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Issues:	Tax Issues
Witness:	James I. Warren
Sponsoring Party:	Union Electric
Type of Exhibit:	Rebuttal Testimony
Case No.:	EC-2002-1
Date Testimony Prepared:	May 10, 2002

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EC-2002-1

REBUTTAL TESTIMONY

OF

JAMES I. WARREN

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

Exhibit No. 161
Date 7/10/02 Case No. EC-2002-1
Reporter KEM

St. Louis, Missouri
May, 2002

REBUTTAL TESTIMONY

OF

JAMES I. WARREN

CASE NO. EC-2002-1

Q. Please state your name and business address.

A. My name is James I. Warren. My business address is 2 Hilton Court, Parsippany, New Jersey 07054.

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

A. I am a tax partner in the accounting firm of Deloitte & Touche LLP.

Q. Please describe your current responsibilities at Deloitte & Touche LLP.

A. I am engaged in the general practice of taxation. I specialize in the taxation of and the tax issues relating to regulated public utilities. Included in this area of specialization is the treatment of taxes in regulation.

Q. Please describe your professional background.

A. I joined Deloitte & Touche in September of 2000. Prior to that time, I was affiliated with the international accounting firms of PricewaterhouseCoopers LLP (Jan. 1998 – Sept. 2000) and Coopers & Lybrand (Mar. 1979 – June 1991) and the law firm, Reid & Priest LLP (July 1991 – Dec. 1997). At each of these professional services firms, I provided tax services primarily to electric, gas and telecommunications industry clients. My practice has included tax planning for the acquisition or transfer of business assets, operational tax planning and the representation of clients in tax controversies with the

IRS at the Audit and Appeals levels. I have often been involved in procuring rulings or technical advice from the IRS National Office. On several occasions, I have represented one or more segments of the utility industry before the IRS and/or Treasury regarding certain positions adopted by the Government. I have testified regarding tax, tax accounting and regulatory tax matters before a number of regulatory bodies including the FERC and the commissions in Florida, Louisiana, Nevada, New Jersey, New York, Connecticut, Pennsylvania and Texas. I have also testified before several Congressional committees and subcommittees and at Department of Treasury hearings regarding legislative and administrative tax issues of significance to the utility industry.

I am a CPA licensed in New York and also a member of the New York and New Jersey Bars. I am a member of the AICPA and the American Bar Association, Section of Taxation where I am a past chair of the Committee on Regulated Public Utilities.

Q. Please describe your educational background.

A. I have received a B.A. (Political Science) from Stanford University, a law degree (J.D.) from New York University School of Law, a Master of Laws (LL.M.) in Taxation from New York University School of Law and a Master of Science (M.S.) in Accounting from New York University Graduate School of Business Administration.

Q. What is the purpose of your testimony?

A. I am testifying on behalf of AmerenUE ("UE" or "the Company") in response to the direct testimony of Staff witness Stephen M. Rackers.

Q. What aspect of Mr. Rackers' testimony will you address?

A. Specifically, I shall rebut his proposal to alter UE's long-standing process for computing the tax expense element of cost of service "...by continuing to calculate tax straight-line depreciation for all plant that is still in service." Rackers, Direct dated March 2002, page 8, lines 8-9. I shall refer to this as the proposed "tax straight line" adjustment.

Q. What is the effect of this proposed adjustment?

A. Based on the schedules appended to his testimony (and subject to any alterations he may subsequently make), Mr. Rackers proposes to reduce the Company's revenue requirement by approximately $2.2 million on account of this proposed adjustment.

Q. Does Mr. Rackers provide a reason for proposing this adjustment?

A. His pre-filed testimony and, particularly, his deposition testimony, provide the clear reason. It is his avowed intent to reduce the Company's revenue requirement. In his own words:

"The Staff is recommending the elimination of the additional revenue requirement resulting from book depreciation expense in cost of service, without a corresponding tax deduction..." Rackers, Direct dated March 2002, page 8, lines 5-7.

"I would characterize it as trying to eliminate this additional revenue requirement that's generated almost solely by the fact that plant is living longer than the life that's indicated by depreciation rate." Rackers, Deposition of November 20, 2001, page 68, lines 11-15.

"...what the goal of the adjustment is to eliminate this additional revenue requirement that comes about because the way that we treat book depreciation and tax depreciation in the calculation of revenue requirement…" Rackers, Deposition of November 20, 2001, page 69, lines 20-24.

