Exhibit No.:
Issues: Deferred Income Taxes For Rate Base, Production Cost Modeling Issues, Storm Costs, Storm AAO, Coal Inventory
Witness: JOHN P. CASSIDY
Sponsoring Party: MoPSC Staff
Type of Exhibit: Surrebuttal Testimony
Case No.: ER-2008-0318
Date Testimony Prepared: November 5, 2008

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

JOHN P. CASSIDY

UNION ELECTRIC COMPANY, d/b/a AMERENUE

CASE NO. ER-2008-0318

Jefferson City, Missouri
November 2008

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****Denotes Highly Confidential Information****

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d/b/a AMERENUE

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SURREBUTTAL TESTIMONY

OF

JOHN P. CASSIDY

UNION ELECTRIC COMPANY

d/b/a AMERENUE

CASE NO. ER–2008–0318

Q. Please state your name and business address.

A. John P. Cassidy, 9900 Page Avenue, Suite 103, Overland, Missouri 63132.

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

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

Q. Are you the same John P. Cassidy who participated in the Missouri Public Service Commission Staff's (Staff) Cost of Service Report?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of this surrebuttal testimony is to respond to the rebuttal testimony of Company witnesses (1) Gregory L. Nelson regarding deferred income taxes that offset rate base, (2) Timothy D. Finnell regarding production cost modeling inputs and under-forecasting error, (3) Shawn E. Schukar regarding the appropriate treatment for potentially refundable Entergy Arkansas, Inc. (formerly Arkansas Power & Light Company) costs as part of the SO2 tracker, (4) Lynn M. Barnes regarding the issues of test year non-labor related storm costs and the starting point for the amortization period related to the

Commission approved January 2007 ice storm AAO, and (5) Robert K. Neff regarding coal inventory.

DEFFERED INCOME TAXES – RATE BASE

Q. Please briefly explain deferred income taxes.

A. Deferred income taxes result when temporary timing differences occur between the book and tax treatment of an item of income or expense. The income tax effect of these timing differences, i.e., the tax treatment is offset by deferred income taxes recorded on the Company's books. In the aggregate, due to the availability of accelerated depreciation, a deferred tax liability is recorded by the Company to reflect the lower taxes paid. For rate purposes, the income tax effect of the timing difference is not reflected in expense so the ratepayers pay in rates the deferred taxes. However, since the Company temporarily has use of these funds not paid in taxes by the utility, but deferred, the liability is an offset to rate base.

Q. Please explain the deferred income tax issue in this case.

A. The deferred income tax issue in this case relates to three deductions taken by the Company in prior years which reduced its state and federal income taxes. The Company indicated to the Staff that it recorded ** __________ ** of deferred income tax reserves (liability) associated with these particular tax deduction items. As a result, the Staff has reflected the ** __________ ** liability as a reduction (offset) to the Company's rate base. Based on the Staff's rate of return, this rate base offset reduces the revenue requirement calculation by approximately ** __________ **.

The Staff contends that the Company is currently realizing the benefit of the tax deductions associated with these items and that it is appropriate to reduce the Company's rate base by the associated tax deferrals. This treatment is required because the deferred taxes represent an interest free loan from the ratepayers to the Company.

Q. Please summarize the Company's position with regard to the appropriate treatment of these tax deferrals.

A. Company witness Gregory L. Nelson suggests in his rebuttal testimony that these deferred tax balances should not be used to reduce rate base because they represent uncertain tax positions taken by AmerenUE before the Internal Revenue Service (IRS). Mr. Nelson contends that these income tax deductions are under review by the IRS as part of a current IRS audit and that the outcome as to whether these tax positions will ultimately be allowed or disallowed by the IRS is, at this time, uncertain. Company witness Nelson supports his argument by citing Financial Accounting Standards Board Interpretation No. 48 (FIN 48) that requires the Company to record a liability on its books associated with its best estimate of any amount of a deferral of tax that the Company, as a taxpayer, has already claimed on its tax returns that the Company may be required to pay to the taxing authority. The Staff disagrees with Company witness Nelson's proposed exclusion of the ** ___________ ** rate base deduction associated with the deferred income tax balances that are related to these items.

