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MISSOURI PUBLIC SERVICE COMMISSION

Case No. ER-2011-0028

REBUTTAL TESTIMONY

OF

JAMES I. WARREN

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a Ameren Missouri

St. Louis, Missouri
March, 2011

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OF

JAMES I. WARREN

CASE NO. ER-2011-0028

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 Missouri Public Service Commission ("Commission") on behalf of Union Electric Company d/b/a Ameren Missouri ("UE" or "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) and 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, Tennessee, 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. The purpose of my testimony is to respond to four aspects of the direct testimony of Michael L. Brosch filed on behalf of the Missouri Industrial Energy Consumers. I shall address his proposals to reflect in UE's federal income tax expense the effect of tax deductions claimed by Ameren Corporation ("Ameren") that are attributable to the payment of dividends (1) by Ameren with respect to Ameren stock held by Ameren's qualified Employee Stock Ownership Plan ("ESOP") and (2) by UE with respect to certain preferred stock issued by UE (Page 4, line 19 through Page 5, line 17). Insofar as the Missouri Public Service Commission Staff has also proposed these adjustments (Staff Report, Revenue Requirement, Cost of Service, page 105), my testimony responds to

their proposal as well. I shall also address his proposal that this Commission alter the policy it adopted barely two years ago in a Company rate proceeding (Case No. ER-2008-0318) regarding the treatment of its FIN 48 amounts (Page 8, line 6 through page 22, line 8). Finally, I shall respond to Mr. Brosch's "placeholder" comments regarding the Company's treatment of tax net operating losses (Page 22, line 9 through page 24, line 12).

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS AS TO THESE FOUR ISSUES.

A. 1. The tax benefit attributable to Ameren's dividends paid with respect to ESOP stock is unrelated to the provision of UE's regulated service and is, therefore, properly ignored in the calculation of its cost of service;

2. In contrast to the ESOP dividend paid deduction referenced above, the tax benefit attributable to UE's dividends paid with respect to certain preferred stock should arguably have an impact on UE's cost of capital (preferred capital). As a consequence, it is my opinion that it is appropriate to include this tax benefit in UE's cost of service;

3. This Commission just recently developed a policy for the Company's FIN 48 amounts which the Company believes is sound and works for the long term benefits of both the Company and its customers. Mr. Brosch's invitation to alter this considered judgment should be declined; and

4. The Company's treatment of its net operating loss ("NOL") carryforwards is entirely proper and accurately reflects the economic consequences of these tax attributes.

The ESOP Dividends Paid Deduction

Q. WHAT IS AN ESOP?

A. An ESOP is one of a number of types of tax-qualified employee benefit plans that must meet a complex set of requirements established by the Internal Revenue Code ("Code"). Where the requirements are met, there are certain tax advantages that follow.

Q. DOES UE MAINTAIN AN ESOP?

A. UE does not itself maintain an ESOP. However, its parent, Ameren does maintain an ESOP as a component of its 401(k) plan (again, a type of tax-qualified benefit plan). All eligible employees of all of the corporations in the Ameren group – including those of UE - can, if they wish, participate in the Ameren 401(k) plan.

Q. GENERALLY, HOW DOES THIS WORK?

A. Each year, each eligible employee has the discretion to have a designated percentage (up to a limit) of his or her salary withheld and contributed to the Ameren 401(k) plan. The employee's employer will then match a percentage of that contribution, also up to a limit. The employee has the right to select into which one of more than 21 investment funds his or her contribution (including the match) will be placed. One of the investment fund options is the Ameren ESOP. Thus, each employee who decides to participate in the 401(k) plan can make a decision to invest none, some or all of his or her contribution (including the match) in Ameren stock. This investment decision can be changed periodically.

