1, 2018. Among the most notable change is a reduction in the federal corporate income tax rate from 35 percent to 21 percent.

Q. What is the relevance of TCJA to this case?

A. In Dockets UE-180282 and UG-180283, PSE was the first utility in Washington to lower its customer rates to pass along the benefits of the change in the federal corporate income tax rate from 35 percent to 21 percent. That portion of the TCJA is not part of this proceeding[1]. The tax rate change resulting from the TCJA also affects deferred income tax assets and liabilities on PSE's balance sheet. In this case, PSE will specifically address the deferred taxes associated with plant-related book/tax differences. The deferred taxes associated with non-plant-related differences, as well as the over-collection of tax expense between January 1, 2018 and April 30, 2018, will be addressed in PSE's accounting petition. The historical test year in this case includes six months before the TCJA took effect and six months under the TCJA. As discussed in more detail later in my testimony, PSE is

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[1] The deferral associated with the time between the enactment of the TCJA and rates from UE-180282 and UG-180283 is the subject of an accounting petition under Dockets UE-171225 and UG-171226 (the "TCJA Accounting Petition").

proposing a method of passing back a full year of excess deferred income taxes under the average rate assumption method ("ARAM") in a manner that will not violate the IRS normalization requirements or the consistency rule.

Q. What are deferred taxes?

A. In general, deferred taxes are created when the timing of the tax deduction for an expenditure differs from the book deduction for the same expenditure. If the tax deduction occurs first, a deferred tax liability ("DTL") is created. If the book deduction occurs first, then a deferred tax asset ("DTA") is created. When these timing differences are recorded, they are tax effected at the enacted tax rate for the period in which the timing difference is expected to reverse.

Because PSE had a net DTL when the tax rate was lowered, PSE is in a net excess deferred income tax ("EDIT") position. In other words, PSE has a net DTL which was established using 35 percent, but it will pay the liability to the IRS at 21 percent; thus, its net DTL is too large due to the change in corporate tax rates.

B. Excess Deferred Income Tax Balances

Q. Are all EDIT balances the same?

A. While the mechanics of calculating EDIT is the same for all deferred taxes, it is important to divide the population into two general categories: (i) non-plant related timing differences in FERC Accounts 190 and 283; and (ii) plant related timing differences in FERC Account 282. The distinction is important because the IRS has rules on how EDIT on plant related balances must be handled – the normalization rules.

There is no normalization requirement covering the Company's balances in FERC account 190 and FERC account 283. In contrast, most of the balances in FERC account 282 are subject to normalization. Each of these categories will be discussed separately below.

Q. Are the balances of the electric and gas EDIT in FERC Accounts 190 and 283 being addressed in the expedited rate filing?

A. No, these EDIT balances are addressed in the TCJA Accounting Petition. The EDIT balances associated with these accounts, which total $38.6 million, remain as a rate base offset as part of accumulated deferred income taxes.

Q. What is the balance of the electric and gas EDIT in FERC Account 282?

A. The excess deferred income taxes relating to plant differences amounted to $574.9 million for electric and $241.1 million for gas at December 31, 2017.

C. <u>Normalization in General</u>

Q. Please provide an overview of the tax normalization rules.

A. The normalization requirements of the Internal Revenue Code 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."[2] The tax laws require certain plant related book/tax timing differences to be normalized. When something is normalized for tax purposes, it means that the deferred tax is recorded on the balance sheet and is

[2] IRC §168(i)(9)(A).

factored into the company's ratemaking.

The normalization requirements were added to the Internal Revenue Code by Congress with the Tax Reform Act of 1969. The normalization rules were enacted in response to concern over the impact on federal revenues from the growing trend towards the "flow-through" of accelerated depreciation tax benefits to ratepayers. Before normalization, the tax benefits of accelerated depreciation could be passed from the utility to ratepayers (i.e., flowed through) by reducing the federal income tax expense component of cost of service for the accelerated depreciation deductions. The reduced cost of service, in turn, lowered the revenue requirements for the utility. Therefore, the tax benefits were not retained by the utility but, instead, were flowed through to ratepayers in the form of lower utility rates. In addition, Congress was concerned about the "double loss" of tax revenue: first, when the utility claimed the accelerated tax deductions; and second, when it received lower tax revenue from regulated utility companies. The combined effect results in the utility's taxable income being lowered twice for the same tax benefit.

A regulated utility company is considered to use a normalization method of accounting for 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 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 a deferred tax asset or liability account). The reserve balance attributable to this adjustment may be treated as a reduction from the rate base or as zero-cost capital.

Q. Isn't tax normalization just a rate making issue, not an accounting issue?

A. It's both. The accounting is very important. After all, the IRS requires a "normalization method of *accounting*." So the accounting is important.

To see just how important the *accounting* is, consider Reg. 1.167(l)-1(h), which lays out additional rules for a normalization method of accounting. In fact, the IRS goes so far as to specify some of the debits and credits required:

> *(2) Adjustments to reserve.*
>
> (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account.

That is fairly specific accounting instructions. While the IRS has not laid out all of the debits and credits in the regulations, it clearly requires proper accounting entries.

