



BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 950379-EI
IN RE: DETERMINATION OF REGULATED
EARNINGS OF TAMPA ELECTRIC COMPANY PURSUANT
TO STIPULATIONS FOR CALENDAR YEARS
1995 THROUGH 1999

TESTIMONY
OF
JAMES W. SHARPE

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1 BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

2 PREPARED DIRECT TESTIMONY

3 OF

4 JAMES W. SHARPE

5
6 **Q.** Please state your name and business address.

7
8 **A.** My name is James W. Sharpe and my business address is
9 1100 Campanile Building, 1155 Peachtree Street, Atlanta,
10 Georgia 30309.

11
12 **Q.** By whom are you employed?

13
14 **A.** PricewaterhouseCoopers LLP ("PwC" or "the firm").

15
16 **Q.** What are your particular responsibilities with PwC?

17
18 **A.** I am a tax partner in the Global Energy and Mining unit
19 of the firm and, more specifically, I am the leader of
20 the Utility Tax Section of that unit. My practice
21 includes regulated gas and electric utilities involved in
22 generation, transmission and distribution. My clients
23 include both corporations and partnerships.

24

25

1 Q. Please briefly describe your education and professional
2 background.

3
4 A. I received Bachelor of Science in Business Administration
5 and Master of Business Administration degrees from the
6 University of South Carolina. My undergraduate work
7 includes a major in Accounting and I am a Certified
8 Public Accountant. I started my career with South
9 Carolina Electric and Gas Company where I held various
10 positions including Director of Income, Property and
11 License Taxes. I also was Manager of Taxes for Kansas
12 City Power & Light Company before joining Coopers &
13 Lybrand L.L.P. in 1985. Coopers & Lybrand and Price
14 Waterhouse L.L.P. merged on July 1, 1998 to form
15 PricewaterhouseCoopers LLP. I have been working in the
16 utility industry for over 27 years and concentrating in
17 utility taxation for over 23 years. In my role with PwC
18 I have advised utility clients with respect to tax law
19 changes, tax planning and the regulatory impact of income
20 tax expense in cost of service and its corresponding
21 effects on rate base. I have spoken to industry and
22 internal PwC groups on many occasions regarding tax
23 issues affecting utilities. I have requested private
24 letter rulings for utility clients and have submitted
25 testimony before state public service commissions

1 including Missouri, Pennsylvania, Kentucky, Kansas and
2 Nevada. I have also submitted testimony before the
3 Federal Energy Regulatory Commission.
4

5 **Q.** Mr. Sharpe, would you briefly describe your experience
6 serving Tampa Electric Company ("Tampa Electric" or
7 "Company")?
8

9 **A.** Yes. I have been working on the Tampa Electric audit
10 engagement since I joined the firm in 1985, first as the
11 tax manager and since 1988 as the tax partner. One of my
12 responsibilities as the PwC tax partner for Tampa
13 Electric is to review the Company's tax accrual and to
14 ensure that the Company's tax expense and tax liability
15 are adequate and conform to Generally Accepted Accounting
16 Principles ("GAAP").
17

18 **Q.** Mr. Sharpe, what is the purpose of your testimony in this
19 proceeding?
20

21 **A.** My testimony relates to certain tax adjustments and the
22 related interest expense that Tampa Electric recorded in
23 1999 and to offer support for these adjustments. During
24 the course of PwC's annual audit of Tampa Electric, the
25 firm reviewed the tax adjustments that Tampa Electric

1 recorded and we agreed with such adjustments. More
2 specifically, due to the chain of events related to the
3 examination by the Internal Revenue Service ("IRS") of
4 Tampa Electric, PwC believed that GAAP required that
5 Tampa Electric reflect its tax positions for the years
6 under audit and appeals, and for similar issues included
7 in years yet to be audited.

8
9 **Q.** Mr. Sharpe, does Tampa Electric accrue its estimate of
10 its tax liability each year for the current year and if
11 so, why was it necessary to adjust its tax expense for
12 such year in a later year?

