

ILLINOIS COMMERCE COMMISSION

DOCKET NO. 12-0001

REBUTTAL TESTIMONY

OF

**JAMES I. WARREN
MILLER & CHEVALIER CHARTERED**

Submitted on Behalf Of

**AMEREN ILLINOIS COMPANY
d/b/a Ameren Illinois**

MAY 9, 2012

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8 **I. INTRODUCTION**

9 **Q. Please state your name and business address.**

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

12 **Q. By whom are you employed and in what capacity?**

13 A. I am a member of the law firm of Miller & Chevalier Chartered (M&C).

14 **Q. Please describe your current responsibilities at M&C.**

15 A. I am engaged in the general practice of tax law. I specialize in the taxation of and the tax
16 issues relating to regulated public utilities. Included in this area of specialization is the treatment
17 of taxes in regulation.

18 **Q. On whose behalf are you submitting this testimony?**

19 A. I am submitting this testimony on behalf of Ameren Illinois Company d/b/a Ameren
20 Illinois (AIC or the Company).

21 **Q. Please describe your professional background.**

22 A. I joined M&C in February of 2012. For the three years prior, I was a partner in the law
23 firm Winston & Strawn and for the five years prior to that, I was a partner in the law firm of
24 Thelen Reid Brown Raysman & Steiner LLP. Before that, I was affiliated with the international
25 accounting firms of Deloitte LLP (October 2000 – September 2003) and
26 PricewaterhouseCoopers LLP (January 1998 – September 2000), the law firm Reid & Priest LLP
27 (July 1991 – December 1997) and the international accounting firm of Coopers & Lybrand
28 (March 1979 – June 1991). At each of these professional services firms, I provided tax services
29 primarily to electric, gas, telephone and water industry clients. My practice has included tax
30 planning for the acquisition and transfer of business assets, operational tax planning and the
31 representation of clients in tax controversies with the Internal Revenue Service (IRS) at the audit
32 and appeals levels. I have often been involved in procuring private letter rulings or technical
33 advice from the IRS National Office. On several occasions, I have represented one or more
34 segments of the utility industry before the IRS and/or the Department of Treasury regarding
35 certain tax positions adopted by the federal government. I have testified before several
36 Congressional committees and subcommittees and at Department of Treasury hearings regarding
37 legislative and administrative tax issues of significance to the utility industry. I am a member of
38 the New York, New Jersey and District of Columbia Bars and also am licensed as a Certified
39 Public Accountant in New York and New Jersey. I am a member of the American Bar
40 Association, Section of Taxation where I am a past chair of the Committee on Regulated Public
41 Utilities.

42 **Q. Have you previously testified in any regulatory proceedings?**

43 A. Yes I have. I have testified regarding tax, tax accounting and regulatory tax matters
44 before a number of regulatory bodies including the Federal Energy Regulatory Commission and
45 the utility commissions in Florida, Arkansas, Louisiana, Nevada, Delaware, West Virginia, New
46 Jersey, the District of Columbia, the City of New Orleans, New York, Connecticut, Ohio,
47 California, Maryland, Pennsylvania, Missouri, Illinois, Kentucky, Vermont, Tennessee, Indiana
48 and Texas.

49 **Q. Please describe your educational background.**

50 A. I earned a B.A. (Political Science) from Stanford University, a law degree (J.D.) from
51 New York University School of Law, a Master of Laws (LL.M.) in Taxation from New York
52 University School of Law and a Master of Science (M.S.) in Accounting from New York
53 University Graduate School of Business Administration.

54 **II. PURPOSE OF TESTIMONY**

55 **Q. What is the purpose of your testimony?**

56 A. The purpose of my testimony is to respond to one particular aspect of the direct
57 testimonies of Mr. David J. Effron filed on behalf of the Illinois Office of Attorney General (AG)
58 and AARP, Mr. Steven M. Rackers filed on behalf of Illinois Industrial Energy Consumers
59 (IIEC), and Mr. Ralph C. Smith filed on behalf of the Citizens Utilities Board (CUB). Mr.
60 Effron proposes an adjustment of \$39.6 million to rate base; Mr. Rackers and Mr. Smith propose
61 to reduce rate base by \$43.7 million. I explain why the Company contests these proposed
62 adjustments. Specifically, I address their proposal that AIC should treat as cost-free capital an
63 amount (the "FIN 48" amount) that the Company's internal and external tax experts have
64 determined will not be cost-free capital (Effron, page 8, line 166 through page 12, line 271;

65 Rackers, page 7, line 138 through page 9, line 170; Smith, page 14, line 302 through page 25,
66 line 605).

67 **Q. Are there elements of the testimonies of Messrs. Effron, Rackers and Smith with**
68 **which you agree?**

69 A. I agree with many elements of their testimony. I would even say there are few basic
70 factual disagreements. I do, however, strenuously disagree with those three witnesses regarding
71 the significance of those facts for the setting of rates.

