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APPLICATION OF ENTERGY GULF STATES, INC. FOR AUTHORITY TO CHANGE RATES AND TO RECONCILE FUEL COSTS	§ § § §	BEFORE THE STATE OFFICE OF ADMINISTRATIVE HEARINGS

REBUTTAL TESTIMONY

OF

JAMES I. WARREN

ON BEHALF OF

ENTERGY GULF STATES, INC.

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ENTERGY GULF STATES, INC.
REBUTTAL TESTIMONY OF JAMES I. WARREN
2007 TEXAS RATE CASE

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I. INTRODUCTION

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. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

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

Q. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT THELEN.

A. I am engaged in the general practice of taxation. 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 and Trusts and Estate Department.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

A. I joined Thelen in November of 2003. Prior to that time I was affiliated with the international accounting firms of Deloitte & Touche LLP (Oct. 2000 – Sept. 2003), PricewaterhouseCoopers LLP (Jan. 1998 – Sept. 2000) and Coopers & Lybrand (Mar. 1979 – June 1991) and the law firm, Reid & Priest LLP (July 1991 – Dec. 1997). At each of these professional services firms, I provided tax services primarily to electric, gas and telephone industry clients. My practice has included tax planning for the acquisition or transfer of business assets, operational tax planning and the representation of clients in tax controversies with the Internal Revenue Service ("IRS") at the audit and appeals levels. I have often been involved in procuring private letter rulings or technical advice from the IRS National Office. On several occasions, I have represented one or more segments of the utility industry before the IRS and/or the Department of Treasury regarding certain tax positions adopted by the federal government. I have testified regarding tax, tax accounting and regulatory tax matters before a number of regulatory bodies including the FERC and the commissions in Florida, Louisiana, Nevada, Delaware, West Virginia, New Jersey, New York, Connecticut, Pennsylvania, Kentucky and Texas. I have also testified before several Congressional committees and subcommittees and at Department of Treasury hearings regarding legislative and administrative tax issues of significance to the utility industry. I am a member of the New York and New Jersey Bars and also am licensed as a Certified Public Accountant in those two states. I am a member of the American Bar Association, Section of Taxation where I am a past chair of the Committee on Regulated Public Utilities.

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.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to certain aspects of the testimonies of Michael L. Arndt (on behalf of Cities), Ellen Blumenthal (on behalf of OPC) and Candice J. Romines (on behalf of Staff). Specifically, I address two topics – (1) the treatment of uncertain tax positions and (2) the propriety and calculation of a consolidated tax adjustment ("CTA").

Q. WILL YOU SUMMARIZE YOUR TESTIMONY?

A. Yes. With regard to uncertain tax positions, I believe that the portion of a tax benefit claimed by the Company that has been determined under Generally Accepted Accounting Principles to be sufficiently uncertain so as to require recordation as a tax liability instead of as a deferred tax should be treated in accordance with that economic reality. Consequently, such a liability should not reduce rate base. With regard to CTAs, as a threshold matter, I believe that the imposition of a CTA by this Commission in this proceeding would be inappropriate. This is my primary and overarching view. However, I am aware of this Commission's recent practice of adopting CTAs. If, in fact, a CTA is to be adopted, at the very least it ought to be reasonably and accurately calculated. In this regard, I support the Company's CTA calculation. As I discuss in detail hereafter, the failure by witnesses Arndt, Blumenthal and Romines to recognize the incontrovertible economic fact that the Entergy Group's substantial consolidated net operating loss ("NOL") carryover could not possibly be the source of a "tax shield" and, consequently, their failure to recognize this NOL as a reduction to the tax shield for purposes of the interest credit CTA calculation is a major — and fatal — flaw in their proposed adjustments.

II. UNCERTAIN TAX POSITIONS

Q. WILL YOU FRAME THE ISSUE HERE?

A. In a nutshell, the issue is whether or not the tax benefits of uncertain tax positions should be treated as deferred taxes. The resolution of this issue will determine whether or not these amounts are included in the accumulated deferred income tax ("ADIT") balance which is used to reduce rate base.

Q. WHAT ARE THE POSITIONS OF WITNESSES ARNDT, BLUMENTHAL AND ROMINES IN THIS REGARD?

A. The three of them maintain that these amounts should be treated as ADIT.

Q. IN THE TESTIMONIES OF THESE THREE WITNESSES, THERE IS MUCH DISCUSSION REGARDING TECHNICAL ACCOUNTING RULES. IS THIS A TECHNICAL ACCOUNTING ISSUE?

A. No, it is an economic issue. While there are certainly technical accounting rules that impact the recordation of the tax benefits of uncertain tax positions, particularly a recent pronouncement called FIN 48, the issue is not (and should not be) where they are recorded but what they are and what they mean.

Q. WHAT IS THE COMPANY'S POSITION WITH REGARD TO UNCERTAIN TAX POSITIONS?

A. The Company took one or more tax positions on its filed federal income tax returns that were, and remain, technically controversial. It is the Company's position that, to the extent that the tax consequences of these positions must, under FIN 48, be recorded as tax liabilities instead of deferred taxes and interest must be accrued on the amounts of these liabilities, they are (and should be) distinguishable from the ADIT balance that is normally a reduction in rate base. I agree with this position.

Q. AS A THRESHOLD MATTER, WHY DO ADIT BALANCES REDUCE RATE BASE?

A. ADIT balances reduce rate base because they represent a source of cost-free capital.

Q. PLEASE PROVIDE A COMMON EXAMPLE OF THIS.

A. The most common — and most material — example is probably accelerated depreciation. The tax law permits deductions for asset depreciation that, in the early years of an asset's life, significantly exceed the actual, economic depreciation of the asset. The entire purpose of allowing this is to provide additional cash flow to the taxpayer through the operation of the tax code.