13
14 **A.** Tampa Electric does estimate its tax liability each year
15 for the current operating year. It is important to note
16 that each year's tax expense is an estimate. Like most
17 expenses that are estimates, subsequent events can cause
18 estimates to be adjusted. Moreover, I believe there are
19 various times when tax expense and interest on tax
20 deficiencies and overpayments are accruable. The first
21 time is the normal current year accrual of tax expense
22 based on current results that reflect the Company's best
23 estimate, at that time, of its tax expense. The next
24 time is after the Company has filed its current year tax
25 return and it uses better information to refine its prior

1 estimate of tax expense. Tampa Electric, like most large
2 companies, typically adjusts its prior year tax accrual
3 to reflect its actual filing position in the subsequent
4 year. The next time is upon receipt of proposed audit
5 adjustments and it is probable that the proposed tax
6 adjustments will not be resolved favorably for the
7 Company. Also, there may IRS administrative
8 pronouncements or court decisions that could impact the
9 tax treatment of a specific item. This could cause the
10 Company's tax liability to be adjusted. The last time
11 is after the IRS has audited the Company's tax return and
12 the Company and IRS have finally determined the tax
13 treatment of various issues and the IRS can no longer
14 make adjustments to taxable income. Effectively, a
15 taxpayer's final tax expense for any particular year is
16 not known until the taxpayer and the IRS determine the
17 proper tax treatment of items of revenue and expense.

18
19 **Q.** Mr. Sharpe, would you please briefly describe the IRS'
20 audit procedures?

21
22 **A.** Yes. Due to the fact that Tampa Electric's parent
23 company TECO Energy, Inc. ("TECO") is a large publicly
24 traded entity, the IRS audits every tax return that TECO
25 files. During these audits, the IRS will issue Form

1 5701, Proposed Adjustments, setting forth their proposed
2 adjustments to taxable income. The taxpayer then has the
3 opportunity to respond to the IRS' proposed audit
4 adjustments. For issues in which the IRS and the
5 taxpayer do not agree during the audit process, the IRS
6 will issue its Revenue Agent's Report ("RAR") for
7 adjustments to taxable income including a redetermination
8 of the tax and any resulting interest expense. The
9 taxpayer then has the option of agreeing to the tax as
10 determined by the IRS or protesting the adjustments by
11 formally notifying the IRS that the taxpayer does not
12 agree to the tax treatment as proposed by the revenue
13 agent. This protest is filed with IRS District Director
14 and requests a conference with the IRS Appeals Office.
15 This is the next administrative level. During this
16 phase, the taxpayer and the appeals officer attempt to
17 resolve differences. If the taxpayer and the IRS cannot
18 agree, the taxpayer's next course of action is to go to
19 court and let the court decide whether the taxpayer or
20 the IRS has reached the correct conclusion with respect
21 to a specific issue. Also, it is not uncommon for the
22 IRS or the taxpayer to appeal a lower court decision in
23 which the lower court reaches an unfavorable decision.
24 The United States Supreme Court ultimately decides
25 certain tax disagreements.

1 Q. Mr. Sharpe, is it common for the IRS and taxpayers to
2 disagree about the tax treatment of an item or issue?

3
4 A. Yes. It is common for the IRS and taxpayers to disagree
5 about the tax treatment of a particular item. While
6 there are many items or issues in which there is no doubt
7 as to the proper tax treatment, there are many situations
8 in which there is no clarifying income tax regulation,
9 clear-cut Internal Revenue Code section or court decision
10 directly on point with regard to a particular factual
11 situation. Thus, taxpayers must attempt to determine the
12 correct tax treatment by relying on similar situations in
13 which there is some related administrative, regulatory or
14 case law guidance. Given that taxpayers do not want to
15 pay any more tax than absolutely necessary and that the
16 IRS is trying to ensure compliance and to collect tax,
17 there is a natural tension between taxpayers and the IRS.
18 Taxpayers will typically interpret laws in a way that
19 minimize their tax and the IRS will interpret those same
20 laws in a way that maximize the tax. Simply stated,
21 taxpayers should be aggressive to minimize their tax.