Q. What theoretical justification does Mr. Rackers' testimony provide for this proposal?

A. Aside from articulating his intent to reduce rates, Mr. Rackers' testimony devotes itself exclusively to describing both the Company's relevant practices and the mechanics of his proposal. Nowhere does it offer even a shred of theoretical support for his proposed adjustment.

Q. Does his testimony contain support of any kind at all for the proposed adjustment?

A. To the extent it contains anything at all supportive, it is confined to his assertions that this Commission has previously adopted this adjustment in two prior proceedings, St. Joseph Light and Power Company, Case No. ER-93-41 and Laclede Gas Company, Case No. GR-94-220 and that the method recommended by the Staff for calculating tax straight-line depreciation "is reflected in the rates established" for Missouri Gas Energy Company, Laclede Gas Company, Empire District Electric Company, UtiliCorp-Missouri Public Service Division and UtiliCorp-St. Joseph Light and Power Division. Rackers, Direct dated March 2002, page 8, lines 11-22.

Q. Does the result in the Laclede proceeding, Case No. GR-94-220, support his proposed adjustment?

A. No it doesn't. Mr. Rackers himself points out that, in that proceeding, this Commission did not consider the issue but merely adopted a Stipulation and Agreement in which a "tax straight line" adjustment was incorporated. Rackers, Direct dated March

2002, page 8, lines 14-16. There was, therefore, no evaluation whatsoever of the merits of such an adjustment in that case.

Q. **What about Mr. Rackers' assertion that his proposed adjustment is "reflected in the rates" of Missouri Gas Energy Company, Laclede Gas Company, Empire District Electric Company, UtiliCorp-Missouri Public Service Division and UtiliCorp–St. Joseph Light and Power Division?**

A. Mr. Rackers confirms in his deposition that this Commission did not have an opportunity to consider the merits of his proposed adjustment in *any* of these proceedings. Rackers, Deposition of April 17, 2002, page 26, line 14 through page 28, line 5.

Q. **Does the result in the St. Joseph proceeding, Case No. ER-93-41, support his proposed adjustment?**

A. Not in my opinion. The St. Joseph proceeding involved an application by the company for an increase in rates. As such, the burden of proving its entitlement to the increase lay entirely on the company. The Slip Opinion in that matter indicates that an adjustment somewhat similar to the one proposed by Mr. Rackers in this case was, in fact, considered by this Commission. This Commission's decision was that "...the Staff's adjustment on this issue is the more reasonable approach" and that "...SJLPC has not presented any evidence that convinces the Commission to deviate from its normal practice." Thus, St. Joseph simply did not carry its burden of proof with respect to this issue. While I am unable to establish from the Opinion exactly what the company's arguments were with respect to this adjustment, it certainly makes no reference to any of the conceptual, economic and accounting flaws I find inherent in such an adjustment. I can only conclude that the Commission's adoption was a function of an "uninspired" showing by St. Joseph who, in that case (and in contrast to UE in this proceeding), had the burden of proof.

Q. The St. Joseph Slip Opinion makes reference to the Staff "tax straight line" adjustment representing "normal practice." Do you agree with this?

A. Absolutely not. It is my understanding that UE has never, ever computed its tax expense element of cost of service using anything even remotely approaching the methodology proposed by Mr. Rackers. Thus, it is certainly not (and never has been) "normal practice" for UE. Further, there have been no changes in the tax or accounting rules relating to asset depreciation that require a revision to UE's historical methodology. Finally, I have never seen a procedure such as the one proposed by Mr. Rackers employed by any utility anywhere – either voluntarily or by direction. In my opinion, it is not "normal practice" anywhere. Mr. Rackers concedes that he knows no other jurisdiction using his method. Rackers, Deposition of April 18, 2002 at p. 57, lines 8-13.

Q. Do you know of any authority which supports an adjustment of the type proposed by Mr. Rackers?

A. I have never seen an adjustment of this type proposed or even described in any treatise, article, report or study or at any regulatory or tax presentation I have attended. Mr. Rackers had admitted that he, too, is not aware of any such support for the adjustment he proposes. Rackers, Deposition of April 18, 2002, at page 56, line 20 through page 57, line 7.

