

Exhibit No.:

Issues: L&P Transition Costs,
Deferred Income Taxes
And AAO

Witness: H. Davis Rooney

Sponsoring Party: Aquila Networks-MPS
And L&P

Case No.: ER-2005-0436

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of the State of Missouri

Surrebuttal Testimony

of

H. Davis Rooney

Exhibit No. 24
Case No(s) ER-2005-0436
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ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NO. ER-2005-0436**

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**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
SURREBUTTAL TESTIMONY OF H. DAVIS ROONEY
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS AND AQUILA NETWORKS-L&P
CASE NO. ER-2005-0436**

1 Q. Please state your name and business address.

2 A. My name is Davis Rooney. My business address is 10750 E. 350 Highway, Raytown,
3 MO 64138.

4 Q. Are you the same Davis Rooney that has previously filed testimony in this case before the
5 Missouri Public Service Commission ("Commission")?

6 A. Yes.

7 Q. What is the purpose of your surrebuttal testimony?

8 A. The purpose of my testimony is to respond to the rebuttal testimony of Office of the
9 Public Counsel ("OPC") witness Ted Robertson and AARP witness David Effron as to
10 the ratemaking treatment of certain costs associated with the integration and assimilation
11 of St. Joseph Light and Power Company ("SJLP" or "L&P") into Aquila; and the
12 ratemaking treatment of deferred taxes related to accounting authority orders and other
13 liabilities.

14 **EXECUTIVE SUMMARY**

15 Q. Please provide a summary of your testimony.

16 A. My testimony in summary:

- 1 • Merger Costs - OPC incorrectly claims that Aquila agreed to never seek recovery
2 of the SJLP merger costs. Aquila expressly agreed to exclude only the premium.
3 The Company has demonstrated significant on going savings in excess of \$10
4 million per year. The merger cost amortization in the amount of approximately
5 \$671,030 (jurisdictional) per year for approximately the next 5 years should be
6 approved.
- 7 • Deferred Income Taxes Related to Liabilities - The Commission should reject
8 AARP's proposed adjustment related to deferred taxes because it is incorrectly
9 premised on the assumption that all the related liabilities have been excluded from
10 rate base.
- 11 • OPC's AAO Methodology – OPC's proposal to include rate base reductions
12 related to deferred taxes but exclude the related rate base increases of deferred
13 costs are unsupported by the facts and should be rejected. Rate payers provide no
14 cash for the rate base offset proposed by OPC. The Company only fully recovers
15 its costs when both items are included in rate base. The Company only recovers
16 the amount deferred (but not its costs of capital) when both items are excluded
17 from rate base. The Company recovers less than the amount deferred under
18 OPC's proposal.

RATEMAKING TREATMENT OF MERGER COSTS

20 Q. What issue does this section of your testimony discuss?

21 A. This section discusses Aquila, Inc.'s ("Aquila" or "Company") ratemaking treatment of
22 costs to achieve the St. Joseph Light and Power ("SJLP") synergies.

1 Q. What treatment should be allowed?

2 A. Recovery of the costs to achieve the SJLP synergies as proposed by Company should be
3 permitted.

4 Q. What objections does OPC witness Ted Robertson raise in his rebuttal testimony?

5 A. In summary, OPC has the following objections:

6 • OPC incorrectly claims that Aquila agreed to never seek recovery of these merger
7 costs. Aquila expressly agreed to exclude only the premium.

8 • OPC incorrectly implies that premium, merger costs, and synergies are all the
9 same thing. OPC contradicts its own actions and prior testimony regarding what
10 constitutes premium.

11 • OPC incorrectly asserts that there is no basis for Aquila to have deferred these
12 costs on its books. Aquila has basis for its accounting in the order of the
13 Commission, the testimony of the Staff, and the FERC Uniform System of
14 Accounts (USoA).

15 Q. What objections did AARP witness David Effron raise?

16 A. Other than implying that AARP might have further objections later, AARP stated only
17 that merger costs should be allowed only to the extent of savings.