72 **Q. On what points do you believe everyone can agree?**

73 A. I believe we all agree on the following points.

- 74 1. The Company has in its possession a quantity of capital which it procured by
75 means of filing income tax returns.
- 76 2. The capital at issue here resulted from claiming tax deductions which experts
77 have concluded the Company is more likely than not going to lose.
- 78 3. When the Company loses the deductions, it will pay the capital back to the
79 taxing authorities with interest.

80 **Q. What, then, is the point on which the parties disagree?**

81 A. The disagreement is over the treatment of this capital in the ratemaking process after it is
82 procured but before it is paid back. The three witnesses whose testimony I rebut propose to treat
83 it as cost-free capital. I believe that their proposed treatment flies in the face of reality. I shall
84 explain my views in this regard after I provide some context for those views.

85 **Q. Are you sponsoring any exhibits with your testimony?**

86 A. No, I'm not.

87 **III. THE TREATMENT OF FIN 48 AMOUNTS**

88 **Q. What is FIN 48?**

89 A. FIN 48 is a financial accounting pronouncement that establishes rules for identifying
90 uncertain tax positions taken by companies, measuring the portion of tax benefits claimed that
91 are likely to be forfeited, and reflecting that fact on their financial statements. I will describe
92 FIN 48 in greater detail a little later in my testimony.

93 **Q. What is the purpose of FIN 48?**

94 A. Each taxpayer has the responsibility both for filing tax returns to report how much tax it
95 owes and for paying that amount. This self-reporting is subject to review (*i.e.*, audit) by the
96 relevant taxing authorities. The tax law is exceedingly complex and contains many provisions
97 that are subject to more than one interpretation. It is not uncommon for a taxpayer to interpret
98 the tax law in a way that could be disputed by the taxing authorities. It is similarly not
99 uncommon for a taxpayer to view a transaction, and, hence, the tax consequences of the
100 transaction, in a way that could be disputed by the taxing authorities. FIN 48 prescribes, for
101 financial reporting purposes, a single standard, a single process, and a single disclosure regime
102 for identifying uncertain tax positions and measuring the amount of tax benefits associated with
103 those positions that are not likely to be sustained when challenged by the tax authorities.

104 **Q. What is the fundamental policy issue the Illinois Commerce Commission must**
105 **consider with regard to FIN 48?**

106 A. When you cut through all of the references to accounting pronouncements and tax rules,
107 the issue distills down to the simple question of whether or not this Illinois Commerce
108 Commission (Commission) should characterize the capital described above and, therefore, set

109 rates using the best available expert information. The Company supports its use. The three
110 witnesses would have the Commission ignore it.

111 **Q. To what kind of information are you referring?**

112 A. The numerical dispute here relates to the quantity of cost-free, government-furnished
113 capital that the Company should reflect as a reduction in rate base. There are two types of
114 capital the government extends through the tax system. One type is interest-free. Hereafter, I
115 refer this type of capital as accumulated deferred income tax (ADIT) capital. The second type of
116 capital has an interest cost. Hereafter, I refer to this type of capital as non-ADIT capital. The
117 “best available expert information” I referred to above is the information that informs this
118 Commission (among others) as to which of the two types of capital the Company’s FIN 48
119 amount is.

120 **Q. How does the government provide ADIT capital through the tax system?**

121 A. The mechanics and nature of ADIT capital is best illustrated by a simple example.
122 Assume that, in a non-bonus depreciation year, an electric utility acquires and places in service a
123 distribution line that costs \$1 million. On its tax return, it takes the position that the line is
124 depreciable over 20 years on an accelerated basis. This would be the technically correct tax
125 treatment. The utility will claim accelerated depreciation on its tax return and, as a result, reduce
126 its tax liability. The reduction in the utility’s tax liability will give rise to a loan from the
127 government. This is ADIT capital. Indeed, the Congressional purpose in enacting accelerated
128 depreciation was to provide ADIT capital to businesses. The loan will be paid back in the later
129 years of the distribution line’s useful life (*i.e.*, after year 20) when it is still providing service
130 (and, therefore, generating taxable revenue) but no additional tax depreciation is available
131 because it has all been claimed. Thus, the mechanism for repaying the loan is embedded in the

132 asset. It will be repaid over a predictable schedule – as the depreciation timing differences
133 reverse. The actual repayment will be accomplished by filing future tax returns that will reflect
134 incremental taxable income (because there will be no tax depreciation). Moreover, repayment
135 will not be due until those future tax returns are due. Because the loan is repaid to the
136 government by the filing of tax returns for future tax years, there is no interest associated with it.
137 It remains interest-free as long as it is outstanding.

