Exhibit No.:
Issues: *Deferred Tax Amortization, State Flow-Through and Corrections to Direct Filing*
Witness: *Amanda C. McMellen*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Rebuttal Testimony*
Case No.: *ER-2016-0023*
Date Testimony Prepared: *May 2, 2016*

MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION
AUDITING DEPARTMENT

REBUTTAL TESTIMONY

OF

AMANDA C. MCMELLEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2016-0023

Jefferson City, Missouri
May 2016

TABLE OF CONTENTS OF

REBUTTAL TESTIMONY

OF

AMANDA C. MCMELLEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2016-0023

REBUTTAL TESTIMONY

OF

AMANDA C. MCMELLEN

THE EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2016-0023

Q. Please state your name and business address.

A. Amanda C. McMellen, 200 Madison St., Suite 440, Jefferson City, MO 65101.

Q. By whom are you employed and in what capacity?

A. I am employed by the Missouri Public Service Commission ("Commission") as a Utility Regulatory Auditor V.

Q. Are you the same Amanda C. McMellen who has previously filed portions of the Commission Staff's ("Staff") Cost-of-Service - Revenue Requirement Report in this proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to The Empire District Electric Company's ("Empire" or "Company") direct filing regarding two income tax expense matters; cost of removal deferred tax amortization and state income tax flow-through.

Lastly, I will provide a list of the corrections to Staff's direct revenue requirement calculation for Empire in this proceeding.

COST OF REMOVAL DEFERRED TAX AMORTIZATION

Q. What is "cost of removal?"

A. "Cost of removal" is the cost of demolishing, dismantling, tearing down or otherwise removing plant in service at the end of its useful life.

Q. How is cost of removal currently treated for ratemaking purposes?

A. In Missouri, cost of removal is currently included in the cost of service on an accrual basis as a component of a utility's authorized depreciation rates. Except for a brief period in the prior decade, Empire's cost of removal has been recovered from customers using this approach. This approach means that customers pay in rates an estimation of the future cost of removal for the plant while the plant is still in service.

Q. How is cost of removal treated for income tax purposes?

A. The Internal Revenue Service ("IRS") allows a deduction on a utility's income tax returns only for cost of removal amounts that are actually incurred. The difference between the accrual approach used for cost of removal in setting rates and the cash approach used for this cost for income tax purposes means that cost of removal is a "tax timing difference." The term "tax timing difference" applies to costs for which the timing of recognition for financial accounting and income tax purposes is different.

Q. Is it reasonable to expect the amount of cost of removal collected in rates by a utility will ever be equal to the amount of cost of removal actually incurred by a utility?

A. No. Current ratemaking policy allows for collection in rates of estimated cost of removal amounts in some cases decades in advance of when the actual expenditures are expected to be made. This means, as a practical matter, that the amount of cost of removal collected in rates will never be "trued-up" to the amount of actual costs of removal expenditures for a company.

Q. What is the difference between "normalization" treatment and "flow-through" treatment of tax timing differences for rate purposes?

A. "Normalizing" tax timing differences means that, for rate purposes, a cost is considered to be recognized in the income tax calculation at the same time as the item is recognized as an expense on the utility's income statement. "Flowing through" tax timing differences means that, for rate purposes, a cost is recognized in the income tax calculation at the same time the item is recognized as a deduction on the utility's income tax returns.

As it applies to cost of removal, normalization of this item would mean the cost is taken as a deduction for ratemaking purposes at the time it is accrued as part of the utility's depreciation rates. Under the flow-through approach, the cost would be taken as an income tax deduction at the time the utility's cost of removal expenditures are made.

Q. What is the Company's position regarding this issue?

A. The Company has included an adjustment for a cost of removal deferred tax amortization in its workpapers for this case, but has provided no support for this adjustment in its filed direct testimony. This adjustment was an issue in previous Empire rate cases, including its last general rate proceeding, Case No. ER-2014-0351. In that case, the Company alleged that the tax deduction for cost of removal was inadvertently provided to customers twice in prior Empire rate cases from 1981 to 2008, once by normalizing the cost of removal component included in Empire's authorized depreciation rates for tax purposes and again by simultaneously flowing through the amount of cost or removal actually incurred by the utility in the income tax calculation. The Company believed that this resulted in an alleged under recovery of accumulated deferred income tax by Empire, and that this amount should be recouped through an amortization of a cost of removal deferred tax asset over an 18-year period.

Q. What is Staff's position regarding this proposed amortization?

A. Staff is opposed to inclusion in rates of this amortization. Staff has not been provided credible evidence that this alleged double-reflection of the cost of removal tax deduction in cost of service actually occurred.

Q. Is it possible to determine how certain items are treated for rate purposes based upon a review of income tax accounting schedules from previous cases?

A. No. The income tax accounting schedules used in Staff's accounting schedules do not necessarily contain the necessary level of detail of how certain values contained therein are derived. Also, many rate case proceedings are settled and a negotiated dollar basis does not usually allow for a direct reconciliation of the negotiated amount of any one party's revenue requirement.

Q. Were some of Empire's rate case filings from 1981 to 2008 resolved by stipulation and agreement?

A. Yes, most of them were. Even for those cases that went to hearing, to my knowledge, no tax issues associated with cost of removal were litigated. Of course, the existence of stipulations and agreements in Empire's past rate cases reflecting a "black box" settlement of revenue requirement makes it very difficult to make a determination of how certain items, such as income tax treatment of cost of removal, were treated for ratemaking purposes.