Q. What, then, do you conclude regarding the basis for Mr. Rackers' proposed adjustment?

A. Based on my reading of his testimony and my attendance at his depositions, I believe that he simply does not like the revenue requirement effect of proper tax accounting for depreciation. He therefore proposes an adjustment to eliminate the effect. That is the long and the short of his position. He seems totally unperturbed by the lack of any economic, accounting or regulatory foundation for the adjustment. In short, the means are unimportant. It is the end that matters.

Q. Please summarize your position regarding the proposed "tax straight line" adjustment.

A. This proposed adjustment is absolutely erroneous. The tax benefits that Mr. Rackers proposes to provide to customers have never existed, do not now exist and will never exist. In short, he proposes to give recognition to totally fictitious tax benefits in an attempt to reduce rates. In fact, the "problem" Mr. Rackers seeks to remedy by means of his proposed adjustment does not even exist. Imposition of his proposed adjustment can only be viewed as a regulatory disallowance without any of the analysis necessary to support such an action. The proposal is inappropriate from an economic, an accounting and a regulatory perspective. Moreover, such an adjustment is inconsistent with this Commission's long-standing treatment of the tax benefits associated with the vintages which give rise to the proposed adjustment.

Q. What are the circumstances that lead Mr. Rackers to propose his adjustment?

A. The situation that prompts Mr. Rackers' proposed adjustment occurs due to the fundamental difference between the concept (and computation) of depreciation for tax purposes and its concept (and computation) for regulatory or book purposes (hereafter, the terms "regulatory" and "book" will be used interchangeably).

Q. Please explain the tax concept of depreciation.

A. Tax depreciation operates as a "closed account" or a "static" system. By this, I mean that the tax law requires the identification of (1) specific assets or (2) groups of similar assets placed in service in the same year (*i.e.*, vintage accounts). The cost of each specific asset or vintage account is "recovered" through depreciation deductions over a specified life using a prescribed computational method (*e.g.*, straight line, declining balance, etc.). Neither more nor less than the original cost can be "recovered" in this fashion.

Q. Please provide a simple example of this "closed" system.

A. Assume that Asset X costs $1,000, has a tax life of 10 years and must use the straight-line method of depreciation for tax purposes. The schedule of tax depreciation would be:

Year	Depreciation Deduction	Accumulated Depreciation
1	$100	$100
2	$100	$200
3	$100	$300
4	$100	$400
5	$100	$500
6	$100	$600
7	$100	$700
8	$100	$800
9	$100	$900
10	$100	$1,000
11	$0	$1,000

Q. What is noteworthy about this table?

A. This depreciation table will apply to each and every Asset X individually (or each and every Asset X vintage account). Once the full original tax cost of Asset X (or the vintage account) is recovered, no more tax depreciation can be claimed. Thus, in Year 11 (or Year 12, or Year 13 or any subsequent year), there is no tax depreciation available. The table demonstrates the basic principle underlying tax depreciation – the recovery of a specific asset's (or vintage account's) original cost over time.

Q. What is the regulatory concept of depreciation?

A. I would characterize the regulatory concept of depreciation as a "dynamic" or an "open" system. There is no depreciation of individual assets or vintage accounts. Depreciation is based on studies which ascertain the rate at which *the entire population of similar assets* declines. It is unconcerned with recovering the cost of specific assets or vintage accounts.

Q. Please provide a simple example of a dynamic system.

A. Assume that the taxpayer owns the same Asset X as in the first example and that its original cost is the same for books as it is for tax. Assume also that the latest depreciation study has disclosed that the population of Asset Xs diminishes at a rate of 5% per year (a 20 year life). Each year's regulatory depreciation will be computed by multiplying the original cost of all surviving Asset Xs by the 5% rate. Moreover, this process will continue so long as any Asset X survives. Thus, if a single Asset X remains in service through Years 21, 22, and 23, that asset will continue to be depreciated at the 5% rate in each of those years. Regulatory depreciation makes no attempt to associate any accumulated depreciation balance with any particular asset or vintage account – only with the total cost of all Asset Xs.

Q. Doesn't this permit "over-depreciation"?

A. No it doesn't. With a large enough population of Asset Xs, there will be some that fail to survive through their expected lives, and these will, on balance, compensate for those that survive beyond their expected lives. Thus, in aggregate, there will be no over-recovery.

