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February 8, 2011

VIA HAND DELIVERY

filed electronically in docket office on 02/08/11

Chairman Mary W. Freeman
c/o Sharla Dillon
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, Tennessee 37243

Re: Docket No. 10-00189: *Petition Of Tennessee American Water Company To Change And Increase Certain Rates And Charges So As To Permit It To Earn A Fair And Adequate Rate Of Return On Its Property Used And Useful In Furnishing Water Service To Its Customers*

Dear Chairman Freeman:

Enclosed please find an original and five (5) sets of copies of Tennessee American Water Company's Rebuttal Testimony filed on behalf of the following witnesses: Bernard L. Uffelman, James H. Vander Weide, James I. Warren, Sheila A. Miller, Patrick L. Baryenbruch, Paul R. Herbert, Dr. Edward L. Spitznagel, John S. Watson and Michael A. Miller.

Two disks are included with this submission. The first disk, labeled "Docket Manager Disk" contains PDF images of the testimony of each witness. The second disk contains all of the documents submitted in their native formats.

Please file the original and four copies of this Rebuttal Testimony and stamp the additional copy as "filed." Then please return the stamped copy to me by way of our courier.

Should you have any questions concerning this matter, please do not hesitate to contact me at the email address or telephone number listed above.

Sincerely,

David Killion

Enclosures

IN THE TENNESSEE REGULATORY AUTHORITY
AT NASHVILLE, TENNESSEE

IN RE:	)	
	)	DOCKET NO. 10-00189
PETITION OF TENNESSEE-AMERICAN WATER COMPANY TO CHANGE AND INCREASE CERTAIN RATES AND CHARGES SO AS TO PERMIT IT TO EARN A FAIR AND ADEQUATE RATE OF RETURN ON ITS PROPERTY USED AND USEFUL IN FURNISHING WATER SERVICE TO ITS CUSTOMERS	))))))))	

REBUTTAL TESTIMONY

OF

JAMES I. WARREN

TAX PARTNER

WINSTON & STRAWN LLP

ON BEHALF OF

TENNESSEE-AMERICAN WATER COMPANY

FEBRUARY 8, 2011

BACKGROUND AND INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is James I. Warren. My business address is 1700 K Street, N.W., Washington, D.C. 20006.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am a tax partner in the law firm of Winston & Strawn LLP ("Winston").

Q. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT WINSTON.

A. I am engaged in the general practice of tax law. I specialize in the taxation of and the tax issues relating to regulated public utilities. Included in this area of specialization is the treatment of taxes in regulation.

Q. ON WHOSE BEHALF ARE YOU SUBMITTING THIS TESTIMONY?

A. I am submitting this testimony to the Tennessee Regulatory Authority ("TRA" or "Authority") on behalf of Tennessee-American Water Company ("TAWC" or the "Company").

Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

A. I joined Winston in September of 2008. For the five years prior to that time, I was a partner in the law firm of Thelen Reid Brown Raysman & Steiner LLP and resident in its New York office. Before that, I was affiliated with the international accounting firms of Deloitte & Touche LLP (October 2000 – September 2003), PricewaterhouseCoopers LLP (January 1998 – September 2000), Coopers & Lybrand (March 1979 – June 1991) and the law firm Reid & Priest LLP (July 1991 – December 1997). At each of these professional services firms, I provided tax services primarily to electric, gas, telephone and water industry clients. My practice has included tax planning for the acquisition or transfer of business assets, operational tax planning and the representation of clients in tax controversies with the Internal Revenue Service ("IRS") at the audit and appeals levels. I have often been involved in procuring private letter rulings or technical advice from the IRS National Office. On several occasions, I have represented one or more segments of the utility industry before the IRS and/or the Department of Treasury regarding certain tax positions adopted by the federal government. I have testified before several Congressional committees and subcommittees and at Department of Treasury hearings regarding legislative and administrative tax issues of significance to the utility industry. I am a member of the New York, New Jersey and District of Columbia Bars and also am licensed as a Certified Public Accountant in New York and New Jersey. I am a member of the American Bar Association, Section of Taxation where I am a past chair of the Committee on Regulated Public Utilities.

Q. HAVE YOU TESTIFIED IN ANY REGULATORY PROCEEDINGS?

A. Yes I have. I have testified regarding tax, tax accounting and regulatory tax matters before a number of regulatory bodies including the Federal Energy Regulatory Commission and the utility commissions in Florida, Arkansas, Louisiana, Nevada, Delaware, West Virginia, New Jersey, the District of Columbia, New York, Connecticut, Ohio, California, Maryland, Pennsylvania, Missouri, Illinois, Kentucky, Vermont and Texas.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I earned a B.A. (Political Science) from Stanford University, a law degree (J.D.) from New York University School of Law, a Master of Laws (LL.M.) in Taxation from New York University School of Law and a Master of Science (M.S.) in Accounting from New York University Graduate School of Business Administration.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am testifying on behalf of TAWC. The purpose of my testimony is to rebut certain aspects of the testimony of Mr. Terry Buckner who filed direct testimony on behalf of the Consumer Advocate and Protection Division in the Office of the Attorney General. Specifically, I shall address Mr. Buckner's amended testimony as it implicates (1) the tax expense element of cost-of-service as well as (2) the quantity of accumulated deferred income taxes ("ADIT") by which it is appropriate to reduce the Company's rate base.

Q. WITH REGARD TO THE TAX EXPENSE ELEMENT OF COST OF SERVICE, IN WHAT WAYS ARE MR. BUCKNER'S PROPOSAL ERRONEOUS?

A. Mr. Buckner makes two very basic mistakes in his tax expense proposal. First, he does not allow the Company to recover the tax benefits it previously flowed through to customers even though those benefits now have to be repaid to the government. This failure breaches the implicit regulatory promise that is a necessary (and standard) feature of "flow through" tax accounting. I shall explain this in more detail hereafter. Second, he does not allow the Company to recover the tax that will be imposed on its collection of its equity AFUDC. In effect, the Company is awarded $1 (after tax) but only allowed to collect 65¢ ($1 less the tax due [at 35%] on the receipt of the $1). This insures that the Company will never have the opportunity to recover its equity AFUDC rate of return.

