

Exhibit No.:
Issue: *ISRS Income Taxes*
Witness: *Stephen M. Rackers*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Direct Testimony*
Case No.: *GO-2004-0443*
Date Testimony Prepared: *April 26, 2004*

MISSOURI PUBLIC SERVICE COMMISSION
UTILITY SERVICES DIVISION

DIRECT TESTIMONY
OF
STEPHEN M. RACKERS

LACLEDE GAS COMPANY

CASE NO. GO-2004-0443

Jefferson City, Missouri
April 2004

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)

GO-2004-0443

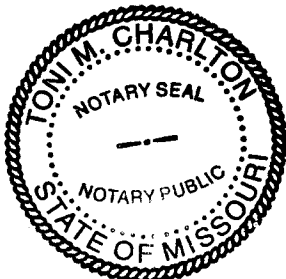
AFFIDAVIT OF STEPHEN M. RACKERS

STATE OF MISSOURI)
)
COUNTY OF COLE) ss.

Stephen M. Rackers, being of lawful age, on his oath states: that he has participated in the preparation of the following Direct Testimony in question and answer form, consisting of 5 pages to be presented in the above case; that the answers in the following 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 20th day of April 2004.





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

DIRECT TESTIMONY
OF
STEPHEN M. RACKERS
LACLEDE GAS COMPANY
CASE NO. GO-2004-0443

Q. Please state your name and business address.

A. Stephen M. Rackers, 1845 Borman Court, Suite 101, St. Louis, Missouri
63146.

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

A. I am employed by the Missouri Public Service Commission (Commission) as
a Regulatory Auditor V.

Q. Please describe your educational background.

A. I attended the University of Missouri – Columbia, where I received a Bachelor
of Science degree in Business Administration with a major in Accounting in 1978. I have
passed the Uniform Certified Public Accountant examination and am licensed to practice in
the state of Missouri.

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

A. I have conducted and assisted with the audits and examinations of the books
and records of utility companies operating within the state of Missouri.

Q. Have you previously filed testimony before the Commission?

A. Yes, I have. Please refer to Schedule 1, attached to this direct testimony, for a
list of cases in which I have previously filed testimony.

1 Q. With reference to Case No. GO-2004-0443, have you made an investigation
2 of the books and records of Laclede Gas Company (Laclede or Company) related to its
3 Application for an Infrastructure System Replacement Surcharge (ISRS)?

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

5 Q. Please discuss the results of Staff's investigation.

6 A. Based on its investigation, the Staff disagrees with the method used by the
7 Company to calculate income taxes. The Staff recommends the use of its calculation of
8 income taxes, which appears in its ISRS Report, a summary of which is attached to this
9 testimony as Schedule 2. However, if the Commission finds that the Company's income tax
10 methodology is appropriate and in accord with the statutory requirements, the Staff agrees
11 with Laclede's calculation of ISRS revenues.

12 Q. Please describe the Staff's calculation of income taxes.

13 A. The Staff's calculation of income taxes is in compliance with the Missouri
14 Revised Statutes associated with income taxes for an ISRS for gas utilities, sections
15 393.1009(1)(a) and (b). Section 393.1009(1)(a) and (b) state:

16 (1) "Appropriate pretax revenues", the revenues necessary to produce net
17 operating income equal to:

18 (a) The gas corporation's weighted cost of capital multiplied by the net
19 original cost of eligible infrastructure system replacements, including
20 recognition of accumulated deferred income taxes and accumulated
21 depreciation associated with eligible infrastructure system replacements
22 which are included in a currently effective ISRS; and

23 (b) Recover state, federal, and local income or excise taxes applicable to
24 such income
25

26 Based on the Staff's calculation there are no applicable income taxes. This occurs because
27 tax deductions associated with installation of the plant included in the Company's ISRS

1 Application generate enough tax savings to offset any income taxes applicable to the return
2 calculation described in 393.1009(1)(a). The Company's failure to appropriately recognize
3 all the available deductions results in an overstatement of the ISRS revenues.

4 Q. Are income taxes mentioned elsewhere in the Missouri Revised Statutes for
5 an ISRS for gas utilities?

6 A. Yes. Section 393.1015.4(1) states that the Commission will only consider the
7 current state, federal and local income tax rates. There is no disagreement between the Staff
8 and the Company with regard to the income tax rate to be considered in the calculation of the
9 ISRS revenues.

10 Q. What items are deductible in the calculation of income taxes associated with
11 Laclede's ISRS Application?

12 A. The tax deductions that Laclede claims for installation of ISRS property are
13 interest expense, service transfers and Internal Revenue Code (IRC) Section 263A transfers.
14 These deductions result in income tax savings of approximately \$2 million, which more than
15 offsets the \$1.3 million of income tax before considering any tax-deductible items. This
16 calculation is shown on lines 24 through 42, of Schedule 2, attached to my testimony.

17 Q. Please explain the deduction for interest expense.

18 A. The weighted cost of debt, which is multiplied by the ISRS investment in
19 compliance with section 393.1009(1)(a), includes a component for both long-term and short-
20 term debt. As a result, the return on ISRS investment includes interest paid to debt holders.
21 This interest payment is tax deductible. Both the Company and the Staff have recognized
22 this tax deduction in the calculation of income taxes.