In fact, when the IRS specified rules to establish compliance with the normalization requirements in Reg. §1.167(l)-1(h)(3) with respect to its operating results and adjustments to a reserve, it refers to the periodic reporting required by the regulatory body. For PSE, that would be its reports to the Commission. The IRS requires that the reports PSE files with the Commission comply with the normalization requirements.

The accounting, regulatory reporting, and the ratemaking must comply with the normalization requirements.

Typically, the use of a historical test year makes compliance with normalization very simple as the normal accounting entries PSE makes in the historical period captures everything that the IRS requires.

D. Normalization More Specifically

Q. Can you elaborate on the normalization requirements?

A. Book/tax differences that are subject to the normalization requirement are considered "protected". All other book/tax differences are considered "unprotected". The two primary areas that give rise to protected differences are book/tax differences for depreciation method and life of the asset (commonly referred to as "method/life differences"). PSE records these deferred taxes in FERC account 282.

Q. Are all normalized differences considered protected?

A. No. Any book/tax difference for which deferred taxes are recorded would be called "normalized". Only the book/tax differences related to plant method and life are subject to normalization protection.[3]

Q. Are all of PSE's deferred taxes in FERC account 282 protected?

A. No. Most of PSE's balance in FERC account 282 is protected because it relates to accelerated depreciation – mainly bonus depreciation. However, there is a smaller

[3] It should be noted that normalization also applies to the investment tax credit, which is not relevant to this testimony. Those rules stem from a different statute, not §168(i)(9).

amount that relates primarily to tax repairs[4] which are technically unprotected.

Q. How is PSE currently treating the unprotected balances in FERC account 282?

A. PSE normalizes the unprotected balances in FERC account 282, just like it treats the protected balances because in PSE's tax software, the balances are not differentiated between protected versus unprotected. Therefore, PSE applies the same rules and logic to both the protected and unprotected balances in FERC account 282.

Q. Why does the Company normalize both protected and unprotected plant balances?

A. As it relates to the tax repairs book/tax difference, PSE normalizes it because the Commission specifically authorized it[5]. As for the other items, they have been normalized for decades. The normalization of the plant-related tax benefits is also the best method for sharing the tax benefits of an investment with all generations

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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 is capitalized for book; while for tax, the replacement of one pole is simply a deductible repair on the much larger tax UOP. PSE records a deferred tax on the difference.

[5] Following my rebuttal testimony on normalization treatment in PSE's 2009 general rate case in Dockets UE-090704 and UG-090705, *see* Exh. MRM-4T, page 30, lines 13-16, the Commission said the following in Order 11, paragraph 197: "Having made this determination for purposes of this proceeding, we note that the Company should implement an *increase to ADIT* in a future case if the IRS approves its methodology for treatment of repair costs following an audit." (Emphasis added).

of customers who benefit from the use of the asset.

Q. How much of the EDIT balance in FERC account 282 could be considered unprotected?

A. Of the EDIT of $816 million, $31.2 million in electric and $21.6 million in gas could be considered unprotected but normalized.

Q. How has the Commission handled the protected and unprotected balances in FERC account 282 for other utilities?

A. In recent Cascade and Avista orders,[6] the Commission coined a new term to refer to the comingled balance in FERC account 282 – "protected-plus". This is an appropriate term that captures the balance well. In its orders, the Commission applied the same treatment to the whole protected-plus balance. This approach has the advantage of being much simpler and easier to implement than an approach that would try to differentiate between protected versus unprotected balances in FERC account 282. PSE's proposal, discussed below, follows the Commission's approach.

E. <u>Normalization and EDIT</u>

Q. EDIT is caused by a lowering of the tax rate. Since it is not a method/life difference, why do you think the normalization rules apply to EDIT?

A. On its face, that statement appears to be true, and the actual language of §168(i)(9) would appear to support it. However, the IRS has concluded in Private

[6] UG-170929 and UE-170485/UG-170486.

Letter Ruling ("PLR") 8920025 that normalization does apply to EDIT. I will discuss that PLR in more detail later in my testimony.

Q. Please describe the normalization rules that apply to EDIT.

A. The normalization rules for EDIT have two components. First, the EDIT can be passed through to customers no more quickly than over the remaining book life of the underlying asset. This is achieved by applying ARAM to the amount of the reversal occurring in the period[7]. The statute specifies the mathematical calculation that is required. It has the practical effect of spreading the EDIT over the remaining book life of the underlying assets.

Q. Does PSE have the records that are required to calculate ARAM?

A. Yes, PSE has the vintage records that are required to calculate the ARAM rates.

Q. Does the IRS require anything else in order to use a normalization method of accounting for the reversal of EDIT?

A. Yes. In addition to the use of ARAM, taxpayers must also follow the usual normalization provisions of §168(i)(9), the most relevant being the consistency rule of §168(i)(9)(B):

> (B) Use of inconsistent estimates and projections, etc.
>
> (i) In general.
> One way in which the requirements of subparagraph (A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).

[7] *See* TCJA of 2017 §13001(d)(1). This provision is taken verbatim from the Tax Reform Act TRA of 1986 ("TRA") §203(e)(1). As a result, there is a high likelihood that the IRS will follow the precedence of TRA when interpreting these provisions of TCJA.