Q. WHAT ARE THE TAX BENEFITS ASSOCIATED WITH THIS TYPE OF TAX-QUALIFIED BENEFIT PLAN?

A. The employer gets a tax deduction for the compensation paid to its employee, including the amount that the employee contributes to the 401(k) plan. The employer also gets a deduction for the match. The employee reports neither his or her contribution nor the Company match as taxable income until he or she receives distributions from the plan. The fact that the employer can claim a deduction while the employee does not report taxable income is unusual in the tax law and is a clear benefit intended to be supportive of the creation of such benefit plans. Moreover, and of particular relevance to this proceeding, the Code permits a deduction to any corporation that pays a dividend on its stock to the extent that such stock is held by an ESOP.

Q. WHICH CORPORATION IS ENTITLED TO THE DIVIDENDS PAID TAX DEDUCTION PROVIDED FOR BY THE CODE?

A. The Code provides that a deduction is available to a corporation that pays a dividend with respect to "applicable employer securities." It further provides that "applicable employer securities" include common stock issued by the employer or a member of the group of corporations of which the employer is a member that are held in an ESOP. Obviously it is Ameren, not UE or any other Ameren subsidiary, that pays the dividends with respect to "applicable employer securities." It is Ameren, therefore, that is entitled to the dividends paid tax deduction under the Code.

Q. HOW HAS UE TREATED THE TAX BENEFITS OF ITS 401(k) QUALIFIED PLAN FOR RATEMAKING PURPOSES?

A. UE funds both its employees' salaries as well as the 401(k) matches for its employees. These amounts are included in UE's cost of service. Consequently, UE has claimed tax deductions for these expenditures on its tax returns. Since these are expenditures included in UE's cost of service that produce a tax benefit, it is appropriate and necessary to reflect that tax benefit in establishing UE's tax expense for ratemaking purposes, and UE has done so. By contrast, UE does not pay dividends with respect to "applicable employer securities," nor has it included any such dividend payments in its cost of service. Further, it has not claimed a tax deduction for dividends paid with respect to such stock. Its parent, Ameren, has. It would, therefore, be inappropriate for UE to reflect the benefit of the tax deduction available to Ameren in establishing its tax expense for ratemaking purposes.

Q. YOU STATE THAT UE HAS NOT INCLUDED ANY OF THE DIVIDENDS AMEREN PAYS IN ITS COST OF SERVICE. PLEASE ELABORATE.

A. UE's cost of service does not include dividends paid by Ameren on a number of levels. First, and most obviously, whether or not Ameren pays a dividend is completely unrelated to UE's "pre-tax" cost of service. Customers pay not a nickel more or less because of Ameren's dividend policy – though Mr. Brosch would apparently like to change this.

Q. IS AMEREN'S PAYMENT OF DIVIDENDS NECESSARILY RELATED TO UE'S OPERATIONS?

A. No it is not. Any dividend paid by Ameren is paid at the sole discretion of Ameren's Board of Directors. The Board's decision in this regard is not legally dependent on

anything that occurs at UE. Ameren has numerous sources of funds out of which it can pay dividends. It has other subsidiaries that provide cash. But, it is not even necessary that it receive a single dollar from its subsidiaries in order for it to pay dividends. Ameren can simply borrow any money it needs to pay a dividend. In other words, the dividends paid deduction can be generated with or without distributions from UE.

Q. IS THE FACT THAT THE DEDUCTION IS ATTRIBUTABLE TO THE PAYMENT OF DIVIDENDS SIGNIFICANT?

A. Very significant. Dividends are paid out of a corporation's retained earnings. Retained earnings represent the investment its shareholders have in the company. Clearly, a utility's retained earnings belong to its shareholders – not its customers. The disposition of a utility's retained earnings is a matter of relevance to shareholders only and should have no impact on the utility's cost of service. Ameren is UE's shareholder, and UE's retained earnings belong to Ameren. Similarly, any tax consequence associated with the disposition of the retained earnings that belongs to Ameren should have no impact on UE's cost of service.

