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Missouri Public
Service Commission

Exhibit No.

Issue: State Deferred Income Tax Expense,
Accumulated Deferred Income Taxes and
Regulatory Amortization

Witness: L. Jay Williams

Type of Exhibit: Rebuttal Testimony

Sponsoring Party: Empire District

Case No. ER-2006-0315

**Before the Public Service Commission
of the State of Missouri**

Rebuttal Testimony

of

L. Jay Williams

July 2006

Empire Exhibit No. 13
Case No(s). ER-2006-0315
Date 9-05-06 Rptr DF

L. JAY WILLIAMS
REBUTTAL TESTIMONY

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

1 **INTRODUCTION**

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

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

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

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

7 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND WORK**
8 **BACKGROUND.**

9 A. I graduated from Missouri Southern State University with a BS in Business
10 Administration with an emphasis in accounting in 1975. I hold certificate number
11 8047 from the Missouri State Board of Accountancy. Prior to joining Empire in
12 1983, I spent 6 years in public accounting primarily in the income tax field.
13 Except for a short period in Empire's Internal Auditing Department, I have spent
14 my entire tenure in the tax area of the Company. My tax experience at the
15 Company includes the responsibility for tax compliance in the areas of property,
16 sales/use, corporate franchise and income taxes.

17 **Q. HAVE YOU FILED TESTIMONY PREVIOUSLY BEFORE THE**
18 **MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?**

19 A. Yes.

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1 **Q. PLEASE BRIEFLY SUMMARIZE YOUR REBUTTAL TESTIMONY.**

2 A. My testimony concerns the proposed recovery of state deferred income tax
3 benefits flowed through for the benefit of ratepayers from 1954 through August
4 15, 1994. I also discuss an issue concerning the amount of deferred income taxes
5 used by the Commission Staff ("Staff") as a reduction from rate base and discuss
6 specific aspects of the supplemental direct testimony of Staff Witness Mark L.
7 Oligschlaeger concerning potential "regulatory plan" amortization and its
8 taxability.

9 **RECOVERY OF DEFERRED STATE INCOME TAXES**

10 **Q. WHAT IS THE ISSUE INVOLVING DEFERRED STATE INCOME**
11 **TAXES AS YOU UNDERSTAND IT?**

12 A. The income tax calculation displayed on Schedule 11 of the Staff's accounting
13 schedules and sponsored by Staff witness Amanda C. McMellen does not take
14 into consideration the fact that Empire has previously flowed through to its
15 customers certain state income tax deductions.

16 **Q. PLEASE EXPLAIN.**

17 A. From January 1, 1954 until August 15, 1994, Empire flowed through to its
18 customers the state income tax benefits of accelerated depreciation. During that
19 timeframe, the deferred income tax expense included in the Company's filings
20 only included the deferred federal income tax computed at the federal statutory
21 rates then in effect. This calculation effectively flowed through to customers the
22 lower state income tax expense. This benefit must begin to be recovered by

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1 Empire in this rate case or the state income tax benefits already given to the
2 Empire customers once, will be improperly given to them a second time.

3 **Q. HOW DO YOU KNOW THAT EMPIRE FLOWED THROUGH THE**
4 **DEFERRED STATE INCOME TAX BENEFITS TO RATEPAYERS**
5 **PRIOR TO AUGUST OF 1994?**

6 A. Prior to its 1973 rate case, Empire only reflected current income taxes as part of
7 its cost of service. As a result of the 1973 case, Empire began recovering only
8 deferred federal income taxes related to accelerated depreciation. In addition to
9 deferred state income tax flowed through to customers, Empire flowed through
10 the income tax benefits associated with the current deductions for capitalized
11 overheads (until 1987), as well as the costs of removal in excess of salvage, which
12 it continues to do today.

13 **Q. WHEN DID YOUR RESEARCH INDICATE THAT THE COMMISSION**
14 **FIRST ADDRESSED DEFERRED INCOME TAX ACCOUNTING?**

15 A. A 1956 Accounting Order from the Commission required Empire to record, for
16 financial reporting purposes, the federal deferred income taxes for the timing
17 differences related to the use of accelerated depreciation. In addition, the
18 Accounting Order was explicit that this accounting requirement only applied to
19 federal income taxes.

