



Control Number: 32766



Item Number: 1273

Addendum StartPage: 0

**SOAH DOCKET NO. 473-06-2536
DOCKET NO. 32766**

APPLICATION OF SOUTHWESTERN §
PUBLIC SERVICE COMPANY FOR: §
(1) AUTHORITY TO CHANGE RATES; § BEFORE THE STATE OFFICE
(2) RECONCILIATION OF ITS FUEL §
COSTS FOR 2004 AND 2005; §
(3) AUTHORITY TO REVISE THE § OF
SEMI-ANNUAL FORMULAE §
ORIGINALLY APPROVED IN §
DOCKET NO. 27751 USED TO ADJUST § ADMINISTRATIVE HEARINGS
ITS FUEL FACTORS; AND §
(4) RELATED RELIEF §

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**REBUTTAL TESTIMONY
of
JAMES I. WARREN
on behalf of
SOUTHWESTERN PUBLIC SERVICE COMPANY
(Revenue Requirement)
(Filename: 7J1.pdf; Total Pages: 28)
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Glossary of Acronyms and Defined Terms

Acronym/Defined Term	Meaning
Commission	Public Utility Commission of Texas
CTA	Consolidated Tax Adjustment
IRS	Internal Revenue Service
PURA	Texas Public Utility Regulatory Act
SPS	Southwestern Public Service Company
Staff	Public Utility Commission of Texas Staff
Thelen	Thelen Reid Brown Raysman & Steiner LLP
Xcel Energy	Xcel Energy Inc.

**REBUTTAL TESTIMONY OF
JAMES I. WARREN**

I. INTRODUCTION AND QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is James I. Warren. My business address is 875 Third Avenue, New York, New York 10022.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. I am testifying on behalf of Southwestern Public Service Company (SPS), a wholly owned subsidiary of Xcel Energy Inc. (Xcel Energy).

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT POSITION?

A. I am a tax partner in the law firm of Thelen Reid Brown Raysman & Steiner LLP (Thelen).

Q. PLEASE BRIEFLY DESCRIBE YOUR RESPONSIBILITIES AT THELEN.

A. I am engaged in the general practice of tax law. I specialize in the taxation of and the tax issues relating to regulated public utilities. Included in this area of specialization is the treatment of taxes in regulation. I also chair the firm's Tax, Benefits and Trusts and Estate Department.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

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

1 Q. WHAT IS YOUR PROFESSIONAL EXPERIENCE?

2 A. I joined Thelen (formerly Thelen Reid & Priest) in November of 2003. Prior to
3 that time, I was affiliated with the international accounting firms of Deloitte &
4 Touche LLP (Oct. 2000 – Sept. 2003), PricewaterhouseCoopers LLP (Jan. 1998 –
5 Sept. 2000) and Coopers & Lybrand (Mar. 1979 – June 1991) and the law firm,
6 Reid & Priest LLP (July 1991 – Dec. 1997). At each of these professional
7 services firms, I provided tax services primarily to electric, gas and telephone
8 industry clients. My practice has included tax planning for the acquisition or
9 transfer of business assets, operational tax planning and the representation of
10 clients in tax controversies with the Internal Revenue Service (IRS) at the audit
11 and appeals levels. I have often been involved in procuring private letter rulings
12 or technical advice from the IRS National Office. On several occasions, I have
13 represented one or more segments of the utility industry before the IRS and/or the
14 Department of Treasury regarding certain tax positions adopted by the federal
15 government. I have also testified before several Congressional committees and
16 subcommittees and at the Department of Treasury hearings regarding legislative
17 and administrative tax issues of significance to the utility industry.

18 Q. DO YOU HOLD A PROFESSIONAL LICENSE?

19 A. Yes. I am a member of the New York and New Jersey Bars and also am licensed
20 as a Certified Public Accountant in those two states.

1 Q. ARE YOU A MEMBER OF ANY PROFESSIONAL ORGANIZATIONS?

2 A. I am a member of the American Bar Association, Section of Taxation where I am
3 a past chair of the Committee on Regulated Public Utilities and am also a member
4 of the American Institute of Certified Public Accountants.

