R-00973953

PECO STATEMENT NO. 9-RJ

Phila 10/14, 10/15, 10/16/97
E. Holwit

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

APPLICATION OF PECO ENERGY COMPANY
FOR APPROVAL OF ITS RESTRUCTURING PLAN
UNDER SECTION 2806 OF THE PUBLIC UTILITY CODE

REJOINDER TESTIMONY OF

JAMES I. WARREN

Responding to Testimony in Opposition to
the Joint Petition for Partial Settlement

October 8, 1997

10/08/97/PPV/04899/003/MEMO/152191.1

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REJOINDER TESTIMONY OF JAMES I. WARREN

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

A. My name is James I. Warren. My business address is 40 West 57th Street, New York, New York 10019.

Q. **Did you previously submit direct and rebuttal testimony on this proceeding?**

A. Yes. A description of my qualifications was provided in Exhibit JIW-I, which accompanied my direct testimony (PECO Statement No. 9). I also submitted rebuttal testimony which was marked as PECO Statement No. 9-R.

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

A. The purpose of this testimony is to respond to portions of the supplemental testimony submitted by Mr. Steven A. Mitnick on behalf of ENRON, NEV and Delmarva. Specifically, I will respond to Mr. Mitnick's assertion that PECO's agreement to forego the collection of $2.0 billion of its stranded costs somehow produces a cash tax "windfall" having a value of hundreds of millions of dollars and that the amount of this "benefit" should be available to mitigate the amount of PECO's stranded costs. In addition, I will address Mr. Mitnick's assertion that the tax deduction associated with interest on transition bonds can be used to mitigate stranded costs.

Q. How would you characterize Mr. Mitnick's proposal regarding the alleged benefits to PECO of the proposed $2.0 billion write-off?

A. In my opinion, Mr. Mitnick's proposal lacks any basis whatsoever in logic and is completely fallacious in its assumptions regarding applicable tax law rules.

Q. How does the partial settlement agreement deal with the $2.0 billion in disallowed stranded costs?

A. PECO has agreed to forego the collection of approximately $2.0 billion of regulatory assets.

Q. What does Mr. Mitnick propose in connection with this proposal?

A. Mr. Mitnick claims that the elimination of the regulatory assets should enable PECO to further reduce its recovery of other stranded costs by the tax effect of that foregone receivable.

Q. Is this a logical proposition?

A. Absolutely not, as can be readily illustrated by applying Mr. Mitnick's principle in a more conventional and simplistic context. Assume that an individual, Jane, is an employee of Company X. Jane has an annual salary of $50,000. In June, Jane is awarded a $10,000 bonus payable on December 31. However, by the time it comes to December, Company X is experiencing financial problems. Jane agrees to forego her bonus. Company X not only doesn't pay Jane her bonus, it immediately docks Jane's $50,000 salary by the tax effect of the bonus, since, by not receiving it, Jane is relieved of the tax obligation associated with its receipt. This seems to me (and would certainly seem to Jane) illogical and inequitable. It is no less so in PECO's case than in Jane's.

Q. What does this example make apparent regarding the consequences of Mr. Mitnick's proposal?

A. In the illustration above, Jane would be worse off than if she hadn't earned the bonus at all. So it is that the application of Mr. Mitnick's approach would render PECO worse off than if it had never been the beneficiary of the regulatory commitments. In Mr. Mitnick's view, the more PECO gives, the more it can afford to give. This is perverse logic that, aside from being counter-intuitive, affirmatively discourages compromise. It should be rejected.

Q. Mr. Mitnick also implies that the tax benefit associated with PECO's surrender of $2.0 billion of regulatory assets will produce a cash infusion. Is that correct?

A. No it is not. This is due to the status of regulatory assets under the tax law, which is best understood by comparing it with the tax status of customer receivables. Customer receivables arising from the provision of services are included in taxable income as the service is provided. Because they have been included in taxable income, these receivables have tax basis. As a result, when a customer receivable is forgiven or otherwise compromised, it produces a tax deduction, *i.e.*, its tax basis is "written off" for tax purposes. By contrast, regulatory assets are, from a tax perspective, mere promises from the regulators that the Company will receive taxable revenue in the amount of the revenue requirement on those assets at some time in the future. Unlike customer receivables, regulatory receivables are not includable in taxable income until they are converted into customer receivables, *i.e.*, when future services are provided under authorized rates that provide for recovery of regulatory receivables. They therefore have no tax basis. Their surrender, consequently, can produce no tax deduction and, hence, no cash benefit -- now or ever.

Q. What, then, can be stated with regard to PECO'S willingness to forego recovery of $2.0 billion of its regulatory assets?

A. The surrender of $2.0 billion or any quantum at all, of PECO's regulatory assets will produce not a scintilla of a cash tax benefit.

Q. In light of the above, do you perceive any economic or logical justification whatsoever for Mr. Mitnick's proposal?

A. As I stated at the beginning of this testimony, I find the proposal without support in logic, equity, economics or the tax law.

Q. Do you have any further comment regarding Mr. Mitnick's testimony?

A. Yes, Mr. Mitnick's states that the deductibility of interest paid with respect to securitization bonds should somehow reduce the Company's stranded cost recovery amount (Mitnick, Supplemental, pg. 33, ln. 7-9).

Q. What is the effect of the deductibility of this interest?

A. Because the interest is deductible, PECO needs to collect only $1 from its customers to fund $1 of interest. The collection of the $1 of revenue necessary to fund the interest cost is a taxable event, subject to a 35% federal tax. Without an offsetting deduction , therefore, the Company would not fund its $1 interest requirement. However, the allowable $1 interest deduction offsets entirely the taxable income associated with the receipt of the revenue and allows the Company to meet its debt service obligation. The customer receives the benefit of the deduction by only having to fund the interest cost "dollar for dollar." As such, it would be totally inappropriate to take a tax offset against PECO's stranded costs as Mr. Mitnick proposes.

Q. Does this conclude your testimony?

A. Yes.