Case Nos. 16-E-0060 and 16-G-0061

CONSOLIDATED EDISON COMPANY OF NEW YORK, INC.

INCOME TAX PANEL UPDATE/REBUTTAL TESTIMONY

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I. Introduction & Purpose

Q. Please state the names of the Income Tax Panel members.

A. Matthew Kahn, Jeffrey Kalata and Charles Lenns.

Q. Are you the same Company Income Tax Panel that previously submitted direct testimony in these proceedings?

A. Yes. We previously submitted direct testimony as the Income Tax Panel on behalf of Consolidated Edison Company of New York, Inc. ("CECONY" or the "Company"). Our credentials were previously submitted as part of that direct testimony.

Q. What is the purpose of your update and rebuttal testimony?

A. This update and rebuttal testimony responds to the testimony of the Staff Accounting Panel and Mr. Whitfield Russell, testifying on behalf of the County of Westchester ("COW"), in regard to the Company's income tax positions in these proceedings. We will specifically address the following topics:

- Updates to the Income Tax Panel Proposal;

- Rebuttal to Staff Accounting Panel's testimony on tax accounting for removal costs;
- Rebuttal to Staff Accounting Panel's testimony on the Company's level of excess deferred federal income tax balances; and
- Rebuttal to COW on the tax implications of the proposed transfer of the retired Hudson Avenue facility from steam to electric service.

II. Updates to Income Tax Proposal

Q. Does the Income Tax Panel have any updates to the proposals set forth in its direct testimony?

A. Yes. The Company has updated its proposal for the following adjustments:

- Calculation of additional forecasted basis differences between financial accounting and accounting for income taxes and associated deferred tax balances; and
- Removal of the Company's proposal for prospective normalization accounting for all plant-related timing differences.

<u>II. a. Forecasted Basis Differences</u>

Q. Please discuss the Company’s update regarding its calculation of additional basis differences in the Rate Year (*i.e.*, twelve months ending December 31, 2017) and beyond.

A. The Company’s initial filing, as well as its preliminary update filed in March 2016 (“March Preliminary Update”), did not incorporate an appropriate level of additional basis differences associated with the temporary differences between financial accounting and the accounting for income tax purposes specific to the following adjustments:

1. Materials and supplies;
2. Capitalized accrued management bonus;
3. Capitalized other post-employment benefits (“OPEBs”);
4. Capitalized pension expense; and
5. Capitalized vacation pay.

Q. What is the impact of these updates?

A. The impact of these updates is an increase to the deferred tax liability balance in the Rate Year. An increase to deferred tax liabilities will reduce rate base in the Rate Year. For details on these updates, please see the Accounting Panel's updates to Exhibits AP-E8 for electric service, and AP-G8 for gas service.

II. b. Normalization

Q. In its direct testimony (p. 116), the Staff Accounting Panel disagrees with the Company's proposal to adopt prospective normalization of all temporary difference on plant related costs during the Rate Year and beyond. Does the Company agree with the Staff's position?

A. While the Company disagrees with the Staff's assessment of normalization as being a position that is at odds with the Company's 2015 electric rate filing, in order to limit the number of issues to be resolved in these proceedings, the Company has updated its position to no longer propose prospective normalization for plant related costs during the Rate Year and beyond. The Company's acceptance of Staff's position in this case, however, should not be held against the Company if the Company pursues prospective normalization in a future case.

III. Tax Accounting for Removal Costs

Q. Does the Company have concerns with the Staff Accounting Panel’s description of the historical method of tax accounting for removal costs provided by the Company?

A. Yes. In its direct testimony (p. 104), the Staff Accounting Panel refers to the Company’s previous rate filing, Case 15-E-0050, in which the Company stated that the regulatory asset related to previously flowed-through tax deductions for removal costs had no ability to reverse.

Q. What is the Company’s concern with this reference?

A. In its previous rate filing, Case 15-E-0050, the Company proposed to adopt and implement a full normalization method of accounting for income tax purposes to apply to all plant-related temporary differences. Full normalization of temporary differences would provide for no further flow-through treatment of temporary differences, thus stranding the regulatory asset on the Company’s balance sheet. Rather, the Company proposed, at that time, an amortization of the regulatory asset that had accumulated as a result of the tax benefits passed through to ratepayers over the history of the previous method of flow-through accounting for income tax purposes.