Q. WHY IS THERE NO DISCUSSION OF PRIOR FLOW THROUGHS AND EQUITY AFUDC IN MR. BUCKNER'S TESTIMONY?

A. Mr. Buckner's proposals with regard to these items are not explicitly articulated. They are embedded in the calculation of his proposed Federal Income Tax Expense (found on his Amended Consumer Advocate Exhibit

Schedule 7). I will explain how this is the case later on in my testimony. When properly understood, this difference between the Company and Mr. Buckner with regard to the tax expense element of cost of service is not a disagreement about policy or accounting or some other issue upon which reasonable people might disagree. It is, instead, a clear cut - and fundamental - error in his calculation.

Q. WITH REGARD TO THE ADIT RATE BASE OFFSET, IN WHAT WAY IS MR. BUCKNER'S PROPOSAL ERRONEOUS?

A. Mr. Buckner’s error in this regard relates to his treatment of the Company's FIN 48 amount.[1] After a comprehensive analysis, the Company and its outside auditors have concluded it likely that its FIN 48 amount will not be a cost-free source of capital for the Company. Mr. Buckner, without any analysis whatsoever, nevertheless proposes to treat it as cost-free (Buckner, page 55, lines 7-13). In short he proposes that this Authority simply ignore the best available expert information.

[1] FIN 48 refers to the Financial Accounting Standards Board Interpretation No. 48, a pronouncement that is described in more detail later in this testimony.

Q. WHAT WOULD BE THE CONSEQUENCES OF THE ACCEPTANCE BY THIS AUTHORITY OF MR. BUCKNER'S TAX-RELATED PROPOSALS?

A. Their acceptance would deny the Company the opportunity to earn its allowed rate of return. In this regard, my testimony supports that of Company witness Michael Miller.

II. THE TAX EXPENSE ELEMENT OF COST OF SERVICE

A. Overview

Q. WHAT IS THE TAX EXPENSE ELEMENT OF COST OF SERVICE?

A. An investor owned utility ("IOU") such as TAWC files income tax returns and pays income taxes just like all other businesses. In fact, income taxes are an inevitable cost of an IOU's provision of regulated utility services. As a consequence, income taxes are one of the costs that must be factored into the rate-setting process in order to afford the utility an opportunity to earn an adequate return on its invested capital.

Q. IS CALCULATING THE TAX EXPENSE ELEMENT OF COST OF SERVICE A SIMPLE UNDERTAKING?

A. Unfortunately, it almost never is. There are two primary reasons for the complexity. First, the tax law is, itself, enormously complicated such that its application to any business transaction or set of transactions is highly difficult. However, even more problematic is the fact that many items of income and expense incurred by most utilities are treated very differently for regulatory purposes than they are for tax purposes. There are, in effect, two quite different regimes. It is reflecting the differences between these two regimes in the setting of rates that produces some of the knottiest problems.

Q. DID MR. BUCKNER REFLECT THE GAP BETWEEN THE REGULATORY AND THE TAX TREATMENT OF CERTAIN ITEMS PROPERLY IN HIS TAX EXPENSE CALCULATION?

A. No he did not.

Q. WHAT ERRORS DID HE COMMIT IN HIS CALCULATION?

A. Mr. Buckner committed two major errors. First, he failed to allow TAWC to recover from its customers certain tax benefits previously flowed through to them. Customers will, therefore, be provided the tax benefit of the same tax deductions twice (though, clearly the IRS would never allow such a double deduction). I will refer to this as the "Reversing Flow Through Error." Second, he failed to permit TAWC to recover enough to pay the tax it will owe on the recovery of its equity AFUDC[2] embedded in the depreciation it charges customers. As a consequence of this, the Company will not be afforded an opportunity to earn the rate of return that was incorporated into its AFUDC during the construction of its assets. I will refer to this as the "Reversing AFUDC Error."

[2] This term will be defined in the section of the testimony that addresses this error.

B. The Reversing Flow Through Error

Q. WHAT IS THE NATURE OF MOST OF THE DIFFERENCES BETWEEN THE TAX TREATMENT OF ITEMS AND THE REGULATORY TREATMENT OF THESE SAME ITEMS?

A. Most such differences involve items of income or expense that are reflected in rate-setting and on the tax return at different times. These are commonly referred to as "timing" or "temporary" differences.[3] With respect to these items, the same aggregate quantity of dollars ultimately get reflected for both purposes – just at different times.

Q. WHAT ARE SOME EXAMPLES OF TIMING DIFFERENCES?

A. For tax purposes, a utility may deduct expenditures as repairs for tax purposes that are capitalized and depreciated for regulatory purposes. Ultimately, the total cost of each expenditure is expensed for both regulatory and tax purposes. However, the timing of recognizing the expense is different. Deferred compensation often gives rise to timing differences. Cost of removal is accrued over the life of the asset for regulatory purposes while it is deducted when incurred for tax purposes. And, of course, there is depreciation. For regulatory purposes, assets are depreciated over specified regulatory lives on a straight line basis. For tax purposes, they are depreciated over specified tax lives (almost always shorter than the regulatory lives) using an accelerated method. Thus, as a

[3] Hereafter, I shall use the terms interchangeably.

general proposition, tax depreciation is a good deal more rapid than regulatory depreciation.

