Exhibit No.:	
Issue:	**Income Taxes**
Witness:	**Gregory L. Nelson**
Type of Exhibit:	**Supplemental Rebuttal Testimony**
Sponsoring Party:	**Union Electric Company**
Case No:	**EO-96-14**

FILED
MAY 14 1999
Missouri Public Service Commission

MISSOURI PUBLIC SERVICE COMMISSION

Case No. EO-96-14

SUPPLEMENTAL REBUTTAL TESTIMONY

OF

GREGORY L. NELSON

ST. LOUIS, MISSOURI
May, 1999

MISSOURI PUBLIC SERVICE COMMISSION

STATE OF MISSOURI

In the Matter of the Investigation into the Class Cost of Service and Rate Design for Union Electric Company	)))	Case No. EO-96-14

AFFIDAVIT OF GREGORY L. NELSON

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

Gregory L. Nelson, being first duly sworn on his oath, states:

1. My name is Gregory L. Nelson. I work in the City of St. Louis, Missouri, and I am the Vice President and Tax Counsel of Ameren Services Company.

2. Attached hereto and made a part hereof for all purposes is my Supplemental Rebuttal Testimony consisting of pages 1 through 10, including Exhibits 1-2, all of which has been prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. EO-96-14.

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

G. L. Nelson
Affiant

Subscribed and sworn to before me this 12th day of May, 1999.

R. P. Anzalone
Notary Public

R. P. ANZALONE NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

R. P. ANZALONE
NOTARY PUBLIC – STATE OF MISSOURI
ST. LOUIS COUNTY
MY COMMISSION EXPIRES MAY 18, 2000

Supplemental Rebuttal Testimony
of
Gregory L. Nelson
Vice President and Tax Counsel
MPSC Case No. EO-96-14

Q. Please state your name and business address.

A. My name is Gregory L. Nelson, and my business address is 1901 Chouteau Avenue, St. Louis, Missouri, 63103.

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

A. I am employed by Ameren Services Company as Vice President and Tax Counsel.

Q. Please describe your educational background and work experience.

A. I graduated from Vanderbilt University in 1978 with a Bachelor of Arts degree in Business Administration. I also received a Juris Doctor degree from Vanderbilt University in 1981 and a Master of Laws in Taxation from Georgetown University in 1988.

I assumed the position of Manager of the Tax Department of Union Electric Company ("Company") in October, 1995. On December 31, 1997, with the closing of the merger transaction involving the Company and CIPSCO, Inc., I became the manager of the Tax Department of Ameren Services Company. I was elected to my current position in February, 1999. My department is responsible for the federal, state and local tax compliance and planning functions for the Ameren group of corporations, including the Company.

From 1988 through 1995, I was employed by the Washington, D.C. office of the law firm Reid & Priest. My responsibilities at Reid & Priest were representing and counseling electric utilities and the Edison Electric Institute, the trade association of investor-owned electric utilities, on taxation matters. From 1984 through 1988, I was a trial attorney for the Tax Division of the United States Department of Justice in Washington, D.C. From 1982 through 1984, I was an Assistant Attorney General for the State of Tennessee. From 1981 through 1982, I was a tax consultant with Touche Ross and Company in Nashville, Tennessee.

I am a member of the Missouri, District of Columbia and Tennessee bars.

Purpose of Testimony

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to rebut portions of the direct testimony of Commission Staff witness Stephen M. Rackers concerning Staff's proposed adjustments related to federal income taxes in connection with the computation of the sharing credits in the third year of the Experimental Alternative Regulation Plan ("EARP") for the Company approved in Case No. ER-95-411.

Proposed Adjustment Regarding the Debt Component of AFUDC

Q. What adjustment is Mr. Rackers proposing at page 12, line 14 through page 13, line 6?

A. Mr. Rackers is proposing to include the debt portion of the allowance for funds used during construction ("AFUDC") as a deduction in the calculation of current income taxes for purposes of the EARP.

Q. Do you agree with this proposed adjustment?

A. No. Mr. Rackers' adjustment has the effect of providing for the deduction of the same interest twice in computing current income taxes. Such a double deduction is not permitted by the tax law and is not reflected on the Company's tax returns or on its books.