> (ii) Use of inconsistent estimates and projections.
> The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (A)(ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

Q. Please discuss PLR 8920025.

A. PLR 8920025 is attached as Exh. MRM-3. In that ruling, the IRS considered a situation where a plant was transferred out of regulatory accounting, and one of the questions at issue was whether the EDIT on that plant could still be amortized back to utility customers once the plant was no longer part of rate base. While the issue of regulated versus unregulated assets is not relevant to PSE at this time, the IRS' comments on the nature of amounts "originally deferred pursuant to a normalization method of accounting" (i.e. EDIT) are instructive. The EDIT in the PLR was created as part of the Tax Reform Act of 1986 ("TRA").

The ruling has two important parts: First, the IRS concluded that:

> amounts which were originally deferred pursuant to a normalization method of accounting remain subject to the normalization rules of sections 167(l) and 168(i)(9) of the Code. Accordingly, all amounts previously deferred under corporate tax rates at 46 percent are part of a "reserve to reflect the deferral of taxes" as described in sections 167(l)(2)(G)(ii) and 168(i)(9)(A)(ii), and become inseparable from the assets which initially gave rise to the deferral.

The amounts that are deferred (i.e. EDIT) remain attached to the underlying assets. They do not take on any unique characteristics of their own. They are anchored to the asset and whatever happens to the asset must therefore happen to the EDIT (e.g. if the asset is transferred to non-regulatory, the EDIT is also transferred; if the asset's book life is extended or shortened, so too is the corresponding EDIT reversal). The EDIT follows the regulatory consequences associated with the underlying property. The EDIT cannot do something that the underlying asset is not doing.

Second, in the PLR, the commission and attorney general claim that the consistency provisions of normalization (§168(i)(9)(B)) do not apply because Congress established a special regulatory treatment for the EDIT (e.g. requires the use of ARAM which is not part of the normalization provisions under §168(i)(9)). For this, the IRS concludes otherwise. "We [the IRS] also believe that [the Tax Reform Act of 1986] does not override the consistency requirements of sections 167(l) and 168(i)(9)."

In this ruling, the IRS clearly applies normalization (ARAM and consistency) to the EDIT. As a result, PSE's treatment of EDIT must clear both hurdles. Clearing only one of the hurdles will result in a normalization violation.

Q. Has PSE had any dealings with the IRS regarding normalization and the consistency rule?

A. Yes. Many years ago, it was the normal practice in this state to use the average of the monthly averages ("AMA") technique to calculate rate base in a rate filing and to pair the AMA rate base with the end of period ("EOP") accumulated deferred income tax balances ("ADIT"). Obviously, AMA and EOP are different techniques to measure balances for use in setting rates. In 2006, PSE raised the question of consistency under the normalization provisions. Fortunately, PSE was able to work with the Commission and Staff and used a consistent approach on its next rate filing while PSE pursued a PLR with the IRS.

Q. What was the result of PSE's PLR?

A. PSE received PLR 108661-07[8] from the IRS in February 2008, which is provided as Exh. MRM-4. In this PLR, the IRS ruled that the use of AMA rate base with EOP accumulated deferred taxes was inconsistent. However, PSE was not subject to sanction because the violation was inadvertent; and it was never PSE's or the Commission's intent to violate the normalization provisions.

That ruling served to heighten PSE's sensitivity to normalization issues in general and the consistency rule in particular.

Q. Are there additional IRS rulings on the treatment of EDIT related to the 1986 tax reform?

A. Most rulings that refer to EDIT do so in the context of assets being sold or becoming deregulated. Some refer to EDIT related to the investment tax credit.

There is a surprising dearth of guidance around EDIT coming out of the 1986 tax reform. That may be because the net DTLs on the books of utilities in 1986 was much smaller than what we see today. After three decades of modified accelerated cost recovery system ("MACRS") and one decade of bonus depreciation, utilities across the country have enormous DTL balances, which lead to enormous EDIT balances. In contrast, the balances in 1986 may have been too small to garner

[8] The public redacted version is PLR 200824001.

much attention.

Q. Did PSE's regulatory filing for the TRA of 1986 address EDIT?

A. I reviewed PSE's 1987 rate filing as it related to tax reform. While tax reform was clearly discussed and dealt with, I saw no indication in the order that EDIT was even considered. In fact, I did not see EDIT discussed in any of the Commission's orders from that time period.

Q. Are there any other PLRs that you think are relevant to PSE's current EDIT situation?

A. There are a number of IRS rulings on consistency, but only the 8920025 ruling combines consistency with EDIT. However, one of the recent rulings on consistency, PLR 201820010, is of particular interest. It is provided as Exh. MRM-5. In that ruling, the taxpayer enters into a settlement with the IRS, which causes its net operating loss ("NOL") to shrink significantly. The taxpayer uses a historical test year. The settlement occurs in the last month of the historical test year. The taxpayer also uses an AMA methodology such that only about $1/13^{th}$ of the settlement appears in the rate base calculation. The commission's position is to include the full amount of the settlement as a known and measurable adjustment in the rate base calculation, while leaving all other items of rate base and deferred taxes at AMA. The IRS rules that this is a normalization violation because it violates the consistency principle.

