Exhibit No.:	
Issues:	Cash Working Capital
Witness:	Michael J. Adams
Sponsoring Party:	Union Electric Company
Type of Exhibit:	Rebuttal Testimony
Case No.:	ER-2008-0318
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2008-0318

REBUTTAL TESTIMONY

OF

MICHAEL J. ADAMS

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

St. Louis, Missouri
October, 2008

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OF
MICHAEL J. ADAMS
CASE NO. ER-2008-0318

I. INTRODUCTION AND WITNESS QUALIFICATIONS

Q. Please state your name and business address.

A. My name is Michael J. Adams. My business address is 293 Boston Post Road, Suite 500, Marlborough, Massachusetts 01752.

Q. Are you the same Michael J. Adams that filed direct testimony in this proceeding?

A. Yes, I am.

II. PURPOSE AND SCOPE

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the Cash Working Capital ("CWC") calculation sponsored by Missouri Public Service Commission ("MPSC" or the "Commission") Staff witness Erin Carle.

Q. Please summarize your conclusions with regards to Ms. Carle's CWC calculation.

A. For the most part, the Company concurs with Staff's CWC analysis. There are four corrections, however, which must be made to Staff's CWC analysis to achieve an accurate result.

First, Staff's overall revenue lag inappropriately excludes the payment processing lag. As a result, the revenue lag is understated by 0.59 days.

Second, Staff erroneously applies zero revenue lag days to sales tax dollars and a reduced revenue lag to gross receipts tax dollars. No support is provided in the Staff Report to justify such a position. The Company has only one revenue stream, however, and that revenue stream does not vary depending upon each individual expense considered in the CWC analysis.

Third, the vacation accrual represents a liability on the Company's books and is not a cash operating expense which should be considered in the CWC analysis. Staff's inclusion of the vacation accrual violates Staff's own handbook on how to prepare a CWC analysis.

Finally, Staff should consistently apply either statutory due dates or actual payment dates to all taxes. Selectively choosing which dates to apply to the individual taxes undermines the credibility of the entire analysis and appears results-oriented; that is, appears to be an attempt to cherry pick items that tend to reduce CWC and the resulting revenue requirement associated with CWC.

Q. What level of CWC requirement did the Company file for in its direct case?

A. The Company's direct filing contained a total CWC requirement (cash requirement plus interest and tax offsets) of negative $15.5 million. The request was updated to reflect a total CWC requirement of negative $14.8 million.

Q. What level of CWC requirement is Staff recommending in its direct case?

A. Ms. Carle recommended a cash working capital requirement of <u>negative</u> $81.1 million updated to reflect a CWC requirement of negative $90.0 million.

Q. To what do you attribute the differences in the level of CWC requirements requested by the Company and that sponsored by Ms. Carle?

A. The primary drivers of the differences between the Company's requested level of CWC and that proposed by Staff are as follows:

1. Staff's adjusted expense levels which are different than those requested by the Company;
2. The revenue lag and expense lead day calculations proposed by Staff reflect updated information;
3. Staff's revenue lag erroneously excludes the payment processing component;
4. Staff's inclusion of non-cash items (i.e., vacation payroll) in the cash working capital analysis;
5. Staff's use of understated revenue lag days associated with Sales Taxes and Gross Receipts Taxes; and
6. Different expense lead days for federal, state and city tax offsets.

Q. What is your position with regard to the level of expenses included in the CWC analysis?

A. While Company witness Gary Weiss testifies to the level of expenses which should be included in the CWC calculation, the final determination of the CWC requirement to be included in rate base should be based upon the level of expenses which are ultimately approved by the Commission in this proceeding.

Q. What is your position regarding Staff's updated leads and lags?

A. As I will discuss, Staff's revenue lag is understated. Further, I do not agree with the revenue lags which Staff uses for Sales Taxes and Gross Receipts Taxes.

I agree with the expense lead days utilized by Staff, with the exception of those employed for Federal, State and City tax offsets.

III. REVENUE LAG

Q. Has Ms. Carle updated the revenue lag to reflect off-system sales?

A. Yes, she has.

Q. Do you agree with Ms. Carle's inclusion of off-system sales in the determination of the revenue lag?

A. Yes, I do.

Q. Has Ms. Carle included all aspects of the revenue lag in her calculation?

A. No. Ms. Carle has inexplicably excluded the payment processing lag, which amounts to 0.59 days.

Q. What is the payment processing lag?

A. The payment processing lag represents the amount of time that it takes the Company from the receipt of a customer's payment to record and deposit the payment.