22
23 In order to protect the revenues for the United States
24 Treasury Department, the IRS will challenge taxpayers on
25 selected issues. In addition to the normal issues that

1 are raised and discussed during the course of audit, the
2 IRS attempts to ensure that taxpayers with similar issues
3 are treated similarly. Thus, there are occasions when
4 the IRS' utility industry group develops new issues for
5 examining agents to audit. An example of such an issue is
6 removal costs. Utilities consistently deducted removal
7 costs as incurred for years after 1970. Several years
8 ago, the IRS utility industry group pushed revenue agents
9 to challenge the deductibility of removal costs as
10 incurred. The IRS insisted that removal costs be
11 capitalized and depreciated over the recovery period of
12 the new property.

13
14 **Q.** Mr. Sharpe, what happens when taxpayers are too
15 aggressive and take positions that are not justified?

16
17 **A.** Congress has granted the IRS broad authority to assess
18 penalties when taxpayers are too aggressive in taking
19 positions that are not justified by existing regulations,
20 case law, administrative pronouncements or other similar
21 guidance. In addition, any such assessed penalties are
22 not deductible. Unlike penalties, interest is
23 automatically calculated on tax deficiencies or
24 overpayments. Interest reflects the time value of money
25 that either the taxpayer benefited from when they

1 underpaid their tax or the government benefited when
2 taxpayers overpaid their tax. Unlike penalties, interest
3 expense assessed on tax deficiencies is deductible.
4

5 **Q.** Have Tampa Electric or TECO Energy ever been assessed
6 penalties for taking a position on their tax returns that
7 was too aggressive?
8

9 **A.** Neither Tampa Electric nor TECO Energy has ever been
10 assessed penalties. Tampa Electric incurs interest
11 expense and interest income on tax adjustments. It is my
12 opinion that taxpayers, including Tampa Electric, should
13 interpret tax laws and regulations in the way most
14 favorable to them. In other words, taxpayers should be
15 aggressive in interpreting tax provisions provided that
16 they are not so aggressive that they incur non-deductible
17 penalties. If a taxpayer takes a position on its return
18 and the taxpayer ultimately loses the issue, the taxpayer
19 is only out-of-pocket for the interest on the tax
20 underpayment. If you assume that the taxpayer invests the
21 underpayment in tax at a rate similar to that charged by
22 the IRS, the taxpayer does not incur any net cost related
23 to taking an aggressive position on its return. If the
24 taxpayer ultimately sustains the aggressive tax position
25 taken on its return, the taxpayer has had the use of the

1 funds and does not have to pay the tax relating to that
2 issue. The IRS will not generally look for items that
3 result in an overpayment of tax. The point is that tax
4 practitioners urge taxpayers to be aggressive but not so
5 aggressive or frivolous that penalties are incurred. The
6 Florida Public Service Commission ("Commission") should
7 likewise encourage this policy.

8
9 Q. Do you think that Tampa Electric's basic approach to its
10 income tax return filings has been reasonable?

11
12 A. Most definitely yes. As I stated earlier, I have been
13 reviewing Tampa Electric's income tax accrual and tax
14 returns for over 15 years. In my opinion, Tampa Electric
15 has been reasonable in its filing positions. Tampa
16 Electric has not been too aggressive or too conservative.
17 Like most taxpayers, Tampa Electric has filed tax returns
18 based on reasonable positions seeking to pay the
19 appropriate amount of tax due.

20
21 Q. If Tampa Electric has sought to pay the appropriate
22 amount of tax due, why has it had to adjust its income
23 tax and interest expense?