Q. Will the Company have the ability to recover the regulatory asset it has recorded associated with the amounts it has historically flowed-through for income tax purposes?

A. The regulatory asset on the Company's books accounts for the flow-through of tax deductions related to plant removal costs net of salvage value. Under the Company's accounting method, book depreciation on removal costs results in a depreciation expense for which no income tax benefit is included in cost of service, and actual removal costs results in an income tax deduction, without a corresponding book expense, for which an income tax benefit is included in cost of service. Each of these items is treated as a flow-through item, although the nature of removal costs is a temporary difference.

At any given time, the Company will have on its books either a regulatory asset or a regulatory liability that reflects the Company's cumulative difference between the flow-through of book depreciation on removal costs, and the Company's flow-through of the tax benefit of actual removal costs. The regulatory asset on the Company's books reflects the cumulative impact of both the double counting of removal costs for which prospective relief has been requested, and the significant excess of actual plant removal costs, incurred over the years, over book depreciation that accounts for the amortization of estimated removal costs.

It is true that over the years the Company has incurred actual plant removal costs that have exceeded book depreciation on removal costs. In many cases, the actual costs to remove assets have exceeded the original cost of the asset. In such cases, the Company would have flowed-through to its customers a tax benefit for removal costs that exceeds the flow-through of book depreciation for removal costs. The excess also creates a regulatory asset. The assumption here is that book depreciation will increase in future rate cases, allowing the Company to recover this imbalance. The increase in book depreciation expense would result in a flow-through of book depreciation that will reverse the regulatory asset.

Book depreciation expense is not tracked on a specific asset basis. This makes it virtually impossible for any regulated utility to specifically match the actual removal cost of an asset with the amount of book depreciation allowed with respect to that asset over the life of the asset. Accordingly, the Company constantly changes its estimate of how much book depreciation should be allowed to account for the expected costs of removal for those plant assets that remain on its books. For this reason, the income tax accounting for removal costs should be normalized, rather than treated as a flow-through item. In fact, the normalization rules suggest that temporary differences related to net salvage value should be normalized.

It is the Company’s position that over the remaining lives of the plant assets on the Company’s books, assuming the double counting error is corrected, the regulatory asset on the Company's books will reverse through the flow-through of book depreciation on removal costs.

Q. Can you provide an example of this inadequacy in depreciation rates for the recovery of future removal costs?

A. Yes. For the period of 1998 through 2015, the Company has incurred actual removal costs of approximately $3 billion, whereas the amount provided for in book depreciation rates has been approximately $2.5 billion. The recovery in book depreciation rates, being less than what has been spent by the Company, places the Company in a position of spending more than what has been provided in rates on the costs to remove assets that are no longer providing service.

Q. Please explain how the difference between the amounts that have been provided for future removal costs and the actual amounts incurred for removal costs contributes to an accumulation of a regulatory asset?

A. Total book depreciation and removal costs are treated as flow-through items in calculating income tax expense for both financial accounting and for rate making purposes. As a result of generating more costs to remove assets from service, than what is provided for in book depreciation, the Company is in a position where the amounts spent generate tax deductions that are far greater than the amounts added back to taxable income for its non-deductible book depreciation expenses. This is reflected and can be observed in the historical levels of the Company's effective tax rate, as demonstrated in the Company's 10-K filings. As provided for in the rate reconciliation, included in the notes to the financial statements for income taxes, removal costs are consistently a rate reconciling item that has reduced the effective tax rate below the statutory rate. By providing tax benefits to ratepayers for the costs incurred to remove assets from service which exceed amounts provided for in book depreciation rates, the Company remains in a position that is underfunded for the tax effects of these costs.