Q. Is the payment processing lag a component which is typically included in a CWC analysis?

A. Yes. Every jurisdiction in which I have testified on the topic of cash working capital includes a payment processing lag in the calculation of the revenue lag.

Q. What explanation does Ms. Carle provide for excluding the payment processing lag?

A. The Staff Report is silent as to why the payment processing lag might be excluded.

Q. Is the payment processing lag a legitimate lag which should be considered in the CWC analysis?

A. Yes. Customer payments are sent directly to the Company. The collections lag reflects the elapsed time from the mailing of the customers' bill to the receipt of the payment. The payment processing lag must be included to reflect the elapsed time from receipt of the payment to the depositing of the payment. The payment processing lag amounts to 0.59 days.

IV. VACATION PAYROLL

Q. What is the purpose of a CWC analysis?

A. The purpose of the CWC analysis is to evaluate the timing of cash flows. In other words, the CWC analysis evaluates the timing of receipt of revenues from customers for the provisioning of utility services and the Company's payment for goods and services received.

Q. Do both the Company and Staff employ a similar methodology by which to measure the Company's CWC requirements?

A. Yes. Both the Company and Staff employ what is commonly referred to as the Net Lag Methodology to determine the Company's CWC requirements.

Q. What revenues and expenses are typically included in a CWC analysis?

A. A CWC analysis typically includes revenues associated with the provisioning of utility services and cash operating expenses paid by the utility during the test year. The revenues and cash operating expenses would be reported on the Company's income statement.

Q. Has Ms. Carle included a non-cash item in her CWC analysis?

A. Yes. Ms. Carle has included approximately $9.6 million of vacation payroll in her CWC analysis.

Q. Does the vacation accrual represent an operating expense which should be considered in the CWC analysis?

A. No. The vacation accrual represents a liability on behalf of the Company associated with vacation time earned by its employees. The vacation accrual is recorded on the Company's balance sheet. The accrual is adjusted as necessary to reflect the total liability. The only portion of the accrued vacation which would ever hit the income statement is the change to increase or decrease the overall accrual. The amount which is recorded as an expense, however, does not represent a *cash* operating expense.

Q. Is it appropriate to include the vacation accrual in a cash working capital analysis?

A. No. As I previously stated, the CWC analysis is intended to measure the timing of *cash* receipts and *cash* operating expenses. The vacation accrual is a *non-cash* liability on the Company's balance sheet and therefore should not be included in the CWC analysis. Staff does not propose to include other liabilities in the analysis, so it is unclear why the vacation accrual should be afforded different treatment than other liabilities.

Further, the Company's proposed level of expenses already reflects twelve months of payroll-related expenses. Ms. Carle's treatment of the vacation accrual as a cash expense infers that an employee of the Company has the opportunity to earn extra cash while on vacation. This is simply not the case. An employee of the Company earns his/her regular paycheck while on vacation. For Ms. Carle's treatment to be accurate either the Company would need to cease operations or every employee would have to quit after they had vested vacation time, obligating the Company to pay vacation accruals in cash. Neither scenario is likely to occur. Thus, vacation payroll is not a cash expense and has not been considered in the Company's study.

Q. Does Ms. Carle explain in the Staff's Report why it is appropriate to include the vacation accrual in the CWC analysis?

A. No. After explaining how AmerenUE employees earn vacation, Ms. Carle leaps to an unsubstantiated position to include the vacation accrual in the CWC analysis by stating "Failure to recognize this situation will result in excess CWC being included in the determination of revenue requirement.[1]"

Q. Does the Missouri PSC Staff have a position regarding the inclusion of non-cash items in lead lag studies?

A. Yes. Based upon my understanding of Staff's Cash Working Capital handbook, Staff has opposed inclusion of non-cash items in lead lag studies. The handbook correctly states, "the utility does not need to have cash on hand for these expenses because there is no cash outlay associated with these items.[2]" See Schedule MJA-RE2.

[1] Staff Report, p. 7.
[2] Staff Handbook, p. 21.

Q. Has Ms. Carle explained why she deviated from Staff's handbook regarding the inappropriateness of including non-cash operating expenses in the CWC analysis?

A. She has not.

Q. Does Ms. Carle assign an expense lead to the vacation accrual?

A. Yes, she does. Ms. Carle assigns an expense lead of 385.99 days to the vacation accrual.

By assigning a precise level of expense lead days to the vacation accrual, Ms. Carle asserts a level of certainty to the payment of vacation accrual-related dollars which simply does not exist. Ms. Carle's analysis implies that the Company tracks or that she has analyzed the precise timing of receipt of vacation-related dollars and payment of such dollars to AmerenUE employees. This is simply not the case. The accrued level of expenses which flow in and out of the liability account are not tracked with precision. Rather, the accrual is adjusted, as necessary, to reflect the level of the Company's liability if all employees had to be paid at once for their accrued vacation time. Such a situation has never occurred.