Q. What observations do you have regarding this PLR?

A. I have a few observations: (a) by using the full amount of the settlement on the

NOL, the commission essentially moved only the NOL to EOP, while everything else remained at AMA; (b) if the commission had moved all items of rate base and deferred tax to EOP, there would be no consistency issue with using the full impact of the settlement on the NOL; (c) the fact that the settlement was known and measurable appeared to play no role in the IRS determination of consistency; and (d) this situation is very similar to PSE's situation in this filing with a June 30 historical test year where the EDIT reversal is present for only the last six months of the historical test year but not the first six months of the historical test year.

Q. Are there any common themes in the IRS' consistency ruling?

A. I see a couple of common themes running through the IRS' rulings on consistency. First, the IRS is laser focused on all four items being consistent: depreciation expense, tax expense (including deferred tax expense), accumulated deferred taxes on the balance sheet, and rate base. They must be treated the same (e.g., same population, same time period, same convention, same measurement technique). All must be the same, with no exception.

Second, the IRS never considers the direction of the consistency infraction. For example, in PSE's PLR, the IRS did not explore whether the infraction was beneficial to the company versus customers or whether the effect was too quick or not quick enough. Inconsistency is an infraction regardless of the size or direction of the dollars involved.

F. <u>Normalization Violation</u>

Q. What are the consequences of violating the normalization rules?

A. The consequences of not complying with the normalization rules are significant. I mentioned earlier that PSE's treatment of EOP versus AMA treatment of ADIT caused an inconsistency, but the IRS did not impose sanctions because the violation was inadvertent.

Under the TCJA for a violation related to EDIT, the IRS cannot be so lenient. TCJA §13001(d)(4)[9] adds a new provision that was not present in the TRA of 1986. It requires that the taxpayer's tax be increased by the amount that the utility has passed back to customers beyond what is allowed. It does not appear that the IRS has the ability to permit a taxpayer to correct the infraction without a penalty as it has in other inconsistency infractions unrelated to EDIT. Note that this new increase in tax appears to have the effect of preventing customers from ever benefitting from EDIT that is passed to customers inappropriately.

Beyond this new provision, the usual normalization penalties would apply. The impact would be significant to PSE and its customers. PSE would be prohibited from using accelerated tax depreciation. For example, PSE currently depreciates its wind farms over five years using MACRS depreciation. If PSE violates the normalization rules, it would be forced to depreciate its wind farms using the same method and life that is used for book purposes (e.g., straight-line over 25 years). This would represent a huge cost increase to PSE and its customers,

[9] See Exh. MRM-6 for all of the normalization provisions in the TCJA, including the new provision for additional tax.

especially when this effect is extrapolated to all of PSE's depreciable assets. The penalties for EDIT-related violations are larger than other normalization violations.

III. PSE'S PROPOSED TREATMENT OF ARAM

A. PSE's Proposal in this Filing

Q. What is the test year for this filing?

A. This filing covers the historical test year from July 1, 2017 through June 30, 2018.

Q. With respect to tax reform, what issue does this test year present?

A. The historical test year for this filing would include only six months of ARAM being reflected in rates. ARAM on the EDIT did not start until January 1, 2018. Thus, it is present in PSE's actual results of operations only from January through June 2018. The first six months of the historical test year, July 1, 2017 through December 31, 2017, predate tax reform.

Q. Can PSE make a simple pro forma adjustment to the ARAM calculation to capture the impact for 12 full months of ARAM in the ERF?

A. No. Beyond the limitation of pro forma adjustments in an ERF that is discussed in Ms. Barnard's testimony, the IRS normalization and consistency requirements also have implications. As PLR 201820010, discussed above, demonstrates, a pro forma adjustment to add or remove deferred taxes that were not present in the historical test period would violate the consistency rule. To reflect ARAM in the period of the historical test year for which it did not exist (i.e. July 2017 through December 2017) is not permitted.

A helpful way of looking at this is to consider the mechanics of this hypothetical pro forma adjustment. The pro forma adjustment would be pulling in 12 months of ARAM. But the 12 month period of ARAM would cover January 2018 through December 2018. That is the crux of the problem. The time periods do not match with the historical test year. This is clearly illustrated in the table below:

Table 1 ERF Normalization

Consistency Item	Time Period
Rate base	July 2017 – June 2018
ADIT	July 2017 – June 2018
Depreciation expense	July 2017 – June 2018
Tax expense, generally	July 2017 – June 2018
ARAM portion of tax expense	January 2018 – December 2018

As shown above, the ARAM covers the wrong period. Viewing the information in this light helps to illuminate the solution that PSE has proposed in this filing.

Q. How would PSE modify the hypothetical pro forma adjustment in this ERF to avoid a consistency violation?

A. To avoid consistency issues, the approach must be multifaceted.

First, PSE proposes to start with EOP rate base and ADIT as of June 30, 2018. That locks down the population for all of the following calculations as everything else – depreciation expense, current and deferred tax expense, and accumulated deferred income taxes must be handled in a consistent manner as the rate base.