Q. What is the nature of the deferred tax asset that Empire seeks to amortize in the rate proceeding?

A. The amount proposed for amortization by Empire in this case is derived from a deferred tax asset booked by Empire pursuant to Financial Accounting Standard ("FAS") No. 109, "Accounting for Income Taxes." This asset was not booked by Empire until the early 1990s, when the provisions of FAS 109 went into effect, even though some of the cost of removal expenditures reflected within the asset balance date back to 1981.

Q. Is the cost of removal deferred tax asset the same type of deferred tax asset/liability ordinarily given rate treatment by the Commission?

A. No. The deferred tax assets and liabilities reflected in the Company's rate base result from prior normalization treatment of utility tax timing differences. The cost of removal deferred tax asset Empire is seeking to amortize in this case results from prior flow-through treatment of this tax timing difference. This amount has also not been reflected in Empire's rate base in past rate proceedings, unlike other deferred tax assets and liabilities.

Q. Is the cost of removal deferred tax asset that Empire seeks to amortize a "regulatory asset?"

A. No, not in the usual sense of that term. It is my understanding that Empire is booking this particular asset as a requirement applied to regulated utilities under the provision of FAS No. 109. This amount is not a regulatory asset in that its booking was not authorized or approved by the Commission through an accounting authority order application or other means. This issue has the characteristics of attempting to validate after the fact a regulatory asset placed on the books without regulatory approval that will need to be written off if regulatory approval for rate recovery is not given.

STATE TAX FLOW-THROUGH

Q. What is the issue related to state tax flow-through?

A. The state flow-through adjustment amount was included in the Company's workpapers supplied in this case, though there was no support for this adjustment in the filed direct testimony submitted by Empire in this proceeding. This adjustment was an issue in previous Empire general rate proceedings, including its most recent case, Case No. ER-2014-0351. My understanding of this issue is that Empire is asserting that the normalization treatment of tax timing differences provided to it by the Commission up to the early 1990s was authorized only at the stand-alone federal tax rate, and not the composite federal-state income tax rate usually used to record deferred taxes resulting from normalization of tax timing differences. Therefore, when Staff applies the current composite federal-state income tax rate for the purpose of returning deferred taxes to customers, Empire claims that use of the composite tax rate for this purpose, which is higher than the stand-alone federal rate, results in a shortfall to the Company. Empire is proposing in this case to recover this alleged shortfall through an amortization over 18 years.

Q. What is the current difference between the federal-state composite tax rate and the stand-alone federal income tax rate?

A. The current composite income tax rate used by Staff is 38.3886%, while the stand-alone federal income tax rate is 35%.

Q. What is Staff's position on this issue?

A. Staff is opposed to Empire's proposed state tax flow-through amortization.

Q. To your knowledge, what has been Staff's position in the past regarding the calculation of deferred taxes for purposes of setting customer rates?

A. To my knowledge, Staff has advocated the approach of calculating deferred income taxes using a composite federal-state income tax rate. I am not aware of any instance of the Commission ordering rates to be set using a different income tax rate to calculate the deferred income taxes.

Q. If Empire's deferred taxes were calculated using the normal composite federal-state tax rate, how would acceptance of its state tax flow-through amortization affect its customers?

A. Adoption of Empire's proposed amortization would mean its ratepayers would not be fully compensated for the full amount of deferred taxes they provided to Empire in earlier rate cases. This result would be unfair and inequitable.

<u>CORRECTIONS TO DIRECT FILING</u>

Q. Is Staff aware of corrections that need to be made to Staff's direct revenue requirement calculations?

A. Yes. After the direct filing on March 25, 2016, Staff became aware of corrections that needed to be made to the direct revenue requirement amount.

Q. What are the corrections?

A. The following issues were corrected:

- Low-Income Weatherization - Included stipulated amount.
- Riverton 12 Tracker – Included stipulated amount.
- Fuel Inventory – Staff corrected balance.
- Pension Tracker – Staff corrected balance.
- Prepaid Pension Asset – Staff removed portion related to gas and applied Missouri Jurisdictional factor.
- Cash Working Capital – Staff corrected balances.
- Plant O&M Normalization – Staff corrected adjustments for Iatan Common, Iatan 2 and Plum Point.
- Intangible Amortization – Staff removed portion related to gas.
- ITC Amortization – Staff corrected adjustment.
- Employee Benefits – Staff corrected adjustment.
- Staff O&M Ratio – Staff corrected ratio.
- Rate Case Expense – Staff updated rate case expense to the most current amount.

Q. What is Staff's recommended revenue requirement after reflecting the above corrections?

A. With the above corrections, Staff's calculated revenue requirement for Empire in this proceeding ranges from approximately $21,416,726 to $24,269,015, based upon a recommended rate of return range of 7.36% to 7.61%. Staff's recommended revenue requirement at the midpoint of the rate of return range (7.48%) is $22,848,740. All of Staff's revenue requirement amounts discussed above include a true-up estimate for the construction cost of Riverton 12 due to be completed in June 2016, after the end of the update period in this case.

Q. Does this conclude your rebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric	)	
Company's Request for Authority to Implement	)	Case No. ER-2016-0023
a General Rate Increase for Electric Service	)	

AFFIDAVIT OF AMANDA C. McMELLEN

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

COMES NOW AMANDA C. McMELLEN and on her oath declares that she is of sound mind and lawful age; that she contributed to the foregoing REBUTTAL TESTIMONY; and that the same is true and correct according to her best knowledge and belief.

Further the Affiant sayeth not.

Amanda C McMellen

AMANDA C. McMELLEN

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 28th day of April, 2016.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin

Notary Public