Q. Are there additional contributing factors to the accumulation of the regulatory asset?

A. Yes. As discussed in the direct testimony of both the Staff and the Company, the Company’s historical method of accounting for flow-through tax depreciation has generated a greater discrepancy between the amounts provided for in book depreciation for future removal costs, and the amounts incurred for actual removal costs. The impact of this method has reduced the temporary timing differences between book depreciation and accelerated tax depreciation for the purposes of establishing deferred tax liabilities, and instead flowed-through a greater amount of tax deductions that have off-set the recovery of future removal costs via increased tax expenses associated with book depreciation. As a result, the Company has been further underfunded for the amounts it requires to remove assets from service.

Q. Has the amount of the increased flow-through tax depreciation been included in the Company’s rate filings?

A. Yes. The Company’s financial accounting has consistently followed the rate design provided for in its rate case proceedings. The Company has never established a financial accounting method or income tax accounting method for its costs, different from what has been provided for in rates.

Q. In its direct testimony, Staff has indicated that they made attempts to informally and timely obtain information needed to verify the Company’s tax accounting claims, and that they were unsuccessful. Has the Company provided responses to all of the information requests made both formally and informally in a timely manner?

A. Yes, the Company has responded to all of Staff’s tax accounting related interrogatories. In addition to providing significant amounts of information in support of its tax accounting claims, the Company has visited Staff on multiple occasions in order to explain and facilitate the Staff’s understanding of the Company’s positions in these proceedings.

Q. In their direct testimony (p. 113), Staff has indicated that the Company is applying the controls of a tax basis balance sheet and the PowerTax software in an attempt to recover its regulatory asset resulting from improper accounting for removal costs. Is this an accurate representation of the application of these controls?

A. No. The Company transitioned from its legacy system, Acufile, to PowerTax for the reasons set forth in DPS-13-422 Attachment 5, which is a financial reporting memorandum that speaks to the business reasons for this transition. The Company specifically noted that the Acufile system was no longer supportable and that, "to continue reliance upon an inefficient-outdated software product and server space puts the Company's reporting at risk." The Company has provided additional information regarding the controls of the system at the request of Staff, in an effort to facilitate Staff's understanding of the PowerTax system and its benefit to the reporting function for the Company's income tax accounting. The Company has never indicated that it transitioned to a new software product in an effort to correct for its methods of accounting.

Q. Please explain why the Company indicated that a tax basis balance sheet would provide additional controls around the recording and reporting of its deferred taxes.

A. The Company developed a tax basis balance sheet in 2013. Prior to its development, a tax basis balance sheet was not a requirement for reporting purposes. The purpose of a tax basis balance sheet is to track and maintain the differences between financial accounting basis and tax basis, for which deferred taxes are derived and supported.

Q. How does a tax basis balance sheet and the PowerTax system support the deferred taxes associated with the historical method of accounting for removal costs?

A. The historical method of accounting for removal costs has provided for a reduction in the temporary timing differences between accelerated tax depreciation methods and book depreciation methods. The result has been a reduced level of deferred taxes associated with this reduced timing difference, and a level that is both supported and controlled by a comparison of basis between the financial accounting records and the income tax records of the Company. The book and tax basis are tracked inside the PowerTax system, and the reversal of these temporary timing differences is accounted for and recorded inside the system. The results of both the originating timing differences, and the eventual reversal, are maintained on a tax basis balance sheet annually.

Q. In its direct testimony (p. 114), Staff notes, “If Con Edison reflected this error in its calculation of income tax expense in its previous rate filings that were reviewed and whose rates were approved by the Commission there is the question of the appropriateness of now providing Con Edison increased rates to correct for these past accounting errors.” Is it appropriate to provide flow-through accounting for amounts that historically received flow-through treatment?

A. It is certainly appropriate to allow a temporary timing difference that has been flowed-through at the time in which the temporary timing difference originated, to also flow-through at the time of reversal. Flow-through accounting does not represent a permanent difference between financial accounting and accounting for income taxes, but rather provides an impact on the effective tax rate at both the time of origination, as well as the time of reversal. It would be inappropriate to treat a temporary timing difference as if it was a permanent difference between accounting for financial purposes and accounting for income taxes.