Q. IS THIS PRINCIPLE GENERALLY RECOGNIZED IN THE REGULATORY COMMUNITY?

A. Yes it is. For example, if a utility makes a charitable contribution that is not permitted to be included in its cost of service (either by statute, regulation or regulatory order), the contribution is shouldered by the company's shareholders. In every jurisdiction of which I am aware, the benefit of the tax deduction produced by such a "disallowed' contribution is likewise excluded from cost of service. Since shareholders fund the contribution, they

are allocated the tax benefit of the contribution. This same treatment is afforded all disallowed and non-included costs. The principle is, in my experience, universal.

Q. HOW DOES THIS PRINICPLE IMPACT THE ESOP DIVIDENDS PAID DEDUCTION?

A. The expenditure of a charitable contribution that is not included in cost of service represents a disposition of shareholder, not customer, funds. The same is true of the payment of a dividend. The treatment of the tax consequences should be no different.

Q. IS THE TAX BENEFIT IN THIS CASE EVEN MORE REMOTE FROM UE'S CUSTOMERS?

A. Yes it is. The charitable contribution example above addresses the disposition of utility retained earnings owned by a utility's shareholder. However, the dividends that produce the tax benefit in this case are not those paid by UE – the utility. They are the dividends paid by Ameren – the parent corporation. Thus, we are talking not about the disposition of retained earnings owned by UE's shareholder - Ameren. To the contrary, we are talking about the disposition of retained earnings owned by the shareholders of UE's shareholder – by the general public who own Ameren's stock. The relationship between the tax benefit and UE's customers is attenuated in the extreme.

Q IS THE DISCRETION EXERCISED BY UE EMPLOYEES RELEVANT TO YOUR CONCLUSION?

A. Yes it is. As I indicated above, employees who elect to participate in the Ameren 401(k) have 21 investment options available to them. One of them is to invest their earnings in

the Ameren ESOP. It is only with respect to those investments that a dividends paid deduction is possible. Consequently, the source of that deduction is, in one sense, an investment decision made by UE employees with respect to money they have earned – after they have earned it. In other words, the deduction does not flow from compensating them. It flows from the way they choose to invest their earnings ***after*** they are compensated. In this way, too, the tax benefit is unrelated to the customers' cost of service.

Q. WHAT, THEN, DO YOU CONCLUDE WITH REGARD TO THE COMPANY'S TREATMENT OF THE ESOP DIVIDENDS PAID DEDUCTION TAX BENEFIT?

A. In my opinion, the Company's exclusion of the tax benefit from its tax expense calculation was entirely appropriate. Otherwise, UE's ratepayers would receive a benefit from the discretionary disposition by Ameren of *Ameren's* property, which would be inappropriate.

The Preferred Dividends Paid Deduction

Q. PLEASE COMMENT ON MR. BROSCH'S POSITION REGARDING THE TREATMENT OF THE TAX BENEFIT PRODUCED BY DIVIDENDS PAID WITH RESPECT TO CERTAIN PREFERRED STOCK.

A. The Code provides for a tax deduction in the amount of the dividends paid with respect to certain utility preferred stock. UE has such stock outstanding and, consequently, pays dividends that produce tax deductions. This tax benefit this deduction produces belongs to UE and not to any other Ameren group company. Further, the benefit is associated

with UE's providers of preferred capital – not the providers of capital for any other Ameren group company. Finally, preferred stock is, in many ways, very similar to debt. Just as the tax benefit of the interest deduction associated with UE's debt is reflected in UE's cost of service, so, arguably, should the dividend deduction associated with its eligible preferred stock. For these reasons, it is my opinion that it would be appropriate to reflect the tax benefit of UE's preferred dividend paid deduction in its cost of service.

FIN 48 and the Company's ADIT Balance

Q. IS THE "FIN 48" ISSUE RAISED BY MR. BROSCH A NEW ONE FOR THIS COMMISSION?

A. No it is not. The Commission addressed this precise issue in depth in the Company's rate proceeding Case No. ER-2008-0318.