Q. DOES THIS ADDITIONAL CASH FLOW HAVE TO BE RETURNED?

A. Yes it does. Over the life of the asset, tax and economic depreciation are the same. It is just a matter of timing. The process of providing accelerated tax depreciation results in a loan from the government in the early years of the life of an asset. The loan is extended through the taxpayer's tax return when it claims accelerated depreciation deductions. The loan is then "repaid" in the later years of the asset's life.

Q. WHAT IS THE CRITICAL ASPECT OF THIS LOAN?

A. The important aspect of this particular loan is that there is no borrowing cost. In other words, the ability to claim accelerated tax depreciation provides free funds – "zero-cost" capital.

Q. WHY DOES CONGRESS PROVIDE FOR LOANS OF THIS TYPE?

A. It is a capital formation subsidy. By providing temporary "free" capital, the cost of asset ownership is reduced and taxpayers are thereby encouraged to buy and build depreciable assets – an important aspect of the country's economic health.

Q. IS THERE A RECENT EXAMPLE OF THE GOVERNMENT PROVIDING SUCH AN INCENTIVE?

A. Yes there is. In response to the chaos of "9/11," Congress enacted bonus depreciation allowing taxpayers to "write off" 30% (and later 50%) of their cost for an asset in the year of acquisition. This was an obvious attempt to pump up the economy by motivating taxpayers to buy and build depreciable assets. The incentive expired at the end of 2004.

Q. IS THERE EVEN A MORE RECENT EXAMPLE?

A. Yes. Congress restored 50% bonus depreciation for 2008 in response to the credit market meltdown. Again, there was an intent to provide more "free" temporary cash to taxpayers who would use the cash to increase productive business activity.

Q. HOW IS THIS "FREE CASH" TREATED FOR REGULATORY PURPOSES?

A. The governmental loans are generally recorded as ADIT. This is a liability account that represents the necessity to pay back the loans to the government. Because these loans do not require the payment of interest, they are appropriately reflected in ratemaking as a reduction in rate base. This makes perfect sense. The offsetting of rate base is the mechanism for accurately reflecting the utility's cost — or, rather, lack of cost — of this capital.

Q. WHAT ARE THE TAX CONSEQUENCES WHERE A TAXPAYER CLAIMS ACCELERATED DEPRECIATION DEDUCTIONS ON ITS TAX RETURN TO WHICH IT IS NOT ENTITLED?

A. Upon audit by the IRS, the taxpayer's taxable income would be adjusted to reflect the correct amount of the depreciation deduction. The incremental taxable income for the year adjusted would give rise to a tax deficiency. The taxpayer would have to pay the tax deficiency plus interest on the amount of the tax deficiency due from the date the incremental tax would have been due had the taxpayer filed an accurate return.

Q. WHAT ARE THE ECONOMIC CONSEQUENCES OF SUCH AN EVENT?

A. In the situation described above, the taxpayer would have received a loan from the federal government. Further, the loan would have been extended as the taxpayer claimed the accelerated depreciation deductions. So, in these two regards, the tax benefits of the erroneous accelerated depreciation deductions are identical to those produced by valid depreciation deductions.

Q. IS THERE A DIFFERENCE BETWEEN THESE DEDUCTIONS AND CONVENTIONAL ACCELERATED DEPRECIATION DEDUCTIONS?

A. There is a critical difference. Whereas conventional accelerated depreciation deductions produce "zero-cost" loans, the erroneous deduction described above produces a loan with a distinct cost. The cost is the interest charged by the IRS on the tax deficiency.

Q. BASED ON THE ABOVE, WERE A UTILITY TAXPAYER TO CLAIM AN ERRONEOUS DEDUCTION, WOULD IT BE APPROPRIATE TO REFLECT THE ASSOCIATED LOAN AS A RATE BASE OFFSET?

A. It would not. The economic premise underlying the reduction of rate base is that the governmental loan is cost-free. Where that is not the case, the premise does not exist.

Q. SHOULD IT MATTER WHERE THE GOVERNMENTAL LOAN IS REFLECTED ON THE UTILITY'S BALANCE SHEET FOR FINANCIAL OR REGULATORY REPORTING PURPOSES?

A. No it should not. What is dispositive is the underlying nature of the loan — not where it is recorded. Granted, most of the loans reflected in ADIT accounts are cost-free. However, where it can be demonstrated that one or more loans are not of that type, the appropriate ratemaking ought to follow.

Q. WHAT IS FIN 48?

A. FIN 48 is an accounting pronouncement issued in 2006 by the Financial Accounting Standards Board. It prescribes the way in which companies must analyze, quantify and display tax benefits associated with positions that are technically uncertain. It is operative for years beginning after December 15, 2006 — this is, for calendar 2007 and thereafter.

Q. WHAT DO YOU MEAN BY "TECHNICALLY UNCERTAIN?"

A. The tax law is both voluminous and complex. The Internal Revenue Code itself consumes thousands of pages. The applicable regulations are four or five times as long. And there are tens of thousands of pages of administrative material and thousands of judicial decisions. But even with all this material, the application of the law to many sets of facts remains uncertain. Not only does the law change constantly, situations, contexts and transactions experienced by businesses evolve, morph and/or are invented at a rapid pace. It is the application of changing law to changing circumstances that infuses so much uncertainty into the arena. As a result, in the case of many, if not most, large and active business enterprises, the way in which many transactions are reflected on their tax returns is subject to question by the IRS and other taxing authorities.

Depending on the positions taken, the risk of successful challenge by the taxing authorities varies from item to item.

Q. WHAT IS THE PURPOSE OF FIN 48?

A. Prior to FIN 48, the accounting standard applicable to the evaluation and reflection of tax risk was FAS 5. FAS 5 dealt with accounting for contingencies – all contingencies. Taxes were treated no differently from any other contingency. As a consequence of its broad coverage, FAS 5 was not particularly specific when it came to the standards applicable to the evaluation of tax risk. This lack of specificity spawned wide variations in practice. These variations existed not only among industries but even among companies within the same industry. FIN 48 was intended to impose a uniform evaluation process for and a uniform disclosure of tax risk. It governs no risks other than tax risk.

