Exhibit No:	
Issues:	Cost of Removal & Net Salvage
Witness:	Larry W Mulligan
Type of Exhibit:	Rebuttal Testimony
Sponsoring Party:	
Case No:	GR-2004-0072
Date Testimony Prepared:	February 13, 2004

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. GR-2004-0072

REBUTTAL TESTIMONY

OF

LARRY W MULLIGAN

ON BEHALF OF

AQUILA, INC.
D/B/A
AQUILA NETWORKS – MPS
AND
AQUILA NETWORKS – L&P

KANSAS CITY, MISSOURI

FEBRUARY, 2004

Exhibit No. 14
Date 3/31/04 Case No. GR-2004-0072
Reporter KF

State of Missouri)

) ss

County of Jackson)

AFFIDAVIT OF LARRY W. MULLIGAN

Larry W. Mulligan, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony and schedules entitled "Rebuttal Testimony of Larry W. Mulligan"; that said testimony was prepared by him and/or under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

L. W. Mulligan

Subscribed and sworn to before me this 10th day of February, 2004.

GENERAL NOTARY - State of Nebraska
TERESA A. KEEFE
My Comm. Exp. Oct 31, 2005

Teresa A Keefe
Notary Public

My Commission expires:

October 31, 2005

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REBUTTAL TESTIMONY OF LARRY MULLIGAN

Q. Please state your name and business address.

A. My name is Larry Mulligan and my business address is 20th West Ninth Street, Kansas City, Missouri 64105.

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

A. I am employed by Aquila, Inc. (Aquila) in the Networks Asset Accounting Department. My position is Accounting Manager. The Networks Asset Accounting Department accounts for the assets of all regulated electric and gas utilities.

Q. Please describe your educational and professional background for the Missouri Pubilc Service Commission ("Commission")

A. I graduated from the University of Missouri at Kansas City in December 1978 with a Bachelor of Business Administration Degree with a major in accounting. I graduated from Rockhurst College in May of 1988 with a Master of Business Administration Degree with an emphasis in Finance. In January 1979 I was employed by Missouri Public Service (Predecessor to Aquila) in the accounting department. I have remained with Aquila for 25 years and have performed various accounting tasks during this time. Some of these tasks include the preparation of regulatory filings such as FERC Form 1 & 2 reports, 10K reports and assistance in asset depreciation studies.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Staff witnesses on the ratemaking treatment of net salvage (salvage and cost of removal). My rebuttal testimony will closely follow the rebuttal testimony provided by Company Witness Davis Rooney in Case Nos. ER-2004-0034 and HR-2004-0024 (consolidated). It is the Company's intention to preserve its current accounting treatment of this issue and defend in a similar manner against the Staff's proposed ratemaking treatment whether it is for electric, steam or gas utilities in the state of Missouri.

Q. What is meant by the terms cost of removal and salvage?

A. Inherent in the process of retiring or removing fixed capital assets from service is a cost. This cost is termed "cost of removal." Sometimes the utility is able to recycle or resell the removed property and the value is termed "salvage."

Q. Please explain Staff's adjustments for cost of removal and salvage.

A. Staff witness Cary Featherstone describes the purpose of his adjustments S-76.1 in the MPS gas case and S-74.1 in the L&P gas case is to include cost of removal and salvage costs as part of the cost of service expense ("cost of service" method or "Staff's method").

Q. Do you agree with the accounting treatment proposed by Staff?

A. No. I believe that the traditional method of recording these items to the accumulated depreciation reserve (rate base treatment) is the best method for accounting and ratemaking.

Q. Why do you disagree with Staff's accounting treatment?

A. My key points follow:

- Rate base treatment has checks and balances that provide equal protection to both the ratepayer and the Company to ensure that all and only all actual net salvage incurred is paid by the ratepayer.

- Both the Missouri Code of State Regulations and the Code of Federal Regulations require rate base accounting treatment for net salvage.

- Rate base treatment is better regulatory policy.

- The amount of net salvage allowed for ratemaking treatment is a separate issue from its accounting treatment in the regulated chart of accounts.

- Both the Missouri Code of State Regulations and the Code of Federal

- Regulations include net salvage in the definition of depreciation for rate-regulated entities.

<u>**Rate Base Treatment Provides Equal Protection**</u>

Q. Why is it important that net salvage be recorded in accumulated depreciation and also included in the depreciation rate ("rate base method" or "rate base treatment")?

A. Unlike Staff's method, rate base treatment ensures that the ratepayer pays for all and only all the actual net salvage costs of the Company.

