Exhibit No.
Issues: Tax Costs of Removal, State Income
Tax Flow-Through, Unit Train
Witness: Robert W. Sager
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Empire District Electric
Case No. ER-2012-0345
Date Testimony Prepared: February 2013

Before the Public Service Commission
of the State of Missouri

Surrebuttal Testimony

of

Robert W. Sager

February 2013

EMPIRE
SERVICES YOU COUNT ON

SURREBUTTAL TESTIMONY
OF
ROBERT W. SAGER
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2012-0345

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Robert W. Sager, 602 Joplin Street, Joplin, Missouri 64801.

Q. WHO IS YOUR EMPLOYER AND WHAT POSITION DO YOU HOLD?

A. The Empire District Electric Company ("Empire" or "Company") is my employer. I hold the position of Controller, Assistant Treasurer, Assistant Secretary, and Principal Accounting Officer.

Q. ARE YOU THE SAME ROBERT W. SAGER THAT PROVIDED DIRECT AND REBUTTAL TESTIMONY IN THIS CASE?

A. Yes, I am.

Q. PLEASE EXPLAIN THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY.

A. The purpose of my surrebuttal testimony is to address the rebuttal testimony of Staff witnesses Mark Oligschlaeger and John Robinett. My testimony concerns Staff's position regarding the Company's request to recover tax benefits related to costs of removal incurred and flowed through to ratepayers, and the under recovery of state income tax related to deferred income taxes. I also address the 2007 unit train accounting remarks prepared by Mr. Robinett.

TAX COSTS OF REMOVAL

Q. DOES MR. OLIGSCHLAEGER DISAGREE THAT STAFF INCLUDED A CURRENT DEDUCTION FOR COST OF REMOVAL IN ITS INCOME TAX CALCULATIONS?

A. No. Empire provided copies of Staff's workpapers (provided in response to DR 178) relating to cases in the 1990s as examples showing where a current tax benefit was being provided to customers immediately based on amounts utilized on the Company's tax return and it is Empire's understanding that Mr. Oligschlaeger does not dispute this fact.

Q. WHAT APPEARS TO BE THE MAIN CAUSE OF MR. OLIGSCHLAEGER'S DISAGREEMENT WITH EMPIRE'S POSITION?

A. Empire's original testimony submitted by Mr. Jim Warren alluded to a double tax benefit provided to customers, with one benefit being that customers were given a <u>current</u> tax benefit, which was derived from the amounts deducted on the Company's tax return as noted above. Those benefits can only be deducted at the end of an assets life when a company incurs actual costs to remove an asset. Mr. Oligschlaeger also acknowledged this in his testimony. The second tax benefit provided to customers was derived from a <u>deferred</u>, tax benefit. This deferred tax benefit appears to be the cause of Mr. Oligschlaeger's disagreement.

Q. DID MR. OLIGSCHLAEGER PROVIDE EVIDENCE THAT EMPIRE'S POSITION ON THE DEFERRED TAX BENEFIT WAS NOT PROVIDED TO CUSTOMERS?

A. No. Mr. Oligschlaeger indicates that Staff schedules from those cases "do not show to what extent a cost of removal accrual was incorporated within Staff's tax straight-line depreciation deduction." Mr. Oligschlaeger goes on to suggest in his testimony that "straight-line" depreciation "will not provide for a deduction amount for cost of removal." It is unclear whether Mr. Oligschlaeger believes the straight-line components would include, to some extent, the cost of removal or none at all.

Q. DO YOU AGREE THAT THE "STRAIGHT-LINE" DEPRECIATION ADJUSTMENT CALCULATION IN THE RATE CASES WOULD NOT REFLECT COST OF REMOVAL?

A. Yes. The original cost of an asset, as it is recorded on the Company's books, can be different than the original cost basis utilized for tax purposes for numerous reasons. The straight-line tax depreciation used in ratemaking is intended to account for this "basis" difference in the original cost of an asset and would not provide for cost of removal.

