Exhibit No.:	
Issue:	ISRS Income Taxes
Witness:	James A. Fallert
Type of Exhibit:	Rebuttal Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GO-2004-0443

LACLEDE GAS COMPANY

GO-2004-0443

REBUTTAL TESTIMONY

OF

JAMES A. FALLERT

REBUTTAL TESTIMONY OF JAMES A. FALLERT

General Information/Qualifications

Q. Please state your name and business address.

A. My name is James A. Fallert, and my business address is 720 Olive Street, St. Louis, Missouri 63101.

Q. What is your present position?

A. I am Controller for Laclede Gas Company ("Laclede" or "Company").

Q. Please state how long you have held your position and briefly describe your responsibilities.

A. I was appointed to my present position in February 1998. In this position, I am directly responsible for the Company's customer accounting functions, and also participate in the preparation and review of financial statements, budgets, and financial plans.

Q. What is your educational background?

A. I graduated from Southeast Missouri State University in 1976 with the degree of Bachelor of Science in Business Administration, majoring in administrative management. In 1981, I received a Master's Degree in Business Administration from Saint Louis University.

Q. Will you briefly describe your experience with Laclede prior to becoming Controller?

A. I joined Laclede in July 1976, and held various staff and supervisory positions in the Methods and Procedures Department, Internal Audit Department, and Budget Department until April 1988, when I was promoted to the position of Manager of

Budget and Financial Planning. I held this position until being promoted to Manager of Financial Services in February 1992. I was elected Controller effective February 1, 1998.

Q. Have you previously filed testimony before the Missouri Public Service Commission ("Commission")?

A. Yes, I have, in Case Nos. GR-90-120, GR-92-165, GR-94-220, GR-96-193, GR-98-374, GR-99-315, GR-2001-629, GR-2002-356 and GT-2003-0117.

Purpose of Testimony

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to respond to the direct testimony and memorandum submitted in this case by Staff witness Steven M. Rackers on the issue of whether certain tax deductions associated with Laclede's ongoing construction activities should be reflected in the calculation of the Company's Infrastructure System Replacement Surcharge ("ISRS"). As discussed below, I believe it is fundamentally inappropriate to reflect such deductions for three main reasons.

Q. Please summarize why you have reached that conclusion.

A. First, contrary to what Mr. Rackers implies in his direct testimony and memorandum, the financial benefit of these tax deductions has already been recognized in the Company's rates and flowed through to its customers as a result of the Company's last general rate case proceeding. Accordingly, Staff's attempt to reflect such deductions again as a part of the ISRS calculation amounts to a classic "double dip" – a result that Staff has previously characterized as unfair and inconsistent with the spirit and intent of the legislation authorizing an ISRS. Second, in contrast to the way the ISRS Statute works for all other cost and revenue items, the Staff's approach for calculating taxes uses neither a known actual number, nor a method for estimating this item that can actually be found in the Statute. In view of this consideration, I do not see how one could conclude that such tax deductions are a factor that the ISRS legislation intended the Commission to consider in calculating the amount of an ISRS. Finally, Staff's attempt to recognize these deductions twice – once in current rates and again in the calculation of the ISRS – has the effect of imposing a financial penalty on the Company for utilizing its experienced union employees to perform this safety-related work. Obviously, we do not believe that it benefits either our customers or our employees to seek, let alone adopt, adjustments that artificially discourage the Company's use of its own union employees to perform such work.

Q. Is this issue also being addressed by another Company witness?

A. Yes. In addition to the reasons discussed in my testimony, Company witness Glenn Buck also addresses a number of other considerations that warrant rejection of Staff's proposed adjustment to the Company's ISRS filing.

<u>Recognition of Tax Deductions in Rates</u>

Q. Please describe the tax deductions that have been inappropriately included by Staff in its ISRS calculation.

A. These deductions fall into two categories:

1. Transfer of Services from Old to New Mains: This is the cost of transferring a service line from a retired main to a replacement main. These costs are capitalized on the Company's books, but expensed for income tax purposes.
2. Various costs capitalized for tax purposes pursuant to the provisions of the Internal Revenue Code (commonly referred to as "Section 263A"): Costs that are capitalized on the Company's books are generally larger in amount than those capitalized for income tax purposes. One example of such a cost is Administrative and General salaries and expenses, which are capitalized on the books to a greater extent than required in the tax code.

Q. What has been the ratemaking treatment of these items in the past?

A. These tax deductions associated with transfer of services and Section 263A items have been recognized in the Company's rates and flowed through to customers as they occur.

Q. Were these items recognized in rates in the Company's most recent general rate case, No. GR-2002-356?

A. Yes.

Q. What is the impact of Staff's proposal to reduce the ISRS by the amount of these deductions?

A. Staff's approach effectively recognizes these deductions twice, first in the current base rates, and again in the calculation of the ISRS rates.

