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IN THE SUPREME COURT OF THE UNITED STATES

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PPL CORPORATION AND SUBSIDIARIES, :

Petitioner : No. 12-43

v. :

COMMISSIONER OF INTERNAL REVENUE :

- - - - - x

Washington, D.C.

Wednesday, February 20, 2013

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:17 a.m.

APPEARANCES:

PAUL D. CLEMENT, ESQ., Washington, D.C.; on behalf of Petitioner.

ANN O'CONNELL, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of Respondent.

	C O N T E N T S	
1		
2	ORAL ARGUMENT OF	PAGE
3	PAUL D. CLEMENT, ESQ.	
4	On behalf of the Petitioner	3
5	ORAL ARGUMENT OF	
6	ANN O'CONNELL, ESQ.	
7	On behalf of the Respondent	27
8	REBUTTAL ARGUMENT OF	
9	PAUL D. CLEMENT, ESQ.	
10	On behalf of the Petitioner	53
11		
12		
13		
14		
15		
16		
17		
18		
19		
20		
21		
22		
23		
24		
25		

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P R O C E E D I N G S

(11:17 a.m.)

CHIEF JUSTICE ROBERTS: We'll hear argument next in Case 12-43, PPL Corporation and Subsidiaries v. the Commissioner of Internal Revenue.

Mr. Clement?

ORAL ARGUMENT OF PAUL D. CLEMENT

ON BEHALF OF THE PETITIONER

MR. CLEMENT: Mr. Chief Justice, and may it please the Court:

This case has its origins in a decision by the British government in the Major Thatcher years to privatize a number of previously State-owned utilities. The government's plan was to keep prices constant and allow the companies to make profits by increasing efficiencies and reducing costs. Only after an initial period in which prices would be fixed would the prices be re-jiggered and then savings passed on to the consumers.

Now, this, in practice, worked very well for the companies. They were able to increase their efficiencies and cut costs to a greater extent than people expected. This was not, however, greeted as a uniform success. Instead, the opposition party criticized this and said that the fat cats at the

1 utility companies had earned too much and the  
2 conservative government had made a mistake by valuing  
3 the shares at IPO too cheaply.

4 And so they promised, as an express election  
5 promise, to impose a tax on the excess profits of  
6 privatized utilities. And, when elected, they made good  
7 on that promise and passed the Windfall Act --

8 JUSTICE SOTOMAYOR: See, I have a problem  
9 with this argument because it assumes a way of looking  
10 at this, but it's an assumption. You can look at it in  
11 either way. You can look at it as they made too much  
12 money, we want a part of that profit, or they paid too  
13 little for what they got.

14 And that was the debate going on in  
15 Congress. Did they pay too little on the floatation  
16 value? Or did they make too much money? And what the  
17 government says -- rightly -- is whether you paid too  
18 much or too little money depends on the value of the  
19 company. And one of the factors that goes into that is  
20 how much money has the company made?

21 And so you always have to look at profits,  
22 to some extent. So what's wrong with looking at it  
23 their way? Why does it have to be your way?

24 MR. CLEMENT: Well, it has to be my way  
25 because of the way the specific tax was designed. But

1 the first --

2 JUSTICE SOTOMAYOR: No, you can only do it  
3 your way if you do what the amici says, which is to take  
4 out from your simplified equation the fact that the  
5 time -- the D element of your equation -- is constant.  
6 You artificially freeze it the time at which they  
7 operated. Only by freezing that number can you come out  
8 with your equation.

9 MR. CLEMENT: Well, Your Honor, we're not  
10 artificially freezing the -- the number. The number --  
11 the D -- 1461 for almost every company -- is, itself,  
12 part of the statute because they picked a period by  
13 which they were going to measure the profit in  
14 value-making terms.

15 JUSTICE SOTOMAYOR: But there was at least  
16 two or three companies that had a very different period,  
17 and they paid a huge amount, much further than their  
18 gross profits.

19 MR. CLEMENT: Well, I can talk about the  
20 outlying --

21 JUSTICE SOTOMAYOR: Because of that, D  
22 changed for them.

23 MR. CLEMENT: I can talk about the outlying  
24 companies. They paid a different effective rate because  
25 the D was different. But there's two important things

1 to remember. One, I believe it's common ground between  
2 the parties, that the way you applied this regulation is  
3 to look at the tax in -- to use the regulatory phrase --  
4 in the normal circumstances in which it applies.

5 So I believe it's common ground that you  
6 ignore the outliers anyway.

7 JUSTICE SOTOMAYOR: But you change the other  
8 part of the equation -- or of the tax regulation, which  
9 says it has to be true for all taxpayers.

10 MR. CLEMENT: No. That particular  
11 provision -- think of it as like a Clark v. Martinez  
12 principle for taxes. They either are creditable or  
13 they're not. That's what that principle has been  
14 interpreted to. The case you should look at, if you're  
15 really interested in it, is the Exxon case, the tax  
16 court, we cite it in both our briefs.

17 And, there, it was a situation where, again,  
18 a British Excess Profits Tax, in the main, it was an  
19 Excess Profits Tax on the companies that were developing  
20 the North Sea oil field. But, as the tax applied to a  
21 couple of companies that really hadn't gotten any oil  
22 out, it applied very differently.

23 And the tax court and the government in that  
24 case both conceded, no, you look at the tax in its main  
25 applications. And in those main applications, everyone

1 concedes that this tax operates exactly like a  
2 51.75 percent tax on profits above a threshold, a  
3 threshold of 4/9ths of the floatation value.

4 And that is not an accident. That's not  
5 some kind of tricky math thing that somebody pulled up.  
6 It's right there in the statute itself because --

7 JUSTICE KENNEDY: Suppose everyone in the  
8 case conceded that the purpose of this statute was to  
9 compensate the government for having valued the shares  
10 at too low a price, and this was stated right in the  
11 enactment. Would that change your argument?

12 MR. CLEMENT: It wouldn't, Justice Kennedy,  
13 because, at the end of the day, it's the substance of  
14 the tax, not its purpose behind it that matters. Now, I  
15 do think, in this case, as Justice Sotomayor alluded to,  
16 everybody in this process really understood that those  
17 were just the flip side of the same coin.

18 You can talk about the profits being too  
19 high, vis-à-vis floatation, you can talk about  
20 floatation being too low vis-à-vis the subsequently  
21 reported profits, but what makes --

22 JUSTICE KENNEDY: Well, suppose we think  
23 this is both a tax on profits and a tax on low value.  
24 Then what do we do?

25 MR. CLEMENT: Well, in this particular case,

1 you would say it's creditable because the only measure  
2 of value here is by looking at retrospective earnings  
3 over a 4-year period. And the best hypothetical I can  
4 give you is think about a foreign government that says  
5 we want to tax the value of corporations, but the way we  
6 are idiosyncratically going to measure value is to look  
7 at their earnings over the past year.

8 Now, I would hope that tax would be for U.S.  
9 substantive economic tax purposes fully creditable. Of  
10 course, it's a tax on income, by our eyes. Now, in  
11 saying that, you're not suggesting that the other company --  
12 the other country did something wrong or that's not value in  
13 their conception.

14 But the whole point that this Court made  
15 clear in the Biddle case, going back 75 years ago, is  
16 when you're looking at foreign taxes, for purposes of  
17 applying the foreign tax credit, you don't take the  
18 foreign characterizations, the foreign classifications,  
19 as a given. You look at the substance of the tax for  
20 our purposes.

21 And, if you look -- if you apply that  
22 mechanism to this tax, this tax looks exactly like a  
23 U.S. Excess Profits Tax. It is really --

24 JUSTICE KAGAN: Mr. Clement, if I --

25 JUSTICE KENNEDY: Suppose it's a one -- if I



1 could just -- suppose -- we say, well, this is a  
2 one-time tax, in order to recalculate, reassess the  
3 value. If it's on income, it's still an Excess Profits  
4 Tax, in your view?

5 MR. CLEMENT: Yes. And, of course, you  
6 could have had a one-time, one-off tax, to use the  
7 British phrase, and you could have taxed the difference  
8 between the value at floatation and -- let's say the  
9 London Stock Exchange price at some later point. And  
10 that would have been a normal estimate of value, and it  
11 would not have been creditable for a number of reasons.

12 But when you do what this tax uniquely did,  
13 which is you don't look at a normal rubric of value, but  
14 you look at a construct -- I mean, the very fact that  
15 they had to use the phrase "value in profit-making  
16 terms" tells you something weird's going on here. I  
17 mean, if they were really --

18 JUSTICE GINSBURG: Mr. Clement, is there  
19 another example -- Justice Kennedy mentioned that this  
20 was what they call "one-off." It's one time only, and  
21 it's retrospective. Is -- is there any instance in  
22 which a foreign tax credit has been given to something  
23 that looks like this, a one-time only adjustment that  
24 is -- that operates retrospectively on past earnings?

25 MR. CLEMENT: Justice Ginsburg, I can't put

1 all the pieces of that together and say there's one case  
2 that had all of these various features, and then it was  
3 still creditable, but I don't think that matters. It's  
4 very clear, I think, for starters, that the fact that  
5 this is a retroactive tax is not dispositive.

6           You look at one of the regulatory  
7 requirements, and that's realization. And that treats  
8 an estimate of future income generation very differently  
9 because that doesn't involve a realization event. But  
10 what the regulation says is that the tax has to be  
11 imposed upon or subsequent to.

12           JUSTICE SOTOMAYOR: My fear is, as warned by  
13 the government and the tax professors, that the rule you  
14 want us to announce to help you win is to say anytime a  
15 tax uses estimates of profits, no matter how it does it,  
16 it is credible -- creditable. That's the rule you want.

17           MR. CLEMENT: No, it is not. It is  
18 emphatically not. And let me tell you why there is no  
19 slippery slope here. First, the big thing they want to  
20 tell you is this is a normal way of valuation. And, if  
21 you allow this, then any valuation is going to be  
22 creditable. That is flat wrong, and the reason that's  
23 flat wrong is because almost every effort in valuation  
24 is prospective.

25           If you want to try to value a piece of

1 property, you could value it by saying, well, what kind  
2 of rents can I get on this property, and I'll discount  
3 them back to net present value. And I suppose you can  
4 conceive of a property tax as a tax on a percentage of  
5 those projected future earnings.

6 But you know what? Easily obviously not  
7 creditable because the first requirement on the  
8 regulation is that there be a realization event. And  
9 when you're talking about projected future income  
10 streams, there's no realization events. So all of those  
11 are off the table.

12 JUSTICE SOTOMAYOR: So why isn't that to say  
13 I want to find the original floatation value, and,  
14 instead of estimating what the profits are, I'm simply  
15 going to use the ones that happen?

16 MR. CLEMENT: Exactly --

17 JUSTICE SOTOMAYOR: So why is that  
18 different?

19 MR. CLEMENT: Because you never would do  
20 that in any normal valuation. What you would do --  
21 occasionally, in valuation, you have to go back in time.  
22 This isn't the only place in the world that anybody  
23 said, I wonder what Google's stock was worth, like, back  
24 in the day.

25 But, when you do that for valuation

1 purposes, the first rule of thumb is to avoid hindsight  
2 bias, and so this tax uniquely taxes nothing, but  
3 hindsight bias. It's going back to 1990 --

4 JUSTICE SOTOMAYOR: Well, there -- there is  
5 an argument about that because it has two components  
6 that you keep ignoring, the floatation value and the  
7 time that the company --

8 MR. CLEMENT: I would love to talk about  
9 those other variables. The floatation value -- I mean,  
10 it's a tax between the difference between -- between two  
11 variables.

12 The reason I am focusing on the value and  
13 profit-making terms is because it's the larger of the  
14 two numbers, and the tax falls in the difference between  
15 the two, and the floatation value is basically taken as  
16 a given. And --

17 JUSTICE KAGAN: Well, Mr. -- I'm sorry,  
18 please.

19 MR. CLEMENT: Go ahead. I mean, I could  
20 talk floatation value all day.

21 JUSTICE BREYER: Well, I'd really like to  
22 hear -- I'd really like to hear what you are going to  
23 say.

24 JUSTICE KAGAN: Okay. Then let me ask you  
25 my question.

1 CHIEF JUSTICE ROBERTS: Wait, Justice Kagan.

2 No, Justice Kagan.

3 JUSTICE KAGAN: Ok. Do you agree -- I mean, you  
4 said we should look to the way this is designed, so  
5 let's look to the way that the actual formula is  
6 designed.

7 Do you agree that this tax would impose  
8 identical tax liability for companies with -- at the  
9 same average profits, but could impose very different  
10 tax liability for companies with the same total profits?

11 That's the way the thing is designed, is it  
12 not?

13 MR. CLEMENT: Yes, and that's true of every  
14 Excess Profits Tax, Your Honor. What matters for those  
15 tax --

16 JUSTICE KAGAN: Well, that's the question.  
17 Is that true of every Excess Profits Tax? Take a -- a  
18 hypothetical like this: You have two companies, Company  
19 A and Company B, and one company operates over four  
20 years and makes a lot of money, and one company operates  
21 over one year and makes only a quarter of that amount of  
22 money.

23 Now, a typical Excess Profits Tax is going  
24 to take Company A, which has made a lot of money, and --  
25 and it's going to end up paying four times as much tax

1 as Company B, which has made only a quarter of the  
2 amount of money. But, under this tax, Company A and  
3 Company B pay the exact same thing; isn't that right?

4 MR. CLEMENT: No. They -- they would pay  
5 different taxes. I mean, they pay the same rate --

6 JUSTICE KAGAN: One year or four years?  
7 Four --

8 MR. CLEMENT: They have the same -- they'd  
9 have the same rate. They'd have -- I mean,  
10 the same calculation, but it would affect them very  
11 differently. But in --

12 JUSTICE KAGAN: In other words, a company  
13 that has made four times as much profits under this  
14 formula could pay the same tax; isn't that right?

15 MR. CLEMENT: I -- I don't think --

16 JUSTICE KAGAN: Because it was operating  
17 four times as long.

18 MR. CLEMENT: Right.

19 JUSTICE KAGAN: And because there is that D  
20 variable.

21 MR. CLEMENT: Right -- that's right. But,  
22 of course, the floatation value is going to play a  
23 bigger role in the other company --

24 JUSTICE KAGAN: Assuming the floatation  
25 value is the same for both companies.

1           MR. CLEMENT: Then -- then maybe it could,  
2 Justice Kagan, but let me say two things about that --

3           JUSTICE KAGAN: It definitely could. It  
4 would have to. And that's because what this is trying  
5 to tax is not total profits. This is trying to tax  
6 average profits, or what may be the better way to say  
7 it, is it's taxing profitability and not profits.

8           MR. CLEMENT: No. With all due respect,  
9 it's taxing profits above a threshold, and the threshold  
10 is determined by floatation value. For most companies  
11 that the tax applies -- and that is the way you look at  
12 the creditability of these taxes, you ignore the  
13 outlier. For most of those companies, it's going to be  
14 4/9ths of the floatation value.

15           JUSTICE KAGAN: But -- but the reason why  
16 this formula was devised in the way that this formula  
17 was devised was specifically to get at the outlier. In  
18 other words, it was to get at the company that only  
19 operated for a short amount of time, but they wanted  
20 that company to pay just as big a tax bill as the  
21 company that had operated for a much longer amount of  
22 time and had made many more profits.

23           So the end result is that this company that  
24 operates for a very short amount of time and makes  
25 almost no excess profits pays the exact same tax bill as

1 a company with four times as much excess profits.

