

Exhibit No.:
Issues: *Income Tax Expense; Deferred
Income Taxes-Rate Base Offset;
and Pension Liability*
Witness: *Stephen M. Rackers*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Direct Testimony*
Case No.: *EC-2002-1*
Date Testimony Prepared: *March 1, 2002*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

STEPHEN M. RACKERS

FILED³

MAR 01 2002

**Missouri Public
Service Commission**

**UNION ELECTRIC COMPANY
d/b/a AMERENUE**

CASE NO. EC-2002-1

*Jefferson City, Missouri
March 2002*

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UNION ELECTRIC COMPANY
d/b/a AMERENUE
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DIRECT TESTIMONY
OF
STEPHEN M. RACKERS
UNION ELECTRIC COMPANY
d/b/a AMERENUE
CASE NO. EC-2002-1

Q. Please state your name and business address.

A. Stephen M. Rackers, 815 Charter Commons Drive, Suite 100 B,
Chesterfield, Missouri 63017.

Q. By whom are you employed and in what capacity?

A. I am a Regulatory Auditor V in the Accounting Department, in the
St. Louis Office, for the Missouri Public Service Commission (Commission).

Q. Please describe your educational background.

A. I graduated from the University of Missouri at Columbia, Missouri in
1978, from which I received a Bachelor of Science degree in Business Administration,
majoring in Accounting. I have passed the Uniform Certified Public Accountant
examination and am currently licensed in the state of Missouri.

Q. What has been the nature of your duties while in the employ of this
Commission?

A. I have supervised and assisted in audits and examinations of the books and
records of public utility companies operating within the State of Missouri. I have listed
cases in which I have previously filed testimony on Schedule 1.

1 Q. With reference to Case No. EC-2002-1, have you made an investigation of
2 the books and records of Union Electric Company d/b/a AmerenUE (UE or Company)?

3 A. Yes, with the assistance of other members of the Commission Staff
4 (Staff).

5 Q. What is the purpose of your direct testimony?

6 A. My direct testimony will discuss the following items:

7 1) The Staff's calculation of Income Tax, which appears on Accounting
8 Schedule 11;

9 2) The balance of Deferred Income Taxes, which reduces Rate Base and
10 appears on Accounting Schedule 2; and

11 3) The Pension Liability, which also reduces Rate Base.

12 Q. Have you previously filed direct testimony in Case No. EC-2002-1?

13 A. Yes. I previously filed direct testimony in this case on July 2, 2001
14 addressing the same areas that I will be discussing in this filing.

15 Q. Please list the Accounting adjustments, schedule balances and schedules
16 you are sponsoring.

17 A. I am sponsoring the following Accounting schedule balances, adjustments
18 and schedules:

19 **Accounting Schedule 2 - Rate Base**

20 Deferred Income Taxes

21 Pension Liability

22 **Accounting Schedule 10 - Adjustments to Income Statement**

23 S-33.1 Annualization of Current Income Taxes

S-34.1, S-36.1 and S-37.1 Adjustments to Deferred Income Tax

Accounting Schedule 11 - Income Tax Calculation

INCOME TAX EXPENSE

Q. Please provide a brief discussion of the methodology the Staff has used in its calculation of income tax expense.

A. With the exception of the items that are further discussed below, the Staff is following the methodology that the parties agreed to and used to calculate income tax expense in both of the Company's Experimental Alternative Regulatory Plans (EARPs). The starting point for the Staff's determination of income tax expense is the calculation that the Company presented in the third sharing period of the second EARP, for the year ending 6/30/2001. Changes were made to the following items in that calculation to determine the Staff's annualized level of income taxes: interest expense, net salvage, depreciation expense, uncollectible reserve, legal reserve, injuries and damages reserve and miscellaneous adjustments. In addition to these changes, the Staff has also increased the amount of tax straight-line depreciation.

Q. Please explain the changes to the interest expense, net salvage and depreciation expense items.

A. The Staff has calculated its own level of interest expense based on its recommended capital structure and cost of debt, net salvage expense based on a ten-year average, and depreciation expense based on adjusted plant at September 30, 2001 and on Staff's recommended depreciation rates. The changes to these items synchronize the tax calculation with the Staff's recommendations in these three areas.

