SOAH DOCKET NO. 473-04-1033
PUC DOCKET NO. 28840

PUBLIC UTILITY COMMISSION OF TEXAS

APPLICATION OF

AEP TEXAS CENTRAL COMPANY

FOR AUTHORITY TO CHANGE RATES

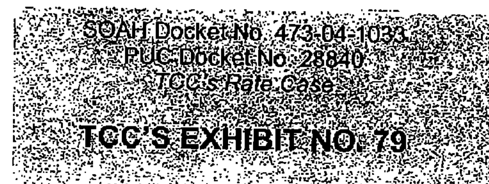
REBUTTAL TESTIMONY OF

JAMES I. WARREN

FOR

AEP TEXAS CENTRAL COMPANY

FEBRUARY 2004



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16 I. INTRODUCTION

17 Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

18 A. My name is James I. Warren. My business address is 875 Third Avenue, New York,

19 New York 10022.

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

21 A. I am a tax partner in the law firm of Thelen Reid & Priest LLP.

1 Q. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT THELEN REID
2 & PRIEST LLP.
3 A. I am engaged in the general practice of taxation. I specialize in the taxation of and the
4 tax issues relating to regulated public utilities. Included in this area of specialization
5 is the treatment of taxes in regulation. I also chair the firm's Tax, Benefits and Trusts
6 and Estate Department.
7 Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.
8 A. I joined Thelen Reid & Priest in November of 2003. Prior to that time I was affiliated
9 with the international accounting firms of Deloitte & Touche LLP (Oct. 2000 – Sept.
10 2003), PricewaterhouseCoopers LLP (Jan. 1998 – Sept. 2000) and Coopers &
11 Lybrand (Mar. 1979 – June 1991) and the law firm, Reid & Priest LLP (July 1991 –
12 Dec. 1997). At each of these professional services firms, I provided tax services
13 primarily to electric, gas and telephone industry clients. My practice has included tax
14 planning for the acquisition or transfer of business assets, operational tax planning
15 and the representation of clients in tax controversies with the Internal Revenue
16 Service (IRS) at the audit and appeals levels. I have often been involved in procuring
17 rulings or technical advice from the IRS National Office. On several occasions, I
18 have represented one or more segments of the utility industry before the IRS and/or
19 the Department of Treasury regarding certain tax positions adopted by the federal
20 government. I have testified regarding tax, tax accounting and regulatory tax matters
21 before a number of regulatory bodies including the Federal Energy Regulatory
22 Commission (FERC) and the commissions in Florida, Louisiana, Nevada, New

1 Jersey, New York, Connecticut, Pennsylvania and Texas. I have also testified before
2 several Congressional committees and subcommittees and at the Department of
3 Treasury hearings regarding legislative and administrative tax issues of significance to
4 the utility industry. I am a member of the New York and New Jersey Bars and also
5 am licensed as a Certified Public Accountant in those two states. I am a member of
6 the American Bar Association, Section of Taxation where I am a past chair of the
7 Committee on Regulated Public Utilities and also a member of the AICPA.
8 Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.
9 A. I have received a B.A. (Political Science) from Stanford University, a law degree
10 (J.D.) from New York University School of Law, a Master of Laws (LL.M.) in
11 Taxation from New York University School of Law and a Master of Science (M.S.) in
12 Accounting from New York University Graduate School of Business Administration.
13 Q. DID YOU FILE DIRECT TESTIMONY IN THIS CASE?
14 A. No, I did not.
15
16 II. PURPOSE OF TESTMONY
17 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?
18 A. I am testifying on behalf of AEP Texas Central Company (TCC or Company) in
19 response to Michael Arndt's direct testimony on behalf of the Cities. Specifically, I
20 shall rebut his proposal to impute to TCC a benefit attributable to the tax effect of
21 costs incurred by (and tax deductions claimed by) various non-regulated businesses
22 conducted within the American Electric Power Company, Inc. (AEP) consolidated tax

1 group (and within the Central and South West Corporation (CSW) consolidated tax
2 group prior to CSW's acquisition by AEP).
3 Q. WHAT FORM DOES THIS BENEFIT IMPUTATION TAKE?
4 A. Mr. Arndt proposes to accomplish this benefit imputation by reducing TCC's revenue
5 requirement by $15,197,000. He derives this figure by "grossing up" the "interest
6 credit" amount reflected on his Exhibit MLA-6 ($9,878,000). This latter figure is the
7 amount he apparently believes represents TCC's "fair share of the savings resulting
8 from..." being included in the AEP group consolidated federal income tax returns and
9 in the CSW consolidated federal income tax returns prior to CSW's acquisition by
10 AEP.
11 Q. WHAT ASPECTS OF MR. ARNDT'S PROPOSAL WILL YOU ADDRESS?
12 A. I shall address two overarching flaws in Mr. Arndt's proposal:
13 (1) that the imputation of any benefit whatsoever is, under TCC's circumstances,
14 "fair;" and
15 (2) that Mr. Arndt's proposed revenue requirement reduction effects anything less
16 than a 100% confiscation of the tax benefits he believes exist.
17 I shall also address six errors in the methodology Mr. Arndt employs to
18 compute the "fair share" of the tax benefits he believes exist. These are:
19 (A) the Gross-Up Error;
20 (B) the Functionalization Error;
21 (C) the AEP Acquisition Error;
22 (D) the Regulated Company Error;
23 (E) the With/Without Error; and
24 (F) the Pour Over Error.

1 III. CONSOLIDATED TAX SAVINGS

2 Q. WHAT DO YOU UNDERSTAND TO BE MR. ARNDT'S APPROACH TO
3 "CONSOLIDATED TAX SAVINGS?"

4 A. Exhibit MLA-6 effectively defines his approach. First, it is important to understand
5 two basic rules of tax law. The first is that the tax law permits a corporate taxpayer to
6 carry back an unused tax net operating loss (NOL) to offset taxable income produced
7 in prior years and forward to offset income produced in subsequent years. For NOLs
8 incurred in years prior to 1998, the carryback period was 3 years and the carryforward
9 period was 15 years. For NOLs incurred in years after 1997, the carryback period is
10 2 years and the carryforward period is 20 years, unless the loss was generated in 2001 or 2002, in which case it may be carried back 5 years. Thus, a company with an NOL
11 carryforward must wait to "monetize" its NOL until such time as it produces taxable
12 income. The second rule is that a consolidated tax return group reports a single, net
13 taxable income number upon which its tax liability is based. Thus, the filing of a
14 consolidated income tax return enables the tax NOLs of "tax loss" members to
15 immediately offset the taxable income of other members, thereby immediately
16 reducing the group's tax liability. In this way, with regard to any single group
17 member, NOL utilization may be accelerated vis a vis what would have occurred in
18 an unconsolidated context. With this in mind, Mr. Arndt's Exhibit MLA-6 computes
19 the extent to which individual group members were able to use tax NOLs in
20 consolidation in excess of the NOLs they would have been able to use had they not
21 filed as part of a consolidated tax group. With respect to each corporation in the
22 group, he identifies these "extra" NOLs and multiplies them by the highest corporate

1 tax rate applicable to the particular year. The aggregate of these amounts
2 ($850,026,996 [MLA-6, line 112]) he presumably considers the tax avoided as a
3 result of accelerating the use of the "extra" NOLs. He allocates this amount among
4 all the group members (including TCC) which produced taxable income against
5 which the NOLs were used in proportion to the taxable income produced by each.
6 TCC was allocated $171,506,828 (MLA-6, line 114) based on the relationship of its
7 aggregate taxable income ($2,027,427,000 [MLA-6, line 3) to the aggregate taxable
8 income of all companies producing taxable income ($10,048,391,073 [MLA-6, line
9 109]). He then proceeds to determine the value of the benefit of the acceleration
10 allocated to TCC by multiplying the amount by TCC's long term debt rate (5.76%).
11 This produces the $9,878,793 referred to on page 45, line 28 of his Direct Testimony.
12 Finally, he "grosses up" the amount to arrive at a revenue requirement effect
13 ($15,197,000 [Arndt, Direct, page 45, line 29]).

14 Q. HOW DOES THIS APPROACH PURPORT TO QUANTIFY A CONSOLIDATED
15 RETURN BENEFIT?

16 A. The benefit of using a tax NOL is that it generates incremental cash. Where an NOL
17 is carried forward to offset one's own taxable income, the cash takes the form of a
18 reduced tax payment in the later year. Where an NOL offsets another group
19 member's taxable income in the year it is generated, the cash takes the form of a tax
20 sharing payment. Inherent in Mr. Arndt's approach is the presumption that, due to
21 consolidated filing, certain NOL companies benefited from (*i.e.*, were paid for) the
22 use of their NOLs prior to the time they would have benefited had they filed on an

1 unconsolidated basis. The source of the payment was the group members having
2 taxable income who paid "stand alone" taxes, some portion of which were used to
3 compensate the tax loss group members for the use of their NOLs. Had the
4 compensatory payments by the "taxable income" members (including TCC) been
5 retained by them until the tax loss group members would have been able to use their
6 NOLs on an unconsolidated basis, then the "taxable income" companies would have
7 had additional capital to deploy. Mr. Arndt's use of TCC's long term debt rate
8 reflects the notion that, had TCC retained its portion of the cash benefits of NOL
9 acceleration, it would have reduced its long term debt by that amount, thereby
10 avoiding an interest charge it, in fact, is incurring. He, thus, adjusts TCC's cost of
11 service by, in effect, imputing the reduced interest cost.

12 Q. IN YOUR VIEW, BY VIRTUE OF NOT PROPOSING A "CONSOLIDATED TAX
13 SAVINGS ADJUSTMENT," HAS MR. BARTSCH DISREGARDED THE
14 COMMISSION'S ORDER IN DOCKET NO. 14965?

15 A. No. Texas regulatory law requires the assignment to a utility of its "fair share" of the
16 savings from filing a consolidated tax return. That is a subjective standard which
17 must be based on the facts and circumstances of each situation. "Fair share"
18 determinations have varied widely in different situations. They have been zero. To
19 my knowledge, there has not been a generic proceeding or rulemaking in which
20 specific mechanics were prescribed for the computation of a "fair share" in all
21 circumstances. Thus, Mr. Bartsch has independently, and, as I will describe at length

1 hereafter, appropriately, determined TCC's "fair share" under the circumstances to be
2 zero.
3 Q. WHAT IS YOUR VIEW OF "CONSOLIDATED TAX SAVINGS?"
4 A. "Consolidated tax savings," when used in a utility rate proceeding in one of those few
5 jurisdictions in which it is even considered, generally refers to the ability within a
6 consolidated tax return to offset tax NOLs incurred by one or more corporate
7 members against taxable income produced by one or more other corporate members.
8 I will hereafter refer to this feature of consolidated filing as "income netting." This
9 very narrow definition of the "consolidated tax savings" issue is unfortunate insofar
10 as "income netting" represents only one aspect of a much larger conceptual issue –
11 how should a group of corporations included in a consolidated income tax return
12 allocate the single tax imposed upon the annual activities of the group as a whole
13 among its constituent members?
14 Q. WHAT ARE SOME OF THE OTHER ALLOCATION ISSUES?
15 A. There are many tax allocation issues that arise on a fairly regular basis. Examples
16 include:
17 • Capital losses can only be used to offset capital gains. What if one member
18 incurs a capital loss but produces no capital gain while another member
19 produces a capital gain but no capital loss?
20 • Tax credits can only be used in reduction of a tax liability. What if one member
21 produces tax credits but no taxable income and another member produces
22 taxable income but no credits? Alternatively, what if one member produces

1 both tax credits and taxable income but another member produces tax NOLs
2 which eliminate the consolidated tax liability and, hence, the ability to use any
3 credits?
4 • Normally, for tax depreciation purposes all assets are deemed to be placed in
5 service in the middle of the year. Thus, a half-year depreciation is allowed in
6 that first year. However, if a consolidated group places 40% or more of its
7 assets in service in the last quarter of the year, then all assets placed in service
8 during the year are deemed to be placed in service in the middle of the quarter.
9 What if one member would not be subject to this "mid-quarter convention" but
10 for the placement in service of assets by another member?
11 • The alternative minimum tax is a tax which is calculated by reference to the
12 amount of preferences produced relative to the level of regular tax, both
13 calculated on a consolidated basis. What if one member produces preferences
14 but a sufficient level of regular tax to avoid AMT while another member
15 produces no preferences (and would, therefore, not be subject to the AMT) but
16 enough tax losses such that there is a consolidated AMT?
17 There are numerous other (and many more complex) examples.
18 Q. WHAT IS THE SIGNIFICANCE OF ALL OF THIS?
19 A. My point is that tax allocation is an extremely complex and challenging matter. It is
20 never as simple as one might suspect from the debate that "consolidated tax savings"
21 has engendered. Moreover, one should not view the allocation of the effect of
22 "income netting" as something apart from the much larger task of which it is only one

1 component. Thus, the identification and assignment of "consolidated tax savings" is
2 rarely, if ever, a "black or white" process and needs to be part of a larger thought
3 process.

