Exhibit No.:
Issues: Overview, Income Tax and Territorial Agreements
Witness: Stephen M. Rackers
Sponsoring Party: MoPSC Staff
*Type of Exhibit:* *Direct Testimony*
Case No.: EM-96-149

# MISSOURI PUBLIC SERVICE COMMISSION

## UTILITY SERVICES DIVISION



# DIRECT TESTIMONY

# OF

# STEPHEN M. RACKERS

## UNION ELECTRIC COMPANY

## CASE NO. EM-96-149

*Jefferson City, Missouri*
*February 1999*

**DIRECT TESTIMONY**

**OF**

**STEPHEN M. RACKERS**

**CASE NO. EM-96-149**

**UNION ELECTRIC COMPANY**

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.

Q. What is the purpose of your direct testimony?

A. My direct testimony will discuss the following items:

1) The Staff's recommendation regarding the amount of sharing credits in the third year of the Experimental Alternative Regulation Plan (EARP)

for Union Electric Company (UE or Company), approved in Case No. ER-95-411.

2) The Staff's recommendation regarding the quantification of the weather normalized permanent rate reduction which is an item that was agreed to in conjunction with a second three year EARP proposed and approved in Case No. EM-96-149.

3) A general discussion regarding the basis for all of the Staff's adjustments which are at issue in this proceeding.

4) A discussion of the adjustments I am specifically supporting.

Q. Please explain the term "sharing credits".

A. The term relates to the amount of earnings that are returned to the ratepayers, on a one-time basis, depending on UE's achieved equity return during each annual sharing period. The annual sharing period is July 1 of one year through June 30 of the next year. The initial EARP, approved in Case No. ER-95-411, provided for three annual sharing periods from July 1, 1995 through June 30, 1998. The second EARP, approved in Case No. EM-96-149, provides for three additional annual sharing periods from July 1, 1998 through June 30, 2001.

Q. How is the achieved return on equity determined for each one year sharing period?

A. The achieved equity return is based on the average capital structure, the average rate base and the booked earnings, as adjusted, during the particular one year sharing period.

Q. What amount of sharing period earnings are credited to ratepayers?

A. Fifty percent of the sharing period earnings that reflect an achieved equity return above 12.61% and less than or equal to 14% is credited to the ratepayers. One hundred percent of the sharing period earnings that reflect an achieved equity return above 14% is credited to the ratepayers.

Q. What is the Staff's recommended level of credits for the sharing period ended June 30, 1998?

A. The Staff's recommended level of sharing credits is $40,609,000. This amount of sharing credits is comprised of $24,144,000 of earnings at the 50% sharing level and $16,465,000 at the 100% sharing level. These earnings levels have been factored-up for income taxes. The Staff Accounting and Monitoring Schedules included in this direct filing support these calculations. The amounts referenced above specifically appear on Accounting Schedule 1 and Monitoring Schedule 4.

Q. Please explain the term "weather normalized permanent rate reduction".

A. In accordance with the Stipulation and Agreement approved in Case No. EM-96-149, UE's rates will be reduced, on a permanent basis, by an amount equal to the average level of credits for the three sharing periods, from July 1, 1995 through June 30, 1998, as adjusted for normal weather. The credits are adjusted by increasing or decreasing earnings to reflect the level of KWh sales that would have been realized had normal temperatures been experienced during the sharing period. The procedures for adjusting earnings for normal weather appear in Attachment A to the Stipulation and Agreement approved in Case No. EM-96-149. In accordance with these procedures, adjustments were made to Revenue and Fuel Expense for the first three sharing periods.

Q. What is the Staff's recommendation for the permanent rate reduction?

A. The Staff's recommendation for the permanent rate reduction is $27,394,000. Schedule 2, attached to my testimony, summarizes the Staff's recommendations for the sharing credits and permanent rate reduction.