1 Q. Please explain the changes to uncollectible reserve, legal reserve and
2 injuries and damages reserve.

3 A. The Company accounts for these three items on an accrual basis. This
4 means that an accrual, or estimate, is charged to expense and also to a reserve. Actual
5 account write-offs, legal cost payments, and payments to settle claims for injuries and
6 damages are charged against these reserves. The Company only receives a tax deduction
7 for the actual accounts written off or expenditures made. As a result, taxable income is
8 either increased or decreased to reflect the difference between the actual accounts written
9 off or expenditures made and the accruals charged to expense. However, the Staff is
10 recommending that uncollectible expense only reflect actual write-offs and that legal
11 expense and injuries and damages expense only reflect actual payments. Therefore, the
12 taxable income, as determined by the Staff, does not need to be adjusted by these changes
13 in reserve levels and the resulting tax effects for the twelve months ended June 30, 2001
14 should be eliminated. The changes to these items synchronize the tax calculation with
15 the Staff's recommendations in these three areas.

16 Q. Please explain the change to miscellaneous adjustment.

17 A. The Company makes the miscellaneous adjustment to bring its starting
18 point for calculating taxable income in line with final booked net income. Since the
19 Staff's case begins with final booked net income for the twelve months ending June 30,
20 2001, this adjustment is unnecessary and has been eliminated from the Staff's
21 calculations.

22 Q. Please explain the adjustment to tax straight-line depreciation.

1 A. The Staff is proposing to calculate tax straight-line depreciation consistent
2 with the calculation of book depreciation expense.

3 Q. Please explain the relationship between tax straight-line depreciation and
4 book depreciation.

5 A. Book depreciation is calculated by multiplying the depreciation rates,
6 approved by the Commission, by the plant-in-service balances. A portion of this amount
7 is expensed and reflected in the income statement as an expense and a reduction to net
8 income. A portion of the amount is also capitalized as part of the cost of construction and
9 included in the plant-in-service balances and appears as an increase in the rate base. The
10 total amount of book depreciation calculated is accumulated in a depreciation reserve,
11 which is a reduction to the rate base. As long as the plant remains in service,
12 depreciation expense associated with the plant will continue to be calculated.

13 For the purpose of calculating income taxes, however, the book depreciation is
14 generally reduced to reflect tax straight-line depreciation. This is required to reflect the
15 fact that the plant balances for book depreciation (book bases) are larger than the plant
16 balances for tax depreciation (tax bases). The difference in book and tax bases generally
17 results from the fact that certain items, for example capitalized payroll taxes, are
18 capitalized for book purposes, but were deducted in the year incurred for tax purposes.

19 An additional reason why tax straight-line depreciation is lower than book
20 depreciation is that UE stops calculating tax straight-line depreciation when the
21 accumulated reserve, for a vintage year, equals the tax basis. For example, assume that a
22 vintage (specific year) had depreciable plant additions of \$1,000,000 and the weighted
23 average book depreciation rate was 10%. UE would recognize \$100,000 in tax straight-

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1 line depreciation annually for 10 years. At the end of year 10, the accumulated tax
2 straight-line reserve would be equal to the tax basis of the property. No additional
3 straight-line tax depreciation would be recognized in year 11 even though the plant
4 investment was still in use and the Company continued to accrue (recognize) book
5 depreciation for financial reporting and ratemaking purposes.

6 Q. Why does book depreciation continue to accrue on plant even though the
7 tax straight-line reserve indicates full recovery of depreciation?

8 A. No attempt is made to track the accumulated book depreciation reserve by
9 year (vintage). Book depreciation continues to accrue for financial accounting and
10 ratemaking purposes until the associated accumulated book depreciation reserve is equal
11 to an entire plant account (all vintage year additions) and the Commission orders a 0%
12 depreciation rate for that account. This method of depreciation is often referred to as
13 mass asset accounting.

14 Q. Why is book depreciation computed on an entire plant balance
15 (all vintages) instead of on an individual vintage basis used in computing tax depreciation
16 and straight-line tax depreciation?

17 A. The mass asset accounting method used for book depreciation simplifies
18 the accounting process. When an asset is retired, no attempt is made to determine the
19 actual accumulated depreciation reserve for that asset. For example, when \$1,000,000 of
20 plant is retired, both the associated plant and accumulated depreciation reserve accounts
21 are reduced by \$1,000,000. This method treats all retired plant as though it was fully
22 depreciated. The theory supporting this treatment is that while some amount of plant will
23 be retired before the end of its depreciable life, an equal amount of plant will be retired

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after its depreciable life. Therefore, in the aggregate, it is assumed that early retirements of plant will be offset by an equal amount of late retirements.