4 Q. DOES TAX ALLOCATION EVEN MATTER OUTSIDE THE CONTEXT OF
5 UTILITY RATEMAKING?

6 A. It most certainly does. First and foremost, within a consolidated group, it promotes or
7 discourages certain behavior. For example if a group member is not paid for its
8 NOLs, it usually will seek to avoid incurring them – whether or not this is
9 advantageous to the group as a whole. Tax allocation can also be of great importance
10 to "outsiders." Thus, minority owners of a member's stock and owners of "tracking
11 stock" clearly care about tax allocation. So do the creditors of individual group
12 members who are rightfully very interested in whether or not the member to whom
13 they have lent money gets paid for its tax losses when those losses produce a benefit
14 to the consolidated group or only at some later, indeterminate date.

15 Q. TO WHICH ENTITIES DOES MR. ARNDT'S PROPOSAL PROVIDE THE
16 BENEFITS OF "INCOME NETTING" – AND WHEN?

17 A. Under Mr. Arndt's proposal, ultimately, the companies that generate the tax NOLs are
18 entitled to the cash produced by those NOLs. There is no disagreement as to the
19 propriety of this aspect of his proposal. The issue in controversy relates entirely to the
20 timing of the provision of the benefit. Mr. Arndt's approach proposes that these "tax
21 loss" companies be provided the benefit of the cash produced by their tax losses only
22 when they could have generated the tax benefit had they hypothetically not filed as

1 part of a consolidated tax return with AEP. Since they are not entitled to the cash
2 benefit of their NOL in the year in which it generates a cash benefit to the
3 consolidated group, by default, the benefit of the cash must be allocated elsewhere. In
4 this case, elsewhere includes, to some extent, TCC to which Mr. Arndt imputes a time
5 value benefit.

6 Q. IN GENERAL, WHAT IS THE BASIC PRINCIPLE BY WHICH YOU APPROACH
7 TAX ALLOCATION?

8 A. In crafting a tax allocation agreement, I attempt to ascertain which member is most
9 responsible for producing the tax benefit or incurring the tax cost. I then allocate that
10 tax consequence to that member.

11 Q. YOU USE THE PHRASE "MOST RESPONSIBLE," WHY?

12 A. The tax law is very complex when applied to a single corporation. When it is applied
13 to a group of corporations, the many interactions of situations which routinely occur
14 often result in no single member being definitively and exclusively responsible for a
15 particular tax outcome. The several examples I provided at the beginning of this
16 testimony (as well as the many additional examples that could be described) attest to
17 this fact. Thus, any attempt to allocate consolidated taxes must, in many situations,
18 involve an inquiry into the member most responsible. The relevant question is, if the
19 cash benefit has to go somewhere, which member has the strongest claim?

20 Q. WHAT DOES THIS SUGGEST WITH REGARD TO THE ALLOCATION OF THE
21 BENEFIT OF "INCOME NETTING?"

1 A. It suggests that the "but for" analysis that is frequently employed (and is the one
2 inherent in Mr. Arndt's approach) is flawed. The "but for" analysis I refer to is the
3 one that starts and ends with the statement, "But for the taxable income of TCC and
4 the other taxable members, the NOLs of certain non-regulated affiliates could not
5 have been used and, thus, the tax benefits could not have been produced."

6 Q. IF THE "BUT FOR" STATEMENT CAN BE SHOWN TO BE TRUE, WHY DO
7 YOU BELIEVE THIS ANALYSIS IS FLAWED?

8 A. When examining historical tax returns, this statement can be demonstrated to be true.
9 While it is appealingly simple and seemingly conclusive, it is grossly incomplete. It
10 is just as true that, "But for the NOLs of the tax loss affiliates, there would have been
11 no tax reduction." Again, this is a demonstrably true statement. So, as is often the
12 case in the world of consolidated returns, no single group member can lay exclusive
13 claim.

14 Q. IS THIS RELEVANT FOR RATEMAKING?

15 A. Absolutely. This discussion is not about the propriety of mere accounting entries, but
16 of the flow of cash. And the subject matter cash is produced by tax NOLs. In short,
17 its about the real economics of tax sharing. That is precisely what the "fair share"
18 determination required under Texas regulatory law is about. Thus, my discussion has
19 direct application to the setting of rates in this proceeding.

20 Q. WHAT ARE THE ELEMENTS OF TCC'S CLAIM TO THE BENEFIT OF
21 "INCOME NETTING?"

1 A. In order to determine which consolidated group member possesses the highest
2 entitlement, further inquiry into each member's contribution to the creation of the
3 benefit is necessary. With regard to TCC, its only contribution to the creation of the
4 benefit was its production of taxable income – something it would have done in
5 precisely the same way and in precisely the same amount whether or not there was an
6 "income netting" benefit to be had. By itself, TCC could have done absolutely
7 nothing to produce the benefit. In short, TCC was a completely passive participant
8 and, to the extent it is allocated any of the benefit (even if only to "warehouse" it until
9 some later point in time), it would be fair to say that the benefit essentially "falls into
10 its lap." It reaps a windfall.

11 Q. WHAT ARE THE ELEMENTS OF THE TAX LOSS MEMBERS' CLAIMS TO
12 THE BENEFIT OF "INCOME NETTING?"

13 A. By far the most important element is that each dollar of NOL represents a dollar
14 expended or a dollar of liability incurred by the tax loss member. In other words,
15 each loss member suffered a substantive change in its economic position to produce
16 the NOL. This cannot be said with respect to TCC and the other taxable group
17 members.

18 Q. ARE THERE ADDITIONAL ELEMENTS OF THE TAX LOSS MEMBERS'
19 CLAIMS TO THE BENEFIT OF "INCOME NETTING?"

20 A. Yes. The tax loss members could have done a fair amount to render their
21 expenditures "tax efficient" even in the absence of the consolidated return. First and
22 foremost, they could have moderated their deductible expenditures. For example,

1 they could have leased depreciable assets instead of owning them, extracting the
2 benefits of accelerated tax depreciation through lower lease payments. They could
3 have organized along alternative lines. For example, they could have operated as
4 divisions of larger corporations or as wholly owned limited liability companies (the
5 existence of which are ignored for tax purposes). They could have co-ventured in
6 partnership form and specially allocated deductible items to a co-venturer that could
7 make efficient use of additional tax deductions in exchange for enhanced ownership
8 terms.

9 Q. WHAT DOES THIS SUGGEST REGARDING THE TAX LOSS MEMBERS'
10 ENTITLEMENT?

11 A. It was well within the power of many of the tax loss members to recognize the tax
12 benefits (directly or indirectly) in the absence of TCC's or any other member's
13 taxable income. The implementation of alternative strategies was, however,
14 unnecessary due to the fact that other group members did in fact produce taxable
15 income. This element of control over the recognition of tax benefits supports the
16 notion that the benefit of "income netting" properly lies with the companies that
17 produced the NOLs.

18 Q. AS A TAX PRACTITIONER, DO YOU BELIEVE THAT THERE ARE
19 STRUCTURAL STEPS THAT COULD BE TAKEN TO ELIMINATE THE
20 NECESSITY TO "INCOME NET?"

21 A. I am confident that many, if not most, of the tax loss members could readily
22 implement alterations in their corporate structures such that, along with some re-

1 crafting of their investment activities, they could eliminate much of the their NOLs
2 and, hence, the necessity to "income net."
3 Q. BASED ON THE ABOVE, WHICH MEMBER DO YOU BELIEVE IS "MOST
4 RESPONSIBLE" FOR THE BENEFITS OF "INCOME NETTING?"
5 A. It is clear to me that it is the tax loss members that are "most responsible" for the cash
6 benefits of their NOLs when those benefits are realized by the consolidated group and
7 they should, therefore, be allocated the cash benefit.
8 Q. IN YOUR EXPERIENCE, IS PAYING A TAX LOSS MEMBER FOR THE TAX
9 BENEFIT OF ITS NOLS AS THOSE NOLS REDUCE THE GROUP'S TAXABLE
10 INCOME A COMMON TAX ALLOCATION METHODOLOGY?
11 A. This is the method employed by the vast preponderance of consolidated groups with
12 which I am familiar – both those which include utility members and those that do not.
13 It is AEP's method. In fact, I cannot recall seeing consolidated tax group that does
14 not compensate members for utilized benefits.
15 Q. DO YOU BELIEVE THAT THE ABILITY TO FILE AS PART OF A
16 CONSOLIDATED TAX GROUP CONFERS A COMPETITIVE ADVANTAGE ON
17 THE AEP TAX LOSS COMPANIES?
18 A. No. In the first place, as I indicated above, the tax loss companies could, if required,
19 have largely (if not completely) avoided the necessity to rely on the taxable income of
20 the regulated members. Thus, consolidated filing provides them little, if anything,
21 they wouldn't otherwise have. Moreover, as I will show later on, the non-regulated
22 operations as a whole produced sufficient taxable income to absorb all of the NOLs of

1 all of the tax loss members. Thus, merely filing a consolidated return with the other
2 non-regulated group members would have allowed all tax loss companies to monetize
3 their NOLs. They wouldn't need the regulated group members. Finally, my
4 experience convinces me that it is highly unlikely that any of the competitors of the
5 tax loss companies file as other than members of a consolidated tax group. Thus,
6 under the circumstances, consolidated filing achieves a level playing field and nothing
7 more.

8 Q. DO YOU AGREE WITH MR. ARNDT THAT MR. BARTSCH HAS FAILED TO
9 ASSIGN TO TCC ITS FAIR SHARE OF THE SAVINGS RESULTING FROM THE
10 FILING OF A CONSOLIDATED INCOME TAX RETURN?

11 A. No I do not. Under the circumstances, I believe that assigning no benefit of "income
12 netting" to TCC is rational, equitable and represents TCC's true fair share of the
13 benefits of consolidated filing.

14 Q. PLEASE DISCUSS THE NOTION THAT THE "INTEREST CREDIT"
15 METHODOLOGY PROPOSED BY MR. ARNDT TO REFLECT THE BENEFITS
16 OF FILING A CONSOLIDATED TAX RETURN EFFECTS A "SHARING" OF
17 THESE BENEFITS BETWEEN CUSTOMERS AND THE COMPANY?

18 A. As Mr. Arndt recognizes, "income netting" by members of a consolidated return
19 group can accelerate the timing of the favorable cash consequences of a tax loss
20 member's NOL. The premise underpinning Mr. Arndt's methodology is that, in the
21 setting of regulated rates, tax loss members ought to be placed in precisely the same
22 position they would have occupied had they filed unconsolidated income tax returns.

1 Their ability to enhance their cash flows by participating in a consolidated filing is,
2 for that purpose, effectively denied them.
3 Q. WHAT ARE THE IMPLICATIONS OF THIS?
4 A. It is obvious that, where there is an "income netting" benefit derived from filing a
5 consolidated tax return (as is clearly the case in the AEP situation), and where the tax
6 loss member is no better off than if it had filed on an unconsolidated basis, then 100%
7 of the benefit of the consolidated filing must be going elsewhere. And so it is. The
8 benefit in its entirety is being allocated to the taxable members who, as I previously
9 indicated, have a clearly subsidiary entitlement.
10 Q. WHAT, THEN, DO YOU CONCLUDE REGARDING THE PROPRIETY OF
11 IMPOSING A "CONSOLIDATED TAX ADJUSTMENT" IN THIS PROCEEDING?
12 A. I believe that those companies which, by their affirmative actions, impacted their
13 economic positions in ways that resulted in the production of NOLs have a claim on
14 the cash benefit produced by those NOLs which is superior to that of the companies
15 who were "by-standers" both as to the activities themselves and to their economic
16 consequences.
17
18 IV. SPECIFIC CALCULATION ERRORS
19 Q. WHAT IS THE "GROSS-UP" ERROR TO WHICH YOU REFERRED EARLIER
20 IN YOUR TESTIMONY?
21 A. I previously offered my characterization of the mechanics of the computations
22 reflected in Mr. Arndt's Exhibit MLA-6. I believe that the entire thrust of the process

1 he follows is geared towards calculating an amount of "incremental" interest expense
2 to which TCC is subject and then to propose an adjustment to offset it. The very
3 name of his methodology, the "interest credit" methodology, confirms that this is
4 precisely what is intended. Consequently, while the adjustment he proposes may have
5 been occasioned by tax cash flows, it is not truly a tax expense adjustment – it is an
6 interest expense adjustment. As such, there is no theoretical construct that would
7 support a "gross up." The only things that require a "gross up" are adjustments to
8 equity return, federal taxes and other items of income and expense that have no tax
9 consequences (*e.g.*, non-deductible meals and entertainment expenses, non-deductible
10 fines and penalties, etc.). The $9,878,793 that Mr. Arndt calculates on his Exhibit
11 MLA-6 is none of these. Thus, even if Mr. Arndt were otherwise entirely correct in
12 his proposal (which, of course, I do not believe to be the case), the proper level of his
13 proposed adjustment should not be $15,197,000 but rather $9,878,793.