Q. What methodology did the Staff use to adjust the sharing credits to reflect normal weather?

A. The Staff's adjustments to KWh sales to reflect normal weather are discussed in the testimony of Staff witnesses Dennis Patterson of the Commission's Electric Department Staff and Dr. Steven Qi Hu, a climatological consultant appearing on behalf of the Staff.

Q. What is the basis for the adjustments made by the Staff which are at issue in this proceeding?

A. The Staff is proposing its adjustments in accordance with the criteria established in the Stipulation and Agreements approved by the Commission in Case Nos. ER-95-411 and EM-96-149. Part of this criteria from the Stipulation and Agreement approved in Case No. ER-95-411 appear on pages 9 and 10 in sections 3.f.vii. and viii. These same sections also appear on pages 17 and 18 of the Stipulation and Agreement approved in Case No. EM-96-149. These sections state that:

> <u>vii.:</u>
> UE, Staff, OPC and other signatories reserve the right to bring issues which cannot be resolved by them, and which are related to the operation or implementation of the Plan, to the Commission for resolution. Examples include disagreements as to the mechanics of calculating the monitoring report, alleged violations of the Stipulation and Agreement, alleged manipulations of earnings results, or requests for information not previously maintained by UE. An allegation of manipulation could include significant variations in the level of expenses associated with any category of cost, where no reasonable explanation has been provided. The Commission will determine in the first instance whether a question of manipulation exists and whether that question should be heard by it.
>
> <u>viii.:</u>
> Staff, OPC and other signatories have the right to present to the Commission concerns over any category of cost that has been included in UE's monitoring results and has not been included previously in any ratemaking proceeding.

Adjustments based on this language are sponsored by Staff Accounting witnesses Arlene Westerfield, Michael Gruner and myself.

Additional criterion from page 3, section 4 of the Stipulation and Agreement approved in Case No. EM-96-149, states that:

> The annual amortization of merger transaction and transition costs will be the lesser of: (1) the Missouri jurisdictional portion of the total Ameren amount of $7.2 million; or (2) the Missouri jurisdictional portion of the total Ameren unamortized amount of actual merger transaction and transition costs incurred to date.

Adjustments based on this provision are discussed in the testimony of Staff witness Gruner.

The Staff is also relying on the Reconciliation Procedure, Attachment C to the Stipulation and Agreement in Case No. ER-95-411, Section 2.f., for an adjustment to the calculation of income taxes. This section states, in part, that:

> The earnings report will utilize: Staff's traditional calculation of income tax (refer to the income tax calculation in Case No. EC-87-114).

This provision also is in the Stipulation and Agreement for Case No. EM-96-149. I will discuss this adjustment later in my testimony.

Finally, I would note that the Reconciliation Procedure, Attachment C, Section 2.g. states, in part, that:

> UE/Staff/OPC reserve the right to petition the Commission for resolution of disputed items relating to the operation or implementation of this Plan.

Q. Please identify the Staff Adjustments you are sponsoring that are at issue in this case.

A. I am sponsoring the Staff Adjustments associated with Territorial Agreements and Income Taxes.

Territorial Agreements

Q. Please explain the Staff Adjustments associated with territorial agreements.

A. These adjustments reverse the effect on earnings related to two territorial agreements entered into between UE and Black River Cooperative, Case No. EO-95-400, et al., and Macon Electric Cooperative, Case No. EO-97-6, et al. In both of these cases, the Staff recommended approval of the territorial agreements with the condition that it have the right to examine the effect that the sales from the customers in the affected service territories would have on earnings and future sharing credit calculations.

Q. Why was this condition necessary?

A. The criteria that must be met for approval of a territorial agreement is no detriment to ratepayers. In both of these cases, the earnings realized by UE declined as a result of the territorial agreements. The decline in earnings resulted from UE realizing a net loss of customers and associated revenue as a result of exchanging a portion of its service area with the cooperatives. This decline in earnings could result in reducing the amount of annual sharing credits, as well as the permanent rate reduction. In the Staff's opinion, this situation would constitute detriment to ratepayers.