Q. How is the revenue requirement affected by the continued recovery of book depreciation associated with plant that remains in service after its depreciable life and upon which tax straight-line depreciation is no longer calculated?

A. Straight-line tax depreciation is substituted for book depreciation in the calculation of income taxes for ratemaking purposes. Referring to my previous example, book depreciation continued to be calculated in year 11 at \$100,000 while tax straight-line depreciation was \$0 after year 10. Therefore, while book depreciation continues, no associated deduction is available for the calculation of income taxes. The additional revenue requirement borne by customers associated with this situation is calculated below:

	<u>Year 11</u>
1. Revenues	\$ 100,000
2. Book Depreciation	<u>100,000</u>
3. Income before Income Tax	0
Add back:	
4. Book Depreciation	100,000
Subtract:	
5. Straight Line Tax Depreciation	<u>0</u>
6. Taxable Income (Line 3 + 4 - 5)	100,000
7. Income Tax Rate	<u>38.39%</u>
8. Income Tax	38,390
9. Tax Conversion Factor	<u>1.62</u>
10. Revenue Requirement	<u>\$ 62,192</u>

In summary, every dollar of book depreciation included in the cost of service with no corresponding tax straight-line deduction results in approximately an additional \$.62 cash outlay from ratepayers. This additional revenue requirement occurs because a plant

1 asset remains in service longer than the "estimated" life used to compute the book
2 depreciation rate for the asset.

3 Q. What is the Staff's recommendation for calculating tax straight-line
4 depreciation to address this situation?

5 A. The Staff is recommending the elimination of the additional revenue
6 requirement that results from including book depreciation expense in the cost of service
7 without a corresponding tax deduction. This revenue requirement can be eliminated by
8 continuing to calculate tax straight-line depreciation for all plant that is still in service.
9 This treatment is consistent with the calculation of book depreciation.

10 Q. Has this issue been specifically addressed by the Commission?

11 A. Yes. In the St. Joseph Light and Power Company rate case, Case No.
12 ER-93-41, the Commission heard this issue and ruled in favor of the Staff's position.
13 This issue was also presented in testimony in the Laclede Gas Company (Laclede) rate
14 case, Case No. GR-94-220. Although the Commission did not hear the issue in the
15 Laclede case, the Staff's position was adopted by Laclede and is specifically addressed in
16 the Stipulation And Agreement.

17 Q. Has this method for calculating tax straight-line depreciation been
18 consistently used in establishing rates for other utility companies operating in Missouri?

19 A. Yes. The method recommended by the Staff for calculating tax straight-
20 line depreciation is reflected in the rates established for Missouri Gas Energy Company,
21 Laclede Gas Company, Empire District Electric Company, UtiliCorp-Missouri Public
22 Service Division and UtiliCorp-St. Joseph Light and Power Division.

1 Q. Where do the changes to the tax calculation and the additional straight-line
2 depreciation appear?

3 A. The current income tax adjustments related to these changes are included
4 in "Addbacks" and "Other deductions," which appear on Accounting Schedule 11,
5 Income Tax Calculation, lines 9 and 12, respectively. These components are included in
6 the calculation of current income taxes, which appears on line 34 of Accounting
7 Schedule 11. The deferred income tax effects of the changes appear in the related
8 accounting adjustments.

9 Q. Please explain Accounting Adjustments S-33.1, S-34.1, S-36.1 and S-37.1.

10 A. These adjustments appear on pages 7 and 8 of Accounting Schedule 10,
11 Adjustments to Income Statement. The adjustments are determined by subtracting the
12 test year current and deferred income tax amounts appearing on Accounting Schedule 9,
13 Income Statement, from the annualized and adjusted current and deferred income tax
14 amounts. A separate calculation of current income taxes, which incorporates the changes
15 described above and the other adjustments to expenses and revenues proposed by the
16 Staff, appears on Accounting Schedule 11.