5 Q. HAVE YOU TESTIFIED BEFORE ANY REGULATORY AUTHORITIES?

6 A. I have testified regarding tax, tax accounting and regulatory tax matters before a
7 number of regulatory bodies including the Federal Energy Regulatory
8 Commission and the commissions in Florida, Louisiana, Missouri, Delaware,
9 Nevada, New Jersey, New York, Connecticut, Pennsylvania, Kentucky, West
10 Virginia and Texas.

11 Q. ON HOW MANY OCCASIONS HAVE YOU TESTIFIED ON TAX MATTERS
12 IN TEXAS?

13 A. I have presented tax-related testimony to this Commission on at least ten
14 occasions and, more specifically, addressed issues involving consolidated tax
15 filings on at least eight occasions beginning in 1988.

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II. GENERAL

Q. WHAT IS YOUR ASSIGNMENT IN THIS PROCEEDING?

A. In this testimony, I will respond to the testimonies of Ellen Blumenthal, who filed direct testimony on behalf of the Alliance of Xcel Municipalities, and David J. Effron, who filed direct testimony on behalf of the Office of Public Utility Counsel. Specifically, I will rebut their assertions that their proposed adjustments to tax expense, which are based on their Exhibits EB-5 and DJE-1, Schedule 3, page 5, respectively, comply with the requirements of the Texas Public Utility Regulatory Act (PURA). I will also comment on the Public Utility Commission of Texas (Commission) Staff's (Staff) Statement of Position.

Q. GENERALLY, WHAT IS THE NATURE OF THE ADJUSTMENTS PROPOSED BY MR. EFFRON AND MS. BLUMENTHAL?

A. Each asserts that the inclusion of SPS in the filing of consolidated federal income tax returns has produced tax benefits and that these benefits ought to be reflected in SPS's rates.

Q. WHAT IS THE STANDARD FOR EVALUATION OF THEIR POSITIONS?

A. Each of these positions must be measured against the standard established by PURA §36.060. That is, it must assign to the utility its "fair share" of the savings resulting from its participation in the filing of federal consolidated income tax returns.

1 Q. IS THERE ANY PRECISE GUIDANCE REGARDING WHAT CONSTITUTES
2 A "FAIR SHARE" OF TAX SAVINGS?

3 A. Not really. Obviously, "fair share" is a subjective standard, which, like "just and
4 reasonable," must be based on the facts and circumstances of each situation.
5 "Fair share" determinations have varied widely in different proceedings over
6 time. They have been determined by this Commission to be zero in circumstances
7 not vastly different from SPS's. They have also been determined to be more than
8 zero on a number of occasions in similar situations. Being a subjective standard,
9 this Commission has discretion in its interpretation. The goal should be to arrive
10 at a balanced and equitable result in light of the particular facts presented. There
11 is no one formula for this.

12 Q. ARE YOU FAMILIAR WITH THE GENERAL PRACTICE FAVORED OF
13 LATE BY THIS COMMISSION IN ITS DETERMINATION OF "FAIR
14 SHARE?"

15 A. Yes, I am. This Commission has approved something referred to as the "interest
16 credit" method for determining "fair share" in a number of cases involving the
17 filing of consolidated tax returns.

18 Q. WHAT IS THE THEORY UNDERLYING THE "INTEREST CREDIT"
19 METHOD?

20 A. The theory is that a Texas utility's participation in a consolidated federal income
21 tax return can produce a "tax shield." Any "tax shield" provided by the Texas
22 utility should be identified and valued. The value of the "tax shield" should be

1 reflected in the utility's rates because it represents the "fair share" of the benefits
2 of consolidated filing referred to in PURA §36.060.

3 Q. WHAT IS THE VALUE OF THE "TAX SHIELD?"

4 A. In the case of *Central Power and Light Company v. PUCT*,¹ the court defined this
5 value as follows:

6 The value of the tax shield CPL provides to CSW
7 competitive affiliates is equal to the amount of consolidated
8 tax savings over the last fifteen years that would not have
9 been realized by CSW affiliates as of the test year *but for*
10 their affiliation with CPL, multiplied by the time value of
11 money. (Emphasis added.)

