

Exhibit No:
Issues: Alternative Regulation Plan
and Agreements; Computer
Software Maintenance;
Territorial Agreements; and
Injuries and Damages Expense
Witness: Benjamin A. McKnight
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Union Electric Company
Case No: EO-96-14

MISSOURI PUBLIC SERVICE COMMISSION

Case No. EO-96-14

REBUTTAL TESTIMONY

OF

BENJAMIN A. McKNIGHT

FILED
APR 2 1999
Missouri Public
Service Commission

ST. LOUIS, MISSOURI
April 2, 1999

1 **REBUTTAL TESTIMONY**

2 **OF**

3 **BENJAMIN A. McKNIGHT**

4 **MISSOURI PUBLIC SERVICE COMMISSION**

5 **Docket No. EO-96-14**

6
7 **BACKGROUND**

8 **Q. Please provide your name, occupation and business address.**

9 A. My name is Benjamin A. McKnight. I am a certified public accountant
10 and a partner in the firm of Arthur Andersen LLP (Arthur Andersen), independent public
11 accountants. My business address is 33 West Monroe Street, Chicago, Illinois 60603.

12 **Q. Please describe the firm of Arthur Andersen.**

13 A. Arthur Andersen is an independent public accounting firm with more than
14 325 offices in over 75 countries located throughout the world. Our clients include a large
15 number of New York Stock Exchange companies. We provide audit services to
16 approximately one-third of the rate-regulated electric and gas distribution companies in
17 the United States and to a substantial number of natural gas transmission, water and
18 telephone companies.

19 **Q. Please state your professional background and qualifications to testify**
20 **as an expert witness in this proceeding.**

21 A. I have a Bachelor of Science degree from Florida State University and a
22 Masters in Business Administration from Northwestern University. I have been with
23 Arthur Andersen since 1971. A substantial portion of my career has been devoted to
24 accounting and regulatory matters related to the electric, gas, telecommunications and

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1 water industries. I have performed numerous audits of companies in these industries. I
2 have participated in or been responsible for the determination of historical cost, working
3 capital and cost of service, including affiliated transactions, as required by state and
4 federal regulatory commissions, and have supervised our professional services in
5 connection with numerous rate case proceedings and a large number of public financings.
6 I have testified on accounting and regulatory matters before various utility commissions.
7 I have also testified in proceedings addressing accounting, regulatory and tax issues
8 before the United States District Court, United States Treasury and Internal Revenue
9 Service National Office officials.

10 I have authored a chapter on regulation and accounting for regulated enterprises
11 published in *Accountants' Handbook*, (Eighth Edition, © 1996 by John Wiley & Sons,
12 Inc.) and co-authored a chapter on natural gas industry accounting and financial reporting
13 developments published in *The 1994 Natural Gas Yearbook* (© 1994 by Executive
14 Enterprises). I am a frequent speaker on regulatory and accounting subjects before
15 regulators, industry groups and professional organizations. I am a member of the
16 American Institute of Certified Public Accountants (AICPA) and the Illinois CPA
17 Society.

18 **Q. What are your responsibilities?**

19 **A.** Since 1985 I have been the Accounting and Audit Technical Coordinator
20 for Arthur Andersen's Utilities and Telecommunications Industries Program, which
21 includes our practice with respect to electric, natural gas, telecommunications and water
22 companies. In this capacity, I am responsible for the consistent applications of
23 accounting principles and audit procedures relating to our clients in these industries. I am

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1 or have been the engagement partner for various electric and gas utility and
2 telecommunications clients, including Northern Illinois Gas Company, Iowa Electric
3 Light and Power Company, Central Illinois Light Company, Central Illinois Public
4 Service Company, Kentucky Utilities Company, Commonwealth Edison Company and
5 Telephone & Data Systems, Inc. I am a current and past (1986 through 1992) member of
6 the AICPA Public Utilities Committee, including a three-year term as chairman. The
7 focus of the Committee is to help identify evolving accounting, auditing and reporting
8 issues that affect rate-regulated enterprises. Some of the more significant issues
9 addressed over the last ten or so years relate to deregulation and changes from traditional
10 to incentive-based regulation. The activities of the Committee also include semi-annual
11 liaison meetings with the Staff Subcommittee on Accounts of the National Association of
12 Regulatory Utility Commissioners and the accounting staffs of various regulatory
13 commissions, including the Securities and Exchange Commission (SEC). I have worked
14 closely with the Financial Accounting Standards Board (FASB) and its staff on various
15 technical and practice issues regarding regulated enterprise projects, including those
16 addressed to its Emerging Issues Task Force (EITF). The FASB is an authoritative body,
17 which established a common set of financial accounting concepts, standards, procedures
18 and conventions commonly known as generally accepted accounting principles ¹
19 (GAAP).