20 **Q. WHAT OTHER PAST COMMISSION ORDERS DID YOU LOCATE ON**
21 **DEFERRED INCOME TAXES?**

22 A. In the 1970's, the Commission ordered Empire to record deferred income tax
23 expense related to the tax amortization of pollution control facilities. Once again

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1 this only applied to federal income taxes, not state income taxes, and was for
2 financial reporting purposes only.

3 **Q. WHEN DID YOUR RESEARCH INDICATE THAT THE COMMISSION**
4 **FIRST ADDRESSED THE ISSUE OF INCOME TAX NORMALIZATION**
5 **AND ITS USE IN SETTING EMPIRE'S RATES?**

6 A. The Commission, at Empire's written request, authorized Empire to use income
7 tax normalization for ratemaking purposes in 1970. Had Empire normalized
8 federal or state deferred taxes in its rate cases prior to 1970, it would not have
9 needed an authorization letter from the Commission at a later date to do just that.
10 In addition, the IRS regulations stemming from provisions in the 1969 Tax
11 Reform Act included certain normalization requirements of federal deferred
12 income taxes for ratemaking that limited what the Commission could do in this
13 area without jeopardizing a company's ability to use accelerated tax depreciation.

14 **Q. DID THE 1969 TAX REFORM ACT HAVE ANY INFLUENCE ON STATE**
15 **INCOME TAX BENEFITS THAT COULD BE FLOWED THROUGH TO**
16 **THE CUSTOMER?**

17 A. No. State income tax benefits were not protected by the 1969 Tax Reform Act
18 and therefore could continue to be flowed through to the Empire customers
19 without violating the IRS normalization rules.

20 **Q. WHAT DOES THE SERIES OF COMMISSION ACTIONS REFERRED**
21 **TO ABOVE INDICATE TO YOU WITH RESPECT TO STATE INCOME**
22 **TAX NORMALIZATION?**

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1 A. This series of orders from the Commission only specifies that Empire was
2 authorized to record deferred federal income taxes, not deferred state income
3 taxes. In addition, the IRS regulations only apply to the normalization of federal
4 income taxes. There was no reason for anyone to believe Empire was recovering
5 state deferred income taxes in the rates it charged to its retail customers during
6 that time.

7 **Q. DID ANY OF THE EMPIRE RATE PROCEEDINGS OR GENERAL**
8 **COMMISSION ORDERS FROM THE PERIOD JANUARY 1, 1954 TO**
9 **AUGUST 15, 1994 REQUIRE THE NORMALIZATION OF STATE**
10 **DEFERRED INCOME TAXES FOR RATE PURPOSES?**

11 A. No. The Company never received any order from the Commission authorizing
12 the recovery of deferred state income tax expense. My research also indicates that
13 there were no Commission orders related to any utility company operating in
14 Missouri that directed the use of tax normalization ratemaking treatment for
15 accumulated deferred income taxes from accelerated depreciation from 1954
16 through 1969.

17 **Q. IS THIS SIGNIFICANT?**

18 A. Yes.

19 **Q. WHY?**

20 A. Had the Commission authorized income tax normalization in ratemaking it would
21 have required the accumulated deferred income taxes to be used to reduce rate
22 base in cases prior to 1970.

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1 **Q. DO YOU KNOW IN WHAT EMPIRE RATE CASE THE STAFF BEGAN**
2 **TO PROPOSE TO ALLOW THE RECOVERY OF DEFERRED STATE**
3 **INCOME TAX EXPENSE?**

4 A. No, it is not clear when the Staff began to normalize state income tax expense in
5 Empire's rate cases. In part this is due to the fact that, per my research, all of
6 Empire's rate cases between 1973 and 1994 involved negotiated settlements.
7 However, during the settlement negotiation in all of these rate cases, with the
8 exception of the 1994 rate case, Empire only used the statutory federal income tax
9 rate to determine deferred income tax expense.

10 **Q. WHAT IS THE SIGNIFICANCE OF THE PERIOD JANUARY 1, 1954 TO**
11 **AUGUST 15, 1994?**

12 A. The Internal Revenue Code first allowed the use of accelerated depreciation
13 beginning January 1, 1954. When the new electric rates went into effect on
14 August 15, 1994, Empire began to recover state deferred income tax expense as a
15 component of its cost of service.