12 Q. HOW, THEN, DOES ONE CALCULATE THE "TAX SHIELD?"

13 A. One determines the quantity of tax losses produced by non-regulated members of
14 the consolidated return group that were used on tax returns to reduce consolidated
15 taxable income and that would not have been so used *but for* the affiliation of
16 these members with SPS. As explained by Mr. Christopher A. Arend and as I will
17 discuss below, under the unique facts presented in this case, SPS's taxable income
18 has provided very little, if any, of the federal income tax savings that have
19 occurred over the last fifteen years.

¹ 36 S.W.3d 547 (Tex. App. – Austin 2001, pet. denied).

1 **III. THE ADJUSTMENTS PROPOSED BY MS. BLUMENTHAL AND MR.**
2 **EFFRON DO NOT REASONABLY REFLECT THE "TAX SHIELD"**
3 **PROVIDED BY SPS**
4

5 Q. PLEASE DESCRIBE MS. BLUMENTHAL'S "TAX SHIELD" MODEL.

6 A. Ms. Blumenthal's Exhibit EB-5 contains her detailed calculation of the "tax
7 shield." It is apparent from this exhibit that she does her computation on a
8 *cumulative basis* that is consistent with the approach employed in a number of
9 recent proceedings before this Commission. The heart of her computation is her
10 allocation to SPS of a portion of the tax benefit of the total "tax shield." She
11 starts by calculating the cumulative amount of tax losses of all companies
12 producing net tax losses during the fifteen year period² [REDACTED]. She
13 then multiplies that figure by the tax rate, 35%, to determine the amount of the
14 total "tax shield" [REDACTED]. She then allocates a portion of this amount to
15 SPS by applying the ratio of the cumulative amount of taxable income produced
16 by SPS during the fifteen year period [REDACTED] over the cumulative
17 taxable income of all companies producing net taxable income during the portions
18 of the fifteen year period during which they were included in consolidated income
19 tax returns with SPS [REDACTED]. This multiplication results in
20 [REDACTED] of the total "tax shield" being apportioned to SPS. She then
21 multiplies this amount by SPS's current cost of long term debt to arrive at the
22 "value" of the tax shield and then "grosses up" the result to its revenue
23 requirement equivalent.

² Modified, appropriately, to eliminate the effect of Net Operating Loss ("NOL") carryforwards not yet used and NOLs of regulated companies.

1 Q. DOES THE CUMULATIVE APPROACH PROVIDE A REASONABLE
2 REFLECTION OF THE "TAX SHIELD?"

3 A. In most typical cases where there are (i) no drastic changes in the relative levels
4 of a Texas utility's taxable income within a fifteen-year period and (ii) no drastic
5 changes in the levels of affiliate tax losses within that same period, a cumulative
6 model probably does a decent job of measuring the "tax shield" provided by the
7 Texas utility. However, SPS's position is far from typical. Rather, there is a very
8 unusual and strongly inverse correlation between SPS's share of taxable income
9 and the timing of the production of affiliate tax losses within the consolidated
10 income tax return groups that included SPS. In this context, the cumulative
11 model substantially overstates the "tax shield" that could have been provided by
12 SPS. As a consequence, the cumulative model reflected in Exhibit EB-5 must be
13 refined somewhat to measure the "tax shield" provided by SPS with any
14 reasonable degree of accuracy in this case.

15 Q. WILL YOU EXPLAIN WHY?

16 A. Yes. The best way to explain this is by way of a simple hypothetical. Assume
17 that SPS operates as a stand-alone entity for fourteen years, and at the beginning
18 of Year 15, it is acquired by Acquiror, which has a subsidiary, Affiliate. In each
19 of the first fourteen years, SPS produces \$200 of taxable income. In Year 15, SPS
20 produces \$0 of taxable income, Acquiror produces \$600 of taxable income and
21 Affiliate produces a \$500 tax loss. The fifteen years of tax results thus appear as
22 follows:

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11	Yr 12	Yr 13	Yr 14	Yr 15	Total
SPS	200	200	200	200	200	200	200	200	200	200	200	200	200	200	0	2,800
Acquiror															600	600
Affiliate															(500)	(500)

1 Q. HOW MUST THE "TAX SHIELD" BE COMPUTED IN THIS EXAMPLE?

2 A. We must quantify the extent to which Affiliate's inclusion in a consolidated tax
3 return with SPS allowed it to use its Year 15 tax loss.