¹ The phrase "generally accepted accounting principles" is a technical accounting term that encompasses the conventions, rules and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. Those conventions, rules and procedures provide a standard by which to measure financial presentations. Statement On Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditor's Report*, a pronouncement of the Auditing Standards Board, the senior technical body of the AICPA, sets forth the generally accepted accounting principles hierarchy for financial statements of nongovernmental entities.

1 **Q. Would you please explain what the EITF is and what its relationship**
2 **and responsibilities relative to the SEC and FASB are.**

3 A. Under securities legislation enacted by Congress in the 1930's, the SEC
4 has the responsibility for establishing accounting principles for entities such as Union
5 Electric Company (UE or the Company), whose securities are sold or traded in interstate
6 commerce. The SEC has delegated primary responsibility for establishing GAAP to the
7 FASB.

8 The FASB instituted the EITF in 1984 to assist with the early identification of
9 issues affecting financial reporting and of problems in implementing authoritative
10 pronouncements. There are 13 voting members of the EITF and agreement among the
11 members on an issue is recognized as a "consensus," if no more than two members
12 disagree with a position. The SEC's Chief Accountant will challenge any accounting that
13 differs from a consensus of the EITF as not being in accordance with GAAP, because the
14 consensus position represents the best thinking on areas for which there are no specific
15 standards.

16 UE is required by law to file financial statements with the SEC that are presented
17 in accordance with GAAP. Accordingly, such financial statements must include the
18 proper application of any relevant consensus of the EITF.

19 **Q. What is the purpose of your rebuttal testimony?**

20 A. In 1995, the Missouri Public Service Commission (MPSC) adopted a
21 Stipulation and Agreement (dated June 12, 1995) that provided for UE to credit
22 customers' rates by \$30 million and to permanently reduce ongoing rates by \$30 million,
23 effective August 1, 1995. A three-year rate moratorium was also instituted. During the

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1 moratorium, UE operated under an experimental alternative regulatory plan. In 1997, a
2 second experimental alternative regulatory plan was established to be in effect for the
3 three years beginning July 1, 1998. Because the Stipulation and Agreement for both
4 plans are similar, they are referred to as the "Agreement" in this testimony. The purpose
5 of my rebuttal testimony is to address certain proposals set forth by the MPSC staff
6 (Staff) and the Public Utility Accountant for the Office of the Public Counsel (OPC) in
7 direct testimony filed in this proceeding. These proposals relate to the adjustment of the
8 Company's Final Earnings Report (the Earnings Report) filed in connection with the third
9 sharing period of this Agreement. Specifically, I will comment on the following direct
10 testimony.

11 MPSC Staff

12 Arlene S. Westerfield regarding Year 2000 Related Computer
13 Repair and Maintenance Costs and Other Computer Costs

14 Stephen M. Rackers regarding Territorial Agreements

15 Michael G. Gruner regarding Injuries and Damages Expense

16
17
18
19 OPC

20 Ted Robertson regarding Year 2000 Related Computer Repair and
21 Maintenance Costs and Other Computer Costs

22
23 I will also comment on why the adjustments proposed by the Staff and OPC are
24 contrary to the terms of the Agreement itself and the primary objectives of entering into
25 an incentive-based regulatory arrangement.

26 **Q. Mr. McKnight, would you please summarize your overall conclusions**
27 **in this rebuttal testimony?**

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1 A. In 1995, the Company, Staff and OPC agreed to adopt an alternative,
2 incentive-based form of regulation that was intended to be different from the traditional
3 rate case process. The procedures, assumptions and other details required for executing
4 and administering this new alternative form of regulations were clearly defined and
5 documented in the Agreement. Various interested parties have relied on the contract that
6 resulted from this change to report financial results, evaluate or project UE's performance
7 and make investment and other decisions.