Q. WHAT IS THE BASIC ARCHITECTURE OF FIN 48?

A. Obviously, tax risk revolves around whether or not tax benefits claimed by a taxpayer will, in fact, be available to that taxpayer. FIN 48 mandates a two-step process for evaluating tax risk. First, it requires that each and every tax position taken by the taxpayer be technically evaluated to determine whether or not there is more than a 50% chance that such position will be sustained. If not, no benefit whatsoever is recognized. If so, then the benefit recognized must be measured. The benefit reflected is the largest amount that it is more than 50% likely to be realized upon settlement.

Q. DOES THIS TWO STEP PROCESS APPLY TO TEMPORARY DIFFERENCES?

A. No it does not.

Q. WHAT IS A TEMPORARY DIFFERENCE?

A. A temporary difference is an item of income and expense that is reported in different periods for book and tax purposes. Ultimately, the item will be reported for both purposes — it just occurs at different times. Examples of common positions that produce temporary differences include the claiming of accelerated tax depreciation, repairs that are capitalized for book purposes and deducted for tax purposes and most deferred compensation. There are many others of this type.

Q. WHY DOESN'T THE TWO-STEP PROCESS APPLY TO TEMPORARY DIFFERENCES?

A. Temporary differences will, by definition, produce a tax benefit — it is only a question of when. Thus, the fact of a deduction is not at risk. Thus, the first step is not relevant. You go right to the measurement step.

Q. WHAT HAPPENS AS A RESULT OF THE APPLICATION OF FIN 48?

A. Any difference between the benefit recordable under FIN 48 and the benefit claimed on the tax return (the "Excess Benefit") is recorded as a tax liability. The liability is either short term or long term, depending on when it appears the liability will be paid.

Q. ARE THERE ANY ADDITIONAL CONSEQUENCES?

A. Yes. Interest is charged on any amount of Excess Benefit at the rates imposed by the relevant taxing authority. Also, penalties are accrued if necessary and appropriate.

Q. WILL YOU PROVIDE A SIMPLE EXAMPLE?

A. Since, in the case of utilities, most uncertain tax positions involve temporary differences, I will use one in the illustration. Assume a 40% tax rate. A utility expends $20 million for the implementation of SAP, an enterprise resource planning (ERP) system. For financial and regulatory reporting purposes, the cost is amortized over 10 years. On its tax return, the utility deducts the entire amount as software development costs. Consequently, as of the end of Year 1, the utility has recognized a tax deduction of $18 million in excess of its book ERP amortization expense ($20 million less $2 million). This excess deduction produced $7.2 million of cash ($18 million X 40%). The IRS is known to assert that ERP costs are not software development costs and are, therefore, not deductible currently. The IRS position is that these costs are amortizable over

3 years. At the end of Year 1, the utility reviews the item in light of FIN 48 and concludes that it is more than 50% likely that it will settle the issue for a deduction of $14 million and 3 year amortization of the remaining $6 million. If such a settlement were reached, at the end of Year 1, the utility would be permitted to deduct a total of $16 million – the $14 million that was deductible under the settlement and 1/3 of the $6 million that was amortizable under the settlement. This projected settlement would leave a remaining tax basis of $4 million to be amortized over the next two years. The unamortized book amount would equal $18 million at that time ($20 million less one year's amortization of $2 million). The utility would provide a deferred tax on the tax effect of the difference between the book basis ($18 million) and the tax basis as it would be were the FIN 48 settlement reached ($4 million). This ADIT would equal $5.6 million ($14 million X 40%). The $1.6 million difference between the $5.6 million ADIT and the $7.2 million cash tax benefit actually received by claiming the entire $20 million deduction on the tax return is the Excess Benefit and would be reflected as a tax liability. Interest at the IRS deficiency rate would be accrued on this amount and charged to expense.

Q. WHAT REGULATORY ISSUE DOES THIS RAISE?

A. The $1.6 million Excess Benefit described above is reflected as a tax liability and not as a component of ADIT. The regulatory issue is whether or not it should be treated that way for regulatory purposes.

Q. HAS THE FEDERAL ENERGY REGULATORY COMMISSION ("FERC") ADDRESSED THE ISSUE?

A. In Docket No. AI07-2-000 (May 25, 2007, 119 FERC ¶62,167) FERC addressed the accounting implications of FIN 48 – that is, the way in which items impacted by FIN 48 should be recorded in the Uniform System of Accounts ("USOA").

Q. WHAT ARE FERC'S INSTRUCTIONS?

A. FIN 48 does not allow the tax benefit of an uncertain tax position to be recorded in an ADIT account. FERC stated that this required classification of a tax liability as a tax liability account produces a loss of important information. It therefore instructed jurisdictional utilities to, essentially, ignore the tax account classification required by FIN 48.

Q. DOES THIS MEAN THAT THE TAX BENEFITS SUBJECT TO RECLASSIFICATION BY FIN 48 SHOULD BE TREATED AS CONVENTIONAL ADIT FOR RATEMAKING PURPOSES?

A. No. Significantly, FERC stated that its instructions in this regard are for financial accounting and reporting purposes only and are without prejudice to the ratemaking treatment for the items affected.

Q. HOW, THEN, SHOULD THE TAX BENEFITS SUBJECT TO CLASSIFICATION AS A TAX LIABILITY UNDER FIN 48 BE TREATED FOR RATEMAKING PURPOSES?

A. While it is true that implementation of FIN 48 may, in some cases, involve the tax account classification described above, this represents merely the end result of the FIN 48 analytical process. Without understanding this new process, it is impossible to reasonably analyze its result and, hence, its proper regulatory implications.