4 Q. AND WHAT IS THAT AMOUNT?

5 A. In this example, the fact that Affiliate was included in a consolidated tax return
6 with SPS in Year 15 in no way enabled or enhanced its ability to use its tax loss.
7 Under the facts as presented, SPS provided no "tax shield" whatsoever. In short,
8 SPS's taxable income did not monetize (or even assist in monetizing) Affiliate's
9 tax loss because Affiliate's Year 15 tax loss was fully monetized by Acquiror's
10 Year 15 income.

11 Q. WHAT WOULD THE APPLICATION OF THE CUMULATIVE MODEL
12 PRODUCE AS THE SPS SHARE OF THE "TAX SHIELD" IN THIS
13 ILLUSTRATION?

14 A. The cumulative model would compute a ratio of SPS's total taxable income
15 during the fifteen year period, \$2,800, over the total of all taxable income during
16 the period, \$3,400. This ratio, 82%, would then be used to determine SPS's share
17 of the total consolidated "tax shield." The total consolidated "tax shield" would
18 be \$175, the product of the total of all losses during the fifteen year period (\$500)
19 and the tax rate (35%). Thus, the cumulative model would attribute to SPS a "tax

1 shield” of \$144 (82% X \$175), even though it had, in fact, provided no benefit
2 whatsoever.

3 Q. DOES THE ILLUSTRATION ABOVE ACCURATELY REPRESENT SPS’S
4 SITUATION?

5 A. Yes and no. On the one hand, it is an extreme example that is intended to make a
6 mathematical point rather than to illustrate SPS’s precise posture. On the other
7 hand, it accurately depicts the consequences of the inverse correlation of most of
8 SPS’s income to when the losses were incurred, which is the source of the
9 material distortion that infects the result of applying the “interest credit” model on
10 a cumulative basis in this case.

11 Q. PLEASE EXPLAIN THE RELATION TO SPS’S SITUATION.

12 A. As Mr. Arend describes in his testimony, during the fifteen year period relevant to
13 the calculation of the “tax shield” (1991 through 2005), SPS’s consolidated return
14 posture was radically transformed twice due to major corporate mergers. The first
15 was the 1997 combination with Public Service Company of Colorado. The
16 second was the 2000 combination with Northern States Power Company. In each
17 case (i) SPS’s relative share of its group’s taxable income was dramatically
18 reduced, and (ii) a number of loss affiliates were introduced into the consolidated
19 tax group in which SPS was included, *the use of whose losses could not, under the*
20 *applicable tax law, have been affected by SPS’s pre-merger taxable income.*

1 Q. WHY CAN'T SPS'S PRE-MERGER TAXABLE INCOME PRODUCE ANY
2 "TAX SHIELD?"

3 A. While tax losses can be carried forward twenty years to offset future taxable
4 income, they can only be carried back two years to offset prior taxable income.
5 Because 2003 was the first year that any of the consolidated groups experienced a
6 net operating loss, 2001 was the earliest year to which any loss could be carried
7 back. Thus, SPS's pre-merger taxable income cannot produce any "tax shield"
8 for any of the post-merger affiliate losses.

9 Q. WHAT ARE THE "FAIR SHARE" IMPLICATIONS OF THIS FACT?

10 A. Because the SPS taxable income from prior to 2001 could not, as a matter of tax
11 law, be a part of the "tax shield" with respect to certain tax losses, the result of
12 any computational model that includes this income in the valuation of the "tax
13 shield" reflects an error in the application of the federal income tax law, and
14 cannot, by definition, represent the "fair share" mandated by PURA §36.060.

15 Q. CAN MS. BLUMENTHAL'S MODEL BE REFINED TO PRODUCE A
16 RESULT THAT MORE REASONABLY MEASURES WHAT IT IS
17 INTENDED TO MEASURE?

18 A. Yes, it can. Rather than perform the calculation on a fifteen year cumulative
19 basis, the application of the actual tax rules to the calculation (observing the legal
20 ability to carry back and carry forward losses and the impacts of acquisitions on
21 those abilities) will produce a reasonable approximation of a real "tax shield" as
22 that term has been defined.

1 Q. HAS THE COMPANY PERFORMED SUCH A CALCULATION?

2 A. Yes, it has. Mr. Arend's testimony contains such a calculation which determines
3 the tax shield that can be lawfully provided by SPS through a year-by-year
4 calculation.

