Exhibit No.:	
Issues:	*Income Taxes; and Pension Liability*
Witness:	*Stephen M. Rackers*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Direct Testimony*
Case No.:	*EM-96-149*
Date Testimony Prepared:	*April 12, 2002*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

STEPHEN M. RACKERS

FILED
APR 15 2002
Missouri Public
Service Commission

UNION ELECTRIC COMPANY
d/b/a AMERENUE

CASE NO. EM-96-149

Jefferson City, Missouri
April 2002

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UNION ELECTRIC COMPANY

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DIRECT TESTIMONY

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UNION ELECTRIC COMPANY

d/b/a AMERENUE

CASE NO. EM-96-149

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 rate 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) A general discussion regarding the basis of the Staff's adjustments I am sponsoring that are at issue in this proceeding.

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

Q. What is the basis for the Staff's adjustments you are sponsoring to the calculation of sharing credits?

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.vi., 3.f.vii. and 3.f.viii. These same sections also appear on pages 14 and 15 of the Stipulation And Agreement approved in Case No. EM-96-149. These sections state that:

> <u>7.f.vi</u>:
> If Staff, OPC or other signatories find evidence that operating results have been manipulated to reduce amounts to be shared with customers or to misrepresent actual earnings or expenses, Staff, OPC or other signatories may file a complaint with the Commission requesting that a full investigation and hearing be conducted regarding said complaint. UE shall have the right to respond to such request and present facts and argument as to why an investigation is unwarranted.
>
> <u>7.f.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 New 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.
>
> 7.f.viii:
> 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.

The Staff is also relying on the Reconciliation Procedure, Attachment C to the Stipulation And Agreement in Case No. EM-96-149, Section 2.f., for adjustments to the calculation of income taxes and the pension liability reduction to rate base. 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).
> - Staff's position regarding the calculation of Pension and OPEB expense as exemplified in the St. Louis County Water rate case, Case No. WR-95-145.

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 areas of the Staff's calculation of sharing credits that you are sponsoring in this case.

A. I am sponsoring the Staff Adjustments associated with income tax expense and the rate base balances for deferred taxes and pension liability. The adjustments, balances and schedules I am sponsoring are listed below.

Accounting Schedule 2	**Rate Base**
Deferred Income Tax Balance	
Pension Liability Balance	
Accounting Schedule 8	**Adjustments to Income Statement**
S-27.1	Annualization of Current Income Taxes
S-28.1	Annualization of Deferred Income Tax
Accounting Schedule 9	**Income Tax**

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, uncollectible reserve, legal reserve, injuries and damages reserve and miscellaneous adjustments

Q. Please explain the changes to the interest expense.

A. The Staff has calculated its own level of interest expense based on its recommended capital structure, weighted cost of debt and rate base. This calculation of the interest deduction synchronizes the tax calculation with the Staff's recommendations in these areas.

Q. Please explain the changes to the income taxes associated with uncollectible reserve, legal reserve and injuries and damages reserve.

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

Q. Please explain the change to miscellaneous adjustment.

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

Q. Where do the changes to the tax calculation appear?

A. The current income tax adjustments related to these changes are included in "Additions To Net Income" and "Other deductions," which appear on Accounting Schedule 9, Income Tax Calculation, lines 8 and 11, respectively. These components are included in the calculation of current income taxes, which appears on line 27 of Accounting Schedule 9. The deferred income tax effects of the changes appear in the related accounting adjustments.

Q. Please explain Accounting Adjustments S-27.1 and S-28.1.

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

Q. According to which terms of the Stipulation And Agreement is the Staff proposing this adjustment?

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 these items is consistent with the Staff's traditional calculation of income tax, which attempts to synchronize that calculation with other adjustments made to the case that affect the income tax calculation.

The Staff also believes its adjustments are in accordance with Sections 7.f.vii and 2.g. of the Reconciliation Procedure which allows parties to bring disputes regarding the operation and implementation on the Plan to the Commission for resolution.

DEFERRED INCOME TAX BALANCE

Q. What methodology has the Staff used in its determination of the rate base offset for deferred income tax balance?

A. Except for three adjustments, the Staff is including the same balances that were recognized and agreed to by the parties in the calculation of income tax expense in both EARPs. The starting point for the Staff's determination of the rate base offset for deferred income taxes is the amount reflected in the calculation of sharing credits for the period ending 6/30/2001.

Q. Please explain the first two adjustments you are proposing to the deferred taxes.

A. The first two adjustments eliminate the current year deferred taxes associated with the change in the reserves for legal expense and injuries and damages expense. As previously discussed, the Staff has only included actual payments for legal expenses and injuries and damages claims. Therefore, the test year tax effects of these components have been eliminated from the deferred tax balances. The third adjustment eliminates the entire deferred tax balance associated with the change in the uncollectible reserve. Only recognizing actual accounts written off, rather than an estimate of uncollectible accounts, has been the Staff's standard historical practice, both in prior rate cases and EARPs. Therefore, the entire deferred tax balance for the change in the uncollectible reserve has been eliminated from rate base. These adjustments are also necessary to provide consistent treatment between the calculation of income tax expense and the recognition of deferred income tax balances.

Q. According to which terms of the Stipulation And Agreement is the Staff proposing this adjustment?

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 these items is consistent with the Staff's traditional calculation of income tax, which attempts to synchronize that calculation with other adjustments made to the case.

The Staff also believes its adjustments are in accordance with Sections 7.f.vii and 2.g. of the Reconciliation Procedure which allows parties to bring disputed items regarding the operation and implementation of the Plan to the Commission for resolution.

PENSION LIABILITY BALANCE

Q. Please explain the pension liability balance.

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

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

A. Prior to the beginning of the initial EARP on July 1, 1995, UE's rates had reflected pension expense on a pay-as-you-go basis, including an amount that reflected actual payments to the pension fund. When the first EARP was established, the method of determining pension expense for ratemaking was changed, in accordance with

Commission and Staff policy, to a method based on Financial Accounting Standard Number 87, "Employer's Accounting For Pensions" (FAS 87).

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

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

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

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

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

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

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

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

Q. According to which terms of the Stipulation And Agreement is the Staff proposing this adjustment?

A. Section 2.f. of the Reconciliation Procedure states that the earnings report will utilize Staff's position regarding the calculation of Pension and OPEB expense as exemplified in the St. Louis County Water rate case, Case No. WR-95-145.

The Staff also believes its adjustments are in accordance with Sections 7.f.vii. and 2.g. of the Reconciliation Procedure which allows parties to bring disputed items regarding the operation and implementation of the Plan to the Commission for resolution. Also, according to Section 7.f.viii, parties have the right to present concerns of categories of costs that have not been included in previous UE ratemaking proceedings. The Staff is unaware of any UE ratemaking proceeding in which the Commission has addressed the pension liability.

Q. Is the Staff asserting manipulation regarding the pension liability?

A. The Staff believes that inclusion of this item is indicated by the reference to St. Louis County Water Company in the reconciliation procedure. However, if it is determined that other terms of the Stipulation And Agreement do not apply, the Staff asserts that not including the pension liability balance as an offset to the rate base, is a manipulation of earnings according to Sections 7.f.vi. and 7.f.vii. Not recognizing the affect on calculated earnings of including the offset to rate base associated with the pension liability balance reduces the amount to be shared with customers.

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 11 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 11th day of April 2002.

Toni M Charlton

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

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

Company	Case Number
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