Q. What is AFUDC?

A. AFUDC is a term used in the utility industry to describe a utility's carrying costs for construction work in progress. AFUDC includes both debt and equity components.

Q. Describe the Company's ratemaking and financial accounting treatment of AFUDC.

A. The Company follows the electric utility industry practice of capitalizing both the debt and equity portions for recovery through future rate revenues. Specifically, the Company:

- Records all interest on its long-term debt, including interest on the debt component of AFUDC, as an expense.
- Records the debt and equity components of AFUDC as non-operating income.

Q. Describe the federal income tax treatment of equity and interest.

A. Costs of equity are not deductible for federal income tax purposes. Interest is either deductible as incurred or capitalized for federal income tax purposes.

Q. What is the difference between the book treatment and tax treatment of the debt component of AFUDC?

A. The same amount will ultimately be recovered for book and tax purposes (*i.e.*, recorded as a book expense and claimed as a deduction in computing taxable income), but the timing of that recovery will be different. Essentially, interest is deducted sooner for tax purposes than it is expensed for book purposes.

Q. How does the Company show the differences between the book treatment and tax treatment of items on its federal income tax returns?

A. The Company shows its book/tax differences on Schedule M-1 of its annual federal income tax return. Schedule M-1 requires the taxpayer to reconcile its book income and taxable income. This reconciliation is accomplished by identifying book/tax differences in the following four different categories:

- Income that is subject to tax, but not recorded on the books;
- Expenses that are recorded on the books, but not deducted on the return;
- Income recorded on the books, but not subject to tax; and
- Deductions on the return, but not expensed on the books.

Items in these categories are referred to as "Schedule M" items. For example, tax-exempt interest is a Schedule M item in the third category—income that is recorded on the books, but not subject to tax. Tax depreciation in excess of book depreciation is another Schedule M item; it is an expense that is deducted on the tax return, but not expensed on the books.

Q. How do the Company's books reflect temporary differences between book treatment and tax treatment of Schedule M items?

A. The Company establishes and adjusts deferred tax accounts to reflect temporary differences between book treatment and tax treatment. For example, in the case of accelerated depreciation, utility assets are typically depreciated more rapidly for tax purposes than for book purposes. In addition to recording the differences on Schedule M of its the tax returns, the Company increases its deferred tax liability during those years when tax depreciation exceeds book depreciation and reduces its deferred tax liability during those years when book depreciation exceeds tax depreciation. Over the life of a single asset, the effect of these deferred tax adjustments is zero.

Q. Describe the formula by which the Company computes its current income tax expense for book purposes.

A. Net operating income
Plus/minus: non-operating income and expense items
Plus: current and deferred income taxes
Equals: pre-tax book income
Plus/minus: Schedule M items
Equals: taxable income
Times: applicable tax rates
Equals: current income tax expense

Q. Describe this process as it relates to AFUDC.

A. Due to the complexity of the computation of current taxes, the process is best explained by using a hypothetical example, which for convenience is summarized on a single page, Schedule 1 to my testimony. The example will compare the computation of current income tax expense under the Company's book method described above, under the method that the Company provided to Mr. Rackers in this proceeding and under Mr. Rackers' method. It will demonstrate the error of Mr. Rackers' method.

The example makes the following assumptions:

- Net operating income is $100.
- Interest on long-term debt is $50.
- Total AFUDC is $20, of which $10 is AFUDC-equity and $10 is AFUDC-debt.
- $8 of the AFUDC-debt is capitalized for tax purposes, and $2 is deducted currently for tax purposes.
- There are no other items of non-operating income, nor are there any other schedule M items.
- To simplify the calculation, current and deferred taxes are not added to book income in computing current tax liability.

Using these assumptions, the company should have a net Schedule M item in its current tax calculation of $12 ($10 related to the AFUDC-equity and $2 related to the currently-deductible AFUDC-debt).