23 Q. Please explain the deduction for service transfers.

1 A. On the Company's regulatory books, the cost of transferring service
2 connections from the old main to the new main is capitalized, meaning that these costs
3 become part of the Company's investment, and are included in plant. However, Laclede
4 expenses the cost of service transfers for income tax purposes and deducts these costs in the
5 calculation of the Company's applicable income tax. The Company's ISRS Application
6 includes \$1,415,465 of service transfers, which were capitalized on the Company's books
7 during the seventeen-month period of August 2002 through December 2003. Since the ISRS
8 revenues are calculated on an annual basis, the Staff divided the total service transfers by
9 seventeen and multiplied by twelve to determine an annual amount. The amount of this
10 annual deduction for income taxes appears on line 36, of Schedule 2, attached to my
11 testimony.

12 Q. Please explain the tax deduction for 263A transfers.

13 A. Section 263A, of the IRC, discusses the tax treatment, capitalization versus
14 expense, for various plant related costs. On the Company's regulatory books, these various
15 plant related costs may be treated differently than the treatment prescribed by the Code. In
16 the aggregate, more costs are capitalized on the Company's regulatory books than are
17 required to be capitalized for tax purposes. The amount capitalized on the Company's books
18 in excess of the amount capitalized for tax purposes is deductible in the calculation of
19 applicable income taxes. Based on the plant additions during the seventeen-month period
20 included in the Company's ISRS Application, the difference between the amount capitalized
21 for tax purposes and the amount capitalized on the Company's books was \$1,781,796.
22 Again, since the ISRS revenues are calculated on an annual basis, the Staff divided the total
23 263A transfers by seventeen and multiplied by twelve to determine an annual deduction

1 amount of \$1,257,738. The amount of this annual deduction for income taxes appears on
2 line 35, of Schedule 2, attached to my testimony.

3 Q. Has the Company included the tax deductions for either service transfers or
4 263A transfers in its calculation of income taxes in its ISRS Application?

5 A. No. As a result of not recognizing either of these tax deductions, the
6 Company has overstated the amount of applicable taxes and, therefore, of ISRS revenues by
7 \$668,039.

8 Q. Are there other tax items related to the ISRS plant that have not been
9 considered by the Company in its calculations?

10 A. Yes. Several of the ISRS plant projects include reimbursements, which offset
11 the cost of construction. For example, Laclede may receive a reimbursement from a public
12 authority associated with a main relocation necessitated by road construction. These funds
13 reduce the cost of the plant on the Company's books. However, for tax purposes, some or all
14 of these funds are treated as income and result in an increase in income taxes.

15 Q. Does this situation affect the Staff's recommendation?

16 A. No. The tax deductions associated with installation of the plant included in
17 the Company's ISRS Application generate enough tax savings to offset any income taxes
18 applicable to the return calculation, even if all of the reimbursements received by Laclede
19 associated with the ISRS plant are treated as taxable income.

20 Q. Does this conclude your direct testimony?

21 A. Yes, it does.

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
St. Louis County Water Company	WR-94-166
St. Louis County Water Company	WR-95-145
Union Electric Company	ER-95-411

<u>Company</u>	<u>Case Number</u>
Union Electric Company d/b/a AmerenUE	EM-96-149
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
Laclede Gas Company	GR-2001-629
Union Electric Company d/b/a AmerenUE	EC-2002-1
Union Electric Company d/b/a AmerenUE	EC-2002-1025
Laclede Gas Company	GR-2002-356
Missouri-American Water Company	WR-2003-0500

**Laclede Gas Company
ISRS Revenues Calculation**

393.1009(5)(a), (b) & (c) - ISRS Gas Utility Plant Projects:

Main Replacements and Other Projects Extending Useful Life of Mains	3,747,359
Service Line Replacements and Insertion Projects	19,942,774
Regulator Stations	1,238,843
Service Line Replacements and Insertion Projects	4,037,654
Main Reinforcements Related to Other ISRS Eligible Projects	134,127
Total ISRS Utility Plant Projects	29,100,757

393.1009(1)(a) - Return on Investment:

Total ISRS Utility Plant Projects	29,100,757
Deferred Taxes	(3,325,893)
Accumulated Depreciation	(392,077)
<u>Net ISRS Utility Plant Projects</u>	<u>25,382,787</u>
Overall Rate of Return per Testimony from GR-2002-356	8.16%
Net Operating Income	2,071,691

393.1009(1)(b) - Applicable Income Taxes:

Net Operating Income	2,071,691
Income Tax Factor at a Tax Rate of 38.5596%	0.62759
<u>Income Tax Before Interest, 263A Transfers and Service Transfers Deductions</u>	<u>1,300,180</u>
Net ISRS Utility Plant Projects	25,382,787
Weighted Cost of Debt per Testimony from GR-2002-356	3.80%
Interest Deduction	965,210
263A Transfers Deduction	1,257,738
Service Transfer Deduction	999,152
Total Tax Deductible Items	3,222,100
Income Tax Factor	0.62759
<u>Income Tax Reduction Due to Deductible Items</u>	<u>2,022,169</u>
Applicable Income Tax	0

393.1009(1)(c) - Other ISRS Costs:

Depreciation Expense	496,653
Property Taxes	623,324
Total Other ISRS Costs	1,119,977
Total ISRS Pretax Revenues	3,191,668