Exhibit No.
Issues: Income Tax Cost of Service and Deferred Taxes
Witness: L. Jay Williams
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Empire District Electric
Case No. ER-2014-0351
Date Testimony Prepared: March 2015

Before the Public Service Commission of the State of Missouri

Rebuttal Testimony

of

L. Jay Williams

March 2015

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L. JAY WILLIAMS
ON BEHALF OF
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
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INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. L. Jay Williams. My business address is 602 S. Joplin Avenue, 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 Regulatory Tax Manager.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

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

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

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I will respond to the Commission Staff's computation of income tax cost of service and deferred taxes used to adjust rate base, as set forth in Staff's Report-Cost of Service-Revenue Requirement. I disagree with Staff's deduction of the Employee Stock Option Plan ("ESOP") dividends allowed to the Company, Staff's computation of tax straight line ("SL") depreciation, and Staff's disallowance of previously flowed through tax benefits of costs of removal and state income tax expense.

ESOP DEDUCTION

Q. PLEASE EXPLAIN THE SOURCE OF THE ESOP TAX DEDUCTION.

A. A tax deduction is allowed when an ESOP elects to give plan participants the right to receive dividends currently from the company stock held in the plan. The amount of the company's tax deduction is determined solely at the employees' discretion in their role as stockholders, not as employees.

Q. HAS THIS ESOP TAX DEDUCTION ISSUE BEEN ADDRESSED BY THE COMMISSION?

A. Yes. The Commission addressed this same issue in Commission Case No. ER-2012-0166, an Ameren Missouri electric rate case. In that case, the Commission determined that "No portion of the income tax benefit realized on dividends paid on Ameren Corporation shares held in Employee Stock Ownership Plan ("ESOP") should be a deduction to Ameren Missouri's revenue requirement." The Commission should make the same determination in this case with regard to Empire's ESOP, and no portion of the income tax benefit should be deducted from Empire's revenue requirement.

TAX SL DEPRECIATION

Q. WHAT IS YOUR CONCERN WITH STAFF'S COMPUTATION OF TAX SL DEPRECIATION?

A. Staff used data from a previous rate case in making its estimate in this case.

Q. HAS STAFF CORRECTED THIS ERROR?

A. We believe so. Updates received since the initial filing by Staff appear to have been properly calculated.

<u>FLOWED THROUGH TAX BENEFITS OF COSTS OF REMOVAL AND STATE INCOME TAX EXPENSE</u>

Q. ARE THERE OTHER ISSUES IN THE STAFF'S COMPUTATION OF THE COST COMPONENT OF INCOME TAXES?

A. Yes. The Staff has not included recovery of previously flowed through tax benefits of costs of removal and state income tax expense.

<u>FLOWED THROUGH COSTS OF REMOVAL</u>

Q. PLEASE EXPLAIN THE TERM "FLOW THROUGH" IN TERMS OF THE INCOME TAX CALCULATION AND THE REGULATORY RATEMAKING PROCESS.

A. The "flow through" of income tax deduction benefits occurs when a deduction reduces current taxable income on the company's tax return and also is used to reduce the overall tax expense component in the regulatory ratemaking process with no offsetting increase to deferred income taxes. This was a common practice throughout the industry.

Q. WHEN DID THIS PRACTICE CHANGE?

A. Financial Accounting Standard 109 ("FAS 109") was issued in 1992 and required the balance sheet recognition of these unrecovered tax benefits.

Q. PLEASE ILLUSTRATE "FLOW THROUGH" IN TERMS OF THE INCOME TAX CALCULATION.

A. In the example below, the company's generally accepted accounting principles ("GAAP") books reflect a $5 cost of removal because the company accretes an estimated liability over a period of time until the actual cash costs of removal are paid. At that time, the book liability is removed. Alternatively, the Internal Revenue Code ("IRC") allows the deduction to occur when the cash is paid. For "flow through" purposes, the $50 deduction would be used in determining the income tax cost of service component for ratemaking purposes ($19).