2 MR. CLEMENT: No, that's not right, Your  
3 Honor. I -- it really is not. And what they were  
4 trying to do -- first of all, the outliers, the reason  
5 they included them in is they figured they had to  
6 because it fit within their definition of the regulated  
7 companies they were trying to catch.

8 Now, they knew they had -- and this is only  
9 two companies we are talking about -- they knew they had  
10 a shorter period, so they knew this would fall  
11 differently on them as a substantive matter no matter --  
12 no matter how they did it.

13 The reason they didn't care much is because  
14 those companies got something that the other companies  
15 didn't, which is they got to operate for the next three  
16 years in a favorable regulatory environment in which no  
17 Excess Profits Tax would be imposed on them. So it may  
18 look like they have a higher rate -- effective rate  
19 under our calculation.

20 They do have a higher effective rate over  
21 a -- over a relatively small amount over the threshold,  
22 but they make that up, essentially, in the out-years  
23 because they make money under the favorable regulatory  
24 regime.

25 And, again, the theory of this is, for four



1 years after floatation, there is a favorable regulatory  
2 regime in which they make excess profits. Those two  
3 companies get to make money in the out-years, two,  
4 three, four, without any excess profits because it was  
5 really important for them to make this a one-off tax.

6 But if I can get back to your question  
7 because there is this phenomenon --

8 JUSTICE SCALIA: Excuse me. Why -- why  
9 didn't -- why weren't they subject to a favorable  
10 regulatory regime in two, three, and four?

11 MR. CLEMENT: They were. They weren't --  
12 but they weren't subject to any tax for it because,  
13 remember, they -- this is very important for Labour.  
14 They are coming in after 20 years of conservative rule.  
15 They don't want to be the old Labour party. They don't  
16 want to put in a new permanent tax, so they want to do  
17 this once.

18 And so that works great for my clients  
19 because they -- they were privatized in 1990. But, when  
20 they're doing this in 1997, they get a couple of  
21 outlying companies that were only privatized in '96. So  
22 what they do is they hit them with a reasonably tough  
23 tax in year one, but year two, three, and four, they  
24 were in a favorable regulatory environment, and they get  
25 no tax at all. So -- you know, don't -- don't cry any

1 tears for them.

2 Now, the point I thought you were going  
3 to ask me, though, is, even with the companies with the  
4 same denominator, it is true that companies with the  
5 same profits can be subjected to different taxes, but  
6 that's because it's an Excess Profits Tax. And that is  
7 what is true of --

8 JUSTICE KAGAN: No, but even companies with  
9 the exact same profits and the exact same floatation  
10 value can be subject to different taxes, and that's a  
11 result of the amount of time, that's a result of the D  
12 variable. If you were right --

13 MR. CLEMENT: With respect, that's only true  
14 of --

15 JUSTICE KAGAN: Excuse me. If you were  
16 right, the D variable wouldn't exist. If this were an  
17 Excess Profits Tax, it would have been written without a  
18 D variable because they would not have cared whether it  
19 was four years or one year or any place in-between.

20 MR. CLEMENT: With respect, I disagree  
21 because, first of all, it's only those two companies,  
22 from what you said, is -- it could possibly be true. As  
23 to the rest of the companies, the reason that they were  
24 trying to use D is because they were trying to capture  
25 the excess profits during a period in which there is a

1 particular regulatory environment with -- where they --  
2 where they thought they earned excess profits.

3 For all of the companies they reached, that  
4 period was the D with the exception of the outliers, and  
5 the reason they had a different outlier is because they  
6 were recently privatized. But, if you think about the  
7 substance of this tax, it is taxing -- their term --  
8 value and profit-making terms, but not any abstract  
9 profit-making terms, profits over a reported period.

10 JUSTICE KAGAN: If you were right, it would  
11 just be a 52 percent tax on annual profits above 1/9th  
12 of floatation value, and it's not that. It's not  
13 that -- specifically, in order to get at railroad track,  
14 which would have paid very little tax under your  
15 formula, but, instead, pays a great amount of tax  
16 because they think that railroad track got the same good  
17 deal at the beginning as all these other companies did,  
18 but -- so, even though they didn't make very much  
19 in the way of excess profits, they were going to tax  
20 them just as much.

21 MR. CLEMENT: Because they had three free  
22 years in the out-years. And, if you are looking at how  
23 this applies, in the normal circumstances of its  
24 application, then you don't have the full analysis of a  
25 railroad track.

1 JUSTICE SOTOMAYOR: The problem with their  
2 argument, Mr. Clement, is that you are undermining your  
3 own argument. If they are getting three full years at a  
4 lesser tax, it's because their floatation value was made  
5 more equal by this formula.

6 MR. CLEMENT: No, that's not right.

7 JUSTICE SOTOMAYOR: So they don't need to be  
8 taxed any more, moving forward, because they got it  
9 right.

10 MR. CLEMENT: No, that's -- with all due  
11 respect, that's not right. The floatation value is  
12 calculated the same way for each of these companies, and  
13 the theory of why the floatation value is too low is the  
14 same for all of them, which is, under the regulatory  
15 policies, they are going to hold the prices firm for a  
16 four-year period, and they are going to increase  
17 efficiencies and reduce costs, and they are going to  
18 make money.

19 That is supposed to incentivize them, and  
20 then that's the basis for all the regulatory policies  
21 going forward.

22 JUSTICE BREYER: I wanted -- I just wanted  
23 to hear what you were going to say in answer to the  
24 second part of Justice Sotomayor's earlier question.  
25 And, to remind you of that, you were going to explain to

1 us, which I felt I needed, the second term -- that  
2 second term. And that just says, "FV," for value.

3 MR. CLEMENT: Right. Right.

4 JUSTICE BREYER: But I did notice, that if  
5 you make .23 times fair value, not quite by coincidence,  
6 happens to be what the companies would have made over  
7 a period of 2 years in profit, had it been the truth  
8 that the value of such companies was, as valued by the  
9 market, 9 times their earnings because a company that's  
10 valued 9 times its earnings earns about 11 point  
11 something percent per year -- taking aside all other  
12 factors -- and 2 years' worth is that.

13 And I don't know if I've got that part  
14 right, but, if I do have that part right, then what this  
15 tax does is it takes the profits the firms actually --  
16 actually made over 2 years -- not quite actually. It  
17 assumes twice the -- the value of the first year.

18 You see, so whatever they made the first  
19 year -- and, if it's only 6 months, it's twice 6  
20 months -- you know -- that first part figures out what  
21 they really made over the first year and then multiplies  
22 it by two. And you take that, and you subtract from  
23 that the amount that they would have made over 2 years.

24 Now -- so it looked, to me, pretty -- this  
25 helps you, of course, but -- but it also is calculated

1 on an average, the average of the first year's profit,  
2 they consider that the average; and, therefore, they are  
3 right in saying -- you know, a firm that was only in  
4 business for 6 months will be taxed -- the whole 2-year  
5 extra will be taken away, even when there was no 2-year  
6 extra, you see? So that firm would have paid more than  
7 their gross income.

8 Of course, there is no such firm, and that's  
9 their problem, but we come to that later. But I want  
10 your view, if you can -- if I've explained it clearly  
11 enough, so you get where I'm coming from, and -- and --  
12 if -- if I have explained that clearly enough, I'd really  
13 appreciate what you think about it.

14 MR. CLEMENT: Well, I -- I think so, but I  
15 think I get there in a slightly different way because I  
16 guess I don't see the natural relationship between the  
17 23 percent and the floatation value, but I think I get  
18 to a similar place, which is, if you think about it the  
19 way that we formulate it, it's 51.75 percent of 4/9ths  
20 of floatation value.

21 Now, the -- the floatation value is  
22 calculated based on the initial share price, plus the  
23 number of shares. And the initial share price for all  
24 the electrical utilities was 2 pounds, 40 pence. So  
25 it's just 2 pounds, 40 pence, by however many shares

1 there were. Okay. So that's floatation value.

2 The -- the floor for the excess profits is  
3 4/9ths of floatation value. Now, if you want to get it  
4 on an annualized average basis and if you want to -- you  
5 know, this is at 64a of the petition appendix when the  
6 Tax Court did it -- but what that means in practice is  
7 this tax is taxing 51.75 percent of the profits above  
8 1/9th of the floatation --

9 JUSTICE BREYER: It will do that for firms  
10 that are in business for 4 years.

11 MR. CLEMENT: Yes.

12 JUSTICE BREYER: Absolutely. It won't do  
13 that for a firm that was in business 6 months. And --  
14 and --

15 MR. CLEMENT: It -- it will give you a  
16 different number.

17 JUSTICE BREYER: A very different number.

18 MR. CLEMENT: Yes.

19 JUSTICE BREYER: Indeed, a number that could  
20 exceed the money -- all the money they really make in  
21 the next 2 years.

22 MR. CLEMENT: That's not true.

23 JUSTICE BREYER: I could.

24 MR. CLEMENT: I mean, of any company here --  
25 of any company here, that's not true.

1 JUSTICE BREYER: Yes, that's correct.  
2 That's not true. There is only one company like that;  
3 absolutely right.

4 MR. CLEMENT: It's stipulated --

5 JUSTICE BREYER: And -- but -- but some,  
6 particularly on the other side, want to make quite a lot  
7 out of that fact. And they want to make quite a lot out  
8 of the fact that for that single -- whatever it's called  
9 railroad something --

10 MR. CLEMENT: Railtrack. But, again,  
11 Railtrack did not pay more in taxes than they made in --

12 JUSTICE BREYER: I know -- I know they  
13 didn't. It didn't happen in this instance.

14 MR. CLEMENT: And -- and -- and that is a  
15 very important fact because when you are trying to  
16 figure out --

17 JUSTICE BREYER: Okay. Okay.

18 MR. CLEMENT: -- what -- and, again, their  
19 regulation says, you look to the application of the  
20 statute, in the normal circumstances in which it  
21 applies.

22 In the normal circumstances in which this  
23 applies -- and, this, the parties stipulated to -- every  
24 company paid less in this Excess Profits Tax or windfall  
25 tax than they made in initial period profits. And that



1 is all that really matters.

2                   They want to focus on the fact that, well,  
3 for a lot of these companies, the base amount was larger  
4 than the -- than their initial period profits. Who  
5 cares? I mean, that's just an artificial number.  
6 This --

7                   JUSTICE SOTOMAYOR: Let's go back to my  
8 initial question. What's the rule? If someone uses  
9 your actual profits in any way, it's a credit that they  
10 are entitled to?

11                  MR. CLEMENT: No. I don't think so because,  
12 again --

13                  JUSTICE SOTOMAYOR: Well, I don't know how  
14 you get around it because you seem to be saying to us  
15 that, no matter how -- what formula you create, so long  
16 as we can simplify it in math to affect which -- take  
17 any variables in it and fix them in any way, that's a  
18 creditable tax. That seems to be what your argument is.

19                  MR. CLEMENT: No, it's not,  
20 Justice Sotomayor. Now, there's two things your  
21 question, I think, got to; one, I thought I already  
22 dealt with, which is future valuation is not a problem.  
23 There is no realization of it.

24                  JUSTICE SOTOMAYOR: No, I'm saying to you  
25 that any tax that relies upon actual profits, in any

1 way, you say is wrong.

2 MR. CLEMENT: And it's not right or wrong.  
3 We would say it's creditable, if that's its predominant  
4 character. So if you want to put that as part of a  
5 ten-factor test, where past realized profits is one of  
6 the ten factors, but you also look at real market  
7 valuation and some other factor, then I'm probably going  
8 to lose.

9 But, in this instance, the only moving  
10 factor -- the only thing that changes from  
11 company-to-company, other than the floatation value,  
12 which is fixed, is their profits. And nobody -- you  
13 know, nobody doubts --

14 JUSTICE SOTOMAYOR: No, the floatation value  
15 is not fixed. It was different for each company.

16 MR. CLEMENT: Right. But --

17 JUSTICE SOTOMAYOR: They only fixed the  
18 percentage that they're going to use, but the actual  
19 amount paid was different for every company.

20 MR. CLEMENT: But, again, that is classic  
21 Excess Profits Tax. So let me try to come at it this  
22 way, which is to say, suppose you had a country that had  
23 a tax that said, we are going to tax your value, and we  
24 are going to measure your -- your -- your value based on  
25 the income you made in the last year or the last 2

1 years.

2 Now, I would say that that is clearly a  
3 creditable income tax. If they said the same thing, we  
4 are going to tax your value, and we are going to  
5 calculate your value based on your income over the last  
6 2 years, but we are going to subtract 10 percent of your  
7 market cap, that would be an Excess Profits Tax.

8 The market cap would be different for every  
9 company, so there would be another thing that was  
10 different for each company, and the effective rate might  
11 be different, but that's okay because that's how an  
12 excessive profits tax works.

13 The last thing I'd say before I go sit down  
14 is that's how the 1917 United States Excess Profits Tax  
15 worked. In 1918, when Congress said that foreign excess  
16 profits taxes are creditable, surely, that's what they  
17 had in mind, and this is very similar to that classic,  
18 prototypical Excess Profits Tax.

19 If I could reserve the remainder of my time?

20 CHIEF JUSTICE ROBERTS: Thank you, counsel.

21 Ms. O'Connell?

22 ORAL ARGUMENT OF ANN O'CONNELL

23 ON BEHALF OF THE RESPONDENT

24 MS. O'CONNELL: Mr. Chief Justice, and may  
25 it please the Court:

1           The windfall tax is not an income tax. It  
2 tax -- is a tax on an increment of company value. A  
3 company's profits multiplied by a price to earnings  
4 ratio is a typical way of imputing a value on a company.  
5 Using profits as one variable in that valuation formula  
6 does not transform a tax on company value into an income  
7 tax.

8           JUSTICE SCALIA: That -- that's a way of  
9 estimating future value. I -- I don't know that anybody  
10 values a company that -- that is sold on the market by  
11 saying how much money did they make in the last 2 years,  
12 and we are going to multiply that by 9. You look at  
13 what people were paying you in the market.

14           MS. O'CONNELL: Well, Justice Scalia, the --  
15 what Parliament was trying to do here was to impute a  
16 value on the company for which it should have been sold in  
17 1990. And so using a stock price at some later date  
18 would not have been an adequate proxy to determine what  
19 that value should have been.

20           JUSTICE BREYER: If they know what it really  
21 was, I guess they're all billionaires. You've got  
22 triple billionaires. I mean, if you could go and figure  
23 out what companies could really be sold at, as opposed  
24 to what the market says, I think I have the solution for  
25 you. I don't know why either of us is working here.

1 (Laughter.)

2 MS. O'CONNELL: Well, the point is that  
3 Parliament was trying to come up with a value that it  
4 should have charged for these companies in 1990 and --  
5 you know --

6 JUSTICE BREYER: So, since there is no real  
7 value, I -- I mean, maybe there is because they did it  
8 in the form of an IPO, and the share then went the next  
9 day into the market, and, when it went the next day into  
10 the market, did the market pay a lot more?

11 MS. O'CONNELL: Yes, it did.

12 JUSTICE BREYER: Really?

13 MS. O'CONNELL: There -- there is --

14 JUSTICE BREYER: All right. Then you could  
15 use that. You could use that, I guess.

16 MS. O'CONNELL: Well, but if you use --

17 JUSTICE BREYER: But, how does that relate  
18 to the number 9?

19 MS. O'CONNELL: If you use just the profits  
20 on the next day, that wouldn't capture all of the  
21 efficiencies that were realized over the --

22 JUSTICE BREYER: Yes, yes. But, of course,  
23 in the -- in the past, we are making a prediction  
24 about what efficiencies will be realized, and, in the  
25 future, we know. So the one thing we don't know, since

1 life is risky -- or we do know for sure -- is whatever  
2 it shows up to be in the future couldn't have been the  
3 value that shareholders would put on it in the past  
4 because they know life a risky.