14 Q. BASED ON YOUR REVIEW OF THE RELEVANT DOCUMENTS, DO YOU
15 BELIEVE THAT DOCKET NO. 14965, UPON WHICH MR. ARNDT PURPORTS
16 TO BASE HIS APPROACH, INCORPORATED A "GROSS-UP?"

17 A. Based on my review of the relevant documents, it did not.

18 Q. WHAT IS THE FUNCTIONALIZATION ERROR TO WHICH YOU REFERRED
19 EARLIER IN YOUR TESTIMONY?

20 A. In MLA-6, Mr. Arndt apportions the aggregate "income netting" benefit among the
21 taxable group members based on the ratio of each one's separate taxable income to
22 the aggregate of all members' taxable income. TCC is apportioned a 20.18% share of

1 the total (MLA-6, line 113). This apportionment is based on the premise that TCC
2 produced total taxable income of $2,027,427,000 over the prior 15 years (MLA-6,
3 line 3). His error arises from the fact that the TCC business for which this
4 Commission is setting rates in this proceeding, its transmission and distribution
5 (T&D) business, represents only a portion of TCC's historically integrated operations.
6 Each year's taxable income reflected on line 3 of his worksheet includes the effect of
7 the generation business. It would be both illogical and inequitable to attribute to the
8 T&D business any "income netting" tax benefits which were "produced" by TCC's
9 generation operations. To ascertain an accurate application of Mr. Arndt's "interest
10 credit" methodology, TCC's T&D-related taxable income would have to be split out
11 for each of the 15 years.

12 Q. DOES TCC HAVE THE ABILITY TO DO THIS?

13 A. Up until 2002, the Company never prepared "functionalized" taxable income
14 computations. In fact, it had no reason to do so prior to the Texas restructuring
15 legislation that mandated functionalization beginning in that year.

16 Q. WHAT WERE THE FUNCTIONALIZED RESULTS IN 2002?

17 A. In 2002, TCC produced $184,543,842 of taxable income. I asked Mr. Bartsch to
18 provide me with a functionalized breakdown of this figure. He informed me that the
19 T&D function produced $8,175,978 of taxable income and the generation function
20 produced $176,367,864 of taxable income.

21 Q. ASSUMING THAT THIS RELATIONSHIP BETWEEN T&D AND GENERATION
22 TAXABLE INCOME IS REPRESENTATIVE OF PRIOR YEARS' OPERATIONS,

1 WHAT WOULD BE THE PROPER WAY TO RECAST MR. ARNDT'S EXHIBIT
2 MLA-6?

3 A. Mr. Arndt's line 3 should be subdivided into a T&D line and a generation line and the
4 "interest credit" amount computed by reference to the former. I asked Mr. Bartsch to
5 replicate Mr. Arndt's Exhibit MLA-6 incorporating this feature. The result is
6 reflected in his Exhibits JBB-1R and JBB-2R (which include a number of other
7 modifications which I will describe hereafter). If the same ratio of taxable income
8 were to be applied to prior years, the aggregate T&D taxable income would be
9 $89,822,548. This would change the ratio of the "income netting" benefit allocated to
10 TCC for purpose of this proceeding from 20.18% to 0.8939%. As a result, the
11 "interest credit" amount would be materially reduced.

12 Q. IN YOUR VIEW, IS THIS A NECESSARY MODIFICATION TO MLA-6?

13 A. Frankly, I cannot imagine how Mr. Arndt's approach can be applied under Texas law
14 without accounting appropriately for functionalization. Thus, I think the modification
15 is essential.

16 Q. WHAT IS THE AEP ACQUISITION ERROR TO WHICH YOU REFERRED
17 EARLIER IN YOUR TESTIMONY?

18 A. A review of Mr. Arndt's Exhibit MLA-6 discloses that the AEP acquisition of CSW
19 produces a dramatic effect on the calculation of the "interest credit" amount. In his
20 computation, Mr. Arndt makes no theoretical distinction between legacy CSW and
21 legacy AEP group members. The only practical difference is that the legacy CSW
22 consolidated group members have tax histories which predate the AEP acquisition of

1 CSW and the legacy AEP consolidated group members do not. There are two distinct
2 reasons why treating the legacy AEP group members as indistinguishable from all
3 other consolidated group members is erroneous. First, Mr. Arndt's mechanical
4 approach has "cut off" the 15 year history of several of the AEP tax loss members
5 depriving them of the ability to offset their losses with their own taxable income.
6 Moreover, the AEP acquisition should have no effect whatsoever on the setting of
7 TCC rates.

8 Q. WHAT EFFECT DOES THE INCLUSION OF ONLY POST-ACQUISITION TAX
9 RESULTS OF THE LEGACY AEP COMPANIES HAVE ON THE "INTEREST
10 CREDIT" CALCULATION?

11 A. As I indicated, MLA-6 incorporates only the post-acquisition tax results of the AEP
12 legacy consolidated group members. On one level, this is entirely appropriate since
13 the tax-related cash transfers occurring prior to the acquisition of CSW by AEP could
14 have produced absolutely no incremental interest cost to TCC. Thus, they are
15 irrelevant. However, because Mr. Arndt premises the availability of an "income
16 netting" tax benefit on the ability of a tax loss member to produce sufficient taxable
17 income to absorb its own NOL, it is critical to consider each tax loss member's ability
18 to carry back its NOLs produced during the post-acquisition period to offset its own
19 pre-acquisition taxable income. To the extent it is able to so offset the NOLs, then,
20 under Mr. Arndt's approach, it should not produce "income netting" benefits.

1 Q. ARE THERE ANY SITUATIONS OF WHICH YOU ARE AWARE IN WHICH
2 LEGACY AEP CONSOLIDATED GROUP MEMBERS WOULD BE ABLE TO
3 CARRY BACK POST-ACQUISITION NOLS?
4 A. Mr. Bartsch informs me of two material instances (as well as two additional
5 immaterial ones) in which this is the case. Both Central Ohio Coal (MLA-6, line 81)
6 and Windsor Coal (MLA-6, line 107) are reflected on MLA-6 as companies which
7 produce "interest netting" tax benefits. The former's NOL is $107,479,709 and the
8 latter's is $90,368,431. I am advised that, on a non-consolidated basis, these two
9 companies could have carried back ~~significant amounts of~~ their NOLs against taxable
10 income produced in the ~~7~~ 5 year carryback period, thereby ~~reducing~~ eliminating the NOLs reflected
11 in MLA-6 considered by Mr. Arndt in his calculation of the "interest credit" amount.
12 ~~The carryback amounts were $26,455,322 in the case of Central Ohio Coal and~~
13 ~~$64,419,357 in the case of Windsor Coal.~~ The effect of these carrybacks has been
14 reflected in Mr. Bartsch's Exhibit JBB-1R.
15 Q. PLEASE COMMENT ON THE EFFECT OF THE AEP ACQUISITION.
16 A. Up until the AEP acquisition of CSW in 2000, TCC operated within the CSW
17 consolidated tax group. That group had (and continues to have) taxable members as
18 well as tax loss members and TCC could have been allocated an "interest credit"
19 amount computed by reference to the tax results of those group members. The AEP
20 acquisition brought the CSW group into a larger, pre-existing consolidated tax group.
21 The AEP group itself had (and continues to have) both taxable members and tax loss
22 members. There is no sound theoretical reason why, so long as (1) all NOLs

1 produced by former CSW consolidated group members are absorbed within the
2 historical CSW group and (2) all NOLs produced by former AEP consolidated group
3 members are absorbed within the historical AEP group, the mere change in ownership
4 of CSW should have consequences for the "interest credit" computation. Where the
5 two above-mentioned conditions apply, the acquisition did nothing to enhance either
6 legacy group's ability to utilize member NOLs. Therefore, it is difficult to devise a
7 theory under which the mere combination of two self-sustaining (from an NOL
8 absorption perspective) tax groups should alter this Commission's view of the benefit
9 of "interest netting." It should be calculated, if at all, on the basis of the historical
10 CSW consolidated group.

11 Q. WHAT WOULD THE RESULTS OF SUCH A RECALCULATION BE?

12 A. I asked Mr. Bartsch to recalculate Mr. Arndt's Exhibit MLA-6 using only the legacy
13 CSW consolidated group members (and incorporating the functionalization
14 modification discussed earlier). The resulting worksheet is attached to his Rebuttal
15 testimony as Exhibit JBB-2R. The result of this recalculation is that the "interest
16 credit" amount is, again, materially reduced.

17 Q. WHAT IS THE REGULATED COMPANY ERROR TO WHICH YOU REFERRED
18 EARLIER IN YOUR TESTIMONY?

19 A. In Exhibit MLA-6, Mr. Arndt includes as a tax loss member Transok Gas
20 Transmission Company (Transok), a FERC-regulated gas transmission company
21 (MLA-6, line 22). On an unconsolidated basis, Transok produced an aggregate NOL
22 carryforward of $60,358,083. Mr. Arndt's methodology ascribes to this regulated

1 entity a benefit of "income netting" it should not have enjoyed based on its inability to
2 utilize its NOLs on an unconsolidated basis. Its loss is thus included in his "interest
3 credit" calculation. It is my understanding of FERC ratemaking that FERC would not
4 view Transok as having received an unwarranted benefit. Thus, FERC and Texas
5 ratemaking would be diametrically inconsistent, leaving the shareholders of TCC and
6 Transok in a "heads I win, tails you lose" position.

7 Q. WHAT DOES THIS POTENTIAL INCONSISTENCY SUGGEST WITH RESPECT
8 TO MR. ARNDT'S "INTEREST CREDIT" PROPOSAL?

9 A. This situation highlights one of the practical issues associated with the use of his
10 "interest credit" approach. When it produces a rate reduction, various parties to a rate
11 proceeding are inclined to support it. However, under the right circumstances, the
12 application of this theory will actually produce a rate increase. Under such
13 circumstances, one wonders how much regulatory support such a proposal would
14 receive. If, upon honest reflection, this Commission is willing to admit that it would
15 be unlikely it would impose a "reverse interest credit" adjustment in a Texas rate
16 proceeding, then it should definitely think twice about reducing rates as Mr. Arndt
17 proposes.

18 Q. WHAT ARE THE WITH/WITHOUT AND THE POUR OVER ERRORS TO
19 WHICH YOU REFERRED EARLIER IN YOUR TESTIMONY?

20 A. Mr. Arndt's approach, as reflected in MLA-6, mechanically treats all corporate
21 entities included in the consolidated tax filing as essentially the same. By this I mean
22 that there is no critical analysis applied to determine whether or not there ought to be

1 logical groupings of member companies and, if so, what those groupings might be.
2 This single-minded focus on legal entities is highly formalistic and leads to unsound
3 results.

4 Q. PLEASE DESCRIBE A GROUPING YOU BELIEVE MIGHT BE LOGICALLY
5 CONSIDERED AND THE RESULTS OF THAT GROUPING.

6 A. One logical grouping would be to consider all companies other than TCC as a single
7 group. If this were done, it is obvious from a cursory review of MLA-6 that there
8 would be no "interest credit" amount. This is because, as a separate group, the non-
9 TCC entities were able to utilize all of their NOLs.

10 Q. IS THERE ANOTHER GROUPING THAT SUGGESTS ITSELF TO YOU?

11 A. Yes there is. If the concern is that non-regulated operations are somehow receiving
12 unwarranted cash flows from regulated operations, it makes sense to create two
13 groups – a regulated one and a non-regulated one. I requested that Mr. Bartsch
14 prepare such a worksheet. It is attached to his Rebuttal Testimony as Exhibit
15 JBB-3R.

16 Q. WHAT IS THE IMPACT OF SUCH A GROUPING ON THE COMPUTATION OF
17 AN "INTEREST CREDIT" AMOUNT?

18 A. Exhibit JBB-3R indicates that each of the two groups would be able to absorb all of
19 the NOLs produced by any of its individual members. Consequently, there would be
20 no "interest credit" amount. This illustrates that the AEP regulated operations are in
21 no sense subsidizing the AEP non-regulated operations by means of tax sharing.