Q. Setting aside the question of whether the vacation payroll issue is an accrual or not, do you agree with the expense lead that Ms. Carle applies to vacation amounts?

A. No. The expense lead used by Ms. Carle is unreasonably long. The fact is that the Company's payment of vacation time is on the same timeframe as regular payroll expenses. No separate fund of money is funded or maintained associated with the accrued vacation. Those vacation payments are made from normal cash flows the same as payroll expenses. Therefore, the payroll lead should also be applied to the vacation payroll amounts, as has been reflected in the Company's CWC analysis.

V. REVENUE LAG DAYS ASSOCIATED WITH SALES TAXES

Q. What revenue lag does Ms. Carle apply to sales tax dollars?

A. Ms. Carle assigns zero revenue lag days to the sales tax dollars.

Q. What justification does Ms. Carle provide to support her position?

A. The Staff Report is silent on the issue of the revenue lag applied to sales tax dollars. No justification or explanation has been provided by Ms. Carle to support Staff's position.

Q. Has Staff consistently taken this approach in other recent rate proceedings?

A. No. In The Empire District Electric Company's recent rate proceeding, Case ER-2008-0093, Staff recommended a revenue lag of 21.9279 and an expense lead of 22.1911 for sales taxes. Staff's proposed revenue lag and expense lead days in that proceeding appear to exclude the service lag/lead, as opposed to the entire revenue lag.

Q. Has Ms. Carle explained why AmerenUE's sales tax dollars should be afforded different treatment than those of The Empire District Electric Company?

A. No, she has not.

Q. Has Staff proposed to eliminate the service lead element of the overall expense lead days in this proceeding?

A. No. Therefore, Staff has eliminated the entire revenue lag but made no adjustment to the expense lead in this proceeding.

Q. Do you agree that zero revenue lag days should be assigned to Sales Tax dollars?

A. I do not.

Q. Please explain.

A. In prior proceedings, Staff has argued that the Company's liability for forwarding sales taxes to the respective taxing authorities does not begin until such taxes are collected. Thus, a revenue lag time of zero was assigned to sales taxes.

Q. To assign zero revenue lag days to the sales tax dollars implies that the revenues used to pay such taxes mysteriously appear. How do you respond to such a position?

A. The revenue lag consists of a chain of events. The customer receives a service from the Company; the Company reads the meter to determine the amount of service received during a given period of time; the Company bills the customer for that service; the customer pays the bill; the Company processes the payment; and the funds become available to the Company at the bank. This chain of events is not altered depending upon which expense is being paid. There is no separate source of revenues for each type of expense. The customers' payment of their utility bills is the Company's only source of funds.

By employing zero revenue lag days, Ms. Carle would have the Commission believe that the Company incurs an obligation related to sales taxes without any consideration of the revenue lag process. The sales tax payment, however, is clearly the result of the services provided by the Company to its customers. Therefore, it is appropriate to reflect the entire revenue lag amount when determining the cash working capital impact associated with the sales taxes.

Q. Staff's use of zero revenue lag days for sales taxes implies that the Company has access to and use of such funds until payment is remitted to the proper taxing authorities. Is such a position accurate?

A. No. Staff's position implies that the Company has access to the funds for 35.29 days prior to remitting such funds. Ms. Carle's position fails to differentiate between companies which maintain their books on a cash basis versus those on an accrual basis. Ms. Carle assumes that the Company remits payment of sales taxes only once the funds are received from its customers. Such an assumption is incorrect.

Q. Please explain.

A. Under Mo. Code Regs. 12 CSR 10-103.560 Section (1) states "In general, a taxpayer should report gross receipts in the period in which payment is actually received. A taxpayer using the accrual basis of accounting may report gross receipts in the period in which the transaction takes place."

Q. Does AmerenUE employ the accrual basis of accounting?

A. Yes, it does.

Q. When would the Company remit payment of sales taxes under the accrual basis of accounting?

A. Under accrual accounting, AmerenUE would remit the sales taxes on the 20th of the month following the month in which the customers were billed for the utility services.

Q. What revenue lag and expense lead days should be used for sales taxes?

A. A revenue lag of 34. 65[3] days and an expense lead of 35.29 days should be applied to sales tax dollars. Such revenue lag days and expense lead days accurately reflect the fact that the Company actually remits payment of the sales taxes to the appropriate taxing authorities 0.64 days prior to receipt of the dollars from its customers.