Q. How does the rate base method protect the ratepayer?

A. Under the rate base method, when cost of removal is collected from the customer through authorized depreciation rates, the amount received is recorded in the depreciation reserve account. Upon removal of the property, the actual cost of removal is paid by the Company and charged to the depreciation reserve account. If the amount collected from the customer is greater than the amount spent by the Company, rate base is reduced. This rate base reduction is carried forward to future rate cases, reducing the revenue requirements until lower depreciation rates are established. The ratepayers receive the Company's cost of capital as return on any over collected money through the reduction of the Company's rate base until they receive return of their money through lower depreciation rates. Over time the ratepayer pays no more than what the Company paid and earns a return through reduced rates in the interim.

Q. How is the Company protected?

A. The exact same situation exists for the Company. When the cost of removal collected from the ratepayers is not enough to cover actual costs, rate base is increased until depreciation rates are increased. The Company receives its authorized cost of capital as return on the under collected money through the increase in rate base until they receive return of their money through higher depreciation rates. This approach is both fair and equitable to both the Company and the ratepayer.

<u>**Rate Base Treatment Recommended by Missouri State Code of Regulations**</u>

Q. Where should net salvage be recorded in the regulated books and records?

A. The Federal Energy Regulatory Commission ("FERC") requires that both salvage value and cost of removal, hence net salvage, be recorded in accumulated depreciation – FERC account 108 (Title 18 Code of Federal Regulations, Part 201 instructions for account 108).

Q. What treatment does the Missouri State Code of Regulations ("MoCSR") require?

A. The MoCSR requires that the FERC Uniform System of Accounts ("USOA") be followed except as modified by the MoCSR.

Q. Does the MoCSR prescribe how net salvage shall be recorded?

A. Yes. The MoCSR specifically provides, separate and apart from the general instruction to follow the FERC Uniform System of Accounts, that upon retirement "each gas corporation subject to the commission's jurisdiction shall...charge original cost less **net salvage** to account 108..." (4 CSR 240-40.040(2)) H) (Emphasis added).

Q. Is account 108 – accumulated depreciation – a component of rate base?

A. Yes.

Q. What do you conclude from this?

A. That both the FERC and the MoCSR recommend that net salvage be recorded in accumulated depreciation account 108. Account 108 is a normal component of rate base. Additionally, as a component of accumulated depreciation under Missouri regulations, it is recommended and appropriate to include net salvage in the depreciation rate. In light of the equal protection it provides the ratepayer and the Company, it is the most logical and prudent approach to advocate, and in my opinion, the ratemaking approach intended by the MoCSR accounting rules.

Rate base Treatment as Policy

Q. Why is the Commission's policy toward the method of recording net salvage important?

A. Through rate base and depreciation, the Company's investment in assets is among the largest drivers of gas utility revenue requirements. Changes to well established practices can result in significant harm to both the ratepayer and the Company.

Q. How can such harm arise?

A. The FERC USOA is a collection of rules that work together to balance the interests of the ratepayer with the interests of the Company. Replacing one isolated rule with another, without extensive study and consideration, may result in unintended consequences to either the ratepayer or the Company, or both. Additionally, such changes may tip the balance of protection either to the harm of the ratepayer or the harm of the Company.

Q. How can harm arise to Ratepayers and the Company?

A. Utilities are generally granted rates of returns that reflect the level of stability created by regulation. Lenders and investors will note instability. This can lead to higher required costs of money and higher costs to ratepayers.

Q. How has net salvage been treated in the past?

A. Net salvage has been accounted for under the rate base method at least since 1951. Numerous FERC Form 2 reports for Missouri Public Service and St. Joseph Light and Power were reviewed for the period 1951 through 2002. In all the forms reviewed, salvage and cost of removal were accorded rate base treatment by being charged to account 108 – accumulated depreciation.