Q. How do the Staff's Adjustments prevent detriment to ratepayers?

A. The adjustments reverse the net reduction in earnings realized during the third sharing period. By reversing the net reduction in earnings, the effect of the territorial agreements on the sharing credits and the permanent rate reduction is eliminated. This reversal was accomplished by restoring the net loss in revenues and the associated fuel cost, maintenance expense, depreciation expense, and plant and reserve additions. By restoring the net reduction in earnings the Staff has prevented any detrimental impacts of the territorial agreements from being flowed through to UE's customers.

Q. What section of the Stipulation and Agreement approved in Case No. ER-95-411 provides the Staff's justification for making this adjustment in the context of the calculation of the sharing credits?

A. Section 3.f.viii. states that signatories have the right to present to the Commission concerns over any category of cost that has been included in UE's monitoring results and has not been included previously in any ratemaking proceeding. The Staff is not aware of a situation where earnings results were adjusted to prevent detriment to ratepayers as a result of the affect of a territorial agreement in a revenue requirement determination proceeding. Section 3.f.vii. states that the Staff reserves the right to bring issues which are related to the operation or implementation of the EARP to the Commission for resolution.

In both dockets, EO-95-400 and EO-97-6, the Staff's recommendation stated that the Staff reserved the right to examine the revenue requirement effect of the territorial agreements in the context of a future rate case or sharing credit calculation. UE did not indicate an objection to this approach. A similar concern of the Staff is seen in Section 4 "Rate Design" of the Stipulation and Agreement wherein there is provision for determining on a case-by-case basis, by agreement or by decision of the Commission, how revenues foregone as a result of a change in rate design and/or other tariff language will be treated for purposes of the Plan Reconciliation Procedure (Attachment C). This section of the Case No. ER-95-411 Stipulation and Agreement shows concern that changes in rate design and/or other tariff provisions not automatically be precluded because of the change causing a reduction in credits that would otherwise be available for distribution under the EARP.

***Income Taxes***

Q. Please explain the Staff's Adjustments to income taxes.

A. In December 1997, UE made several adjustments on its books to income tax expense associated with the results of Internal Revenue Service (IRS) audits for tax years

1978 through 1991. The Staff's Adjustments eliminate the effect of these IRS adjustments from the calculation of sharing credits.

Q. Please discuss the IRS adjustments.

A. The adjustments can be divided into three components: accelerated depreciation, other deferred items and investment tax credit (ITC).

Accelerated depreciation refers to the use of tax depreciation rates rather than Commission approved book depreciation rates to more rapidly recover capital assets for tax purposes. The use of these different rates results in a reduction in current income taxes and an offsetting increase in deferred income taxes. In this instance, the IRS disallowed accelerated depreciation on a portion of the Company's plant causing a write-off of the associated balance of deferred tax reserves.

Other deferred items refers to items that are recognized as income or expenses for tax purposes during a different period than when the items are recognized on the Company's books. An example would be the expensing by the Company of deferred compensation in the year it is earned. For tax purposes, deferred compensation would not be a deductible expense until it was paid. The difference in current income tax realized due to the recognition of this item is offset by a corresponding provision for deferred taxes. In this instance, the Company was allowed by the IRS to recognize more deductions than previously taken. This caused a reduction in current income taxes and an increase in associated deferred income taxes

ITC refers to a credit or reduction in income taxes paid, as a result of investment in certain types of property. ITC reduces current income tax expense and is offset by an increase in deferred taxes. In this instance, the Company was allowed by the IRS to recognize (1) additional ITC to reduce current tax and (2) a resulting increase in the amortization of deferred ITC.

