Exhibit No.
Issue: Tax Expense
Witness: James I. Warren
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Sponsoring Party: Empire District Electric
Case No. ER-2012-0345
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Before the Public Service Commission of the State of Missouri

Direct Testimony

of

James I. Warren

July 2012

DIRECT TESTIMONY
OF
JAMES I. WARREN
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2012-0345

BACKGROUND AND INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is James I. Warren. My business address is 655 Fifteenth Street N.W., Washington, D.C., 20005.

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

A. I am a tax partner in the law firm Miller and Chevalier Chartered ("M&C").

Q. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT M&C.

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 on behalf of The Empire District Electric Company ("Empire" or the "Company").

Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

A. For more than 20 years, I have been involved in the provision of tax services almost exclusively to companies in various segments of the utility industry. I joined M&C in February of 2012. For the three and a half years prior, I was a partner in the law firm Winston & Strawn (September 2008 – February 2012) and for the five years prior to that, a partner in the law firm Thelen Reid Brown Raysman & Steiner LLP (September 2003 - September 2008). Before that, I was a partner in the accounting firms Deloitte LLP

(October 2000 – September 2003) and PricewaterhouseCoopers LLP (January 1998 – September 2000) and a partner in 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 and 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, the City of New Orleans, New York, Connecticut, Ohio, California, Maryland, Pennsylvania, Missouri, Illinois, Kentucky, Vermont Tennessee, Indiana 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.

PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses a single aspect of Empire's tax expense element of cost of service – the treatment of the costs it incurs to remove assets when those assets reach the end of their useful lives ("Cost of Removal" or "COR"). More specifically, I shall explain that, while the Company currently normalizes these costs, in prior years flow through tax accounting was applied which provided the tax benefit of these costs to customers twice. As a consequence, the Company's accumulated deferred income tax account was, and remains, under recovered. The Company seeks to recover this deferred tax over the remaining life of the assets to which it relates.

TAX EXPENSE

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

A. An investor owned utility ("IOU"),[1] such as Empire, 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 capital investment.

[1] An investor owned utility is a utility that is not owned by its customers (operating as a cooperative), a municipality or an instrumentality of a government. It is, instead, owned by owners seeking a return on their investment.

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 situation or transaction is often highly complex. 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 gap between these two regimes in the setting of rates that produces some of the more difficult problems.

Q. WHAT IS THE NATURE OF THIS GAP?

A. For purposes of this proceeding, the differences that matter are those 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. 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 TEMPORARY DIFFERENCES?

A. Probably the most prominent 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 accelerated methods (sometimes extremely accelerated such as in the case of 100% bonus depreciation). Thus, as a general proposition, tax depreciation is a good deal more rapid than regulatory depreciation. Many more differences exist as this is just one example.

Q. IS COST OF REMOVAL A DIFFERENCE OF THIS TYPE?

A. Yes, it is. For regulatory purposes, Cost of Removal is generally a component of the asset depreciation rate. As such, it is accrued over the life of the asset to which it relates. For tax purposes, COR is deducted in the year it is incurred.

Q. WHAT IS THE CRITICAL FEATURE OF TEMPORARY DIFFERENCES, INCLUDING COST OF REMOVAL?

A. They reverse. In each case, the same amount of the item of income or expense is reported for both regulatory and tax 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 TREATMENT AND THE TAX TREATMENT OF ITEMS REFLECTED 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, 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, in any period, customers are provided the tax benefit commensurate with the expenses they fund in cost of service as they fund them.

Q. WHAT IS FLOW THROUGH TAX ACCOUNTING?

A. Using flow through tax accounting, one calculates regulatory tax expense by reference to the treatment of items of income and expense as they 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.

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

A. This is easiest to see in the context of a temporary difference which normally produces tax deductions prior to the time it produces regulatory expense (as is the case with accelerated depreciation). This is by far the most common situation. In this context, the approaches differ 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 the utility simply pays it back. Applying flow through, the tax money produced by the temporary difference is passed on to customers. They, then, hold the 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 to the government. Regulatory tax accounting does not impact the relationship between the utility and the government. Again, it only determines, as between the utility and its customers, who holds the money that will be used to pay back the government in the interim. The applicable accounting requirements reflect this reality.