Q. Explain how to calculate the current tax expense using these assumptions under the Company's book method.

A. The first step is to compute pre-tax book income. The Company's book method accomplishes this step by adjusting its net operating income for the two non-operating items:

Nonoperating income:	$100
Plus: AFUDC (debt and equity) income	20
Minus: Interest on long-term debt	(50)
Equals: Pre-tax book income	$70

The second step is to compute taxable income. To do this, the Company would make two Schedule M adjustments to pre-tax book income.

Pre-tax book income	$70
Minus: Schedule M item to remove AFUDC (debt and equity)	(20)
Plus: Schedule M item to reverse the book interest deduction for the portion of interest that is capitalized for tax purposes	8
Equals: Taxable income	58

The reason for the first Schedule M item is that the AFUDC is income for book purposes, but not for tax purposes. The reason for the second Schedule M item is that all interest relating to AFUDC-debt is expensed for book purposes, *i.e.*, it is included in the $50 interest on long term debt which was deducted in computing book income. Therefore, the interest that is capitalized for tax purposes (*i.e.*, not deducted in the year incurred) is a book expense, but not a tax deduction.

This calculation demonstrates that the net Schedule M item for AFUDC is $12 ($10 for the AFUDC-equity and $2 for the AFUDC-Debt that is deducted currently for tax purposes).

The final step is to compute the tax:

Taxable income:	$58
Times: tax rate	40%
Equals: current income tax	$23.2

Q. In responding to Staff's requests for data on the current income tax calculation, did the Company follow the foregoing format?

A. No, in responding to Staff's request for data on its current income tax calculation, the Company departed from the foregoing analysis in two places. Using the numbers from the example, the Company omitted the $20 AFUDC addition to net operating income and the corresponding Schedule M item to subtract the same $20 AFUDC. The net effect of the omission of the two items was zero—the taxable income was still $58 and the tax was still $23.2, as depicted in Schedule 1 (the second calculation).

Q. How does Mr. Rackers' approach differ from the Company's approach?

A. Mr. Rackers' approach followed the data that Staff was given by the Company, but he added a deduction for the interest on the AFUDC-debt. In the example, Mr. Rackers would have added a deduction for the $10 interest on the AFUDC-debt. This treatment is incorrect because the $10 interest on AFUDC-debt was already included in the $50 interest on long-term debt that was deducted in computing the book income.

Mr. Rackers' treatment therefore has the effect of deducting the $10 twice. This results in an incorrect taxable income of $48 and an incorrect tax of $19.2 in the example.

Q. Why is Mr. Rackers' proposed adjustment incorrect?

A. The tax law does not permit a taxpayer to deduct an item twice in computing taxable income.

Q. What is the rationale for Mr. Rackers' adjustment?

A. Mr. Rackers states at page 12, lines 17-20 that a provision for deferred tax associated with AFUDC has been included in the calculation of income taxes and that it is therefore appropriate to have an associated deduction in the calculation of current income taxes. Thus, it appears that he noticed the deferred tax entries associated with the AFUDC-debt but did not see AFUDC-debt as a separate Schedule M item.

Q. Why did Mr. Rackers not see AFUDC-debt as a separate Schedule M item?

A. As I stated above, the Company's response to the Staff's request followed the Company's book treatment with two differences: the AFUDC was not added to net operating income, nor listed as a Schedule M item. These omissions netted dollar-for-dollar and did not affect the calculation of deferred taxes. However, their omission appears to have caused Mr. Rackers to conclude that there was not a Schedule M item for AFUDC when in fact there was.

Q. What is the effect of Mr. Rackers' proposed adjustment for the debt component of AFUDC?

A. The Company's calculation of current income tax liability for the 12 months ending June 30, 1998 for book purposes is attached as Schedule 2. The total

AFUDC is $11,599,424 (analogous to the $20 in the example). The portion that Mr. Rackers proposes to deduct twice (the $10 in the example) is $2,773,969. This adjustment thus understates the Company's taxable income by $2,773,969. The Missouri jurisdictional portion of that amount is $2,538,459. That understatement of income has the effect of understating the Company's current tax liability by approximately $1,015,387. The Company's treatment, on the other hand, is consistent with the actual income tax calculation on the tax return and in its provision for income taxes in its books. Mr. Rackers' proposed adjustment under the EARP therefore is inappropriate and should be rejected.