Q. How are the tax benefits associated with Asset X provided to customers?

A. Using conventional normalization accounting, the Company provides the tax benefits associated with each of its assets, including Asset X, over the regulatory life of that asset. Using the above example, the tax benefits to be derived from Asset X would be provided to customers over 20 years.

Q. Please provide an example of the way in which the benefits would be provided.

A. Schedule 1, attached hereto, depicts the way in which the $400 of tax benefits (using an assumed tax rate of 40%) associated with each Asset X (or Asset X vintage account) would be provided to customers.

Q. What is notable about Schedule 1?

A. Column F lays out the schedule over which the total tax benefits available as a result of owning Asset X are provided to customers. It shows that each year over the regulatory life of the asset, customers receive a $20 tax benefit in the form of a reduction in the tax expense element of cost of service. By the end of Year 20, all $400 of the tax benefits to be derived from Asset X have been provided to customers – no more and no less.

Q. What is the significance of an asset's original tax cost?

A. The original tax cost of an asset represents the aggregate quantum of tax depreciation deductions that can be claimed. It is, therefore, this amount, and only this amount, that produces real depreciation-related tax benefits and it is only these that can be, and, in fact, are provided to customers through the tax expense element of cost of service.

Q. How, then, is "tax straight line depreciation" related to an asset's original tax cost?

A. Under normalization accounting, the tax benefit of the Company's ability to depreciate the original tax cost is provided to customers over the regulatory life of the asset even where, as is often the case, the actual tax depreciation is claimed over a shorter "tax life." The appropriate tax benefit for any given year is, therefore, computed by multiplying the book depreciation rate by the original tax basis. The result of this computation is "tax straight line depreciation" for any year.

Q. Please relate these terms to the information in Schedule 1.

A. In Schedule 1, the book depreciation rate is 5%. The original cost of Asset X is $1,000. Thus, the "tax straight line depreciation" is $50 in any year. This means that, in any year, customers should receive a tax benefit commensurate with $50 of tax depreciation, or $20 (assuming a 40% tax rate). This represents one year's allocable portion of the actual depreciation tax benefits flowing from the asset's original cost.

Q. What would the regulatory and tax consequences be if Asset X survives past year 20?

A. For regulatory purposes, the asset will produce an additional 5%, or $50, of depreciation in Year 21, Year 22 and in each year thereafter so long as it remains in service. For tax purposes, the asset has been fully depreciated since Year 10. It has produced no tax depreciation since then and will never produce any additional tax depreciation.

Q. If Asset X were to survive for a period shorter than its regulatory life (e.g., 5 years), would all of the tax benefits inherent in the tax basis of Asset X still be provided to customers?

A. The Company provides all of the tax benefits that are produced by the entire tax basis of such an asset to customers notwithstanding its abbreviated life span.

Q. In the event that Asset X survives past year 20, what does the company do with respect to the provision of tax benefits?

A. The Company provides no tax benefits associated with the additional regulatory depreciation applicable to Asset X in Year 21, Year 22, or in any year thereafter. Mechanically, it accomplishes this by ceasing "tax straight line depreciation."

Q. Why is this so?

A. The Company provides no tax benefits because there are none to provide. All of the tax benefits that can be derived from Asset X, all $400, were provided to customers over the first 20 years – the "tax straight line" life. There are simply no additional tax benefits left to provide.

Q. What is Mr. Rackers' position in this regard?

A. Mr. Rackers proposes to continue "tax straight line depreciation" in year 21 and in each subsequent year so long as the asset survives.

Q. What would be the mechanical consequence of adopting Mr. Rackers' proposed adjustment?

A. As a result of continuing "tax straight line depreciation," the tax expense element of cost of service would be reduced (*i.e.*, benefited) by an amount equal to the tax rate multiplied by the amount of incremental "tax straight line depreciation."

Q. What would be the economic consequence of adopting Mr. Rackers' proposed adjustment?

A. The Company would be providing a tax benefit that simply does not exist in real life. The Company will never receive another dime from any taxing authority on account of Asset X. Moreover, it has already provided the full measure of tax benefits associated with Asset X to customers.