Q. WHAT IS THE CRITICAL FEATURE OF TIMING DIFFERENCES?

A. They reverse. In each case, the same item of income or expense is reported for both purposes – just over differing time frameworks. Thus, it is a "zero sum" game. For example, the more by which tax depreciation exceeds regulatory depreciation early in the life of an asset, the more by which regulatory depreciation must exceed tax depreciation later on in its life. The two are equal over time.

Q. HOW IS THE GAP BETWEEN THE REGULATORY AND THE TAX TREATMENT OF TIMING ITEMS TREATED IN THE CONTEXT OF UTILITY RATEMAKING?

A. In utility ratemaking, there are two alternative approaches to the treatment of this gap – normalization tax accounting and flow through tax accounting.

Q. WHAT IS NORMALIZATION TAX ACCOUNTING?

A. Using normalization tax accounting, one calculates regulatory tax expense by reference to the receipts and expenditures that are recognized for ratemaking purposes. In other words, tax expense is calculated by reference to "book" numbers – irrespective of how those items are reflected on the utility's tax return. The effect of this is that customers get the tax benefit commensurate with the expenses they fund.

Q. WHAT IS FLOW THROUGH TAX ACCOUNTING?

A. Using flow through tax accounting, one calculates regulatory tax expense by reference to the receipts and expenditures that are reflected on the utility's tax return. In other words, it is calculated by reference to "tax" numbers – irrespective of how those items are reflected for ratemaking purposes. Thus, if comprehensive flow through tax accounting were applied, the utility's tax expense element of cost of service would be equal to the tax it would pay to the government at that time.

Q. WHAT IS THE ESSENCE OF THE DIFFERENCE BETWEEN NORMALIZATION AND FLOW THROUGH TAX ACCOUNTING?

A. In both cases, the utility claims the same deductions on its tax return and enjoys the identical reduction in the tax due. The difference between the two approaches lies in who holds the tax money that is generated by the timing differences. Applying normalization, the utility holds the tax money until it must be paid back to the government, at which time it simply pays it back. Applying flow through, customers hold the tax money and they must pay it back to the utility when the utility must pay it back to the government. Note that, in either case, the utility has the obligation to pay the money back. Regulatory tax accounting does not impact the relationship between the utility and the government. Again, it only determines who holds the money that will be used to pay back the government until it is needed. The applicable accounting requirements reflect this reality.

Q. PLEASE PROVIDE A SIMPLE EXAMPLE.

A. Assume a utility undertakes a $3,000 software installation project. The cost of the project can be deducted ratably over 3 years for tax purposes ($1,000 per year) and is amortized over 10 years for regulatory purposes ($300 per year). The project is placed in service on the first day of Year 1. The federal tax rate is 35%.

Q. HOW DOES THIS SITUATION GET REFLECTED IN RATES UNDER NORMALIZATION TAX ACCOUNTING?

A. In Year 1, customers will be charged $300 for the project. The tax expense, which they also fund, will be reduced by $105 ($300 X 35%) – the tax benefit commensurate with the amount they are funding. However, the utility will deduct $1,000 on its tax return for that year and, thus, garner a $350 cash tax benefit. The $245 of the cash tax benefit not passed through to customers ($350 - $105) will be retained by the utility as a deferred tax "fund" and will be available to be reflected as zero cost capital so long as it exists. The same thing will happen in Years 2 and 3. By the end of Year 3, the utility will have accumulated a “deferred tax” fund of $735 ($245 X 3). In each of the 7 years from Year 4 through Year 10, customers will be charged (and the utility will collect) $300 of amortization. The $300 in revenue will be fully taxable (there will be no tax deductions flowing from the asset because its entire cost was deducted in Years 1, 2 and 3) and will give rise to a tax of $105 ($300 X 35%) in each year. However, customers will not be charged for this tax. Instead, the utility will fund each year's tax out of the $735 in cash it derived from the Years 1, 2 and 3 tax deductions. By the end of Year 10, the entire deferred tax fund will have been paid back to the government (7 X $105 = $735).

Q. HOW DOES THIS SITUATION GET REFLECTED IN RATES UNDER FLOW THROUGH TAX ACCOUNTING?

A. Because in Year 1 the utility claims a tax return deduction for $1,000 of the project costs, it enjoys a $350 tax benefit that will be flowed through to customers in that year by reducing the tax expense for which they are charged by that amount. In short, the benefit of the large tax deduction is passed through to customers. This is so notwithstanding that, in Year 1, customers funded only $300 of the cost of the project.

Q. WHAT IS THE RATE IMPLICATION OF REDUCING TAX EXPENSE BY $350?

A. Customer rates will be reduced not only by the $350 tax benefit, but by a "gross-up" factor. This gross-up factor is necessary to capture the incremental tax benefit produced by passing the $350 tax benefit through to customers (that is, taxable revenues will be reduced and that will further reduce the utility's tax liability). The actual reduction in Year 1 revenue requirement would be $540 ($350/[1-0.35]), where the tax rate is assumed to be 35%. Precisely the same things will transpire in Years 2 and 3.

Q. WHAT WOULD HAPPEN IN YEARS 4 THROUGH 10?

A. Even though, in each of those years, customers would be charged $300 for amortization, they would be provided no tax benefit. In fact, they already received the full tax benefit of the $3,000 incurred in connection with the software project in Years 1, 2 and 3. In each of the later 7 years, the utility will have a tax of $105 to pay on account of its collection of the $300 in depreciation-related revenues (again, there will be no tax deductions flowing from the asset because its entire cost was deducted in Years 1, 2 and 3). However, unlike the normalization situation, the utility will have no fund from which to pay the tax. This is because it passed the entire fund ($735) through to customers in Years 1, 2 and 3 by reducing their rates. Therefore, in each of the 7 subsequent years, customers must fund the tax. This will be done by increasing their tax expense sufficient to increase their revenue requirement by $162 each year. After paying $57 ($162 X 35%) of tax on the receipt of the money, the utility would have the $105 to pay each year's tax due to the government.

