EXECUTIVE SUMMARY
FOR THE SURREBUTTAL TESTIMONY
OF
L. JAY WILLIAMS
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2006-0315

Purpose:
This surrebuttal testimony to Ted Robertson of the OPC discusses the deductibility of the Staff and OPC proposed "regulatory plan" amortization expense for income tax purposes and how the related current income tax liability should be taken into account to provide the Company with enough Funds From Operations ("FFO") to meet the minimum financial requirements established by the financial rating agencies.

Summary and Conclusion:
The proposed "regulatory plan" amortization is essentially additional book depreciation. Due to the fact that tax depreciation, which is the only depreciation allowed to be used in computing taxable income, does not change as the result of the regulatory amortization, the additional revenue associated with regulatory amortization will increase current taxable income and current income tax expense. In order to achieve the level of FFO that the regulatory plan intends, the amortization (additional cash needed to be generated) must be increased to reflect the additional income taxes due so that the revenues, less the additional current tax liability will provide the required cash flow.

Exhibit No.
Issue: Amortization
Witness: L. Jay Williams
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Empire District
Case No. ER-2006-0315

Before the Public Service Commission
of the State of Missouri

Surrebuttal Testimony

of

L. Jay Williams

August 2006

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Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. L. Jay Williams. My business address is 602 Joplin Street, Joplin, MO.

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

A. I am employed by The Empire District Electric Company ("Empire or Company") as Manager of Tax Planning.

Q. ARE YOU THE SAME L. JAY WILLIAMS THAT HAS PREVIOUSLY FILED REBUTTAL TESTIMONY IN THIS CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes.

Q. PLEASE BRIEFLY SUMMARIZE YOUR SURREBUTTAL TESTIMONY.

A. My testimony concerns the gross-up of income taxes related to the potential "regulatory plan" amortization as addressed by Ted Robertson of the Office of the Public Counsel ("OPC") beginning at page 19 of his rebuttal testimony, with particular emphasis on his contention that the amortization should not be grossed-up for income taxes. I will also discuss my concern that by ignoring the current income tax liability related to the additional regulatory amortization, the OPC and Commission Staff ("Staff") recommendations may prevent the regulatory plan from achieving its specific goal of maintaining the cash flow from the Company's Missouri electric operations at investment grade levels.

Q. CAN YOU EXPLAIN WHAT GROSS-UP MEANS?

A. Yes. Gross-up refers to the method of increasing a revenue stream to include additional income tax expense in the cost of service. This process results in the proper matching of additional revenue with the additional income tax expense related to the additional revenue.

Q. WHAT POSITION HAS THE OPC TAKEN ON THE INCOME TAXES RELATED TO THE REGULATORY AMORTIZATION IN THIS CASE?

A. The OPC has taken the position that the revenue associated with the regulatory amortization should not be increased to reflect any additional income taxes (Robertson rebuttal, page 27). This position is identical to that taken by the Staff as sponsored by Mark Oligschlaeger in his supplemental direct testimony.

Q. CAN YOU PROVIDE AN EXAMPLE OF HOW THIS INCOME TAX GROSS-UP PROCESS WORKS?

A. Yes. This is illustrated by the attached example (Surrebuttal Schedule LJW-1) which is in the same general format as used by the Staff when computing the income tax component of cost of service. It also uses the same numbers as Staff witness Mark Oligschlaeger used in the attachment to his Supplemental Direct testimony (Schedules 1-1 and 1-2). In computing taxable income, book depreciation is added back to net income and tax depreciation is deducted in its place. Any change in book depreciation or book amortization without additional revenues results in no change in taxable income. As displayed in my schedule, there is no change in tax depreciation. Therefore, any regulatory amortization expense requiring additional revenues, increases taxable income and the income tax that is currently payable. Funds From Operations ("FFO") are provided at net of the additional income tax currently payable.