Q. How, then, would you characterize these tax benefits – and what would be their source?

A. Since the tax benefit Mr. Rackers proposes to provide has absolutely no basis in tax law, it can accurately be characterized as fictitious. And, since the benefit will not be forthcoming from any taxing authority, it can have only one of two sources – shareholders or customers. If the source is to be the shareholders, then the Company is being deprived of the opportunity to earn its allowed rate of return by the amount of this disallowance. If the source of the benefit is to be the Company's customers, this means that ratepayers will simply have to give it back at some future point in time. If this latter situation were the case, the adjustment is, as a practical matter, meaningless.

Q. In your opinion, does this proposed adjustment make economic sense?

A. No it does not.

Q. Does Mr. Rackers' proposed adjustment make accounting sense?

A. No it does not. Tax expense consists of two components: current and deferred. Mr. Rackers' proposed adjustment to the tax expense element of cost of service makes no sense as either a current tax benefit or as a deferred tax benefit.

Q. Why doesn't it make any sense as a current tax benefit?

A. It is clear that, with respect to Asset X, there has been no tax depreciation since Year 10. There will certainly be none in Year 21. Since there will be no tax depreciation in Year 21, there will be no reduction in cash taxes in that year. Thus, the benefit he proposes cannot be a current tax benefit. Consequently, any benefit must, if anything, be a deferred tax benefit.

Q. Why doesn't it make any sense as a deferred tax benefit?

A. Schedule 1 makes clear that, as of the end of Year 20, all deferred taxes associated with Asset X have reversed. Thus, any deferred tax benefit provided in Year 21 must mark the creation of a new temporary (*i.e.*, timing) difference. In fact, deferred taxes can only exist where there is a difference between the regulatory and tax recognition of an item of income or expense. Thus, deferred tax accounting is appropriate during the first 20 years of the life of Asset X. However, with respect to Year 21 regulatory depreciation, there will never be a tax event that will give rise to the reversal of the deferred tax benefit that Mr. Rackers proposes to create. Thus, elementary accounting would not countenance the creation of a deferred tax asset.

Q. Can the solution then be to adjust rates in this proceeding as Mr. Rackers suggests and to, somehow, not reflect the effect of the adjustment in the Company's accounting entries?

A. The reduction in rates on account of a tax benefit is generally accompanied by a reduction in tax expense. In this way, there is no adverse effect on the net income of the Company and no diminution in its ability to earn its allowed rate of return. This is precisely the situation when the tax benefit of an item is "flowed through" to customers. Revenues are reduced – but so is tax expense. Any reduction in rates which is not offset by an offsetting reduction in tax expense would effectively reduce the Company's allowed rate of return below that ostensibly set by this Commission. This would, obviously, be contrary to the intent of the Commission. A reduction in rates without a deferred tax entry would accomplish exactly this. In my opinion, such a reflection in ratemaking of non-existent tax benefits for the sole purpose of reducing rates would not constitute "just and reasonable" ratemaking.

Q. What, then, do you conclude regarding Mr. Rackers' proposed adjustment?

A. In accounting terms, the provision of such a benefit to customers cannot be justified as either a current or a deferred tax benefit. Not only will it not produce a current reduction in taxes, it will never produce such a reduction. In economic terms, it will pass through to customers a presumed future cash flow from the government where such a future cash flow is impossible. In regulatory terms, it will result in inappropriate and unsound ratemaking and will effectively undercut this Commission's determination regarding an appropriate rate of return.

Q. Why do you believe that the imposition of Mr. Rackers' proposed adjustment would amount to a regulatory disallowance?

A. In the rate setting process, a utility must be afforded the opportunity to recover all prudently incurred costs appropriately associated with the provision of the regulated service. Mr. Rackers states in no uncertain terms that the only rationale for his proposal is that it mitigates the necessity for a tax "gross up" – the $.62 to which he refers in his Direct testimony Rackers, Direct dated March 2002, page 7, line 30. It does indeed. However, there is nothing inherently wrong with tax "gross ups." These are a normal feature of cost-based regulation, necessary to the recovery of, among other items, the equity return, federal taxes and the depreciation of previously capitalized equity AFUDC. The failure to permit a tax "gross up" with respect to any of these items would operate as a partial disallowance since, without one, the full amount of the item itself could not be recovered. So it is with Mr. Rackers' proposed adjustment. Without the tax "gross up" which is eliminated by his proposal, the Company will not be afforded an opportunity to recover its full measure of book depreciation. This seems to me to be the operative definition of a disallowance.