Q. WHAT IS THE SOURCE OF THE "DEFERRED" TAX BENEFIT TO THE CUSTOMER?

A. In addition to the straight-line tax adjustment for basis, another depreciation expense component is utilized in ratemaking to account for the difference in the book depreciation expense recorded and the accelerated depreciation rates afforded for taxes. The book depreciation expense recorded by the Company and prescribed by Staff calculations includes a regular depreciation expense component and a component for the accrual for estimated costs of removal. As explained by Empire witness Jim Warren in his direct testimony, this additional accrual for cost of removal expenses reduces the difference between book depreciation and the accelerated tax depreciation. Since the gap between book and tax depreciation expense is diminished, it ultimately lowers deferred tax expense as well. The reduced deferred tax expense is where the second benefit was provided to the customer.

Q. HAS STAFF'S INCOME TAX CALCULATON ALWAYS PROVIDED EMPIRE'S MISSOURI JURISDICTIONAL CUSTOMERS WITH A DOUBLE TAX BENEFIT?

A. No. After discussions with Staff and after reviewing past rate cases, Empire acknowledges the cost of removal accrual for books was actually removed from the overall book depreciation rates for a brief time approximately from 2001-2005. As a result, the deferred tax expense component included in rates would not have been improperly reduced in that time period.

Q. HAS STAFF'S TREATMENT OF THE CURRENT TAX BENEFIT BEEN CONSISTENT?

A. No. Empire provided copies of the 1994 and 1997 Staff workpapers, where the current benefit was "flowed-through" to the customers, as noted previously. In recent Empire cases, Staff workpapers have not included this as a current benefit. On page 19 of Mr. Oligschlaeger's testimony, he indicates, "the Company's actual cost of removal tax return deductions on the Staff income tax accounting schedule would not have resulted in a double reflection of the tax deduction." Mr. Oligschlaeger is referring to the current tax benefit in this statement that had been flowed-through.

Q. IF THE DEDUCTION WAS NOT A DOUBLE REFLECTION PREVIOUSLY AND THE TREATMENT FOR THE DEFERRED TAX EXPENSE HAS NOT CHANGED, THEN WHY DID STAFF STOP INCLUDING THIS CURRENT TAX BENEFIT IN LATER YEARS?

A. I do not have the documentation which supports Staff's change in position, but as a result of the Staff's changed position, Empire's Missouri customers no longer receive a duplicated tax benefit for cost of removal.

Q. IN YOUR OPINION, DOES THIS APPEAR TO BE RETROACTIVE RATEMAKING, AS MR. OLIGSCHLAEGER SUGGESTS?

A. No. Many adjustments made in rate cases are the result of timing differences between when the Company incurs costs and when the customers ultimately pay for them in rates. The timing for tax deductions is generally more difficult because of the initial difference between the Company's filed tax returns and the Company's books, and then consideration must be given to when the customers receive the benefit of the tax deductions in their rates. Customers should rightfully receive the benefit of tax deductions and this is generally accomplished through the normalization process. Empire is simply requesting that an item that was previously "flowed-through" to customers be returned, because the customers were also receiving the benefit in the deferred tax computation.

Q. ARE THERE ALTERNATIVES THAT COULD BE CONSIDERED FROM A RATEMAKING STANDPOINT?

A. In order to minimize the impact to customer rates, Empire recommends an alternative for ratemaking purposes that we believe has been utilized in other jurisdictions. We suggest that the regulatory asset for tax cost of removal be returned to the Company over an 18 year period. As an offset to this increase in rates, the book accrual for cost of removal that is included in the overall book depreciation rates could be lowered so that the impact to customers is neutral.

STATE INCOME TAX FLOW THROUGH

Q. HOW DID THE FLOW THROUGH OF STATE INCOME TAX BENEFITS OCCUR?

A. The normalization requirements of the Internal Revenue Code specify that to comply with the regulations, the federal statutory rate must be provided for in deferred tax expense. The additional component of the state rate in excess of the federal rate was not required.

Q. HAS THE COMPANY EVER BEEN ORDERED TO USE THE COMPOSITE FEDERAL AND STATE RATES IN DETERMINING DEFERRED TAX IN RATE CASES?

A. No. To the contrary, the Company has only been ordered to provide deferred taxes at the federal rate.

Q. WAS A COPY OF THIS ORDER PROVIDED TO STAFF?

A. Yes. A copy of this order was provided in Empire’s response to DR 0177.

Q. WHEN DID THE COMPANY START DEFERRING TAXES AT THE FEDERAL/STATE COMPOSITE RATE IN ITS BOOKS AND RECORDS?

A. As a part of ratemaking practice, the Company began deferring tax at the composite rate with rates that went into effect in August, 1994.