18 Q. Have you provided testimony in this case concerning merger savings?

19 A. Yes. In my rebuttal testimony, I provided several simple specific examples of savings
20 achieved. This short list of savings totals well in excess of \$10 million annually. To put
21 the total savings into perspective, it should be noted that the savings necessary to recover
22 the acquisition premium were more than 10 times the size of the savings needed to

1 recover the costs to achieve the merger. The Company has previously testified that
2 savings and synergies exist to allow recovery of both the premium and the costs to
3 achieve. Since the Company has agreed not to seek recovery of the acquisition premium,
4 it is more than 10 times likely that adequate savings exist to justify recovery of the costs
5 to achieve the merger. Said another way, if actual synergies and savings are even 10% of
6 what was initially projected, the synergies and savings exceed the costs to achieve the
7 merger.

8 Q. What is OPC's first objection?

9 A. OPC claims that the "Company explicitly dropped its request to recover the merger costs
10 in that case and all other future cases." (Robertson Rebuttal, page 16, line 14).

11 Q. Is this claim accurate?

12 A. No.

13 Q. What support does OPC offer for this claim?

14 A. OPC quotes the Commission's Second Report and Order, Case No. EM-2000-292 where
15 the Commission refers to a February 25, 2004 document filed by Aquila.

16 Q. What does the February 25, 2004 document filed by Aquila state?

17 A. The February 25, 2004 document states:

18 "2. In connection therewith, Aquila states that it will not seek to recoup or otherwise
19 recover through rates **the subject acquisition premium**.

20 3. In addition, Aquila states that it will not seek to recover through rates the merger
21 savings or synergies in connection with the merger transaction which is the
22 subject of this proceeding (**which savings recovery the Staff has characterized**
23 **as "premium recovery"**) either in the pending Aquila rate cases, Case No. ER-
24 2004-0034..." (emphasis added).
25

26 Q. What did Aquila agree to forego?

1 A. Aquila agreed not to seek recovery of the acquisition premium directly or indirectly
2 through the merger savings sharing mechanism proposed in Case No. ER-2004-0034.
3 Aquila's reference to synergy savings was expressly limited to savings, not costs,
4 characterized as "premium recovery."

5 Q. What was the "subject acquisition premium?"

6 A. \$111,663,835 was recorded on L&P's books in FERC Account 114-Acquisition
7 Adjustment as of 12/31/2002 – the end of the test year in Case No. ER-2004-0034.

8 Q. Did this acquisition premium include the costs to achieve the merger?

9 A. No. The costs to achieve the merger have consistently been recorded separately in
10 Account 186. In prior testimony, these costs were occasionally referred to as "non-
11 premium costs" (Siemek Rebuttal, Case No. ER-01-672, page 19, line 7).

12 Q. What did the Commission order in its Second Report and Order, Case No. EM-2000-
13 292?

14 A. It ordered "That UtiliCorp United Inc. shall not be allowed to recover from its ratepayers
15 the acquisition premium arising from the transaction that was approved in this Report and
16 Order."

17 Q. Did the Commission order more that Aquila give up more than it had offered?

18 A. No. The Commission addressed only recoupment of the acquisition premium, which was
19 all that Aquila offered in its February 25, 2004 filing.

20 Q. Did OPC seek to expand this ruling by seeking a rehearing of the Second Report and
21 Order in Case No. EM-2000-292?

1 A. Yes. OPC claimed, among other things, that the Commission should have considered
2 other issues besides just the recoupment of the acquisition premium. (OPC Application
3 for Rehearing, pages 4-5, item 4d.)

4 Q. How was this rehearing issue resolved?

5 A. OPC withdrew its application for rehearing pursuant to a condition contained in the
6 Unanimous Stipulation and Agreement in Case No. ER-2004-0034.

7 Q. Is it accurate for OPC to claim now that the Commission also ordered Aquila not to
8 recover its merger related costs?