Q. WHAT IS THE FIN 48 PROCESS?

A. FIN 48 requires an analysis of each uncertain tax position taken by a company. As a practical matter, the analysis usually includes an in-depth review of all tax returns for all years that are still open to adjustment by taxing authorities. This purpose of this review is to identify and "inventory" all of the tax positions taken by the company. From this inventory of positions, the company performs a high-level technical review to ascertain those that have any element of uncertainty (*i.e.*, risk) to them. These then are rigorously analyzed from a technical perspective in order to determine (1) whether they reach the "more-likely-than-not" threshold and (2) what the highest level of settlement it is more likely than not that the company will achieve.

Q. WHAT IS THE RESULT OF THIS ANALYSIS?

A. This analysis produces an amounts of the tax benefit claimed by the company that, based on a systematic and detailed evaluation, it believes it will have to pay back to the government without interest (which will be classified as ADIT) and the amount it will have to pay back to the government with interest (which will be classified as a tax liability).

Q. IS THIS THE BASIS FOR THE FIN 48 REQUIREMENT THAT INTEREST BE ACCRUED ON THE EXCESS BENEFIT CLAIMED?

A. Yes it is.

Q. IS THE AMOUNT OF THE EXCESS BENEFIT SIMPLY THE COMPANY'S GUESS AS TO THE OUTCOME?

A. No. The company's independent auditors loom large in the process. They review all of the analyses of all of the positions and bring to bear their own expertise and resources in each case in which it is called for. The review is extremely thorough and, based on my understanding of it, often engenders spirited exchanges of views. Remember, it is usually in a company's interest to minimize the Excess Benefit, for, every dollar of Excess Benefit will attract an interest charge to earnings.

Q. WHAT, THEN, DOES THE EXCESS BENEFIT ECONOMICALLY REPRESENT?

A. What evolves at the end of the FIN 48 process is an amount that, like ADIT, represents a borrowing from the government. However, unlike conventional ADIT, it has been determined by both the company and its auditors that this borrowing is not cost-free. Both the company and its auditors have concluded that there is a better than even chance that this borrowing will have to repaid with interest. This interest is charged for financial reporting purposes. And the conclusion that this is capital with a cost is not a mere guess or an idle speculation. It is the result of a detailed, issue-by-issue analysis.

Q. IS THIS DIFFERENT THAN THE TAX RISK ASSESSMENT PROCESS THAT COMPANIES USED PRIOR TO FIN 48?

A. In my experience in the accounting industry, it is quite different – both quantitatively and qualitatively. Moreover, because it is now a uniform process, there is a level of comparability that never previously existed.

Q. HOW SHOULD THE EXCESS BENEFIT UNDER FIN 48 BE HANDLED FOR REGULATORY PURPOSES?

A. I believe it would be appropriate to treat it as FIN 48 does – regardless of what account it occupies. The recordation in any particular account is ministerial. It should govern ratemaking only insofar as it is consistent with the economics of the item. If this Excess Benefit is treated as conventional ADIT for ratemaking, then the ultimate payment of interest to the taxing authorities will result in the provision of a financing benefit to customers that never, in fact, existed. While this might have been an acceptable outcome where the company never performed a truly detailed analysis upon which to premise a different result, the quality of the information available now dictates a new regime.

Q. WHAT WOULD BE THE EFFECT OF REDUCING RATE BASE BY THE TAX BENEFITS OF UNCERTAIN TAX POSITIONS?

A. The effect would be to pass on to customers a financing benefit that the Company and its outside auditors do not anticipate the Company will enjoy. The inevitable impact of providing a non-existent financing benefit to customers is clear. Holding all other variables constant, reducing rate base by the tax benefits of uncertain tax positions will preclude the Company from earning its allowed rate of return.

III. <u>CTAS AND THE COMPANY'S CTA CALCULATION</u>

Q. HOW HAVE YOU ORGANIZED THIS PORTION OF YOUR TESTIMONY?

A. While my primary contention is that there should be no CTA, I address that in the final portion of this section of my testimony. This should in no way be construed as indicating any lack of conviction. I believe CTAs are wrong and I have testified before this Commission as to the reasons on a number of occasions over a number of years. I do so again here.

The Company's CTA Calculation

Q. IN WHAT WAYS ARE THE CTA CALCULATIONS PREPARED BY THE COMPANY AND THOSE PREPARED BY WITNESSES ARNDT, BLUMENTHAL AND ROMINES THE SAME?

A. The calculations of all parties employ the "interest credit" CTA procedure that has been approved on a number of occasions by this Commission. Basically, this procedure (1) quantifies the aggregate "tax shield" provided by the members of the Entergy consolidated tax group, (2) allocates a portion of this tax shield to EGSI and then (3) multiplies the allocated amount by EGSI's weighted cost of long term debt to derive the adjustment to EGSI's tax expense. All parties agree on two out of three of the elements of this three-part computation. They agree on both the ratio for allocating the aggregate tax shield to EGSI (9.78%) and on EGSI's weighted cost of long term debt (6.5%).

Q. IN WHAT WAYS ARE THE CTA CALCULATIONS PREPARED BY THE COMPANY DIFFERENT FROM THOSE PREPARED BY WITNESSES ARNDT, BLUMENTHAL AND ROMINES?

A. There is one major difference between the Company's calculation of the aggregate tax shield and that produced by the three witnesses. The Company reduces the aggregate tax shield by the Entergy Group consolidated NOL carry forward. The calculations of the other three do not.

Q. PLEASE EXPLAIN THE COMPANY'S CALCULATION IN THIS REGARD.

A. This goes to the very heart of the interest credit CTA methodology. The Company reduced the tax shield by the NOL carry forward because any tax losses included in that carry forward could not have contributed to the creation of any portion of the tax shield. It is a mathematical – and an economic - impossibility.

Q. PLEASE EXPLAIN THIS.

A. To appreciate this, we must review the principles underlying the "interest credit" methodology and, in particular, the role of the "tax shield."

