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APPLICATION OF ENTERGY	§	
TEXAS, INC. FOR AUTHORITY TO	§	BEFORE THE
CHANGE RATES, RECONCILE	§	STATE OFFICE OF
FUEL COSTS, AND OBTAIN	§	ADMINISTRATIVE HEARINGS
DEFERRED ACCOUNTING	§	
TREATMENT	§	

REBUTTAL TESTIMONY

OF

JAMES I. WARREN

ON BEHALF OF

ENTERGY TEXAS, INC.

APRIL 2012

625

ENTERGY TEXAS, INC.
REBUTTAL TESTIMONY OF JAMES I. WARREN
DOCKET NO. 39896

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I. INTRODUCTION

A. Introduction and Qualifications

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

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

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

Q. PLEASE DESCRIBE YOUR CURRENT RESPONSIBILITIES AT MILLER.

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.

Q. ON WHOSE BEHALF ARE YOU SUBMITTING THIS TESTIMONY?

A. I am submitting this testimony on behalf of Entergy Texas, Inc. ("ETI" or the "Company").

Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

A. I joined M&C in February of 2012. For the three years prior, I was a partner in the law firm Winston & Strawn and for the five years prior to that, I was a partner in the law firm of Thelen Reid Brown Raysman & Steiner LLP. Before that, I was affiliated with the international accounting

firms of Deloitte LLP (October 2000 – September 2003) and PricewaterhouseCoopers LLP (January 1998 – September 2000), the law firm Reid & Priest LLP (July 1991 – December 1997) and the international accounting firm of Coopers & Lybrand (March 1979 – June 1991). At each of these professional services firms, I provided tax services primarily to electric, gas, telephone and water industry clients. My practice has included tax planning for the acquisition and 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 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, New Jersey and District of Columbia Bars and also am licensed as a Certified Public Accountant in New York and New Jersey. 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. HAVE YOU TESTIFIED IN ANY REGULATORY PROCEEDINGS?

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

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I earned 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.

B. Purpose

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to respond to one particular aspect of the direct testimony of Mark E. Garrett filed on behalf of Cities Served by Entergy Texas, Inc. Specifically, I address his proposal that ETI should treat as cost-free capital an amount (the "FIN 48" amount) that the Company's internal and external experts have determined will not be cost-

free capital (Garrett, page 5, line 4 through page 7, line 5). The amount of his proposed incremental reduction to rate base is $5,916,461, as described in the rebuttal testimony of ETI witness Rory L. Roberts.

Q. WHAT IS FIN 48?

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

Q. PLEASE SUMMARIZE MR. GARRETT'S TESTIMONY INSOFAR AS IT ADDRESSES FIN 48.

A. Mr. Garrett makes two points – one theoretical and one procedural. As far as articulating a theoretical basis for his position, he states that, "...rate base should reflect the actual amount of cost free capital in the ADFIT [accumulated deferred federal income tax] accounts at test year end." Procedurally, he references this Commission's order in Docket No. 35717[1] and asserts that the treatment afforded the FIN 48 amount in that proceeding should be applied in this proceeding.

[1] Application of ONCOR Electric Delivery Company LLC for Authority To Change Rates.

Q. PLEASE SUMMARIZE YOUR RESPONSE TO THESE TWO CONTENTIONS.

A. I wholeheartedly agree with Mr. Garrett's theoretical statement. Rate base *should* reflect the actual amount of cost-free capital possessed by the Company. However, Mr. Garrett's proposed adjustment stands or falls on his unsupported presumption that the Company's FIN 48 amount is, in fact, cost-free capital. This is an incorrect premise. As for his reliance on the order in Docket No. 35717, I believe that order represented a very early, if not an initial, "stab" at addressing the FIN 48 issue. Since the issuance of that order, the Commission has altered its view, as I will describe later in my testimony. In short, that order no longer represents authoritative precedent regarding FIN 48 issues.

II. FIN 48

Q. WHAT IS THE FUNDAMENTAL POLICY ISSUE THIS COMMISSION MUST CONSIDER WITH REGARD TO FIN 48?

A. When you cut through all of the references to accounting pronouncements and tax rules, the issue distills down to the simple question of whether or not this Commission should set rates using the best available expert information. The Company supports the use of the best information. Mr. Garrett opposes it.

Q. TO WHAT KIND OF INFORMATION ARE YOU REFERRING?

A. The numerical dispute here relates to the quantity of cost-free, government-furnished capital that the Company should reflect as a reduction in rate base. There are two types of loans the government extends through the tax system. One type is interest-free. Hereafter, I refer this type of loan as an accumulated deferred income tax, or ADIT, loan.[2] The second type is interest-bearing. Hereafter, I refer to this type of loan as a non-ADIT loan. The information I refer to is that which informs this Commission (among others) as to which of the two types of loans the Company has.