Q. When will the final outcome of the current IRS audit be known by the Company?

A. ** ____

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Q. If the IRS ultimately rules against the Company with regard to this issue will the Staff propose to continue to reduce the Company's rate base balance for the associated deferred tax balances in future rate cases?

A. No. If the IRS determines that the deductions taken by the Company are inappropriate and in fact requires the Company to pay the federal government the prior deductions, the Staff will of course remove any rate base reductions associated with the deferred tax balances related to these tax items.

Q. How does the Staff respond to the point made by Company witness Nelson on page 5 of his rebuttal testimony on lines 1-6, that "Because these liabilities to the government bear interest, they are not cost-free capital to AmerenUE."?

A. The Staff does not disagree with the Company that if it is required to pay the federal government for these deductions it will also have to pay interest as part of its payment. However, the Company ignores the fact that the Company has also earned some amount of interest on the use of the money, prior to being reflected in rates that has offset, perhaps entirely, any interest amount that it ultimately may be required to pay.

Q. Please respond to Company witness Nelson's statements found on page 6 of his rebuttal testimony on lines 3 through 9, that indicates that if the outcome of the IRS audit and any future appeals matches the Company's FIN 48 estimate that there will be no deferral of tax and no mechanism for AmerenUE to recover the amount included by the Staff that reduced rates but was not ultimately realized by the utility.

A. The Staff believes the Company is looking at this issue on a selective basis. If the adjustment proposed by the Staff is not made by the Commission and the Company prevails on these tax issues, there is no mechanism in place for the ratepayers to recover the higher rates they will have paid. In addition until recognized in rates, the Company will enjoy the time value of money associated with any future beneficial tax items that may occur.

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<u>PRODUCTION COST MODELING INPUTS</u>

Q. Has Company witness Timothy D. Finnell identified any remaining issues with regard to production cost modeling inputs?

A. Yes. The Staff agrees with Company witness Finnell that the Company's ProSym and the Staff's RealTime production cost models produce nearly identical results given the same set of inputs. The only differences between the Company and Staff with regard to production cost model inputs are related to the hourly market energy prices, natural gas prices and coal dispatch prices. Company witness Finnell in his rebuttal testimony adopted a two year average of market energy prices and coal dispatch prices through September 30, 2008. The Company used a two year average of natural gas prices through August 31, 2008, because natural gas prices for the month of September were not available at the time the Company's witnesses filed rebuttal testimony. Previously, in its Cost of Service Report, the Staff recommended hourly market energy prices, natural gas prices and coal dispatch prices that were based on test year ending March 31, 2008.

These differences in inputs are the basis for the differences that exist between the Company and Staff with regard to off-system sales, fuel and purchased power costs. Staff witness Erin L. Maloney is sponsoring Staff's position with regard to these three differing production cost model inputs. For a complete discussion regarding hourly market energy prices, natural gas prices and coal dispatch prices please refer to the surrebuttal testimony of Staff witness Erin L. Maloney.

The Staff plans to true-up its production cost model through September 30, 2008 to reflect all appropriate changes needed to account for additional customer growth, updated load information, hourly market energy prices, coal dispatch prices and all fuel costs, including natural gas prices. If these results are completed earlier than the scheduled true-up deadline, the Staff will provide these results to all of the parties to the case as soon as they are completed.

INCLUSION OF REFUNDABLE ENTERGY ARKANSAS, INC. (ENTERGY ARKANSAS) EQUALIZATION COSTS IN SO_2 TRACKER

Q. Please briefly explain the potential refundable energy costs that the Company may receive as a result of ongoing litigation before the Federal Energy Regulatory Commission (FERC).