8 The Staff and OPC are now attempting to alter the terms of the Agreement during
9 its third sharing period. In particular, the Staff and OPC repudiate the terms of the
10 Agreement through proposing adjustments for the third sharing period that are
11 inconsistent with historical financial reporting and regulatory practices agreed to under
12 the Agreement. Accordingly, these proposed adjustments should be rejected by the
13 MPSC.

14 **Q. Mr. McKnight, have you read the testimony filed by other witnesses**
15 **in the proceeding?**

16 A. Yes. I have read the rebuttal testimony of Donald E. Brandt and Warner
17 L. Baxter on behalf of Union Electric, in addition to the direct testimony of Arlene S.
18 Westerfield, Michael G. Gruner and Stephen M. Rackers on behalf of the Staff and Ted
19 Robertson on behalf of the OPC.

20 **Q. Mr. McKnight, have you read the Agreement noted above?**

21 A. Yes, I have read the Agreement, including Attachment C.

22 **Q. In terms of rate regulation, how would you describe the Agreement?**

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1 A. In Mr. Brandt's rebuttal testimony, he characterizes the Agreement as the
2 "introduction of incentive rate regulation," which I believe is correct. Numerous
3 regulatory jurisdictions have concluded that they cannot supervise every aspect of a
4 utility's operations in order to encourage the entity to run better, to lower its costs, and/or
5 to improve business processes or ways of doing business in response to growing
6 competitive pressures. Increasingly, a solution to the problem is to give a utility
7 incentives to operate in a more efficient manner. An additional objective is to move
8 away from the traditional rate case process and the costs, in terms of both time and
9 resources, that come with contentious issues, elaborate testimony and lengthy hearings
10 and appeals. Several types of incentive plans are in operation, including those that utilize
11 a rate moratorium, performance index, price cap, rate of return range and profit sharing.
12 Generally, in the United States, regulators have favored price cap regulation for telephone
13 companies and profit sharing for electric utilities.

14 **Q. Is the Agreement essentially a profit sharing incentive plan?**

15 A. Yes, it is. A profit sharing arrangement involves setting a hurdle level for
16 the allowed rate of return. For achieved rates of return at or below this level, the utility
17 simply operates just as if it is under standard fair return regulation. No sharing of profit
18 takes place with ratepayers. For achieved rates of return above the hurdle level, a profit
19 sharing arrangement takes place between the utility and the ratepayers. For example, the
20 utility may keep half of the profits in excess of the hurdle for rate of return and will pass
21 the other half of these profits on to ratepayers through one-time refunds. A second hurdle
22 fair rate of return may also be involved in this type of a plan, one that is well in excess of

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1 the first hurdle rate. Most, if not all, of the profits beyond this second hurdle rate are
2 generally passed on to customers, also in the form of one-time refunds.

3 A profit sharing incentive plan differs from traditional rate setting because it is
4 designed to determine a refund to be provided back to customers for a distinct period of
5 time based on the utility's results for that period. The refund amount, if any, is based on
6 terms and provisions agreed to under the plan and the utility's actual results. This form of
7 regulation is not concerned with how the profits earned during this period may or may
8 not affect future rates to customers, because it is designed to determine the one-time
9 refund to customers for the period under review.

10 Even though some profit sharing plans put a cap on profits, the utility is still given
11 plenty of room to improve its operations and, thereby, its return to shareholders. The
12 Agreement, which Mr. Brandt describes in his rebuttal testimony, is the same type of
13 incentive-based regulatory plan.

14 **Q. Why have electric utilities and their regulators opted towards profit**
15 **sharing plans when selecting an incentive-based form of regulation?**

16 A. I am sure there are different reasons in each regulatory jurisdiction for
17 selecting a profit sharing form of regulation over other alternatives. However, probably
18 the most attractive feature of a profit sharing arrangement is that it is simple to
19 understand and, after the terms of the plan have been agreed to by all interested parties,
20 simple to administer. With these features, regulatory inefficiencies and uncertainties
21 should be significantly reduced during the period that the plan is scheduled to be in
22 effect, primarily because traditional regulatory issues are resolved at the front end. The
23 determination of a test period and all the work associated with that process are not