UNIT TRAIN

Q. DO YOU AGREE WITH MR. ROBINETT'S RECOMMENDATION CONCERNING EMPIRE'S UNIT TRAIN, AT PAGE 4, LINES 16 THROUGH 18, OF HIS REBUTTAL TESTIMONY?

A. No. As I indicated in my rebuttal testimony on this issue, Empire has properly accounted for the sale of the unit train and Empire has properly accounted for the revenue Empire was able to earn by leasing this unit train by reducing the Company's fuel costs. Mr. Robinett's unit train accounting recommendation is incorrect from a fixed asset accounting perspective, essentially, counts the benefits related to the transaction twice, and improperly provides rate reductions to customers when the investment is no longer in service. My rebuttal testimony includes details surrounding the transactions involved and how Empire recorded the transactions on its books and records.

Q. HOW IS MR. ROBINETT'S UNIT TRAIN RECOMMENDATION INCORRECT FROM A FIXED ASSET ACCOUNTING PERSPECTIVE?

A. The revenue Empire was able to earn from the lease is not related to Empire's retirement of the unit train. This revenue was not, and is not, salvage value from the standpoint of fixed asset accounting. Mr. Robinett's recommendation to essentially treat the revenue Empire was able to earn on the unit train prior to its disposition as salvage is incorrect and not supported by the facts.

Q. HOW WAS THE REVENUE GENERATED FROM THE LEASE OF THE UNIT TRAIN ACCOUNTED FOR BY EMPIRE?

A. As I mentioned in my rebuttal testimony, this revenue was earned while the unit train was still owned by Empire, prior to its retirement and sale, and the lease revenue was used to reduce the fuel costs recorded on Empire's books. This method of accounting properly matched the revenue received during the lease with the cost of Empire's unit train ownership. The revenue was either recovered as a part of fuel expense considered in establishing base rates or recovered through fuel adjustment mechanisms in each of our jurisdictions, including Missouri. Mr. Robinett's recommendation did not take any of these past impacts into account.

Q. IF MR. ROBINETT'S RECOMMENDATION IS ACCEPTED BY THE COMMISSION WILL EMPIRE'S CUSTOMERS BENEFIT MORE THAN ONCE FROM THE TRANSACTION?

A. Yes. Not only will the fuel costs associated with the customers' electric service have been reduced during the time the unit train was owned and leased by Empire, but Empire's current customers, who are not being charged for the unit train, would see a reduction in their electricity costs of around $508,000 annually. Assuming a remaining Asbury service life of twenty years, Mr. Robinett's recommendation could result in an inappropriate reduction in electricity costs to current and future Empire customers of over $10 million for an asset that is not used to serve their needs.

SUMMARY

Q. PLEASE PROVIDE A SUMMARY OF YOUR SURREBUTTAL TESTIMONY?

A. Empire is seeking to recover the tax impact related to costs of removal that was flowed through to customers' benefit even though the tax benefit was already being provided through a reduction in deferred income tax expense. Providing for the recovery of this item still allows the customers to receive the benefit of this tax deduction without penalizing the Company for a tax timing difference that was originally flowed through to customers.

Empire also seeks to recover the state deferred income taxes that were previously flowed through to customers. This was the result of only utilizing the federal tax rate for normalization income tax items and created an income tax shortfall in rates, as the Company paid state income taxes.

Empire has accounted for the unit train lease income correctly and Mr. Robinett's recommendations with respect to the disposition of the unit train should be rejected by the Commission. Mr. Robinett's testimony concerning the unit train inaccurately indicated that customers did not receive the benefit of the lease income when in fact they did through a reduction in fuel costs.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

AFFIDAVIT OF ROBERT W. SAGER

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 1st day of February, 2013, before me appeared Robert W. Sager, to me personally known, who, being by me first duly sworn, states that he is the Director of Financial Services of The Empire District Electric Company and acknowledges that he has read the above and foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.

Robert W. Sager

Robert W. Sager

Subscribed and sworn to before me this 1st day of February, 2013.

ANGELA M. CLOVEN
Notary Public - Notary Seal
State of Missouri
Commissioned for Jasper County
My Commission Expires: November 01, 2015
Commission Number: 11262659

Angela M. Cloven

Notary Public

My commission expires: 11/01/15.