5 Q. WHAT IS THE COMMISSION STAFF'S POSITION WITH RESPECT TO MS.
6 BLUMENTHAL'S CALCULATION?

7 A. The Staff endorses her calculation.

8 Q. ON WHAT BASIS DO THEY ENDORSE HER CALCULATION?

9 A. The sole reason appears to be that her methodology was employed in a number of
10 prior proceedings.

11 Q. IN YOUR VIEW, IS THIS A VALID RATIONALE?

12 A. No, it is not. The methodology employed by Ms. Blumenthal in her calculation
13 may have been appropriate (that is, it may have been non-distortive) in those other
14 proceedings. If so, it served its purpose in those instances. The fact that it can be
15 demonstrated that it causes a substantial distortion in this case is reason enough to
16 seek a better approach.

17 Q. AGAIN, WHAT IS THE PURPOSE OF MS. BLUMENTHAL'S - AND ALL -
18 "INTEREST CREDIT" CALCULATIONS?

19 A. These calculations are mere tools used to quantify the "tax shield" so that it can
20 be valued. In other words, they are a means towards an end. The tool should
21 never be confused with the purpose it serves.

1 Q. DOES THE "TAX SHIELD" MODEL THAT UNDERLIES MR. EFFRON'S
2 PROPOSED ADJUSTMENT SUFFER FROM THE SAME DEFECT AS DOES
3 MS. BLUMENTHAL'S?

4 A. No, it does not. Mr. Effron used the same basic year-by-year calculation as did
5 Mr. Arend, which SPS provided in response to request for information Staff CR-
6 6-4. This response incorporated a determination of the "tax shield" based on the
7 operation of the tax law and, thus, avoided the defects inherent in the cumulative
8 methodology employed by Ms. Blumenthal. Mr. Effron adopted this refinement
9 as to this aspect of his computation.

10 Q. IF MR. EFFRON'S PROPOSED ADJUSTMENT WAS COMPUTED USING
11 THE APPROPRIATELY REFINED TAX SHIELD MODEL, DOES IT
12 PROPERLY CALCULATE THE VALUE OF THE "TAX SHIELD?"

13 A. Not entirely. On Exhibit DJE-1, Schedule 3, page 5, Mr. Effron arrives at a Total
14 Company Interest Credit Adjustment figure, [REDACTED], derived by using the
15 proper year-by-year method for taxable income. However, he then proceeds to
16 abandon the year-by-year approach and applies the current Texas retail
17 asset-based allocator of .5856, to this figure to determine the portion of the
18 adjustment that he proposes should impact this proceeding. The use of this
19 current, asset-based allocator renders his result outside the structure and logic of
20 the Commission's definition of the "tax shield" and, hence, renders his result
21 unfair.

1 Q. PLEASE EXPLAIN WHY THIS IS SO.

2 A. The “tax shield” that is relevant in this proceeding is the shield attributable to
3 SPS’s Texas retail operations. Under the “tax shield” theory, each year there may
4 be a quantity of affiliate losses that could not have produced a benefit had it not
5 been for the inclusion of SPS’s taxable income in the consolidated tax return.
6 And each year, a portion of SPS’s taxable income is produced by its Texas retail
7 operations. It is this quantity of jurisdictional taxable income that drives the
8 relevant “tax shield.” It has absolutely nothing to do with assets. Moreover, as
9 previously discussed, it is only the Texas retail taxable income that was available
10 under the tax law to absorb the loss affiliates’ tax losses that can arguably have
11 produced the “tax shield.” Thus, using an asset-based rather than an income-
12 based allocator cannot produce a reasonable result. Moreover, using a current,
13 rather than a contemporaneous, allocator will further distort the already-flawed
14 computation.

15 Q. HOW CAN THIS DISTORTION BE ELIMINATED?

16 A. Mr. Arend’s testimony includes a “tax shield” computation that employs the
17 contemporaneous Texas retail net income as the basis of its allocation.

18 Q. WHAT DOES MR. EFFRON STATE IN RESPONSE TO THE COMPANY’S
19 POSITION?

20 A. On page 28 of his direct testimony, Mr. Effron asserts that the jurisdictional plant
21 allocator in the test year should be used. His rationale appears to be that it is used
22 for other purposes, so it should be used for this purpose also.