Q. Do you agree with Mr. Rackers' statement at page 13, lines 1-2 that his proposed treatment is consistent with the income tax calculation in Case No. EC-87-114?

A. Yes. However, the fact remains that such treatment is erroneous and distorts the Company's income tax calculation under the EARP. As stated in the rebuttal testimony of Messrs. Brandt and Baxter, it is appropriate to correct errors under the terms of the EARP agreement. Similar corrections have been accepted by the Company in this proceeding, such as in the case of property taxes on plant held for future use, as discussed in the rebuttal testimony of Mr. Baxter.

Proposed Treatment IRS Audit Adjustments

Q. Would you like to address any other matters raised in Mr. Rackers' testimony?

A. Yes, at page 7, line 24 through page 12, line 13, Mr. Rackers proposes to eliminate the effect of adjustments that the Company made on its books to its income tax expense in connection with adjustments to its tax liability as determined upon audit by the Internal Revenue Service. Mr. Rackers proposes to defer ratemaking treatment of these items until the first general rate or complaint case following the second EARP.

Q. Do you agree with Mr. Rackers' proposal?

A. I concur with Mr. Rackers' conclusion that his proposed adjustments should not be considered in this proceeding. However, I disagree with his contention that these adjustments should be considered in a future proceeding. The Company's omission of prior period tax adjustments is "consistent with the Staff's traditional calculation of income taxes" and therefore should not be considered for purposes of computing the EARP. If the Commission proposes to address those proposed adjustments in this proceeding, I request the opportunity to supplement this testimony to address the substance of those proposed adjustments.

Q. Does this conclude your supplemental rebuttal testimony?

A. Yes, it does.

Assumptions:

1	Net operating income	100
2	Interest on long-term debt	50
3	AFUDC, debt and equity	20
4	AFUDC, equity	10
5	AFUDC-debt, tax deductible portion	2
6	AFUDC-debt, tax capitalized portion	8
7	No other additions to net operating income	
8	No other Schedule M items	
	Simplifying assumption: current and deferred taxes are not added to book income.	

Current Income Tax Expense Calculation

		AmerenUE (books and tax return)	AmerenUE (regulatory)	Rackers	
9	Net operating income	100.0	100.0	100.0	line 1
10	AFUDC-debt and equity income	20.0			line 3
11	Interest on long-term debt	(50.0)	(50.0)	(50.0)	line 2
12	Book income	70.0	50.0	50.0	line 9 + line 10 + line 11
13	Schedule M (to remove AFUDC-debt and equity book income)	(20.0)			line 3
14	Schedule M (to reverse book deduction of tax capitalized interest)	8.0	8.0	8.0	line 6
15	Taxable income	58.0	58.0	58.0	line 12 + line 13 + line 14
16	Deduction of AFUDC-debt interest			(10.0)	line 5 + line 6
17	Taxable income	58.0	58.0	48.0	line 15 + line 16
18	Tax rate	40%	40%	40%	Assumed tax rate
19	Tax	23.2	23.2	19.2	line 17 + line 18

Schedule 1

Union Electric Company
Provision for Income Taxes - Electric Only
June 1998 Year to Date