Q. ARE THE INCREMENTAL TAX PAYMENTS THAT MUST BE COLLECTED FROM CUSTOMERS IN YEARS 4 THROUGH 10 THE EFFECT OF THE REVERSAL OF THE FLOW THROUGH FROM YEARS 1, 2 AND 3?

A. Exactly. These amounts are merely the required repayment by customers of the tax benefit they enjoyed earlier.

Q. IS THIS REPAYMENT OBLIGATION CONTROVERSIAL?

A. Not in the slightest. The necessity to fund that tax on the reversal of a prior flow through is a natural feature of flow through tax accounting.

Q. WHICH OF THESE TWO TAX ACCOUNTING POLICIES DOES TAWC FOLLOW?

A. It is my understanding that the Company applied flow through tax accounting to all depreciation timing differences associated with assets acquired prior to 1981 and normalization tax accounting to all depreciation timing differences associated with assets acquired after 1980.

Q. HOW IS THIS RELEVANT TO MR. BUCKNER'S TESTIMONY?

A. In his testimony, Mr. Buckner proposes an extremely simplified tax expense calculation. This is set forth on Amended Consumer Advocate Exhibit Schedule 7. Most of the schedule is devoted to calculating pre-tax book income. In fact, line 23 is labeled precisely that – "Pre-tax Book Income." That amount ($4,728,442) is adjusted by a very small quantity ($6,961) of permanent differences (book/tax differences that never reverse) such as meals and entertainment and lobbying expenses. These expenditures, while they are recognized expenses for book purposes, will never be deductible for tax purposes. He then applies the state tax rate (6.50%) to this total ($4,735,403) to derive state tax expense element of cost of service ($307,801 on line 27). He proceeds to deduct the state tax expense so calculated ($307,801) from the state taxable income ($4,735,403) to derive federal taxable income ($4,427,602 on line 34). To this amount he applies the federal corporate tax rate of 35% to produce Federal Income Tax Payable of $1,549,661.[4] He completes his calculation by reducing this amount by the amortization of some investment tax credits claimed in prior years (this amortization is not relevant to the Company's disagreement with Mr. Buckner's calculation).

[4] Note that this label is inaccurate. This amount reflects the book, not tax, level of expenses. Thus, the fact that the Company can claim accelerated tax depreciation and accelerated repair deductions (and all other such differences) are not reflected in this number.

Q. HOW WOULD YOU SUM UP MR. BUCKNER'S TAX EXPENSE CALCULATION?

A. He basically applies the statutory tax rates to the Company's regulatory items of income and expense.

Q. ISN'T THAT NORMALIZATION TAX ACCOUNTING?

A. Yes it is.

Q. IF MR. BUCKNER'S TAX EXPENSE CALCULATION EMPLOYS NORMALIZATION TAX ACCOUNTING AND THIS COMMISSION APPLIES NORMALIZATION TAX ACCOUNTING, WHAT IS THE ISSUE?

A. Mr. Buckner does nothing to take account of all of the timing differences relating to assets it acquired prior to 1981 whose tax benefits were flowed through to customers in prior years and which now need to be repaid to the government. In his normalization calculation, he provides customers with a tax benefit commensurate with the expenses they are funding. However, to the extent that these expenses produced tax return benefits in prior years and those benefits were flowed through to customers, there are simply no additional tax benefits to give. Said another way, in Mr. Buckner's calculation, the same tax benefits that were flowed through to customers during the flow through period are now being provided to customers a second time. This is inconsistent with the accounting principles and outcomes described above, and is economically and equitably unjustifiable as well.

Q. PLEASE PROVIDE A SIMPLE EXAMPLE OF HOW THIS OCCURS.

A. I previously provided an illustration in which a utility undertakes a $3,000 project that is amortized over 3 years for tax purposes ($1,000 per year) and over 10 years for regulatory purposes ($300 per year). The federal tax rate is 35%.

Q. WHAT HAPPENS IF THE TAX BENEFIT OF THE YEAR 1, 2 AND 3 TAX DEDUCTIONS ARE FLOWED THROUGH?

A. As I indicated above, the tax expense element of cost-of-service is reduced by $350 ($1,000 X 35%) in each year and customer revenue requirement is reduced by $540. In so doing, the utility is providing the entire tax benefit of the $3,000 expenditure to customers in those three years. After that, there is no further associated tax benefit to give them.

Q. WHAT HAPPENS IF, IN YEAR 4, THE COMMISSION CHANGES TO NORMALIZATION TAX ACCOUNTING?

A. In Year 4, customers will be charged $300 of depreciation with respect to the asset (as they are in all years). Mechanically applying normalization tax accounting, the utility would provide to customers a tax benefit calculated by reference to the regulatory expense – that is, $300. Thus, the tax expense element of cost-of-service would be reduced by $105 ($300 X 35%) in that year.

Q. IS THAT WHAT MR. BUCKNER'S CALCULATION DOES?

A. That is precisely what Mr. Buckner's calculation does.

Q. IS THAT CORRECT?

A. No. It is wrong. In Years 1, 2 and 3, customers received the tax benefit of the entire $3,000 expenditure. Giving them a $105 tax benefit in Year 4 (not to mention in each of the subsequent 6 years) clearly double-counts. The same benefits are effectively taken twice. This is patently improper. It uses a tax benefit for ratemaking purposes which clearly the IRS would not allow for tax purposes.

Q. WHAT SHOULD HAPPEN?

A. In Years 4 through 10, the timing difference reverses. Customers have to return the tax benefit to the utility so that it can pay the tax it owes to the government. The change from flow through accounting to normalization does not relieve customers of the obligation to pay back the "front-ended" tax benefits they previously received.