16 **Q. WHY ARE YOU CERTAIN THAT EMPIRE DID NOT RECOVER**
17 **DEFERRED STATE INCOME TAX EXPENSE IN RATES PRIOR TO**
18 **AUGUST 15, 1994?**

19 A. Until new rates went into effect on August 15, 1994, Empire had consistently
20 flowed through to customers the federal and state income tax benefits of certain
21 timing differences not protected by IRS normalization rules. During the 1994 rate
22 case, Empire recognized that continuing to flow through state deferred income tax
23 expense to the current ratepayers would be at the expense of future ratepayers

1 unless the benefits were normalized. Therefore, the Company changed its state
2 income tax ratemaking practice and implemented a new accounting practice of
3 normalizing deferred state income tax in the 1994 case. This new practice
4 continued to be used in future rate proceedings.

5 **Q. IF THE FLOW-THROUGH OF STATE DEFERRED INCOME TAX**
6 **EXPENSE ENDED IN 1994, WHY IS THE COMPANY NOW SEEKING**
7 **TO RECOVER THOSE COSTS?**

8 A, The Company in 1994 did not recognize that the traditional ratemaking
9 procedures would not allow the recovery of the state deferred income tax benefits
10 that had previously been flowed through to the customers. In order for Empire to
11 recover those amounts, additional deferred income tax expense is required. The
12 Staff's income tax calculation in this rate case fails to include this additional
13 deferred income tax expense. In the Staff's income tax calculation, reversals of
14 timing differences, which were originally deferred at only the federal statutory
15 rate, reverse at the composite federal and state rates. This mechanically returns
16 the state deferred income tax expense to customers that were previously flowed
17 through to the customers prior to August 15, 1994.

18 **Q. WHEN DID THE COMPANY DISCOVER THIS PROBLEM?**

19 A. As part of its compliance with Sarbanes-Oxley, in 2005 Empire analyzed the
20 components of the regulatory asset that had previously been recorded in
21 accordance with FAS 109. These components represent revenues associated with
22 accumulated flowed through deferred income tax benefits to be recovered from
23 future ratepayers. As part of this process, Empire identified and analyzed the

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1 amount and the recoverability of the deferred state income tax benefits previously
2 flowed through to ratepayers. Due to the fact that deferred income taxes provided
3 previously in rates at only the federal statutory rate would be amortized (turned
4 around) at the composite federal and state statutory rates in the normal ratemaking
5 computation, an amount needs to be added to the deferred income tax expense to
6 keep from returning to current customers the state deferred income tax benefits,
7 which had previously been flowed through to customers prior to August 15, 1994.

8 **Q. HOW DOES THE COMPANY PROPOSE TO RECOVER THE**
9 **DEFERRED STATE INCOME TAX BENEFITS THAT HAD**
10 **PREVIOUSLY BEEN FLOWED THROUGH AND WHAT IS THE**
11 **AMOUNT?**

12 A. Empire proposes to recover the previously flowed through deferred state income
13 tax benefits under the "South Georgia" method. Under the Empire proposal, the
14 \$2,347,760 that Empire has recorded for financial reporting purposes as a
15 deferred state income tax liability and a corresponding regulatory asset will be
16 recovered ratably over the estimated remaining life of the assets involved, which
17 is 18 years. This equals an annual recovery of \$130,431.

18 **Q. WHAT EFFECT DOES THIS ISSUE HAVE ON EMPIRE'S BOOKS AND**
19 **FINANCIAL STATEMENTS?**

20 A. Generally Accepted Accounting Principles ("GAAP") requires that for a company
21 to maintain an asset on its balance sheet the ultimate recovery of that asset must
22 be probable. Without Empire's proposed recovery mechanism, recovery might

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1 not be considered probable. If the deferred state income tax is deemed to be non-
2 recoverable, stockholders not customers will be charged the cost.