9 A. No. The Commission's order only addressed the premium. When OPC filed its request
10 for rehearing, it did so based on the argument that the Commission Order was improperly
11 limited to the single issue of acquisition premium. Specifically, OPC refers to the
12 Commission's Second Report and order saying, "...it did not reach any finding regarding
13 the acquisition premium in conjunction with the other issues raised in this case." (Case
14 No. EM-2000-292, OPC Application for Rehearing, page 5, item 4d.) This filing was a
15 clear statement by OPC that other costs, such as those for the integration and assimilation
16 of SJLP, had not been excluded by the Commission Order. Aquila does not believe it is
17 credible for OPC, having withdrawn its attempt to expand the Commission's ruling after
18 obtaining satisfaction in the Stipulation in Case No. ER-2004-0034, to now claim that the
19 Commission's ruling addresses more than the premium.

20 Q. Were the acquisition premium and the costs to achieve the merger the same issue in Case
21 No. EM-2000-292?

1 A. No. In the first Report and Order, the acquisition premium recovery was discussed in the
2 section headed "Recovery of the Acquisition Premium," while the costs to achieve the
3 merger were discussed in the section headed "Other Aspects of the Regulatory Plan".

4 Q. Are the merger costs really "misclassified" premium?

5 A. No. Aquila has presented a distinction between the premium paid to the former owners
6 of SJLP in excess of their net book value and other costs incurred to assimilate the SJLP
7 operations.

8 Q. Is this distinction consistent with your understanding of the Commission's ruling?

9 A. Yes. On page 4 of its Second Report and Order in Case No. EM-2000-292, the
10 Commission refers to Company's testimony and states "For regulatory purposes, an
11 acquisition adjustment is simply the difference between the consideration that the
12 purchaser pays for the assets and the net book value of those assets."

13 Q. What is your understanding of "consideration that the purchaser pays for the assets?"

14 A. It is my understanding that this represents amounts paid to the seller.

15 Q. Is this understanding consistent with OPC's view of premium?

16 A Yes. In a prior MPS rate case, OPC testified that "Payment of a premium results in
17 financial rewards to both the seller and purchaser of utility property. The seller obviously
18 benefits by receiving a greater profit on the sale." (Trippensee Direct, Case No. ER-93-
19 37, page 38 lines 22-25). In the L&P merger case EM-2000-292, OPC witness Ted
20 Robertson uses this same definition to describe the premium. His testimony uses seller's
21 and buyer's premium interchangeably. In one such example, he states "The acquisition
22 premium merely represents a financial transaction among shareholders....From the

1 perspective of the current SJLP shareholders the acquisition premium merely represents
2 nothing more than the financial gain on their investment.” (Robertson Rebuttal, Case No.
3 EM-2000-292, page 17, lines 16-21.) Payments made by the buyer to a lawyer to make a
4 regulatory filing, for example, do not provide a financial gain to the seller and are not
5 acquisition premium.

6 Q. Is this distinction between costs paid to the seller and other costs incurred a reasonable
7 one?

8 A. Yes. Consider one of the simplest utility sales - cash for 100% of the stock of a public
9 utility at precisely book value. In such a transaction, the buyer would receive no premium
10 to their recorded costs and the seller would pay no premium for that book value.

11 However, as noted in my rebuttal testimony, the SEC, IRS, MPSC, PBGC, FTC, FCC,
12 and perhaps other regulatory agencies would all require the buying company to properly
13 incur compliance costs for their laws, rules, regulations, and oversight. Add a little
14 complexity from a stock for stock sale and you also have changes in corporate
15 registrations, property re-titling, re-licensing, final tax and financial filings, etc. None of
16 these costs are paid to the seller.

17 Q. How would you characterize these costs?

18 A. These costs are most properly considered the cost of regulation. If premiums plus these
19 costs are arbitrarily disallowed as a matter of regulatory policy, regardless of the
20 synergies, the seller would not be able to sell his investment except at a loss to his book
21 value. A buyer would not purchase unless able to extract the cost of regulation from the
22 seller. This would in essence create a disallowance for the seller because of regulation.