Q. Has the Commission supported rate base treatment of net salvage in recent MPS cases?

A. Yes. In cases GR-88-171, GR-90-198, GR-93-172, ER-90-101, ER-93-37, and ER-97-394.

Q. Did the Commission discuss net salvage in these prior cases?

a) Yes. Rate base treatment was allowed in all these cases. In GR-88-171 gas depreciation rates were approved. The approved rates included a net salvage rate.

b) In GR-90-198 depreciation rates, including the net salvage rate, established in GR-88-171 was utilized.

c) In GR-93-172 Depreciation rates, including the net salvage rate, established in GR-88-171 were utilized.

d) In the ER-90-101 order, the Commission stated "It is also customary to recover through the depreciation rates the estimated cost of ultimately removing the asset offset by the projected amount to be realized from its salvage price." (Report and Order Case No. ER-90-101 page 36).

e) In the ER-93-37 case, the issue was settled with rate base treatment of net salvage in depreciation rates.

f) In the ER-97-394 order, the depreciation rates also included a provision for net salvage. (Report and Order Case No. ER-97-394 page 25)

Q. What has been the Commission's policy in recent cases?

A. Mr. Featherstone includes a list of cases in which Staff recommended cost of service treatment. The Commission has at different times supported both rate base treatment of net salvage and cost of service treatment. The Commission supported rate base treatment in GR-99-315, Laclede Gas Company, and again in WR-2000-844, St. Louis Water. A number of the cases on Mr. Featherstone's list were settled for dollar amounts without resolving this issue in favor of Staff. At least one case appears to still be ongoing.

However, in ER-2001-299, Empire District Electric, the Commission moved away from rate base treatment. The Commission approved Staff's method in that case. However, the Commission recognized that its position was out of the ordinary and stated that its "conclusion in this case should not be taken as an endorsement of Staff's approach."

Q. What is your view of the ratemaking policy of including net salvage in the depreciation rates?

A. I think there are several key considerations, all of which support rate base treatment vs. Staff's proposed cost of service treatment:

1. Rate base treatment is supported by the accounting rules of net salvage as established in both a federal and state process that resulted in published rules in both the Code of Federal Regulations and the Missouri Code of State Regulations.

2. Rate base treatment of net salvage ensures that, over time, all and only all gross salvage received is returned to the ratepayer and that, over time, all and only all cost of removal paid by the Company is charged to the ratepayer.

3. Rate base treatment of net salvage compensates, on an equal basis, the ratepayer and the Company for any delays in returning or collecting these amounts.

4. Rate base treatment of net salvage ensures that when, not if, actual results vary from the estimates used, both the Company and the ratepayer receive return on their money at the same fair rate authorized by the Commission, the Company's rate of return.

5. Comprehensive use of rate base treatment for both net salvage and original cost provides an important compensating control on depreciation of original cost to ensure fair treatment of these important costs.

Q. What do you conclude?

A. As a matter of policy for net salvage, rate base treatment balances the interest of the ratepayer and Company in a fair manner. The cost of service method does not. The Commission should decide in favor of its traditional method of handling this cost as a component of depreciation.

<u>Amount Allowed is a Separate Issue</u>

Q. Does the recovery of an average annual amount spent, rather than an accrual amount, require cost of service treatment?

A. No. For ratemaking the Missouri Commission has included both pay as you go and accrual levels in its depreciation rates. In MPS Case No. ER-90-101, Staff witness Melvin Love describes in his direct testimony a methodology to recover a five year average level of net salvage through the depreciation rate. His recommendations were adopted. A similar method was recommended and adopted in MPS Case No. ER-93-37. In Case No. ER-97-394, Staff Witness Guy Gilbert, recommended accrual levels to be recovered through depreciation rates. This treatment was also accepted by the Commission.

Q. What do you conclude.

A. Although, the Company has a clear preference for the accrual levels of net salvage proposed by Company witness Dr. Ronald White, the rate base treatment is not dependent on the amount authorized for recovery. Rate base treatment is compatible with both the accrual amount and the average annual amount. As explained above, the rate base treatment provides balanced protection to the interests of both the ratepayer and the Company. The Commission should retain its traditional rate base treatment of net salvage regardless of the level of recovery it ultimately allows in rates.

<u>Net Salvage is a Required Component of Depreciation</u>

Q. Would you please provide a formal definition of net salvage value?

A. The Missouri Code of State Regulations (MoCSR) directs gas corporations within the Commission's jurisdiction to use the uniform system of accounts prescribed by the Federal Energy Regulatory Commission (FERC). The

MoCSR points out that FERC's uniform system of accounts contains definitions relevant to gas utilities (4 CSR 240-40.040(1)). The definition of net salvage can be found in the FERC Uniform System of Accounts.

> "Net salvage value means the salvage value of property retired less the cost of removal" (18 CFR Part 201 Definitions (23)).

Salvage value is sometimes referred to as "gross salvage value".