Q. But aren't the deductions in the current rates related to different capital expenditures than those included in the ISRS, which occurred after the current rates went into effect?

A. It is important to understand that the tax deduction included in current rates is based on an annual level of ongoing construction activity, not a deduction related to any particular period's activity. As such, the inclusion of this deduction in the rates established in GR-2002-356 recognized that such construction activity would continue going forward. Staff's inclusion of this deduction again in the ISRS calculation produces a double-count of the deduction.

Q. What was the amount of these deductions included in rates in GR-2002-356?

A. Attached as Schedule I to my testimony is a copy of Accounting Schedule 11 from Staff's filing in Case No. GR-2002-356. This schedule details Staff's calculation of income taxes in the case. Line 20 of this schedule includes a subtraction from net income of $3,165,000 for A&G Expense Capitalized (i. e., Section 263A deductions). Line 21 of this schedule includes a subtraction from net income of $1,069,000 for Transfer of Services.

Method of Calculating Tax Deductions Effects

Q. Is the consideration and calculation of tax deductions reflected in Staff's approach different from the consideration and calculation of other cost or revenue items addressed by the ISRS Statute?

A. Yes. In addressing the consideration and calculation of cost and revenue items, the ISRS Statute does two things in order to expedite the processing of an ISRS filing and avoid the interjection of other factors that would defeat that goal. Specifically, it either specifies that a known cost, such as the costs of ISRS-eligible investments, be used in calculating ISRS revenues or it describes a very specific method for how the cost or revenue item should be estimated. The method for determining the weighted cost of capital to be used in calculating ISRS revenues is one example of the latter.

Q. What significance does this have in terms of the appropriateness of Staff's proposed method for addressing taxes?

A. In contrast to the approach taken in the ISRS Statute, Staff's approach for determining the level of tax deductions to be considered by the Commission neither uses a known actual number nor a method that is actually described in the ISRS Statute for arriving at a number. In fact, the Staff had to invent an entirely new method to implement its approach and arrive at its number. In view of this circumstance, I do not see any basis for concluding that such deductions are a factor that the ISRS statute intended to be considered.

<u>Penalty for Using Its Own Employees</u>

Q. You previously indicated that Staff's attempt to recognize the tax deductions associated with its ISRS investments has the effect of imposing a financial penalty on the Company for utilizing its own experienced union employees to perform this safety-related work. Please explain what you mean.

A. When Laclede uses its own employees to construct capital assets, section 263A of the Internal Revenue Code (26 U.S.C. §263A) and applicable IRS regulations dictate the Administrative and General costs that Laclede must capitalize. The remainder may be expensed and deducted for tax purposes. Section 263A operates to permit Laclede to expense and deduct up front for tax purposes a greater share of the Administrative and General costs than it expenses for book purposes. This creates an up front tax savings, which does not benefit Laclede, but is flowed through to customers each year through lower rates. However, if, as Staff recommends, Laclede must flow through this up front tax benefit a second time, this "double dip" would actually penalize Laclede for using its own employees to construct assets.

Q. What is the tax benefit if Laclede used independent contractors to construct assets?

A. There would be no tax benefit, because the amount paid to the contractors would be capitalized both for tax purposes and on Laclede's books. Thus, there would be no difference between the amounts expensed for tax purposes and book purposes.

Q. So how does the Staff's position penalize the Company for utilizing its in-house union employees to perform safety-related work?

A. With outside contractors, there would be no up front tax benefit, and therefore no opportunity to double count it. There would be no positive or negative up front tax effect associated with construction. With in-house employees doing construction work, Laclede would receive an up front tax benefit once, but pay it out at least twice, resulting in an actual financial loss from the use of such employees.

Q. Do you believe such a result is appropriate?

A. Of course it's not appropriate. There are many factors that can and should influence whether a company uses its own employees to perform a particular work function or instead out-sources that work to an independent contractor. There is no justification, however, for creating the kind of artificial and punitive disincentive for using in-house employees that Staff's approach to this issue would clearly establish.

Q. Isn't it possible, however, that this kind of result, no matter how unfair or inappropriate, is required by the legislation that authorized the ISRS?

A. Absolutely not. A disincentive to use in-house union employees is in no way required or even contemplated by such legislation. Instead, it is simply the result of a Staff method that diminishes the value of the ISRS mechanism by proposing calculations and adjustments that are completely at odds with the ISRS Statute. For all of these reasons, Staff's approach should be rejected.