Q. WHY, THEN, IS MR. BROSCH RAISING THE SAME ISSUE IN THIS PROCEEDING?

A. He does so because he didn't like the considered judgment of this Commission the last time the issue was addressed, approximately two years ago. He is apparently hoping to re-litigate this issue to achieve a more favorable result for his clients.

Q. IN YOUR VIEW, IS THERE ANY REASON WHATSOEVER THAT THIS COMMISSION SHOULD ALTER THE JUDGMENT IT REACHED IN CASE NO. ER-2008-0318?

A. None. The Commission got it right the first time.

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

A. The issue distills down to whether or not this Commission should set rates using the best expert information available. The Company supports this. Mr. Brosch opposes it.

Q. PLEASE PROVIDE A SUMMARY OF THE BACKGROUND OF THIS ISSUE.

A. While I understand that the Commission developed a complete understanding of this issue in the Company's rate case two years ago, I will summarize briefly the basics of FIN 48 as a means of refreshing the Commission's recollection. The FIN 48 issue is not conceptually complex. The Company has, through its income tax return filings, essentially 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. Brosch 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 an electric utility builds a distribution line at a cost of $1 million. On its tax return, it takes the position that the plant is depreciable over 20 years on an accelerated basis. This would be the technically correct tax treatment. The utility will claim accelerated depreciation on its tax return and, by virtue of that fact, reduce its tax liability. The reduction in the utility's tax liability would give rise to 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 distribution line's useful life (*i.e.*, after year 20) when it is still providing service (and, therefore, generating taxable revenue) but no additional tax depreciation is available because it has all been claimed. Because the "loan" is repaid to the government 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 electric utility decides to deduct the entire cost of the distribution line 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 produce 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 accumulated deferred income tax ("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. BROSCH?

A. The Company believes that its FIN 48 amount is properly treated as a loan of the second type – a "with interest" loan. Mr. Broach believes it should be treated as a "depreciation" loan – a "without interest" loan.

Q. WHAT IS FIN 48?

A. As Mr. Brosch indicates in his testimony, 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."[1] FIN 48 (which is an acronym for FASB Interpretation No. 48) prescribes the way in which companies must analyze, quantify, and display the consequences of tax positions that are technically uncertain. It applies to calendar year 2007 and thereafter.

Q. WHAT IS THE PURPOSE OF FIN 48?

A. Each taxpayer has the responsibility both for filing tax returns to report how much tax 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 by the tax authorities. 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 by the tax authorities. FIN 48 prescribes a single standard, a single process, and a single disclosure regime for uncertain tax positions taken by a taxpayer, *i.e.*, tax positions taken by a taxpayer that may be disputed by the tax authorities.

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

[1] This pronouncement has recently been "codified" as FASB ASC 740-10. I will nevertheless refer to it as FIN 48 throughout my testimony.

on a tax return. With respect to those tax positions 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 does the company's internal tax department 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 DETERMINED?

A. As a general proposition, the amount of tax that it is 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. WHAT IS THE ISSUE WITH FIN 48 THAT THE COMMISSION CONSIDERED IN CASE NO. ER-2008-0318 AND IS BEING ASKED TO RECONSIDER HERE?

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 due consideration to the analysis of the experts inside and outside of the utility in forming its conclusion as to the capital's cost status? I would note again that this analysis is prescribed by FIN 48 and involves a rigorous review process for assessing the likelihood of having to make additional tax payments (with interest and penalties) to the taxing authority. The purpose of the compulsory review is to ensure that the financial statements the investing public relies upon provide information that is as accurate as possible about the true nature of the company's liabilities. The result of the review is reflected in the company's filings with the Securities and Exchange Commission.