Q. HOW DOES THE GOVERNMENT EXTEND ADIT LOANS THROUGH THE TAX SYSTEM?

A. The mechanics and nature of an ADIT loan is best illustrated by a simple example. Assume that, in a non-bonus depreciation year, an electric utility acquires and places in service a distribution line that costs $1 million. On its tax return, it takes the position that the line is depreciable over 20 years on an accelerated basis. This would be the technically correct tax treatment. The utility will claim accelerated depreciation on its tax return and, as a result, reduce its tax liability. The reduction in the utility's tax liability will give rise to a loan from the government – an ADIT loan. Indeed, the Congressional purpose in enacting accelerated depreciation

[2] What I refer to as ADIT, Mr. Garrett refers to as ADFIT. They are the same.

was to extend ADIT loans to businesses. The loan will be paid back in the later years of the distribution line's useful life (*i.e.*, after year 20) when it is still providing service (and, therefore, generating taxable revenue) but no additional tax depreciation is available because it has all been claimed. Thus, the mechanism for repaying the loan is embedded in the asset. It will be repaid over a predictable schedule – as the depreciation timing differences reverse. The actual repayment will be accomplished by filing future tax returns that will reflect incremental taxable income (because there will be less tax depreciation). Moreover, repayment will not be due until those future tax returns are due. Because the loan is repaid to the government by the filing of tax returns for future tax years, there is no interest associated with it. It remains interest-free as long as it is outstanding.

Q. PLEASE DESCRIBE THE NATURE OF A NON-ADIT LOAN.

A. The best way to illustrate a non-ADIT loan is, again, by means of an example. Assume the same facts as in the preceding illustration, except that the electric utility decides to deduct the entire cost of the distribution line in the year it is placed in service. In that event, the deduction will reduce the utility's tax liability for that year. Although this would be a technically incorrect tax position, it would also produce a governmental loan – one larger than the loan created by "merely" claiming accelerated depreciation. Upon audit, the IRS will disallow the tax deduction to the

extent it exceeds the permissible level of depreciation and require the utility to pay back a substantial portion of the loan (*i.e.*, the non-ADIT portion) immediately. Thus, the mechanism for repaying the loan has nothing to do with filing tax returns for future tax years. It depends on the necessity to pay additional tax with respect to an already-filed tax return. Moreover, unlike the ADIT loan where scheduled repayment is triggered by predictable timing difference reversals, the repayment of a non-ADIT loan can come whenever the IRS assesses a tax deficiency. There is no embedded reversal device. Finally, as with all taxes owed for prior years, interest is charged on the amount due.

Q. WHAT ARE THE CRITICAL DISTINCTIONS BETWEEN THE TWO TYPES OF LOANS?

A. Though both loans are extended through the tax system, they are very different. The first loan, the depreciation-related one, is a creature of the tax law. It is a conventional ADIT loan. It is the result of a conscious decision by Congress to subsidize the cost of capital assets by the extension of interest-free loans. The benefit of that subsidy is clearly one that needs to be reflected in the ratemaking process - and it is. The loan is reflected in the company's ADIT balance and that balance is reflected as an offset to regulated rate base because it is cost-free capital. The second loan, the expense-related loan, is not part of a Congressional subsidization scheme and the utility will be charged a carrying cost with

respect to it. In fact, by reflecting an aggressive tax position on its tax return, the utility simply borrowed money from the government in the same way it could have from a bank (though, admittedly, the formalities are quite different).

Q. IN THE EXPENSE-RELATED LOAN SITUATION, IS THE LOAN INTEREST-FREE UP UNTIL THE IRS REQUIRES REPAYMENT?

A. No. It is never interest-free. The IRS will charge interest on its assessment not from the date of the assessment, but from the date the utility filed its erroneous tax return – that is, from the date of the loan itself. In short, there is no period during which such a loan is interest-free.

Q. WHAT IS THE DISAGREEMENT BETWEEN THE COMPANY AND MR. GARRETT?

A. The Company submits that its FIN 48 amount is not an ADIT loan and should not be treated as one. Mr. Garrett believes it should be.