17 **DEFERRED INCOME TAXES – RATE BASE OFFSET**

18 Q. What methodology has the Staff used in its determination of the rate base
19 offset for deferred income taxes?

20 A. Consistent with other rate base components in the Staff's case, the offset
21 for deferred income taxes reflects the balance at September 30, 2001. Also, except for
22 four adjustments, the Staff is including the same balances that were recognized and
23 agreed to by the parties in the calculation of income tax expense in both EARPs. The

1 starting point for the Staff's determination of the deferred income taxes – rate base offset
2 is the amount reflected in the calculation of sharing credits for the period ending
3 6/30/2001.

4 Q. Please explain the first three adjustments you are proposing to the deferred
5 tax - rate base offset.

6 A. The first two adjustments eliminate the current year deferred taxes
7 associated with the change in the reserves for legal expense and injuries and damages
8 expense. As previously discussed, the Staff has only included actual payments for legal
9 expenses and injuries and damages claims. This method of recognizing legal expenses
10 and injuries and damages claims has been advocated by the Staff for the last three sharing
11 periods. Therefore, the test year tax effects of these components have been eliminated
12 from the deferred tax balances. The third adjustment eliminates the entire deferred tax
13 balance associated with the change in the uncollectible reserve. Only recognizing actual
14 accounts written off, rather than an estimate of uncollectible accounts, has been the
15 standard historical practice for establishing UE's rates, both in prior rate cases and
16 EARPs. Therefore, the entire deferred tax balance for the change in the uncollectible
17 reserve has been eliminated from rate base.

18 Q. Please explain the fourth component of the adjustments the Staff is
19 making to the deferred taxes - rate base offset.

20 A. The fourth component deals with an adjustment made by the Company to
21 reflect deferred taxes associated with prior periods. This adjustment recognized deferred
22 taxes associated with the years 1992 through 1998. However, the reduction in prior
23 period deferred income tax expense has not been reflected in the determination of the net

1 income that was recognized in rates or in the annual EARP sharing calculations for these
2 years.

3 **PENSION LIABILITY**

4 Q. Please explain the pension liability rate base offset.

5 A. The pension liability rate base offset calculated by the Staff represents the
6 difference between the amount expensed for pensions and the amount paid into the
7 pension fund by the Company. The Staff has included pension expense in the prior
8 years' determination of credits for the EARPs. This level of pension expense has
9 exceeded the amount actually paid into the pension fund by UE.

10 Q. Please explain the relationship between pension expense and funding.

11 A. Prior to the beginning of the initial EARP on July 1, 1995, UE's rates had
12 reflected pension expense on a pay-as-you-go basis, including an amount that reflected
13 actual payments to the pension fund. When the first EARP was established, the method
14 of determining pension expense for ratemaking was changed, in accordance with
15 Commission and Staff policy, to a method based on Financial Accounting Standard
16 Number 87, "Employer's Accounting For Pensions" (FAS 87).

17 Pension expense calculated according to FAS 87 is based on a different
18 calculation than the method used to determine the required level of pension funding. The
19 level of funding is based on a method determined by the Employee Retirement Income
20 Security Act of 1974 (ERISA). Although both methods employ actuarial techniques, the
21 level of pension expense calculated according to FAS 87 can be quite different from the
22 amount required to be funded according to ERISA.

1 For example, using the FAS 87 method, pension expense may be a negative
2 amount. However, the funding requirement for ERISA cannot be less than \$0. The
3 difference between pension expense, according to FAS 87, and the amount funded
4 according to ERISA is accumulated in a pension liability account, if the FAS 87 amount
5 is greater than the ERISA amount, or in a pension asset account, if the FAS 87 amount is
6 less than the ERISA amount.

7 Q. Why is it appropriate to include the difference between the pension
8 amounts calculated according to FAS 87 and ERISA in rate base?

9 A. Including this difference recognizes the accumulated funds, provided by
10 either ratepayers or the Company, that are associated with pensions. If the pension
11 expense included in rates is greater than the level of pension funding, ratepayers have
12 provided cash to UE and the difference should be a reduction to rate base. This is similar
13 to the standard practice of including the accumulated balance of deferred income taxes as
14 a reduction to rate base, since ratepayers are providing funds to the Company in excess of
15 the level of income taxes actually paid. On the other hand, if the pension expense
16 included in rates is less than the level of pension funding, UE has provided the cash
17 necessary to fund pensions in excess of the level included in rates and this difference
18 should be an increase to rate base. This is similar to the standard practice of including
19 prepayments as an increase to rate base, since companies provide the funds to pay for
20 these investments far in advance of when they are reflected in expense.