1 Q. CAN YOU PROVIDE A SPECIFIC EXAMPLE WHERE THE FAILURE TO
2 CONSIDER THE RELATIONSHIP AMONG GROUP MEMBERS FOR
3 PURPOSES OF MAKING A "FAIR SHARE" DETERMINATION PRODUCES AN
4 INEQUITABLE RESULT?

5 A. Yes I can. There is an egregious example of this in connection with the Transok
6 group of companies. These were gas-related assets owned by CSW prior to its
7 acquisition by AEP. They were sold in 1996, again, prior to the AEP acquisition.
8 The relevant taxable income and loss amounts for each of the 8 companies are set out
9 on Mr. Arndt's Exhibit MLA-6 at lines 12, 14, 18, 19, 20, 22, 23, and 24. Transok,
10 the parent of the group, occupies line 12. Of the 8 group members, 5 produced
11 aggregate NOLs which contributed to Mr. Arndt's "interest credit" amount. These
12 were:
13 Line 18 – Transok Acquisitions ($6,743,540)
14 Line 20 – Transok Gas Gathering ($41,656,689)
15 Line 22 – Transok Gas Transmission ($60,358,083)
16 Line 23 – Transok Gas Processing ($7,669,471)
17 Line 24 – Transok Properties ($2,329,925)
18 Thus, the total NOL generated by these companies was $118,757,708. In 1996, these
19 companies were sold at a huge taxable gain. This gain was largely responsible for the
20 $495,817,782 of taxable income reported by Transok in that year (MLA-6, line 12).
21 Thus, as an economic unit, the Transok group produced a sizeable quantity of net
22 taxable income. Notwithstanding this fact, due to the mechanical approach proposed

1 by Mr. Arndt, the NOLs of the subsidiaries are effectively segregated from the profit
2 on their sale to the benefit of an increased "interest credit" - and to the detriment of
3 logic and equity.

4 Q. WHAT, THEN, IS YOUR CONCLUSION REGARDING MR. ARNDT'S
5 PROPOSAL TO IMPOSE AN "INTEREST CREDIT" ADJUSTMENT?

6 A. Such an adjustment is unwarranted and would, in fact, be erroneous. The Company's
7 computation of tax expense provides TCC with its fair share of the benefits of being
8 included in a consolidated income tax return. On the other hand, Mr. Arndt's
9 proposed adjustment constitutes a confiscation of an allocable amount of the benefits
10 to which every other member is entitled as a result of consolidated filing. If, for
11 whatever reason, this Commission decides to impose an "interest credit" adjustment,
12 it should be modified in the various ways described above.

13

14 V. CONCLUSION

15 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

16 A. Yes, it does.

SOAH DOCKET NO. 473-04-1033

PUC DOCKET NO. 28840

PUBLIC UTILITY COMMISSION OF TEXAS

APPLICATION OF

AEP TEXAS CENTRAL COMPANY

FOR AUTHORITY TO CHANGE RATES

REMAND CONSOLIDATED TAX SAVINGS (CTS)

REBUTTAL TESTIMONY OF

JAMES I. WARREN

FOR

AEP TEXAS CENTRAL COMPANY

SEPTEMBER 2, 2004

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14

15 SEPTEMBER 2, 2004

16

17 I. INTRODUCTION

18 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

19 A. My name is James I. Warren. My business address is 875 Third Avenue, New York,

20 New York 10022.

1 Q. ARE YOU THE SAME JAMES I. WARREN WHO FILED REMAND
2 TESTIMONY IN THIS PROCEEDING?
3 A. Yes, I am.
4
5 ## II. PURPOSE OF TESTIMONY
6 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?
7 A. The purpose of my testimony is to rebut the Remand Testimony of Cities witness
8 Michael L. Arndt. Specifically, I will rebut his contentions that:
9 1. If the Commission determines that any consolidated tax savings
10 ("CTS") should be assigned to TCC and that such savings should be
11 functionally allocated, that the appropriate bases for the allocation are
12 the allocation factors used in Docket 22352, TCC's UCOS case
13 (Arndt, Remand, page 8, lines 1-4);
14 2. In light of the sale of generation, a functional CTS allocation would
15 deny customers a benefit they generated and to which they are entitled
16 (Arndt, Remand, page 6, line 12 through page 7, line 8); and
17 3. The "gross up" of his proposed adjustment is necessary or even
18 appropriate (Arndt, Remand, pages 8-15).

1 III. THE FUNCTIONALIZATION FACTORS

2 Q. WHAT DOES MR. ARNDT PROPOSE AS THE BASES FOR THE FUNCTIONAL
3 ALLOCATION OF ANY CTS ASSIGNED TO TCC?

4 A. Mr. Arndt proposes that in the event that the Commission decides to functionally
5 allocate the total CTS assigned to TCC between the generation and the transmission
6 and distribution (T&D) activities, the bases of such allocation should be the
7 percentages from Docket No. 22352. These were 59.41% for generation, 11.36% for
8 transmission and 28.96% for distribution. Using these percentages, he proposes to
9 allocate $6.127 million (40.32%) of his total proposed CTS adjustment to the T&D
10 function (Arndt, Remand, page 8, lines 1-4.)

11 Q. WHAT IS YOUR UNDERSTANDING OF HOW THESE PERCENTAGES WERE
12 DERIVED?

13 A. It is my understanding that these percentages represent the relative functional values
14 of the September 30, 1999 rate base presented in TCC's UCOS filing, Docket No.
15 22352. It is also my understanding that the 1999 rate base levels that Mr. Arndt
16 advocates were not used to set the unbundled T&D rates approved in TCC's case.

17 Q. DO YOU BELIEVE THAT IT IS APPROPRIATE TO USE THESE
18 PERCENTAGES FOR THE PURPOSE OF ALLOCATING ANY CTS?

19 A. No, I do not. Recall that the "interest credit" methodology is entirely driven by yearly
20 computations of taxable income or loss over a 15 year period. This is abundantly
21 apparent from the complex schedules produced by Messrs. Arndt and Bartsch. The
22 reason we are reduced to developing an allocation methodology in the first place is

1 that separate year-by-year computations of taxable income for each of the bundled
2 utility functions for the prior 15 years does not exist. Whatever we do should
3 approximate the amount of taxable income for the various functions during this 15
4 year period. In other words, we should be using the methodology that best estimates
5 the taxable income produced by the generation, transmission and distribution
6 functions each year during the prior 15 years.

7 Q. DOES USING THE ALLOCATION PERCENTAGES FROM DOCKET NO. 22352
8 ACCOMPLISH THIS?

9 A. No it does not. The premise underlying an allocation based on asset value (or rate
10 base) is that a relationship exists between that value and taxable income. In the
11 context of a regulated utility where rates are set to allow a return on rate base, this
12 makes particular sense. This logic is, in fact, supported by the Staff's Statement of
13 Position on Remand (Page 3). The use of relative asset values as they existed in 1999
14 as a predictor of taxable income over the prior 15 years only makes sense if (1) it can
15 reasonably be presumed that the relative values have not changed over the 15 year
16 period or (2) there is no better information available.

17 Q. ARE EITHER OF THESE THE CASE?

18 A. No they are not. We have available the relative rate base values as they were
19 recognized in rate-setting proceedings at various points during the relevant 15 year
20 period. These were the values that actually drove taxable income in the years in
21 which they affected rates. This information clearly indicates that the relative values
22 varied materially over the period.

1 Q. IF ANY ALLOCATION FACTORS MUST BE USED, WHAT ALLOCATION
2 FACTORS DO YOU BELIEVE SHOULD BE USED?
3 A. It makes no sense to use inferior information when better information is available.
4 The better information is that listed in Mr. Moncrief's Exhibit DRM-1 Remand CTS
5 and used by Mr. Bartsch in his calculation reflected in Exhibit JBB-3R Remand CTS.
6 He uses the actual relative rate base values approved by this Commission during the
7 period. These must produce a more accurate estimation than Mr. Arndt's. However,
8 for 2002, the factor produced by the actual taxable income for the various functions is
9 the best information available because it is taxable income and not a rate base proxy
10 and should be used.
11
12 IV. CUSTOMER ENTITLEMENT TO CTS
13 Q. WHAT DOES MR. ARNDT SAY REGARDING CUSTOMERS' ENTITLEMENT
14 TO CTS?
15 A. Mr. Arndt states that customers should not be denied the CTS they generated and are
16 entitled to when generation assets are being sold (Arndt, Remand, page 6, line 12
17 through page 7, line 8).
18 Q. IN WHAT WAY DOES A SALE OF GENERATION ASSETS HAVE ANYTHING
19 TO DO WITH THE FUNCTIONAL ALLOCATION OF THE CTS?
20 A. It has nothing whatsoever to do with it. We would be having precisely the same
21 disagreements if the generation assets were not being sold. The Company's
22 computations are not at all dependent on a sale. They would be the same with or

1 without one. Mr. Arndt fails to suggest a way in which his computations would vary
2 if there were no sale. In short, the introduction of the sale as a potential issue is a
3 diversion – nothing more. The Texas Legislature enacted legislation that required that
4 the generation, T&D, and retail functions be separated and it did not provide for any
5 subsidization of the T&D function by the generation function.

6 Q. IN WHAT WAY DID CUSTOMERS GENERATE THE CTS?

7 A. The customers did not generate any CTS. CTS are generated by tax losses of non-
8 regulated affiliated companies that do not provide regulated electric service to TCC's
9 customers. Truly, the only thing customers did was to be fortunate enough to be in
10 the service territory of a utility company that filed as part of a consolidated group
11 having tax loss affiliates. No customer ever paid higher rates because of this
12 affiliation. In fact, if anything, they paid lower rates - due to inclusion of CTS
13 adjustments – than they would have paid had there been no loss affiliates. To
14 characterize this complete passivity as "generating" anything at all is, well, simply
15 bogus. They paid for nothing (other than the electric service they received and for
16 which they would have paid regardless), risked nothing and took no actions. On the
17 contrary, they received a "windfall" that resulted solely from activities and risks that
18 were undertaken by other group entities. The CTS adjustment is pure mathematics.
19 Customers have no "entitlement" unless the math works for them. It is inappropriate
20 to complain when the math swings back towards neutrality. In short, this is not a
21 fairness issue but a mechanical one.

1 V. THE PROPRIETY OF GROSSING UP AN "INTEREST CREDIT" ADJUSTMENT

2 Q. DOES MR. ARNDT ACCURATELY DESCRIBE HIS OWN PROPOSED CTS
3 ADJUSTMENT ON PAGE 8, LINES 12-13 OF HIS REMAND TESTIMONY?

4 A. No he does not. In that testimony, he describes the CTS adjustment as simply the
5 product of "continuing tax losses times the federal income tax rate." Assuming by
6 "continuing tax losses" he means affiliate tax losses that could not be used on a non-
7 consolidated basis, he has omitted that portion of the computation that is most
8 relevant to the "gross up" controversy. He failed to include the multiplication of the
9 mathematical product described above by the Company's long-term debt rate. That is
10 certainly how he derived his proposed CTS adjustment of $9,878,000 (before gross
11 up). What he describes is the consolidated tax savings, not the consolidated tax
12 savings adjustment.

13 Q. WHY DO YOU STATE THAT THE MULTIPLICATION BY THE LONG-TERM
14 DEBT RATE IS THE STEP MOST RELEVANT TO THE "GROSS UP"
15 CONTROVERSY?

16 A. There are a number of types of CTS adjustments. The propriety of "grossing up" any
17 particular CTS adjustment is entirely dependent on the fundamental nature of that
18 adjustment. Much of the confusion and inconsistency associated with this
19 Commission's treatment of CTS adjustments in this regard may be alleviated by an
20 analysis of this fundamental nature. The fundamental nature of a CTS adjustment that
21 is produced by the "interest credit" methodology is such that a gross up is not only
22 unnecessary, it is wrong. The fundamental nature of an "interest credit" CTS

1 adjustment is conclusively defined by the step omitted by Mr. Arndt (*i.e.*, the
2 multiplication of the consolidated tax savings by the long-term debt rate).

3 Q. WHAT IS THE FUNDAMENTAL NATURE OF AN "INTEREST CREDIT" CTS
4 ADJUSTMENT?

5 A. The best way to illustrate its nature is by means of a simplified example. Assume a
6 consolidated tax group consisting of Parent and its subsidiary, Utility X. Parent
7 produces no taxable income or loss in any year. Utility X produces $100 of taxable
8 income in each of years 1, 2 and 3 and has an 8% long-term debt rate. Corp. Y joins
9 the consolidated tax group at the beginning of year 1 and produces tax losses of $100
10 in each of years 1 and 2 and produces $200 of taxable income in year 3. Assume a
11 35% tax rate.