Q. Does Mr. Rackers offer any basis in support of his proposed disallowance?

A. No he does not. There is no allegation of imprudency. Rackers, Deposition of April 18, 2002, at page 22, lines 18-21. Nor does he assert that the subject depreciation does not benefit customers. He provides no support whatsoever.

Q. You state that Mr. Rackers' proposal is aimed to remedy a "problem" that does not exist. Can you describe what you mean by this?

A. Yes I can. Earlier in this testimony I used a simplified model to illustrate the mechanics that give rise to the necessity to impose the tax "gross up" which Mr. Rackers finds so distasteful. This illustration demonstrated that such a "gross up" is a computational necessity where an asset in a particular vintage account remains in service for a time period that exceeds its book depreciable life (*i.e.*, the tax straight line life). A very slightly more sophisticated model will demonstrate that the results produced by vintage accounts of this type are entirely "self corrected" by the results from those vintage accounts in which assets are retired from service prior to reaching the end of their book depreciable lives.

Q. Please explain.

A. Consider two similar vintage accounts. Each account contains two assets, each of which costs $100. All four assets have a book life (*i.e.*, tax straight line) of 10 years. All four assets have a 5 year tax life computed using the straight line method. A 40% tax rate is applicable. In vintage account #1, one of the two assets is retired in year 5 and the second asset is retired in year 20. Schedule 2 depicts the regulatory tax consequences of such an account over the entire life of both assets. In vintage account #2, one of the two assets is retired in year 5 and the second asset is retired in year 10. Schedule 3 depicts the regulatory tax consequences of such an account over the entire life of both assets.

Q. What is notable about Schedule 2?

A. The second and last columns, the bolded ones, contain the data of critical import. The second column indicates that the aggregate amount of depreciation funded by customers over the life of both assets is $250. The last column indicates that the aggregate tax benefit customers have received over the assets' lives is $80. This amount is less than the $100 ($250 of book depreciation multiplied by the 40% tax rate) of benefit customers would have received had all book depreciation provided tax benefits at the statutory tax rate. However, the Company's system does not, and cannot, provide such benefits because the assets only generate $80 of actual tax benefits. This represents precisely the "problem" Mr. Rackers seeks to remedy.

Q. What is notable about Schedule 3?

A. Again, the second and last columns, the bolded ones, contain the data of critical import. The second column indicates that the aggregate amount of depreciation funded by customers over the life of both assets is $150. The last column indicates that the aggregate tax benefit customers have received over the assets' lives is $80. This amount is *more than* the $60 ($150 of book depreciation multiplied by the 40% tax rate) of benefit customers would have received had all book depreciation provided tax benefits at the statutory tax rate.

Q. What conclusions are compelled from a comparison of these two models?

A. Mr. Rackers' "problem" is a feature of vintage accounts where the average life of all assets in the vintage account exceeds the tax straight line life. However, Schedule 3 demonstrates that precisely the opposite tax effect occurs in those vintage accounts wherein the average life of all assets in the vintage account is less than the tax straight line life. *The Company's system automatically provides all possible tax benefits to customers on a vintage-acount-by-vintage-account basis.* In fact, if the four assets depicted on Schedules 2 and 3 are considered together, customers fund $400 of depreciation and receive $160 in tax benefits – exactly the right amount.

Q. How do you know that the offset actually occurs?

A. Assuming that the book depreciation lives are properly measured, then to the extent that any asset exceeds its book life, there must necessarily be one or more assets retired prematurely by a like amount. Similarly, if there is a vintage account wherein the average asset life exceeds the assigned book life, there must be one or more vintage accounts wherein the average asset life is shorter. In short, for every one of Mr. Rackers' "problem" vintage accounts, there must be one or more Schedule 3 "bonus" vintage account. It is a "zero sum game" in which customers are neither disadvantaged nor advantaged. The offset is self-executing.

Q. What, then, do you conclude with regard to Mr. Rackers' proposal?

A. His proposed adjustment represents a solution in search of a problem. It is simply unjustifiable and unnecessary.

Q. Is Mr. Rackers' adjustment based on an erroneous false assumption concerning the way the Company provides tax benefits to ratepayers?