Q. WHAT IS THE SOURCE OF THE "TAX SHIELD?"

A. In general, a corporation generating a tax loss in any year can carry that loss back to offset any taxable income it generated in its two prior tax years. If it does so, it can claim a refund of taxes previously paid. If it did not have any taxable income during that period, it can carry its tax loss forward 20 years to offset any taxable income produced in those years. This enables the loss company to pay less tax in the year of offset than it otherwise would have. In a consolidated return group, the losses of any member can be offset against the taxable income of any other member. Moreover, the ability to carry back or carry forward consolidated tax losses is computed on a consolidated, not an individual company, basis. Consequently, a tax loss produced by any particular group member can sometimes be used to offset consolidated taxable income earlier than it could have been used had that member not filed as part of the consolidated group. In other words, the loss company doesn't have to rely on its own taxable income production in the future to offset its current tax loss. It can use the loss to offset another member's taxable income immediately. The acceleration of the tax loss usage represents one important type of consolidated tax benefit.

Q. WHAT, THEN, IS THE TAX SHIELD?

A. As this term is used by this Commission, the tax shield is the taxable income produced by a member to the extent that it facilitates the use of any other member's otherwise unusable tax loss.

Q. DOES THIS STRIKE YOU AS AN ODD DEFINITION?

A. Definitely. It seems very strange to me that taxable income is deemed to provide a "shield." Its production does not, in fact, lower taxes paid one iota. In normal tax (and economic) parlance, it would be the tax loss that produces the "tax shield" because it is the thing that actually lowers (*i.e.*, deflects) the group's tax liability. Nevertheless, this confused and counter-intuitive definition is employed and apparently accepted without comment in proceedings before this Commission.

Q. PLEASE EXPLAIN THE RELATIONSHIP OF THE TAX SHIELD TO THE INTEREST CREDIT CTA METHOD?

A. The "interest credit" CTA method was first applied by this Commission in Docket 14965 (Central Power and Light Company). In that proceeding, the Administrative Law Judges proposed that the Commission not impose a CTA of any kind. However, this Commission disagreed with their recommendation and decided to do so.

Q. HOW DID THIS COMMISSION DESCRIBE THE CTA IT IMPOSED?

A. Finding of Fact 112A of the Order, the Order on Rehearing and the Second Order on Rehearing stated:

> 112A. In view of the advantage CSW competitive affiliates gain over competitors and to compensate CPL for the benefits it conveys to unprofitable CSW affiliates, CPL should be compensated for *the value of the tax shield it provides to CSW affiliates*. [Emphasis added.]

Q. HOW DID THIS COMMISSION DESCRIBE THE TAX SHIELD?

A. The tax shield is best described in Findings of Fact 108 and 111 of those same orders in which this Commission stated:

> 108. By filing a consolidated tax return with a profitable utility, the unprofitable CSW subsidiaries receive an immediate payment for the tax savings recognized on the consolidated return. The benefit for the unprofitable CSW subsidiaries is directly related to the profits earned by CPL in providing service.
>
> 111. Filing a consolidated tax return benefits CSW's loss affiliates by allowing them to realize the tax

> advantage of a loss in the current year without waiting until they earn a profit.

Q. HOW DID THIS COMMISSION DESCRIBE THE VALUE OF THE TAX SHIELD?

A. In Finding of Fact 112B of those orders, this Commission stated:

> 112B. The value of the tax shield CPL provides to CSW competitive affiliates is equal to the amount of consolidated tax savings over the last fifteen years that would not have been realized by CSW affiliates as of the test year, but for their affiliation with CPL, multiplied by the time value of money.

Q. WOULD YOU PLEASE SUMMARIZE THIS COMMISSION'S HISTORIC VIEW OF THE TAX SHIELD?

A. In Docket 14965, this Commission intended to ascertain the extent to which CPL's affiliates produced tax losses that were used in the CSW consolidated tax return – and for which they were paid - in excess of the amount they could have used to offset their own taxable income had they not filed as part of the CSW consolidated return. This consolidated return benefit was then allocated to all of those companies producing the taxable income (*i.e.*, tax shields) which was offset by these tax losses the use of which would otherwise have been deferred.

Q. WHAT, THEN, IS THE IMPORT OF THE TAX SHIELD?

A. The tax shield is the major driver of the interest credit CTA computation.

Q. DOES THE COMPANY'S CTA CALCULATION ACCURATELY COMPUTE THE TAX SHIELD?

A. Yes it does.

Q. DO THE CTA CALCULATIONS OF THE THREE WITNESSES ACCURATELY COMPUTE THE TAX SHIELD?

A. They fail to even approximate the tax shield.

Q. PLEASE EXPLAIN THEIR FLAW.

A. The major flaw lies in their handling (or, rather, ignoring) of the Entergy consolidated group NOL carry forward. A simple example best illustrates this shortcoming. Assume a consolidated group consisting of only two members, Utility and Affiliate, produces the following tax results over the relevant 15 year period:

	Utility	Affiliate	Consolidated
Year 1	$100	$0	$100
Year 2	$100	$0	$100
Year 3	$100	$0	$100
Year 4	$100	$0	$100
Year 5	$100	$0	$100
Year 6	$100	$0	$100
Year 7	$100	$0	$100
Year 8	$100	$0	$100
Year 9	$100	$0	$100
Year 10	$100	$0	$100
Year 11	$100	$0	$100
Year 12	$100	$0	$100
Year 13	$100	$0	$100
Year 14	$100	$0	$100
Year 15	$100	($1,500)	($1,400)
15 Year Total	$1,500	($1,500)	

Q. IN THE EXAMPLE ABOVE, WHAT WOULD BE THE CONSEQUENCE OF THE YEAR 15 TAX RESULTS?

A. The consolidated group produced a $1,400 net operating loss in Year 15. Under the tax law, this NOL can be carried back 2 years and forward 20 years. Since the group produced $200 of taxable income in the carry back period, that income could be offset and a tax refund obtained. However, $1,200 of the Year 15 tax loss could not be carried back and would be carried forward to offset future taxable income.