Q. MORE PRECISELY, HOW DOES THIS QUESTION RELATE TO RATEMAKING IN THIS CASE?

A. A FIN 48 balance, that is, a liability on the balance sheet for amounts that the experts have determined will likely have to be paid to the taxing authorities with interest (and, perhaps, penalties) should not be reflected as ADIT. This was the Commission's view based upon the policy it formulated just two years ago and it remains the Company's view now. Otherwise, ratepayers will see a reduction in rate base that the FIN 48 process has concluded is neither real nor sustainable.

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

A. Yes there is. Admittedly, it is not absolutely certain that the governmental loans will require interest. However, it is less likely that the governmental loans will be interest-free. Thus, there will be a degree of uncertainty regardless of which position is adopted.

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

A. Yes I am. And it is my view that the Commission has properly adopted the more likely of the two alternatives – that is, to respect the FIN 48 characterization. This makes far more sense than Mr. Brosch's position, which, in effect, assumes that the Company will prevail on *every* uncertain tax position it has taken – even with respect to those with respect to which the experts have determined it is likely that the Company will *not* prevail.

Q. SHOULD THE COMMISSION ENCOURAGE THE COMPANY TO TAKE UNCERTAIN TAX POSITIONS?

A. Absolutely - and the Commission concluded as much in Case No. ER-2008-0318 as is clear from the excerpt in its Report and Order set forth on page 16 of Mr. Brosch's testimony. 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 Commission to encourage such positions. Obviously, when the governmental funds produced by the assertion of an uncertain tax position are treated as cost-free capital, it becomes contrary to the Company's interest to make the attempt because a rate base reduction occurs for sums that are likely not to be cost-free capital. This treatment extracts return from the Company. The Company would be better off not taking the uncertain position.

Q. WHAT WAS (IN CASE NO. ER-2008-0318) AND REMAINS 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 is 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 because internal experts and external auditors have determined that the FIN 48 amounts are likely to ultimately have to be repaid to the taxing authorities with interest. This position is entirely consistent with the Commission's determination in Case No. ER-2008-0318 where it concluded:

> 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.[2]

Q. AT PAGES 18 THROUGH 20 OF HIS TESTIMONY, MR. BROSCH DISCUSSES APPROACHES ADOPTED BY THE FEDERAL ENERGY REGULATORY COMMISSION ("FERC") AND THE PUBLIC UTILITY COMMISSION OF TEXAS ("PUCT") FOR DEALING WITH THE FIN 48 ISSUE. PLEASE COMMENT ON THESE.

A. With regard to FERC, on page 19 of his testimony, Mr. Brosch accurately points out that FERC requires that FIN 48 amounts be accounted for as deferred tax liabilities. However, he neglects to mention that FERC explicitly caveated the guidance he cites as follows:

> This guidance is for Commission financial accounting and reporting purposes only and is without prejudice to the ratemaking practice or treatment that should be afforded the items addressed herein.

In other words, the FERC guidance was not a pronouncement as to ratemaking – only as to accounting.

Q. DO YOU KNOW ANYTHING ABOUT THE PUCT ORDER IN CONNECTION WITH THE ONCOR ELECTRIC DELIVERY COMPANY LLC RATE CASE

[2] Case No. ER-2008-0318, Report and Order (effective Feb. 6, 2009), pp. 55-56.

(PUCT DOCKET NO. 35757) DISCUSSED BY MR. BROSCH ON PAGES 19-20 OF HIS TESTIMONY?

A. Yes I do. I participated in that proceeding. I would observe that the FIN 48 tax issue was not the major tax issue in that case. It was, in my view, not afforded as much attention as it should have been afforded. While I disagree with the conclusion of the PUCT in that case with regard to FIN 48 for a number of reasons, its finding of fact 59 – that the IRS may not audit Oncor's tax position - is simply not the case with regard to UE's uncertain tax positions. Each of UE's uncertain tax positions that impact its rate base computation has been identified by the IRS as an issue for attention and will, undoubtedly, be audited in depth. This certainty of IRS audit distinguishes the UE situation from the Oncor one.