Q. PLEASE PROVIDE AN EXAMPLE.

A. Assume a utility undertakes a $3,000 software development and 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 ($1,000 X 35%) 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 each of Year 2 and Year 3. By the end of Year 3, the utility will have accumulated a 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 on account of its continuing amortization of the software. The $300 in revenue will be fully taxable (there will be no tax deductions flowing from the software 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 immediately. This is so notwithstanding that, in Year 1, customers fund only $300 of the cost of the project. This same thing would happen in each Year 2 and Year 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 of expenditures 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 by $105 in each of those years.

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. Yes. These amounts are merely the required repayment from customers of the tax benefit they enjoyed earlier.

Q. IS THIS REPAYMENT OBLIGATION CONTROVERSIAL?

A. No. The necessity to fund that tax on the reversal of a prior flow through is a natural feature of flow through tax accounting and is well-recognized.

Q. IS THERE SOMETHING OUT OF THE ORDINARY IN THE CASE OF COST OF REMOVAL EXPENDITURES?

A. Yes, there is. As I stated earlier, most temporary differences involve expenditures that are claimed as tax deductions on tax returns prior to the time they are recognized as

expenses for regulatory purposes. While COR is certainly a temporary difference just as these are, it operates inversely from the norm.

Q. WHY IS THAT?

A. For regulatory purposes, COR is incorporated into the book depreciation rate. For example, if an asset costs $1,000, has a ten year regulatory life and a $200 projected Cost of Removal, its book depreciation rate would be 12% - 10% per year for actual depreciation and 2% per year to recover the COR costs. Thus, of the $120 per year included in book depreciation expense, $100 is depreciation and $20 is COR. As a consequence, the $200 COR will be recovered over the regulatory life of the asset at the rate of $20 per year through depreciation expense. By contrast, for tax purposes, the deduction for COR will occur at the end of Year 10 when the asset is removed and $200 is actually expended for the purpose. Thus, unlike most temporary differences, the book expense for COR generally precedes the tax deduction.

Q. IN SUCH A SITUATION, WHAT IS THE PATTERN OF THE COR TEMPORARY DIFFERENCE?

A. In each of the years 1 through 9, customers will be charged for $20 of COR costs through their depreciation charge. In the 10^{th} year, they will be charged another $20 but the utility will finally incur the $200 COR cost. In short, in the first 9 years, the COR temporary difference originates and in Year 10, it reverses.

Q. HOW DOES ALL OF THIS RELATE TO THE COMPANY'S TAX EXPENSE CALCULATION IN THIS PROCEEDING?

A. With respect to COR, the Company's tax expense reflects both types of tax accounting. For the COR reflected in both its book depreciation and as deductions claimed on its tax return for the test period, the Company applies normalization tax accounting. Thus,

customers receive the tax benefit of the level of COR embedded in its book depreciation rate. However, its tax expense calculation includes an adjustment of $615,079 which increases its tax expense to account for the effect of flow through tax accounting which was utilized in prior years.

Q. PLEASE EXPLAIN THE ADJUSTMENT FOR PRIOR FLOW THROUGH TAX ACCOUNTING?

A. During the period in which flow through tax accounting was applied to COR, the customers were given the benefit of the actual COR tax deduction on the Company's tax return in addition to the normalized tax benefit that results from the COR included in regulatory depreciation rates. Empire's customers ultimately received the overall tax benefits of COR twice. The adjustment seeks to recover the flow-through portion of this benefit previously provided.

Q. PLEASE PROVIDE A SIMPLE EXAMPLE OF THIS PROBLEM.

A. For this purpose, I will revisit my previous example of the $1,000 asset that has a 10 year regulatory life and a projected $200 COR. Let us further assume that the asset is eligible for 100% bonus depreciation (that is, the $1,000 cost of the asset can all be deducted in Year 1), that the tax benefits of accelerated depreciation are intended to be normalized, that the tax benefits of COR are intended to be flowed through and that the tax rate is 35%.