Q. Does this conclude your testimony?

A. Yes.

Laclede Gas Company
Case No. GR-2002-356
Test Year Ending November 30, 2001 Updated Through March 31, 2002

Income Tax
(000)

Line	Description	Test Year	7.37% Return	7.58% Return	7.79% Return
	(A)	(B)	(C)	(D)	(E)
1	Net Operating Income (Acctg. Sch. 1)	$ 51,922	$ 45,908	$ 47,216	$ 48,524
2	Add:				
3	Current Income Tax	12,972	9,225	10,040	10,855
4	Deferred Income Taxes				
5	Deferred Income Tax Expense- Dr	6,803	6,803	6,803	6,803
6	Deferred Income Tax Expense - Cr	(2,971)	(2,971)	(2,971)	(2,971)
7	Deferred ITC Amortization	(318)	(318)	(318)	(318)
8	Net Income Before Taxes (Acctg. Sch. 9)	$ 68,409	$ 58,647	$ 60,770	$ 62,893
9	Add to Net Income Before Taxes				
10	Book Depreciation and Amortization	25,143	25,143	25,143	25,143
11	Contributions In Aid of Construction	1,610	1,610	1,610	1,610
12	Miscellaneous Non-deductible Expnses	177	177	177	177
13	AAO Amortization	667	667	667	667
14	Total Additions	$ 27,597	$ 27,597	$ 27,597	$ 27,597
15	Subtractions From Net Income Before Taxes				
16	Inventory Overheads Capitalized	1,380	1,380	1,380	1,380
17	Interest Expense @ 3.70%	$ 23,047	$ 23,047	$ 23,047	$ 23,047
18	Tax Straight Line Depreciation	16,561	16,561	16,561	16,561
19	Excess Tax Depreciation	15,147	15,147	15,147	15,147
20	A&G Expense Capitalized	3,165	3,165	3,165	3,165
21	Transfer of Services	1,069	1,069	1,069	1,069
22	Laclede Pipeline	282	282	282	282
23	Cost of Removal	2,943	2,943	2,943	2,943
24	Total Subtractions	$ 62,214	$ 62,214	$ 62,214	$ 62,214
25	Net Taxable Income	$ 33,791	$ 24,030	$ 26,153	$ 28,276

Laclede Gas Company
Case No. GR-2002-356
Test Year Ending November 30, 2001 Updated Through March 31, 2002

Income Tax
(000)

Line	Description (A)		Test Year (B)	7.37% Return (C)	7.58% Return (D)	7.79% Return (E)
26	Provision For Federal Income Tax					
27	Net Taxable Income (Page 1)		$ 33,791	$ 24,030	$ 26,153	$ 28,276
28	Deduct:					
29	Missouri Income Tax	100.00%	1,762	1,253	1,363	1,474
30	City Income Tax		0	0	0	0
31	Federal Taxable Income		$ 32,030	$ 22,777	$ 24,790	$ 26,802
32	Federal Income Tax	@ 35.00%	$ 11,210	$ 7,972	$ 8,676	$ 9,381
33	Provision For Missouri Income Tax					
34	Net Taxable Income (Page 1)		$ 33,791	$ 24,030	$ 26,153	$ 28,276
35	Deduct:					
36	Federal Income Tax	50.00%	5,605	3,986	4,338	4,690
37	City Income Tax		0	0	0	0
38	Missouri Taxable Income		$ 28,186	$ 20,044	$ 21,815	$ 23,586
39	Missouri Income Tax	@ 6.25%	$ 1,762	$ 1,253	$ 1,363	$ 1,474
40	Provision For City Income Tax					
41	Net Taxable Income (Page 1)		$ 33,791	$ 24,030	$ 26,153	$ 28,276
42	Deduct:					
43	Federal Income Tax		NA	NA	NA	NA
44	Missouri Income Tax		NA	NA	NA	NA
45	City Taxable Income		$ 33,791	$ 24,030	$ 26,153	$ 28,276
46	City Income Tax	@ 0.00%	$ 0	$ 0	$ 0	$ 0
	Less Tax Credit		0	0	0	0
	City Income Tax		$ 0	$ 0	$ 0	$ 0
47	Summary of Provision For Income Tax					
48	Federal Income Tax		$ 11,210	7,972	8,676	9,381
49	Missouri Income Tax		1,762	1,253	1,363	1,474
50	City Income Tax		0	0	0	0
51	Total Income Tax		$ 12,972	$ 9,225	$ 10,040	$ 10,855

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the matter of the verified application and petition of Laclede Gas Company for establishment of an infrastructure system replacement surcharge	))))	**<u>Case No. GO-2004-0443</u>** Tariff No. YG-2004-1028

<u>AFFIDAVIT</u>

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

James A. Fallert, of lawful age, being first duly sworn, deposes and states:

1. My name is James A. Fallert. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Controller for Laclede Gas Company.

2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony, including any schedules.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Jim A. Fallert
James A. Fallert

Subscribed and sworn to before me this 20th day of May, 2004.

Joan T. Roeper
JOAN T. ROEPER
Notary Public — Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: June 9, 2007