1 Q. Has FERC recognized a distinction between the costs to achieve a transaction and the
2 costs paid to the seller as premium?

3 A. Yes. In FERC Docket EC00-49-000 approving the merger of Consolidated Edison, Inc.
4 and Northeast Utilities, FERC approved recording the premium paid above the net book
5 value separately from costs to achieve the merger. The costs to achieve the merger were
6 recorded in account 186 by the applicant. FERC ordered that such merger costs probable
7 of recovery in future rates recorded on the jurisdictional subsidiary's books should be
8 recorded in FERC Account 182.3-Other Regulatory Assets.

9 Q. OPC asserts that Company had no authority to defer the merger costs. How do you
10 respond?

11 A. OPC's testimony implies that an order from the Commission is required to defer costs on
12 the jurisdictional books. This is contrary to the FERC USoA. For example, as noted
13 above in FERC Docket EC00-49-000, amounts may be deferred if it is probable that the
14 amounts will be recovered in future rates. Further, the account instructions for FERC
15 Account 186 allow amounts to be recorded there when "the final disposition...is
16 uncertain." Neither of these accounts requires an explicit order. Both allow amounts to
17 be deferred and recorded expressly where there is no order and uncertainty exists.

18 Q. Did the Commission express its intent to defer a ruling on the final disposition of these
19 costs until a later rate case?

20 A. Yes. In the First Report and Order in Case No. EM-2000-292, which was reaffirmed in
21 the Second Report and Order, the Commission ordered, among other things, "14. That the

Commission reserves the right to consider any ratemaking treatment to be afforded the transactions herein involved in a later proceeding.”

Q. Does this make the final disposition of the costs to achieve the merger uncertain?

A. Yes.

Q. Did Staff witnesses specifically recommend recovery in prior cases of, among other costs, the OPEB, severance, and system conversion costs included in the costs to achieve the merger?

A. Yes. From the Company’s point of view, this makes it probable that most of these costs will be afforded recovery. These three items alone make up approximately two-thirds of all the costs being sought for recovery in this case. However, to be conservative, we have continued to record these costs in FERC Account 186, rather than in FERC Account 182.

Q. Has the Commission Staff stated a position in the current rate case?

A. Yes. Staff witness Charles Hyneman indicated in rebuttal testimony that Staff would consider recovery of these items if Aquila provided more detailed support.

Q. Did Aquila provide this support?

A. Yes. I provided invoices, journal entries, cost descriptions, and other support for the costs. As a result, it is my understanding that Staff has proposed to allow costs of approximately \$500,000 per year. Although Aquila believes all the costs proposed for recovery were necessary to achieve the synergies, the Company will accept Staff’s adjustment.

Q. Can you summarize your surrebuttal testimony on transition and transaction costs?

1 A. Aquila has provided specific clear examples of achieved and on-going savings that
2 greatly exceed the costs to achieve the merger and synergies. The Company has shown
3 that neither Aquila's statements, nor the Commission's order, can be properly interpreted
4 to mean that Aquila is prevented from seeking recovery of the non-premium costs to
5 achieve the merger and its synergies. The Company has shown that its accounting is
6 supported by the USoA. In conclusion, Aquila requests that the Commission approve
7 recovery of the requested costs to achieve the merger and its synergies.

8 **DEFERRED INCOME TAXES RELATED TO LIABILITIES**

9 Q. What issue does this section of your testimony discuss?

10 A. This section discusses Aquila, Inc.'s surrebuttal to the rebuttal testimony of AARP
11 regarding the ratemaking treatment of deferred taxes related to certain items, specifically
12 allocated costs, employee incentives, maintenance accruals, supplemental retirement, and
13 other post employment benefits (OPEBs).

14 Q. What has AARP proposed?

15 A. AARP has proposed to entirely remove substantial deferred tax balances from the
16 calculation of rate base.

17 Q. Why has AARP proposed this?

18 A AARP bases its proposal on this one premise - that these items are "related to certain
19 reserves, deferred credits, or accrued liabilities that are not recognized in the calculation
20 of rate base." (Effron Rebuttal, page 7, lines 15-16.)