VI. REVENUE LAG DAYS ASSOCIATED WITH GROSS RECEIPTS TAXES

Q. What revenue lag days does Staff apply to gross receipts taxes in its CWC analysis?

A. Ms. Carle originally assigned the full revenue lag of 34.17 days to gross receipts taxes. Staff subsequently revised its position and now assigns a revenue lag of 20.37 days to the gross receipts taxes.

Q. Does Ms. Carle explain the basis for her revised position in the Staff Report?

A. No, the Staff Report is silent on the issue of the appropriate revenue lag days to be assigned to the gross receipts dollars.

Q. Is any reduction to the revenue lag days assigned to the gross receipts dollars appropriate?

A. No. As I explained with regards to sales taxes, there is only one source of revenues for the Company and that is the payment by its customers of the monthly utility bill. Therefore, the same revenue lag should be applied to all cash operating expenses

[3] Reflects Ms. Carle's revenue lag of 34.17 days plus the weighted impact of including the 0.59 days for payment processing.

considered in the CWC analysis. To adjust the revenue lag implies that the Company collects the revenues associated with the gross receipts taxes in a manner and at a time different than the actual collection process. Such an alternative revenue stream simply does not exist.

VII. EXPENSE LEAD DAYS ASSIGNED TO TAXES

Q. How did the Company determine the appropriate expense lead days to apply to both income and non-income taxes?

A. The Company employed a statutory approach to determine the appropriate expense lead days for each type of tax. Under the statutory approach, the payment dates which are prescribed by law or administrative rule were used.

Q. Did Staff employ a statutory approach when determining the appropriate expense lead days for each type of tax?

A. Staff used the statutory approach for all of the non-income taxes. For federal, state and city income taxes, Ms. Carle used actual payment dates in the CWC analysis.

Q. Is it inappropriate to use actual payment dates to determine the expense lead days for taxes?

A. No. Staff should be consistent when applying a methodology. If actual payment dates is the preferred approach, then actual payment dates should be used for all taxes, not just the income taxes.

VIII. SUMMARY OF RECOMMENDATIONS

Q. Please summarize your recommendations to the Commission.

A. I recommend that the Commission:

1. Apply the same revenue lag to all cash operating expenses included in the CWC analysis;
2. Include the payment processing lag of 0.59 days in the revenue lag;
3. Reject the inclusion of non-cash items, i.e., vacation payroll, in Ms. Carle's analysis because it does not reflect the actual flow of funds associated with payroll;
4. Uniformly apply either statutory payment dates or actual payment dates to all taxes; and
5. Require the Company to update its presentation of CWC once these lead-lag studies and CWC issues, as well as other issues related to the level of the Company's Operation and Maintenance Expenses, have been resolved.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a AmerenUE for Authority to File Tariffs Increasing Rates for Electric Service Provided To Customers in the Company's Missouri Service Area.	))))))	Case No. ER-2008-0318

AFFIDAVIT OF MICHAEL J. ADAMS

STATE OF MISSOURI)
) **ss**
CITY OF ST. LOUIS)

Michael J. Adams, being first duly sworn on his oath, states:

1. My name is Michael J. Adams. I am employed by Concentric Energy Advisors as Vice-President.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Union Electric Company, d/b/a AmerenUE, consisting of 14 pages and Schedule MJA-RE2 all of which have been prepared in written form for introduction into evidence in the above-referenced docket.

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

Michael J. Adams
Michael J. Adams

Subscribed and sworn to before me this 9th day of October, 2008.

Amanda Tesdall
Notary Public

My commission expires: ________________

Amanda Tesdall - Notary Public
Notary Seal, State of
Missouri - St. Louis County
Commission #07158967
My Commission Expires 7/29/2011