138 **Q. Please describe the nature of Non-ADIT capital.**

139 A. The best way to illustrate non-ADIT capital is, again, by means of an example. Assume
140 the same facts as in the preceding illustration except that the electric utility decides to deduct the
141 entire cost of the distribution line in the year it is placed in service. In that event, the deduction
142 will reduce the utility's tax liability for that year. Although this would be a technically incorrect
143 tax position, it would also produce a governmental loan – one larger than the loan created by
144 "merely" claiming accelerated depreciation. Upon audit, the IRS will disallow the tax deduction
145 to the extent it exceeds the permissible level of depreciation and require the utility to pay back a
146 substantial portion of the loan (*i.e.*, the non-ADIT portion) immediately. Thus, the mechanism
147 for repaying the loan has nothing to do with filing tax returns for future tax years. It depends on
148 the necessity to pay additional tax with respect to an already-filed tax return. Moreover, unlike
149 ADIT capital where scheduled repayment is triggered by predictable timing difference reversals,
150 the repayment of a non-ADIT loan can come whenever the IRS assesses a tax deficiency. There
151 is no embedded reversal device. Finally, as with all taxes owed for prior years, interest is
152 charged on the amount due.

153 **Q. What are the critical distinctions between the two types of capital?**

154 A. Though both types of capital are extended through the tax system, they are very different.
155 The first loan, the one that constitutes ADIT capital, is a creature of the tax law. It is the result of
156 a conscious decision by Congress to subsidize the cost of capital assets by the extension of
157 interest-free loans. The benefit of that subsidy is clearly one that needs to be reflected in the
158 ratemaking process - and it is. The capital is reflected in the company's ADIT balance and that
159 balance is reflected as an offset to regulated rate base because it is cost-free capital. The second
160 loan, the one that constitutes non-ADIT capital, is not part of a Congressional subsidization
161 scheme and the utility will be charged a carrying cost with respect to it. In fact, by reflecting an
162 aggressive tax position on its tax return, the utility simply borrowed money from the government
163 in the same way it could have from a bank (though, admittedly, the formalities are quite
164 different).

165 **Q. Is Non-ADIT capital interest-free up until the Internal Revenue Service requires**
166 **repayment?**

167 A. No. It is never interest-free. The Internal Revenue Service (IRS) will charge interest not
168 from the date of the assessment of tax, but from the date the utility originally filed its erroneous
169 tax return – that is, from the date of the loan itself. In short, there is no period during which such
170 capital is interest-free.

171 **Q. On Page 8, Lines 160-163 of his testimony, Mr. Rackers characterizes this Non-**
172 **ADIT capital as an interest-free loan from ratepayers. Is that a reasonable**
173 **characterization?**

174 A. No. It is no more an interest-free loan from ratepayers than the draw down on a bank
175 credit facility is an interest-free loan from ratepayers because the proceeds are not passed
176 through to them.

177 **Q. What is the disagreement between the Company and Messrs. Effron, Rackers and**
178 **Smith?**

179 A. The Company submits that its FIN 48 amount is not ADIT capital and should not be
180 treated as such. The three witnesses believe it is and should be so treated.

181 **Q. What happens as a result of the application of FIN 48?**

182 A. FIN 48 requires that a taxpayer identify all of its "tax positions." The definition of a tax
183 position is very broad. It really goes to the way in which an economic action is reflected on a tax
184 return. With respect to those tax positions that are uncertain, the extent of the uncertainty must
185 be evaluated and the probable loss of tax benefits quantified.

186 **Q. What is the nature of this evaluation?**

187 A. The evaluation process is extremely rigorous. Not only does the company's internal tax
188 department analyze the positions and assess the risk levels, the company's external auditors, and
189 most especially their auditor's tax experts, thoroughly review the results of the company's
190 process and often challenge its conclusions. At the end of the process, the company and its
191 external auditors generally reach a consensus as to the amount of tax at risk with respect to each
192 uncertain tax position (*i.e.*, how much incremental tax is it likely will be paid or recovered).

193 **Q. What would FIN 48 mean in terms of your simple example involving the electric**
194 **utility that builds a distribution line and deducts its cost all in one year?**

195 A. In the context of that example, one might say that the purpose of FIN 48 is precisely to
196 distinguish between ADIT capital produced by claiming legitimate accelerated depreciation and
197 non-ADIT capital produced by claiming the illegitimate deduction for the entire cost of the asset.