21 Q. Is this premise correct?

1 A. No. Mr. Effron's analysis is in error. Staff and Company have included significant rate
2 base reductions for these items. Staff and Company take a similar approach in
3 summarizing myriad items together. Mr. Effron incorrectly concluded that these items
4 were omitted since he could not see the individual items listed.

5 Q. Where are these items included to reduce rate base?

6 A. They are included in the calculation of the cash working capital. In Staff's accounting
7 schedules filed with its direct testimony, Staff reduces rate base by nearly \$20 million for
8 the net impact of these items.

9 Q. How do you know they have been included?

10 A. Staff and Company have taken similar approaches. Staff has included all of these items:
11 allocated costs, employee incentives, and maintenance accruals in its operations and
12 maintenance expense (Staff Accounting Schedule 9-3, line 96). All of these costs are
13 included in the calculation of cash working capital (Staff Accounting Schedule 8-1,
14 line 16). Certain expense items included in Schedule 8-1, line 16 are separately
15 considered in the calculation of cash working capital on lines 2-15 of that schedule. All
16 the rest of the items are considered on line 1. The net impact of all these items is
17 included in the calculation of the rate base reduction (Staff Accounting Schedule 2-1).
18 Mr. Effron has concluded that since his particular items were not separately itemized,
19 they must have been omitted. They were not.

20 Q. Has Mr. Effron taken a similar approach with OPEBs?

1 A. Yes. He has again improperly eliminated the entire deferred tax balance, in spite of the
2 fact that OPEB expense remains included in operations and maintenance expense, and
3 hence has been included in rate base through the cash working capital calculation.

4 Q. What do you conclude?

5 A. The Commission should reject AARP's proposed adjustment related to deferred taxes
6 because it is incorrectly premised on the assumption that all the related liabilities have
7 been excluded from rate base.

8 **ICE STORM AAO DEFERRED INCOME TAXES**

9 Q. What issue does this section of your testimony discuss?

10 A. This section discusses Aquila, Inc.'s surrebuttal to the rebuttal testimony of OPC witness
11 Ted Robertson regarding deferred taxes related to the ice storm accounting authority
12 order (AAO).

13 Q. What is the proper treatment of the ice storm deferred income taxes?

14 A. In my rebuttal testimony, I state that the deferred expense asset and the related deferred
15 taxes should be treated consistently in rate base. This is the fair treatment required by the
16 IRS for plant related deferred taxes, and it is the fair treatment that should be used here.

17 Q. Has Company reflected these items on a consistent basis?

18 A. Yes. However, Company's direct case reflected the deferred expense asset in rate base
19 but incorrectly excluded the related deferred taxes.

20 Q. OPC has proposed an inconsistent treatment by excluding the ice storm asset from rate
21 base but including the related deferred taxes to reduce rate base. Why is this
22 inappropriate?

1 A. Rate base reductions (other than prudence disallowances) generally occur for one of two
2 reasons. Either the rate payer has advanced money to the Company in advance of the
3 Company spending it (this is not the case in this ice storm AAO as the Company has
4 spent the money in advance of recovery); or the rate payer is paying the Company a return
5 on an asset and the reduction is intended to reflect the Company's net cash investment in
6 that asset (this is not the case, as OPC has not included the ice storm asset in rate base).
7 The ratepayer has not paid in advance for the ice storm. The money has already been
8 spent by the Company. OPC's treatment creates a net negative rate base for this item. In
9 effect, OPC has the Company paying a return to the rate payer on money not advanced by
10 the rate payer and not held by the Company. This is not fair treatment.

11 Q. Isn't it normal to offset plant related deferred taxes?

12 A. As stated in my rebuttal testimony, under IRS rules, plant related deferred taxes may only
13 be offset against rate base if the related property is included in rate base. OPC has not
14 included the related ice storm asset in rate base. OPC has ignored that the Company has
15 advanced the costs of the ice storm. Therefore, it seems to me a fairness issue. OPC
16 has proposed to provide a rate base reduction, instead of a rate base increase, when the
17 Company has fronted cash that will not be recovered in rates until later.