	12 Months Ending December, 1997 Per Accruals	December, 1997 RAR Adjustments *	12 Months Ending December, 1997	6 Months Ending June, 1997	6 Months Ending June, 1998	12 Months Ending June, 1998
Net Operating Income	445,967,275		445,967,275	165,607,846	149,193,486	429,552,915
Non-Operating Income and Deductions						
Subsidiary Notes Receivable	2,136,119		2,136,119	982,680	1,210,833	2,364,272
Miscellaneous	1,708,864		1,708,864	781,854	325,244	1,252,254
Allowance for Funds Used During Construction	11,137,358		11,137,358	5,074,355	5,536,421	11,599,424
Miscellaneous Income Deductions						
Account 426-4	(195,599)		(195,599)	(60,067)	(78,174)	(213,706)
Miscellaneous	(10,026)		(10,026)	(24)	(116)	(10,118)
Interest Charges						
Interest on Long-Term Debt	(116,528,336)		(116,528,336)	(59,528,521)	(59,104,513)	(116,104,328)
Other Interest Charges - Gateway	(6,426,247)		(6,426,247)	(3,096,291)	(2,847,970)	(6,177,926)
Amortization of Loss on Reacquired Debt	(2,261,052)		(2,261,052)	(1,130,526)	(1,046,165)	(2,176,691)
Amortization of Bond Discount	(1,327,999)		(1,327,999)	(664,255)	(669,226)	(1,332,970)
Amortization of Premium on Debt	1,345		1,345	1,345		-
Other Interest Charges	(9,084,266)		(9,084,266)	(4,657,665)	449,718	(3,976,883)
Net Income From Operations	325,117,436	-	325,117,436	103,310,731	92,969,538	314,776,243
Add:						
Provision for Current Income Taxes	237,783,000	11,204,000	226,579,000	72,987,000	76,594,000	230,186,000
Deferred Income Taxes - Net	(35,066,000)	(9,159,000)	(25,907,000)	(1,673,000)	(6,480,000)	(30,714,000)
Amortization of Investment Tax Credit	(10,379,000)	(4,284,000)	(6,095,000)	(3,048,000)	(2,713,000)	(5,760,000)
TOTAL INCOME	517,455,436	(2,239,000)	519,694,436	171,576,731	160,370,538	508,488,243
Deductions						
Allowable Depreciation - S.L.	227,085,000		227,085,000	115,043,000	112,029,000	224,071,000
Amortization of Osage	110,000		110,000	55,000	54,000	109,000
Depreciation per Books	(253,960,923)		(253,960,923)	(125,952,937)	(131,754,166)	(259,762,152)
Additional Depreciation	(26,765,923)	-	(26,765,923)	(10,854,937)	(19,671,166)	(35,582,152)
Accelerated Depreciation - Net	13,517,000		13,517,000	6,756,000	5,940,000	12,701,000
Westinghouse Credit Adjustment - Tax Basis	(3,135,970)		(3,135,970)	(69,438)	(417,698)	(3,484,230)
Westinghouse Credit Adjustment - Book Basis	2,423,520		2,423,520	1,211,760	1,223,814	2,435,574
Nuclear Fuel Expense	(37,126,054)		(37,126,054)	(19,900,573)	(16,182,884)	(33,408,365)
Dismantling Expense	12,263,684		12,263,684	6,366,861	3,249,446	9,146,269
Disallowance of Meals, etc.	(476,371)		(476,371)	(238,008)	(233,944)	(472,307)
Environmental Tax			-	325,000		(325,000)
Allowance for Funds Used During Construction	11,137,358		11,137,358	5,074,355	5,536,422	11,599,425
Tax Interest Capitalized	(5,817,573)		(5,817,573)	(2,622,830)	(3,129,339)	(6,324,082)
Account 426-4	(195,599)		(195,599)	(60,067)	(78,174)	(213,706)
Pensions Capitalized	411,138		411,138		186,274	597,412
Social Security Taxes Capitalized	460,083		460,083		192,842	652,925
Employee Benefits Capitalized	1,315,472		1,315,472		605,766	1,921,238
Injuries and Damages Capitalized	217,200		217,200		172,892	390,092
Customer Advances and CIA's	(5,570,699)		(5,570,699)	(2,370,714)	(1,866,897)	(5,066,882)
Club Dues	(955)		(955)	(96)	519	(340)
Environmental Clean-Up Costs Capitalized	(2,393,228)		(2,393,228)	(1,625,754)	(99,071)	(866,545)
Decommissioning Costs	6,691,188		6,691,188	3,345,594	3,570,935	6,916,529
Maintenance Costs Capitalized	(10,000,000)		(10,000,000)		(4,998,000)	(14,998,000)
Defeasance	(2,270,208)		(2,270,208)	(1,135,104)	(1,051,777)	(2,186,881)
Amortization of Easements	470,000		470,000	234,000	234,000	470,000
Reserve and Clearing Accounts	344,887		344,887			344,887
Preferred Dividend Paid Credit	1,816,000		1,816,000	906,000	906,000	1,816,000
Computer Software Capitalized	(9,000,000)		(9,000,000)		(7,002,000)	(16,002,000)
Penalties	(10,026)		(10,026)	(24)	(116)	(10,118)

