

Exhibit No.:
Issues: Income Tax Expense
Deferred Income Taxes
Pension Liability
Witness: Stephen M. Rackers
Sponsoring Party: MoPSC Staff
Type of Exhibit: Direct Testimony
Case No.: EC-2002-1
Date Testimony Prepared: July 2, 2001

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

STEPHEN M. RACKERS

UNION ELECTRIC COMPANY

d/b/a AMERENUE

CASE NO. EC-2002-1

Exhibit No. 76 NP
Date 7/10/02 Case No. EC-2002-1
Reporter Klm

Jefferson City, Missouri
July 2001

****Denotes Proprietary Information****

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UNION ELECTRIC COMPANY

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DIRECT TESTIMONY
OF
STEPHEN M. RACKERS
UNION ELECTRIC COMPANY
d/b/a AMERENUE
CASE NO. EC-2002-1

Q. Please state your name and business address.

A. Stephen M. Rackers, 815 Charter Commons Drive, Suite 100 B,
Chesterfield, Missouri 63017.

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

A. I am a Regulatory Auditor V in the Accounting Department, in the
St. Louis Office, for the Missouri Public Service Commission (Commission).

Q. Please describe your educational background.

A. I graduated from the University of Missouri at Columbia, Missouri in
1978, from which I received a Bachelor of Science degree in Business Administration,
majoring in Accounting. I have passed the Uniform Certified Public Accountant
examination and am currently licensed in the state of Missouri.

Q. What has been the nature of your duties while in the employ of this
Commission?

A. I have supervised and assisted in audits and examinations of the books and
records of public utility companies operating within the State of Missouri. I have listed
cases in which I have previously filed testimony on Schedule 1.

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1 Q. With reference to Case No. EC-2002-1, have you made an investigation of
2 the books and records of Union Electric Company d/b/a AmerenUE (UE or Company)?

3 A. Yes, with the assistance of other members of the Commission Staff
4 (Staff).

5 Q. What is the purpose of your direct testimony?

6 A. My direct testimony will discuss the following items:

- 7 1) The Staff's calculation of income taxes;
8 2) The balance of deferred income taxes, which reduces Rate Base and
9 appears on Accounting Schedule 2; and
10 3) The balance of the pension liability, which also reduces Rate Base.

11 Q. Please list the Accounting adjustments, schedule balances and schedules
12 you are sponsoring.

13 A. I am sponsoring the following Accounting schedule balances, adjustments
14 and schedules

15 **Accounting Schedule 2 Rate Base**

16 Deferred Income Tax Balance

17 Pension Liability Balance

18 **Accounting Schedule 10 Adjustments to Income Statement**

19 S-28.1 Annualization of Current Income Taxes

20 S-29.1 Annualization of Deferred Income Tax

21 **Accounting Schedule 11 Income Tax**

1 **INCOME TAX EXPENSE**

2 Q. Please provide a brief discussion of the methodology the Staff has used in
3 its calculation of income taxes.

4 A. With two exceptions, the Staff is following the methodology used and
5 agreed to by the parties in the calculation of income tax expense in both of the
6 Company's Experimental Alternative Regulatory Plans (EARPs). The first exception is
7 the exclusion of unbilled gross receipts taxes and the second is an adjustment to the
8 amount of tax straight-line depreciation.

9 Q. Please explain the unbilled gross receipts tax item.

10 A. **

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16 Q. **

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18 A. **

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22 Q. How is the Staff proposing to treat this item?

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1 A. The Staff believes this item should be eliminated from the calculation of
2 income taxes. As I stated before, this adjustment would be necessary, absent any other
3 income statement adjustment. However, the Staff's income statement has already been
4 adjusted to remove gross receipts taxes. As a result the Staff's calculation of income
5 taxes, which will begin with its net income amount, needs no further adjustment for gross
6 receipts taxes to arrive at the appropriate level of taxable income.

7 Q. Please explain the adjustment to tax straight-line depreciation.

8 A. The Staff is proposing to calculate tax straight-line depreciation consistent
9 with the calculation of book depreciation expense.