5 MS. O'CONNELL: Well, that is true. And  
6 that is one thing that is -- is the --

7 JUSTICE BREYER: So the reason that that is  
8 relevant here, of course, is this number 9 is a made-up  
9 number. It may be made up by great experts, but since  
10 they are all not geniuses who are -- own the whole  
11 world, they must not be perfect experts.

12 MS. O'CONNELL: It is -- it is --

13 JUSTICE BREYER: Isn't that true?

14 MS. O'CONNELL: The number 9 was not an  
15 arbitrary number. It was --

16 JUSTICE BREYER: No, it was a number picked  
17 by whatever company had -- what is it, the -- the lowest  
18 price earnings ratio or something like that.

19 MS. O'CONNELL: Right. The lowest average  
20 price ratio.

21 JUSTICE BREYER: Okay. But that doesn't --  
22 that means whatever company that the shareholders  
23 thought would deviate the least from whatever the return  
24 was and that doesn't apply the others. But you don't  
25 want a lecture from me on this subject.

1                   What I want is an answer from you, and the  
2 answer I want from you is this: As I read it and once  
3 understand that this number is a semi made-up number, I  
4 did look at that second term, and I thought that .23  
5 times 9 is about 2 years' worth -- about 2 years' worth  
6 of profits that would be expected, all things left out  
7 of it, except profit.

8                   And so then, once I saw that, I looked at  
9 the first term. And the first term seemed, to me, to be  
10 their actual profit -- their actual profit on an annual  
11 basis multiplied by about the same number, you see?

12                   And so what we do is we take -- about  
13 multiplying, you see -- so we take about two years'  
14 worth of profit that they actually made, and we subtract  
15 from that two years' worth that our experts tell us they  
16 should have made as -- on the basis of the original  
17 market price. The rest is excess profit, and we seize  
18 all of it, for two years only.

19                   And, by the way, if a company had only six  
20 months' worth, well, then -- you know, they might really  
21 be hurt because, after all, they only earned six months  
22 at the annual rate that showed something, and maybe they  
23 didn't really earn it over the next 18 months. But the  
24 reply was there was no such company. And, of course,  
25 because time periods vary, rates will vary.

1                   But I don't know that that matters for an  
2 income tax. It's not a question of the rate; it's a  
3 question on what you impose it. And you impose it on  
4 income because, as he says, there are two choices here.  
5 Number is really calculated on the basis of income, and  
6 there is another number going on, the actual floatation  
7 value, and this third thing, which is called the number  
8 9. But, primarily, it is the income that makes the  
9 difference.

10                   Now, that's his argument. What's your  
11 response? That's his argument, as I understand it. I  
12 don't want to put words in his mouth. But you -- you  
13 explain it to me.

14                   MS. O'CONNELL: Justice Breyer, I think the  
15 problem with -- when we start to reformulate what this  
16 tax is or is not taxing or what the amount of the actual  
17 tax is, just shows the danger of trying to reformulate  
18 what parliament actually did in trying to determine if  
19 it's an income tax.

20                   As the professor's amicus brief points out,  
21 if you reformulated this into an average annual profit  
22 or left the P over 4 as it was and then divided  
23 everything else by 9, this would become a 207 percent  
24 tax on --

25                   JUSTICE BREYER: But I said, so what? Now,



1 you can answer that by saying, no, it's not so what. I  
2 mean, isn't an income tax dependant upon whether it's a  
3 tax on income, not the rate? And -- and whether some  
4 companies pay a high rate and others pay a low rate,  
5 even if that's totally arbitrary, wouldn't make a  
6 definition to the characterization.

7 MS. O'CONNELL: In that characterization --

8 JUSTICE BREYER: As long as you're not --  
9 they actually have the gross income from which this  
10 comes.

11 MS. O'CONNELL: In that characterization,  
12 Justice Breyer, the 207 percent of average annual  
13 profits over 1/9th of floatation value, then, no, it's  
14 not an income tax and the rate does matter because it's  
15 completely confiscatory of that profits base.

16 JUSTICE BREYER: No, it will. Wait, wait,  
17 wait, wait. It is greater than the profit they earned  
18 during the year, but it is not greater than the profit  
19 that they earned during the two years -- or whatever the  
20 period is that everybody's paying this on.

21 MS. O'CONNELL: Right.

22 JUSTICE BREYER: Is that right?

23 MS. O'CONNELL: Which -- which -- it's true.  
24 It's true.

25 JUSTICE BREYER: So, here, by good luck for

1    them or bad luck for you or whatever it is, they have  
2    not taxed more than the gross income of the companies.  
3    Is that -- is that --

4                   MS. O'CONNELL:  They have not taxed more  
5    than the total profits over a four-year period, which  
6    is --

7                   JUSTICE BREYER:  Four-year period.  Well,  
8    that's -- well -- well, is it not going to be an income  
9    tax if what the U.S. government says, though it hasn't  
10   said it, it could say, we want -- we want 35 percent of  
11   what you earn over six years.  Okay.  That's what we  
12   want.  Now, that's still an income tax, isn't it?

13                   MS. O'CONNELL:  Well, the U.S. income tax --  
14   what the regulation looks for is taxes that have the  
15   essential features of the U.S. income tax.  And, no, the  
16   U.S. income tax has never been imposed on a multiple of  
17   profits.  It's -- it's imposed as a percentage of --

18                   JUSTICE BREYER:  So you say whatever -- if  
19   they impose it on more than a year, any -- any country  
20   that calculates the income tax over a period for more  
21   than a year is outside the tax treaty because it's  
22   essential to the nature of the American income tax  
23   system that it be calculated year by year.

24                   You're hesitating to say that, but  
25   I think --

1 MS. O'CONNELL: Yes, I am. I am. I think  
2 if there was a country that imposed an income tax every  
3 six years and said, every sixth year, you'll pay an  
4 income tax over the last six years, then that would  
5 probably still be an income tax.

6 But the point is that, here, that's not  
7 anything close to what they're doing or what Parliament  
8 has done. Parliament has taken a valuation formula,  
9 where it takes an actual earnings figure from the  
10 company -- an average annual earnings figure, and  
11 multiplies it by a price-to-earnings ratio to impute a  
12 value on the company.

13 It then subtracts out what it actually  
14 received for the company, which we think shows that the  
15 substance of this tax is that it's a tax on an increment  
16 of company value. Parliament is calculating what it  
17 should have sold the company for, subtracting out what  
18 it actually received.

19 CHIEF JUSTICE ROBERTS: Counsel --

20 JUSTICE SOTOMAYOR: I mean, could you -- I'm  
21 sorry.

22 CHIEF JUSTICE ROBERTS: We had a lot of --  
23 your friend had a lot of questions on the different  
24 periods -- the initial periods and changing the D value  
25 and what that did to the -- that is not an argument that

1 you've made, is it?

2 MS. O'CONNELL: That's right. I think we  
3 generally agree with the Petitioner that a tax is -- is  
4 either an income tax or not an income tax for everybody  
5 that's subject to the tax and that you look at it in the  
6 normal circumstances in which it applies.

7 But -- but I do completely agree that the  
8 fact that the D figure changes makes this -- just  
9 reinforces the idea that the substance of this tax --

10 CHIEF JUSTICE ROBERTS: Well, but that is --  
11 again, that's not an argument you've made.

12 MS. O'CONNELL: No, but our the amicus did  
13 make it. I mean, that --

14 CHIEF JUSTICE ROBERTS: Well, the amicus  
15 did, but I don't think we should do a better job of  
16 getting money from people than the IRS does.

17 (Laughter.)

18 MS. O'CONNELL: Well, the point is that --  
19 the fact that there is a D variable there shows that  
20 what Parliament was trying to do was to place an annual  
21 earnings figure on each company to create a value for  
22 it. A company -- it's not similar to an Excess Profits  
23 Tax in that way, that where a company that operated for  
24 only six months is paying the tax at the same level that  
25 a company would be that was making profits at the same

1 rate for the entire four-year period.

2 CHIEF JUSTICE ROBERTS: No, that's a good  
3 articulation of the argument you haven't made.

4 JUSTICE SOTOMAYOR: So you are accepting the  
5 position the government made in PPL v. Exxon. You're  
6 not disavowing the position you took there?

7 MS. O'CONNELL: Right. But it -- it depends  
8 on the normal circumstances in which it applies. But --

9 JUSTICE KAGAN: But you're -- you're not  
10 saying that the amicus brief is wrong. The Chief  
11 Justice is, of course, right, the amicus brief is the  
12 amicus brief, and the amicus brief develops this  
13 argument, which I think is the right argument. But  
14 you're not saying that's wrong?

15 MS. O'CONNELL: It's not wrong. We think  
16 that both the -- the D variable and the flotation value  
17 variable add extra support for the idea that this is a  
18 tax on an increment of company value. The D shows that  
19 it's trying to impute an annual earnings figure on each  
20 company.

21 The flotation value shows that it's not  
22 concerned just with how profitable any particular  
23 company is, but with how profitable it is in relation to  
24 what the UK government received for it as value when it  
25 floated the company.

1 CHIEF JUSTICE ROBERTS: I thought you were  
2 saying that that argument was wrong because you looked  
3 to the predominant character of the tax and that it's  
4 either a tax -- it's either an income tax or it's not.

5 It wouldn't be an income tax on the vast  
6 majority of the companies where it was the same and not  
7 on the companies where it was a large value or the other  
8 way around. You look at the predominant characteristic  
9 and you decide whether it's a tax or not on that basis.

10 MS. O'CONNELL: That's right. But I'm not  
11 saying that the -- that the argument the amicus are  
12 making is wrong. We're -- we're just saying --

13 JUSTICE KAGAN: Because they're saying this  
14 is not an income for anybody because, in fact, this  
15 doesn't tax anybody's income. It taxes annual -- excuse  
16 me -- it taxes average profits, not total profits. It  
17 taxes profitability as a mechanism to tax value.

18 MS. O'CONNELL: That particular aspect of  
19 the amicus brief that says, if it's bad for one, it's  
20 bad for all, yes, that is not our position. If it -- it  
21 is not our position, that you look at the tax based on  
22 the normal circumstances in which it applies.

23 So I think we are in general agreement with  
24 PPL that, if there are outliers, where net gain would be  
25 totally confiscated, you'd look at it in the -- in the

1 normal circumstances in which it applies. That's what  
2 the regulation says.

3 JUSTICE KAGAN: Well, now, I'm totally  
4 confused because this outlier is an outlier not because  
5 the tax hasn't worked. It's an -- it's an outlier that  
6 the tax is designed to get at, that this formula was  
7 developed with this D variable, in order to make sure  
8 that outliers, meaning people -- companies that operated  
9 for only a short amount of time would still pay a  
10 significant tax bill.

11 So the whole design of this tax was to get  
12 at the outlier. That seems, to me, to suggest that the  
13 predominant character of the tax is not an income tax,  
14 but is, instead, a value tax.

15 MS. O'CONNELL: Well, I mean, you could also  
16 get to that by saying that the predominant character of  
17 this tax is -- is not an income tax because of the way  
18 that it applies to everybody else. I think that's our  
19 principal argument.

20 If there were some outlying companies for  
21 which this didn't look like an income tax, I think the  
22 regulation allows some flexibility there where it says,  
23 we look at it in the normal circumstances in which it  
24 applies. And, if that makes it an income tax, then it's  
25 an income tax for everybody.

1           I think an important point here is that the  
2           Petitioners have conceded that if Parliament had chosen  
3           a different valuation method, like the stock price, for  
4           any particular company and then subtracted out the  
5           floatation value, that that would not be a tax on  
6           income, that that would be a value tax.

7           The fact that Parliament chose a different  
8           way to place a value on each company shouldn't become a  
9           tax on income just because profits is one variable in  
10          that tax equation. That would open up many foreign  
11          taxes that just use this typical earnings times the  
12          price-to-earnings ratio for an income tax credit -- a  
13          dollar-for-dollar credit in the United States, just  
14          because the tax was written that way.

15          We think what Parliament was doing here was  
16          clearly trying to impute a value on each company and  
17          then subtracting out what it actually received. In  
18          substance, it's a tax on value, as well as in form.

19          If the Court thinks that both of the  
20          formulas are equivalent, the tax that Parliament  
21          actually wrote and the rewritten tax of 51.75 percent of  
22          your four years of profits over 4/9ths of the floatation  
23          value, then there is a couple of reasons that you should  
24          go with the tax that Parliament actually wrote.

25          The first is that exemptions from taxation



1 are construed narrowly, and a business -- a foreign  
2 income tax that is paid to a foreign -- or I'm sorry --  
3 a foreign tax that is paid to a foreign government that  
4 is not an income tax is usually just treated as a  
5 deduction.

6 And the IRS has said, throughout this case,  
7 that it is perfectly happy to treat this windfall tax as  
8 a deduction; it just would not get a dollar-for-dollar  
9 credit --

10 JUSTICE BREYER: On that -- on the question  
11 of how to treat, I -- there isn't authority, but, I  
12 mean, if I'm quite honest about how I think about it, I  
13 think the people in the tax court actually, usually,  
14 know more about it than the judges who are not on the  
15 tax court.

16 And so when I get an opinion and the tax  
17 court all thinks one thing and then the court of appeals  
18 is thinking something else and it's highly technical,  
19 I -- I tend to be tempted to say, well, the tax courts  
20 deserve something.

21 Now, is there anything, really? Am I just  
22 doing that wrong, if I did that?

23 MS. O'CONNELL: Well, Justice Breyer, with  
24 due respect to the tax court, the tax court didn't even  
25 analyze any of the three regulatory tests that are set

1     forth in the regulation.  I --

2                   JUSTICE GINSBURG:  I thought you would --  
3     you would answer that, that the Commissioner gets some  
4     credit, too.  This is the Commissioner -- this is a  
5     Treasury regulation.  So one question is:  Do we owe  
6     that regulation any kind of -- any kind of deference?

7                   MS. O'CONNELL:  Yes.  I think, to the extent  
8     that there is any ambiguity about what the regulation  
9     means, then the Commissioner's interpretation of his own  
10    regulation is entitled to some order of deference along  
11    the lines of "our."  And all --

12                   CHIEF JUSTICE ROBERTS:  But there is no  
13    difference between what the Commissioner says the  
14    regulation means and what it says.

15                   MS. O'CONNELL:  That's true.  Well --

16                   CHIEF JUSTICE ROBERTS:  It doesn't seem to  
17    move the ball much, one way or the other.

18                   MS. O'CONNELL:  That's true, unless you  
19    accept Petitioner's argument, that what the regulation  
20    means when it says you evaluate the tax based on its  
21    predominant character is that that means you can rewrite  
22    the tax before you start testing it against the three  
23    regulatory requirements, and, in which case, this would  
24    be a 51.75 percent tax on four years of profits that you  
25    are testing against the three regulatory requirements.

1           In which case, yes, it would probably be an  
2 income tax, but that's not how the Commissioner views  
3 the regulation. The Commissioner views that predominant  
4 character test as, so long as the tax is predominantly  
5 one where you -- it is on realized income and is  
6 calculated by starting with gross receipts and  
7 subtracting out costs and expenses, there can be minor,  
8 nonconforming elements in the tax base -- like the  
9 inclusion of imputed rental income that is not actually  
10 earned by a taxpayer, which some countries include in an  
11 income tax, and the tax could still be creditable.