A. AmerenUE entered into a ten year purchased power service agreement with Entergy Arkansas (formerly Arkansas Power & Light Company) in 1999. AmerenUE indicated to the Staff that it agrees that it is obligated to pay Entergy Arkansas its invoiced charges under the 1999 service agreement; however AmerenUE is disputing, before the FERC, additional charges associated with the pass-through of production cost equalization payments made by Entergy Arkansas to its Entergy Operating Company affiliates (i.e., Entergy-Gulf States, Inc., Entergy Louisiana, LLC, Entergy Mississippi, Inc., and Entergy New Orleans, Inc.) based upon a previous FERC ruling (Opinion Nos. 480 and 480-A) which addressed a complaint filed by the Louisiana Public Service Commission. As a result of this ruling, Entergy Arkansas has allocated and invoiced AmerenUE for its alleged share of the equalization payments that Entergy Arkansas makes to the other Entergy Operating Companies. AmerenUE and other parties are appealing this decision before the FERC, however, the FERC has not yet rendered a final ruling on this case.

Entergy Arkansas first invoiced the effect of the equalization payments to AmerenUE in July 2007 for service beginning June 2007. AmerenUE expects the equalization payments among the Entergy Operating Companies to continue at least through the end of the 1999 Service Agreement between Entergy Arkansas and AmerenUE, scheduled to expire in August 2009. These equalization charges apply to AmerenUE during the seven month period covering June through December each year, but do not apply during January through May. The Staff included these additional equalization charges, consistent with the Company, in its production cost modeling and these costs are included in the calculation of the AmerenUE cost of service. Because these costs have been included by the Company and the Staff in the cost of service calculation for AmerenUE in this rate proceeding and will be paid for by AmerenUE ratepayers, it is appropriate for those ratepayers to benefit from any future refunds that may occur for these uncertain costs.

Q. Has the Company incurred outside legal costs associated with this dispute before the FERC?

A. ** ____

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Q. Why is the Staff proposing to include any potential refunds received from Entergy Arkansas in the SO_2 tracker?

A. To the extent that ratepayers pay for these Entergy Arkansas costs, in addition to the external legal costs, and AmerenUE recovers these costs in rates and ultimately receives a refund for some or all of these Entergy Arkansas costs, then ratepayers should receive recognition for any such refund. The Staff is not proposing any cost of service treatment for these potential refunds as part of this rate proceeding, nor is the Staff proposing any specific regulatory treatment for these potential refunds in any future rate proceeding at this time. The Staff is merely requesting that the Commission require the Company to track any such refunds as part of the Commission established SO_2 tracker that both the Company and the Staff have agreed to continue as part of this proceeding, or another tracker that the Commission determines to be appropriate. Tracking all Entergy Arkansas refunds received by AmerenUE will preserve these funds so they can be appropriately addressed as part of a future rate proceeding involving AmerenUE.

<u>TEST YEAR NON-LABOR STORM COSTS</u>

Q. Please explain the Staff's adjustment to test year non-labor storm costs.

A. During the test year, the Company incurred approximately $10 million of non-labor related storm costs. The Staff included in the cost of service calculation an approximate $5.2 million normalized level related to non-labor storm costs, which is based upon a three-year average of non-labor storm costs for the period covering July 1, 2005 through June 30, 2008. This test year non-labor storm normalization adjustment reduces the cost of service calculation by approximately $4.8 million in order to eliminate non-recurring non-labor storm costs from the test year.

Q. Did the Staff make any adjustments to the actual costs, prior to calculating its three-year average?

A. Yes. The Staff excluded all costs associated with 2006 storms that occurred on July 19, 2006, September 22, 2006 and November 30, 2006 consistent with the Commissions Report and Order issued as part of Case No. ER-2007-0002. Specifically, the Commission stated the following on page 77 of that Report and Order:

> The Commission concludes that AmerenUE's 2006 storm related operating and maintenance costs shall be offset against its 2006 SO_2 allowance sales revenue. Thereafter, the company's 2006 storm related operating and maintenances costs shall not be considered in any manner in any future rate proceeding.

Similarly, the non-labor storm costs associated with a January 13, 2007 ice storm were not included in the Staff's three-year average of storm costs because these costs are addressed by a Commission approved AAO in Case No. EU-2008-0141. The Staff and Company have agreed upon the amount of the January 2007 ice storm costs to be deferred by the AAO in Case No. EU-2008-0141. However, there is disagreement between Staff and Company about the appropriate starting point for the beginning of the amortization period for this AAO, which I address in the next section of my surrebuttal testimony.