IV. Excess Deferred Federal Income Taxes

Q. Please address the Staff Accounting Panel's testimony regarding the level of excess deferred federal income taxes.

A. In its direct testimony (p. 128), the Staff Accounting Panel states that the Company was unable to provide a schedule of accounts showing the activity and monthly balance of accumulated deferred income taxes applicable to the movement in the balance of excess deferred federal income taxes. The Company cannot produce journal entries, or account activity that does not exist on the Company's financial books and records. The Company would note that there is no deficiency in its record keeping for financial accounting purposes or in its accounting for income taxes.

Q. Does the Company agree with Staff's recommendation to reflect balances from a previous rate case proceeding for the level of excess deferred federal income taxes?

A. No. For the reasons explained above, the Company maintains its proposal to reflect the level that it reflects for excess deferred federal income taxes on its financial books and records, and not an amount that existed prior to this rate case.

V. Hudson Avenue Station Tax Implications

Q. Please describe the Company's concern with Mr. Russell's testimony, on behalf of COW, regarding the tax implications of the proposed transfer of Hudson Avenue Station from steam to electric service.

A. Mr. Russell testifies that the Company has not addressed tax implications as part of its consideration of the Hudson Avenue Station transfer.

Q. Is this assessment accurate?

A. No, it is not. In its 2014 Hudson Avenue Station Filing (p. 32), the Company acknowledged the deferred tax implications of the transfer and identified that the "approximately $37.5 million of accumulated deferred income tax credits currently classified in steam operations will be reclassified to electric operations."

Q. Does the Company have any additional concerns with Mr. Russell's testimony concerning the tax implications of the transfer?

A. Yes. It appears that Mr. Russell has misinterpreted the implications of the deferred taxes associated with the transfer. He states (p. 15), "I expect that most of the $37.5 million arose as a result of Con Ed's collecting excess income taxes from steam and electric customers over the life of the Facility to date, most recently from steam customers." He further states, "…Con Ed proposes to transfer the deferred tax balance to the books of its Electric Operations where it will presumably provide an unearned benefit to electric ratepayers if, as and to the extent that the Facility's costs are included in the electric rate base." The deferred tax liability, in the amount of $37.5 million, is a temporary timing difference between the remaining book basis of $92.3 million and tax basis of zero; it is not the result of an over-collection of income taxes as suggested by Mr. Russell. In 2011, the Company properly reflected a loss on the retirement of the Hudson Avenue Station for tax purposes. The deferred tax liability represents a future income tax obligation associated with the undepreciated book basis, and not excess income taxes. As the remaining undepreciated book cost is recovered via book amortization expense, the associated deferred tax liability will reverse, and thus, produce an income tax liability to be paid by the customers of the service recording the expense (as book depreciation is not a tax deductible item).

Q. Do you have any other observations regarding Mr. Russell’s testimony?

A. In his direct testimony (pp. 15-16), Mr. Russell states:

> In addition, Con Ed has not indicated whether it wrote off its $56.5 million tax basis in the Facility and claimed a loss when it retired the Facility. If Con Ed did so, its remaining basis in the plant would be about 40% lower than its present $56.5 million tax basis or $33.96 million. If Con Ed had used this much lower $33.96 million measure of its investment in the Hudson Avenue Facility instead of the $92.3

> million book value in analyzing the costs and benefits of disposing of it, the $33 million loss on sale at market value for manufacturing use (after considering demolition costs) would be reversed and the $61 million gain on its sale at market value for residential use would exceed Con Ed’s remaining investment in the Facility of $33.96 million.

This is a clear misinterpretation of the tax implications. In 2011, the Company properly claimed a loss on the retirement of its steam facility for income tax purposes. This tax loss results in no remaining tax basis in the facility, and has no impact on the remaining undepreciated book basis. The $92.3 million of undepreciated book basis remains a component of the steam service’s rate base, along with the associated deferred tax liability. There should be no consideration of an amount of tax basis in connection with the facility’s cost-benefit analysis, as there is no remaining tax basis for consideration.

VI. Conclusion

Q. Does this conclude your update and rebuttal testimony?

A. Yes, it does.