198 **Q. How is the amount at risk determined and then reflected?**

199 A. As a general proposition, the amount of tax that it is more likely than not will be paid to
200 the taxing authorities in connection with the uncertain position must be reflected by the company
201 on its balance sheet as a tax liability. FIN 48 does not permit this amount to be reflected as
202 ADIT. Interest must be accrued on any amount recorded as a liability under FIN 48 at the
203 interest rates imposed by the relevant taxing authorities on tax underpayments. In addition,
204 where appropriate, any applicable penalties must be accrued.

205 **Q. Why are FIN 48 amounts not reflected in ADIT?**

206 A. ADIT balances represent interest-free capital having all of the other characteristics I
207 previously described. FIN 48 amounts, by contrast, are not interest-free capital and have starkly
208 different features. It is, therefore, entirely logical that FIN 48 amounts must not be treated as
209 ADIT balances.

210 **Q. Are there checks on the veracity of the amounts determined to be FIN 48 amounts?**

211 A. Yes. The FIN 48 analysis involves a rigorous review process for assessing the likelihood
212 of having to make additional tax payments (with interest and penalties) to the taxing authorities.
213 In the case of companies with publicly traded securities, each company's independent auditors
214 review the company's conclusions. Moreover, it is really not in any company's best interests to

215 seek to maximize its FIN 48 amounts. First, because of the adverse earnings implications of
216 designating FIN 48 amounts (that is, the necessity to accrue incremental interest expense), no
217 company has an incentive to designate a larger FIN 48 amount than it has to. Further, any FIN
218 48 amount must now be disclosed on a Schedule UTP attached to each company's federal
219 income tax return.¹ Thus, a FIN 48 designation virtually ensures the issue will be audited by the
220 IRS. No reasonable company would extend an open invitation to the IRS to audit an issue by
221 unnecessarily designating it an uncertain tax position. Finally, the purpose of the review of a
222 company's FIN 48 designation by its independent auditors is to ensure that the financial
223 statements the investing public relies upon provide information that is as accurate as possible
224 about the true nature of the company's liabilities. The result of the review is reflected in the
225 company's filings with the Securities and Exchange Commission (SEC). The adverse
226 consequences of misreporting to the SEC can be significant. Thus, it is in a company's interest
227 to designate FIN 48 amounts only when reasonable and appropriate.

228 **Q. What, then, is the issue this Commission must address?**

229 A. Where a utility holds a quantity of funds the cost status of which is uncertain, should this
230 Commission apply the presumption that those funds are cost-free simply because of the
231 mechanical manner in which they were procured (by means of a tax return) or should it give due
232 consideration to the analysis of the experts inside and outside of the utility in forming its
233 conclusion as to the cost status of the funds?

234 **Q. Specifically, how does the FIN 48 question relate to ratemaking in this case?**

235 A. A FIN 48 balance—that is, a liability on the balance sheet for amounts that the experts
236 have determined will likely have to be paid to the taxing authorities with interest—should not be

¹ This is described by Mr. Smith in his testimony on page 17, line 359 through page 360, line 380.

237 reflected as ADIT. Otherwise, ratepayers will see a reduction in the Company's rate base
238 predicated on a false assumption regarding the level of zero-cost financing. It is a false
239 assumption because the FIN 48 process has concluded that the amount is not, in fact, zero-cost
240 financing. In sum, the FIN 48 amounts do not represent zero-cost capital and should not be
241 treated as such.

242 **Q. Is there uncertainty associated with the FIN 48 tax liability?**

243 A. Admittedly, it is not absolutely certain that all of the governmental-source capital
244 identified as FIN 48 amounts will be assessed and require repayment with interest. However, it
245 is even less likely that that governmental capital will be interest-free. Thus, there is a degree of
246 uncertainty regardless of which position is adopted.

247 **Q. Are you suggesting that it comes down to a choice between two uncertain**
248 **alternatives?**

249 A. Yes I am. And it is my view that the Commission should adopt the more likely of the
250 two alternatives – to respect the FIN 48 characterization. This is not simply because it is an
251 accounting rule. It is because doing so makes far more sense than the proposals offered by
252 Messrs. Effron, Rackers and Smith, which, in effect, assume that the Company will prevail on
253 every uncertain tax position it has taken – even in the face of the contrary conclusion of the
254 Company's experts.