Q. Does the Staff propose that some rate recovery be allowed for the non-recurring $4.8 million level of test year non-labor storm costs as suggested by Company witness Lynn M. Barnes in her rebuttal testimony?

A. No. The level of revenues and expenses that were actually incurred during the test year are annualized and normalized in the determination of the ongoing cost of service and the revenue requirement in a rate case. The Staff used a three-year average to normalize the level of expense for non-labor storm costs to determine an ongoing level. Likewise, the Staff has normalized weather in this case to determine a normal ongoing level to be reflected in the cost of service set in this proceeding. To the extent a Company's booked test year expense in a given category exceeds the amount it is expected to incur for that item in the future at a normal, ongoing level, then that excess amount of test year expense is appropriately removed from allowable expense.

Q. Is Company witness Lynn M. Barnes' proposal on pages 6-7 of her rebuttal testimony to include recovery of the $10 million level of non-labor storm costs as an ongoing expense level reasonable?

A. No. The Company's proposed recovery for the $10 million level of test year non-labor storm costs as an ongoing expense level is not reasonable. Company witness Barnes cites additional costs associated with shorter response times due to the Company's recently improved restoration practices. Company witness Barnes also mentions that the number of major storms incurred during a 12 month period has remained consistent therefore, restoration costs per storm have simply increased. However, the Company's proposal to include the $10 million test year level is more than double the $4.2 million level that the Company experienced for non-labor storm costs during the June 30, 2006 test year in the previous rate proceeding. During the twelve months ending June 30, 2005, the Company incurred only $752,000 for non-labor storms costs associated with only one major storm event during that twelve month period. The recent history of actual storm occurrence does not suggest a consistent 12 month level and does not suggest that any one year represents the normal ongoing level of storms. The Staff believes its proposed $5.2 million normalized non-labor storm costs amount is a reasonable and appropriate ongoing expense level.

<u>2007 ICE STORM COSTS AAO – CASE NO. EU-2008-0141</u>

Q. Please explain the unresolved issue concerning the starting point of the amortization regarding the January 13, 2007 ice storm AAO.

A. As a result of Case No. EU-2008-0141, the Commission granted AmerenUE an AAO to defer the costs related to the ice storm that occurred on January 13, 2007. There is no dispute between the Staff and the Company with regard to the $24.56 million amount of total storm costs to be included in the AAO and amortized over five years. The Commission approved the agreement of the Staff and the Company to defer the determination of an appropriate starting point for the five-year amortization for these ice storm costs to the current rate case. The Staff recommends that the five-year amortization of the costs deferred through the AAO should begin on February 1, 2007 and end on January 31, 2012. The Staff has modified its original position of recommending that the amortization begin on January 15, 2007. AmerenUE proposes that the five-year amortization of deferred costs should begin on the effective date of rates established in this rate case, approximately March 1, 2009.

Q. Why has the Staff modified its starting point for the amortization from January 15, 2007 to February 1, 2007?

A. Company witness Barnes expressed some concern with beginning an amortization prior to the Company knowing the full cost of the storm. The Staff does not believe this is a concern and points out that the Company believed it had sufficient knowledge of the total storm costs to record an estimate in its books that very closely approximated the final cost of the storm by January 31, 2007. The Staff's slight modification in the starting date for the amortization corresponds to the date the Company recorded its estimate of the storm costs.

Q. Please respond to Company witness Barnes concern that beginning the amortization prior to the effective date of rates to be established in this rate case insures that the Company will not recover the total amount of its storm costs.

A. This statement is not accurate. The actual recovery of this item will be based on the timing of a future rate case near the end of the five year amortization period. For whatever period of time the Company maintains this five year amortization in rates beyond the Staff's proposed January 31, 2012 ending point, the Company will continue to enjoy the benefits associated with recovery for this item in rates. Therefore it is possible that the Company could not only fully recover these deferred costs in rates, but the opportunity exists for AmerenUE to over-recover these deferred costs in rates.

Q. In general, is it appropriate to synchronize the beginning of an AAO deferral amortization with the effective date of new rates from a general rate proceeding?