Q. How have these items historically been treated for regulatory purposes?

A. UE has received full normalization treatment with regard to these items in the past by the Commission. This means that although the Company's tax liability was reduced for accelerated depreciation, other deferred items and ITC, the tax expense reflected in the cost of service and rates was unaffected. Consequently, the Company had use of the funds generated as a result of charging rates associated with higher booked income tax expense rather than actual taxes paid to the IRS. With regard to accelerated depreciation and other deferred items, the ratepayer is compensated by receiving a reduction in rate base for the related balance of deferred taxes and an amortization of this balance over the life of the associated plant. With regard to ITC, the ratepayer only receives an amortization of the related deferred tax balance over the life of the associated plant.

Q. How has normalization treatment been accomplished with regard to these items?

A. Normalization treatment has been accomplished through two methods: explicit recognition and omission. When explicitly normalizing an item, a specific increase or decrease in current income tax and an offsetting decrease or increase in deferred income tax, respectively, appear in the tax calculation. When normalizing by omission, the item is simply left out of the tax calculation. The use of either method results in the ratepayer providing the same total income tax expense in rates. The use of either method also entitles the ratepayer to the recognition of a related deferred tax balance offset to rate base and an associated amortization of this balance over the life of the plant.

Q. What treatment is the Staff proposing with regard to each of these components in the calculation of sharing credits?

A. The Staff is proposing to eliminate the affect of the adjustment associated with accelerated depreciation (i.e., reverse the IRS adjustment). The Staff believes the elimination of this item is appropriate since the Company has been denied any past and future accelerated depreciation on the associated plant.

The Staff is also proposing to eliminate deferred tax expense associated with other deferred items (i.e., reverse the IRS adjustment). Because these other deferred items would have received full normalization treatment in the years realized, there would have been no effect on the total tax expense included in customers' rates. Although the Company would have experienced lower taxes in the years realized, the ratepayers would have been unaffected. As a result, the ratepayer is not liable for this increase in deferred tax expense. However, as previously discussed, the ratepayer is entitled to the related deferred tax balance as an offset to rate base and an associated amortization of these deferred taxes. The Staff proposes to defer ratemaking treatment on this item until the first general rate or complaint case following the second EARP.

Finally, the Staff is proposing to eliminate the deferred tax expense associated with ITC (i.e., reverse the IRS adjustment). However, as previously discussed the ratepayer is entitled to an amortization of these deferred taxes. The past regulatory treatment with regard to ITC is recognition of the amortization. The ITC should not be eliminated but should flow to ratepayers consistent with past regulatory treatment. The Staff is also proposing to defer ratemaking treatment on this item until the first general rate or complaint case following the second EARP.

Q. Why is the Staff proposing to defer ratemaking treatment until the first general rate or complaint case following the second EARP?

A. The ITC and other deferred items are associated with tax years 1978 through 1988. During those years, new rates became effective as a result of 7 rate cases filed by UE and one complaint case filed by the Staff and the Office of Public Counsel. The total effects of similar tax items were flowed to the cost of service and ratepayers in those cases.

Therefore, the Staff believes that the revenue requirement effect of these items should be flowed to ratepayers in their entirety, rather than being reduced through an earnings sharing mechanism.

Q. What section of the Stipulation and Agreement approved in Case No. ER-95-411 provides the Staff's justification for making this adjustment in the context of the calculation of the sharing credits?

A. Section 3.f.viii. states that signatories have the right to present to the Commission concerns over any category of cost that has been included in UE's monitoring results and has not been included previously in any ratemaking proceeding. The Staff is not aware of a situation where the effect of IRS adjustments on earnings was considered in a revenue requirement determination proceeding. Section 3.f.vii, states that the Staff reserves the right to bring issues which are related to the operation or implementation of the EARP to the Commission for resolution.

Q. Has UE reversed the IRS adjustments in its calculation of sharing credits?

A. Yes. UE is proposing to reverse the IRS adjustments. In this instance, UE is proposing adjustments to booked earnings as appropriate for the calculation of sharing credits.