10 Q. Please explain the relationship between tax straight-line depreciation and
11 book depreciation.

12 A. Book depreciation is calculated by multiplying the depreciation rates,
13 approved by the Commission, by the plant in service balances. A portion of this amount
14 is expensed and reflected in the income statement as an expense and a reduction to net
15 income. A portion of the amount is also capitalized as part of the cost of construction and
16 included in the plant in service balances shown as an increase in the rate base. The total
17 amount of book depreciation calculated is accumulated in a depreciation reserve, which is
18 a reduction to the rate base. As long as the plant remains in service, depreciation
19 associated with the plant will continue to be calculated.

20 For the purpose of calculating income taxes, however, the book depreciation is
21 generally reduced to reflect tax straight-line depreciation. This is required to reflect the
22 fact that the plant balances for book depreciation (book bases) are larger than the plant
23 balances for tax depreciation (tax bases). The difference in book and tax bases generally

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1 results from the fact that certain items, for example capitalized payroll taxes, are
2 capitalized for book purposes, but were deducted in the year incurred for tax purposes.

3 An additional reason why tax straight-line depreciation is lower than book
4 depreciation is that UE stops calculating tax straight-line depreciation when the
5 accumulated reserve, for a vintage year, equals the tax basis. For example, assume that a
6 vintage (specific year) had depreciable plant additions of \$1,000,000 and the weighted
7 average book depreciation rate was 10%. UE would recognize \$100,000 in tax straight-
8 line depreciation annually for 10 years. At the end of year 10, the accumulated tax
9 straight-line reserve would be equal to the tax basis of the property. No additional
10 straight-line tax depreciation would be recognized in year 11 even though the plant
11 investment was still in use and the Company continued to accrue (recognize) book
12 depreciation for financial reporting and ratemaking purposes.

13 Q. Why does book depreciation continue to accrue on plant even though the
14 tax straight-line reserve indicates full recovery of depreciation?

15 A. No attempt is made to track the accumulated book depreciation reserve by
16 year (vintage). Book depreciation continues to be accrued for financial accounting and
17 ratemaking purposes until the associated accumulated book depreciation reserve is equal
18 to an entire plant account (all vintage year additions) and the Commission orders a 0%
19 depreciation rate for that account. This method of depreciation is often referred to as
20 mass asset accounting.

21 Q. Why is book depreciation computed on an entire plant balance
22 (all vintages) instead of on an individual vintage basis used in computing tax depreciation
23 and straight-line tax depreciation?

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1 A. The mass asset accounting method used for book depreciation simplifies
2 the accounting process. When an asset is retired, no attempt is made to determine the
3 actual accumulated depreciation reserve for that asset. For example, when \$1,000,000 of
4 plant is retired, both the associated plant and accumulated depreciation reserve accounts
5 are reduced by \$1,000,000. This method treats all retired plant as though it was fully
6 depreciated. The theory supporting this treatment is that while some amount of plant will
7 be retired before the end of its depreciable life, an equal amount of plant will be retired
8 after its depreciable life. Therefore, in the aggregate, it is assumed that early retirements
9 of plant will be offset by an equal amount of late retirements.

10 Q. How is the revenue requirement affected by the continued recovery of
11 book depreciation associated with plant that remains in service after its depreciable life
12 and upon which tax straight-line depreciation is no longer calculated?
13

14 **THE REMAINDER OF THIS PAGE INTENTIONALLY LEFT BLANK**

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A. Straight-line tax depreciation is substituted for book depreciation in the calculation of income taxes for ratemaking purposes. Referring to my previous example, book depreciation continued to be calculated in year 11 at \$100,000 while tax straight-line depreciation was \$0 after year 10. Therefore, while book depreciation continues, no associated deduction is available for the calculation of income taxes. The additional revenue requirement borne by customers associated with this situation is calculated below:

	<u>Year 11</u>
1. Revenues	\$ 100,000
2. Book Depreciation	<u>100,000</u>
3. Income before Income Tax	0
Add back:	
4. Book Depreciation	100,000
Subtract:	
5. Straight Line Tax Depreciation	<u>0</u>
6. Taxable Income (Line 3 + 4 - 5)	100,000
7. Income Tax Rate	<u>38.39%</u>
8. Income Tax	38,390
9. Tax Conversion Factor	<u>1.62</u>
10. Revenue Requirement	<u>\$ 62,192</u>

In summary, every dollar of book depreciation included in cost of service with no corresponding tax straight-line deduction results in approximately an additional \$.62 cash outlay from ratepayers. This additional revenue requirement occurs because a plant asset remains in service longer than the "estimated" life used to compute the book depreciation rate for the asset.