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1 necessary after the plan has been established. The only thing left to do is determine the
2 earnings of the company under the terms of the plan, and the corresponding sharing
3 credit, if any, for the established monitoring periods. Again, this process should also be
4 simple because the credit can be objectively measured based on actual results and the
5 accounting principles and regulatory policies set forth in the plan. The affected utility is
6 also able to rely on the plan to prepare its interim and annual financial statements in
7 accordance with GAAP (as well as any regulatory reports in accordance with the uniform
8 system of accounts (USOA) adopted by the utility's regulator). An important estimate
9 that the utility's management must assert in these financial statements is that, to the extent
10 any refund obligation to customers exists under the plan, it has been properly recorded in
11 accordance with the provisions of Statement of Financial Accounting Standards (SFAS)
12 No. 5, *Accounting for Contingencies*. Shareholders, investment analysts, credit analysts
13 and other users of the utility's financial statements, in turn, rely on management's
14 assertion, as well as the integrity of the plan, to establish reasonable expectations as to
15 how well the company should perform.

16 **Q. In your opinion, should the determination of UE's refund to its**
17 **customers under the Agreement be a simple process?**

18 A. Yes, it should. The Agreement, including Attachment C, clearly
19 establishes the operating periods and results, accounting principles, regulatory policies
20 and agreed to assumptions that should be consistently applied in the annual Earnings
21 Report to measure UE's refund obligation for each sharing period. For example, the
22 determination of cash working capital is one of the most controversial elements in
23 ratemaking. Even though working capital generally represents a small portion of the total

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1 investment in rate base, it often consumes a significant portion of the hearing time in a
2 regulatory proceeding. Cash working capital should not be an issue under the Agreement
3 because, as set forth among the many detailed procedures on Attachment C, all of which
4 the Earnings Report must reflect, a rate base offset of \$24 million is established.

5 **Q. Why has it not been a simple process for the third sharing period?**

6 A. It has not been a simple process because the Staff and OPC are attempting
7 to breach the Agreement. The purpose of the Earnings Report is to calculate the earnings
8 of UE based on the specific terms of the Agreement, which relies heavily on the
9 Company's historical accounting methods to determine whether UE has a refund
10 obligation for the third sharing period. However, the Staff and OPC apparently do not
11 like the earnings results reflected in the Earnings Report as calculated in accordance with
12 the Agreement, and have proposed adjustments which, in effect, create a biased,
13 retroactive test period. The Earnings Report is not supposed to be the "unadjusted"
14 starting point to create a representative test period for purposes of setting UE's future
15 rates. Instead of continuing to consistently apply the provisions of the Agreement and
16 follow the alternative regulatory approach established in 1995, the Staff and OPC are
17 now reverting back to the old rate case process, a process which the various interested
18 parties struck a contract to change for at least six years. The proposed adjustments of the
19 Staff and OPC to the Earnings Report for the third sharing period violate the terms of the
20 Agreement. The proposed adjustments would impute nonexistent income, selectively
21 substitute actual results with "normalized" results, ignore the historical regulatory
22 treatment for select categories of costs, ignore select accounting principles that have been
23 consistently applied for extended periods of time and, in substance, selectively early

1 adopt a new accounting principle, even though it is inconsistent with the MPSC's past
2 regulatory actions. The balance of my testimony discusses some of these proposed
3 adjustments.

4 **COMPUTER SOFTWARE MAINTENANCE**

5 **Q. Historically and in the third sharing period under the terms of the**
6 **Agreement, how has the Company recorded its computer repair and maintenance**
7 **costs, such as those related to Year 2000 costs?**

8 A. UE has historically expensed its computer repair and maintenance costs in
9 the period incurred. This accounting policy was consistently applied for such costs
10 throughout the sharing periods, including the computer repair and maintenance costs that
11 are Year 2000 related.

12 **Q. What is your understanding of the Staff's proposal for UE's computer**
13 **repair and maintenance costs related to Year 2000?**

14 A. Ms. Westerfield states in her testimony that: "for ratemaking purposes,
15 nonrecurring items like Year 2000 costs should not be charged to expense." She goes on
16 to propose that the costs should be deferred and "if such nonrecurring items are given rate
17 treatment at all, the costs should be amortized to expense over a reasonable length of
18 time."