Second, PSE proposes to extend the book depreciation calculation to cover July

2018 through December 2018 for all assets in place at June 30th. We would drop the actual depreciation expense from the period July 2017 to December 2017 (to avoid any double counting of book depreciation). PSE would also pickup additional book depreciation from January 2018 through June 2018 for the assets on the books at June 30. The essence of these adjustments to book depreciation result in the assets at June 30 receiving a full 12 months of depreciation at current depreciation rates.

Third, by extending book depreciation through December 2018, we will need to reflect the additional book accumulated depreciation in rate base.

Fourth, these adjustments will require corresponding changes to tax expense and ADIT to roll them forward to balance at December 2018 in a like manner to the book depreciation adjustments.

This methodology provides consistent treatment for all aspects of PSE's accounts and clears the way for the inclusion of the entire 2018 ARAM.

The key to IRS consistency is to apply the same approach to the same population using the same assumptions.

The updated normalization table would look like this:

Table 2 Updated ERF Normalization	
Consistency Item	Time Period
Rate base	EOP June 2018, with adjustments to accumulated depreciation
ADIT	EOP June 2018, with adjustments for book and tax depreciation
Depreciation expense	12 months depreciation on all June 2018 assets
Tax expense, generally	12 months tax depreciation on all June 2018 assets
ARAM portion of tax expense	12 months of ARAM on all June 2018 assets

This approach achieves the goal of including July through December 2018 ARAM in rates. It complies with the normalization and consistency rules. It avoids the harsh consequences of a violation. It is a workable alternative to using the actual rate base, ADIT, depreciation expense, and tax expense (with six months of ARAM) from the historical period, which would mean forgoing the inclusion of the July through December 2018 ARAM in rates. PSE's preference is to move forward as proposed in this filing.

B. Treatment of 2018 ARAM from January 1, 2018 to the Rate Effective Date

Q. How has PSE treated the ARAM that has occurred, and will occur, between January 1, 2018 and the rate effective date?

A. PSE has been recording ARAM as part of its deferred tax expense calculation each month. In reality, PSE has been calculating ARAM for decades, but the amounts are much larger now with the tax rate dropping to 21 percent.

Q. How much ARAM has PSE deferred?

A. PSE has not deferred any reversing EDIT in calculating its deferred tax expense.

Q. Why not?

A. Deferring only the ARAM component of deferred tax expense would result in PSE <u>not</u> using a "normalization method of accounting", as discussed above.

C. <u>Not "more quickly or to a greater extent than the reserve would be reduced under ARAM"</u>

Q. Wouldn't deferral result in passing the EDIT more slowly than over the book life of the asset?

A. It may result in the EDIT being passed back more slowly but only with respect to the time period while the deferral is growing. In all of the time periods when the deferral is reversing, the impact of the EDIT recorded in those periods would be greater than if no deferral had been recorded.

Q. Can you provide an example?

A. Yes. If the first year of ARAM was $100 and it is deferred, the deferral will be spread over two years, beginning in the second year. In Year 2, ARAM for the year would be $100, plus $50 coming from the deferral. With respect to Year 2, the impact of ARAM would be $150, not $100. An impact of $150 would be more than what is allowed under a normalization method of accounting (i.e. it is faster with respect to Year 2 relative to what is provided by the ARAM calculation of $100).

Q. Doesn't the IRS allow taxpayers to use any method to reverse EDIT as long as its excess deferred tax reserve is not reduced "more quickly or to a greater extent than the reserve would be reduced under ARAM"?

A. It is not likely. Whenever the IRS discusses ARAM, it uses the exact same phrasing: it cannot be done "more quickly or to a greater extent than the reserve would be reduced under ARAM". This same phrase is repeated, without variation.

Q. What does the IRS mean by not "more quickly or to a greater extent than the reserve would be reduced under ARAM"?

A. I have been unable to find any IRS rulings or guidance where the IRS permitted a taxpayer to employ a calculation other than ARAM. The IRS always requires the exact ARAM calculation[10]. There is no variability in the guidance.

Q. Is there any other issue with the deferral concept?

A. Yes. The consistency rule precludes PSE from deferring the 2018 deferred tax expense for ARAM when nothing else is deferred. As I mentioned above, deferring only the ARAM portion of deferred tax expense and nothing else would violate consistency.

To apply this to the example I used above, multiple inconsistencies would be created – one in Year 1 when the deferral is created and one in each year that the deferral reverses, e.g. Year 2 and Year 3. It is very unlikely that the IRS would

[10] The only exception is where a taxpayer lacks the records required for the ARAM calculation. In that case, taxpayers can use the Reverse South Georgia Method.

conclude that multiple inconsistencies equate to a valid "normalization method of accounting".