1 Q. DO YOU FIND THIS RATIONALE CONVINCING?

2 A. No. The level of “tax shield” provided by Texas retail operations is never a
3 function of its relative amount of plant assets. It is a direct result of the taxable
4 income produced by those operations in the years in which the tax losses were
5 incurred. Thus, in my view, SPS’s use of the Texas retail net income allocator
6 makes much more sense than does the use of a plant-based allocator.

7 Q. ARE THERE OTHER FACTORS THAT COMPOUND THE DEFECTS IN THE
8 CUMULATIVE METHOD AND SUPPORT A REFINEMENT IN THIS CASE?

9 A. Yes. In *Central Power and Light Company* (Docket No. 14965), the Commission
10 recognized that the effect of the consolidated tax adjustment (CTA) calculation on
11 the utility’s financial strength is a factor to be considered. In this regard, it found:

12 Whether or not the test year tax savings resulting from the losses of
13 unprofitable CSW subsidiaries are allocated to CPL will *not affect*
14 *CPL’s financial strength*. Finding 109. (Emphasis added.)
15

16 Here, the financial impact is very severe. An adjustment resulting from the
17 cumulative method would be approximately \$17.3 million, which is almost 42%
18 of the original revenue deficiency of \$41.6 million and ■■■ of the total federal
19 income tax expense of ■■■■■. On top of its demonstrable inaccuracy and
20 its disregard of the tax law that forms the theoretical underpinning by which the
21 Commission has supported the adjustment, such a severe result further weighs
22 against the application of the cumulative method.

1 Q. IS IT APPROPRIATE TO ELIMINATE FROM THE COMPUTATION OF THE
2 VALUE OF THE "TAX SHIELD" THE HUGE, NON-RECURRING TAX
3 LOSSES ATTRIBUTABLE TO THE NRG INVESTMENT?

4 A. Yes. It is appropriate to eliminate these losses for the various reasons set out in
5 Mr. Arend's testimony as well as based on the rationale articulated by this
6 Commission for the imposition of CTAs at all.

7 Q. WHAT HAS THE COMMISSION STATED TO BE ONE OF THE
8 RATIONALES UNDERLYING THE IMPOSITION OF A CTA?

9 A. In *Central Power & Light Company* (Docket No. 14965), the Commission found
10 as a finding of fact:

11 112A. In view of the advantage CSW competitive affiliates gain
12 over competitors and to compensate CPL for the benefits it
13 conveys to unprofitable CSW affiliates, CPL should be
14 compensated for the value of the tax shield it provides to CSW
15 affiliates.

16
17 Thus, the Commission has premised the imposition of a CTA, at least in part, on
18 the perceived advantage provided to these competitive affiliates as a result of
19 consolidated filing.

20 Q. DOES THIS RATIONALE SUPPORT INCLUDING THE TAX LOSSES
21 PRODUCED BY THE FAILED NRG INVESTMENT IN THE "FAIR SHARE"
22 CALCULATION IN THIS PROCEEDING?

23 A. It does not. The NRG loss was an investment loss, not an operating loss. As
24 such, any "tax shield" provided no competitive advantage to the operations of the
25 NRG affiliates engaged in the unregulated activity. Further, that tax loss resulted
26 from a unique situation in which ownership of the competitive operations was

1 forfeited by virtue of the bankruptcy proceeding. As a result, these competitive
2 enterprises ceased entirely to be affiliated with the Xcel Energy consolidated
3 group. In this unique situation, the SPS “tax shield” provided no operational
4 advantage whatsoever to the NRG operations and, hence, no “gain over
5 competitors.” Consequently, the reflection of the NRG loss in the “interest
6 credit” calculation is not warranted under the Commission's stated rationale.

1 **IV. THE “INTEREST CREDIT” METHODOLOGY DOES NOT EFFECT**
2 **THE SHARING REQUIRED BY PURA**

3
4 Q. PLEASE DISCUSS THE NOTION THAT THE “INTEREST CREDIT”
5 METHOD AFFECTS A “FAIR” SHARING – OR ANY TYPE OF SHARING -
6 OF THE BENEFITS OF CONSOLIDATED FILING.