19 **Q. Do you agree with Ms. Westerfield that the Year 2000 related costs**
20 **incurred by UE are nonrecurring?**

21 A. No, I do not. The Company has routinely incurred computer repair and
22 maintenance costs and it will continue to do so in the future. Year 2000 related activities
23 involve costs that are no different from those resulting from other computer repair and

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1 maintenance activities. This view is consistent with the requirement under GAAP that
2 external and internal costs specifically associated with modifying internal-use software
3 for the Year 2000 are period costs and should be charged to expense as incurred.

4 The basis for this requirement, as set forth in EITF Issue No. 96-14 (Issue 96-14),
5 *Accounting for the Costs Associated with Modifying Computer Software for the Year*
6 *2000*, is that these costs are incurred to keep the software updated and therefore should be
7 classified similar to other computer repair and maintenance expenses. Also, Year 2000
8 modifications, which basically consists of reviewing application code piece by piece and
9 changing it, are not readily distinguishable from other types of repair and maintenance
10 activities. These modifications involve fixing a programming bug so that the application
11 survives typical conditions -- such as date rollovers. Such modifications do not extend
12 the use of the software beyond the life that it was originally intended to be used for and
13 do nothing more than restore the software to its normal state, without adding
14 functionality. Incidentally, this conclusion/consensus was accepted unanimously by all
15 13 members of the EITF.

16 **Q. Ms. Westerfield testified that it is appropriate under the Agreement to**
17 **propose her Year 2000 cost adjustment because it is a "category of cost that has**
18 **been included in UE's monitoring results and has not been included in any**
19 **ratemaking proceeding." Do you agree?**

20 **A.** No, I do not. As discussed above, the costs in question relate to computer
21 repair and maintenance activities that have been and will be continually performed by
22 UE. UE's accounting for such costs has been historically consistent -- expensed when
23 incurred as a period cost. This accounting treatment reflects the continuous regulatory

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1 treatment accorded computer repair and maintenance costs for ratemaking purposes by
2 the MPSC. It would not be credible for Ms. Westerfield to assert that computer repair
3 and maintenance costs have not been included in any of UE's ratemaking proceeding.
4 Instead, she proposes to eliminate a portion of the Company's computer repair and
5 maintenance expense by simply calling it something different. Thus, she invents a "new"
6 category of costs – Year 2000 costs. As noted above, distinguishing computer repair and
7 maintenance costs in this manner is totally inappropriate.

8 **Q. In Ms. Westerfield's direct testimony, she includes a quote from the**
9 **MPSC in Case No. 00-99-43 which leads her to conclude that "the Commission's**
10 **stated preference" is to defer the total Missouri jurisdictional portion of UE's Year**
11 **2000 related computer repair and maintenance costs. Do you agree with Ms.**
12 **Westerfield's conclusion?**

13 A. Based on the information provided in Ms. Westerfield's direct testimony,
14 her conclusion is unsupported. I do not see a reference to deferring costs in the MPSC
15 statement quoted by Ms. Westerfield. The MPSC's statement, which also includes a
16 statement from a Commissioner on the Federal Communications Commission (FCC),
17 basically says that there is a major problem that needs to be fixed, so fix it now and fix it
18 right. In fact, both the MPSC and the FCC Commissioner warn against not getting the
19 job done due to the type of "squabbling" that Ms. Westerfield is initiating with her
20 proposed adjustment. Ms. Westerfield is simply stretching to justify her proposal to
21 retroactively normalize or eliminate a portion of UE's computer repairs and maintenance
22 costs.

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1 **Q. In Ms. Westerfield's direct testimony, she indicates that a prudence**
2 **determination is needed for the Company's Year 2000 related computer repair and**
3 **maintenance costs. Does she provide any explanation or specifics as to why UE's**
4 **Year 2000 related computer repair and maintenance costs are not prudent?**

5 A. No, she does not.

6 **Q. Does Ms. Westerfield explain why a prudence determination is needed**
7 **for UE's computer repair and maintenance costs but not other categories of cost?**

8 A. No, she does not.

9 **Q. Mr. McKnight, what does Mr. Robertson conclude with regard to**
10 **UE's Year 2000 related computer repair and maintenance costs?**

11 A. Mr. Robertson's testimony indicates that the costs incurred by the
12 Company to modify computer systems should have been capitalized and amortized over a
13 period representative of the service life of the modifications.