18 Q. Can you describe further why this treatment is not reasonable?

19 A. Yes, however to fully cover the issue, I have addressed this in a separate section of my
20 surrebuttal testimony. Please see the section titled "OPC's AAO Methodology".

1 Q. In your testimony above regarding liabilities, you describe how certain items are included
2 in rate base through the cash working capital calculation. Does this testimony also apply
3 to the deferred ice storm costs being amortized?

4 A. No. Company and Staff have recorded the deferred ice storm cost amortization as a
5 component of amortization, not operations and maintenance expense. Therefore, this cost
6 did not enter into the cash working capital calculation.

7 Q. What do you recommend?

8 A. I recommend that the Commission reject OPC's proposal to inconsistently and one-
9 sidedly exclude the ice storm moneys advanced by the Company from rate base, while
10 including a rate base reduction for the deferred taxes created solely by the ice storm
11 AAO.

12 **SIBLEY AAO DEFERRED INCOME TAXES**

13 Q. What issue does this section of your testimony discuss?

14 A. This section discusses Aquila, Inc.'s surrebuttal to the rebuttal testimony of OPC witness
15 Ted Robertson regarding deferred taxes related to the 1990 and 1992 Sibley accounting
16 authority order (AAO).

17 Q. Did you address this issue in your rebuttal testimony?

18 A. Yes.

19 Q. Does your rebuttal testimony regarding the Sibley AAO's still represent your position?

20 A. Partially. As stated above and in my rebuttal testimony, a rate base offset for deferred
21 taxes is not appropriate except when the item related to the deferred tax is also included
22 in rate base.

1 Q. What has changed?

2 A. Since writing my rebuttal testimony on this issue, additional documentation has come to
3 my attention that requires me to change my position. In particular, I have been provided
4 with additional schedules from MPS's rate cases in 1990, 1993, and 1997. These
5 schedules show that the Sibley AAO's were included in rate base, but the amounts
6 included in rate base were net of an amount for deferred taxes. An amortization schedule
7 for the 1990 Sibley AAO and a calculation for the 1993 Sibley AAO were also located.
8 The amounts included in the rate base work papers for those cases are consistent with the
9 schedules located.

10 Q. What do these schedules show?

11 A. These schedules show that deferred taxes were calculated on all components of the AAO
12 deferred costs, except for the depreciation deferred costs.

13 Q. What is your position?

14 A. It is my position, consistent with the treatment ordered in 1990, 1993 and 1997 and the
15 treatment indicated in the schedules and work papers to those cases, that the unamortized
16 Sibley AAO's from 1990 and 1992 be included in rate base net of the deferred taxes on
17 the non-depreciation amounts.

18 **OPC'S AAO METHODOLOGY**

19 Q. What issue does this section of your testimony discuss?

20 A. This section discusses Aquila, Inc.'s surrebuttal to the rebuttal testimony of OPC witness
21 Ted Robertson's recommendation on how to treat AAO's in rate base.

22 Q. What is OPC's position?

1 A. OPC "opposes the inclusion of the unamortized AAO deferred cost balances in rate base
2 and supports the reduction of rate base for the associated deferred income taxes
3 component." (Robertson Rebuttal page 2 lines 13-15).

4 Q. Why do you oppose OPC's AAO methodology?

5 A. I oppose OPC's AAO methodology for the following reasons:

- 6 • The methodology proposes a rate base reduction where no funds have been
7 advanced by the customers.
- 8 • The methodology denies a return on funds advanced by the Company.
- 9 • By inappropriately including a rate base reduction where no funds have been
10 advanced by the rate payer, the utility will not recover the actual amounts it was
11 allowed to defer, but rather a lesser amount.
- 12 • The IRS has extensively considered the fair treatment of plant related rate base
13 and the related deferred taxes. They have concluded that one may not be included
14 in rate base in a manner inconsistent with the rate base treatment of the other. By
15 including the deferred taxes as a rate base offset and excluding the related
16 deferred asset, OPC would treat AAO's in a manner that would not be considered
17 fair or allowable in the case of plant related rate base and deferred taxes.