Q. HOW IS THIS OBLIGATION DISCHARGED?

A. An adjustment to the tax expense element of cost-of-service must be made to reflect the fact that the regulatory depreciation that customers are funding carries with it no tax benefits (*i.e.*, they were already provided). Mechanically, this increases the utility's effective tax rate. Mr. Buckner's calculation does not include any such adjustment. It therefore is materially incorrect.

Q. IS IT THE REVERSAL OF THESE PRIOR FLOW THROUGHS THAT MR. BUCKNER FAILS TO CONSIDER?

A. Yes it is. As explained in the rebuttal testimony of Mr. Miller, the income tax calculation in the Company's filing properly captures this effect.

C. <u>The Reversing AFUDC Error</u>

Q. WHAT IS AFUDC?

A. AFUDC is the acronym for Allowance for Funds Used During Construction. It relates to construction projects. TAWC has capital tied up in projects as they are constructed. However, because these facilities are not included in rate base until they are placed in service and, consequently, do not earn a cash return until then, TAWC has no ability to recover the cost associated with this capital from its customers during the period of construction. AFUDC is an accounting mechanism which remedies this situation. The Company calculates its cost of the capital it uses in its construction projects – both the cost of debt and the cost of equity capital. This is its AFUDC rate. This rate is then applied to the construction balance to produce AFUDC, the cost of the capital tied up in construction projects for the period. This AFUDC amount is then added to the balance of the construction project (*i.e.*, it is capitalized). By capitalizing AFUDC, TAWC's customers are not required to pay for it – at least for the time being. However, the capitalization increases the carrying value of the asset, producing greater book depreciation when it is finally placed in service. It is by means of this incremental depreciation charge – the recovery of the previously capitalized AFUDC – that TAWC eventually recovers from customers its construction period cost of capital. In short, AFUDC is a mechanism to defer the recovery of a return during the construction period of an asset until it is operating and providing service to customers.

Q. SO SOME PORTION OF THE INCREMENTAL DEPRECIATION REPRESENTS THE COLLECTION OF BOTH A DEBT AND AN EQUITY RETURN ON THE CONSTRUCTION PROJECT WHILE IT WAS BEING CONSTRUCTED?

A. Yes it does. When customers pay the incremental depreciation, they pay for the deferred construction period cost of capital, including a deferred equity return.

Q. PLEASE PROVIDE A SIMPLE ILLUSTRATION OF THIS CONCEPT.

A. Assume that an investor decides to build a $5 million rental property that will take a year to construct. The cost of the building is incurred ratably over the one-year period. The investor, thus, has an average of $2.5 million tied up in the project during the year. If all of the funds were borrowed from a bank at 6% interest, then the investor will pay $150,000 during the construction period ($2,500,000 x 6%). The building obviously produces no revenue for the year during which it is under construction. Therefore, the investor must look to future rental income to not only compensate him for the investment and operating costs once the building is in service but the future rental income must be sufficient to recover the construction period interest as well. If, instead of borrowed funds the investor used his own funds, the same economics apply. However, instead of recovering the construction period interest, he must recover the economic cost of his equity tied up in the project for the year ($300,000 assuming an equity cost of 12%). In a utility context, the way this is accomplished is to compute equity AFUDC (in this example, $300,000) and capitalize it into the carrying value of the building ($5,000,000 + $300,000 = $5,300,000). Customers will be charged for depreciation of the building over its life. Each year about 6% ($300,000/$5,300,000) of the customer depreciation charge will represent the recovery of the construction period equity return.

Q. IS THIS WHAT YOU REFER TO AS THE REVERSAL OF AFUDC?

A. Yes it is.

Q. WHAT IS THE NATURE OF AN EQUITY RETURN?

A. An equity return is an after-tax amount.

Q. WHAT DOES IT MEAN TO BE AN AFTER-TAX AMOUNT?

A. It means that it is an amount that the entitled party must be left with after all taxes are paid on account of the collection of the amount. Thus, in order to recover $1 of equity return, a utility must receive an amount which is "grossed-up" to reflect the tax that will need to be paid upon the collection of that equity return. With a federal income tax rate of 35%, the amount that must be collected to produce $1 of equity return is $1.54. Upon receipt of that amount, a tax of $.54 ($1.54 X 35%) will be paid. That will leave the utility with the required $1 of equity return.

Q. IS THIS "GROSS-UP" REQUIRED REGARDLESS OF WHETHER THE EQUITY RETURN IS COLLECTED (1) WHEN THE COST OF CAPITAL IS INCURRED OR (2) WHEN IT IS DEFERRED UNTIL THE ASSET IS PLACED IN SERVICE (AS IS THE CASE WITH AFUDC)?

A. It is necessary in either case.

Q. IN THE CASE OF REVERSING EQUITY AFUDC, HOW IS THE GROSS-UP REFLECTED?

A. It is reflected in the tax expense element of cost-of-service.

Q. MORE SPECIFICALLY, HOW IS THIS ACCOMPLISHED?

A. Mechanically, the portion of the book depreciation which is equity AFUDC is presented in the tax expense calculation as depreciation for which no tax benefit is provided. As such, it increases the effective tax rate above the statutory rate.