Q. AS OF THE END OF YEAR 15, WOULD THE $1,200 NOL CARRYFORWARD GENERATED IN THAT YEAR HAVE OFFSET ANY GROUP MEMBER'S TAXABLE INCOME OR PRODUCED ANY CASH?

A. Absolutely not.

Q. USING THE METHODOLOGIES EMPLOYED BY WITNESSES ARNDT, BLUMENTHAL AND ROMINES, WHAT WOULD THE TAX SHIELD BE?

A. Using their methodologies, the tax shield would equal the entire $1,500 of utility taxable income generated during the entire period.

Q. IS THAT AN ACCURATE MEASURE OF THE TAX SHIELD AS THAT CONCEPT HAS BEEN DEFINED BY THIS COMMISSION AND AS UNDERSTOOD BY THE COURTS?

A. No. It does not come even close to measuring the extent to which Affiliate's Year 15 NOL offset taxable income to a greater extent than it would have had Affiliate filed separately. That number is $300 – no more and no less.

Q. HOW DOES THE COMPANY'S METHODOLOGY REFLECT THIS?

A. Accurately. By offsetting the aggregate tax loss ($1,500 in the example) by the NOL carry forward ($1,200 in the example), the Company's calculation reflects the true economics of the situation. It measures precisely what this Commission has indicated should be measured.

Q. IS THERE ANY BASIS ON WHICH TO IGNORE THE NOL CARRYFORWARD?

A. The only conceivable basis would be that ignoring it makes for a simpler calculation.

Q. IS THIS A RATIONAL BASIS?

A. It is not. In my experience, most large companies, and I include among this group virtually every publicly traded utility that I know of, can perform an accurate tax shield calculation. There is simply no reason to use inferior, and, in some cases, wildly erroneous, information. The amounts involved may be substantial – as they are in EGSI's case. Under the circumstances, the simplicity argument is, charitably speaking, feeble.

Q. AT PAGE 10, LINES 22 THROUGH 24 OF HER TESTIMONY, MS. ROMINES STATES THAT "...EGSI SHOULD BE REQUIRED TO SUPPORT THAT ITS METHOD FULLY RECOGNIZES CARRYBACKS." TO WHAT DOES THIS REFER?

A. This statement refers to the fact that, in 2003, the Entergy group availed itself of an election to forego carrying back (to the two prior years) the consolidated NOL produced in that year. This is an election that is available to all corporate taxpayers. Ms. Romines is, I believe, proposing that this election to forego the carry back be ignored and that all CTA calculations be made as if the 2003 NOL had, in fact, been carried back.

Q. DO YOU AGREE WITH THIS PROPOSAL?

A. I do not agree.

Q. PLEASE EXPLAIN THE EFFECT OF THE ELECTION.

A. Because carrying back the 2003 NOL would have caused more of it to offset taxable income than carrying it forward did, carrying back would have produced a larger tax shield than, in fact exists. In other words, had the Entergy group carried back that NOL, its consolidated NOL carry forward would be less than it is. Thus, there would be fewer NOLs that hadn't offset taxable income and, hence, a larger tax shield.

Q. WHAT IS THE CRITICAL ISSUE HERE?

A. The critical question is whether or not the Entergy group has an obligation to maximize the tax shield if doing so creates a detrimental tax consequence for the group. Ms. Romines' proposal effectively imposes such a mandate. In so doing, she extends the jurisdiction of this Commission to encompass virtually unlimited intrusion into the operations of non-regulated affiliates.

Q. HOW IS THIS SO?

A. If this mandate exists, then it is only logical for this Commission to examine the operational tax practices of the Entergy affiliates to make sure that everything they do maximizes the tax shield. Thus, the inventory methods used by affiliates as well as the depreciation elections they make are all fair game for review. If any do not maximize the EGSI tax shield, they should be ignored. Finally, if an affiliate leases a depreciable asset instead of buying it and, as a consequence, the affiliate produces a smaller tax loss than it might have otherwise, the lease should be ignored and ownership imputed.

Q. WHAT IS YOUR VIEW OF HER PROPOSAL IN THIS REGARD?

A. Ms. Romines has proposed the creation of a very, very slippery slope. If this Commission asserts its jurisdiction over elections of this type, there is no conceptual stopping point. If proof was ever needed that CTAs import into regulation the tax consequences of activities having nothing to do with the provision of the regulated service, then this proposal bears singular testimony to that fact.

Q. WHAT IS YOUR CONCLUSION WITH REGARD TO MS. ROMINES' PROPOSAL IN THIS REGARD?

A. Ms. Romines invitation to expand the scope of this Commission's tax investigation should be declined.

The Propriety of a CTA

Q. YOU STATED PREVIOUSLY YOUR BELIEF THAT THE IMPOSITION OF A CTA IN THIS PROCEEDING WOULD BE INAPPROPRIATE. PLEASE EXPLAIN THIS VIEW.

A. I believe that taxes charged to customers should not reflect the consequences of income or costs that are not included in the computation of rates for the provision of the Company's regulated service. This should be true whether the income or costs are incurred by EGSI or by other corporate entities included in the Entergy consolidated group.

Q. WHAT IS THE REGULATORY PRINCIPLE THAT EMBODIES THIS VIEW?

A. The principle embedded in this view is cost responsibility. Only the tax benefits of those costs for which customers are responsible (that is, which they appropriately bear) are properly reflected in the rate setting process. Its most frequent and straightforward application is when a cost has been disallowed, be it a plant cost, an advertising expenditure, a trade association or lobbying cost or even a charitable contribution. This Commission has encountered these situations many times. Where such costs are disallowed, this Commission has not generally allowed the tax benefit of the costs to be reflected in the rate setting process. Thus, this Commission has repeatedly demonstrated its acceptance of the principle of cost responsibility.