Q. Did PSE attempt to calculate a deferral scheme that would comply with the consistency rule?

A. As PSE began to understand the implication of the consistency rule, it became clear that bringing all of the consistency factors into alignment would require an increase in customer rates, due to the adjustments necessary to bring depreciation expense forward to 2018. In addition, as discussed above, it is unclear that the IRS would accept such a deferral, regardless of the direction (beneficial or detrimental to customers). As a result, PSE has not recorded a deferral. Such a speculative deferral that would increase customer rates seems to be inconsistent with the policy intent to "ensure those savings [from Tax Reform] will benefit Washington customers"[11]. In one sense, those savings are benefiting customers by reducing, but not eliminating, the need for this filing.

In short, no deferral has been made. PSE does not propose such a deferral in this filing.

D. <u>A Normalization Method of Accounting</u>

Q. Would it be possible to perform the tax and ratemaking calculations in a manner that follows a normalization method of accounting and then, once those entries have been made, create a deferral?

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[11] WUTC press release, January 8, 2018.

A. While this construct has the advantage of performing and recording all balances in a consistent and valid manner from a normalization perspective, any entry that tries to side step the impact of normalization is prohibited.

For example, §168(h)(9)(B)(i) says

> In general. One way in which the requirements of subparagraph (A) [i.e. normalization] are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).

That statement would prohibit an "after-the-fact" deferral even if the utility followed an otherwise valid normalization calculation.

IV. THE FTIP PROJECT

Q. Please describe the FTIP Project.

A. The FTIP project is a redesign, modernization, and simplification of our accounting, budgeting, and forecasting systems, processes, and tools.

Q: Describe your role on the project.

A. For the FTIP 1 project, I was a member of the Steering Committee. For the FTIP 2 project, I was the Sponsoring Director and was responsible for day-to-day operations of the project. Each phase of the FTIP project is described later in my testimony.

Q. Describe the need for the FTIP project.

A. There were a number of reasons PSE needed FTIP. The main reasons were as follows:

- PSE implemented SAP's accounting platform ("ECC") in 1998. Over time, the 20-year-old original installation became outdated and burdensome to maintain.

- PSE needed to eliminate the customizations built into the initial SAP implementation to simplify and make more cost effective other strategic investments, including Integrated Work Management and future projects on the SAP platform.
- Prior to FTIP, the Company operated and maintained four separate budget systems that worked well individually but did not efficiently and consistently support a corporate-wide financial view of PSE.
- Given the separate budget systems described above, budgeting and forecasting activities and processes were more complicated, time consuming, and less efficient to operate and maintain than a single centralized system.
- Many components of budgeting and forecasting were performed in "off system" spreadsheets or databases that were inefficient to operate and maintain and were subject to error, which intensified the need for non-value adding and time-consuming quality controls.
- Inefficient and difficult data mining and analysis delayed decision making.
- Certain "behind the scenes" allocation processes within SAP called assessments[12] hindered and obfuscated cost flows and transparency into

[12] In SAP, an assessment is a process whereby the system will allocate the expenditures in a cost center to work orders. In general, the process is a convenient way to allocate costs. However, it

spending patterns.

- Routine patches and upgrades were more risky and costly due to the customizations built into the original design of the financial systems.
- The accounting system was based on FERC-centric work order numbers, requiring FERC accounting knowledge and decision making throughout the organization.
- Over time, the account structure accumulated over 3,000 cost elements and 2,000 labor activity rates, which increased complexity and reduced transparency.
- The organization inconsistently used key data fields and governance structures within the financial module of SAP.

In short, the software solution that PSE implemented in the late 1990s, which worked well for so many years, needed to be rethought and refreshed in order to meet the current and future needs of PSE and its customers.

In light of these needs, management established its objective to redesign PSE's budgeting process, tools, accounting structure, reporting, and financial accountabilities in order to:

- Evolve the Company's financial systems from one that primarily meets accounting requirements to one that also keeps track of the dollars it uses

has a significant drawback in that if your work order receives an assessment, it is very difficult and time consuming to reverse engineer the process to determine why your work order was assessed that dollar amount in that month. Managers who were on the receiving end of an assessment found the process unpredictable and quite frustrating from a budgeting and forecasting perspective.

- in a manner that more transparently reflects the way the Company manages its business and the work that it performs;
- Reduce the work on budgeting, accounting, and reporting—and get more value out of it;
- Improve the financial information available to management to allow for better decision making.

Q. What was the scope of the FTIP project?

A. As PSE entered the Design Phase[13] of the project, management gained more clarity on the specific scope that would be necessary to achieve the objectives discussed above. That initial scope was extensive. At a high level, it called for a major change in the cost flow model, replacement of the income statement architecture, establishing a newer and more enlightened governance model over key data elements, simplifying and standardizing key data elements, installation of the Budget Planning and Consolidation ("BPC") budgeting tool, installation of the FERC module, migration to Simple Finance, migration to the SAP Hana platform, and installation of SAP's Fiori apps. The established timeline required this work be completed in time to open the books in January 2017 on the new platform – giving PSE a clean break from the old in 2016 and ushering in the new for 2017.

The FTIP project followed PSE's project management guidelines. Those guidelines require a review of the project at each Phase Gate. At the end of the Design Phase in early 2016, management evaluated the project as it prepared to

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[13] PSE's project management process utilizes a Project Lifecycle/Phase Gate Model, which includes five phases: Initiation, Planning, Design, Execution and Close-out. Each phase includes deliverables and activities that allow the project to progress through each phase by way of phase gate approvals.

move from the Design to Execution Phase. As originally designed, the cost had increased. Implementation risk had increased. Schedule risk had increased. Technology risk had increased. Extensive organizational change management would be required, given the level of change proposed.