Assumptions:		
Book costs of removal expense	$5	
Tax costs of removal deduction	$50	
Revenues		$ 100
Costs of removal		5
Income before tax		95
Current tax expense		19
Book income		76
Deduct additional costs of removal (50-5)		(45)
Taxable income		50

*Tax expense assumes a 38% composite fed/state tax rate

Q. PLEASE BRIEFLY EXPLAIN FAS 109.

A. FAS 109 required companies to record an overall provision for income taxes that ignored the tax deduction timing differences between the IRC regulations and GAAP. The most common example of this is the difference in recording depreciation deductions. More often, the IRC allows a higher depreciation rate, or accelerated, compared to the straight-line rate common to GAAP. When FAS 109 required a provision regardless of deduction timing, companies had to account for the timing differences on the balance sheet as "deferrals," since the cash taxes paid were not equivalent to the provision expense being recorded.

Q. WHY DID FAS 109 ALTER COMMON PRACTICE IN THE INDUSTRY?

A. The objectives of accounting for income taxes under FAS 109 are to recognize: (a) the amount of taxes payable (or refundable) for the current year; and (b) deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements. Since the "events" noted above are the result of current costs to provide service to customers, it made sense to "normalize" taxes for ratemaking purposes similar to the requirements under FAS 109.

Q. PLEASE DESCRIBE INCOME TAX NORMALIZATON IN RATE REGULATION.

A. In the regulatory process, income tax normalization results in overall income tax expense that includes current income taxes and a deferred income tax expense component. The combination eliminates any difference that results from deduction timing.

Q. PLEASE PROVIDE AN EXAMPLE OF THIS.

A. The example below illustrates how tax expense is recorded for GAAP purposes under FAS 109 and under "normalization" rate making methods for one cost of removal activity totaling $50. In years 1-9, book expense is accruing the costs of removal, but a tax deduction is not allowed. In year 10, the book expense again reflects $5 of costs, and the accumulated $50 cost of removal liability will be removed when the cash costs are paid. Tax deductions will only be allowed in year 10 when the cash costs are paid as well. Note that the overall tax expense is "normalized" to $36 regardless of which year ratemaking might occur.

Assumptions:	Years 1-9	Year 10
Book costs of removal expense	5	5
Tax costs of removal deduction	-	50
Revenues	$ 100	$ 100
Costs of removal	5	5
Income before tax	95	95
Current tax expense	38	19
Deferred tax expense	(2)	17
Book income	59	59
Add back costs of removal not deductible	5	
Deduct additional costs of removal (50-5)		(45)
Taxable income	100	50

Q. DOES THE "FLOW THROUGH" OF INCOME TAX DEDUCTIONS PRESENT ANY PROBLEMS IN TERMS OF ACCOUNTING?

A. Yes. At the inception of FAS 109, the Company's balance sheet reflected an adjustment to recognize all deferred income taxes related to previous and future timing differences of various income tax deductions. This meant that deferred tax expense was created without a provision (expense) for deferred taxes ever having been accounted for during the ratemaking process.

Q. UNDER FAS 109, HOW WAS THE "FLOW THROUGH" OF THESE VARIOUS PAST INCOME TAX DEDUCTIONS RECORDED ON THE COMPANY'S RECORDS?

A. An income tax liability (or payable) was established along with an offsetting regulatory asset, which reflects the opportunity to recover the flow through of these income tax deductions from current customers.

Q. WHAT IS THE IMPACT OF THE COMPANY BEING DENIED RECOVERY OF THE COST OF REMOVAL INCOME TAX DEDUCTIONS PREVIOUSLY FLOWED THROUGH TO EMPIRE'S CUSTOMERS IN THE FORM OF LOWER RATES?

A. The FAS 109 regulatory asset that was established as an offset to the future income tax liability becomes of questionable value and Empire's independent auditors may require the FAS 109 regulatory asset to be written off to expense.

Q. PLEASE DESCRIBE THE "FLOW THROUGH" OF TAX BENEFITS OF COSTS OF REMOVAL.

A. In years prior to 2008, the current tax benefits of costs of removal were flowed through to ratepayers by immediately reducing tax expense in cost of service. In 2008, the flow through of these benefits was discontinued by Staff in its cost of service for Empire, and the Company began recording the recovery of these benefits over the remaining depreciable lives.

Q. HOW LONG DID THE STAFF TREAT THE COST OF REMOVAL TAX BENEFITS AS A FLOW THROUGH ITEM?

A. The Staff's calculation of income tax expense treated the cost of removal tax benefits as a flow through item until 2008, when Staff started normalizing the item.

Q. ARE THERE OTHER METHODS OF RECOVERY THAT HAVE BEEN PROVIDED BY STAFF IN ORDER FOR EMPIRE TO RECOVER THE FLOWED THROUGH COSTS OF REMOVAL TAX BENEFITS?