255 **Q. Should the Commission encourage the Company to take uncertain tax positions?**

256 A. Absolutely. If, contrary to the expectations of the experts, the Company is able to prevail
257 in the assertion of an uncertain tax position, at that point the non-ADIT capital would be re-
258 characterized as ADIT capital and customers would enjoy incremental zero-cost capital at the

259 next rate proceeding. Obviously, if the Company never asserts its uncertain position, this
260 incremental zero-cost capital cannot come into being. Consequently, it is in the customers' best
261 interests for the Commission to encourage such positions. However, when the governmental
262 funds produced by the assertion of an uncertain tax position are treated as cost-free capital, as
263 Messrs. Effron, Rackers and Smith propose, it becomes contrary to the Company's interests to
264 make the attempt because it produces a reduction in the Company's rate base on account of sums
265 that are non-ADIT capital. This treatment extracts return from the Company. Frankly, the
266 Company would be better off not taking the uncertain position.

267 **Q. What would happen if the IRS disallows more than the amount the experts predict?**

268 A. At that point, the non-ADIT capital as well as the ADIT capital associated with those
269 disallowed deductions would be repaid. A portion of the Company's ADIT balance would
270 thereby be eliminated. This reduced ADIT balance would result in less zero-cost capital (*i.e.*, a
271 lower rate base offset) at the next rate proceeding. In other words, what would transpire if the
272 Company did worse than the experts predicted would be precisely the converse of what would
273 transpire if the Company did better than the experts predicted. It works the same both ways. But
274 either way, it makes the most sense to start with the best information available.

275 **Q. Messrs. Effron and Smith both characterize the Company's FIN 48 amounts as**
276 **“non-investor” supplied capital (Effron, page 12, line 261; Smith, page 21, line 462). Does**
277 **that characterization dispose of the issue?**

278 A. Not in the slightest. In fact, I would agree with that characterization. The issue,
279 however, is not the source of the capital but whether or not it has a cost.

280 **Q. On page 23 of his testimony, Mr. Smith provides an extensive excerpt from a FERC**
281 **issuance in which it provided guidance with respect to FIN 48. Is there something**
282 **important he neglected to mention regarding that excerpt?**

283 A. There is. In its introduction to the guidance portion of the document, the FERC stated:

284 This guidance is for Commission financial accounting and reporting
285 purposes only and is without prejudice to the ratemaking practice or
286 treatment that should be afforded items addressed herein.

287 In other words, in its guidance, the FERC did not intend to prescribe ratemaking – only financial
288 reporting. The document is, therefore, simply not relevant to this Commission’s determination.

289 **Q. On page 22 of his testimony, Mr. Smith excerpts a proposed order from AIC’s last**
290 **rate case. In your view, is the citation to the treatment of FIN 48 amounts as prescribed in**
291 **that proposed order appropriate?**

292 A. No it is not. The Proposed Order does not represent a disposition of the issue by the
293 Commission, and, further, it is my understanding that the docket was dismissed without any
294 decision on the merits. Under the circumstances, it would not seem that the Proposed Order
295 should be persuasive in this proceeding.

296 **Q. Are there any unique attributes of Rate MAP-P that might be relevant to the**
297 **outcome of this issue?**

298 A. I am generally aware that Rate MAP-P would establish a rate scheme in which AIC’s
299 rates will be updated and reconciled annually. If this is so, it seems to me that there is little
300 chance that the Company would benefit or be injured significantly even if it turned out that the
301 ultimate outcome of its tax uncertainties were to vary from its FIN 48 amount. Nevertheless, it
302 still makes sense to me to use the best information available and then updating, if necessary,
303 from the rates so established.

304 **Q. Do the other parties support recovery of the costs of the non-ADIT capital through**
305 **Rate MAP-P?**

306 A. Mr. Rackers makes no mention of it, while Mr. Smith mentions recovery of interest but
307 does not appear to propose it himself. Mr. Effron's position is confusing – he argues that the
308 Company will not likely incur any interest, but concedes that if it does, it should be recovered
309 through Rate MAP-P.

310 **Q. Please summarize the Company's position on the FIN 48 question.**

311 A. The Company maintains that where, of two possible statuses, one has been determined by
312 the Company's experts to be more likely than the other, presuming the less probable of the two
313 in the setting of rates is counter-intuitive. Certainly it makes much more sense to presume the
314 more likely alternative. In this case, the more likely alternative is the non-cost-free status of FIN
315 48 amounts because internal experts and external auditors have determined that the FIN 48
316 amounts are likely to ultimately be repaid to the taxing authorities with interest.

317 **IV. CONCLUSION**

318 **Q. Does that conclude your rebuttal testimony?**

319 A. Yes, it does.