Q. WHAT IS FIN 48?

A. FIN 48 is an accounting pronouncement issued in 2006 by the Financial Accounting Standards Board ("FASB"), the body that establishes the rules that constitute "generally accepted accounting principles."[3] FIN 48 (which

[3] This pronouncement has recently been "codified" as FASB ASC 740-10. I will nevertheless refer to it as FIN 48 throughout my testimony.

is an acronym for FASB Interpretation No. 48) prescribes the way in which companies must analyze, quantify, and disclose the consequences of tax positions that are technically uncertain. It applies to calendar year 2007 and years thereafter.

Q. WHAT IS THE PURPOSE OF FIN 48?

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

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

A. FIN 48 requires that a taxpayer identify all of its "tax positions." The definition of a tax position is very broad. It really goes to the way in which

an economic action is reflected on a tax return. With respect to those tax positions that are uncertain, the extent of the uncertainty must be evaluated and the probable loss of tax benefits quantified.

Q. WHAT IS THE NATURE OF THIS EVALUATION?

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

Q. WHAT WOULD FIN 48 MEAN IN TERMS OF YOUR SIMPLE EXAMPLE INVOLVING THE ELECTRIC UTILITY THAT BUILDS A DISTRIBUTION LINE AND DEDUCTS ITS COST ALL IN ONE YEAR?

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

Q. HOW IS THE AMOUNT AT RISK DETERMINED AND THEN REFLECTED?

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

Q. WHY ARE FIN 48 AMOUNTS NOT REFLECTED IN ADIT?

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

Q. WITH WHAT COMPANY POSITION DOES MR. GARRETT TAKE ISSUE?

A. After completing the identification and evaluation process described above, the Company has "booked" a FIN 48 amount for tax benefits it and its outside auditors agree is likely to be forfeited and has treated this tax

benefit as a non-ADIT loan. Mr. Garrett proposes to treat this amount as an ADIT loan.

Q. PLEASE SUMMARIZE WHAT, IN YOUR VIEW, FIN 48 ENTRIES REPRESENT.

A. FIN 48 amounts represent the incremental quantity of tax that the company and its auditors have concluded that it will most likely owe with respect to previously filed tax returns. These amounts will be payable with interest when they are assessed.

Q. WHAT, THEN, IS THE ISSUE THIS COMMISSION MUST ADDRESS?

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

Q. IS THERE A CHECK ON THE VERACITY OF THE AMOUNTS DETERMINED TO BE FIN 48 AMOUNTS?

A. Yes. The FIN 48 analysis involves a rigorous review process for assessing the likelihood of having to make additional tax payments (with interest and penalties) to the taxing authorities. In the case of all

companies with publicly traded securities, their independent auditors review the company's conclusions. Moreover, it is really not in any company's best interests to seek to maximize its FIN 48 amounts. First, because of the adverse earnings implications of designating FIN 48 amounts (that is, the necessity to accrue incremental interest expense), no company has an incentive to designate a larger FIN 48 amount than it has to. Further, any FIN 48 amount must now be disclosed on a Schedule UTP attached to each company's federal income tax return. Thus, a FIN 48 designation virtually ensures the issue will be audited by the IRS. Finally, the purpose of the review of the company's FIN 48 designation by its independent auditors is to ensure that the financial statements the investing public relies upon provide information that is as accurate as possible about the true nature of the company's liabilities. The result of the review is reflected in the company's filings with the Securities and Exchange Commission. The adverse consequences of misreporting to the SEC can be significant. Thus, it is in a company's interest to designate FIN 48 amounts only when reasonable and appropriate.

Q. SPECIFICALLY, HOW DOES THE FIN 48 QUESTION RELATE TO RATEMAKING IN THIS CASE?

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

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

Q. IS THERE UNCERTAINTY ASSOCIATED WITH THE FIN 48 TAX LIABILITY?

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

Q. ARE YOU SUGGESTING THAT IT COMES DOWN TO A CHOICE BETWEEN TWO UNCERTAIN ALTERNATIVES?

A. Yes I am. And it is my view that the Commission should adopt the more likely of the two alternatives – to respect the FIN 48 characterization. This is not simply because it is an accounting rule. It is because doing so makes far more sense than Mr. Garrett's position, which, in effect, assumes that the Company will prevail on every uncertain tax position it has taken – even on those with respect to which the Company's experts have determined it is likely that the Company will not prevail.

Q. SHOULD THE COMMISSION ENCOURAGE THE COMPANY TO TAKE UNCERTAIN TAX POSITIONS?

A. Absolutely. If, contrary to the expectations of the experts, the Company is able to prevail in the assertion of an uncertain tax position, at that point the non-ADIT governmental loan would be re-characterized as an ADIT loan and customers would enjoy incremental zero-cost capital at the next rate proceeding. Obviously, if the Company never asserts its uncertain position, this incremental zero-cost capital cannot come into being. Consequently, it is in the customers' best interests for the Commission to encourage such positions. However, when the governmental funds produced by the assertion of an uncertain tax position are treated as cost-free capital, as Mr. Garrett proposes, it becomes contrary to the Company's interests to make the attempt because it produces a reduction in the Company's rate base on account of sums that are likely to be non-ADIT loans. This treatment extracts return from the Company. Frankly, the Company would be better off not taking the uncertain position.