At this point, management initiated a mini-redesign phase to divide the program into two parts which would de-risk the project while preserving the benefits. For FTIP 1, the focus of the budget track became the installation of the BPC module without user enhancements. The focus of the accounting track was to make the changes necessary to support the budgeting tool, i.e. change the cost flow model[14] and simplify and standardize key data elements. Everything else was moved to FTIP 2 – FERC, income statement, user enhancements in BPC, Simple Finance, etc. FTIP 1 was completed on time in January 2017 to make a clean break between 2016 and 2017.

In May 2017, FTIP 2 went through its own Design Phase. Its scope included all of the de-scoped items from FTIP 1, with the exception of Simple Finance and Fiori. The FTIP 2 project was completed in May 2018.

Once each project completed its Design Phase, there were no significant changes to the scope, schedule, or budget of either one.

Q: Describe the alternatives evaluated and how this solution was chosen.

A. There were three primary options that the Company considered. The first was to

[14] The cost flow model controls how costs make their way through the accounting system, from the origination of the expenditure through to its final resting place on the financial or regulatory chart of accounts.

install a single budgeting solution without making any changes to the accounting system (SAP's ECC module). This option was extremely unpalatable. Any budget system under this scenario would have required extensive customization in an attempt to replicate the customizations that were in place in the accounting system. While a project of this nature may have been technically possible, the Company would have been doubling-down on the accounting customizations which were proving so problematic in terms of simplicity, transparency, and accountability by forcing similar customizations into a new budgeting solution. This would not have achieved the objectives management laid out for the project nor would it have met the needs of the organization.

The second alternative was to install a budgeting solution, make some modifications to the existing accounting system, but not address the issue of work order numbering and FERC accounting, discussed further below. This option would have provided the Company with a partial solution. The budgeting tool would have required extra customizations. The accounting system would have been improved to a limited extent by removing some assessment cycles. The biggest drawback to this option was the level of customizations that remained in the accounting system (ECC) – the income statement would continue to be derived from work orders, and those work orders would need to have the FERC number in them, which would require manual creation. This arrangement, while plausible, would have significantly hindered future development on the SAP platform, especially in the enterprise asset management space (Integrated Work Management).

The third option was to install a budgeting solution and to bring the accounting system into a standard configuration. This arrangement met all of the criteria. The Company would install one budgeting tool without undue customization which would be used across the whole organization. The accounting system would be brought into a standardized SAP configuration. The cost flow model would be streamlined and simple. Assessments would be nearly eliminated. The move to the FERC module would enable the Company to use natural work order numbering regardless of the FERC classification. Future projects in the SAP landscape could move forward without the accounting system dictating excessive complexity and customizations.

Q. How did the Company decide on SAP's BPC tool as its budgeting solution?

A. PSE considered three budgeting solutions: SAP's BPC solution, SAP's PPM solution, and PowerPlan's budgeting solution. The Company focused on these three products because of (a) their capabilities in budgeting capital projects, (b) both platforms (SAP and PowerPlan) are already deeply embedded in PSE's IT landscape, and (c) both offered fairly seamless integration. Other third-party applications were not considered as the complexity and uncertainty of introducing another vendor and new processes into the landscape carried additional costs and risks beyond what the Company was willing to take on. As explained in the Prefiled Direct Testimony of Margaret F. Hopkins, Exh. MFH-1T, one of PSE's guiding principles for IT projects is to leverage existing technology assets and maximize their use. In addition, both SAP and PowerPlan are respected market leaders in the utility industry.

In the end, the BPC solution was selected. Implementation of the PPM solution would have significantly expanded the scope, schedule, and budget for the project and taken us down a path that was beyond the stated objectives of the project. The PowerPlan solution offered seamless integration on the capital project side but was undifferentiated on the O&M side. It addition, it was projected to be more costly overall.

Q. Did the Company consider changing its accounting system and using something other than SAP?

A. No. SAP is PSE's enterprise resource planning platform ("ERP"). SAP's accounting module (ECC) is the heart of that system. To swap out the accounting module would have completely disrupted the entire platform. Far from improving or simplifying the system, it would have moved the organization in the opposite direction. Other functions performed within SAP would have required a complete retrofit[15] with custom interfaces that would complicate the landscape and lead to higher overall cost of ownership.

Q. Did the Company consider upgrading to the current version of SAP?

A. Yes, PSE evaluated moving from Classic GL to a newer version, either Simple Finance or S/4. Ultimately, the Company decided to remain on Classic GL. Management could not identify compelling benefits to justify the move. During this time, SAP announced that it would continue to support Classic GL through 2025. In addition, very few utilities had moved to either Simple Finance or S/4,

[15] Including PSE's entire billing and human resource systems.

and PSE was not interested in being a pioneer.