A. No. As mentioned above, it is highly doubtful that the end of an AAO deferral amortization would ever be timed to coincide with the effective dates of new rates for a utility. For this reason, tying the beginning of an AAO amortization to the effective date of new rates will almost certainly ultimately result in the utility's over-recovery of the amortization expense in rates from customers.

Q. What is the purpose of an AAO designed to address with regard to a utility's incurrence of extraordinary costs?

A. The purpose of such an AAO is to mitigate the effect of a truly extraordinary event on the financial results of the utility. However, the Staff does not agree that "mitigation" in this context implies that total elimination of regulatory lag related to the extraordinary cost is appropriate. For this reason, the Staff opposes the Company's proposal to provide itself a guaranteed recovery of the full amount of its restoration costs by delaying the start of the amortization period until the time that rates go into effect in the current rate case as Company witness Barnes has suggested in her rebuttal testimony. The ice storm occurred in 2007 and the Company expensed the cost in 2007. Therefore the Staff believes it is inappropriate to wait to begin the amortization of the associated AAO in 2009, as proposed by the Company.

<u>COAL INVENTORY</u>

Q. Has the Staff modified its case with regard to the basemat coal issue discussed in the rebuttal testimony of Company witness Robert K. Neff?

A. Yes. Based on further review, the Staff has modified its case to reflect the 198,000 tons of basemat coal identified by Mr. Neff in the Company's coal inventory balance. The Staff has updated its coal inventory balance to include ** ________ ** related to the coal basemat. The Staff's correction to included basemat coal increases the revenue requirement calculation by approximately ** ________ **.

Q. Has the Staff updated its coal inventory in this case to reflect the inclusion of SO2 premium costs and the fact that the Meramec generating plant can now maintain a 65 average burn day level of inventory by accessing coal stored at the Hillcrest coal terminal?

A. Yes. The Staff modified its overall coal inventory balance to include SO_2 premium costs. The effect of this SO_2 correction increased the Staff's revenue requirement calculation by approximately $80,000. The Staff has also adjusted its case to reflect that the new Hillcrest coal terminal will allow the Meramec generating plant to increase its coal storage capabilities to 65 average days of burn. This change increased the Staff's revenue requirement calculation by approximately ** __________ **. The Staff's cost of service calculation now includes an inventory level at all of the Company's coal generating plants that reflects 65 days of average burn.

Q. What level of coal inventory does Company witness Neff suggest be included as an ongoing coal inventory level?

A. Company witness Neff indicated to the Staff that in 2006 the Company adopted a policy of maintaining a 65 maximum burn day target inventory level. Previously the Company maintained a 55 maximum burn day target inventory level. The Company's new policy was implemented to address severe weather and rail supply disruptions that the Company experienced in recent years.

Q. What level has the Staff included as a proper coal inventory level in its cost of service for the Company?

A. The Staff proposes to include a 65 average burn day inventory level. This level represents an increase from the 60 average burn day inventory level that the Staff determined was appropriate for AmerenUE in its previous rate case, Case No. ER-2007-0002. ** ____

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Q. What is the approximate value of this difference in the 65 maximum burn day and the 65 average burn day inventory level that exists between the Company and the Staff?

A. The differing inventory levels represent a revenue requirement difference of approximately $2.8 million.

Q. Why does the Staff disagree with the Company's proposed 65 maximum burn day target inventory level?

A. The Staff believes that this inventory level exceeds what is required to maintain normal operations. The Company is proposing a coal inventory level that is designed to address an extreme scenario and is asking the ratepayers to pay a return on an ongoing basis for this inflated coal inventory level. The Staff does not believe that it is appropriate to set rates based upon an extreme scenario that is contemplated by the 65 maximum burn day target inventory level.

Q. Does this conclude your surrebuttal 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 JOHN P. CASSIDY

STATE OF Missouri)
) ss.
COUNTY OF Cole)

John P. Cassidy, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the foregoing Surrebuttal 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.

John P. Cassidy
John P. Cassidy

Subscribed and sworn to before me this 5th day of November, 2008.

Nikki Senn
Notary Public

NIKKI SENN
Notary Public - Notary Seal
State of Missouri
Commissioned for Osage County
My Commission Expires: October 01, 2011
Commission Number: 07287016