Q. IS THERE ANOTHER RELEVANT STATE COMMISSION DECISION OF WHICH YOU ARE AWARE?

A. Yes there is. In a rate case involving Kentucky-American Water Company (Case No. 2010-00036), the Kentucky Public Service Commission considered precisely the same uncertain tax position issue that constitutes the major tax issue 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.[3]

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

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

A. In my view, in Case No. ER-2008-0318 this Commission articulated solid reasoning and reached an 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. Even more important, the basis for its conclusion, that is, that the IRS may not audit or reverse Oncor's position, does not apply to UE's situation in this case. Here the uncertain tax positions that impact UE's rate base have already been identified by the IRS. Audit is a certainty.

Q. MR. BROSCH PROPOSES TO TREAT FIN 48 AMOUNTS AS COST-FREE CAPITAL (BY INCLUDING IT IN THE COMPANY'S ADIT BALANCE) AND THEN TO REIMBURSE THE COMPANY FOR IRS INTEREST IF IT TURNS OUT THE AMOUNTS ARE NOT COST-FREE. DOES THIS MAKE SENSE TO YOU?

[3] Re: Kentucky American Water Company, Kentucky PSC Case No. 2010-00036, Order (entered Dec. 14, 2010), p. 20.

A. No it does not. This Commission should set rates using the best information it has available to it. Treating FIN 48 amounts as cost-free capital when, based upon the prescribed FIN 48 accounting process, the experts have already concluded that they are not employs inferior information in the face of the existence of better information. This defies logic. If Mr. Brosch wants to create an architecture for balanced protection of shareholders and customers, he should not start with the use of inferior information. He should utilize the better-informed conclusions – that FIN 48 amounts are not cost-free capital – and, in the event that this conclusion proves incorrect, provide customers with the IRS interest avoided by virtue of the Company's successful assertion of its uncertain tax return position.

Q. WHAT WOULD BE THE CONSEQUENCES OF MR. BROSCH'S PROPOSAL AND THIS ALTERNATIVE PROPOSAL FOR THE INCENTIVE PROVIDED TO THE COMPANY TO ASSERT PRUDENTLY AGGRESSIVE TAX POSITIONS ON ITS TAX RETURN?

A. Mr. Brosch's proposal treats as cost-free capital dollars that experts have determined are likely to have to be repaid to the taxing authorities with interest. If Mr. Brosch's position is adopted, it would create a disincentive for the Company to assert prudently aggressive tax positions and, thereby, contravenes the policy recently adopted by this Commission in Case No. ER-2008-0318.

Net Operating Loss ("NOL") Carryforwards

Q. WHAT IS AN NOL CARRYFORWARD AND HOW DOES IT ARISE?

A. Under our federal income tax system, a tax is imposed on each year's taxable income. Taxable income is derived by deducting all permissible tax deductions from all taxable receipts. In the event that, in any year, tax deductions exceed taxable receipts, an NOL results. In general, the tax law permits an NOL to be carried back two years and forward twenty years. In each carryback or carryforward year, the NOL is claimed as an additional tax deduction so that, if there is otherwise taxable income in the year, the amount will be reduced, thereby resulting in a reduced tax liability.[4]

Q. HOW WOULD YOU DESCRIBE NOL CARRYFORWARDS?

A. NOL carryforwards represent deductions that have been claimed on tax returns but which have not yet reduced the taxpayer's tax liability. They have, therefore, produced no benefit. While they have the capacity to do so in the future, they have not yet done so.

Q. PLEASE PROVIDE A SIMPLE ILLUSTRATION OF THIS SITUATION IN THE CONTEXT OF A REGULATED UTILITY.

A. Assume Utility has income of $200 before depreciation and taxes. Further assume book depreciation is $100 and tax depreciation is $300. Finally, assume a 35% income tax rate and that Utility does not carry back any NOL it generates.