Q. What was the cost of each sub-phase of the project?

A. The following is a summary of the cost of the project by the four sub-phases.

i. The cost for FTIP 1 – Budgeting was $23.9 million. In this sub-phase, PSE installed a new budgeting system called BPC, which stands for Budget, Planning, and Consolidations. This was a new module that was added to SAP. BPC integrates with the company's existing SAP technology footprint and IT support structure. BPC established a common platform for budgeting across the organization and allowed PSE to centralize around one budget system. As a result, we eliminated the side spreadsheets and databases, and we eliminated the small legacy systems, Cognos and Pace, that were used by some groups.

ii. The cost for the FTIP 1 – Accounting was $15.9 million. The installation of BPC would have been completely ineffective without changes to the SAP accounting module, ECC. The most important change to ECC was the alteration to PSE's costs flows, which simplified the path that expenditures flow through the accounting system. In essence, this amounted to reimaging the system. It required that PSE redesign and standardize the usage of such data elements as SAP's work breakdown structures (WBS), cost centers, cost elements, and labor activity rates. These data elements had to be simplified and standardized across the Company. For example, we reduced the number of labor activity rates from about 2,000 to 150 by introducing standard labor rates. Similarly, we reduced the number of cost elements from over 3,000 to 500. In short, we made dramatic changes to ECC putting it on the path toward simplification and clarity.

iii. The cost for the FTIP 2 – Budgeting sub-phase was $7.7 million. In this phase, we automated a number of cumbersome functions, such as adding, removing, and transferring employees among cost centers. We simplified our labor planning for capital projects, added drill-through functionality to assist in researching variances, added detailed tabs to the budgeting forms, and added predictive text to make input easier. We also added better budget to actual reporting. The new functionality greatly improved the usability of the BPC solution beyond that offered at the time of original installation.

iv. The cost for FTIP 2 – Accounting was $24.3 million. As part of this phase of the project, the Company installed the SAP FERC module. This module allows the company to do its FERC reporting from within the system and to generate PSE's income statement using the reporting embedded in the restructured WBSs, as changed in FTIP 1. One of the major customizations instituted back in 1998 was to use the SAP order numbers as the basis for the FERC income statement whereby the FERC account was embedded in the mask for all order numbers, even those used by field operations – a group that is largely supported by contract labor. The old arrangement required (a) field operations to have an understanding of FERC accounting and (b) each order number had to have the FERC order number embedded in its first four digits. By shifting the income statement to the WBS structure and allowing the FERC reporting to be derived from the FERC module rather than from manually created orders containing a FERC hierarchical structure, the Company can now use standard SAP techniques to automatically create orders and continue to successfully report its results on a FERC basis. Additionally, future projects within the SAP landscape will build on this new capability for which FTIP laid the groundwork.

Finally, the FTIP 2 – Accounting sub-phase included a normal maintenance upgrade to the PowerPlan software, which allowed the software to process activity from multiple FERC accounts that are charged to the same capital order.

Q. When did FTIP go into service?

A. In January 2017, FTIP 1 Budget and Accounting went live. In May 2018, the FTIP 2 Budget and Accounting went live.

Q. Describe the benefits of the project.

A. In evaluating the benefits of the FTIP program, all of the sub-parts are inextricably linked. It is impossible to divide the benefits into sub-components as the budget benefits could never have been achieved without the compatible changes to the accounting system. The table following sets forth a summary of the annual benefits:

Table 3

Benefit	Metric	Baseline	Target	Cash Savings	Avoidance
Reduction of construction support costs	Construction support overhead	$128.0M	$113.0M	$15.0M	
Avoidance of construction support costs		$12.0M	$0.0M		$12.0M
Reduction in number of employees in the Budget department	# of FTE in Budget	26	19	$1.0M	
Total cash benefit				**$16.0M**	**$12.0M**
All benefit (incl. cost avoidance)				**$28.0M**	

PSE has already seen the benefit in terms of a reduction in employees working in the Budget department and a reduction in the construction support costs. These savings began in 2017 and are included in the test year in this case. These benefits present a cash-on-cash payback of about 4.5 years or an all-in payback of about 2.6 years. These annual savings do not include the other FTIP benefits.

Q. Are there other benefits resulting from FTIP?

A. The benefits listed above do not capture the full impact of the financial transformation that the project represents. There are many benefits that will not show up directly in the numbers, including:

- Better transparency into the numbers leads to better resource allocation and quicker decision making.
- A common budget platform allows for clear visibility and accountability down to the cost center manager level.
- Future upgrades and service packs can be install more quickly and with less risk

In addition, the accounting platform is now ready for the future. By moving the accounting architecture to a standard SAP methodology and by removing the

FERC account number from PSE's order structure, PSE has paved the way for future technologies that are more directly customer facing. For example, FTIP laid the foundation for PSE's Integrated Work Management which will transform how PSE performs work for customers – from first contact, to order creation, to work assignment, to job completion, to project billing.

The project also lowers PSE's accounting, reporting, budgeting, and technology risk, improves the Company's accountability model, allows for more efficient and better decision making, and paves the way for future improvements.

V. CONCLUSION

Q. Does this conclude your rebuttal testimony?

A. Yes.