Q. WHAT WOULD HAPPEN IF THE IRS DISALLOWS MORE THAN THE AMOUNT THE EXPERTS PREDICT?

A. At that point, the non-ADIT loan as well as the ADIT loan associated with those disallowed deductions would be repaid. A portion of the Company's ADIT balance would thereby be eliminated. This reduced ADIT balance would result in less zero-cost capital (*i.e.*, a lower rate base offset) at the

next rate proceeding. In other words, what would transpire if the Company did worse than the experts predicted would be precisely the converse of what would transpire if the Company did better than the experts predicted. It works the same both ways. But either way, it makes the most sense to start with the best information available.

Q. PLEASE SUMMARIZE THE COMPANY'S POSITION ON THIS QUESTION.

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

Q. MR. GARRETT OBSERVES THAT, IN DOCKET NO. 35717, THIS COMMISSION ORDERED THAT THE FIN 48 AMOUNT BE TREATED AS COST-FREE CAPITAL AND HE ARGUES THAT THIS SAME TREATMENT SHOULD BE IMPOSED IN THIS PROCEEDING. IN YOUR VIEW, SHOULD THIS COMMISSION HEW TO ITS DECISION IN THAT DOCKET?

A. Not in my view. First and foremost, the treatment ordered in that decision employs inferior information when more reliable information was available. Further, in Findings of Fact 59 and 60 of the Order on Rehearing in that docket, the PUCT reasoned:

> 59. The IRS may not audit or reverse Oncor's position as to the tax deductions identified as FIN 48 deductions and moved into the FIN 48 reserve.
> 60. Oncor may not have to pay the IRS the FIN 48 deductions of $96,972,460; and therefore, they should be added back into the ADFIT for ratemaking purposes.

These findings suggest that the Commission focused in on the "audit lottery" – that is, the possibility that the IRS would simply not audit or, if it did audit, the auditors would not recognize the FIN 48 issues as problematic. To the extent that those considerations were relevant at the time the decision in that docket was rendered (*i.e.*, 2009), they no longer are – and this Commission has concluded as much. Since the issuance of that order, the IRS has moved resolutely to capitalize on the information produced by taxpayers who implement FIN 48. Effective with 2010 tax returns, corporate taxpayers must complete and file as part of their returns

a Schedule UTP. UTP is the acronym for Uncertain Tax Positions. On that schedule, the taxpayer's FIN 48 positions must be specifically identified and described. As a consequence, the "audit lottery" has pretty much been shut down.

Q. YOU MENTION THAT THIS COMMISSION HAS RECOGNIZED THE VIRTUAL ELIMINATION OF THE "AUDIT LOTTERY." IN WHAT CONTEXT DID THIS OCCUR?

A. This occurred in Docket No. 38339 (Application of CenterPoint Electric Delivery Company, LLC, For Authority to Change Rates). In its Order on Rehearing in that proceeding, the PUCT specifically evaluated the impact of Schedule UTP. It found a clear increase in the likelihood that the IRS would identify and evaluate the company's FIN 48 tax positions (see Order on Rehearing, page 4 of 47).

Q. WHAT WAS THE COMMISSION'S RESPONSE TO THIS RE-EVALUATION OF THE IRS AUDIT RISKS?

A. As a consequence, the Commission authorized CenterPoint to establish a rider (Rider DTA) which permits it to track and recover any rate base return it loses as a result of adverse results flowing from an IRS audit of the company's FIN 48 amounts.

Q. WOULD YOU SUGGEST THE COMMISSION ADOPT THE SAME APPROACH IN THIS PROCEEDING?

A. No. The CenterPoint approach set rates based on the assumption that the company will sustain tax positions the experts have concluded it will not sustain. The Rider constitutes an "after-the-fact" correction mechanism. I continue to maintain that the PUCT ought to set rates using the best available information. Thus, rates should be set recognizing the opinion of the tax experts - that the FIN 48 amounts are not cost-free capital. If there is to be a correction mechanism, it should be applied to the difference, if any, between the amount of tax benefits the experts predicted would not be sustained and the level of tax benefits that are actually sustained.

III. CONCLUSION

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes it does.