

FILED³

SEP 29 2006

Missouri Public
Service Commission

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

Empire Exhibit No. 14
Case No(s). ER-2006-0315
Date 9-05-06 Rptr. PF

L. JAY WILLIAMS
SURREBUTTAL TESTIMONY

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

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

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

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

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

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

9 A. Yes.

10 **Q. PLEASE BRIEFLY SUMMARIZE YOUR SURREBUTTAL TESTIMONY.**

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

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1 **Q. CAN YOU EXPLAIN WHAT GROSS-UP MEANS?**

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

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

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

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

14 A. Yes. This is illustrated by the attached example (Surrebuttal Schedule LJW-1)
15 which is in the same general format as used by the Staff when computing the
16 income tax component of cost of service. It also uses the same numbers as Staff
17 witness Mark Oligschlaeger used in the attachment to his Supplemental Direct
18 testimony (Schedules 1-1 and 1-2). In computing taxable income, book
19 depreciation is added back to net income and tax depreciation is deducted in its
20 place. Any change in book depreciation or book amortization without additional
21 revenues results in no change in taxable income. As displayed in my schedule,
22 there is no change in tax depreciation. Therefore, any regulatory amortization
23 expense requiring additional revenues, increases taxable income and the income

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1 tax that is currently payable. Funds From Operations ("FFO") are provided at net
2 of the additional income tax currently payable.

3 **Q. PLEASE DESCRIBE SURREBUTTAL SCHEDULE LJW-1.**

4 A. This schedule, which I prepared, displays the calculation of the additional
5 regulatory amortization required. It uses the same assumptions employed by
6 Mark Oligschlaeger and adopted by Ted Robertson of the OPC in his rebuttal
7 testimony. By using this calculation as an example, Empire is not agreeing with
8 the various revenue and cost levels used by Mr. Oligschlaeger, but is using the
9 Staff calculation to illustrate the income tax ramifications associated with
10 regulatory amortization. As demonstrated by the schedule, if additional revenue
11 in the form of Regulatory Amortization of \$9.3 million were authorized by the
12 Commission in this rate case, that amount would need to be increased by \$5.8
13 million to reflect the additional income tax that would be due in order to produce
14 the required increase in FFO of \$9.3 million. In this example, this would make
15 the total revenue increase due to Regulatory Amortization \$15.1 million, not the
16 \$9.5 million recommended by Staff.

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

20 A. Yes.

21 **Q. WHY?**

22 A. The regulatory amortization in reality is additional book depreciation. As
23 proposed by Staff and Mr. Robertson for the OPC in this rate case it will be

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1 accounted for just like book depreciation, increasing accumulated depreciation
2 and reducing rate base. It is an acceleration of book depreciation to allow the
3 company to generate cash to meet certain financial targets, such as FFO, and
4 maintain its credit worthiness.

5 **Q. IS BOOK DEPRECIATION DEDUCTIBLE FOR INCOME TAX**
6 **PURPOSES?**

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

13 **Q. DO YOU AGREE WITH MR. ROBERTSON'S SUGGESTION ON PAGE**
14 **27 OF HIS REBUTTAL TESTIMONY THAT "EXPENSES ARE NEVER**
15 **SUBJECT TO INCOME TAX GROSS-UP"?**

16 A. No. I do not.

17 **Q. WHY NOT?**

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

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

3 A. Yes, I do.

4 **Q. WHAT ARE THOSE CONCERNS?**

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

9 **Q. WHY DOES THIS CONCERN YOU?**

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

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

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

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

4 **A.** Yes, I do. There will be no deduction for the regulatory plan amortization on the
5 income tax return filed for the Company. If the amount of revenue requirement is
6 determined in this case by erroneously assuming the regulatory amortization is tax
7 deductible, the FFO will be provided at only the net of tax amount, slightly over
8 60% of the indicated FFO requirement. The required FFO levels will not be
9 maintained by the regulatory plan and the regulatory plan will fail.

10 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

11 **A.** Yes, it does.

REGULATORY AMORTIZATION

SURREBUTTAL SCHEDULE
LJW-1

	Before Amortization	With Regulatory Amortization	
		No Gross-up	Gross-up
Operating Revenues	312,286,340	312,286,340	312,286,340
Revenues from Regulatory Amortization -			
Before Tax Gross-up		9,274,053	9,274,053
Tax Gross-up	-	-	5,778,784
Regulatory Amortization (Total)	-	9,274,053	15,052,837
Revised Operating Revenues	312,286,340	321,560,393	327,339,177
Operating Expenses	199,821,131	199,821,131	199,821,131
Book Depreciation	32,373,757	32,373,757	32,373,757
Taxes Other Than Income and Misc Exp.	11,413,393	11,413,393	11,413,393
Federal and State Income Tax Expense	17,358,207	17,358,207	17,358,207
Amortization (Total)	-	9,274,053	15,052,837
Total Operating Expenses	260,966,488	270,240,541	276,019,325
Operating Income	51,319,852	51,319,852	51,319,852
Income Tax Expense Computation -			
Operating Income	51,319,852	51,319,852	51,319,852
Add:			
Income Tax Expense	17,358,207	17,358,207	17,358,207
Book Depreciation	32,373,757	32,373,757	32,373,757
Amortization (Total)	-	9,274,053	15,052,837
	49,731,964	59,006,017	64,784,801
Less:			
Interest Expense	23,033,933	23,033,933	23,033,933
Tax Depreciation	36,145,484	36,145,484	36,145,484
	59,179,417	59,179,417	59,179,417
Taxable Income	41,872,399	51,146,452	56,925,236
Current Income Tax Expense @ 38.39%	16,074,814	19,635,123	21,853,598
Deferred Tax -			
Tax Depreciation	36,145,484	36,145,484	36,145,484
Book Depreciation	(32,373,757)	(32,373,757)	(32,373,757)
Amortization (Total)	-	(9,274,053)	(15,052,837)
Deferral Basis	3,771,727	(5,502,326)	(11,281,110)
Deferred Income Tax Expense @ 38.39%	1,447,966	(2,112,343)	(4,330,818)
Income Tax Expense	17,522,780	17,522,780	17,522,780
Funds Provided -			
Operating Income (Before Amortization)	51,319,852	51,319,852	51,319,852
Less Interest Expense	(23,033,933)	(23,033,933)	(23,033,933)
Add Original Income Tax Expense	17,358,207	17,358,207	17,358,207
Less New Income Tax Expense (Above)	(17,522,780)	(17,522,780)	(17,522,780)
Subtotal	28,121,346	28,121,346	28,121,346
Add Non-Cash Expenses -			
Book Depreciation	32,373,757	32,373,757	32,373,757
Amortization	-	9,274,053	15,052,837
Deferred Income Tax Expense	1,447,966	(2,112,343)	(4,330,818)
Funds From Operations (FFO)	61,943,069	67,656,813	71,217,122
Change in FFO	-	5,713,744	9,274,053
Income Tax Provision Proof:			
Income Before Income Tax	45,644,126	45,644,126	45,644,126
New Income Tax Expense	17,522,780	17,522,780	17,522,780
Effective Income Tax Rate	38.39%	38.39%	38.39%

* Excludes Other Miscellaneous Non-Amortization Related Income Tax Items.

AFFIDAVIT OF L. JAY WILLIAMS


STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 15th day of August, 2006, before me appeared L. Jay Williams, to me personally known, who, being by me first duly sworn, states that he is the Manager of Tax Planning 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.



L. Jay Williams

Subscribed and sworn to before me this 15th day of August, 2006



Pat Settle, Notary Public

My commission expires