18 **Funds Not Advanced by Customer**

19 Q. What is the nature of an AAO?

20 A. One type of AAO might relate to an extraordinary and significant event, the costs of
21 which have not been provided for in the existing rates. A major ice storm could be such

1 an example. Although other AAO's might exist, I have used an ice storm for illustrative
2 purposes in my testimony.

3 Q. If these costs have not been provided for in current rates, how does the Company pay for
4 such an ice storm?

5 A. The Company's net income will be less because of the ice storm. Because the
6 Company's net income is less, the Company's tax expense is also less – all because of the
7 ice storm.

8 Q. If these costs have not been provided for in current rates, when will the Company collect
9 the amounts for these expenses?

10 A. When such an event occurs, the Company might seek deferral of those costs for recovery
11 from rate payers in the future. If granted, the Company should collect the deferred
12 expenses in the future.

13 Q. Can you provide an illustration of this?

14 A. Yes. See Surrebuttal Schedule HDR-1. In the first column, I show an illustrative income
15 statement and balance sheet.

16 Q. What is illustrated by the first column?

17 A. This first column shows what the statements might look like if no AAO was recorded and
18 \$10 million of extraordinary maintenance related to an ice storm was incurred. Note that
19 because the ice storm is expensed for both regulated cost of service and tax in the first
20 column, there are no deferred taxes related to the ice storm. As a result there is no
21 deferred tax rate base offset. Since the ice storm was not in current rates, the rate payers
22 have provided no cash for either deferred taxes or the ice storm costs.

1 Q. What is illustrated by the second column?

2 A. The second column shows what the statements might look like if an AAO for the ice
3 storm was granted. Note that although deferred taxes are now recorded, no additional
4 cash has been received. The rate payers have still provided no cash for either the deferred
5 taxes or the ice storm costs.

6 Q. Why does net income differ by \$6 million in the example?

7 A. The cost of the ice storm was \$10 million. This increase in maintenance expenses due to
8 the ice storm, created a reduction in income tax expenses of \$4 million (assuming a 40%
9 tax rate). This results in a net income cost of the ice storm, net of taxes, of \$6 million.

10 Q. What would happen if no AAO were requested or granted?

11 A. The Company would incur a loss (reduced net income for the shareholders) of \$6 million.
12 There would be no deferred taxes related to these items in any rate case.

13 Q. If net income is reduced by \$6 million because of the ice storm, why does the AAO
14 establish a \$10 million asset?

15 A. In order for the Company to collect \$6 million net of tax from the customers, the \$6
16 million must be grossed up for the taxes that will be paid in the future on the collections
17 from the customers. Generally accepted accounting principles generally prohibit the
18 recording of amounts net of tax on the balance sheet. Therefore, the \$6 million is
19 recorded on the balance sheet as a \$10 million asset representing the revenue expected to
20 be collected from rate payers in the future; and a \$4 million deferred tax liability,
21 representing the taxes that will be paid to the IRS in the future out of the \$10 million

1 dollars when it is collected. The net of these two numbers is the \$6 million cash cost paid
2 by the shareholders out of net income.

3 Q. Did the deferred taxes exist in the absence of the Accounting Authority Order?

4 A. No.

5 Q. Did the rate payers advance more cash to the utility at the time the AAO deferral order
6 was issued?

7 A. No.

8 Q. Since the ice storm deferred taxes did not exist before the authorization of an AAO,
9 where did they come from?

10 A. They are created by the AAO. In the simplest terms the deferred taxes are the tax liability
11 that will be paid in the future out of the \$10 million authorized by the AAO to be
12 collected in the future, so that the Company recovers the \$6 million net of tax cost it
13 incurred because of the ice storm.