A. Yes. Mr. Rackers fails to recognize that 100% of the tax benefits associated with an asset flow to ratepayers even when that asset is retired early, as is indicated by the example in Schedule 3. Indeed, he has stated that Staff's position is that ratepayers should be deprived of tax benefits in these circumstances. Rackers Deposition of April 18, 2002, at pp. 44-45, lines 16-23. However, he does not propose any such adjustments.

Q. Is there any other reason why you believe Mr. Rackers' proposed adjustment is inappropriate?

A. Yes there is. This Commission has long treated all depreciation associated with pre-1975 vintages on a "flow through" basis. That is, tax benefits produced by assets placed in service in years prior to 1975 were, by Commission order, provided to customers only when, and to the extent that, they were reflected on the Company's actual income tax returns. Thus, if Asset X in the examples above had been placed in service prior to 1975, no tax benefits whatsoever would have been provided to customers after Year 10. It should be absolutely antithetical to this Commission-mandated, flow through method to start providing tax benefits to customers in any year when there are no tax deductions to be claimed on any tax return.

Q. What portion of the adjustment proposed by Mr. Rackers is produced by asset vintage accounts prior to 1975?

A. Based on my review of the work papers furnished by Mr. Rackers in support of his proposed adjustment, it appears that all or, nearly all, of his proposed adjustment is derived from depreciation associated with pre-1975 asset vintage accounts.

Q. Does that conclude your testimony?

A. Yes it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

AFFIDAVIT OF JAMES I. WARREN

STATE OF NEW JERSEY)) ss COUNTY OF MORRIS)

James I. Warren, being first duly sworn on his oath, states:

1. My name is James I. Warren. I work in Parsippany, New Jersey and I am a tax partner in the accounting firm of Deloitte & Touche LLP.

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 20 pages, Appendix A and Schedules 1, 2 and 3 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.

James I. Warren
James I. Warren

Subscribed and sworn to before me this 1st day of May, 2002.

Patricia I. Bertuzzi
Notary Public

My commission expires:

PATRICIA I. BERTUZZI
Notary Public Of New Jersey
My Commission Expires Oct. 28, 2003

EXECUTIVE SUMMARY

James I. Warren

Tax Partner, Deloitte & Touche LLP

* * * * * * * * * *

Mr. Rackers proposes a "tax straight line" adjustment which would reduce the Company's revenue requirement by approximately $2.2 million. With this adjustment, he proposes to give recognition to totally fictitious tax benefits (that is, nonexistent future tax deductions) just to reduce rates. This adjustment relates to assets which have survived past the end of their projected life spans. The Company and the Staff agree that such assets have no actual tax depreciation capacity remaining – that is, that they will *never* produce any future tax deductions. Nevertheless, the mechanics of the "tax straight line" adjustment impute, for ratemaking purposes, the existence of depreciation tax benefits to these assets – tax benefits that do not exist.

The sole support Mr. Rackers offers for this proposed adjustment is that (1) it lowers rates and (2) this Commission has entertained it previously. The Company contends that, while imposing the adjustment would, in fact, lower rates, it would be economically illogical, contravene accepted accounting principles and constitute inappropriate ratemaking. The crux of the Company's position is that to reflect in rates a tax benefit that has never existed, does not exist now and will never exist violates all three of the referenced disciplines. In fact, it amounts to a regulatory disallowance without any foundation whatsoever to support such an action. Further, the Commission's past actions with respect to the "tax straight line" adjustment are in no way dispositive. It has only examined the issue once, and that was in the context of a request for a rate increase wherein the burden of proof was on the utility, not, as in this proceeding, on the Staff. Moreover, such an adjustment is completely unnecessary insofar as the Company's tax accounting system provides a self-executing offset to the effects of assets outliving their presumed useful lives.

In my experience, the proposed "tax straight line" adjustment is an anomaly. This is a remedy in search of a problem -- while the situation Mr. Rackers seeks to address is a very common feature among utilities, I am unaware that anything like his proposed adjustment is employed in any other jurisdiction. Thus, the imposition of such an adjustment is an extraordinary departure from generally accepted practices. Indeed, there have been no changes in the tax or accounting rules relating to asset depreciation that would mandate or even suggest the propriety of altering the Company's historic method of computing its tax element of cost of service. Such an adjustment is simply unsupportable.