12           The predominant character does not mean --  
13 the predominant character test does not mean that you  
14 completely rewrite the statutory tax base before you  
15 test it against those three regulatory requirements.

16           CHIEF JUSTICE ROBERTS: What if you -- go  
17 ahead.

18           What if they impose this -- what you would  
19 call valuation tax every year, and it was based the same  
20 way, it's based on profits that year, saying, we're  
21 going to say, we think the value of this company is now  
22 this much because they made -- whatever -- \$20 million  
23 last year. And so we impose this -- this set tax.

24           The next year, we think its value is this  
25 because they made -- you know, 10 million, so we are

1 going to impose this tax.

2 MS. O'CONNELL: I think that would not be an  
3 income tax because they are using a valuation formula  
4 that is imputing a value on the company and then  
5 taxing that value. It's like a --

6 CHIEF JUSTICE ROBERTS: Based solely --  
7 based solely on the amount of income?

8 MS. O'CONNELL: Well, if that -- if that  
9 were the only characteristic, then I think a property  
10 tax that is calculated that way could become an income  
11 tax, and that's not what the income tax credit -- the  
12 foreign tax credit is designed to do.

13 CHIEF JUSTICE ROBERTS: How could -- a  
14 property tax calculated that way? In other words, based  
15 on income from the property?

16 MS. O'CONNELL: Times a price-to-earnings  
17 ratio. If -- if what you are saying is that the -- the  
18 tax that the foreign government is imposing is just a  
19 tax based on last year's income, and they are calling it  
20 a property tax or something like that, I think that is  
21 what Petitioner was giving as an example.

22 That, I'm -- I think, I think would be an  
23 income tax. If the only variable in the tax base was  
24 profits, yes. If they --

25 CHIEF JUSTICE ROBERTS: But if they said, we

1 are going to multiply it by a price/earnings ratio.

2 MS. O'CONNELL: Yes.

3 CHIEF JUSTICE ROBERTS: Based on how much  
4 you earned.

5 MS. O'CONNELL: Yes.

6 CHIEF JUSTICE ROBERTS: Which sounds like  
7 income.

8 MS. O'CONNELL: No, that sounds like value.  
9 And I -- and that's another thing that --

10 CHIEF JUSTICE ROBERTS: Well, the "how much  
11 you earned" part sounds like income.

12 MS. O'CONNELL: Yes, but -- but any  
13 valuation formula will use some known data from the  
14 company to determine the company's value. So, if you  
15 are -- if you just -- if you are applying just to a  
16 company -- say that the United States was imposing a  
17 property tax on corporations and it decided to calculate  
18 the value of the corporation by taking its last year's  
19 earnings times the price-to-earnings ratio, that could  
20 be reformulated to look like a tax on the company's --

21 JUSTICE BREYER: If the reformulation --  
22 think of -- think that first term. Put it in your mind.  
23 Now, that first term does have a number -- .23 -- and  
24 let's do times 9, which is that valuation business. And  
25 what you get is a little over 2. Okay?

1           And you are going to get that every time.  
2   That's not going to vary from company-to-company. That  
3   varies as long as the universe is here. So we know  
4   we're going to multiply .2 -- rather, 2 point something  
5   times that first part of the first term.

6           And that first part of the first term  
7   consists of nothing other than, for the four-year  
8   company, the average one-year profit. So the only --  
9   what you are telling people to do in that first term is  
10  simply multiply by a little over than 2 -- a little more  
11  than 2 -- the average profit earned over a four-year  
12  period. That's what it says.

13           So there is nothing there but income. It's  
14  average income, I grant you. But there is nothing there  
15  but income. And then what you subtract from that --  
16  what you subtract from that is a quarter -- is a quarter  
17  of the value, I grant you. But it's a hypothetical  
18  value used with the number 9 of what one-quarter of the  
19  value of the floatation price taken in.

20           So there's an aspect to it that does have --  
21  unless you do it the way I was doing it initially --  
22  there is an aspect to it that does concern at least a  
23  hypothetical value. But the heart of the equation, in  
24  determining this so-called present value, is nothing  
25  other than taking average income over the four-year

1 period.

2 Now, if I'm right -- am I right about that?

3 MS. O'CONNELL: No. If you're --

4 JUSTICE BREYER: Okay.

5 MS. O'CONNELL: First of all, if the first  
6 part of the equation is -- is profits multiplied by 2,  
7 then -- then no. That -- that is not --

8 JUSTICE BREYER: No, no. It is -- the very  
9 first part of the first part is the profits -- the  
10 average profit over the four-year period. It says P.  
11 And then P, with all of this day business, that's just  
12 times 365 because they want to annualize it.

13 So, if you have a four years, what you are  
14 going to have is you -- you will have 365 times -- and  
15 then it's going to wipe out, and you will have divided  
16 by 4. So you will take the total profit over the  
17 four-year period, and you'll divide it by 4. That gives  
18 you the annual profit. So, now, we have finished the  
19 first half of the first part.

20 And the second half -- and we are going to  
21 take .23 of that. Okay?

22 No, we are not going to take any yet.

23 Taking .23 -- you're going to take .23 of the number 9,  
24 and that leaves you with the 2 -- that brings you to the  
25 little over 2.2.

1 MS. O'CONNELL: If you --

2 JUSTICE BREYER: So what we are doing is  
3 taking the average annual profit over a four-year  
4 period, we average it, and then we multiply it by two  
5 point something. Okay? And what that is doing -- and  
6 then what that is doing is giving you just the average  
7 annual, two years' worth of average annual.

8 And, from that, we subtract a quarter of  
9 what they received in the initial price, which happens  
10 to be what the market -- if it really was 9 -- about  
11 was expecting it to earn during a two-year  
12 period. That's why I put in the last part.

13 But even if I am wrong about that, I am  
14 right about the first half, aren't I.

15 MS. O'CONNELL: Well -- and I think what you  
16 are -- the one point of this that is missing is that, if  
17 you are going to multiply the other part by 2, you also  
18 have to multiply the tax rate by 2. And if this is --

19 JUSTICE BREYER: That's why I said  
20 50 percent.

21 MS. O'CONNELL: No, no. It would be -- it  
22 would be 100-and-some percent. It would be twice the  
23 51 point --

24 JUSTICE BREYER: Yes, yes, yes. That rate  
25 could be a problem for somebody at some time, in some



1 place.

2 MS. O'CONNELL: It would be --

3 JUSTICE BREYER: It wasn't a problem here  
4 because all of these companies, but one, did have and  
5 did fit within the four-year category. So as to all  
6 these companies, but one, it did not exceed gross  
7 income; it did not exceed net income; it was 50 -- what  
8 the number that he arrived at.

9 MS. O'CONNELL: Well, Justice Breyer, in  
10 your -- in your reconstructed formula, the tax rate is  
11 going to be twice the 51.75 percent. And that's --

12 JUSTICE BREYER: It is?

13 MS. O'CONNELL: Yes, because you have -- if  
14 you're dividing --

15 JUSTICE BREYER: Of the one year, you  
16 haven't calculated based on one year, but it's 50 percent of  
17 two years, isn't it?

18 I'm sorry. I am now confused enough that  
19 I am not following you.

20 MS. O'CONNELL: It's 50 percent for all four  
21 years. For one year, it's 207 percent.

22 JUSTICE BREYER: All right.

23 MS. O'CONNELL: It's 51.75 percent for all  
24 years.

25 JUSTICE BREYER: All right. I have said

1 enough -- my law clerks will have picked this up. They  
2 will have written it down, and I will be able to go  
3 back with the transcript and study it, which I will do.

4 (Laughter.)

5 MS. O'CONNELL: And, Justice Breyer, I  
6 just -- I want to address for a minute this -- this  
7 issue that it wasn't confiscatory of any particular  
8 taxpayer's net gain. That's not the relevant question,  
9 and I know there's some discussion about this in the  
10 briefs.

11 But, if all you were to do were to compare  
12 the final tax bill to the company's net profits over the  
13 year, there's a lot of things that are not income taxes  
14 that would then become income taxes, like an excise tax  
15 that is charged on the number -- or the -- the number of  
16 products that are manufactured or sold in a particular  
17 company in any given year, so long as there -- as it  
18 leaves the taxpayer with a nickel, then it's -- then  
19 that's an income tax.

20 That's not what the income tax means. What  
21 matters is what the tax base is. That's how you  
22 determine if it's a tax on income. The realization test  
23 requires that because you can't impose a tax on income  
24 that the -- the taxpayer hasn't actually realized. And  
25 the gross receipts and the net income tax also require

1 it.

2 JUSTICE GINSBURG: Ms. O'Connell -- if the  
3 Court should go the way the Fifth Circuit went -- the  
4 way the Tax Court went -- could the regulation be  
5 changed so it wouldn't happen again?

6 MS. O'CONNELL: If so, then I -- I think it  
7 should be changed. And I don't know exactly how that  
8 would look, but maybe it could make it more clear that  
9 you're supposed to just look at the tax base -- I think  
10 the regulation does say that.

11 But, yes, I think there would be room for --  
12 for the IRS to -- to make the regulation even more clear  
13 than it already is, if this Court were to conclude that  
14 the windfall tax is an income tax.

15 JUSTICE BREYER: Why -- why should it be  
16 changed? I mean, why should companies -- American  
17 companies doing business abroad, in borderline cases,  
18 have to pay tax on the same income twice?

19 MS. O'CONNELL: Well, Justice Breyer,  
20 they're -- they're not. SWEB, the subsidiary of  
21 Petitioner, paid the British income tax in the same  
22 years that it paid this windfall tax, in 1997 and 1998.  
23 And Petitioner got a dollar-for-dollar foreign tax  
24 credit for its portion of that British income tax that  
25 was paid in those years.

1           For any other tax that's imposed by a  
2 foreign government that's not the income tax or that's  
3 not an Excess Profits Tax or a war profits tax, the  
4 company can get a tax deduction. That's how profits --  
5 or other taxes are normally treated.

6           You deduct from the amount of income that  
7 you are reporting to the IRS, the dollars that you paid  
8 toward that foreign tax, and the -- the value of that  
9 deduction depends on the marginal tax rate that the  
10 taxpayer is paying.

11           So you might get 35 cents on the dollar for  
12 every dollar that you can subtract from your income tax  
13 base. But the dollar-for-dollar credit in Section 901  
14 is reserved for foreign taxes that have the equivalent  
15 features of the U.S. income tax, and the windfall tax  
16 simply doesn't.

17           It's written as a valuation formula, and  
18 it's not just written that way, but that's the substance  
19 of what it's trying to do. It's imputing a value on  
20 each company for what the U.K. government should have  
21 charged, and it's subtracting out the amount of money  
22 that it actually received.

23           And I think that's an important point to  
24 keep in mind when determining what is the -- the  
25 substance of this tax, is that the U.K. government is not

1 just going out into the world and taxing companies that  
2 it thinks are particularly profitable, to try to get  
3 more money.

4 The U.K. government used to own these  
5 companies, and it sold them at too low a price, and the  
6 windfall tax is an effort to get back some of that value  
7 that it should have asked for when it sold them.

8 Whether that's a good idea or a bad idea,  
9 it's not an income tax, in the U.S. sense, and it should  
10 not be entitled to a credit under Section 901.

11 Thank you.

12 CHIEF JUSTICE ROBERTS: Thank you, counsel.

13 Mr. Clement, you have 4 minutes remaining.

14 REBUTTAL ARGUMENT OF PAUL D. CLEMENT

15 ON BEHALF OF THE PETITIONER

16 MR. CLEMENT: Thank you. Just a few quick  
17 points in rebuttal.

18 First of all, just for the record, if what  
19 they really wanted to do in the British government was  
20 to tax value, as we normally understood it, there was a  
21 ready mechanism available, the London Stock Exchange  
22 price.

23 Now they want to say, well, but we wanted to  
24 go back and value it in 1990, but, as alluded to, they  
25 could have done that because, on day one, there was

1 about a 20 percent pop -- that's -- to use the IPO  
2 word -- there's about a 20 percent pop in value at the  
3 end of the first day's trading. They could have taxed  
4 that.

5 If they wanted to be a little less precise,  
6 but capture a little more value, they could have gone  
7 30 days out or 60 days out, on the theory that it took a  
8 while for the information to make it in to the market.  
9 That would have been a value tax. I wouldn't be up here  
10 arguing that it's creditable.

11 But what they did was something very  
12 different. They used a sui generis, very unique concept  
13 of value, not value unmodified, but value in  
14 profit-making terms. And not profit-making terms in  
15 some abstract sense that takes into account future  
16 income streams, but profit-making terms, as measured by  
17 4 years of reported profits that satisfy every test of  
18 the regulation.

19 They're realized profits, they're based on  
20 gross receipts, and they reflect exactly to the penny --  
21 to the pence, the net income. That's what they base  
22 this tax on.

23 JUSTICE KAGAN: Mr. Clement, what do you  
24 think would -- is the answer -- suppose that the Labour  
25 government had come in -- not after 4 years but after 2

1 years -- that they had looked at those 2 years of profits,  
2 they said, that's enough for us, to know that these  
3 companies were grossly undervalued, and they had done  
4 this exact same formula, and the result is that they  
5 would have ended up with a tax rate of over 100 percent.

6           Would that have been creditable or not?

7           MR. CLEMENT: I would be here with a more  
8 difficult case, Justice Kagan. I would love to argue  
9 that that is still creditable because I think you could  
10 live in a country that has an income tax, especially an  
11 Excess Profits Tax on a few disfavored industries, that  
12 has a rate over 100 percent.

13           But I would run into a regulatory hurdle,  
14 and, if I had had that case, I would have had to  
15 challenge the regulations. I would have loved to do it.

16           JUSTICE KAGAN: I guess what the  
17 hypothetical suggests is that, in some respects, the  
18 fact that you now -- that you have a tax rate here of  
19 between 0 and 1 is a bit of a fluke -- you know, if they  
20 had come in a little bit earlier and done the exact same  
21 thing, based on their understanding of how profitable  
22 these companies were, which they would have seen after 2  
23 years, you wouldn't have been able to make the same  
24 argument.

25           MR. CLEMENT: Can I just say, though, it

1 wouldn't have been a fluke because one of the things  
2 that the people that constructed this tax wanted out of  
3 this tax is they wanted it paid.

4           So it's not a fluke that they didn't impose  
5 a huge tax in excess of initial period profits on any  
6 company because they wanted to make sure the incidents  
7 of this tax was on companies that could actually pay it.  
8 And, if you do that based on 4 years' of reported  
9 profits, you're pretty sure that people are going to be  
10 able to pay it.

11           I would like to bring back to the -- the  
12 concession, I think, that ultimately was made by the  
13 government, that, if a foreign government has a tax on  
14 value, that the only measure of value is the past years'  
15 reported income, that that would be a creditable income  
16 tax. Well, I don't think it changes if you multiply it  
17 by 9. I don't think it changes if you divide it by 4.

18           I don't think if there is one company, that  
19 you divide it by 1/4, instead of 4 -- any of that  
20 changes the analysis, nor does it change the analysis if  
21 you subtract out some figure that represents a market  
22 cap or initial floatation value.

23           That would make it an Excess Profits Tax,  
24 rather than a simple income tax, and that is what the  
25 British government did.



1 I'll just close by bringing you back  
2 75 years to the Biddle case. In the Biddle case, there  
3 was an argument about a British tax and whether we  
4 should follow the form of the tax or the substance of  
5 this tax.

6 This Court said that we, of course, in  
7 looking at a foreign tax, don't bind ourselves by  
8 foreign classifications or characterizations. We look  
9 to the substance of the tax.