Q. PLEASE DESCRIBE SURREBUTTAL SCHEDULE LJW-1.

A. This schedule, which I prepared, displays the calculation of the additional regulatory amortization required. It uses the same assumptions employed by Mark Oligschlaeger and adopted by Ted Robertson of the OPC in his rebuttal testimony. By using this calculation as an example, Empire is not agreeing with the various revenue and cost levels used by Mr. Oligschlaeger, but is using the Staff calculation to illustrate the income tax ramifications associated with regulatory amortization. As demonstrated by the schedule, if additional revenue in the form of Regulatory Amortization of $9.3 million were authorized by the Commission in this rate case, that amount would need to be increased by $5.8 million to reflect the additional income tax that would be due in order to produce the required increase in FFO of $9.3 million. In this example, this would make the total revenue increase due to Regulatory Amortization $15.1 million, not the $9.5 million recommended by Staff.

Q. DO YOU AGREE WITH MR. ROBERTSON THAT THIS REGULATORY AMORTIZATION IS MUCH LIKE ADDITIONAL BOOK DEPRECIATION?

A. Yes.

Q. WHY?

A. The regulatory amortization in reality is additional book depreciation. As proposed by Staff and Mr. Robertson for the OPC in this rate case it will be accounted for just like book depreciation, increasing accumulated depreciation and reducing rate base. It is an acceleration of book depreciation to allow the company to generate cash to meet certain financial targets, such as FFO, and maintain its credit worthiness.

Q. IS BOOK DEPRECIATION DEDUCTIBLE FOR INCOME TAX PURPOSES?

A. No. Book depreciation is never deductible for income tax purposes. Tax depreciation is deductible. Tax depreciation is computed using electric plant in service and its related tax basis. Any change in book depreciation unrelated to a change in plant in service, such as regulatory amortization, has no influence on tax depreciation because the tax basis of the assets being depreciated for income tax purposes does not change.

Q. DO YOU AGREE WITH MR. ROBERTSON'S SUGGESTION ON PAGE 27 OF HIS REBUTTAL TESTIMONY THAT "EXPENSES ARE NEVER SUBJECT TO INCOME TAX GROSS-UP"?

A. No. I do not.

Q. WHY NOT?

A. An expense allowed for ratemaking purposes usually creates an equal amount of required revenue. If that expense is deductible, the required revenue is offset by the allowed expense and taxable income does not change. In this case, the Regulatory Amortization is not tax deductible and it therefore needs to be increased to reflect the additional income taxes that are due and payable if the desired level of FFO is to be attained.

Q. DO YOU HAVE ANY OTHER CONCERNS WITH MR. ROBERTSON'S TESTIMONY?

A. Yes, I do.

Q. WHAT ARE THOSE CONCERNS?

A. Mr. Robertson, on page 26 of his rebuttal testimony, quotes Staff testimony which says the Staff expects "sufficient benefits in deferred taxes from its ongoing plant in service additions to offset any additional tax liability associated with the regulatory plan amortization."

Q. WHY DOES THIS CONCERN YOU?

A. It is not certain that Empire's ongoing operations will yield benefits from deferred income taxes. However, with tax depreciation declining and tax capitalized costs during construction of the new coal plants creating deferred tax assets, it is very possible that cash flow will become negative due to net deferred income taxes decreasing and reducing the funds from operations. In any case, by bringing in hypothetical future events in an attempt to justify their positions, the Staff and OPC have inserted an issue that will likely result in the overall objective of the regulatory amortization not being met.

Q. DOES YOUR ATTACHED SCHEDULE SUPPORT YOUR POSITION ON THIS POINT?

A. Yes, it does. The schedule indicates that with regulatory amortization, deferred tax expense becomes negative (decreases) which represents a reduction in FFO.

Q. DO YOU HAVE ANY OTHER CONCERN ABOUT THE OPC AND STAFF TREATING THE REGULATORY AMORTIZATION AS A DEDUCTIBLE EXPENSE FOR INCOME TAX PURPOSES?

A. Yes, I do. There will be no deduction for the regulatory plan amortization on the income tax return filed for the Company. If the amount of revenue requirement is determined in this case by erroneously assuming the regulatory amortization is tax deductible, the FFO will be provided at only the net of tax amount, slightly over 60% of the indicated FFO requirement. The required FFO levels will not be maintained by the regulatory plan and the regulatory plan will fail.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.