A	B	C	D	E	F
Year	**Tax Depreciation Deduction**	**Regulatory Depreciation Expense**	**Current Tax Expense[1]**	**Deferred Tax Expense[2]**	**Total Tax Expense[3]**
1	$100	$50	($40)	$20	($20)
2	$100	$50	($40)	$20	($20)
3	$100	$50	($40)	$20	($20)
4	$100	$50	($40)	$20	($20)
5	$100	$50	($40)	$20	($20)
6	$100	$50	($40)	$20	($20)
7	$100	$50	($40)	$20	($20)
8	$100	$50	($40)	$20	($20)
9	$100	$50	($40)	$20	($20)
10	$100	$50	($40)	$20	($20)
11	$0	$50	$0	($20)	($20)
12	$0	$50	$0	($20)	($20)
13	$0	$50	$0	($20)	($20)
14	$0	$50	$0	($20)	($20)
15	$0	$50	$0	($20)	($20)
16	$0	$50	$0	($20)	($20)
17	$0	$50	$0	($20)	($20)
18	$0	$50	$0	($20)	($20)
19	$0	$50	$0	($20)	($20)
20	$0	$50	$0	($20)	($20)
TOTAL	$1,000	$1,000	($400)	$0	($400)

1. **Tax Depreciation Deduction (column B) multiplied by the tax rate (40%).**
2. **Difference between Tax Depreciation Deduction (column B) and Regulatory Depreciation Expense (column C) multiplied by the tax rate (40%).**
3. ***Current Tax Expense (column D) plus Deferred Tax Expense (column E).***

UNION ELECTRIC

Book basis	200	(2 Assets @ 100 each)
Book depreciation rate	10.00%	(10 Years)
No slavage; no removal		
Tax Rate	40.00%	
Tax basis	200	(2 Assets @ 100 each)
Tax depreciation	5 yr/SL	
Retirement Asset 1	Year 5	(1 Asset @ 100)
Retirement Asset 2	Year 10	(1 Asset @ 100)

Acufile System -- Computation of Deferred Tax Expense (entered on books monthly)

Year	**Book Depreciation**	Tax SL Depreciation	Tax Deduction	Current Tax Expense	Deferred Tax Expense	**Total Tax Expense**
1	**20**	20	40	(16)	8	**(8)**
2	**20**	20	40	(16)	8	**(8)**
3	**20**	20	40	(16)	8	**(8)**
4	**20**	20	40	(16)	8	**(8)**
5	**20**	10	40	(16)	12	**(4)**
6	**10**	10			(4)	**(4)**
7	**10**	10.			(4)	**(4)**
8	**10**	10			(4)	**(4)**
9	**10**	10			(4)	**(4)**
10	**10**	70			(28)	**(28)**
11					-	**-**
12					-	**-**
13					-	**-**
14					-	**-**
15					-	**-**
Total	**150**	200	200	(80)	-	**(80)**

UNION ELECTRIC

Book basis	200	(2 Assets @ 100 each)
Book depreciation rate	10.00%	(10 Years)
No slavage; no removal		
Tax Rate	40.00%	
Tax basis	200	(2 Assets @ 100 each)
Tax depreciation	5 yr/SL	
Retirement Asset 1	Year 5	(1 Asset @ 100)
Retirement Asset 2	Year 20	(1 Asset @ 100)

Acufile System -- Computation of Deferred Tax Expense (entered on books monthly)

Year	**Book Depreciation**	Tax SL Depreciation	Tax Deduction	Current Tax Expense	Deferred Tax Expense	**Total Tax Expense**
1	**20**	20	40	(16)	8	**(8)**
2	**20**	20	40	(16)	8	**(8)**
3	**20**	20	40	(16)	8	**(8)**
4	**20**	20	40	(16)	8	**(8)**
5	**20**	10	40	(16)	12	**(4)**
6	**10**	10			(4)	**(4)**
7	**10**	10			(4)	**(4)**
8	**10**	10			(4)	**(4)**
9	**10**	10			(4)	**(4)**
10	**10**	10			(4)	**(4)**
11	**10**	10			(4)	**(4)**
12	**10**	10			(4)	**(4)**
13	**10**	10			(4)	**(4)**
14	**10**	10			(4)	**(4)**
15	**10**	10			(4)	**(4)**
16	**10**	10			(4)	**(4)**
17	**10**				-	**-**
18	**10**				-	**-**
19	**10**				-	**-**
20	**10**				-	**-**
Total	**250**	200	200	(80)	-	**(80)**