14 **Q. What is the basis for Mr. Robertson's conclusion?**

15 A. It appears to be based on Mr. Robertson's view that Issue 96-14 is not
16 GAAP.

17 **Q. Do you agree with Mr. Robertson?**

18 A. No, I do not. In preparing its financial statements in accordance with
19 GAAP, UE must apply the accounting requirements of Issue 96-14. As I discussed
20 earlier, a consensus of the EITF becomes part of GAAP and, therefore, must be followed
21 for financial reporting purposes. In addition, AICPA Statement of Position 98-1 (SOP
22 98-1), *Accounting for the Costs of Computer Software Developed or Obtained for*
23 *Internal Use*, states:

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1 This SOP does not change the conclusions reached in Emerging Issues
2 Task Force Issue No 96-14, *Accounting for the Costs Associated With*
3 *Modifying Computer Software for the Year 2000*, which requires that
4 external additional costs associated with modifying internal use
5 software currently in use for the Year 2000 be charged to expense as
6 incurred.

7
8 An SOP is reviewed and cleared by the FASB before issuance and is considered to be
9 GAAP.

10 **Q. Does Mr. Robertson explain why, under the Agreement, his proposed**
11 **adjustment is supportable?**

12 A. No, he does not.

13 **OTHER COMPUTER COSTS**

14 **Q. Would you please describe the "other computer costs" that are at**
15 **issue in this proceeding?**

16 A. In broad terms, they are the costs of certain internally developed computer
17 software and information systems for UE. The costs in question are limited to three
18 specific projects: a customer information system, a power plant maintenance
19 management program and a human resource and payroll system.

20 **Q. Historically and in the third sharing period under the terms of the**
21 **Agreement, how has the Company recorded internally developed software and**
22 **information systems costs?**

23 A. UE has historically expensed internally developed software and
24 information system costs. This accounting policy has been consistently applied for such
25 costs throughout the sharing periods, including the costs related to the three projects
26 noted above. The same policy has been followed by UE for an extended period of time,
27 during which many similar projects have been completed.

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1 **Q. What is the basis for UE's accounting policy?**

2 A. Many companies have long-standing policies to expense internally
3 developed software costs as incurred. This practice was noted in 1985 by the FASB in its
4 SFAS No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or*
5 *Otherwise Marketed*, as follows:

6 The Board considered broadening the scope of this project to include
7 costs incurred for an enterprise's development of computer software for
8 its own use. After evaluation, the Board concluded that accounting for
9 the cost of software used internally is not currently a significant
10 problem and, therefore, decided not to broaden the scope for this
11 project nor add a project on internal use software to its present agenda.
12 The Board recognized that the majority of companies expense all costs
13 of developing software for internal use, and the Board was not
14 persuaded that this current predominate practice is improper.
15 (emphasis added)
16

17 **Q. Why do companies adopt and continue to follow the policy to expense**
18 **such costs as incurred?**

19 A. Included among the reasons is that a net realizable value test cannot be
20 applied easily to capitalized costs from which revenues will not be realized. There has
21 also been a concern that capitalization would result in assets that have arbitrary
22 amortization periods. Also, capitalizing such costs could result in frequent subsequent
23 write-offs when they are eventually determined to be without value.

24 **Q. Are there additional considerations for rate-regulated enterprises?**

25
26 A. Yes, there are. UE's regulatory and external financial reporting reflect the
27 provisions of SFAS No. 71 (SFAS 71), *Accounting for the Effects of Certain Types of*
28 *Regulation*. SFAS 71 provides guidance in preparing general purposes financial
29 statements for most rate-regulated public utilities, such as UE. The USOAs of regulators,

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1 such as the FERC and the MPSC, provide guidance for applying SFAS 71 in order to
2 comply with jurisdictional reporting requirements. The basic purpose of SFAS 71 is that
3 the actions of regulators create a cause and effect relationship between a regulated
4 enterprise's revenues and costs, which should be reflected in that entity's financial
5 reporting. Accordingly, under SFAS 71, UE's accounting for these costs should reflect
6 the MPSC's regulatory treatment accorded such costs when establishing the Company's
7 rates. For example, the costs of computer software developed or obtained for internal use
8 are either incremental or non-incremental in nature. Incremental costs are defined as
9 payments to outsiders or related internal costs to the extent each of these costs would not
10 be otherwise incurred by the utility. If the rates historically established by the MPSC
11 have provided revenues designed to recover UE's incremental and non-incremental costs
12 of developing computer software and information systems for internal use, the
13 capitalization of such costs would not be appropriate. To do so would ignore the
14 economic effect of regulation that is recognized in SFAS 71. In this case, that economic
15 effect is that the MPSC has been providing "current" recovery through rates of UE's
16 costs of developing computer software and information systems for internal use. The
17 costs should be expensed to match the revenues provided for their recovery.