Q. IN THE ABOVE-DESCRIBED SITUATION, WHAT IS UTILITY'S CURRENT INCOME TAX EXPENSE?

[4] UE has state NOL carryforwards as well as federal tax credit carryforwards. The rationale applicable to federal NOL carryforwards is equally applicable to these tax attributes.

A. Utility's taxable income is an NOL of $100 ($200 pre-tax, pre-depreciation income less $300 of tax depreciation). Consequently, its current income tax expense, that is, the tax it will pay on its utility income, is $0.

Q. WHAT IS THE TIMING DIFFERENCE FOR WHICH UTILITY WILL CLAIM AN INCREMENTAL TAX DEDUCTION?

A. The timing difference is $200 – the difference between the book depreciation of $100 and the tax depreciation of $300.

Q. HOW MUCH TAX IS DEFERRED BY VIRTUE OF CLAIMING THE INCREMENTAL $200 OF TAX DEPRECIATION?

A. Utility only has $100 of taxable income before depreciation. Therefore, only $100 of the $200 incremental tax deduction offsets taxable income. Consequently, only $35 of tax is deferred. The other $100 of tax depreciation does not offset any taxable income but, instead, creates an NOL carryforward that can be carried forward for the next 20 years to offset taxable income generated by Utility.

Q. WHAT, THEN, IS UTILITY'S DEFERRED INCOME TAX EXPENSE?

A. Since only $35 of tax is deferred, Utility's deferred income tax expense is $35.

Q. WHAT IS THE ECONOMIC SIGNIFICANCE OF THE NOL CARRYFORWARD?

A. Utility would have paid the same amount of income tax with or without the "extra" $100 depreciation deduction. Thus, that amount does not defer any income tax. The $100

NOL carryforward provides Utility with the ability to defer $35 of income taxes in the future – but only if and when it generates $100 of taxable income. The critical point is that no such income tax deferral has yet taken place.

Q. HOW WOULD THE ABOVE SITUATION BE ACCOUNTED FOR BY UTILITY?

A. As I indicated, Utility's total income tax expense is $35 ($0 current and $35 deferred). On its balance sheet, it would book deferred income taxes ("DIT") of $70 (35% X $200) to track the tax effect of the entire depreciation timing difference. However, it would also book a $35 negative DIT to reflect the fact that, to the extent of $35, the ability to defer taxes is a future benefit that has not yet been enjoyed. The two DIT entries partially offset one another.

Q. WHAT DOES THE PARTIAL DIT OFFSET REPRESENT ECONOMICALLY?

A. The partial DIT offset properly reflects the fact that the $200 incremental depreciation income tax deduction claimed by Utility only generates $35 of cost-free capital, not $70. The net DIT balance should therefore be $35. Since it is only to that extent that Utility enjoys access to cost-free capital, it follows that Utility should reflect a rate base reduction of no more than $35.

Q. DOES THE EXAMPLE ABOVE REFLECT THE WAY IN WHICH THE COMPANY HAS TREATED ITS NOL CARRYFORWARDS?

A. Yes it does. The Company's treatment of its NOL carryforwards properly reflects the extent to which the deductions which gave rise to the carryforward produced cash for the Company through reduced tax payments. To the extent that they did not, then the

Company has not reflected an associated quantity of cost-free capital in its rate base calculation.

Conclusion

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a AmerenUE for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Company's Missouri Service Area.	)))))	Case No. ER-2010-0028

AFFIDAVIT OF JAMES I. WARREN

DISTRICT OF COLUMBIA)
) ss

JAMES I. WARREN, being first duly sworn on his oath, states:

1. My name is **JAMES I. WARREN**. I am employed by the law firm of Winston & Strawn LLP as a tax partner.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Union Electric Company d/b/a Ameren Missouri consisting of 27 pages, all of which have been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

James I. Warren
JAMES I. WARREN

Subscribed and sworn to before me this 23rd day of March, 2011.

Valerie T. Beverly
Notary Public

My commission expires:

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