1 **A.** To restate my earlier comments, there are several steps
2 in determining a taxpayer's final tax liability. The
3 first step is the annual tax accrual that is booked for
4 the current year based upon estimated taxable income.
5 Many items are estimates and the exact amount of revenue
6 or expense is not known until the books are closed and
7 additional work is done. One example of an estimate used
8 during the year is tax depreciation. Determining actual
9 tax depreciation requires a lot of work to be done after
10 the books are closed. After the tax return is filed, the
11 IRS will audit Tampa Electric's income tax returns and
12 propose certain adjustments. Tampa Electric will agree
13 to some of the adjustments and not agree with others.
14 The items that have not been agreed upon are protested
15 and Tampa Electric and the IRS will attempt to reach an
16 agreement during the appeals process.

17
18 Both the examination and appeals process can take several
19 years depending on the complexity of the various issues.
20 This is evident in that it was not until 1999 that the
21 IRS determined the final tax for 1986-1988 and RARs were
22 received for the 1989-1991 and 1992-1994 audit cycles. I
23 also want to make the point that some of the issues
24 resolved for those earlier years affect the current audit
25 cycle and years not yet under audit. That is because

1 some issues are referred to as carryover items. An
2 example might be helpful to explain carryover items.
3 Assume that Tampa Electric has deducted certain costs
4 that the IRS believes must be capitalized. Tampa
5 Electric has consistently deducted the particular item
6 for every year since 1986, then in 1999 the issue is
7 finally determined for tax year 1986 that the cost should
8 be capitalized. Every open tax return filed in years
9 before 1999 has the cost deducted rather than
10 capitalized. Thus, the IRS will have an adjustment for
11 this issue for each open tax return filed before 1999.
12 This is what is referred to as a carryover item. Once
13 the issue is determined for the initial year for which
14 this issue was raised, it is known that tax expense and
15 interest should be recorded for carryover items included
16 in subsequent returns.

17
18 **Q.** Why has it taken Tampa Electric so long to resolve these
19 issues with the IRS?

20
21 **A.** The audit process to final determination proceeds at a
22 pace dictated by the IRS and takes years to complete. In
23 general, the IRS does not begin the audit process until
24 several years after the tax return has been filed. The
25 audit process can, at times, be extremely slow. The

1 appeals process can last years due to many factors
2 including the fact that the IRS has fewer appeals
3 officers with the necessary experience to handle cases as
4 complex as Tampa Electric's. Also, there have been
5 contentious issues that have caused difficulty in
6 reaching resolution. However, once a determination has
7 been made, it can help settle several audit cycles
8 quickly.

9
10 **Q.** When is it determined that an issue is resolved?

11
12 **A.** The resolution can occur at various times. It can occur
13 during the actual audit when the taxpayer and the IRS
14 agree. It can occur during the appeals process. It can
15 occur when the courts render a final decision.

16
17 **Q.** When should a company adjust its tax expense for an item
18 that has been resolved?

19
20 **A.** In general, tax expense and any related interest on a tax
21 adjustment should be recorded when that tax adjustment
22 meets the criteria for recording an expense pursuant to
23 Statement of Financial Accounting Standards No. 5,
24 Accounting for Contingencies ("FAS 5"). Paragraph 8 of
25 FAS 5 generally requires an expense to be booked when

1 information that is available indicates that it is
2 probable that a liability has been incurred and the
3 amount of the expense can be reasonably estimated. Thus,
4 tax expense and interest should be recorded when
5 information available indicates that it is probable that
6 the taxpayer will incur tax expense and related interest.
7

8 **Q.** Based on the FAS 5 probable criteria, did Tampa Electric
9 book its tax adjustment and the related interest in the
10 right year?
11