18 **Q. Historically, has UE expensed all costs of developing software and**
19 **information systems for internal use?**

20 **A.** Yes. As noted above, such costs have been expensed as incurred for
21 regulatory purposes and the MPSC has established the Company's rates on that basis.
22 Thus, UE's financial reporting policy has been consistent with the regulatory practice
23 followed for these costs by the MPSC.

1 **Q. What is your understanding of the Staff's proposal for UE's cost of**
2 **software and information systems developed for internal use?**

3 A. Ms. Westerfield proposes a change during the third sharing period in UE's
4 accounting policy for the three projects in question. Specifically, she proposes to
5 capitalize and amortize over a ten-year period, the amounts expended by UE during the
6 third sharing period for the customer information system, power plant maintenance
7 program and the human resources and payroll system.

8 **Q. What does Mr. Robertson propose for these project costs during the**
9 **third sharing period?**

10 A. The OPC proposes that the project costs should be capitalized and
11 amortized over a period representative of the usefulness or the service lives of the
12 systems.

13 **Q. What is the basis for Ms. Westerfield's proposal?**

14 A. Ms. Westerfield believes that UE's accounting policy for these projects is
15 inappropriate considering the significance of the amounts and the enhanced capabilities
16 of the new systems compared to their predecessors. She believes these costs should be
17 capitalized and treated as plant assets for ratemaking purposes. She also looks to SOP
18 98-1 as support for her position. SOP 98-1, which is effective for UE for financial
19 reporting purposes in 1999, addresses accounting for the costs of computer software
20 developed or obtained for internal use.

21 **Q. In 1999, when SOP 98-1 becomes effective for UE, will all costs related**
22 **to these projects start to be capitalized?**

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1 A. No, they will not. SOP 98-1 provides guidance on when costs incurred for
2 internal-use software are and are not capitalized. Certain costs will be expensed as
3 incurred under SOP 98-1, such as those associated with a project's preliminary stage, data
4 conversion from the old to new systems, training, general and administrative costs and
5 overheads. Also, SOP 98-1 does not alter EITF Issue No. 97-13, (Issue 97-13),
6 *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal*
7 *Project That Combines Business Process Reengineering and Information Technology*
8 *Transformation*. Issue 97-13 requires that the costs of reengineering activities, which
9 often are associated with new or updated software applications and information systems,
10 be expensed as incurred.

11 **Q. Do Ms. Westerfield's proposed adjustments to the third sharing**
12 **period differentiate between costs that would be expensed vs. capitalized under SOP**
13 **98-1 and Issue 97-13?**

14 A. No, they do not.

15 **Q. Has the Company analyzed the financial reporting impact of SOP 98-**
16 **1 on costs incurred during the third sharing period for these projects?**

17 A. To my knowledge, it has not. First off, SOP 98-1 is not effective for UE
18 until January 1, 1999, well after the end of the third sharing period. Also, UE's
19 accounting policy for project costs of this nature reflects the historical economic effect of
20 the MPSC's regulatory treatment. As noted previously, this economic effect of
21 regulation is reflected in UE's regulatory and financial reporting under SFAS 71.
22 Because of the MPSC's historical regulatory treatment, these costs have been expensed,
23 as incurred, to match the revenues provided through rates for their "current" recovery.

1 Accordingly, it is inappropriate, even when SOP 98-1 becomes effective, for UE to
2 change its accounting policy, until the Company's rates are adjusted to reflect a
3 corresponding change in regulatory treatment by the MPSC.

4 UE's rates have been historically established to provide current recovery of its
5 non-incremental and incremental costs for internally developed computer software and
6 information systems. As with virtually all costs, the amount UE incurs for internally
7 developed computer software obviously varies -- both up and down -- from year to year.
8 It is not proper, particularly under the Agreement, to individually isolate or select (based
9 on a year-to-year increase) a category of costs and retroactively change the related
10 accounting policy without regard to the historical regulatory treatment for the category.