Q. CAN YOU PROVIDE A SIMPLE EXAMPLE?

A. Yes I can. Assume that an asset costs $1,000 to construct for both book and tax purposes and that it produces $100 of equity AFUDC during its construction period (which gets added to its book value but does not produce any tax basis). Further assume that the asset, once placed in service, is depreciated ratably over 10 years for both book and tax purposes and that the applicable federal tax rate is 35%. Such an asset will produce $110 of annual book depreciation and $100 of annual tax depreciation. If customers are charged $110 to fund the book depreciation, the company will produce $10 of taxable income ($110 of revenue reduced by $100 of tax depreciation). A tax of $3.50 ($10 X 35%) will be imposed. The company's income statement will appear as follows:

Revenues	$110.00
Book Depreciation	($110.00)
Income Before Tax	0.00
Tax	($3.50)
Profit/Loss	($3.50)

The loss indicates that the company failed to collect the full amount of the AFUDC embedded in its depreciation charge. The company must be allowed to adjust its tax expense to permit recovery of the tax due. Of course, because it is itself taxable, the revenue required to fund a tax of $3.50 is necessarily a grossed-up amount – in this case $5.40 ($3.50/(1 - 0.35)). So, if, in addition to the $110 of depreciation, customers are charged an additional $3.50 of tax expense (an additional $5.40 in revenue requirement), the company will produce $15.40 of taxable income ($115.40 - $100) upon which a tax of $5.40 ($15.40 X 35%) will be imposed. The company's income statement will appear as follows:

Revenues	$115.40
Book Depreciation	($110.00)
Income Before Tax	$5.40
Tax	($5.40)
Profit/Loss	$0.00

This demonstrates that the company fairly collected the entire AFUDC component of its book depreciation charge.

Q. IS THE INCREASE IN TAX EXPENSE NECESSARY TO FULLY RECOVER THE REVERSAL OF EQUITY AFUDC A CONTROVERSIAL PROPOSITION?

A. Not in my experience. It is a standard aspect of ratemaking for AFUDC.

Q. WHAT IS THE ERROR IN MR. BUCKNER'S CALCULATION?

A. Mr. Buckner has failed to increase tax expense to allow for the recovery of the tax that will be imposed on the collection of TAWC's reversing equity AFUDC. Again, as explained in the rebuttal testimony of Mr. Miller, the income tax calculation in the Company's filing captures this effect.

III. <u>EXCESSIVE ACCUMULATED DEFERRED INCOME TAXES</u>

Q. WHAT ARE ACCUMULATED DEFERRED INCOME TAXES?

A. In the usual utility context, ADIT represents the incremental cash available to the utility as a result of being able to reflect its expenses more rapidly for tax purposes than for regulatory purposes. It is useful to think of ADIT as a loan from the government to the utility, which must be paid back at some point in the future. The example earlier in this testimony involving a $3,000 software project illustrates this. The tax amortization period was 3 years and the regulatory period 10 years. In each of the first three years for the asset's life as the utility claims tax depreciation, the government extends a loan of $245 ([$1,000 tax amortization - $300 regulatory amortization] X 35% [the tax rate]). In each year from the fourth through the tenth, the utility pays back $105 ([$0 - $300] X 35%). ADIT loans are extended without interest. Thus, where a utility has access to a governmental loan, it is appropriate to treat it as zero cost capital – but only if the loan is, in fact, interest-free.

Q. PLEASE EXPLAIN THE REASON WHY YOU BELIEVE MR. BUCKNER'S ADIT CALCULATION IS EXCESSIVE?

A. Mr. Buckner includes as ADIT its FIN 48 amounts which, in my view, should not be reflected there because, unlike “normal” ADIT, it is inappropriate to treat them as zero cost capital.

Q. WHAT IS THE FUNDAMENTAL ISSUE WITH REGARD TO FIN 48?

A. This issue is not conceptually complex. The Company has borrowed money from the federal government. The government makes loans for which it charges interest and ones for which it does not charge interest. The Issue is which of these two types of loans the Company has received. The Company has treated its FIN 48 liability as a loan requiring interest. Mr. Buckner proposes to treat it as interest-free.

Q. WHAT IS THE DIFFERENCE BETWEEN THE TWO TYPES OF LOANS?

A. The difference is best illustrated by a simple, albeit extreme, example. Assume that a water utility builds a plant at a cost of $1 million. On its tax return, it is the water utility’s position that the plant is depreciable over 25 years on an accelerated basis. This would be the technically correct tax treatment. The utility would claim accelerated depreciation on its tax return and, by virtue of that fact, reduce its tax liability. The reduction in the tax liability would effect a loan from the government. Indeed, that is the purpose of accelerated depreciation. The loan will be paid back in the later years of the plant's useful life (*i.e.*, after year 25) when the plant is still providing service (and, therefore, taxable revenue) but no additional tax depreciation (it has all been claimed). Because the loan is repaid by the filing of future tax returns, there is no interest associated with it. It is interest-free as long as it is outstanding. By contrast, if the water utility decides to deduct the entire cost of the plant in the year it is placed in service, the deduction will reduce its tax liability for that year. Although this would be an incorrect tax position, it would also effect a governmental loan – one larger than the loan created by "merely" claiming accelerated depreciation. Upon audit, the Internal Revenue Service will disallow the tax deduction to the extent it exceeds the permissible level of depreciation and require the utility to pay back a substantial portion of the loan immediately – with interest. Thus, this latter type of loan is not repaid by filing a subsequent tax return but by receiving an assessment from the IRS relating to a previously-filed tax return.

Q. WHAT ARE THE CRITICAL DISTINCTIONS BETWEEN THE TWO TYPES OF LOANS?

A. Though both loans are extended through the tax system, they are very different. The first loan, the "depreciation" loan, is a creature of the tax law. It is the result of a conscious decision by Congress to subsidize the cost of capital assets by the extension of interest-free loans. The benefit of that subsidy is clearly one that needs to be reflected in the ratemaking process – and it is through the reflection of the loan in the ADIT balance and the reduction of rate base by that balance. The second loan, the "expense" loan, is not part of a Congressional subsidization scheme and will cost the utility a carrying cost. In fact, by reflecting an aggressive tax position on its tax return, the utility simply borrowed money from the government in the same way it could have from a bank (though, admittedly, the formalities are quite different).