3

4 **RATE BASE DEDUCTION OF DEFERRED INCOME TAXES**

5 **Q. WHAT IS THE PURPOSE OF THIS PORTION OF YOUR REBUTTAL**
6 **TESTIMONY?**

7 A. This portion of my testimony will address a deferred income tax balance used by
8 the Staff to reduce rate base that is entitled Deferred Income Taxes-Pension
9 Asset-Missouri. This balance appears on Schedule LJW-1 provided by Staff, has
10 a balance of \$2,324,454 and appears to be related to a Staff proposed pension
11 expense adjustment.

12 **Q. SHOULD THIS AMOUNT BE USED BY THE STAFF TO LOWER RATE**
13 **BASE?**

14 A. No. It should not.

15 **Q. WHY?**

16 A. The Staff's pension expense proposal, which appears to be related to this balance,
17 has been eliminated from the staff's case. This related rate base adjustment
18 should also be eliminated by the Staff.

19

20 **REGULATORY PLAN AMORTIZATIONS**

21 **Q. HAVE YOU REVIEWED THE SUPPLEMENTAL DIRECT TESTIMONY**
22 **OF MARK L. OLIGSCHLAEGER OF THE COMMISSION ON**
23 **REGULATORY PLAN AMORTIZATION?**

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1 A. Yes.

2 **Q. DO YOU AGREE WITH THE STAFF'S (OLIGSCHLAEGER**
3 **SUPPLEMENTAL DIRECT PAGE 11) POSITION THAT THE**
4 **REGULATORY AMORIZATION DOES NOT NEED TO BE GROSSED**
5 **UP FOR INCOME TAXES?**

6 A. No.

7 **Q. WHY?**

8 A. The regulatory amortization that is to be used under the regulatory plan is not a
9 tax deductible expense. The associated increase in revenue that comes with the
10 amortization would be considered taxable income by the IRS and, accordingly,
11 Empire's income tax expense will increase. Unless the revenue impact of the
12 amortization is increased to reflect the associated increase in income taxes, the
13 regulatory amortization will fail to meet the desired coverage ratios.

14 **Q. DO YOU AGREE WITH MR. OLIGSCHLAEGER'S CONTENTION AT**
15 **PAGE 11 OF HIS SUPPLEMENTAL DIRECT TESTIMONY THAT**
16 **EMPIRE'S ONGOING PLANT ADDITIONS CAN BE USED TO**
17 **COMPENSATE EMPIRE FOR ANY ADDITIONAL INCOME TAX**
18 **RELATED TO THE REGULATORY AMORTIZATION?**

19 A. No. It is difficult to tell from Mr. Oligschlaeger's testimony what ongoing plant
20 additions are being referred to, but in any event I cannot see how future plant
21 additions and any associated tax benefits can be used to offset the additional
22 income tax paid due to the recovery of regulatory amortization in current rates.

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1 These two issues are not related in terms of timing and may not even be related to
2 the same plant investment.

3 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

4 **A. Yes, it does.**

Empire District Electric Company
Case No. ER-2008-0315
Deferred Tax - Rate Base Items
Source: DR No. 28

Prepared by: Amanda C McMellen

Schedule LJW-1

Rate Base Items:	<u>Account</u>	<u>31-Dec-05</u>	<u>31-Mar-06</u>
Deferred Income Taxes			
Accumulated Deferred Federal Income Taxes - Electric	282.1	(117,097,781)	(117,204,267)
Accum Def Taxes - Loss on Reacquired Debt	283.9	(5,957,434)	(5,935,496)
Accum Def Taxes - Software Development Cost	283.924	-	-
Accum Def Taxes - License Software	283.4	(275,745)	(278,976)
Deferred Income Taxes - CIAC	190.31	4,129,196	4,152,789
Accum Def Taxes - Interest Capitalized	190.34	<u>3,750,230</u>	<u>3,785,767</u>
		(115,451,534)	(115,480,183)
Deferred Income Taxes - Pension Asset -Missouri			<u>(2,324,454)</u>
Total Deferred Income Taxes			(117,804,637)
Missouri Jurisdictional Factor			<u>85.3656%</u>
Missouri Jurisdictional Deferred Income Taxes			<u>(100,564,635)</u>

AFFIDAVIT OF L. JAY WILLIAMS

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 27th day of July, 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
L. Jay Williams

Subscribed and sworn to before me this 27th day of July, 2006

Patricia A. Settle
Pat Settle, Notary Public

My commission expires