11 **Q. Does Mr. Robertson explain why, under the Agreement, his proposed**
12 **adjustment is supportable?**

13 A. No, he does not.

14 TERRITORIAL AGREEMENTS

15 **Q. What is your understanding of the Staff's proposed adjustment in the**
16 **third sharing period for the territorial agreements between UE and Black River**
17 **Cooperative, Inc. and UE and Macon Electric Cooperative, Inc.?**

18 A. Mr. Rackers, on behalf of the Staff, has asserted that the territorial
19 agreements reduced UE's earnings during the third sharing period. This decline in
20 earnings reduces the amount credited to UE's customers for the third sharing period. To
21 compensate for this decline, Mr. Rackers proposes to reverse the earnings reduction "by
22 restoring the net loss in revenues and the associated fuel cost, maintenance expense,
23 depreciation expense, and reserve additions."

1 **Q. Has Mr. Rackers identified in his direct testimony any revenues or**
2 **expenses, recorded for the new territories by the Company during the third sharing**
3 **period, which he considers to be questionable, unusual or "new" for UE?**

4 A. No, he has not.

5 **Q. What is the basis under the Agreement for the Staff's proposed**
6 **adjustment?**

7 A. The primary justification cited by the Staff is that signatories to the
8 Agreement have the right to present to the MPSC concerns over any category of cost that
9 has been included in UE's monitoring results and has not been included previously in any
10 ratemaking proceeding. Because of the proposed reduction in UE's net earnings for the
11 third sharing period that Mr. Rackers has associated with the territorial agreements, the
12 Staff has deemed such agreements to be "detrimental to ratepayers." In his direct
13 testimony, Mr. Rackers states: "The Staff is not aware of a situation where earnings
14 results were adjusted to prevent detriment to ratepayers as a result of the affect of a
15 territorial agreement in a revenue requirement determination proceeding."

16 **Q. If Mr. Racker's testimony is correct, and such an adjustment has**
17 **never been reflected in a revenue requirement determination, why is the Staff's**
18 **proposed adjustment appropriate for the third sharing period?**

19 A. It is understandable to me that the MPSC has not previously imputed non-
20 existent earnings in determining previous revenue requirement for UE. If this is the case,
21 however, I do not understand why it is appropriate, under the Agreement, for the Staff to
22 propose this new cost category for the third sharing period.

Rebuttal Testimony of
Benjamin A. McKnight

1 A. First, the Staff proposal adjusts the third sharing period's beginning
2 balance down to the average reserve balance for the first two sharing periods. Second,
3 the Staff adds to the calculated amount above, claims paid during the sharing period. The
4 net effect of the two steps is to reduce UE's actual jurisdictional injuries and damages
5 expense for the third sharing period by approximately \$2,275,000.

6 **Q. What is the basis for this proposed adjustment?**

7 A. The Staff cites Section 3.f.viii. However, after reading that section of the
8 Agreement, I cannot determine why the proposed adjustment is appropriate. Because the
9 Staff is not challenging the actual amount of UE's injuries and damages expense for the
10 third sharing period, the section cited is not relevant. There is no disagreements as to the
11 mechanics of a calculation and no allegation of manipulation. UE's actual injuries and
12 damages expense for the third sharing period is what it is.

13 **Q. Does Attachment C of the Agreement include the normalization**
14 **income statement adjustments that have been accepted by its signatories?**

15 A. Yes, it does.

16 **Q. Does it include a normalization adjustment for injuries and damages?**

17 A. No, it does not.

18 **Q. What would be the economic and financial report impact of the Staff's**
19 **proposed adjustment on UE?**

20 A. In addition to being arbitrary, the mechanics of how the Staff's
21 "normalization" methodology would work going forward is unclear. At this point, UE
22 would probably be at risk for not recovering a significant portion of the proposed
23 adjustment.

Rebuttal Testimony of
Benjamin A. McKnight

1 **Q. Would that result be consistent with the intent of the Agreement?**

2 A. No, it would not be.

3 **Q. Mr. McKnight, does this conclude your rebuttal testimony?**

4 A. Yes, it does.