10 In the Biddle case, the rule that you look  
11 to substance, not form, benefited the Commissioner.  
12 There's no reason for a different rule when the shoe is  
13 on the other foot.

14 Thank you.

15 CHIEF JUSTICE ROBERTS: Thank you, counsel.

16 Counsel.

17 The case is submitted.

18 (Whereupon, at 12:14 p.m., the case in the  
19 above-entitled matter was submitted.)

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<b>A</b>				<b>C</b>
<b>able</b> 3:21 50:2 55:23 56:10	<b>analyze</b> 41:25	<b>articulation</b> 37:3	<b>behalf</b> 1:15,18 2:4,7 2:10 3:8 27:23 53:15	<b>C</b> 2:1 3:1
<b>above-entitled</b> 1:11 57:19	<b>ANN</b> 1:17 2:6 27:22	<b>artificial</b> 25:5	<b>believe</b> 6:1,5	<b>calculate</b> 27:5 45:17
<b>abroad</b> 51:17	<b>announce</b> 10:14	<b>artificially</b> 5:6,10	<b>benefited</b> 57:11	<b>calculated</b> 20:12 21:25 22:22 32:5 34:23 43:6 44:10 44:14 49:16
<b>absolutely</b> 23:12 24:3	<b>annual</b> 19:11 31:10 31:22 32:21 33:12 35:10 36:20 37:19 38:15 47:18 48:3,7 48:7	<b>aside</b> 21:11	<b>best</b> 8:3	<b>calculates</b> 34:20
<b>abstract</b> 19:8 54:15	<b>annualize</b> 47:12	<b>asked</b> 53:7	<b>better</b> 15:6 36:15	<b>calculating</b> 35:16
<b>accept</b> 42:19	<b>annualized</b> 23:4	<b>aspect</b> 38:18 46:20 46:22	<b>bias</b> 12:2,3	<b>calculation</b> 14:10 16:19
<b>accepting</b> 37:4	<b>answer</b> 20:23 31:1,2 33:1 42:3 54:24	<b>Assistant</b> 1:17	<b>Biddle</b> 8:15 57:2,2 57:10	<b>call</b> 9:20 43:19
<b>accident</b> 7:4	<b>anybody</b> 11:22 28:9 38:14	<b>Assuming</b> 14:24	<b>big</b> 10:19 15:20	<b>called</b> 24:8 32:7
<b>account</b> 54:15	<b>anybody's</b> 38:15	<b>assumption</b> 4:10	<b>bigger</b> 14:23	<b>calling</b> 44:19
<b>Act</b> 4:7	<b>anytime</b> 10:14	<b>authority</b> 41:11	<b>bill</b> 15:20,25 39:10 50:12	<b>cap</b> 27:7,8 56:22
<b>actual</b> 13:5 25:9,25 26:18 31:10,10 32:6,16 35:9	<b>anyway</b> 6:6	<b>available</b> 53:21	<b>billionaires</b> 28:21 28:22	<b>capture</b> 18:24 29:20 54:6
<b>add</b> 37:17	<b>appeals</b> 41:17	<b>average</b> 13:9 15:6 22:1,1,2 23:4 30:19 32:21 33:12 35:10 38:16 46:8 46:11,14,25 47:10 48:3,4,6,7	<b>bind</b> 57:7	<b>care</b> 16:13
<b>address</b> 50:6	<b>APPEARANCES</b> 1:14	<b>avoid</b> 12:1	<b>bit</b> 55:19,20	<b>cared</b> 18:18
<b>adequate</b> 28:18	<b>appendix</b> 23:5	<b>a.m</b> 1:13 3:2	<b>borderline</b> 51:17	<b>cares</b> 25:5
<b>adjustment</b> 9:23	<b>application</b> 19:24 24:19	<b>B</b>	<b>Breyer</b> 12:21 20:22 21:4 23:9,12,17,19 23:23 24:1,5,12,17 28:20 29:6,12,14 29:17,22 30:7,13 30:16,21 32:14,25 33:8,12,16,22,25 34:7,18 41:10,23 45:21 47:4,8 48:2 48:19,24 49:3,9,12 49:15,22,25 50:5 51:15,19	<b>case</b> 3:4,11 6:14,15 6:24 7:8,15,25 8:15 10:1 41:6 42:23 43:1 55:8,14 57:2,2,10,17,18
<b>affect</b> 14:10 25:16	<b>applications</b> 6:25,25	<b>B</b> 13:19 14:1,3	<b>back</b> 8:15 11:3,21 11:23 12:3 17:6 25:7 50:3 53:6,24 56:11 57:1	<b>cases</b> 51:17
<b>ago</b> 8:15	<b>applied</b> 6:2,20,22	<b>back</b> 8:15 11:3,21 11:23 12:3 17:6 25:7 50:3 53:6,24 56:11 57:1	<b>bad</b> 34:1 38:19,20 53:8	<b>catch</b> 16:7
<b>agree</b> 13:3,7 36:3,7	<b>applies</b> 6:4 15:11 19:23 24:21,23 36:6 37:8 38:22 39:1,18,24	<b>bad</b> 34:1 38:19,20 53:8	<b>ball</b> 42:17	<b>category</b> 49:5
<b>agreement</b> 38:23	<b>apply</b> 8:21 30:24	<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>cats</b> 3:25
<b>ahead</b> 12:19 43:17	<b>applying</b> 8:17 45:15	<b>based</b> 22:22 26:24 27:5 38:21 42:20 43:19,20 44:6,7,14 44:19 45:3 49:16 54:19 55:21 56:8	<b>based</b> 22:22 26:24 27:5 38:21 42:20 43:19,20 44:6,7,14 44:19 45:3 49:16 54:19 55:21 56:8	<b>cents</b> 52:11
<b>allow</b> 3:15 10:21	<b>appreciate</b> 22:13	<b>basically</b> 12:15	<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>challenge</b> 55:15
<b>allows</b> 39:22	<b>arbitrary</b> 30:15 33:5	<b>basis</b> 20:20 23:4 31:11,16 32:5 38:9	<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>change</b> 6:7 7:11 56:20
<b>alluded</b> 7:15 53:24	<b>argue</b> 55:8	<b>beginning</b> 19:17	<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>changed</b> 5:22 51:5,7 51:16
<b>ambiguity</b> 42:8	<b>arguing</b> 54:10		<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>changes</b> 26:10 36:8 56:16,17,20
<b>American</b> 34:22 51:16	<b>argument</b> 1:12 2:2,5 2:8 3:3,7 4:9 7:11 12:5 20:2,3 25:18 27:22 32:10,11 35:25 36:11 37:3 37:13,13 38:2,11 39:19 42:19 53:14 55:24 57:3		<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>changing</b> 35:24
<b>amici</b> 5:3	<b>arrived</b> 49:8		<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>character</b> 26:4 38:3 39:13,16 42:21 43:4,12,13
<b>amicus</b> 32:20 36:12 36:14 37:10,11,12 37:12 38:11,19			<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>characteristic</b> 38:8 44:9
<b>amount</b> 5:17 13:21 14:2 15:19,21,24 16:21 18:11 19:15 21:23 25:3 26:19 32:16 39:9 44:7 52:6,21			<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	<b>characterization</b>
<b>analysis</b> 19:24 56:20,20			<b>base</b> 25:3 33:15 43:8,14 44:23 50:21 51:9 52:13 54:21	

<p>33:6,7,11  <b>characterizations</b>              8:18 57:8  <b>charged</b>29:4 50:15              52:21  <b>cheaply</b> 4:3  <b>Chief</b>3:3,9 13:1              27:20,24 35:19,22              36:10,14 37:2,10              38:1 42:12,16              43:16 44:6,13,25              45:3,6,10 53:12              57:15  <b>choices</b> 32:4  <b>chose</b> 40:7  <b>chosen</b>40:2  <b>Circuit</b> 51:3  <b>circumstances</b> 6:4              19:23 24:20,22              36:6 37:8 38:22              39:1,23  <b>cite</b> 6:16  <b>Clark</b> 6:11  <b>classic</b> 26:20 27:17  <b>classifications</b> 8:18              57:8  <b>clear</b> 8:15 10:4 51:8              51:12  <b>clearly</b> 22:10,12              27:2 40:16  <b>Clement</b> 1:15 2:3,9              3:6,7,9 4:24 5:9,19              5:23 6:10 7:12,25              8:24 9:5,18,25              10:17 11:16,19              12:8,19 13:13 14:4              14:8,15,18,21 15:1              15:8 16:2 17:11              18:13,20 19:21              20:2,6,10 21:3              22:14 23:11,15,18              23:22,24 24:4,10              24:14,18 25:11,19              26:2,16,20 53:13</p>	<p>53:14,16 54:23              55:7,25  <b>clerks</b> 50:1  <b>clients</b> 17:18  <b>close</b> 35:7 57:1  <b>coin</b> 7:17  <b>coincidence</b> 21:5  <b>come</b> 5:7 22:9 26:21              29:3 54:25 55:20  <b>comes</b> 33:10  <b>coming</b> 17:14 22:11  <b>Commissioner</b> 1:6              3:5 42:3,4,13 43:2              43:3 57:11  <b>Commissioner's</b>              42:9  <b>common</b> 6:1,5  <b>companies</b> 3:15,21              4:1 5:16,24 6:19              6:21 13:8,10,18              14:25 15:10,13              16:7,9,14,14 17:3              17:21 18:3,4,8,21              18:23 19:3,17              20:12 21:6,8 25:3              28:23 29:4 33:4              34:2 38:6,7 39:8              39:20 49:4,6 51:16              51:17 53:1,5 55:3              55:22 56:7  <b>company</b> 4:19,20              5:11 8:11 12:7              13:18,19,19,20,24              14:1,2,3,12,23              15:18,20,21,23              16:1 21:9 23:24,25              24:2,24 26:15,19              27:9,10 28:2,4,6              28:10,16 30:17,22              31:19,24 35:10,12              35:14,16,17 36:21              36:22,23,25 37:18              37:20,23,25 40:4,8              40:16 43:21 44:4</p>	<p>45:14,16 46:8              50:17 52:4,20 56:6              56:18  <b>company's</b> 28:3              45:14,20 50:12  <b>company-to-comp...</b>              26:11 46:2  <b>compare</b> 50:11  <b>compensate</b> 7:9  <b>completely</b> 33:15              36:7 43:14  <b>components</b> 12:5  <b>conceded</b> 6:24 7:8              40:2  <b>concedes</b> 7:1  <b>conceive</b> 11:4  <b>concept</b> 54:12  <b>conception</b> 8:13  <b>concern</b> 46:22  <b>concerned</b> 37:22  <b>concession</b> 56:12  <b>conclude</b> 51:13  <b>confiscated</b> 38:25  <b>confiscatory</b> 33:15              50:7  <b>confused</b> 39:4 49:18  <b>Congress</b> 4:15              27:15  <b>conservative</b> 4:2              17:14  <b>consider</b> 22:2  <b>consists</b> 46:7  <b>constant</b> 3:14 5:5  <b>construct</b> 9:14  <b>constructed</b> 56:2  <b>construed</b> 41:1  <b>consumers</b> 3:19  <b>corporation</b> 1:3 3:4              45:18  <b>corporations</b> 8:5              45:17  <b>correct</b> 24:1  <b>costs</b> 3:16,22 20:17              43:7</p>	<p><b>counsel</b> 27:20 35:19              53:12 57:15,16  <b>countries</b> 43:10  <b>country</b> 8:12 26:22              34:19 35:2 55:10  <b>couple</b> 6:21 17:20              40:23  <b>course</b> 8:10 9:5              14:22 21:25 22:8              29:22 30:8 31:24              37:11 57:6  <b>court</b> 1:1,12 3:10              6:16,23 8:14 23:6              27:25 40:19 41:13              41:15,17,17,24,24              51:3,4,13 57:6  <b>courts</b> 41:19  <b>create</b> 25:15 36:21  <b>credible</b> 10:16  <b>credit</b> 8:17 9:22 25:9              40:12,13 41:9 42:4              44:11,12 51:24              52:13 53:10  <b>credibility</b> 15:12  <b>creditable</b> 6:12 8:1              8:9 9:11 10:3,16              10:22 11:7 25:18              26:3 27:3,16 43:11              54:10 55:6,9 56:15  <b>criticized</b> 3:25  <b>cry</b> 17:25  <b>cut</b> 3:22</p> <hr/> <p style="text-align: center;"><b>D</b></p> <hr/> <p><b>D</b> 1:15 2:3,9 3:1,7              5:5,11,21,25 14:19              18:11,16,18,24              19:4 35:24 36:8,19              37:16,18 39:7              53:14  <b>danger</b> 32:17  <b>data</b> 45:13  <b>date</b> 28:17  <b>day</b> 7:13 11:24</p>	<p>12:20 29:9,9,20              47:11 53:25  <b>days</b> 54:7,7  <b>day's</b> 54:3  <b>deal</b> 19:17  <b>dealt</b> 25:22  <b>debate</b> 4:14  <b>decide</b> 38:9  <b>decided</b> 45:17  <b>decision</b> 3:11  <b>deduct</b> 52:6  <b>deduction</b> 41:5,8              52:4,9  <b>deference</b> 42:6,10  <b>definitely</b> 15:3  <b>definition</b> 16:6 33:6  <b>denominator</b> 18:4  <b>Department</b> 1:18  <b>dependant</b> 33:2  <b>depends</b> 4:18 37:7              52:9  <b>deserve</b> 41:20  <b>design</b> 39:11  <b>designed</b> 4:25 13:4              13:6,11 39:6 44:12  <b>determine</b> 28:18              32:18 45:14 50:22  <b>determined</b> 15:10  <b>determining</b> 46:24              52:24  <b>developed</b> 39:7  <b>developing</b> 6:19  <b>develops</b> 37:12  <b>deviate</b> 30:23  <b>devised</b> 15:16,17  <b>difference</b> 9:7 12:10              12:14 32:9 42:13  <b>different</b> 5:16,24,25              11:18 13:9 14:5              18:5,10 19:5 22:15              23:16,17 26:15,19              27:8,10,11 35:23              40:3,7 54:12 57:12  <b>differently</b> 6:22 10:8</p>
---	---	--	--	---