Q. UNDER THESE FACTS, WHAT WOULD BE THE UTILITY'S REGULATORY DEPRECIATION CHARGE IN EACH OF THE YEARS 1 THROUGH 10?

A. In each year, its regulatory depreciation expense would be $120 ($1,000 X 12%). $100 of this amount would be "real" depreciation and $20 would be COR.

Q. IN YEAR 1, HOW WOULD THE TAX EXPENSE ELEMENT OF COST OF SERVICE BE CALCULATED?

A. While the Year 1 entire difference between regulatory depreciation ($120) and tax depreciation ($1,000) would be $880, this amount actually has two components – a depreciation component and a COR component. The difference between "real" regulatory depreciation ($100) and tax depreciation ($1,000), or $900, must be normalized. That is, customers must be provided the $35 tax benefit associated with the $100 of "real" depreciation for which they are being charged ($100 X 35%). The excess of the tax benefit of the $1,000 tax return deduction ($350) over this $35 benefit, or $315, must be reflected as a deferred tax charge. In this way, through the provision of deferred taxes, the depreciation temporary difference would be normalized. Meanwhile, the COR temporary difference is $20 and must be addressed separately. Since it is subject to flow through tax accounting and since there is no tax deduction in Year 1, customers should not be given a tax benefit on account of the $20 of COR they pay. Thus, there should be no deferred tax consequences associated with this COR expense.

Q. WHAT WOULD HAPPEN IN YEARS 2 THROUGH 9?

A. In each of these years, customers would also be charged $120 for regulatory depreciation. There would be no tax deduction in any of the years for either depreciation (it was all claimed in Year 1) or COR (it cannot be claimed until Year 10). Thus, while the total depreciation temporary difference in each year would be $120 ($1,000 X 12%), again this is comprised of two components - $100 of "real" depreciation and $20 of COR. The depreciation difference would be subject to normalization tax accounting. That means that customers would be provided a tax benefit of $35 in each year - the tax benefit commensurate with the "real" depreciation they are funding. This is so even though there

would be no tax deduction claimed on the tax return in any of those years. In each year, the utility would pay $35 of tax (the reversal of the "real" depreciation temporary difference) out of its deferred tax fund. COR, by contrast, because it would be subject to flow through tax accounting, would provide no tax benefit.

Q. WHAT WOULD HAPPEN IN YEAR 10?

A. With respect to "real" depreciation, the treatment would be the same as in years 2 through 9. The last of the utility's deferred tax fund would be depleted in this year. With respect to COR, since the utility incurs the entire $200 cost in Year 10, the entire tax benefit would be provided to customers in that year. As in all prior years, no tax benefit would be provided on account of the $20 of the book depreciation charge which is attributable to COR.

Q. PLEASE PROVIDE THESE RESULTS IN TABULAR FORM.

A. The results by year are reflected below:

Year	Reg. Dep.	"Real" Dep.	Tax Dep.	Reg. COR	Tax COR	Cur. Tax	Def. Tax	Total Tax
1	$120	$100	$1000	$20	$0	($350)	$315	($35)
2	$120	$100	$0	$20	$0	$0	($35)	($35)
3	$120	$100	$0	$20	$0	$0	($35)	($35)
4	$120	$100	$0	$20	$0	$0	($35)	($35)
5	$120	$100	$0	$20	$0	$0	($35)	($35)
6	$120	$100	$0	$20	$0	$0	($35)	($35)
7	$120	$100	$0	$20	$0	$0	($35)	($35)
8	$120	$100	$0	$20	$0	$0	($35)	($35)

9	$120	$100	$0	$20	$0	$0	($35)	($35)
10	$120	$100	$0	$20	$200	($70)	($35)	($105)
Total	**$1200**	**$1000**	**$1000**	**$200**	**$200**	**($420)**	**$0**	**($420)**

Q. WHAT DOES THIS TABLE SHOW?

A. The most important thing it shows is that, over the 10-year period, total tax expense would be reduced by a total of $420, an amount precisely equal to the total tax benefits claimed on the company's tax returns over the same period. Thus, all of the tax benefits available from the $1,000 of asset depreciation and the $200 of COR are provided to customers.