Q. How would current inclusion, rather than deferral, of the effects of ITC and the other deferred tax items change the Staff's calculation of the third year sharing credits and the permanent rate reduction?

A. If the Commission chose to include the effect of ITC currently, the third year sharing credits and permanent rate reduction would increase by $6,162,000 and $2,054,000, respectively. The Staff is currently attempting to calculate the effects of the other deferred items. Based on these calculations, the Staff will supply the Commission with its best estimate of the effects of the other deferred items on the third year sharing credits and permanent rate reduction.

Q. What attempts has the Staff made to calculate the effects of the other deferred items on the third year sharing credits and permanent rate reduction?

A. In Staff Date Request No. 82, the Staff asked the Company to disaggregate the IRS adjustment into its separate components by provision for and amortization of the deferred taxes associated with other deferred items. In response, the Company stated that a quantification of the IRS adjustment for other deferred tax items was not developed separately by provision and amortization. In addition, the Company stated that quantifying the separate components would be extremely time consuming. Finally, the Company responded that it could not provide a reliable estimate of the dollar value of the separate components. As a result, the Staff has calculated an estimate of the separate components and provided it to UE for the Company's critique.

Q. Has the Staff made any other adjustments to the calculation of income taxes?

A. Yes. The Staff has included the debt portion of the allowance for funds used during construction (AFUDC) as a deduction for the calculation of current income taxes.

Q. Why is this adjustment appropriate?

A. A provision for deferred tax associated with AFUDC has been included in the calculation of income taxes. Therefore, it is appropriate to have an associated deduction in the calculation of current income taxes.

Q. What section of the Stipulation and Agreement approved in Case No. ER-95-411 provides the Staff's justification for making this adjustment in the context of the calculation of the sharing credits?

A. Section 2.f. of Attachment C, the Reconciliation Procedure, states that the earnings report will utilize the Staff's traditional calculation of income tax and references

Case No. EC-87-114. The treatment of the debt portion of AFUDC is consistent with the income tax calculation in that case. Section 2.g. of the Reconciliation Procedure states in part that:

> UE/Staff/OPC reserve the right to petition the Commission for resolution of disputed items relating to the operation or implementation of this Plan.

Q. Does this conclude your direct testimony?

A. Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION**

**OF THE STATE OF MISSOURI**

| | | |
|---|---|---|
| In the Matter of the Application of Union Electric Company for an Order Authorizing (1) Certain Merger Transactions Involving Union Electric company; (2) the Transfer of Certain Assets, Real Estate, Leased Property, Easements and Contractual Agreements to Central Illinois Public Service Company; and (3) in Connection Therewith, Certain Other Related Transactions | ) | Case No. EM-96-149 |

AFFIDAVIT OF STEPHEN M. RACKERS

STATE OF MISSOURI )
) ss.
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

Stephen M. Rackers

Subscribed and sworn to before me this 22nd day of February 1999.

Toni M Willmeno

Notary Public
My Commission Expires 6/24/00

RATE PROCEEDING PARTICIPATION

STEPHEN M. RACKERS

| Company | Case Number |
|---|---|
| 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 |

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|---|---|
| St. Louis County Water Company | WR-94-166 |
| St. Louis County Water Company | WR-95-145 |
| Union Electric Company | EO-95-400 et al. |
| St. Louis County Water Company | WR-96-263 |
| Union Electric Company | EO-97-6 et al. |
| St. Louis County Water Company | WR-97-382 |
| St. Louis County Water Company | WO-98-223 |

**CALCULATION OF PERMANENT RATE REDUCTION**

| | SHARING CREDITS | WEATHER NORMALIZED CREDITS |
|---|---|---|
| FIRST YEAR | 43,674 | 14,634 |
| SECOND YEAR | 17,851 | 30,747 |
| THIRD YEAR | 40,609 | 36,801 |
| AVERAGE / PERMANENT RATE REDUCTION | | 27,394 |

Schedule 2