Q. DO YOU HAVE A GENERAL VIEW REGARDING THE PROPRIETY OF CTAS?

A. In my view, CTAs are inherently inappropriate most obviously because they represent a violation of the principle articulated above. CTAs explicitly import into the rate setting process the tax consequences of costs that are not in the slightest way related to the provision of regulated service. If the same costs were incurred in a division of the corporate entity that also provided the regulated service, they would most assuredly not be reflected in rates. The fact that these costs are incurred in one or more other corporate entities is economically and theoretically irrelevant. The same cost responsibility principle is applicable.

Q. DOES TEXAS LAW RECOGNIZE THE PRINCIPLE OF COST RESPONSIBILITY?

A. It does. PURA §36.062 (formerly PURA §41(c)(3)) provides that the Commission cannot consider certain costs for ratemaking purposes, including costs found to be unreasonable, unnecessary or not in the public interest. In its GTE-Southwest decision,[1] the Texas Supreme Court concluded that the tax consequences of such costs cannot be reflected in rates since the consideration of those tax consequences constitutes the consideration of the underlying costs – the exact thing PURA prohibits. The Court obviously recognized that the tax consequence of a cost is an inherent and inseparable element of that cost. Consider the tax consequence and you consider the cost. There is absolutely no basis to distinguish between costs incurred by the corporate entity that conducts the regulated business and any other corporate entity. Using the Supreme Court's logic, imposing a CTA is considering costs incurred by non-regulated entities. It is patently inappropriate.

Q. THE SUPREME COURT ASIDE, WHAT MAKES THE IMPOSITION OF A CTA INAPPROPRIATE?

A. There are three steps to this conclusion.

Q. WHAT IS THE FIRST STEP?

[1] 901 S.W.2d 401 (1993).

A. Most expenditures have the capacity to produce a tax benefit and, as the Supreme Court recognized, this capacity is not something separate and apart from the expenditure itself. It is, in fact, an inherent property of the expenditure. No expenditure, no tax benefit. And the magnitude of the tax benefit is inextricably tied to the magnitude of the expenditure. The cause and effect relationship is direct and indisputable.

Q. WHAT IS THE SECOND STEP?

A. The capacity for an expenditure to produce a tax benefit is something of value. A simple example demonstrates this. Assume Corporation A and Corporation B each own identical machines – the only thing owned by each corporation. Further assume that each corporation is identical in every other respect. Finally, assume that the machine owned by Corporation A has a tax basis of $100 and the machine owned by Corporation B has a tax basis of $0. Thus, Corporation A will, in the future, be able to claim depreciation tax deductions and Corporation B will not. There can be no doubt that the stock of Corporation A is more valuable than that of Corporation B. The sole reason for this difference in valuation is that Corporation A's future tax deductions have value.

Q. IS THERE ANY OTHER EVIDENCE OF THE VALUE OF TAX ATTRIBUTES?

A. In the world of corporate transactions, where a corporation has net operating loss carry forwards, those tax attributes are ascribed real economic value and influence the valuation of such a corporation in the market.

Q. WHAT IS THE THIRD STEP?

A. When a tax loss of one corporation is used to offset the taxable income of another corporation in the context of a consolidated tax group, the tax loss is absorbed. The very process of creating a consolidated tax benefit extinguishes forever the tax loss of the loss affiliate.

Q. HOW DO THESE THREE STEPS TOGETHER SUPPORT YOUR ASSERTION?

A. Each cost, whether borne by customers or by shareholders, has a potential tax benefit embedded within it. This potential benefit has value. Tax losses are nothing more than the aggregation of a number of such costs. The value of a tax loss is extinguished the instant the potential benefit is used to offset taxable income, thereby becoming an actual benefit. No one would dispute the proposition that, when costs borne by customers produce actual tax benefits, these benefits must be passed to customers. Customers have a right to these benefits because they "own" (*i.e.*, are responsible for) the costs of which the benefits are an elemental component. The same rights in the benefits accrue to shareholders when they are the ones who bear cost responsibility.

Q. ASIDE FROM THE CONFISCATORY NATURE OF CTAS, IS THERE A LOGICAL AND EQUITABLE RATIONALE THAT UNDERLIES YOUR OPPOSITION TO THEM?

A. Yes there is. Even ignoring the basic confiscatory nature of CTAs, a simple analysis of the facts relevant to the production of consolidated tax benefits militates against the imposition of a CTA.

Q. PLEASE DESCRIBE THIS ANALYSIS.

A. Let us start with EGSI (though the analysis is equally applicable to all members producing taxable income). The *only* action EGSI took to facilitate the creation of the consolidated tax savings was to generate taxable income – a normal by-product of earning its allowed return. Moreover, even this one action was not in any sense an affirmative act. By this I mean that EGSI would have produced precisely the same amount of taxable income in precisely the same way had there been no consolidated tax benefit potential. Thus, the Company was a completely passive participant in the generation of any consolidated tax benefit. It did not change its position in any way. To the extent that EGSI is allocated any of the tax benefits of consolidated filing, it is accurate to characterize it as a windfall. Again, it did nothing particular to deserve it.

Q. PLEASE APPLY THE ANALYSIS TO THE COMPANIES THAT PRODUCE THE TAX LOSSES.

A. Tax losses don't just happen. They reflect underlying economic activity. Each dollar of tax loss represents a dollar expended or a dollar of liability incurred by the tax loss member. In other words, the tax loss of each loss member is the consequence of that member having substantively altered its economic position. Each such alteration constitutes an affirmative act by that member and the ensuing reduction in tax is a direct result of one or more of these affirmative acts. The contrast between the tax-reducing actions of these companies and those of EGSI could hardly be more pronounced.

Q. IN THE CASE OF EGSI, YOU INDICATED THAT ITS CONDUCT WOULD HAVE BEEN THE SAME WITH OR WITHOUT THE PROSPECT OF A CONSOLIDATED TAX BENEFIT. IS THIS TRUE OF THE LOSS COMPANIES AS WELL?