12 **A.** As the external auditors of Tampa Electric, we believe
13 that the tax adjustment and related interest were
14 recorded in the right year because it became probable in
15 1999, given the events that occurred, that Tampa Electric
16 would owe additional tax and interest. The events that
17 resulted in Tampa Electric's tax liability being adjusted
18 included: 1) In May 1999, Tampa Electric received the RAR
19 for the 1989-1991 audit cycle; 2) In July 1999, the tax
20 liability was finally determined for the 1986-1988 audit
21 cycle; and 3) In November 1999, Tampa Electric received
22 the RAR for the 1992-1994 audit cycle. The determination
23 of taxes for the 1986-1988 audit cycle and the definitive
24 positions taken on the issues under discussion here by
25 the Appeals Officer were the necessary events that

1 triggered the recording of tax and interest expense. The
2 adjustment to tax and the related interest expense
3 included the income statement impact of carryover items
4 in tax years 1995 through 1998. It is PwC's opinion that
5 the IRS' positions and determinations of the issues made
6 it clear that tax and interest expense must be adjusted
7 in 1999. PwC agreed with Tampa Electric that the 1999
8 IRS activity resulted in the interest and tax expense
9 accrual under the standard articulated in FAS 5 and
10 therefore, the year for charging operations with the
11 interest and tax expense adjustment was 1999.

12
13 **Q.** Mr. Sharpe, should the tax adjustment and related
14 interest taken by Tampa Electric in 1999 be considered a
15 prior period adjustment?
16

17 **A.** No. The events that resulted in the accrual for the tax
18 and interest occurred in 1999. It was not until 1999,
19 that it became probable that Tampa Electric would owe
20 additional tax and interest on the adjustments to taxable
21 income. In 1999, it became clear that Tampa Electric was
22 not going to be able to sustain the tax return positions
23 that it had taken on the various returns. Under GAAP,
24 the adjustment of tax expense and the related interest
25 were current year expenses in 1999, the year the

1 adjustment became probable. Once Tampa Electric
2 recognized that its tax was understated, the tax accrual
3 and related interest were required to be booked under
4 GAAP. PwC discussed the various issues with Tampa
5 Electric's Tax Department and the possible scenarios that
6 could occur. We agreed with the conclusions reached by
7 Tampa Electric. Tax expense and interest needed to be
8 adjusted to reflect the most current information
9 available. We also agreed with Tampa Electric's estimate
10 of the amount of the adjustment. The conclusion reached
11 by Tampa Electric and PwC is supported by APB Opinion 20,
12 Accounting Changes, Paragraph 31 that states, in part,
13 that "changes in accounting estimates should be not
14 reported in financial statements of prior periods or by
15 reporting pro forma statements for prior periods."

16
17 **Q.** Mr. Sharpe, do you have an opinion regarding whether the
18 Commission should allow the tax adjustment and related
19 interest to be included as a 1999 operating expense?
20

21 **A.** I do. Utilities should be encouraged to minimize their
22 tax payments to taxing authorities. In the long run, I
23 think that is the best policy for the ratepayers. I have
24 been working in this industry since 1973 and if there is
25 one common criticism that I hear about utilities, it is

1 that they are very conservative from a tax perspective.
2 It is my opinion that utilities are conservative because
3 if they take a tax position that someone might label as
4 an aggressive tax position and subsequently lose the
5 issue, there is the risk that the regulatory body might
6 not allow the adjustment to tax and related interest as
7 legitimate expenses. Thus, some utilities are extremely
8 conservative due to the fact that if they sustain their
9 tax position, the savings are passed to customers, and if
10 they are not able to sustain their position, the
11 shareholders pay the tax and interest. That type of
12 regulatory policy does not encourage innovation and
13 penalizes ratepayers and utilities for trying to minimize
14 tax expense.

15
16 **Q.** Mr. Sharpe, would you summarize your testimony?

17
18 **A.** PwC reviews Tampa Electric's tax accrual and tax returns
19 each year. In 1999, several events occurred that
20 required Tampa Electric to adjust its tax liability and
21 related interest expense. PwC agreed that the
22 adjustments were properly charged to operations in 1999
23 and agreed that the amounts were reasonable.

24
25 **Q.** Does that conclude your testimony?

1 A. Yes.

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