Union Electric Company
Provision for Income Taxes - Electric Only
June 1998 Year to Date

	12 Months Ending December, 1997 Per Accruals	December, 1997 RAR Adjustments *	12 Months Ending December, 1997	6 Months Ending June, 1997	6 Months Ending June, 1998	12 Months Ending June, 1998
Deferred Compensation	(6,584,122)		(6,584,122)	(3,395,848)	(5,288,341)	(8,476,615)
Payments for Deferred Compensation	2,635,325		2,635,325	1,398,981	1,416,801	2,653,145
State Income Taxes	30,942,000		30,942,000	7,953,000	8,447,000	31,436,000
Unbilled Gross Reciepts	101,000		101,000	(1,773,000)	(1,548,000)	326,000
UE FASB 106 Liability	45,452		45,452	649,988	(848,470)	(1,453,006)
Low Level Nuclear Waste Disposal	175,346		175,346		(635,831)	(460,485)
EPA Emission Allowance Proceeds	(92,417)		(92,417)	(111,994)	(107,574)	(87,997)
Pension Expense	(17,700,758)		(17,700,758)	(204,000)	(7,262,266)	(24,759,024)
Repair Allowance			-		4,998,000	4,998,000
Deductible Repairs - Capitalized on Books			-		2,502,000	2,502,000
Late Interest Billing Adjustment			-	6,165		(6,165)
Miscellaneous	(8)		(8)	(4)	5	1
TOTAL DEDUCTIONS	(42,173,258)	-	(42,173,258)	(10,134,687)	(31,238,832)	(63,277,403)
TOTAL TAXABLE INCOME	559,628,694	(2,239,000)	561,867,694	181,711,418	191,609,370	571,765,646
Current Income Taxes						
Normal and Surtax	195,762,000		196,762,000	50,700,000	53,797,000	199,859,000
Adjustment of Prior Years - Federal	11,204,000	11,204,000	-			-
Environmental Tax			-	325,000		(325,000)
FAS 109 Temporary Differences			-		(54,000)	(54,000)
Credit for Federal Taxes on Fuel	(132,000)		(132,000)	(132,000)	(120,000)	(120,000)
Current Federal Income Tax (Excluding Unbilled)	207,834,000	11,204,000	196,630,000	50,893,000	53,623,000	199,360,000
State Income Taxes						
Missouri	27,487,000		27,487,000	7,054,000	7,487,000	27,920,000
Illinois - Regular	1,685,000		1,685,000	448,000	459,000	1,696,000
Illinois - PPRIT	878,000		878,000	234,000	240,000	884,000
Iowa	892,000		892,000	217,000	261,000	936,000
Adjustment of Prior Years - State			-			-
Missouri			-			-
Illinois - Regular			-			-
Illinois - PPRIT			-			-
Iowa			-			-
Current State Income Taxes (Excluding Unbilled)	30,942,000	-	30,942,000	7,953,000	8,447,000	31,436,000
Current Unbilled Taxes						
Federal	(837,000)		(837,000)	12,231,000	12,589,000	(479,000)
State						
Missouri	(57,000)		(57,000)	1,710,000	1,768,000	1,000
Illinois - Regular	(65,000)		(65,000)	131,000	110,000	(86,000)
Illinois - PPRIT	(34,000)		(34,000)	69,000	57,000	(46,000)
Iowa			-			-
Total Current Unbilled Taxes	(993,000)	-	(993,000)	14,141,000	14,524,000	(610,000)
PROVISION FOR CURRENT INCOME TAXES	237,783,000	11,204,000	226,579,000	72,987,000	76,594,000	230,186,000