A. No. Staff witnesses have indicated that they believe the recovery of the deferral was provided by an adjustment in the tax calculation – the tax basis straight-line depreciation adjustment. Costs of removal are charged to the depreciation reserve over the depreciable life and are not a part of the basis (initial investment) in the assets. This adjustment, however, actually represents differences related to "basis" and the cost of removal flow through issue is not a basis adjustment issue.

Q. HAS EVIDENCE BEEN PROVIDED TO STAFF OF THE FLOW THROUGH OF THESE BENEFITS?

A. Yes. Copies of Staff work papers from 1994 and 1997 cases were provided to Staff in DR178 in Case ER-2012-0345. These work papers show the flow through of the cost of removal tax benefits to Empire's ratepayers. Staff discontinued the flow through of these tax benefits when regulatory plan amortization was needed by the Company in 2008. In Commission Case No. ER-2006-0314, a Kansas City Power & Light Company rate case, Staff witness Steve Traxler stated: "Flow through treatment (current year deduction) was used for all Missouri utilities unless the utility could demonstrate the need for additional cash flow to meet interest coverage ratios."

Q. IS EMPIRE AMORTIZING THESE PREVIOUSLY FLOWED THROUGH COSTS?

A. Yes. The Company is amortizing the recovery of this regulatory asset at approximately $615,000 per year, based on the average remaining book life of the assets when the amortization began.

<u>STATE INCOME TAX EXPENSE</u>

Q. HOW DID THE UNDER-RECOVERY OF STATE INCOME TAX EXPENSE OCCUR?

A. The normalization requirement of the IRC specifies that to comply with the IRC, the federal statutory rate must be used in determining deferred income tax expense. Normalization of the amount of the composite federal and state rate in excess of the federal statutory rate was not required under normalization rules. State income tax expense was under-recovered prior to August of 1994, as the composite rate was not used.

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

A. No. In fact, the Company has only been ordered to provide deferred taxes at the federal statutory rate.

Q. HAS A COPY OF THIS ORDER BEEN PROVIDED TO STAFF?

A. Yes. A copy of this order was provided in our response to DR 177 in Case No. ER-2012-0345.

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

A. The Company began deferring tax at the composite rate in August of 1994, consistent with Staff's Missouri rate case that went into effect that year.

Q. HOW IS THE UNDER-RECOVERED STATE INCOME TAX EXPENSE CURRENTLY REFLECTED ON EMPIRE'S BOOKS, AND IS EMPIRE AMORTIZING THIS COST?

A. The Company has recorded the unfunded state income tax as a regulatory asset. The Company is amortizing the recovery of this regulatory asset at approximately $130,000 per year, based on the average remaining life of the assets when the amortization began.

Q. WHAT IS THE IMPACT OF THE COMPANY BEING DENIED RECOVERY OF THE EXCESS OF THE COMPOSITE FEDERAL AND STATE RATE OVER THE STATUTORY FEDERAL INCOME TAX RATE PREVIOUSLY FLOWED THROUGH TO EMPIRE'S CUSTOMERS IN THE FORM OF LOWER RATES?

A. The FAS 109 regulatory asset that was established as an offset to the future income tax liability becomes of questionable value, and Empire's independent auditors may require the FAS 109 regulatory asset to be written off to expense.

<u>RATE BASE ISSUE</u>

Q. WHAT ARE THE ITEMS OF CONCERN RELATED TO STAFF'S DETERMINATION OF DEFERRED INCOME TAX USED IN DETERMINING RATE BASE?

A. The Staff excluded the contra-account related to the reclassification of the current portion of deferred tax liability for financial reporting purposes, thereby overstating deferred taxes used to reduce rate base in its initial filing. In addition, the Staff's initial filing omitted the deferred tax asset related to regulatory amortization provided in Missouri from its rate base computation. Since the last rate case, the Company determined it was necessary to reclassify this deferred tax asset from its original netting with the deferred tax liability for clarity in other jurisdictions where the regulatory amortization does not apply.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

AFFIDAVIT OF L. JAY WILLIAMS

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 6th day of March, 2015, before me appeared L. Jay Williams, to me personally known, who, being by me first duly sworn, states that he is Retulatory Tax Manager 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 6th day of March, 2015.

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 11-01-2015