7 A. The basic premise underlying the “interest credit” method is that, considering the
8 setting of rates, tax loss members ought to be presumed to occupy precisely the
9 same position they would have occupied had they filed unconsolidated income tax
10 returns. The ability to enhance their current cash flows by participating in a
11 consolidated filing is, consequently, effectively denied them.

12 Q. WHAT ARE THE IMPLICATIONS OF THIS?

13 A. It is obvious that, where there is an income netting benefit derived from filing a
14 consolidated tax return and where the tax loss member is no better off than if it
15 had filed on an unconsolidated basis, then 100% of whatever is the time-value
16 benefit of the consolidated filing must be going elsewhere. And so it does using
17 the “interest credit” method. The time-value benefit in its entirety is allocated to
18 the group members that produce taxable income.

19 Q. BUT DOESN'T THE ALLOCATION PROCESS USED IN THIS METHOD
20 CAUSE A SHARING TO TAKE PLACE?

21 A. The allocation embedded in the interest credit mechanics shares 100% of the
22 time-value benefits of consolidated filing among the companies with taxable
23 income. It gives the loss companies *absolutely nothing*. Thus, the only sharing
24 that takes place is between one of the two classes of companies within the group.

1 While this may be a sharing of sorts, it is hardly the equitable sharing required by
2 PURA §36.060. Thus, even assuming that companies producing taxable income
3 are equitably entitled to share in the time-value benefits of consolidated filing,
4 they are entitled to share the benefit - not to take the whole thing. The
5 Commission could adopt a new approach that is more consistent with the statute
6 by sharing the time-value benefit between customers and investors through a
7 simple 50/50 sharing mechanism of the reasonably calculated tax shield.

1 **V. SPS’S INITIAL POSITION REGARDING ITS “FAIR SHARE” OF THE**
2 **BENEFITS OF FILING A CONSOLIDATED REMAINS THE CORRECT**
3 **POSITION**

4
5 Q. WHAT IS THE PRIME CONSIDERATIONS RELEVANT TO ANALYZING
6 THE BENEFIT OF INCOME NETTING?

7 A. The rationale underlying the assignment of consolidated return benefits should be
8 based on principles that make economic, logical and equitable sense.

9 Q. WHAT IS THE NATURE OF CONSOLIDATED TAX BENEFITS?

10 A. For the most part, a consolidated tax benefit is produced by virtue of the ability of
11 a loss company to net a tax loss, which it could not itself use (or not use yet),
12 against the taxable income of an affiliate. Such netting may accelerate the time at
13 which the loss produces a cash benefit (*i.e.*, the loss reduces the tax liability this
14 year as opposed to next year or some time in the next twenty years).

15 Q. WITH RESPECT TO LOSSES OF THIS TYPE, WHAT CREATES THE
16 BENEFIT?

17 A. Obviously, *both* the taxable income of the affiliate as well as the loss itself must
18 exist. *It is key here that the mere production of taxable income can never, by*
19 *itself, produce a consolidated tax benefit.*

20 Q. WHAT ARE THE FACTORS CRITICAL TO DETERMINING THE “FAIR
21 SHARE” MANDATED BY PURA §36.060?

22 A. Under either SPS’s approach as it originally filed or the “interest credit”
23 approach, one class of companies will be better off than it would have been had it
24 not filed as a part of a consolidated group, and the other class of companies will
25 be in precisely the same position. And, as indicated above, income netting

1 requires *both* the production of a tax loss *as well as* the production of taxable
2 income. So the issue is, in light of the necessary presence of both classes, which
3 one of the two should be better off and which should not. The resolution of this
4 issue must be arrived at in light of the PURA §36.060 “fair share” standard.

5 Q. TO WHICH CLASS OF COMPANIES DO YOU BELIEVE THE BENEFIT
6 SHOULD BE ASSIGNED?

7 A. I believe that a principled way to determine this is to “drill down” to ascertain
8 which member is most responsible for producing the tax benefit. The tax benefit
9 ought then to be allocated to that member.