21 Q. Has the difference between pension expense and funding been reflected in
22 rate base for other companies?

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1 A. Yes. It has become the standard practice of the Staff to reflect this
2 difference in rate base. I have personally participated in rate cases for Missouri-
3 American Water Company, Laclede and St. Louis County Water Company, where the
4 Staff proposed and the Company accepted the inclusion, in rate base, of the difference
5 between the pension expense included in rates and the amount actually funded. For
6 Laclede, the rate base was increased due to including this difference and for the water
7 companies, the rate base was reduced by this difference.

8 Q. How did the Staff determine the amount of the pension liability?

9 A. As previously discussed, the change to accounting for pension expense in
10 rates according to FAS 87 for UE occurred at July 1, 1995. Therefore, the accumulated
11 amount of the difference between the pension expense calculated according to FAS 87
12 and the amount actually funded, from July 1, 1995 through September 30, 2001, the end
13 of the ordered update period, has been included in the determination of rate base.

14 Q. Does this conclude your direct testimony?

15 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service)
Commission,)

Case No. EC-2002-1

Complainant,)

vs.)

Union Electric Company, d/b/a AmerenUE,)

Respondent.)

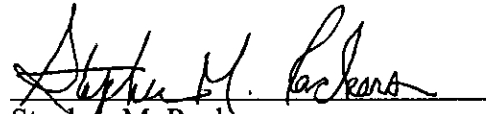
AFFIDAVIT OF STEPHEN M. RACKERS

STATE OF MISSOURI)

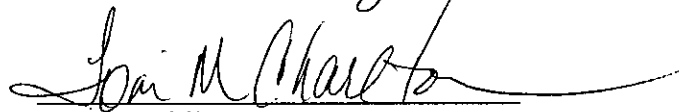
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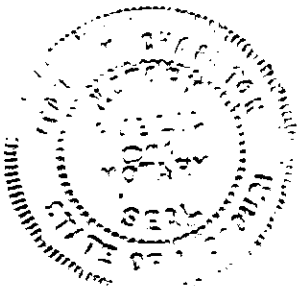
COUNTY OF COLE)

Stephen M. Rackers, is, of lawful age, and on his oath states: that he has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 13 pages to be presented in the above case; that the answers in the foregoing Direct Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.


Stephen M. Rackers

Subscribed and sworn to before me this 28th day of February, 2002.


Notary Public



TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

RATE CASE PROCEEDING PARTICIPATION

STEPHEN M. RACKERS

<u>Company</u>	<u>Case Number</u>
Bowling Green Gas Company	GR-78-218
Central Telephone Company	TR-78-258
Empire District Electric Company	ER-79-19
Fidelity Telephone Company	TR-80-269
St. Louis County Water Company	WR-80-314
Union Electric Company	ER-81-180
Laclede Gas Company	GR-81-245
Great River Gas Company	GR-81-353
Union Electric Company	ER-82-52
Laclede Gas Company	GR-82-200
St. Louis County Water Company	WR-82-249
Union Electric Company	ER-83-163
Union Electric Company	ER-84-168
Arkansas Power and Light Company	ER-85-20
Kansas City Power and Light Company	ER-85-128
Arkansas Power and Light Company	ER-85-265
Union Electric Company	EC-87-114
Union Electric Company	GR-87-62
Southwestern Bell Telephone Company	TC-89-14
St. Louis County Water Company	WR-89-246
Laclede Gas Company	GR-90-120
Missouri Cities Water Company	WR-91-172
St. Louis County Water Company	WR-91-361
Laclede Gas Company	GR-92-165
Missouri Pipeline Company	GR-92-314
St. Louis County Water Company	WR-92-204

<u>Company</u>	<u>Case Number</u>
St. Louis County Water Company	WR-94-166
St. Louis County Water Company	WR-95-145
Union Electric Company	ER-95-411
St. Louis County Water Company	WR-96-263
St. Louis County Water Company	WR-97-382
Laclede Gas Company	GR-99-315
Missouri-American Water Company	WR-2000-281 et al
St. Louis County Water Company	WR-2000-844
Union Electric Company d/b/a AmerenUE	EC-2002-1