Rec'd 9/6/84

CASH WORKING CAPITAL

Cash working capital can be defined as the amount of cash necessary for a utility to pay its day to day expenses which are incurred to provide service to its ratepayers. The need for cash working capital is universal among utilities, so every utility must have a ready supply of cash to pay day to day expenses. Cash working capital is included in a utility's rate base because it represents an investment of funds necessary for the provision of service from the company's investors or ratepayers, for which a return should be earned on. The need for cash working capital comes about because while a utility is allowed through the ratemaking process to recover in full its legitimate expenses incurred in providing service to its customers, the timing of a utility's inflows of cash from customers (revenues) seldom matches exactly its cash outflows necessary for current expenses. When a utility must pay for an expense incurred to provide service to customers before it receives revenues from its customers to pay for that service, then that amount of cash working capital must be obtained from utility investors. Including such on investment in rate base provides the investor a return on the funds provided. Conversely, when a utility receives revenues from its customers before it must pay for certain expenses incurred to provide that service, then the ratepayer has provided the utility with cash working capital up front, eliminate the utility's need to obtain the funds from its investors. The utility in this situation has use of ratepayer-supplied funds for a period of time before they must actually pay the utility vendors for the expenses. Ratepayers are compensated for their up-front investment of cash working capital by reducing rate base by the amount of their investment, thereby allowing them a return on their invested funds. The amount of cash working capital in a measure cash working capital as opposed to a formula approach, or balance sheet approach. As discussed above, the Missouri Commission has settled this question in Missouri by consistently expressing a preference for lead lag studies for cash working capital expenses. The other area of controversy is given that lead lag studies are judged to be the most proper method for calculating cash working capital requirements, what is the proper scope of such a study, what items should it reflect? The two areas of cash working capital scope that has aroused the most controversy are 1) non-cash items, and 2) rate of return components.

NON-CASH ITEMS

As stated before, a lead lag study is intended to measure the utility's need for funds to pay cash expenses before receipt of revenues from ratepayers to cover those expenses. But revenues received from ratepayers covert not only cash expenses but also items such as deferred taxes, depreciation expense, and return on rate base (net operating income), all of which do not require a current outlay of cash by the utility. Some utilities have argued that these non-cash items create a cash working capital requirement because utilities must wait the 35-45 days of the revenue lag before they actually recover the return, depreciation expense, and deferred tax components of the customers' bills. Utilities have claimed that the delay in receiving revenues from customers means they must finance the entire amount of their ongoing accounts receivable, including the portions related to return on rate base, deferred taxes, and depreciation, by reflecting the delay in payment in revenues for these items in a lead lag study. This is done by including these items in the lead lag study with a full revenue lag and a zero expense lag (because no current cash outlay is required for these items). This has the effect of creating positive cash working capital requirements for depreciation, deferred taxes, and return on rate base.

The reason Staff has opposed inclusion of these non-cash items in lead lag studies, and the reason the Commission has without exception ruled against the utilities on this point, is that inclusion of these items defeats the purpose of a cash working capital allowance as Staff defines it. Utilities <u>must</u> have cash on hand to pay its day to day cash expenses, and if it is not available from ratepayer-supplied revenues, then it must be obtained from the utilities' investors. Investor-supplied funds intended for the operation of the utility's business are given rate base treatment to compensate the investor for use of his funds. But for non-cash items such as depreciation and deferred taxes, the utility does not need to have cash on hand for these expenses because there is no cash outlay associated with these items. A utility must obtain cash from one source or another to pay its payroll or fuel expense because the utility's employees and fuel vendors are entitled to the payment. That situation does not exist in regard to depreciation expense and deferred taxes because there is no outside party demanding payment for those items. Depreciation, deferred taxes, and net operating income are included in cost of service because regulatory agencies or governmental bodies have found it appropriate and valid for the utility to recover these expenses from ratepayers. But these items do not in any way reflect a cash <u>need</u> of the utility, and should not be included in a lead lag study designed to measure the utility's need for cash to pay day to day cash expenses. As the Commission stated in the Report and Order for Case No. ER-81-42 (Kansas City Power and Light Company):

> Although depreciation and amortization are booked as expenses, no cash payout is required of the Company. Deferred taxes represent a bookkeeping entry for a tax expense which will not be incurred until a later point in time. The Commission has consistently held that since these expenses require no actual cash outlay, their inclusion in cash working capital is inappropriate.
>
> The Commission has also held, and continues to hold, that net operating income is inappropriate as a positive addition to a cash working capital allowance . . . . The inclusion of net electric operating income in the cash working capital requirement would require the ratepayer to pay a return on the shareholders' ownership interest in the Company through both the rate of return and cash working capital

RATE OF RETURN COMPONENTS

Another common issue concerning the proper scope of lead lag studies involves the treatment of rate of return components used in the ratemaking process (interest expense, preferred divided, common equity costs). In the ratemaking process, such costs are not considered to be above-the-line O&M expenses; rather they are recovered in rates through the application of a rate of return calculation to a rate base figure to derive a net operating income requirement. Looking at interest expense first, utilities have argued in the past that because interest expense represents a portion of the return given to investors through the ratemakig process, it is inequitable to place interest costs in a lead lag study alongside above-the-line O&M cash expenses and taxes. To summarize their position, it is unjust to use part of the return due investors to reduce the overall return given to investors, since interest expense in a lead lag study