Q. IN THE "EXPENSE" LOAN SITUATION, IS THE LOAN INTEREST-FREE UP UNTIL THE IRS REQUIRES REPAYMENT?

A. No. It is never interest-free. The IRS will charge interest on its assessment not from the date of the assessment, but from the date the utility filed its tax return – that is, from the date of the loan itself. In short, there is no period during which such a loan is interest-free.

Q. WHAT IS THE DISAGREEMENT BETWEEN THE COMPANY AND MR. BUCKNER?

A. The Company believes that its FIN 48 amount is properly treated as a loan of the second type. Mr. Buckner believes it should be treated as a "depreciation" loan.

Q. WHAT IS FIN 48?

A. FIN 48 is an accounting pronouncement issued in 2006 by the Financial Accounting Standards Board ("FASB"), the body that establishes the rules that constitute "generally accepted accounting principles." FIN 48 prescribes the way in which companies must analyze, quantify, and display the consequences of tax positions that are technically uncertain. It applies to years beginning after December 15, 2006 — that is, for calendar year 2007 and thereafter.

Q. WHAT IS THE PURPOSE OF FIN 48?

A. Each taxpayer has the responsibility both for reporting how much it owes and for paying that amount. This self-reporting is subject to review (i.e., audit) by the relevant taxing authorities. The tax law is exceedingly complex and contains many provisions that are subject to more than one interpretation. Moreover, it is often possible to view business transactions in more than one way. It is not uncommon for a taxpayer to, either knowingly or unknowingly, interpret the tax law in a way that could be disputed. It is similarly not uncommon for a taxpayer to view a transaction, and, hence, the tax consequences of the transaction, in a way that could be disputed. FIN 48 prescribes a single standard, a single process, and a single disclosure regime for uncertain tax positions

Q. WHAT HAPPENS AS A RESULT OF THE APPLICATION OF FIN 48?

A. FIN 48 requires that a taxpayer identify all of its "tax positions." The definition of a tax position is very broad. It really goes to the way in which an economic action is reflected on a tax return. With respect to those that are uncertain (i.e., subject to dispute by the tax authorities), the extent of the uncertainty must be evaluated.

Q. WHAT IS THE NATURE OF THIS EVALUATION?

A. The evaluation process is extremely rigorous. Not only do the company's internal tax people analyze the positions and assess the risk levels, the company's external auditors, most especially their tax experts, thoroughly review the results of the company's process and often challenge its conclusions. At the end of the process, the company and its external auditors generally reach a consensus as to the amount of tax at risk with respect to each uncertain tax position (*i.e.*, how much incremental tax is it likely will be paid or recovered).

Q. WHAT WOULD FIN 48 MEAN IN TERMS OF YOUR SIMPLE EXAMPLE SET OUT ABOVE?

A. In the context of that example, one might say that the purpose of FIN 48 is precisely to distinguish between "depreciation" loans and "expense" loans.

Q. HOW IS THE AMOUNT AT RISK REFLECTED?

A. As a general proposition, the amount of tax that more likely than not will be paid to the taxing authorities in connection with the uncertain position must be reflected by the company on its balance sheet as a tax liability. FIN 48 does not permit this amount to be reflected as ADIT.

Q. ARE THERE ANY ADDITIONAL CONSEQUENCES?

A. Yes. Interest must be accrued on any amount recorded as a liability under FIN 48 at the rates imposed by the relevant taxing authorities on tax underpayments. In addition, where appropriate, any applicable penalties must be accrued.

Q. WHAT, THEN, DO FIN 48 ENTRIES ECONOMICALLY REPRESENT?

A. FIN 48 amounts represent the incremental quantity of tax that the company and its auditors have concluded that it will most likely owe with respect to previously filed tax returns. These amounts will be payable with interest when they are assessed.

Q. BUT WHAT HAPPENS IF THE DETERMINATION OF THE UTILITY AND ITS AUDITORS REGARDING THE LIKELY TAX OUTCOME TURNS OUT TO BE WRONG?

A. When it becomes less likely than not that the uncertain tax deduction provides cost-free capital, then the FIN 48 entries will be reversed and the amounts can appropriately be treated as zero cost capital.

Q. WHAT IS THE ISSUE WITH FIN 48 THAT THE AUTHORITY MUST CONSIDER?

A. Where a utility holds a quantity of capital the cost status of which is uncertain, should this Commission make the presumption that it is cost-free simply because of the mechanical manner in which it was procured (by means of a tax return) or should it give consideration to the analysis of the experts inside and outside of the utility in forming its conclusion as to the capital's cost status?

Q. IS THERE UNCERTAINTY ASSOCIATED WITH THE FIN 48 TAX LIABILITY?

A. Yes there is – and the uncertainty cuts both ways. It is uncertain that the governmental loans will require interest. By the same token, it is uncertain that the governmental loans will be interest-free. Thus, there will be uncertainty regardless of which position is adopted.

Q ARE YOU SUGGESTING THAT IT COMES DOWN TO A CHOICE BETWEEN TWO UNCERTAINTIES?

A. Exactly. And it is my view that the Authority ought to adopt the more certain of the two uncertainties – that is, to respect the FIN 48 characterization.

Q. IN REACHING ITS DETERMINATION, SHOULD THE AUTHORITY ENCOURAGE TAWC TO TAKE UNCERTAIN TAX POSITIONS?

A. Absolutely. The successful assertion of an uncertain tax position has the capacity to produce incremental cost-free capital. Consequently, it is in the customers' best interests for the Authority to encourage such positions. Obviously, when the governmental funds produced by the assertion of an uncertain tax position are treated as cost-free capital without regard to their probable real cost, it becomes contrary to the Company's interest to make the attempt.

Q. WHAT IS THE COMPANY'S POSITION ON THIS QUESTION?

A. The Company maintains that, where of two possible statuses, one is more likely than the other, presuming the less probable of the two in the setting of rates would seem counter intuitive. Certainly it makes much more sense to presume the more likely alternative. In this case, the more likely alternative is the non-cost-free status of FIN 48 amounts.