12 Q. WHAT WOULD THE "INTEREST CREDIT" CTS ADJUSTMENT BE IF RATES
13 ARE SET AT THE END YEAR 1?

14 A. Because Corp. Y's year 1 tax loss offsets Utility X's taxable income, the tax loss
15 actually reduces the group tax liability by $35. However, Corp. Y could not have
16 used its year 1 $100 tax loss on an unconsolidated basis (*i.e.*, it could not have
17 reduced Corp. Y's cash tax liability because it had none). Under the "interest credit"
18 method, the difference between these two tax liability reductions, $35, is multiplied
19 by Utility X's long term debt rate, 8%, to produce a $2.80 credit to Utility X.

1 Q. WOULD YOU PRESENT THAT DATA IN TABULAR FORM?

2 A. Yes I will.

Table 1 - Rates Set in Year 1	
Parent	$0
Utility X	$100
Corp. Y	($100)
Consolidated	$0
Group Tax Liability	$0
Savings Year 1	$35
Utility X Credit	$2.80

3 Q. WHAT WOULD THE "INTEREST CREDIT" CTS ADJUSTMENT BE IF RATES

4 ARE SET AT THE END YEAR 2?

5 A. Because Corp. Y's year 1 and year 2 tax losses both offset Utility X's taxable income,

6 the tax losses actually reduce the group tax liability by $70. However, Corp. Y could

7 not have used either its year 1 $100 tax loss nor its year 2 $100 tax loss on an

8 unconsolidated basis (*i.e.*, neither could have reduced Corp. Y's cash tax liability

9 because it had none). Under the "interest credit" method, the difference between

10 these two tax liability reductions, $70, is multiplied by Utility X's long term debt rate,

11 8%, to produce a $5.60 credit to Utility X.

1 Q. WOULD YOU PRESENT THAT DATA IN TABULAR FORM?

2 A. Yes I will.

Table 2 - Rates Set in Year 2		
	Year 1	Year 2
Parent	$0	$0
Utility X	$100	$100
Corp. Y	($100)	($100)
Consolidated	$0	$0
Group Tax Liability	$0	$0
Savings Year 1 & 2		$70
Utility X Credit		$5.60

3 Q. WHAT WOULD THE "INTEREST CREDIT" CTS ADJUSTMENT BE IF RATES
4 ARE SET AT THE END YEAR 3?

5 A. Because Corp. Y's year 1 and year 2 tax losses both offset Utility X's taxable income,
6 the tax losses actually reduce the group tax liability by $70. Corp. Y could have used
7 both its year 1 and year 2 losses (as carryovers) to offset its year 3 taxable income had
8 it filed on an unconsolidated basis. Thus, those losses could have reduced Corp. Y's
9 year 3 tax liability by $70. Under the "interest credit" method, because there is no
10 difference between the consolidated tax reduction and the unconsolidated tax
11 reduction, there is no credit to Utility X.

1 Q. WOULD YOU PRESENT THAT DATA IN TABULAR FORM?

2 A. Yes I will.

Table 3 - Rates Set in Year 3			
	Year 1	Year 2	Year 3
Parent	$0	$0	$0
Utility X	$100	$100	$100
Corp. Y	($100)	($100)	$200
Consolidated	$0	$0	$300
Group Tax Liability	$0	$0	$105
Savings Year 1-3			$0
Utility X Credit			$0

3 Q. WHAT DOES THE EXAMPLE ABOVE DISCLOSE REGARDING THE
4 FUNDAMENTAL NATURE OF THE "INTEREST CREDIT" CTS
5 ADJUSTMENT?

6 A. The mechanics of the adjustment produce an annual time value charge applied to the
7 consolidated tax savings, that is the excess of the aggregate tax that would have been
8 paid by the group members had they filed alone over the tax actually paid. The
9 presumption inherent in the computation (and, in general, the reality) is that Utility X
10 made intra-group tax payments based on its own, stand-alone tax computation. The
11 "interest credit" CTS methodology can only logically be viewed as compensation to
12 Utility X for the additional interest expense it incurs as a result of having to pay
13 amounts in taxes in years 1 and 2 ($35 each year) that were not paid to the IRS but
14 were, instead, paid to Corp Y to compensate it for the use of its tax losses (even
15 though Corp Y would not have been able to receive any benefit of its losses had it
16 filed on an unconsolidated basis). Had Utility X not been required to make these tax

1 payments until Corp Y could have used its losses on an unconsolidated basis in year
2 3, it would have retained more cash during years 1 and 2 ($35 in year 1 and $70 on a
3 cumulative basis, in year 2) and, thereby, mitigated its borrowing cost in those years
4 by $2.80 and $5.60, respectively.

5 Q. HOW DOES THIS CHARACTERIZATION BEAR ON THE PROPRIETY OF
6 "GROSSING UP" THE PROPOSED CTS ADJUSTMENT?

7 A. As the example above illustrates, the "interest credit" methodology calculates an
8 interest expense "recovery." Just as interest expense itself is never "grossed up" for a
9 tax effect because it is deductible, so the recovery of "interest expense" should not be
10 grossed up, even if the amount recovered is computed using a CTS calculation.

11 Q. WHY ARE INTEREST EXPENSE ADJUSTMENTS NOT "GROSSED UP?"

12 A. Only items that are not deductible for tax purposes (*e.g.*, non-deductible meals,
13 penalties, fines, *etc.*) or items that have no federal income tax consequences (*e.g.*,
14 equity return) should be grossed up. Interest amounts fit into neither category.

15 Q. BUT ISN'T A CTS ADJUSTMENT AN ADJUSTMENT TO TAX EXPENSE AND
16 SUBJECT TO "GROSS UP" ON THAT BASIS?

17 A. Utility X's long-term debt rate, a critical component of the interest credit CTS
18 calculation, has nothing whatsoever to do with tax expense. This fact precludes the
19 "interest credit" methodology from logically producing an adjustment to tax expense.
20 Instead, the mechanics of the computation completely support its treatment as an
21 interest expense recovery and, as such, it should not be "grossed up."

1 VI. CONCLUSION

2 Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

3 A. If the Commission deems it appropriate to make a CTS adjustment, it should be
4 properly functionalized and in no event should a functional allocation be made based
5 solely on the percentages used in Docket No. 22352. Further, the fact that the
6 Company intends to dispose of its generation assets should have absolutely no bearing
7 whatsoever on the Commission's deliberations. Finally, no "interest credit-based"
8 CTS adjustment should be "grossed-up" because the fundamental nature of such an
9 adjustment is merely to compute the "incremental" interest expense purportedly
10 incurred by the utility.

11 Q. DOES THIS CONCLUDE YOUR REMAND REBUTTAL TESTIMONY?

12 A. Yes, it does.

STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

In the Matter of the Petition of
Public Service Electric and Gas Company
for Approval of an Increase in Gas Rates
and for Changes in the Tariff for Gas Service,
B.P.U.N.J. No. 12, Gas Pursuant to
R.S. 48:2-21 and 48:2-21.1
&
In the Matter of the Petition of
Public Service Electric and Gas Company
for Authority to Revise its
Depreciation rates for its Gas Property
Pursuant to N.J.S.A. 48:2-18

BPU Docket Nos. GR01050328 & GR01050297
OAL Docket Nos. PUC-05052-01N & PUC-0516-01N

REBUTTAL TESTIMONY

OF

JAMES WARREN

On Behalf of
Public Service Electric and Gas Company

P-10 RB
September 6, 2001

1 **PUBLIC SERVICE ELECTRIC & GAS COMPANY**
2 **REBUTTAL TESTIMONY**
3 **OF**
4 **JAMES I. WARREN**
5

6 Q. **PLEASE STATE YOUR NAME AND ADDRESS.**

7 A. My name is James I. Warren. My business address is 2 Hilton Court, Parsippany,
8 New Jersey 07054.
9

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

11 A. I am a tax partner in the accounting firm of Deloitte & Touche LLP.
12

13 Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

14 A. I am testifying on behalf of Public Service Electric & Gas Company ("PSE&G") in
15 response to the direct testimony of New Jersey Division of the Ratepayer Advocate
16 witness Robert J. Henkes. Specifically, I shall rebut his proposal to impute to
17 PSE&G a time value benefit attributable to the tax effect of costs incurred by (and tax
18 deductions claimed by) various non-regulated businesses conducted within the Public
19 Service Enterprise Group ("Enterprise").
20

21 Q. **WHAT FORM DOES THIS BENEFIT IMPUTATION TAKE?**

22 A. Henkes proposes to accomplish this benefit imputation by reducing PSE&G's gas
23 rate base by the $89,363,000 he derives on Schedule RJH-10. This is the amount he

1 apparently believes represents the "…tax savings allocable to a utility as a result of
2 the filing of consolidated income tax returns,…" (Henkes, Direct, page 27, lines 6-7)
3
4 **Q. ASPECTS OF MR. HENKES' PROPOSAL WILL YOU ADDRESS?**
5 A Mr. Krueger will address the various conceptual and mechanical flaws in Mr.
6 Henkes' computation. I shall address the conceptual problems with the basic
7 premise that, under Enterprise's specific circumstances, *any* benefit imputation
8 whatsoever is appropriate. I shall also address the extent to which Mr. Henkes'
9 proposed rate base reduction effects a confiscation rather than a "sharing" of
10 the tax benefits he believes exist.
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12 **Q. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT**
13 **DELOITTE & TOUCHE LLP.**
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15 A. I am engaged in the general practice of taxation. I specialize in the taxation of
16 and the tax issues relating to regulated public utilities. Included in this area of
17 specialization is the treatment of taxes in regulation.
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19 **Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.**
20 A. I joined Deloitte & Touche in September of 2000. Prior to this time, I was
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22 LLP (Jan. 1998 – Sept. 2000) and Coopers & Lybrand (Mar. 1979 – June

1 1991) and the law firm, Reid & Priest LLP (July 1991 – Dec. 1997). At each
2 of these professional services firms, I provided tax services primarily to
3 electric, gas and telephone industry clients. My practice has included tax
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17 I am a CPA licensed in New York and also a member of the New York
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1 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.**

2 A. I have received a B.A. (Political Science) from Stanford University, a law
3 degree (J.D.) from New York University School of Law, a Master of Laws
4 (LL.M.) in Taxation from New York University School of Law and a Master
5 of Science (M.S.) in Accounting from New York University Graduate School
6 of Business Administration.

7

8 **TAX ALLOCATION**

9 **Q. WHAT IS YOUR VIEW OF "CONSOLIDATED TAX SAVINGS?"**

10 A. "Consolidated tax savings," as used in most utility rate proceedings (this one
11 included), refers to the ability within a consolidated tax return to offset tax net
12 operating losses ("NOLs") incurred by one or more non-regulated corporate
13 members against taxable income produced by one or more other corporate
14 members, including, in this instance, PSE&G. This very narrow definition of
15 the "consolidated tax savings" issue is unfortunate insofar as it represents only
16 one piece of a much larger conceptual issue.

17

18 **Q. WHAT EXACTLY DO YOU MEAN BY THIS?**

19 A. The allocation of the benefits of the "income netting" described above is
20 merely one of the many issues that arise in attempting to allocate a single,

1 consolidated tax liability among those corporate group members that cause it.
2 In developing a system of tax allocation, one must adopt principles that are
3 applicable to all situations.
4
5 **Q. WHAT ARE SOME OF THE OTHER ALLOCATION ISSUES?**
6 A. There are many issues, among which are:
7 1. Capital losses can only be used to offset capital gains. What if one
8 member incurs a capital loss but produces no capital gain while another
9 member produces a capital gain but no capital loss?
10 2. Tax credits can only be used in reduction of a tax liability. What if one
11 member produces tax credits but no taxable income and another
12 member produces taxable income but no credits? Alternatively, what if
13 one member produces both tax credits and taxable income but another
14 member produces tax NOLs which eliminate the consolidated tax
15 liability and, hence, the ability to use any credits?
16 3. Normally, for tax depreciation purposes, all assets are deemed to be
17 placed in service in the middle of the year. Thus, a half-year
18 depreciation is allowed in that first year. However, if a consolidated
19 group places 40% or more of its assets in service in the last quarter of
20 the year, then all assets placed in service during the year are deemed to

1 be placed in service in the middle of the quarter. What if one member
2 would not be subject to this "mid-quarter convention" but for the
3 placement in service of assets by another member?