Q. WHAT WOULD HAPPEN IF THE "REAL" BOOK DEPRECIATION WAS NOT PROPERLY BROKEN OUT FROM THE TOTAL BOOK DEPRECIATION?

A. If that was not done, the effect would be to normalize the effects of ***both*** depreciation as well as COR. In short, customers would be given the tax benefit of both the depreciation and the COR they fund in each year. While this may be fine if both costs were subject to normalization tax accounting, it produces the wrong deferred tax charge where, under the facts of this illustration, COR is intended to be subject to flow through tax accounting.

Q. PLEASE ILLUSTRATE THIS OUTCOME.

A. The following table illustrates what would happen if the "real" book depreciation was not properly broken out from the total book depreciation.

Year	Reg. Dep.	Tax Dep.	Tax COR	Cur. Tax	Def. Tax	Total Tax
1	$120	$1000	$0	($350)	$308	($42)
2	$120	$0	$0	$0	($42)	($42)
3	$120	$0	$0	$0	($42)	($42)
4	$120	$0	$0	$0	($42)	($42)
5	$120	$0	$0	$0	($42)	($42)
6	$120	$0	$0	$0	($42)	($42)
7	$120	$0	$0	$0	($42)	($42)
8	$120	$0	$0	$0	($42)	($42)
9	$120	$0	$0	$0	($42)	($42)
10	$120	$0	$200	($70)	($42)	($112)
Total	**$1200**	**$1000**	**$200**	**($420)**	**($70)**	**($490)**

Q. WHAT DOES THIS TABLE SHOW?

A. The most important thing it shows is that, if the "real" book depreciation and the COR are not separated, the result would be that, over the 10-year period, total tax expense would be reduced by $490, an amount that exceeds the actual $420 tax benefit produced by the $1,000 of tax depreciation and the $200 of COR by $70. In short, the tax benefit of the COR deduction would be given to customers twice.

Q. PLEASE SUMMARIZE HOW THIS DOUBLE-BENEFIT OCCURS?

A. The impact of this procedure is to provide the tax benefits of COR to customers each year over the life of the asset through the inadvertent application of normalization tax

accounting to the portion of the regulatory depreciation charge attributable to COR, and then to again provide the tax benefit of the deduction for COR when it is claimed on the tax return.

Q. BASED ON YOUR ANALYSIS, IS THIS WHAT OCCURRED IN PRIOR YEARS?

A. Based on my review of various tax expense schedules from prior rate cases and discussions with Company personnel, I have concluded that this is precisely what occurred in prior years.

Q. WHAT HAS BEEN THE CUMULATIVE RESULT OF THIS PROCEDURE OVER THE PERIOD DURING WHICH FLOW THROUGH TAX ACCOUNTING WAS BEING APPLIED?

A. Based on the Company's analysis, the application of this procedure has resulted in a remaining under-provision of deferred income taxes of approximately $9.3 million on the books as of June 30, 2012. This represents the unrecovered basis as of the date rates from this proceeding can be put into place pursuant to the stipulation in Case NO. ER-2010-0130.

Q. HOW HAS THE COMPANY ADDRESSED THIS UNDER-PROVISION IN THIS PROCEEDING?

A. It has amortized the shortfall over the 18 year composite life of the assets which produced the balance. This amounts to $615,079 per year. That is the derivation and purpose of the adjustment to the tax expense element of cost of service I mentioned at the beginning of this testimony.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

AFFIDAVIT OF JAMES I. WARREN

STATE OF _____)
) **ss**
COUNTY OF District of Columbia)

On the 29TH day of June 2012, before me appeared James I. Warren, to me personally known, who, being by me first duly sworn, states that he is a tax partner in the law firm Miller & Chevalier Chartered and acknowledged 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.

James I. Warren

Subscribed and sworn to before me this 29TH day of June, 2012

Notary Public

My commission expires: April 14, 2017

ROHNDA P. WASHINGTON
NOTARY PUBLIC DISTRICT OF COLUMBIA
My Commission Expires April 14, 2017