<p><b>difficult</b> 55:8  <b>disagree</b> 18:20  <b>disavowing</b> 37:6  <b>discount</b> 11:2  <b>discussion</b> 50:9  <b>disfavored</b> 55:11  <b>dispositive</b> 10:5  <b>divide</b> 47:17 56:17              56:19  <b>divided</b> 32:22 47:15  <b>dividing</b> 49:14  <b>doing</b> 17:20 35:7              40:15 41:22 46:21              48:2,5,6 51:17  <b>dollar</b> 52:11,12  <b>dollars</b> 52:7  <b>dollar-for-dollar</b>              40:13 41:8 51:23              52:13  <b>doubts</b> 26:13  <b>due</b> 15:8 20:10              41:24  <b>D.C</b> 1:8,15,18</p> <hr/> <p style="text-align: center;"><b>E</b></p> <hr/> <p><b>E</b> 2:1 3:1,1  <b>earlier</b> 20:24 55:20  <b>earn</b> 31:23 34:11              48:11  <b>earned</b> 4:1 19:2              31:21 33:17,19              43:10 45:4,11              46:11  <b>earnings</b> 8:2,7 9:24              11:5 21:9,10 28:3              30:18 35:9,10              36:21 37:19 40:11              45:19  <b>earns</b> 21:10  <b>Easily</b> 11:6  <b>economic</b> 8:9  <b>effective</b> 5:24 16:18              16:20 27:10  <b>efficiencies</b> 3:16,22</p>	<p>    20:17 29:21,24  <b>effort</b> 10:23 53:6  <b>either</b> 4:11 6:12              28:25 36:4 38:4,4  <b>elected</b> 4:6  <b>election</b> 4:4  <b>electrical</b> 22:24  <b>element</b> 5:5  <b>elements</b> 43:8  <b>emphatically</b> 10:18  <b>enactment</b> 7:11  <b>ended</b> 55:5  <b>entire</b> 37:1  <b>entitled</b> 25:10 42:10              53:10  <b>environment</b> 16:16              17:24 19:1  <b>equal</b> 20:5  <b>equation</b> 5:4,5,8 6:8              40:10 46:23 47:6  <b>equivalent</b> 40:20              52:14  <b>especially</b> 55:10  <b>ESQ</b> 1:15,17 2:3,6,9  <b>essential</b> 34:15,22  <b>essentially</b> 16:22  <b>estimate</b> 9:10 10:8  <b>estimates</b> 10:15  <b>estimating</b> 11:14              28:9  <b>evaluate</b> 42:20  <b>event</b> 10:9 11:8  <b>events</b> 11:10  <b>everybody</b> 7:16              36:4 39:18,25  <b>everybody's</b> 33:20  <b>exact</b> 14:3 15:25              18:9,9 55:4,20  <b>exactly</b> 7:1 8:22              11:16 51:7 54:20  <b>example</b> 9:19 44:21  <b>exceed</b> 23:20 49:6,7  <b>exception</b> 19:4  <b>excess</b> 4:5 6:18,19</p>	<p>    8:23 9:3 13:14,17              13:23 15:25 16:1              16:17 17:2,4 18:6              18:17,25 19:2,19              23:2 24:24 26:21              27:7,14,15,18              31:17 36:22 52:3              55:11 56:5,23  <b>excessive</b> 27:12  <b>Exchange</b> 9:9 53:21  <b>excise</b> 50:14  <b>excuse</b> 17:8 18:15              38:15  <b>exemptions</b> 40:25  <b>exist</b> 18:16  <b>expected</b> 3:23 31:6  <b>expecting</b> 48:11  <b>expenses</b> 43:7  <b>experts</b> 30:9,11              31:15  <b>explain</b> 20:25 32:13  <b>explained</b> 22:10,12  <b>express</b> 4:4  <b>extent</b> 3:22 4:22              42:7  <b>extra</b> 22:5,6 37:17  <b>Exxon</b> 6:15 37:5  <b>eyes</b> 8:10</p> <hr/> <p style="text-align: center;"><b>F</b></p> <hr/> <p><b>fact</b> 5:4 9:14 10:4              24:7,8,15 25:2              36:8,19 38:14 40:7              55:18  <b>factor</b> 26:7,10  <b>factors</b> 4:19 21:12              26:6  <b>fair</b> 21:5  <b>fall</b> 16:10  <b>falls</b> 12:14  <b>fat</b> 3:25  <b>favorable</b> 16:16,23              17:1,9,24  <b>fear</b> 10:12</p>	<p><b>features</b> 10:2 34:15              52:15  <b>February</b> 1:9  <b>felt</b> 21:1  <b>field</b> 6:20  <b>Fifth</b> 51:3  <b>figure</b> 24:16 28:22              35:9,10 36:8,21              37:19 56:21  <b>figured</b> 16:5  <b>figures</b> 21:20  <b>final</b> 50:12  <b>find</b> 11:13  <b>finished</b> 47:18  <b>firm</b> 20:15 22:3,6,8              23:13  <b>firms</b> 21:15 23:9  <b>first</b> 5:1 10:19 11:7              12:1 16:4 18:21              21:17,18,20,21              22:1 31:9,9 40:25              45:22,23 46:5,5,6              46:6,9 47:5,5,9,9              47:19,19 48:14              53:18 54:3  <b>fit</b> 16:6 49:5  <b>fix</b> 25:17  <b>fixed</b> 3:17 26:12,15              26:17  <b>flat</b> 10:22,23  <b>flexibility</b> 39:22  <b>flip</b> 7:17  <b>floatation</b> 4:15 7:3              7:19,20 9:8 11:13              12:6,9,15,20 14:22              14:24 15:10,14              17:1 18:9 19:12              20:4,11,13 22:17              22:20,21 23:1,3,8              26:11,14 32:6              33:13 37:21 40:5              40:22 46:19 56:22  <b>floated</b> 37:25  <b>floor</b> 23:2</p>	<p><b>flotation</b> 37:16  <b>fluke</b> 55:19 56:1,4  <b>focus</b> 25:2  <b>focusing</b> 12:12  <b>follow</b> 57:4  <b>following</b> 49:19  <b>foot</b> 57:13  <b>foreign</b> 8:4,16,17,18              8:18 9:22 27:15              40:10 41:1,2,3,3              44:12,18 51:23              52:2,8,14 56:13              57:7,8  <b>form</b> 29:8 40:18              57:4,11  <b>formula</b> 13:5 14:14              15:16,16 19:15              20:5 25:15 28:5              35:8 39:6 44:3              45:13 49:10 52:17              55:4  <b>formulas</b> 40:20  <b>formulate</b> 22:19  <b>forth</b> 42:1  <b>forward</b> 20:8,21  <b>four</b> 13:19,25 14:6,7              14:13,17 16:1,25              17:4,10,23 18:19              40:22 42:24 47:13              49:20  <b>four-year</b> 20:16              34:5,7 37:1 46:7              46:11,25 47:10,17              48:3 49:5  <b>free</b> 19:21  <b>freeze</b> 5:6  <b>freezing</b> 5:7,10  <b>friend</b> 35:23  <b>full</b> 19:24 20:3  <b>fully</b> 8:9  <b>further</b> 5:17  <b>future</b> 10:8 11:5,9              25:22 28:9 29:25              30:2 54:15</p>
---	---	---	---	--

<p><b>FV</b> 21:2</p> <hr/> <p style="text-align: center;"><b>G</b></p> <hr/> <p><b>G</b> 3:1  <b>gain</b> 38:24 50:8  <b>general</b> 1:17 38:23  <b>generally</b> 36:3  <b>generation</b> 10:8  <b>generis</b> 54:12  <b>geniuses</b> 30:10  <b>getting</b> 20:3 36:16  <b>Ginsburg</b> 9:18,25              42:2 51:2  <b>give</b> 8:4 23:15  <b>given</b> 8:19 9:22              12:16 50:17  <b>gives</b> 47:17  <b>giving</b> 44:21 48:6  <b>go</b> 11:21 12:19 25:7              27:13 28:22 40:24              43:16 50:2 51:3              53:24  <b>goes</b> 4:19  <b>going</b> 4:14 5:13 8:6              8:15 9:16 10:21              11:15 12:3,22              13:23,25 14:22              15:13 18:2 19:19              20:15,16,17,21,23              20:25 26:7,18,23              26:24 27:4,4,6              28:12 32:6 34:8              43:21 44:1 45:1              46:1,2,4 47:14,15              47:20,22,23 48:17              49:11 53:1 56:9  <b>good</b> 4:6 19:16              33:25 37:2 53:8  <b>Google's</b> 11:23  <b>gotten</b> 6:21  <b>government</b> 3:12              4:2,17 6:23 7:9 8:4              10:13 34:9 37:5,24              41:3 44:18 52:2,20</p>	<p>52:25 53:4,19          54:25 56:13,13,25  <b>government's</b> 3:14  <b>grant</b> 46:14,17  <b>great</b> 17:18 19:15              30:9  <b>greater</b> 3:22 33:17              33:18  <b>greeted</b> 3:23  <b>gross</b> 5:18 22:7 33:9              34:2 43:6 49:6              50:25 54:20  <b>grossly</b> 55:3  <b>ground</b> 6:1,5  <b>guess</b> 22:16 28:21              29:15 55:16</p> <hr/> <p style="text-align: center;"><b>H</b></p> <hr/> <p><b>half</b> 47:19,20 48:14  <b>happen</b> 11:15 24:13              51:5  <b>happens</b> 21:6 48:9  <b>happy</b> 41:7  <b>hear</b> 3:3 12:22,22              20:23  <b>heart</b> 46:23  <b>help</b> 10:14  <b>helps</b> 21:25  <b>hesitating</b> 34:24  <b>high</b> 7:19 33:4  <b>higher</b> 16:18,20  <b>highly</b> 41:18  <b>hindsight</b> 12:1,3  <b>hit</b> 17:22  <b>hold</b> 20:15  <b>honest</b> 41:12  <b>Honor</b> 5:9 13:14              16:3  <b>hope</b> 8:8  <b>huge</b> 5:17 56:5  <b>hurdle</b> 55:13  <b>hurt</b> 31:21  <b>hypothetical</b> 8:3              13:18 46:17,23</p>	<p>55:17</p> <hr/> <p style="text-align: center;"><b>I</b></p> <hr/> <p><b>idea</b> 36:9 37:17 53:8              53:8  <b>identical</b> 13:8  <b>idiosyncratically</b> 8:6  <b>ignore</b> 6:6 15:12  <b>ignoring</b> 12:6  <b>important</b> 5:25 17:5              17:13 24:15 40:1              52:23  <b>impose</b> 4:5 13:7,9              32:3,3 34:19 43:18              43:23 44:1 50:23              56:4  <b>imposed</b> 10:11              16:17 34:16,17              35:2 52:1  <b>imposing</b> 44:18              45:16  <b>impute</b> 28:15 35:11              37:19 40:16  <b>imputed</b> 43:9  <b>imputing</b> 28:4 44:4              52:19  <b>incentivize</b> 20:19  <b>incidents</b> 56:6  <b>include</b> 43:10  <b>included</b> 16:5  <b>inclusion</b> 43:9  <b>income</b> 8:10 9:3              10:8 11:9 22:7              26:25 27:3,5 28:1              28:6 32:2,4,5,8,19              33:2,3,9,14 34:2,8              34:12,13,15,16,20              34:22 35:2,4,5              36:4,4 38:4,5,14              38:15 39:13,17,21              39:24,25 40:6,9,12              41:2,4 43:2,5,9,11              44:3,7,10,11,15              44:19,23 45:7,11</p>	<p>46:13,14,15,25          49:7,7 50:13,14,19          50:20,22,23,25          51:14,18,21,24          52:2,6,12,15 53:9          54:16,21 55:10          56:15,15,24  <b>increase</b> 3:21 20:16  <b>increasing</b> 3:15  <b>increment</b> 28:2              35:15 37:18  <b>industries</b> 55:11  <b>information</b> 54:8  <b>initial</b> 3:16 22:22,23              24:25 25:4,8 35:24              48:9 56:5,22  <b>initially</b> 46:21  <b>instance</b> 9:21 24:13              26:9  <b>interested</b> 6:15  <b>Internal</b> 1:6 3:5  <b>interpretation</b> 42:9  <b>interpreted</b> 6:14  <b>involve</b> 10:9  <b>in-between</b> 18:19  <b>IPO</b> 4:3 29:8 54:1  <b>IRS</b> 36:16 41:6              51:12 52:7  <b>issue</b> 50:7</p> <hr/> <p style="text-align: center;"><b>J</b></p> <hr/> <p><b>job</b> 36:15  <b>judges</b> 41:14</p> <hr/> <p style="text-align: center;"><b>K</b></p> <hr/> <p><b>Kagan</b> 8:24 12:17              12:24 13:1,2,3,16              14:6,12,16,19,24              15:2,3,15 18:8,15              19:10 37:9 38:13              39:3 54:23 55:8,16  <b>keep</b> 3:14 12:6              52:24  <b>Kennedy</b> 7:7,12,22</p>	<p>8:25 9:19  <b>kind</b> 7:5 11:1 42:6,6  <b>knew</b> 16:8,9,10  <b>know</b> 11:6 17:25              21:13,20 22:3 23:5              24:12,12 25:13              26:13 28:9,20,25              29:5,25,25 30:1,4              31:20 32:1 41:14              43:25 46:3 50:9              51:7 55:2,19  <b>known</b> 45:13</p> <hr/> <p style="text-align: center;"><b>L</b></p> <hr/> <p><b>Labour</b> 17:13,15              54:24  <b>large</b> 38:7  <b>larger</b> 12:13 25:3  <b>Laughter</b> 29:1 36:17              50:4  <b>law</b> 50:1  <b>leaves</b> 47:24 50:18  <b>lecture</b> 30:25  <b>left</b> 31:6 32:22  <b>lesser</b> 20:4  <b>let's</b> 9:8 13:5 25:7              45:24  <b>level</b> 36:24  <b>liability</b> 13:8,10  <b>life</b> 30:1,4  <b>lines</b> 42:11  <b>little</b> 4:13,15,18              19:14 45:25 46:10              46:10 47:25 54:5,6              55:20  <b>live</b> 55:10  <b>London</b> 9:9 53:21  <b>long</b> 14:17 25:15              33:8 43:4 46:3              50:17  <b>longer</b> 15:21  <b>look</b> 4:10,11,21 6:3              6:14,24 8:6,19,21              9:13,14 10:6 13:4</p>
--	---	--	---	--