10 Q. WHAT ARE THE ELEMENTS OF SPS’S CLAIM TO THE BENEFIT OF
11 INCOME NETTING?

12 A. With regard to SPS, its only contribution to the creation of any consolidated tax
13 savings was its production of taxable income – something it would have done in
14 precisely the same way and in precisely the same amount whether or not there
15 was an income netting benefit to be had. It is self evident that the tax liability of
16 the consolidated group that includes SPS was not diminished by virtue of the fact
17 that SPS was a part of the group. By itself, SPS could have done absolutely
18 nothing to produce a consolidated tax benefit. In short, SPS was a completely
19 passive participant and, to the extent it is allocated any of the benefit, it would be
20 fair to say that the benefit essentially “falls into its lap.” It is nothing less than a
21 windfall.

1 Q. WHAT ARE THE ELEMENTS OF THE TAX LOSS MEMBERS' CLAIMS TO
2 THE BENEFIT OF INCOME NETTING?

3 A. Tax losses just don't happen. They reflect underlying economic activity. By far
4 the most important element is that each dollar of NOL represents a dollar
5 expended or a dollar of liability incurred by the tax loss member. In other words,
6 each loss member suffered a substantive change in its economic position to
7 produce the NOL. Moreover, at least to some extent, the tax loss members could
8 have done a fair amount to render their expenditures "tax efficient" even had they
9 not been a part of the Consolidated Group. For example, they could have leased
10 depreciable assets instead of owning them, extracting the benefits of accelerated
11 tax depreciation through lower lease payments. Also, they could have organized
12 along alternative, more tax-efficient lines.

13 Q. WHAT DOES THIS SUGGEST REGARDING THE TAX LOSS MEMBERS'
14 ENTITLEMENT?

15 A. This is not to say that they should have avoided tax losses. Indeed, they did not
16 need to due to the fact that other group members did, in fact, produce taxable
17 income. However, this element of control over the recognition of tax benefits
18 supports the notion that the benefit of "income netting" properly lies with the
19 companies that produced the NOLs.

1 Q. BASED ON THE ABOVE, WHICH MEMBER DO YOU BELIEVE IS “MOST
2 RESPONSIBLE” FOR THE BENEFITS OF “INCOME NETTING?”

3 A. It is clear to me that it is the tax loss members that are “most responsible” for the
4 cash benefits of their NOLs when those benefits are realized by the consolidated
5 group and they should, therefore, be allocated the cash benefit.

6 Q. WHAT, THEN, DO YOU CONCLUDE REGARDING THE PROPRIETY OF
7 CTAS IN GENERAL?

8 A. I believe that those companies which, by their affirmative actions, impacted their
9 economic positions in ways that resulted in the production of NOLs have a claim
10 on the cash benefit produced by those NOLs which is superior to that of the
11 companies who were “by-standers” both as to the activities themselves and to
12 their economic consequences. And this conclusion applies not only to the tax
13 reduction itself but also to the time value of the tax reduction.

1

VI. CONCLUSION

2 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

3 A. Yes.

AFFIDAVIT

STATE OF NEW YORK)
)
COUNTY OF NEW YORK)

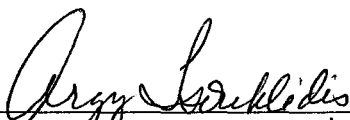
JAMES I. WARREN, being first duly sworn, deposes and states that he is the witness identified in the foregoing prepared testimony, that he has read the testimony and is familiar with its contents, and that the facts set forth are true.



JAMES I. WARREN

Subscribed and sworn to before me this 17th day of
January 2007 by JAMES I. WARREN.

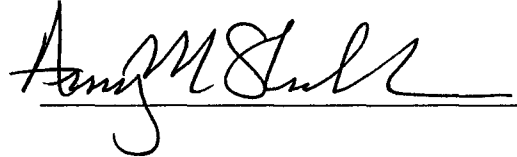
ARGY TSOUKLIDIS
Notary Public, State of New York
No. 01TS4773808
Qualified in Queens County
Commission Expires July 31, 20 10



Notary Public, State of NEW YORK
My Commission Expires: 7/31/2010

CERTIFICATE OF SERVICE

I certify that on the 29th day of January 2007, a true and correct copy of the foregoing instrument was served on all parties of record by hand delivery, Federal Express, certified mail, or facsimile transmission.

A handwritten signature in black ink, appearing to read "Amy M. Sullivan", is written over a horizontal line.