4 4. The alternative minimum tax ("AMT") is a tax, which is calculated by
5 reference to the amount of preferences produced relative to the level of
6 regular tax, both calculated on a consolidated basis. What if one
7 member produces preferences but a sufficient level of regular tax to
8 avoid AMT while another member produces no preferences (and would,
9 therefore, not be subject to the AMT) but enough tax losses such that
10 there is a consolidated AMT?

11

12 **Q. WHAT IS THE SIGNIFICANCE OF ALL OF THIS?**

13 A. My point is that tax allocation is an extremely complex and intellectually
14 rigorous matter. It is never as simple as one might suspect from the debate that
15 "consolidated tax savings" has engendered. Moreover, one should not view
16 the allocation of the effect of "income netting" as something apart from the
17 much larger task of which it is only one component.

18

19 **Q. DOES TAX ALLOCATION EVEN MATTER OUTSIDE THE**
20 **CONTEXT OF UTILITY RATEMAKING?**

1 A. It most certainly does. First and foremost, within a consolidated group, it
2 promotes or discourages certain behavior. For example (and of relevance to
3 the Enterprise situation), if a corporate member is not paid for its NOLs, it
4 usually will seek to avoid incurring them – whether or not this is advantageous
5 to the group as a whole. Tax allocation can also be of great moment to
6 "outsiders." Thus, minority owners of a member's stock and owners of
7 "tracking stock" clearly care about tax allocation. Indeed, the creditors of the
8 individual group members, such as the creditors of Enterprise's unregulated
9 affiliates, care a great deal about how the risk of their investments are affected.
10

11 Q. **IN YOUR VIEW, WHAT ARE THE GOALS IN DEVELOPING A TAX**
12 **ALLOCATION METHODOLOGY?**
13
14 A. I believe that the goals ought to be neutrality, equity and consistency. That is,
15 all members ought to be treated the same, this treatment should be fair, rational
16 and justifiable and it ought to be applied consistently.
17

18 Q. **IN GENERAL, WHAT IS THE BASIC PRINCIPLE BY WHICH YOU**
19 **APPROACH TAX ALLOCATION?**
20
21 A. In drafting a tax allocation agreement, I attempt to ascertain which member is
22 *most responsible* for producing the tax benefit or incurring the tax cost. I then
23 allocate that tax consequence to that member.

1 **Q. YOU USE THE PHRASE "MOST RESPONSIBLE." WHY?**

2 A. The tax law is very complex when applied to a single corporation. When it is
3 applied to a group of corporations, the many interactions of situations which
4 routinely occur often result in no single member being definitively and
5 exclusively responsible for a particular tax outcome. The several examples I
6 provided at the beginning of this testimony are all illustrations of this fact.
7 Thus, any attempt to allocate consolidated taxes must, in many situations,
8 involve an inquiry into the member *most* responsible. The relevant question is,
9 if the cash benefit has to go somewhere, which member has the strongest
10 claim?

11

12 **Q. WHAT DOES THIS SUGGEST WITH REGARD TO THE**
13 **ALLOCATION OF THE BENEFIT OF "INCOME NETTING?"**
14
15 A. It suggests that the "but for" analysis that is frequently employed is flawed.
16 The "but for" analysis I refer to is the one that starts and ends with the
17 statement, "But for the taxable income of PSE&G, the NOLs of certain non-
18 regulated affiliates could not have been used and, thus, the tax benefits could
19 not have been produced." When examining historical tax returns, this
20 statement can be demonstrated to be true. This is in fact the only rationale in
21 support of the allocation of any benefit whatsoever to PSE&G.

1 **Q. IF THE STATEMENT CAN BE SHOWN TO BE TRUE, WHY DO YOU**
2 **BELIEVE THIS ANALYSIS IS FLAWED?**
3
4 A. While it is appealingly simple and seemingly conclusive, it is grossly
5 incomplete. It is just as true that, "But for the NOLs of the affiliates, there
6 would have been no tax reduction." Again, this is a demonstrably true
7 statement. So, as is often the case in the world of consolidated returns, no
8 single member can lay exclusive claim.
9
10 **Q. WHAT ARE THE ELEMENTS OF PSE&G'S CLAIM TO THE**
11 **BENEFIT OF "INCOME NETTING?"**
12
13 A. In order to determine which member possesses the highest entitlement, further
14 inquiry into each member's contribution to the creation of the benefit is
15 necessary. With regard to PSE&G, its only contribution to the creation of the
16 benefit was its production of taxable income – something it would have done
17 in precisely the same way and in precisely the same amount whether or not
18 there was an "income netting" benefit to be had. By itself, PSE&G could have
19 done absolutely nothing to produce the benefit. In short, PSE&G was a
20 completely passive participant and, to the extent it is allocated any of the
21 benefit, it would be fair to say that it essentially "falls into its lap."
22
23 **Q. WHAT ARE THE ELEMENTS OF THE LOSS MEMBERS' CLAIMS**
24 **TO THE BENEFIT OF "INCOME NETTING?"**

1 A. The loss members could have done a fair amount to render their expenditures
2 "tax efficient" even in the absence of the consolidated return. First and
3 foremost, they could have moderated their deductible expenditures. For
4 example, they could have leased depreciable assets instead of owning them,
5 extracting the benefits of accelerated tax depreciation through lower lease
6 payments. They could have organized along alternative lines. For example,
7 they could have operated as divisions of larger corporations or as wholly
8 owned limited liability companies (the existence of which are ignored for tax
9 purposes). They could have co-ventured in partnership form and specially
10 allocated deductible items to a co-venturer that could make efficient use of
11 additional tax deductions in exchange for enhanced ownership terms. They
12 would certainly not have engaged in a tax-oriented leasing operation the
13 success of which depends, in large part, on the availability of taxable income.
14 (See Rebuttal Testimony of Robert C. Krueger, Jr. for a discussion of this
15 issue.)
16
17 **Q. ISN'T THIS CONCLUSION SPECULATIVE AND SELF-SERVING?**
18 A. This conclusion is the same conclusion reached by the Board's own
19 consultants, Liberty Consulting Group, when they undertook to audit and

1 analyze the Enterprise Group. In their "Final Report on the Unregulated
2 Subsidiaries of Public Service Enterprise Group Inc.," they recognized:

> 3 Investment decisions were made with the knowledge that the
> 4 losses could be used to offset the income of PSE&G,
> 5 especially with regard to PSRC tax-oriented investments. A
> 6 different assumed environment would have led to different
> 7 investment decisions for PSRC.

8
9 They concluded:

> 10 It is reasonably clear that past non-utility investment
> 11 decisions would have been different had the benefits of
> 12 consolidation not flowed to the benefit of non-utility
> 13 operations.

14
15 and, further:

> 16 Transferring even a minor share of the benefits of
> 17 consolidation to the utility will make many classes of tax
> 18 advantaged non-utility investments uneconomic. Exit from
> 19 those investment areas may cause a loss of the benefits to the
> 20 non-utility operations, and the loss of potential shared
> 21 benefits to the utility.

22

23 **Q. WHAT DOES THIS SUGGEST REGARDING THE LOSS MEMBERS'**
24 **ENTITLEMENT?**

25

26 A. It was well within the power of many of the loss members to recognize the tax
27 benefits (directly or indirectly) in the absence of PSE&G's taxable income.
28 The implementation of alternative strategies was, however, unnecessary due to
29 the fact that PSE&G did produce taxable income. This element of control over

1 the recognition of tax benefits supports the notion that the benefit of "income
2 netting" properly lies with the loss companies that produced the NOLs.
3
4 **Q. AS A TAX PRACTITIONER AND A TAX ADVISOR TO ENTERPRISE,**
5 **DO YOU BELIEVE THAT THERE ARE STRUCTURAL STEPS THAT**
6 **COULD BE TAKEN TO ELIMINATE THE NECESSITY TO "INCOME**
7 **NET?"**
8
9 A. I am confident the Enterprise could readily implement alterations in its
10 corporate structure such that, along with some modification of its investment
11 activities, it could eliminate all significant member NOLs and, hence, the
12 necessity to "income net."
13
14 **Q. ARE THERE ANY OTHER IMPORTANT ELEMENTS?**
15 A. Yes there are. Perhaps the two most important elements involve the
16 assumption of risk and the current economic effect. As a threshold matter, the
17 non-regulated members have assumed all of the business risks associated with
18 the businesses they conduct. PSE&G and its customers have assumed none of
19 these risks. Further, each dollar of NOL represents a dollar expended or a
20 dollar of liability incurred by the loss member. In other words, each loss
21 member suffered a substantive change in its economic position to produce the
22 NOL. This cannot be said with respect to PSE&G.

1 Q. **BASED ON THE ABOVE, WHICH MEMBER DO YOU BELIEVE IS
2 "MOST RESPONSIBLE" FOR THE BENEFITS OF "INCOME
3 NETTING?"**
4
5 A. It is clear from my analysis that I believe it is the loss affiliates that are "most
6 responsible" and should, therefore, be allocated the cash benefit.
7

8 Q. **IN YOUR EXPERIENCE, IS PAYING A LOSS MEMBER FOR THE
9 TAX BENEFIT OF ITS NOLS AS THOSE NOLS REDUCE THE
10 GROUP'S TAXABLE INCOME A COMMON TAX ALLOCATION
11 METHODOLOGY?**
12
13 A. This is the method employed by the vast preponderance of consolidated groups
14 with which I am familiar – both those which include utility members and those
15 that do not. In fact, I cannot recall seeing one that did not compensate
16 members for utilized benefits.
17

18 Q. **WHAT IS YOUR UNDERSTANDING OF THE ENTERPRISE TAX
19 ALLOCATION METHODOLOGY?**
20
21 A. It is my understanding that all group members with positive taxable income are
22 charged income tax on a pure "stand alone" basis (*i.e.*, as if they filed on an
23 unconsolidated basis). The actual Enterprise consolidated tax liability is
24 satisfied from this fund. Any amounts remaining are allocated among the loss
25 members. This method not only pays loss members for the use of their NOLs,

1 it tends to protect the producers of taxable income, including PSE&G and its
2 customers, from any adverse impacts of consolidated filing.
3
4 **Q. PLEASE EXPLAIN THIS LAST STATEMENT.**
5 A. This statement is best explained by means of a "real life" illustration. Mr.
6 Henkes has noted that Enterprise paid alternative minimum tax (AMT) in a
7 number of years since 1991. However, none of the burden of the AMT was
8 ever allocated to PSE&G. As previously mentioned, AMT is caused by the
9 interplay of items of tax preference and levels of taxable income. Among the
10 most prominent items of tax preference are accelerated depreciation –
11 especially that claimed with respect to assets placed in service between 1981
12 and 1986. In the early 1990's, PSE&G generated a huge amount of tax
13 preferences due to the depreciation it claimed on its nuclear plants. However,
14 it also produced enough taxable income such that, on a "stand alone" basis, it
15 would not have paid any AMT. However, those preferences were a major
16 factor in causing a consolidated AMT liability in a number of years. Under a
17 pure "responsibility" model of tax allocation, I would have concluded that
18 PSE&G should have been allocated some portion of the AMT burden on
19 account of its tax preferences. In fact, the Enterprise method insulated the
20 utility from this detrimental allocation. The Enterprise tax allocation

1 methodology appears to bend over backwards to protect taxable income-
2 generating members.
3
4 Q. **IN LIGHT OF THE ABOVE, WHAT IS YOUR CONCLUSION**
5 **REGARDING ENTERPRISE'S ALLOCATION OF THE BENEFIT OF**
6 **"INCOME NETTING?"**
7
8 A. In my opinion, the allocation methodology employed by Enterprise to reflect
9 the impact of "income netting" is rational and equitable. Moreover, I believe it
10 to be the method most often used by large corporate enterprises.
11

12 **THE EXTENT TO WHICH A RATE BASE**
13 **ADJUSTMENT EFFECTS A "SHARING"**
14
15 Q. **PLEASE DISCUSS THE NOTION THAT THE REDUCTION OF RATE**
16 **BASE TO REFLECT THE BENEFITS OF FILING A CONSOLIDATED**
17 **TAX RETURN EFFECTS A "SHARING" OF THESE BENEFITS**
18 **BETWEEN CUSTOMERS AND THE COMPANY?**
19
20 A. It is often asserted that a rate base adjustment effects an equitable sharing of
21 the benefits of "income netting." One of the major advantages touted by
22 proponents of this type of adjustment is that it is self-reversing. By this they
23 mean that, when the loss member could have used its NOLs on a "stand alone"
24 basis, the rate base reduction is reversed. This places the loss member in
25 precisely the same position with regard to the mechanical use of its NOL's it
26 would have occupied had it filed a separate income tax return. Thus, while

1 from this limited perspective, it will be no worse off than if it had filed on an
2 unconsolidated basis, neither will it be any better off.
3
4 **Q. WHAT ARE THE IMPLICATIONS OF THIS?**
5 A. It is obvious that, if there is an "income netting" benefit (i.e., the ability to use
6 NOL's) derived from filing a consolidated tax return, and if the loss member is
7 no better off with regard to using its losses than if it had filed on an
8 unconsolidated basis, then, any and all benefits of the consolidated filing must
9 be going elsewhere. And so it is. In fact, as indicated by Mr. Krueger, the
10 imposition of a consolidated return adjustment could well impose an economic
11 detriment due to the high return imputed to the benefit.
12
13 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**
14 A. Yes it does.

STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

In the Matter of the Petition of
Public Service Electric and Gas Company
for Approval of Changes in Electric Rates,
for Changes in the Tariff for Electric Service,
B.P.U.N.J. No. 14 Electric Pursuant to
N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.1, for
Changes in its Electric Depreciation Rates
Pursuant to N.J.S.A. 48:2-18, and for Other Relief

BPU Docket No. ER02050303
OAL Docket No. PUC 5744-02

REBUTTAL TESTIMONY

OF

JAMES I. WARREN

P-8-RB

November 15, 2002

JAMES I. WARREN
Docket No. PUC 5744-02
Opening Statement

My name is James I. Warren. I am a tax partner in the Parsippany, New Jersey office of Deloitte & Touche. My business street address is 2 Hilton Court.

My testimony today addresses the proposition that tax deductions claimed by companies other than PSE&G ought somehow to impact the setting of rates for PSE&G. Mr. Henkes, on behalf of the Ratepayer Advocate, asserts as pretty much a forgone conclusion that this should be the case and proposes to reduce PSE&G's rate base by approximately $55.6 million because of it. I believe that such an adjustment cannot withstand analysis. As a threshold matter, it must be recognized that this number fails to include test period results. Mr. Krueger will address the adjustments necessary to reflect these. In addition, the theory of such an adjustment must be accepted, if at all, entirely on the premise that "Right or wrong, that's the way we do things here." I would hope that Your Honor would find this to be an entirely unsatisfactory basis for reaching a determination.

The tax law allows certain groups of separate corporate taxpayers to file consolidated tax returns. One of the features of such filing is that the tax liability of the group is computed by reference to the aggregate net taxable income of the members. Thus the tax losses of one or more members "nets" against the taxable income of other members. As a result of this, the PSE&G Group has paid approximately $55.6 million (again, before test year adjustments) less in taxes than the individual members would have paid had they never filed as a group. The entire reduction results from tax losses produced by non-regulated operations. Notwithstanding that the non-regulated tax losses

actually reduced taxes paid, Mr. Henkes proposes to withhold the benefit of the tax reduction from the companies that produced it until those companies could have used the losses had they never filed on a consolidated basis. Ironically, they only receive the benefit of filing on a consolidated basis when there is no benefit. On the other hand, he proposes that, while there is a benefit of consolidated filing, it be imputed in its entirety to PSE&G.

My view is that the loss companies should receive that benefit of the tax reduction attributable to their activities when it occurs. These companies spent money, incurred liabilities and, in general, altered their economic positions to produce the tax reduction. PSE&G did nothing whatsoever to reduce the tax liability. In fact, it is likely that the loss companies would not have proceeded as they did if the denial of the tax benefits had been known. In light of this, I cannot help but conclude that the loss companies were far more "responsible" for the tax benefit than was PSE&G. And they, not PSE&G, should be allocated the benefits of their own activities.

As I mentioned, it is only when there is no consolidated benefit that Mr. Henkes proposes to allocate the benefit of tax reductions to the companies that produced it. Until that time, he allocates it to PSE&G. In this way, he ensures that loss companies can be no better off than had they filed on a non-consolidated basis. At the same time, he allows PSE&G to be a good deal better off. It gets $55.6 million (before test year adjustments) of imputed cost-free capital – capital produced entirely by the activities of non-regulated affiliates.

It is for these reasons that I strongly contend that the adjustment proposed by Mr. Henkes is inappropriate. I hope Your Honor will take this opportunity to consider its merits and reach a reasoned determination.

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2 **REBUTTAL TESTIMONY**
3 **OF**
4 **JAMES I. WARREN**
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18 benefit attributable to the tax effect of costs incurred by (and tax deductions
19 claimed by) various non-regulated businesses conducted within Public Service
20 Enterprise Group (Enterprise) or entities affiliated with Enterprise.

1 Q. **WHAT FORM DOES THIS BENEFIT IMPUTATION TAKE?**

2 A. Mr. Henkes proposes to accomplish this benefit imputation by reducing Public
3 Service's rate base by the $55,613,000 he derives on Schedule RJH-7. This is
4 the amount he apparently believes represents the "...tax savings allocable to a
5 utility as a result of the filing of consolidated income tax returns..." (Henkes,
6 Direct, page 18).
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8 planning for the acquisition or transfer of business assets, operational tax
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11 technical advice from the IRS National Office. On several occasions, I have
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15 number of regulatory bodies including the FERC and the commissions in
16 Florida, Louisiana, Nevada, New Jersey, New York, Connecticut,
17 Pennsylvania and Texas. I have also testified before several Congressional
18 committees and subcommittees and at the Department of Treasury hearings
19 regarding legislative and administrative tax issues of significance to the utility
20 industry.

1 I am a CPA licensed in New York and also a member of the New York and
2 New Jersey Bars. I am a member of the AICPA and the American Bar
3 Association, Section of Taxation where I am a past chair of the Committee on
4 Regulated Public Utilities.
5
6 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.**
7 A. I have received a B.A. (Political Science) from Stanford University, a law
8 degree (J.D.) from New York University School of Law, a Master of Laws
9 (LL.M.) in Taxation from New York University School of Law and a Master
10 of Science (M.S.) in Accounting from New York University Graduate School
11 of Business Administration.
12
13 **Q. YOU MENTIONED EARLIER THAT MR. HENKES PROPOSES TO**
14 **REDUCE RATE BASE BY APPROXIMATELY $55.6 MILLION ON**
15 **ACCOUNT OF "CONSOLIDATED TAX BENEFITS." WHAT DOES**
16 **THIS AMOUNT REPRESENT?**
17
18 A. Mathematically, this amount equals the amount by which the actual reduction
19 in taxes paid by the Enterprise consolidated group on account of the tax losses
20 of the non-regulated members of the group exceeds the tax benefits these non-
21 regulated members would have received had they never been included in the
22 consolidated filing. It is important to bear in mind that the $55.6 million
23 represents a real reduction in the cash taxes paid by Enterprise. It is not a

1 fictional benefit or a mere accounting entry. It is real cash. I believe that there
2 is no disagreement on this point.
3
4 Q. **TO WHICH ENTITIES DOES MR. HENKES' PROPOSAL PROVIDE**
5 **THE BENEFITS OF THIS CASH – AND WHEN?**
6
7 A. Under Mr. Henkes' proposal, ultimately, the companies that generate the tax
8 losses are entitled to the cash. Again, there is no disagreement as to the
9 propriety of this aspect of his proposal. The issue in controversy relates
10 entirely to the timing of the provision of the benefit. Mr. Henkes proposes that
11 these "tax loss" companies be provided the benefit of the cash produced by
12 their tax losses only when they could have generated the tax benefit, had they
13 hypothetically not filed as part of a consolidated tax return with Public Service.
14 Since $55.6 million of tax benefits actually realized by Enterprise would not
15 have been realized under this hypothetical filing status, then he proposes to, in
16 effect, hypothetically withhold from the non-regulated Enterprise entities that
17 amount of the cash benefit received by Enterprise. Since they do not get this
18 amount of tax benefit, by default, Public Service is deemed to hold the cash
19 (*i.e.*, there is nowhere else for it to go). Hence, Public Service is deemed to
20 have $55.6 million of "cost free" capital available to it. His proposed rate base
21 reduction represents the imputation of this "cost free" capital.

1 **Q. CAN MR. HENKES' APPROACH BE VIEWED AS BEING**
2 **ARBITARY?**
3
4 A. Yes, Mr. Henkes' uses a "stand alone" computation applied to the non-
5 regulated operations. He evaluates the entitlement of these Enterprise
6 members to the actual cash tax benefit produced by their losses based on their
7 ability to generate cash tax benefits had they filed on a "stand alone" basis
8 (obviously, a different basis than the one on which they actually filed). Any
9 benefits they could not have achieved on that basis goes to the residual "home"
10 of all hypothetically unused benefits – Public Service. However, it would be
11 every bit as logical (in fact, more logical, in my view) to do exactly the reverse
12 of what he proposes. This would be to view Public Service (instead of the non-
13 regulated entities) on a "stand alone" basis and allocate any residual (positive
14 or negative) consolidated tax liability to the non-regulated entities (instead of
15 to Public Service). If this were done, Public Service would pay the tax it
16 would have paid had it filed on an unconsolidated basis and the non-regulated
17 entities would receive the cash produced by their tax losses as those losses
18 produced cash for Enterprise. By selecting the non-regulated entities instead of
19 Public Service as the reference point, Mr. Henkes pre-ordains the result – not
20 surprisingly, a rate base reduction, which results in a reduction in Public
21 Service's revenue request.

1 Q. **HAVING POINTED THIS SHORTCOMING OF MR. HENKES' APPROACH, DO YOU OFFER A BETTER ONE?**
2
3
4 A. I believe so. My approach derives from my experience in working with groups
5 of companies filing consolidated income tax returns in developing methods to
6 allocate the consolidated tax liability among the members of the group.
7
8 Q. **WHAT IS YOUR VIEW OF "CONSOLIDATED TAX SAVINGS?"**
9
10 A. "Consolidated tax savings," as used in most utility rate proceedings (this one
11 included), refers to the ability within a consolidated tax return to offset tax net
12 operating losses (NOLs) incurred by one or more corporate members against
13 taxable income produced by one or more other corporate members. I hereafter
14 refer to this feature of consolidated filing as "income netting." This very
15 narrow definition of the "consolidated tax savings" issue is unfortunate insofar
16 as income netting represents only one aspect of a much larger conceptual issue
17 – how should a group of corporations included in a consolidated income tax
18 return allocate the single tax imposed upon the annual activities of the group as
19 a whole among its constituent members?
20
21 Q. **WHAT ARE SOME OF THE OTHER ALLOCATION ISSUES?**
22 A. There are many tax allocation issues, among which are:

1 1. Public Service capital losses can only be used to offset capital gains. What if
2 one member incurs a capital loss but produces no capital gain while another
3 member produces a capital gain but no capital loss?
4 2. Tax credits can only be used in reduction of a tax liability. What if one
5 member produces tax credits but no taxable income and another member
6 produces taxable income but no credits? Alternatively, what if one member
7 produces both tax credits and taxable income but another member produces tax
8 NOLs which eliminate the consolidated tax liability and, hence, the ability to
9 use any credits?
10 3. Normally, for tax depreciation purposes all assets are deemed to be placed in
11 service in the middle of the year. Thus, a half-year depreciation is allowed in
12 that first year. However, if a consolidated group places 40% or more of its
13 assets in service in the last quarter of the year, then all assets placed in service
14 during the year are deemed to be placed in service in the middle of the quarter.
15 What if one member would not be subject to this "mid-quarter convention" but
16 for the placement in service of assets by another member?
17 4. The alternative minimum tax (AMT) is a tax which is calculated by reference
18 to the amount of preferences produced relative to the level of regular tax, both
19 calculated on a consolidated basis. What if one member produces preferences
20 but a sufficient level of regular tax to avoid AMT while another member

1 produces no preferences (and would, therefore, not be subject to the AMT) but
2 enough tax losses such that there is a consolidated AMT?
3
4 There are numerous other (and many more complex) examples.
5
6 Q. **WHAT IS THE SIGNIFICANCE OF ALL OF THIS?**
7 A. My point is that tax allocation is an extremely complex and challenging matter.
8 It is never as simple as one might suspect from the debate that "consolidated
9 tax savings" has engendered. Moreover, one should not view the allocation of
10 the effect of "income netting" as something apart from the much larger task of
11 which it is only one component.
12
13 Q. **DOES TAX ALLOCATION EVEN MATTER OUTSIDE THE**
14 **CONTEXT OF UTILITY RATEMAKING?**
15
16 A. It most certainly does. First and foremost, within a consolidated group, it
17 promotes or discourages certain behavior. For example (and of relevance to
18 the Enterprise situation), if a corporate member is not paid for its NOLs, it
19 usually will seek to avoid incurring them – whether or not this is advantageous
20 to the group as a whole. As Mr. Krueger indicates, without being paid for its
21 tax losses when they produce a tax benefit to the group, a leasing operation
22 cannot, as a practical matter, exist. Tax allocation can also be of great moment

1 to "outsiders." Thus, minority owners of a member's stock and owners of
2 "tracking stock" clearly care about tax allocation. So do the creditors of
3 individual group members who are rightfully very interested in whether or not
4 the member to whom they have lent money gets paid for its tax losses when
5 those losses produce a benefit to the consolidated group or only at some later,
6 indeterminate date.
7
8 Q. **IN YOUR VIEW, WHAT ARE THE GOALS IN DEVELOPING A TAX**
9 **ALLOCATION METHODOLOGY?**
10
11 A. Absent using a tax allocation agreement to affirmatively promote or discourage
12 specific behavior or to flow cash in pre-determined directions, I believe that
13 the goals ought to be neutrality, equity and consistency. That is, all members
14 ought to be treated the same, this treatment should be fair, rational and
15 justifiable and it ought to be applied consistently.
16
17 Q. **IN GENERAL, WHAT IS THE BASIC PRINCIPLE BY WHICH YOU**
18 **APPROACH TAX ALLOCATION?**
19
20 A. In crafting a tax allocation agreement, I attempt to ascertain which member is
21 most responsible for producing the tax benefit or incurring the tax cost. I then
22 allocate that tax consequence to that member.