<p>13:5 15:11 16:18 24:19 26:6 28:12 31:4 36:5 38:8,21 38:25 39:21,23 45:20 51:8,9 57:8 57:10 <b>looked</b> 21:24 31:8 38:2 55:1 <b>looking</b> 4:9,22 8:2 8:16 19:22 57:7 <b>looks</b> 8:22 9:23 34:14 <b>lose</b> 26:8 <b>lot</b> 13:20,24 24:6,7 25:3 29:10 35:22 35:23 50:13 <b>love</b> 12:8 55:8 <b>loved</b> 55:15 <b>low</b> 7:10,20,23 20:13 33:4 53:5 <b>lowest</b> 30:17,19 <b>luck</b> 33:25 34:1</p> <hr/> <p style="text-align: center;"><b>M</b></p> <hr/> <p><b>made-up</b> 30:8 31:3 <b>main</b> 6:18,24,25 <b>Major</b> 3:12 <b>majority</b> 38:6 <b>making</b> 29:23 36:25 38:12 <b>manufactured</b> 50:16 <b>marginal</b> 52:9 <b>market</b> 21:9 26:6 27:7,8 28:10,13,24 29:9,10,10 31:17 48:10 54:8 56:21 <b>Martinez</b> 6:11 <b>math</b> 7:5 25:16 <b>matter</b> 1:11 10:15 16:11,11,12 25:15 33:14 57:19 <b>matters</b> 7:14 10:3 13:14 25:1 32:1 50:21</p>	<p><b>mean</b> 9:14,17 12:9 12:19 13:3 14:5,9 23:24 25:5 28:22 29:7 33:2 35:20 36:13 39:15 41:12 43:12,13 51:16 <b>meaning</b> 39:8 <b>means</b> 23:6 30:22 42:9,14,20,21 50:20 <b>measure</b> 5:13 8:1,6 26:24 56:14 <b>measured</b> 54:16 <b>mechanism</b> 8:22 38:17 53:21 <b>mentioned</b> 9:19 <b>method</b> 40:3 <b>million</b> 43:22,25 <b>mind</b> 27:17 45:22 52:24 <b>minor</b> 43:7 <b>minute</b> 50:6 <b>minutes</b> 53:13 <b>missing</b> 48:16 <b>mistake</b> 4:2 <b>money</b> 4:12,16,18 4:20 13:20,22,24 14:2 16:23 17:3 20:18 23:20,20 28:11 36:16 52:21 53:3 <b>months</b> 21:19,20 22:4 23:13 31:20 31:21,23 36:24 <b>mouth</b> 32:12 <b>move</b> 42:17 <b>moving</b> 20:8 26:9 <b>multiple</b> 34:16 <b>multiplied</b> 28:3 31:11 47:6 <b>multiplies</b> 21:21 35:11 <b>multiply</b> 28:12 45:1 46:4,10 48:4,17,18</p>	<p>56:16 <b>multiplying</b> 31:13</p> <hr/> <p style="text-align: center;"><b>N</b></p> <hr/> <p><b>N</b> 2:1,1 3:1 <b>narrowly</b> 41:1 <b>natural</b> 22:16 <b>nature</b> 34:22 <b>need</b> 20:7 <b>needed</b> 21:1 <b>net</b> 11:3 38:24 49:7 50:8,12,25 54:21 <b>never</b> 11:19 34:16 <b>new</b> 17:16 <b>nickel</b> 50:18 <b>nonconforming</b> 43:8 <b>normal</b> 6:4 9:10,13 10:20 11:20 19:23 24:20,22 36:6 37:8 38:22 39:1,23 <b>normally</b> 52:5 53:20 <b>North</b> 6:20 <b>notice</b> 21:4 <b>number</b> 3:13 5:7,10 5:10 9:11 22:23 23:16,17,19 25:5 29:18 30:8,9,14,15 30:16 31:3,3,11 32:5,6,7 45:23 46:18 47:23 49:8 50:15,15 <b>numbers</b> 12:14</p> <hr/> <p style="text-align: center;"><b>O</b></p> <hr/> <p><b>O</b> 2:1 3:1 <b>obviously</b> 11:6 <b>occasionally</b> 11:21 <b>oil</b> 6:20,21 <b>Ok</b> 13:3 <b>okay</b> 12:24 23:1 24:17,17 27:11 30:21 34:11 45:25 47:4,21 48:5 <b>old</b> 17:15</p>	<p><b>once</b> 17:17 31:2,8 <b>ones</b> 11:15 <b>one-off</b> 9:6,20 17:5 <b>one-quarter</b> 46:18 <b>one-time</b> 9:2,6,23 <b>one-year</b> 46:8 <b>open</b> 40:10 <b>operate</b> 16:15 <b>operated</b> 5:7 15:19 15:21 36:23 39:8 <b>operates</b> 7:1 9:24 13:19,20 15:24 <b>operating</b> 14:16 <b>opinion</b> 41:16 <b>opposed</b> 28:23 <b>opposition</b> 3:24 <b>oral</b> 1:11 2:2,5 3:7 27:22 <b>order</b> 9:2 19:13 39:7 42:10 <b>original</b> 11:13 31:16 <b>origins</b> 3:11 <b>outlier</b> 15:13,17 19:5 39:4,4,5,12 <b>outliers</b> 6:6 16:4 19:4 38:24 39:8 <b>outlying</b> 5:20,23 17:21 39:20 <b>outside</b> 34:21 <b>out-years</b> 16:22 17:3 19:22 <b>owe</b> 42:5 <b>O'Connell</b> 1:17 2:6 27:21,22,24 28:14 29:2,11,13,16,19 30:5,12,14,19 32:14 33:7,11,21 33:23 34:4,13 35:1 36:2,12,18 37:7,15 38:10,18 39:15 41:23 42:7,15,18 44:2,8,16 45:2,5,8 45:12 47:3,5 48:1 48:15,21 49:2,9,13</p>	<p>49:20,23 50:5 51:2 51:6,19</p> <hr/> <p style="text-align: center;"><b>P</b></p> <hr/> <p><b>P</b> 3:1 32:22 47:10,11 <b>PAGE</b> 2:2 <b>paid</b> 4:12,17 5:17,24 19:14 22:6 24:24 26:19 41:2,3 51:21 51:22,25 52:7 56:3 <b>parliament</b> 28:15 29:3 32:18 35:7,8 35:16 36:20 40:2,7 40:15,20,24 <b>part</b> 4:12 5:12 6:8 20:24 21:13,14,20 26:4 45:11 46:5,6 47:6,9,9,19 48:12 48:17 <b>particular</b> 6:10 7:25 19:1 37:22 38:18 40:4 50:7,16 <b>particularly</b> 24:6 53:2 <b>parties</b> 6:2 24:23 <b>party</b> 3:24 17:15 <b>passed</b> 3:18 4:7 <b>PAUL</b> 1:15 2:3,9 3:7 53:14 <b>pay</b> 4:15 14:3,4,5,14 15:20 24:11 29:10 33:4,4 35:3 39:9 51:18 56:7,10 <b>paying</b> 13:25 28:13 33:20 36:24 52:10 <b>pays</b> 15:25 19:15 <b>pence</b> 22:24,25 54:21 <b>penny</b> 54:20 <b>people</b> 3:23 28:13 36:16 39:8 41:13 46:9 56:2,9 <b>percent</b> 7:2 19:11 21:11 22:17,19</p>
--	---	--	---	---

<p>23:7 27:6 32:23 33:12 34:10 40:21 42:24 48:20,22 49:11,16,20,21,23 54:1,2 55:5,12 <b>percentage</b> 11:4 26:18 34:17 <b>perfect</b> 30:11 <b>perfectly</b> 41:7 <b>period</b> 3:17 5:12,16 8:3 16:10 18:25 19:4,9 20:16 21:7 24:25 25:4 33:20 34:5,7,20 37:1 46:12 47:1,10,17 48:4,12 56:5 <b>periods</b> 31:25 35:24 35:24 <b>permanent</b> 17:16 <b>petition</b> 23:5 <b>Petitioner</b> 1:4,16 2:4 2:10 3:8 36:3 44:21 51:21,23 53:15 <b>Petitioners</b> 40:2 <b>Petitioner's</b> 42:19 <b>phenomenon</b> 17:7 <b>phrase</b> 6:3 9:7,15 <b>picked</b> 5:12 30:16 50:1 <b>piece</b> 10:25 <b>pieces</b> 10:1 <b>place</b> 11:22 18:19 22:18 36:20 40:8 49:1 <b>plan</b> 3:14 <b>play</b> 14:22 <b>please</b> 3:10 12:18 27:25 <b>plus</b> 22:22 <b>point</b> 8:14 9:9 18:2 21:10 29:2 35:6 36:18 40:1 46:4 48:5,16,23 52:23</p>	<p><b>points</b> 32:20 53:17 <b>policies</b> 20:15,20 <b>pop</b> 54:1,2 <b>portion</b> 51:24 <b>position</b> 37:5,6 38:20,21 <b>possibly</b> 18:22 <b>pounds</b> 22:24,25 <b>PPL</b> 1:3 3:4 37:5 38:24 <b>practice</b> 3:20 23:6 <b>precise</b> 54:5 <b>prediction</b> 29:23 <b>predominant</b> 26:3 38:3,8 39:13,16 42:21 43:3,12,13 <b>predominantly</b> 43:4 <b>present</b> 11:3 46:24 <b>pretty</b> 21:24 56:9 <b>previously</b> 3:13 <b>price</b> 7:10 9:9 22:22 22:23 28:3,17 30:18,20 31:17 40:3 46:19 48:9 53:5,22 <b>prices</b> 3:14,17,17 20:15 <b>price-to-earnings</b> 35:11 40:12 44:16 45:19 <b>price/earnings</b> 45:1 <b>primarily</b> 32:8 <b>principal</b> 39:19 <b>principle</b> 6:12,13 <b>privatize</b> 3:13 <b>privatized</b> 4:6 17:19 17:21 19:6 <b>probably</b> 26:7 35:5 43:1 <b>problem</b> 4:8 20:1 22:9 25:22 32:15 48:25 49:3 <b>process</b> 7:16 <b>products</b> 50:16</p>	<p><b>professors</b> 10:13 <b>professor's</b> 32:20 <b>profit</b> 4:12 5:13 21:7 22:1 31:7,10,10,14 31:17 32:21 33:17 33:18 46:8,11 47:10,16,18 48:3 <b>profitability</b> 15:7 38:17 <b>profitable</b> 37:22,23 53:2 55:21 <b>profits</b> 3:15 4:5,21 5:18 6:18,19 7:2 7:18,21,23 8:23 9:3 10:15 11:14 13:9,10,14,17,23 14:13 15:5,6,7,9 15:22,25 16:1,17 17:2,4 18:5,6,9,17 18:25 19:2,9,11,19 21:15 23:2,7 24:24 24:25 25:4,9,25 26:5,12,21 27:7,12 27:14,16,18 28:3,5 29:19 31:6 33:13 33:15 34:5,17 36:22,25 38:16,16 40:9,22 42:24 43:20 44:24 47:6,9 50:12 52:3,3,4 54:17,19 55:1,11 56:5,9,23 <b>profit-making</b> 9:15 12:13 19:8,9 54:14 54:14,16 <b>projected</b> 11:5,9 <b>promise</b> 4:5,7 <b>promised</b> 4:4 <b>property</b> 11:1,2,4 44:9,14,15,20 45:17 <b>prospective</b> 10:24 <b>prototypical</b> 27:18 <b>provision</b> 6:11</p>	<p><b>proxy</b> 28:18 <b>pulled</b> 7:5 <b>purpose</b> 7:8,14 <b>purposes</b> 8:9,16,20 12:1 <b>put</b> 9:25 17:16 26:4 30:3 32:12 45:22 48:12 <b>p.m</b> 57:18</p> <hr/> <p style="text-align: center;"><b>Q</b></p> <hr/> <p><b>quarter</b> 13:21 14:1 46:16,16 48:8 <b>question</b> 12:25 13:16 17:6 20:24 25:8,21 32:2,3 41:10 42:5 50:8 <b>questions</b> 35:23 <b>quick</b> 53:16 <b>quite</b> 21:5,16 24:6,7 41:12</p> <hr/> <p style="text-align: center;"><b>R</b></p> <hr/> <p><b>R</b> 3:1 <b>railroad</b> 19:13,16,25 24:9 <b>Railtrack</b> 24:10,11 <b>rate</b> 5:24 14:5,9 16:18,18,20 27:10 31:22 32:2 33:3,4 33:4,14 37:1 48:18 48:24 49:10 52:9 55:5,12,18 <b>rates</b> 31:25 <b>ratio</b> 28:4 30:18,20 35:11 40:12 44:17 45:1,19 <b>reached</b> 19:3 <b>read</b> 31:2 <b>ready</b> 53:21 <b>real</b> 26:6 29:6 <b>realization</b> 10:7,9 11:8,10 25:23 50:22</p>	<p><b>realized</b> 26:5 29:21 29:24 43:5 50:24 54:19 <b>really</b> 6:15,21 7:16 8:23 9:17 12:21,22 16:3 17:5 21:21 22:12 23:20 25:1 28:20,23 29:12 31:20,23 32:5 41:21 48:10 53:19 <b>reason</b> 10:22 12:12 15:15 16:4,13 18:23 19:5 30:7 57:12 <b>reasonably</b> 17:22 <b>reasons</b> 9:11 40:23 <b>reassess</b> 9:2 <b>rebuttal</b> 2:8 53:14 53:17 <b>recalculate</b> 9:2 <b>receipts</b> 43:6 50:25 54:20 <b>received</b> 35:14,18 37:24 40:17 48:9 52:22 <b>reconstructed</b> 49:10 <b>record</b> 53:18 <b>reduce</b> 20:17 <b>reducing</b> 3:16 <b>reflect</b> 54:20 <b>reformulate</b> 32:15 32:17 <b>reformulated</b> 32:21 45:20 <b>reformulation</b> 45:21 <b>regime</b> 16:24 17:2 17:10 <b>regulated</b> 16:6 <b>regulation</b> 6:2,8 10:10 11:8 24:19 34:14 39:2,22 42:1 42:5,6,8,10,14,19 43:3 51:4,10,12 54:18</p>
---	--	---	--	--

<p><b>regulations</b> 55:15  <b>regulatory</b> 6:3 10:6            16:16,23 17:1,10            17:24 19:1 20:14            20:20 41:25 42:23            42:25 43:15 55:13  <b>reinforces</b> 36:9  <b>relate</b> 29:17  <b>relation</b> 37:23  <b>relationship</b> 22:16  <b>relatively</b> 16:21  <b>relevant</b> 30:8 50:8  <b>relies</b> 25:25  <b>remainder</b> 27:19  <b>remaining</b> 53:13  <b>remember</b> 6:1 17:13  <b>remind</b> 20:25  <b>rental</b> 43:9  <b>rents</b> 11:2  <b>reply</b> 31:24  <b>reported</b> 7:21 19:9            54:17 56:8,15  <b>reporting</b> 52:7  <b>represents</b> 56:21  <b>require</b> 50:25  <b>requirement</b> 11:7  <b>requirements</b> 10:7            42:23,25 43:15  <b>requires</b> 50:23  <b>reserve</b> 27:19  <b>reserved</b> 52:14  <b>respect</b> 15:8 18:13            18:20 20:11 41:24  <b>respects</b> 55:17  <b>Respondent</b> 1:19            2:7 27:23  <b>response</b> 32:11  <b>rest</b> 18:23 31:17  <b>result</b> 15:23 18:11            18:11 55:4  <b>retroactive</b> 10:5  <b>retrospective</b> 8:2            9:21  <b>retrospectively</b> 9:24</p>	<p><b>return</b> 30:23  <b>Revenue</b> 1:6 3:5  <b>rewrite</b> 42:21 43:14  <b>rewritten</b> 40:21  <b>re-jiggered</b> 3:18  <b>right</b> 7:6,10 14:3,14            14:18,21,21 16:2            18:12,16 19:10            20:6,9,11 21:3,3            21:14,14 22:3 24:3            26:2,16 29:14            30:19 33:21,22            36:2 37:7,11,13            38:10 47:2,2 48:14            49:22,25  <b>rightly</b> 4:17  <b>risky</b> 30:1,4  <b>ROBERTS</b> 3:3 13:1            27:20 35:19,22            36:10,14 37:2 38:1            42:12,16 43:16            44:6,13,25 45:3,6            45:10 53:12 57:15  <b>role</b> 14:23  <b>room</b> 51:11  <b>rubric</b> 9:13  <b>rule</b> 10:13,16 12:1            17:14 25:8 57:10            57:12  <b>run</b> 55:13</p> <hr/> <p style="text-align: center;"><b>S</b></p> <hr/> <p><b>S</b> 2:1 3:1  <b>satisfy</b> 54:17  <b>savings</b> 3:18  <b>saw</b> 31:8  <b>saying</b> 8:11 11:1            22:3 25:14,24            28:11 33:1 37:10            37:14 38:2,11,12            38:13 39:16 43:20            44:17  <b>says</b> 4:17 5:3 6:9 8:4            10:10 21:2 24:19</p>	<p>28:24 32:4 34:9            38:19 39:2,22            42:13,14,20 46:12            47:10  <b>Scalia</b> 17:8 28:8,14  <b>Sea</b> 6:20  <b>second</b> 20:24 21:1,2            31:4 47:20  <b>Section</b> 52:13 53:10  <b>see</b> 4:8 21:18 22:6            22:16 31:11,13  <b>seen</b> 55:22  <b>seize</b> 31:17  <b>semi</b> 31:3  <b>sense</b> 53:9 54:15  <b>set</b> 41:25 43:23  <b>share</b> 22:22,23 29:8  <b>shareholders</b> 30:3            30:22  <b>shares</b> 4:3 7:9 22:23            22:25  <b>shoe</b> 57:12  <b>short</b> 15:19,24 39:9  <b>shorter</b> 16:10  <b>showed</b> 31:22  <b>shows</b> 30:2 32:17            35:14 36:19 37:18            37:21  <b>side</b> 7:17 24:6  <b>significant</b> 39:10  <b>similar</b> 22:18 27:17            36:22  <b>simple</b> 56:24  <b>simplified</b> 5:4  <b>simplify</b> 25:16  <b>simply</b> 11:14 46:10            52:16  <b>single</b> 24:8  <b>sit</b> 27:13  <b>situation</b> 6:17  <b>six</b> 31:19,21 34:11            35:3,4 36:24  <b>sixth</b> 35:3  <b>slightly</b> 22:15</p>	<p><b>slippery</b> 10:19  <b>slope</b> 10:19  <b>small</b> 16:21  <b>sold</b> 28:10,16,23            35:17 50:16 53:5,7  <b>solely</b> 44:6,7  <b>Solicitor</b> 1:17  <b>solution</b> 28:24  <b>somebody</b> 7:5 48:25  <b>sorry</b> 12:17 35:21            41:2 49:18  <b>Sotomayor</b> 4:8 5:2            5:15,21 6:7 7:15            10:12 11:12,17            12:4 20:1,7 25:7            25:13,20,24 26:14            26:17 35:20 37:4  <b>Sotomayor's</b> 20:24  <b>sounds</b> 45:6,8,11  <b>so-called</b> 46:24  <b>specific</b> 4:25  <b>specifically</b> 15:17            19:13  <b>start</b> 32:15 42:22  <b>starters</b> 10:4  <b>starting</b> 43:6  <b>stated</b> 7:10  <b>States</b> 1:1,12 27:14            40:13 45:16  <b>State-owned</b> 3:13  <b>statute</b> 5:12 7:6,8            24:20  <b>statutory</b> 43:14  <b>stipulated</b> 24:4,23  <b>stock</b> 9:9 11:23            28:17 40:3 53:21  <b>streams</b> 11:10 54:16  <b>study</b> 50:3  <b>subject</b> 17:9,12            18:10 30:25 36:5  <b>subjected</b> 18:5  <b>submitted</b> 57:17,19  <b>subsequent</b> 10:11  <b>subsequently</b> 7:20</p>	<p><b>Subsidiaries</b> 1:3 3:4  <b>subsidiary</b> 51:20  <b>substance</b> 7:13 8:19            19:7 35:15 36:9            40:18 52:18,25            57:4,9,11  <b>substantive</b> 8:9            16:11  <b>subtract</b> 21:22 27:6            31:14 46:15,16            48:8 52:12 56:21  <b>subtracted</b> 40:4  <b>subtracting</b> 35:17            40:17 43:7 52:21  <b>subtracts</b> 35:13  <b>success</b> 3:24  <b>suggest</b> 39:12  <b>suggesting</b> 8:11  <b>suggests</b> 55:17  <b>sui</b> 54:12  <b>support</b> 37:17  <b>suppose</b> 7:7,22 8:25            9:1 11:3 26:22            54:24  <b>supposed</b> 20:19            51:9  <b>Supreme</b> 1:1,12  <b>sure</b> 30:1 39:7 56:6            56:9  <b>surely</b> 27:16  <b>SWEB</b> 51:20  <b>system</b> 34:23</p> <hr/> <p style="text-align: center;"><b>T</b></p> <hr/> <p><b>T</b> 2:1,1  <b>table</b> 11:11  <b>take</b> 5:3 8:17 13:17            13:24 21:22 25:16            31:12,13 47:16,21            47:22,23  <b>taken</b> 12:15 22:5            35:8 46:19  <b>takes</b> 21:15 35:9            54:15</p>
--	---	--	---	---