Q. Can you provide an example of net salvage?

A. Yes. Assume that new gas measuring and regulating equipment is being installed and the old equipment retired. Before the new regulating equipment can be installed the old equipment must be removed. The Company will incur cost to remove the old equipment. This cost is referred to as cost of removal. The Company may also salvage some material. To the extent materials removed are sold for cash, they will generate cash salvage. To the extent materials are in good condition and can be reused, they will be returned to inventory and generate non-cash salvage, also called reuse salvage. The difference between the cost of removal and the salvage value (both cash and non-cash) is net salvage.

Q. Would you please define depreciation?

A. As directed to FERC by the MoCSR, the definition can be found in the FERC Uniform System of Accounts. The FERC USOA defines depreciation as follows (emphasis added):

> Depreciation, as applied to depreciable gas plant, means the loss in **service value** not restored by current maintenance,

> incurred in connection with the consumption or **prospective retirement** of gas plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities. (18 CFR Part 201Definitions (12 B))

Q. Would you please define service value?

A. Again, as directed to FERC by the MoCSR, the definition can be found in the FERC Uniform System of Accounts (emphasis added):

> Service value means the difference between original cost and **net salvage value** of electric plant. (18 CFR Part 201 Definitions (37))

Q. Do you draw any conclusions from these definitions?

A. Depreciation, as it pertains to rate regulated entities, is a specially defined term. Based on the definitions prescribed by the MoCSR, one can conclude that net salvage value is an integral part of the determination of depreciation. One cannot estimate the loss to retirement without considering the value at retirement (net salvage). Both original cost and net salvage are necessary to properly determine depreciation for ratemaking. Therefore, it is appropriate to include net salvage in the depreciation rate.

<u>Conclusion Regarding Ratemaking Accounting for Net Salvage</u>

Q. What actions do you propose for this case?

A. I propose that 1) the Commission approve depreciation rates that include net salvage; and 2) that net salvage be recorded for ratemaking and financial reporting in accumulated depreciation consistent with the state and federal codes of regulations.

ACCRUAL vs. PAY AS YOU GO AMOUNT OF NET SALVAGE

Q. What issue does this section discuss?

A. This section discusses whether the amount of net salvage should be based on accrual or pay as you go amounts. As noted previously, the Company views this issue as separate from the issue of rate base or cost of service treatment.

Q. What is Staff's position on this issue?

A. Staff includes in revenue requirements only the five year average annual amount of net salvage.

Q. Do you agree with this position?

A. No. The ratepayer should pay their share of the costs incurred to serve them regardless of when the Company is required to ultimately pay those costs.

Q. What are pay as you go amounts?

A. Pay as you go refers to the estimated amounts paid or received by the Company for net salvage in any one year.

Q. What are accrual net salvage amounts?

A. This refers to the estimated amounts consumed by ratepayers in any one year.

Q. Can you give an example?

A. Assume a new gas regulating station is installed at a cost of $ 2,000. Upon retirement it will cost $ 450 to remove the gas regulating station. The amount to recover from customers should be $ 2,450.

Q. Who will pay this cost?

A. The depreciation rates proposed by Staff will recover only the original cost of $2,000. This amount will be charged to the customers served by the gas regulating station.

Q. Who pays for the other $450 dollars?

A. Staff proposes that the $450 be charged to future customers that are not being served by the gas regulating station. This shifts part of the total cost of providing service from the current ratepayer and places the cost on the future ratepayer.

Q. What is Company's concern?

A. Besides the concern noted previously that the pay as you go amount proposed by Staff does not cover our actual pay as you go amounts, Company is concerned that:

1. Current customers are being granted lower rates at the expense of future customers (an intergenerational inequity).

2. Recovery of this basic cost of serving current customers might be denied in the future if not collected now.

Q. Why is the Company concerned that net salvage might be denied in the future?

A. Staff's method allows recovery at retirement but not before. In contrast to this method of allowing the costs only at retirement, Public Counsel has, in at least one prior case (WR-2000-281) advanced an argument to disallow those same costs at retirement. In essence, Staff argued the retirement costs should not be recovered during the revenue producing years and Public Counsel argued that any costs not allowed recovery during the revenue producing years should not be allowed any recovery after the revenue producing years. This produces an unusual result if depreciation rates do not include net salvage or the estimated lives are too long. Both undepreciated original cost and net salvage could be disallowed at retirement.

Q. What does the Company propose?

A. The Company should be allowed protection against this hidden disallowance. The Commission should allow, during the revenue producing years of the property, recovery of all property related costs required to serve the customer. The Commission should approve Company's recommended depreciation rates that include net salvage as presented in Company witness Dr. Ronald Whites' testimony.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.