Q. HAS ANY OTHER COMMISSION CONSIDERED THE PROPER RATEMAKING REFLECTION OF FIN 48 ENTRIES?

A. Three other commissions that I know of have done so: Missouri, Kentucky and Texas.

Q. PLEASE DESCRIBE THE MISSOURI COMMISSION'S DETERMINATION.

A. In a Missouri rate case decision involving AmerenUE (Case No. ER-2008-0318) issued at the end of January of 2009, the Missouri Commission stated:

> AmerenUE would exclude its FIN 48 liabilities from Staff's calculations of deferred taxes for ratemaking purposes. Staff would treat the entire amount of potential tax liability as if AmerenUE will win on all positions and never have to pay the tax.
>
> If the ultimate outcome before the IRS matches the FIN 48 analysis, in other words, AmerenUE loses the uncertain tax positions, there would be no deferral of tax and no means by which AmerenUE would recover the amount that reduced rates, but was not actually realized by the company.
>
> Both ratepayers and shareholders benefit when AmerenUE takes an uncertain tax position with the IRS, because saving money on taxes benefits the company's bottom line and reduces the amount of expense the ratepayers must pay. At the hearing, Staff's witness agreed AmerenUE should pursue such positions. The best way to encourage AmerenUE to continue to take uncertain tax positions is to treat the company fairly in the regulatory process.
>
> AmerenUE should not be required to recognize as deferred taxes the amount of its uncertain tax positions it ultimately expects to pay with interest to the IRS. The best means of determining that amount is by recognizing the

> allocation of those costs AmerenUE already makes under FIN 48. Therefore, the Commission will exclude from the deferred taxes account the amount of AmerenUE's FIN 48 liability.

Q. PLEASE DESCRIBE THE KENTUCKY COMMISSION'S DETERMINATION.

A. In a rate case involving Kentucky-American Water Company (Case No. 2010-00036), an affiliate of TAWC's, the Kentucky Commission considered precisely the same uncertain tax position present in this proceeding – the uncertainty resulting from the Company's change in its tax method of accounting for repairs. In an order issued in December of 2010, the Commission stated:

> Kentucky-American determined that some uncertainty exists regarding the legality of the deduction related to the change in accounting methods. No party challenges the reasonableness of this determination or the appropriateness of establishing a reserve in the event of an adverse IRS ruling. Kentucky-American's action, moreover, is consistent with FIN 48. If the IRS ultimately allows the deduction or the statute of limitations expires without a challenge to the deduction, ratepayers and shareholders will benefit from the deferral. If the IRS disallows Kentucky-American's deduction, Kentucky-American has stated that it will not seek recovery for interest and penalties imposed by the IRS and the ratepayers will not be negatively affected.

The Commission approved Kentucky-American's proposal that its FIN 48 amount not be treated as a rate base reduction.

Q. PLEASE DESCRIBE THE TEXAS COMMISSION'S DETERMINATION.

A. In a Texas rate case decision involving Oncor Electric Delivery Company (Docket No. 35717) issued at the end of July of 2009, the Texas commission determined to follow FERC's accounting statement and include the FIN 48 amounts in ADIT. The commission's primary rationale was that the IRS might not audit or reverse Oncor's position as to the tax deductions identified as FIN 48 deductions.

Q. HOW SHOULD THIS AUTHORITY THINK ABOUT THESE THREE PROCEEDINGS?

A. In my view, the Missouri commission articulated solid reasoning and reached an enlightened approach that is fair and that, in the long run, will benefit customers by encouraging the adoption of prudently aggressive tax positions. The Kentucky Commission followed this reasoning. While I certainly respect the Texas commission, its reasoning on this particular point was perfunctory and, to my mind, unconvincing.

IV. <u>CONCLUSION</u>

Q. WILL YOU SUMMARIZE YOUR TESTIMONY?

A. Certainly. This testimony makes the following points:

1. The Company must be allowed to increase its tax expense to enable it to recoup the tax benefits previously flowed through to

customers. Those tax benefits have now reversed and it is incumbent upon this Commission to honor the commitment implicit in the adoption of flow through tax accounting to fund those taxes when they become due. Doing this will also avoid passing through to customers a tax benefit that does not, in fact, exist.

2. The Company must be allowed to increase its tax expense to enable it to recover the tax it will pay on the recovery of its equity AFUDC. Failure to do so would convert what should be (and what was intended to be) an after-tax return into a pre-tax return. In short, if this Commission does not permit the increase, the Company will collect less than 65% of its AFUDC instead of the entire balance, as would be proper.

3. The Company and its outside auditors have gone to great lengths to ascertain the extent to which its future tax liabilities will or will not be interest bearing. To the extent that it has determined that they will be interest bearing (*i.e.*, to the extent of its FIN 48 liability), the liability should not be reflected in the Company's ADIT as zero-cost capital. The Commission should adopt the more likely than not conclusion rather than the less likely than not one.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

TENNESSEE REGULATORY AUTHORITY

DISTRICT OF COLUMBIA) **ss:**

BEFORE ME, the undersigned authority, duly commissioned and qualified in and for the State and County aforesaid, personally came and appeared James I. Warren, being by me first duly sworn deposed and said that:

He is appearing as a witness on behalf of Tennessee-American Water Company before the Tennessee Regulatory Authority, and if present before the Authority and duly sworn, his rebuttal testimony would set forth in the annexed transcript consisting of 37 pages.

James I. Warren

Sworn to and subscribed before me
this 9th day of February 2011.

Valerie T. Beverly
Notary Public

My commission expires

VALERIE T. BEVERLY
Notary Public District of Columbia
My Commission Expires 5/14/2012