A. While this is clearly a hypothetical question, I can state that, based on my more than 25 years of tax experience, a company that faces the prospect of producing tax losses that it cannot use has alternatives available to it to, in effect, transfer the tax benefits in exchange for some other financial benefit. That is, in large part, the basis of the leasing industry. Such a company could lease an asset from a lessor who can use the tax benefits of accelerated depreciation rather than own and depreciate the asset itself. The benefits of the tax depreciation are passed through to the loss company/lessee in the form of lower lease payments. There are other such techniques. In short, loss members can frequently alter the form of their investments and operations to avoid the production of unusable tax losses.

Q. WHAT IS YOUR POINT HERE?

A. My point is not that loss companies in a consolidated group should lease assets or alter their investment strategies or do anything else in particular. They don't have to because of the presence within the group of companies with taxable income. My point is that the ability by a loss company to monetize tax benefits in another way stands in stark contrast to the complete inability of the taxable income company to control a tax benefit. And this represents another indicia of benefit entitlement.

Q. ARE THERE ANY ADDITIONAL CONSIDERATIONS?

A. Yes. The tax losses of non-regulated affiliates are produced by their engagement in activities for which shareholders (and only shareholders) bear risk. Not only will losses from these activities not be compensated for by ratepayers, but, in fact, ratepayers are comprehensively insulated from all manifestations of the risks. When such activities end up producing tax losses, the tax law is structured to mitigate the losses by allowing them to reduce tax that would otherwise be due. In effect, the federal government funds a portion of the loss. Notwithstanding the very deliberate regulatory insulation against the non-regulated risks, CTAs breach the layers of insulation in order to extract for ratepayers these "loss mitigation" effects of the tax law. This is patently inequitable.

Q. WHAT DO YOU CONCLUDE WITH REGARD TO THE ENTITY TO WHICH THE BENEFIT OF A TAX LOSS SHOULD BE ASSIGNED?

A. Any reasoned analysis compels the conclusion that, as between the two types of members, entitlement is never really seriously in question. The loss company has by far the higher entitlement and should be assigned the benefit.

Q. IF THIS IS SO, WHAT ARE THE IMPLICATIONS FOR CTAS?

A. As I stated at the outset, CTAs are inherently inappropriate. They assign tax benefits of costs not related to the provision of regulated service to regulated companies that have clearly inferior claims on those benefits. CTAs are, consequently, wrong on two critical levels.

Q. ARE CTAS COMMONLY MADE BY REGULATORY JURISDICTIONS AROUND THE COUNTRY?

A. No, they are rarely made. There are 52 U.S. regulatory jurisdictions (including D.C. and FERC). The regulators in only one jurisdiction, New Jersey, have seen fit to systematically impose a CTA similar to the one employed in Texas. In one state, Pennsylvania, the regulators are compelled to employ a CTA pursuant to a Supreme Court of Pennsylvania court decision issued several decades ago. In one state, Oregon, a very unusual CTA has been imposed by statute. As in Pennsylvania, the regulators have no discretion. Within the last year the regulators in West Virginia issued an order imposing a CTA similar to the one used in Pennsylvania. That order is still not yet final. Thus, as of right now, aside from Texas, there are only three jurisdictions in which CTAs are systematically imposed – and only a single jurisdiction in which the imposition is a result of regulatory discretion. That means the regulators in at least 47 jurisdictions have chosen not to impose CTAs.

Q. WHAT WOULD BE THE EFFECT ON THE COMPANY'S EQUITY RETURN OF THE IMPOSITION OF A CTA?

A. A CTA does one thing and one thing only for a regulated utility: it reduces its revenues. CTA imposition is completely invisible for all other purposes. The Company's financial reporting tax expense will remain precisely the same with or without a CTA. The Company will actually pay its separate tax liability pursuant to the Entergy Group tax sharing agreement regardless of the imposition of a CTA. Since revenues will decrease while all other financial factors remain the same, the inevitable result is a reduction in the Company's equity return.

Q. WHAT IS THE EFFECT OF THIS EQUITY RETURN REDUCTION?

A. On the one hand, this Commission will establish a stated equity return for the Company. However, at precisely the same time, by flowing through the tax reduction benefits of costs incurred by non-jurisdictional affiliates, this Commission will directly and significantly inhibit attainment of that return. If the articulated rate of return is, in fact, the just and reasonable amount, the effect of imposing a CTA is to provide the company with a return that is not just and reasonable.

Q. UNDER TEXAS LAW, WHAT ARE THE FACTORS THAT MUST BE CONSIDERED IN CONNECTION WITH DETERMINING EGSI'S FAIR SHARE OF CONSOLIDATED TAX SAVINGS?

A. In Docket 14965, this Commission established five factors: (1) benefits following burdens, (2) relationship of the tax savings to utility service, (3) impact on the utility's financial strength, (4) advantages enjoyed by the utility's shareholders and (5) impact on competition between the utility and its affiliates and other entities.

Q. HAVE WITNESSES ARNDT, BLUMENTHAL OR ROMINES ADDRESSED THESE FACTORS?

A. They have not.

Q. WILL YOU APPLY THESE FIVE FACTORS TO EGSI?

A. 1. EGSI ratepayers do not bear the burden of affiliate losses and, hence, are not entitled to any tax benefits flowing therefrom;

2. No tax savings could conceivably exist without the affiliate losses. To the extent utility service produced a potential means of monetization, it may be viewed as a factor – but it is not the major factor;

3. Though Company witness Mr. Bunting addresses this factor, as I noted previously, the imposition of a CTA will erode the Company's ability to earned its allowed rate of return;

4. Without a CTA, EGSI Shareholders enjoy no tax benefits in excess of those to which they are rightfully entitled;

5. There exists not a shred of evidence that filing on a consolidated basis places EGSI or any Entergy affiliates in a competitive advantage vis a vis the competitors of either.

Q. WHAT CONCLUSION DO YOU DRAW FROM THE APPLICATION OF THESE FACTORS?

A. Under any reasonable application of the factors, a majority of them (at the very least) support the impropriety of imposing a CTA.

IV. CONCLUSION

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.