Q. What is the Staff recommendation for calculating tax straight-line depreciation to address this situation?

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1 A. The Staff is recommending the elimination of the additional revenue
2 requirement resulting from book depreciation expense in cost of service, without a
3 corresponding tax deduction, by continuing to calculate tax straight-line depreciation for
4 all plant which is still in service. This treatment is consistent with the calculation of book
5 depreciation.

6 Q. Has this issue been specifically addressed by the Commission?

7 A. Yes. In the St. Joseph Light and Power Company rate case, Case No.
8 ER-93-41, the Commission heard this issue and ruled in favor of the Staff's position.
9 This issue was presented in testimony in the Laclede Gas Company (Laclede) rate case,
10 Case No. GR-94-220. Although the Commission did not hear the issue in the Laclede
11 case, the Staff's position was adopted by Laclede and specifically addressed in the
12 Stipulation And Agreement.

13 Q. Where do the unbilled GRT and additional tax straight-line depreciation
14 appear?

15 A. These components are included in "Other Addbacks," which appears on
16 Accounting Schedule 11, Income Tax, line 3. These components are included in the
17 calculation of current income taxes, which appears on line 27 of Accounting Schedule 11.

18 Q. Please explain Accounting Adjustments S-28.1 and S-29.1.

19 A. These adjustments appear on page 9 of Accounting Schedule 10,
20 Adjustments to Income Statement. The adjustments are determined by subtracting the
21 test year current and deferred income tax amounts appearing on Accounting Schedule 9,
22 Income Statement, from the current and deferred income tax amounts calculated on
23 Accounting Schedule 11.

1 **DEFERRED INCOME TAXES**

2 Q. What methodology has the Staff used in its determination of the rate base
3 offset for deferred income taxes?

4 A. Consistent with the other rate base components in the Staff's case, the
5 offset for deferred income taxes reflects the balance at December 31, 2000. Also, except
6 for two components, the Staff is including the same balances that were recognized and
7 agreed to by the parties in the calculation of income tax expense in both EARPs. The
8 first of these components deals with the recognition of deferred income tax balances from
9 Account 283, Miscellaneous Accumulated Deferred Income Taxes. The second of these
10 components concerns the elimination of the deferred income tax balance associated with
11 Financial Accounting Standard Number 106, "Employers' Accounting for Postretirement
12 Benefits Other Than Pensions" (FAS 106).

13 Q. Please explain the Staff's treatment of these deferred income tax balances.

14 A. The Staff is proposing to treat the deferred income tax balances in a
15 consistent manner with the treatment that has been afforded the deferred income tax
16 expense. The deferred income tax balances represent the accumulation of these prior
17 deferred expenses.

18 With regard to the Account 283 deferred income tax balances, the parties have
19 included the associated deferred income tax expense in the determination of prior years'
20 credits for the EARPs. Therefore, it is appropriate to recognize the associated
21 accumulated deferred income tax balances as proper offsets to rate base. It is inconsistent
22 to include the deferred income tax expense in the determination of revenue requirement
23 without also recognizing the deferred tax balance in the determination of rate base.

1 Regarding the FAS 106 accumulated deferred income tax balances, however, the
2 parties have not included the associated deferred income tax expense in the determination
3 of prior years' credits for the EARPs. Therefore, it is inappropriate to recognize the
4 associated deferred income tax balances as a component of the offset to rate base. It is
5 inconsistent to exclude the deferred income tax expense in the determination of revenue
6 requirement, without also eliminating the accumulated deferred tax balance in the
7 determination of rate base.