<p><b>talk</b> 5:19,23 7:18,19 12:8,20 <b>talking</b> 11:9 16:9 <b>taxation</b> 40:25 <b>taxed</b> 9:7 20:8 22:4 34:2,4 54:3 <b>taxes</b> 6:12 8:16 12:2 14:5 15:12 18:5,10 24:11 27:16 34:14 38:15,16,17 40:11 50:13,14 52:5,14 <b>taxing</b> 15:7,9 19:7 23:7 32:16 44:5 53:1 <b>taxpayer</b> 43:10 50:18,24 52:10 <b>taxpayers</b> 6:9 <b>taxpayer's</b> 50:8 <b>tears</b> 18:1 <b>technical</b> 41:18 <b>tell</b> 10:18,20 31:15 <b>telling</b> 46:9 <b>tells</b> 9:16 <b>tempted</b> 41:19 <b>ten</b> 26:6 <b>tend</b> 41:19 <b>ten-factor</b> 26:5 <b>term</b> 19:7 21:1,2 31:4,9,9 45:22,23 46:5,6,9 <b>terms</b> 5:14 9:16 12:13 19:8,9 54:14 54:14,16 <b>test</b> 26:5 43:4,13,15 50:22 54:17 <b>testing</b> 42:22,25 <b>tests</b> 41:25 <b>Thank</b> 27:20 53:11 53:12,16 57:14,15 <b>Thatcher</b> 3:12 <b>theory</b> 16:25 20:13 54:7 <b>they'd</b> 14:8,9 <b>thing</b> 7:5 10:19</p>	<p>13:11 14:3 26:10 27:3,9,13 29:25 30:6 32:7 41:17 45:9 55:21 <b>things</b> 5:25 15:2 25:20 31:6 50:13 56:1 <b>think</b> 6:11 7:15,22 8:4 10:3,4 14:15 19:6,16 22:13,14 22:15,17,18 25:11 25:21 28:24 32:14 34:25 35:1,14 36:2 36:15 37:13,15 38:23 39:18,21 40:1,15 41:12,13 42:7 43:21,24 44:2 44:9,20,22,22 45:22,22 48:15 51:6,9,11 52:23 54:24 55:9 56:12 56:16,17,18 <b>thinking</b> 41:18 <b>thinks</b> 40:19 41:17 53:2 <b>third</b> 32:7 <b>thought</b> 18:2 19:2 25:21 30:23 31:4 38:1 42:2 <b>three</b> 5:16 16:15 17:4,10,23 19:21 20:3 41:25 42:22 42:25 43:15 <b>threshold</b> 7:2,3 15:9 15:9 16:21 <b>thumb</b> 12:1 <b>time</b> 5:5,6 9:20 11:21 12:7 15:19 15:22,24 18:11 27:19 31:25 39:9 46:1 48:25 <b>times</b> 13:25 14:13 14:17 16:1 21:5,9 21:10 31:5 40:11</p>	<p>44:16 45:19,24 46:5 47:12,14 <b>total</b> 13:10 15:5 34:5 38:16 47:16 <b>totally</b> 33:5 38:25 39:3 <b>tough</b> 17:22 <b>track</b> 19:13,16,25 <b>trading</b> 54:3 <b>transcript</b> 50:3 <b>transform</b> 28:6 <b>Treasury</b> 42:5 <b>treat</b> 41:7,11 <b>treated</b> 41:4 52:5 <b>treats</b> 10:7 <b>treaty</b> 34:21 <b>tricky</b> 7:5 <b>triple</b> 28:22 <b>true</b> 6:9 13:13,17 18:4,7,13,22 23:22 23:25 24:2 30:5,13 33:23,24 42:15,18 <b>truth</b> 21:7 <b>try</b> 10:25 26:21 53:2 <b>trying</b> 15:4,5 16:4,7 18:24,24 24:15 28:15 29:3 32:17 32:18 36:20 37:19 40:16 52:19 <b>twice</b> 21:17,19 48:22 49:11 51:18 <b>two</b> 5:16,25 12:5,10 12:14,15 13:18 15:2 16:9 17:2,3 17:10,23 18:21 21:22 25:20 31:13 31:15,18 32:4 33:19 48:4,7 49:17 <b>two-year</b> 48:11 <b>typical</b> 13:23 28:4 40:11</p>	<p><b>ultimately</b> 56:12 <b>undermining</b> 20:2 <b>understand</b> 31:3 32:11 <b>understanding</b> 55:21 <b>understood</b> 7:16 53:20 <b>undervalued</b> 55:3 <b>uniform</b> 3:24 <b>unique</b> 54:12 <b>uniquely</b> 9:12 12:2 <b>United</b> 1:1,12 27:14 40:13 45:16 <b>universe</b> 46:3 <b>unmodified</b> 54:13 <b>use</b> 6:3 9:6,15 11:15 18:24 26:18 29:15 29:15,16,19 40:11 45:13 54:1 <b>uses</b> 10:15 25:8 <b>usually</b> 41:4,13 <b>utilities</b> 3:13 4:6 22:24 <b>utility</b> 4:1 <b>U.K</b> 52:20,25 53:4 <b>U.S</b> 8:8,23 34:9,13 34:15,16 52:15 53:9</p>	<p>36:19 37:16,17 39:7 40:9 44:23 <b>variables</b> 12:9,11 25:17 <b>varies</b> 46:3 <b>various</b> 10:2 <b>vary</b> 31:25,25 46:2 <b>vast</b> 38:5 <b>view</b> 9:4 22:10 <b>views</b> 43:2,3 <b>vis-à-vis</b> 7:19,20</p>
				<hr/> <p><b>W</b></p> <hr/>
				<p><b>wait</b> 13:1 33:16,16 33:17,17 <b>want</b> 4:12 8:5 10:14 10:16,19,25 11:13 17:15,16,16 22:9 23:3,4 24:6,7 25:2 26:4 30:25 31:1,2 32:12 34:10,10,12 47:12 50:6 53:23 <b>wanted</b> 15:19 20:22 20:22 53:19,23 54:5 56:2,3,6 <b>war</b> 52:3 <b>warned</b> 10:12 <b>Washington</b> 1:8,15 1:18 <b>wasn't</b> 49:3 50:7 <b>way</b> 4:9,11,23,23,24 4:25 5:3 6:2 8:5 10:20 13:4,5,11 15:6,11,16 19:19 20:12 22:15,19 25:9,17 26:1,22 28:4,8 31:19 36:23 38:8 39:17 40:8,14 42:17 43:20 44:10 44:14 46:21 51:3,4 52:18 <b>Wednesday</b> 1:9 <b>weird's</b> 9:16 <b>went</b> 29:8,9 51:3,4</p>
				<hr/> <p><b>V</b></p> <hr/>
				<p><b>v</b> 1:5 3:4 6:11 37:5 <b>valuation</b> 10:20,21 10:23 11:20,21,25 25:22 26:7 28:5 35:8 40:3 43:19 44:3 45:13,24 52:17 <b>valued</b> 7:9 21:8,10 <b>values</b> 28:10 <b>value-making</b> 5:14 <b>valuing</b> 4:2 <b>variable</b> 14:20 18:12,16,18 28:5</p>
				<hr/> <p><b>U</b></p> <hr/>
				<p><b>UK</b> 37:24</p>

<p><b>weren't</b> 17:9,11,12  <b>We'll</b> 3:3  <b>we're</b> 5:9 38:12,12              43:20 46:4  <b>win</b> 10:14  <b>windfall</b> 4:7 24:24              28:1 41:7 51:14,22              52:15 53:6  <b>wipe</b> 47:15  <b>wonder</b> 11:23  <b>word</b> 54:2  <b>words</b> 14:12 15:18              32:12 44:14  <b>worked</b> 3:20 27:15              39:5  <b>working</b> 28:25  <b>works</b> 17:18 27:12  <b>world</b> 11:22 30:11              53:1  <b>worth</b> 11:23 21:12              31:5,5,14,15,20              48:7  <b>wouldn't</b> 7:12 18:16              29:20 33:5 38:5              51:5 54:9 55:23              56:1  <b>written</b> 18:17 40:14              50:2 52:17,18  <b>wrong</b> 4:22 8:12              10:22,23 26:1,2              37:10,14,15 38:2              38:12 41:22 48:13  <b>wrote</b> 40:21,24</p> <hr/> <p style="text-align: center;"><b>X</b></p> <hr/> <p><b>x</b> 1:2,7</p> <hr/> <p style="text-align: center;"><b>Y</b></p> <hr/> <p><b>year</b> 8:7 13:21 14:6              17:23,23 18:19              21:11,17,19,21              26:25 33:18 34:19              34:21,23,23 35:3              43:19,20,23,24</p>	<p>49:15,16,21 50:13              50:17  <b>years</b> 3:12 8:15              13:20 14:6 16:16              17:1,14 18:19              19:22 20:3 21:7,12              21:16,23 23:10,21              27:1,6 28:11 31:5              31:5,13,15,18              33:19 34:11 35:3,4              40:22 42:24 47:13              48:7 49:17,21,24              51:22,25 54:17,25              55:1,1,23 56:8,14              57:2  <b>year's</b> 22:1 44:19              45:18</p> <hr/> <p style="text-align: center;"><b>\$</b></p> <hr/> <p><b>\$20</b> 43:22</p> <hr/> <p style="text-align: center;"><b>0</b></p> <hr/> <p><b>0</b> 55:19</p> <hr/> <p style="text-align: center;"><b>1</b></p> <hr/> <p><b>1</b> 55:19  <b>1/4</b> 56:19  <b>1/9th</b> 19:11 23:8              33:13  <b>10</b> 27:6 43:25  <b>100</b> 55:5,12  <b>100-and-some</b>              48:22  <b>11</b> 21:10  <b>11:17</b> 1:13 3:2  <b>12-43</b> 1:4 3:4  <b>12:14</b> 57:18  <b>1461</b> 5:11  <b>18</b> 31:23  <b>1917</b> 27:14  <b>1918</b> 27:15  <b>1990</b> 12:3 17:19              28:17 29:4 53:24  <b>1997</b> 17:20 51:22  <b>1998</b> 51:22</p>	<hr/> <p style="text-align: center;"><b>2</b></p> <hr/> <p><b>2</b> 21:7,12,16,23              22:24,25 23:21              26:25 27:6 28:11              31:5,5 45:25 46:4              46:4,10,11 47:6,24              48:17,18 54:25              55:1,22  <b>2-year</b> 22:4,5  <b>2.2</b> 47:25  <b>20</b> 1:9 17:14 54:1,2  <b>2013</b> 1:9  <b>207</b> 32:23 33:12              49:21  <b>23</b> 21:5 22:17 31:4              45:23 47:21,23,23  <b>27</b> 2:7</p> <hr/> <p style="text-align: center;"><b>3</b></p> <hr/> <p><b>3</b> 2:4  <b>30</b> 54:7  <b>35</b> 34:10 52:11  <b>365</b> 47:12,14</p> <hr/> <p style="text-align: center;"><b>4</b></p> <hr/> <p><b>4</b> 23:10 32:22 47:16              47:17 53:13 54:17              54:25 56:8,17,19  <b>4-year</b> 8:3  <b>4/9ths</b> 7:3 15:14              22:19 23:3 40:22  <b>40</b> 22:24,25</p> <hr/> <p style="text-align: center;"><b>5</b></p> <hr/> <p><b>50</b> 48:20 49:7,16,20  <b>51</b> 48:23  <b>51.75</b> 7:2 22:19 23:7              40:21 42:24 49:11              49:23  <b>52</b> 19:11  <b>53</b> 2:10</p> <hr/> <p style="text-align: center;"><b>6</b></p> <hr/> <p><b>6</b> 21:19,19 22:4              23:13</p>	<p><b>60</b> 54:7  <b>64a</b> 23:5</p> <hr/> <p style="text-align: center;"><b>7</b></p> <hr/> <p><b>75</b> 8:15 57:2</p> <hr/> <p style="text-align: center;"><b>9</b></p> <hr/> <p><b>9</b> 21:9,10 28:12              29:18 30:8,14 31:5              32:8,23 45:24              46:18 47:23 48:10              56:17  <b>901</b> 52:13 53:10  <b>96</b> 17:21</p>
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