1 Q YOU USE THE PHRASE "MOST RESPONSIBLE." WHY?

2 A. The tax law is very complex when applied to a single corporation. When it is
3 applied to a group of corporations, the many interactions of situations, which
4 routinely occur often, result in no single member being definitively and
5 exclusively responsible for a particular tax outcome. The several examples I
6 provided at the beginning of this testimony (as well as the many additional
7 examples that could be described) testify to this fact. Thus, any attempt to
8 allocate consolidated taxes must, in many situations, involve an inquiry into
9 the member most responsible. The relevant question is, if the cash benefit has
10 to go somewhere, which member has the strongest claim?

11

12 Q. WHAT DOES THIS SUGGEST WITH REGARD TO THE
13 ALLOCATION OF THE BENEFIT OF "INCOME NETTING?"
14
15 A. It suggests that the "but for" analysis that is frequently employed (and is the
16 one inherent in Mr. Henkes' approach) is flawed. The "but for" analysis I refer
17 to is the one that starts and ends with the statement, "But for the taxable
18 income of Public Service, the NOLs of certain non-regulated affiliates could
19 not have been used and, thus, the tax benefits could not have been produced."
20 When examining historical tax returns, this statement can be demonstrated to
21 be true.

1 **Q. IF THE STATEMENT CAN BE SHOWN TO BE TRUE, WHY DO YOU**
2 **BELIEVE THIS ANALYSIS IS FLAWED?**
3
4 A. While it is appealingly simple and seemingly conclusive, it is grossly
5 incomplete. It is just as true that, "But for the NOLs of the affiliates, there
6 would have been no tax reduction." Again, this is a demonstrably true
7 statement. So, as is often the case in the world of consolidated returns, no
8 single member can lay exclusive claim.
9

10 **Q. WHAT ARE THE ELEMENTS OF PUBLIC SERVICE'S CLAIM TO**
11 **THE BENEFIT OF "INCOME NETTING?"**
12
13 A. In order to determine which member possesses the highest entitlement, further
14 inquiry into each member's contribution to the creation of the benefit is
15 necessary. With regard to Public Service, its only contribution to the creation
16 of the benefit was its production of taxable income – something it would have
17 done in precisely the same way and in precisely the same amount whether or
18 not there was an "income netting" benefit to be had. By itself, Public Service
19 could have done absolutely nothing to produce the benefit. In short, Public
20 Service was a completely passive participant and, to the extent it is allocated
21 any of the benefit (even if only to "warehouse" it until some later point in
22 time), it would be fair to say that the benefit essentially "falls into its lap." It
23 reaps a paradigmatic windfall.

1 **Q. WHAT ARE THE ELEMENTS OF THE LOSS MEMBERS' CLAIMS**
2 **TO THE BENEFIT OF "INCOME NETTING?"**
3
4 A. The loss members could have done a fair amount to render their expenditures
5 "tax efficient" even in the absence of the consolidated return. First and
6 foremost, they could have moderated their deductible expenditures. For
7 example, they could have leased depreciable assets instead of owning them,
8 extracting the benefits of accelerated tax depreciation through lower lease
9 payments. They could have organized along alternative lines. For example,
10 they could have operated as divisions of larger corporations or as wholly
11 owned limited liability companies (the existence of which are ignored for tax
12 purposes). They could have co-ventured in partnership form and specially
13 allocated deductible items to a co-venturer that could make efficient use of
14 additional tax deductions in exchange for enhanced ownership terms. They
15 would certainly not have engaged in a tax-oriented leasing operation the
16 success of which depends, in large part, on the availability of taxable income.
17
18 **Q. IS THIS CONCLUSION SPECULATIVE AND SELF-SERVING?**
19 A. This conclusion is the same conclusion reached by the Board's own
20 consultants, Liberty Consulting Group, when they undertook to audit and
21 analyze Enterprise. In their "Final Report on the Unregulated Subsidiaries of

1 Public Service Enterprise Group Inc.," (Docket No. EA92040459, pages III 43-
2 44) they recognized:

3–7
> Investment decisions were made with the knowledge that the losses could be used to offset the income of PSE&G, especially with regard to PSRC tax-oriented investments. A different assumed environment would have led to different investment decisions for PSRC.

8
9 They concluded:
10

11–14
> It is reasonably clear that past non-utility investment decisions would have been different had the benefits of consolidation not flowed to the benefit of non-utility operations.

15
16 and, further:
17

18–23
> Transferring even a minor share of the benefits of consolidation to the utility will make many classes of tax advantaged non-utility investments uneconomic. Exit from those investment areas may cause a loss of the benefits to the non-utility operations, and the loss of potential shared benefits to the utility.

24

25 **Q. WHAT DOES THIS SUGGEST REGARDING THE LOSS MEMBERS'**
26 **ENTITLEMENT?**
27

28 A. It was well within the power of many of the loss members to recognize the tax
29 benefits (directly or indirectly) in the absence of Public Service's taxable
30 income. The implementation of alternative strategies was, however,
31 unnecessary due to the fact that Public Service did in fact produce taxable
32 income. This element of control over the recognition of tax benefits supports

1 the notion that the benefit of "income netting" properly lies with the loss
2 companies that produced the NOLs.
3
4 **Q. AS A TAX PRACTITIONER AND A TAX ADVISOR TO ENTERPRISE,**
5 **DO YOU BELIEVE THAT THERE ARE STRUCTURAL STEPS THAT**
6 **COULD BE TAKEN TO ELIMINATE THE NECESSITY TO "INCOME**
7 **NET?"**
8
9 A. I am confident that Enterprise could readily implement alterations in its
10 corporate structure such that, along with some re-crafting of its investment
11 activities, it could eliminate all significant member NOLs and, hence, the
12 necessity to "income net."
13
14 **Q. ARE THERE ANY OTHER IMPORTANT ELEMENTS?**
15 A. Yes there are. Perhaps the most important element is that each dollar of NOL
16 represents a dollar expended or a dollar of liability incurred by the loss
17 member. In other words, each loss member suffered a substantive change in its
18 economic position to produce the NOL. This cannot be said with respect to
19 Public Service.

1 **Q. BASED ON THE ABOVE, WHICH MEMBER DO YOU BELIEVE IS**
2 **"MOST RESPONSIBLE" FOR THE BENEFITS OF "INCOME**
3 **NETTING?"**
4
5 A. It is clear from my analysis that I believe it is the loss affiliates that are "most
6 responsible" and should, therefore, be allocated the cash benefit.
7
8 **Q. IN YOUR EXPERIENCE, IS PAYING A LOSS MEMBER FOR THE**
9 **TAX BENEFIT OF ITS NOLS AS THOSE NOLS REDUCE THE**
10 **GROUP'S TAXABLE INCOME A COMMON TAX ALLOCATION**
11 **METHODOLOGY?**
12
13 A. This is the method employed by the vast preponderance of consolidated groups
14 with which I am familiar – both those which include utility members and those
15 that do not. In fact, I cannot recall seeing one that did not compensate
16 members for utilized benefits.
17
18 **Q. WHAT IS YOUR UNDERSTANDING OF THE ENTERPRISE TAX**
19 **ALLOCATION METHODOLOGY?**
20
21 A. It is my understanding that all group members with positive taxable income are
22 charged income tax on a pure "stand alone" basis (*i.e.*, as if they filed on an
23 unconsolidated basis). The actual Enterprise consolidated tax liability is
24 satisfied from this fund. Any amounts remaining are allocated among the loss
25 members.

1 **Q. HOW DOES THIS COMPARE WITH THE PURE "RESPONSIBILITY"**
2 **MODEL?**
3
4 A. With regard to basic "income netting," it accomplishes the same result. With
5 regard to some of the more esoteric aspects of consolidated returns, it tends to
6 protect the producers of taxable income from any adverse impacts of
7 consolidated filing.
8
9 **Q. PLEASE EXPLAIN THIS LAST STATEMENT.**
10 A. This statement is best explained by means of a "real life" illustration. Mr.
11 Henkes has noted that Enterprise paid alternative minimum tax (AMT) in a
12 number of years since 1991. However, none of the burden of the AMT was
13 ever allocated to Public Service. As previously mentioned, AMT is caused by
14 the interplay of items of tax preference and levels of taxable income. Among
15 the most prominent items of tax preference are accelerated depreciation -
16 especially that claimed with respect to assets placed in service between 1981
17 and 1986. In the early 1990's, Public Service generated a huge amount of tax
18 preferences due to the depreciation it claimed on its nuclear plants. However,
19 it also produced enough taxable income such that, on a "stand alone" basis, it
20 would not have paid any AMT. However, those preferences were a major
21 factor in causing a consolidated AMT liability in a number of years. Under a
22 pure "responsibility" model of tax allocation, I would have concluded that

1 Public Service should have been allocated some portion of the AMT burden on
2 account of its tax preferences. In fact, the Enterprise method insulated the
3 utility from this detrimental allocation.
4
5 **Q. HOW DOES THIS VARIATION IMPACT YOUR CONCLUSION**
6 **REGARDING THE TREATMENT OF "INCOME NETTING?"**
7
8 A. It does not. It merely points out that the Enterprise tax allocation methodology
9 appears to bend over backwards to protect taxable income-generating
10 members.
11
12 **Q. IN LIGHT OF THE ABOVE, WHAT IS YOUR CONCLUSION**
13 **REGARDING ENTERPRISE'S ALLOCATION OF THE BENEFIT OF**
14 **"INCOME NETTING?"**
15
16 A. In my opinion, the allocation methodology employed by Enterprise to reflect
17 the impact of "income netting" is rational and equitable. Moreover, I believe it
18 to be the method most often used by large corporate enterprises.
19
20 **Q. PLEASE DISCUSS THE NOTION THAT THE REDUCTION OF RATE**
21 **BASE TO REFLECT THE BENEFITS OF FILING A CONSOLIDATED**
22 **TAX RETURN EFFECTS A "SHARING" OF THESE BENEFITS**
23 **BETWEEN CUSTOMERS AND THE COMPANY?**
24
25 A. It is often asserted that a rate base adjustment, such as that proposed by Mr.
26 Henkes, effects an equitable sharing of the benefits of "income netting." One

1 of the major advantages touted by proponents of this type of adjustment is that
2 it is self-reversing. By this they mean that, when the loss member could have
3 used its NOLs on a "stand alone" basis, the rate base reduction is reversed.
4 This places the loss member in precisely the same position it would have
5 occupied had it filed a separate income tax return. Thus, it will be no worse off
6 than if it had filed on an unconsolidated basis. However, the flip side of this is
7 that it will be no better off than if it had filed alone.
8
9 Q. **WHAT ARE THE IMPLICATIONS OF THIS?**
10 A. It is obvious that, if there is an "income netting" benefit derived from filing a
11 consolidated tax return, and if the loss member is no better off than if it had
12 filed on an unconsolidated basis, then 100% of the benefit of the consolidated
13 filing must be going elsewhere. And so it is. The benefit in its entirety is
14 being given to customers who, as I previously indicated, have a clearly
15 subsidiary entitlement.
16
17 Q. **DOES THIS CONCLUDE YOUR TESTIMONY?**
18 A. Yes it does.