8 **PENSION LIABILITY**

9 Q. Please explain the pension liability rate base offset.

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

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

16 A. Prior to the beginning of the initial EARPs on July 1, 1995, UE's rates had
17 reflected pension expense on a pay-as-you-go basis, including an amount that reflected
18 actual payments to the pension fund. When the first EARP was established, the method
19 of determining pension expense for ratemaking was changed, in accordance with
20 Commission and Staff policy, to a method based on Financial Accounting Standard
21 Number 87, "Employer's Accounting For Pensions" (FAS 87).

22 Pension expense calculated according to FAS 87 is based on a different
23 calculation than the method used to determine the required level of pension funding. The

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

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

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

13 A. Including this difference recognizes the accumulated funds, provided by
14 either ratepayers or the Company, that are associated with pensions. If the pension
15 expense included in rates is greater than the level of pension funding, ratepayers have
16 provided cash to UE and the difference should be a reduction to rate base. This is similar
17 to the standard practice of including the accumulated balance of deferred income taxes as
18 a reduction to rate base, since ratepayers are providing funds to the Company in excess of
19 the level of income taxes actually paid. On the other hand, if the pension expense
20 included in rates is less than the level of pension funding, UE has provided the cash
21 necessary to fund pensions in excess of the level included in rates and this difference
22 should be an increase to rate base. This is similar to the standard practice of including

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1 prepayments as an increase to rate base, since companies provide the funds to pay for
2 these investments before they are reflected in expense.

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

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

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

13 A. As previously discussed, the change to accounting for pension expense in
14 rates according to FAS 87 for UE occurred at July 1, 1995. Therefore, the accumulated
15 amount of the difference between the pension expense calculated according to FAS 87
16 and the amount actually funded, since July 1, 1995, has been included in the
17 determination of rate base.

18 Q. Does this conclude your direct testimony?

19 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service Commission,)
)
Complainant,) Case No. EC-2002-1
vs.)
)
Union Electric Company, d/b/a AmerenUE,)
)
Respondent.)

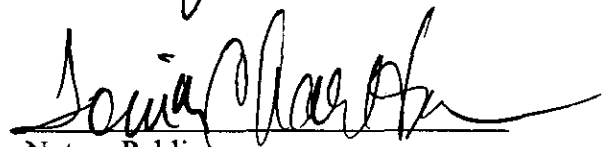
AFFIDAVIT OF STEPHEN M. RACKERS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Stephen M. Rackers, is, of lawful age, and on his oath states: that he has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 12 pages to be presented in the above case; that the answers in the foregoing Direct Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.


Stephen M. Rackers

Subscribed and sworn to before me this 29th day of June, 2001.


Notary Public

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

RATE CASE PROCEEDING PARTICIPATION

STEPHEN M. RACKERS

<u>Company</u>	<u>Case Number</u>
Bowling Green Gas Company	GR-78-218
Central Telephone Company	TR-78-258
Empire District Electric Company	ER-79-19
Fidelity Telephone Company	TR-80-269
St. Louis County Water Company	WR-80-314
Union Electric Company	ER-81-180
Laclede Gas Company	GR-81-245
Great River Gas Company	GR-81-353
Union Electric Company	ER-82-52
Laclede Gas Company	GR-82-200
St. Louis County Water Company	WR-82-249
Union Electric Company	ER-83-163
Union Electric Company	ER-84-168
Arkansas Power and Light Company	ER-85-20
Kansas City Power and Light Company	ER-85-128
Arkansas Power and Light Company	ER-85-265
Union Electric Company	EC-87-114
Union Electric Company	GR-87-62
Southwestern Bell Telephone Company	TC-89-14
St. Louis County Water Company	WR-89-246
Laclede Gas Company	GR-90-120
Missouri Cities Water Company	WR-91-172
St. Louis County Water Company	WR-91-361
Laclede Gas Company	GR-92-165
Missouri Pipeline Company	GR-92-314
St. Louis County Water Company	WR-92-204

<u>Company</u>	<u>Case Number</u>
St. Louis County Water Company	WR-94-166
St. Louis County Water Company	WR-95-145
Union Electric Company	ER-95-411
St. Louis County Water Company	WR-96-263
St. Louis County Water Company	WR-97-382
Laclede Gas Company	GR-99-315
Missouri-American Water Company	WR-2000-281 et al
St. Louis County Water Company	WR-2000-844