14 Q. Do deferred taxes have anything to do with timing differences?

15 A. Yes. Before the authorization of the deferral under the AAO, there was no timing
16 difference because the regulated cost of service and tax treatment was the same. The
17 AAO authorizing deferral of the ice storm expenses removes the expenses from regulated
18 cost of service and places them on the balance sheet as a regulatory asset. This change in
19 the accounting, created by the Accounting Authority Order, creates a difference between
20 the expenses in cost of service and the expenses in the tax return. This difference in
21 treatment gives rise to the deferred income tax liability, but no additional cash is received
22 from the rate payers.

1 Q. Does the AAO affect financial reporting as well as regulated cost of service?

2 A. Yes. For financial reporting purposes, generally accepted accounting principles allow
3 financial reporting to reflect the effects of regulation. Therefore, financial reporting will
4 follow the AAO and also defer the ice storm expenses. As a result the financial
5 statements will also reflect deferred income taxes. Without the AAO, the financial
6 statements would expense the ice storm costs and there would be no deferred taxes.

7 Q. So it is the AAO that gives rise to the deferred taxes?

8 A. Yes. It is the AAO for the ice storm that changes the cost of service and creates the
9 regulatory asset that creates the timing difference, which gives rise to the deferred taxes,
10 all of which are reflected in the financial statements

11 Q. Is it appropriate to say that the deferred taxes are unrelated to the AAO and the deferral of
12 costs?

13 A. No. The deferred taxes did not exist before the ice storm costs were deferred.

14 Q. Is it appropriate to say that the rate payers have previously provided money through rates
15 for the payment of these deferred taxes?

16 A. No. If the Company does not collect the \$10 million authorized by the AAO, the
17 Company will not pay the deferred taxes to the IRS. The tax liability will be paid out of
18 the money collected under the AAO. No liability will be paid if the amounts deferred
19 under the AAO are not collected. Therefore, I can only conclude that the money for the
20 payment of these deferred taxes are included in the AAO deferral that is to be collected
21 from rate payers in the future and have not been previously provided by the rate payer.

1 Q. Assume for a moment that someone has provided cash for deferred taxes. Who has
2 provided it?

3 A. The Company and its investors have provided the cash.

4 Q. Please explain.

5 A. In the illustration, the net amount of the AAO deferral and the AAO deferred taxes is \$6
6 million. Revenue is the money provided by the rate payer. If there had been no ice
7 storm, the amount of cash collected from the rate payer in that year would still be the
8 same. However, if there had been no ice storm, the company would have \$6 million more
9 cash and \$6 million more net income. Because of the ice storm, cash and net income are
10 \$6 million less. Net income is the shareholder's return on their investment. Therefore,
11 the ice storm costs and the deferred taxes have been paid out of the shareholder's return.
12 By granting the AAO, the shareholder's return in that year is restored, but future return
13 may be reduced and the cash does not begin to be restored until new rates are
14 implemented. Until then, the Company and its investors have \$6 million less cash. I
15 conclude that it is only the Company, not the rate payers, that has provided the cash to
16 pay for the ice storm and the deferred taxes.

17 **Full Recovery of Amount Deferred is Denied**

18 Q. What is OPC's position regarding recovery of the amounts deferred?

19 A. OPC states "The utility will still recover the actual amounts it is allowed to defer, but it
20 simply will not be allowed to earn a return on those same costs." (Robertson Rebuttal,
21 page 14, line12).

22 Q. Is this statement accurate?

1 A. No. As was shown in the prior section, the rate payer has not advanced cash to the
2 Company for deferred taxes. By including a rate base offset for the deferred taxes, and
3 thus reducing revenue requirements inappropriately, OPC's AAO methodology provides
4 the utility with recovery of less than all the amounts it was allowed to defer. Said another
5 way and using the illustration on Surrebuttal Schedule HDR-1, OPC's AAO methodology
6 excludes from rate base \$10 million. The Company's net cash cost of the ice storm was
7 \$6 million. By denying return on a greater amount than the cost incurred by the
8 Company, OPC prevents recovery of the actual amounts deferred.

9 **Internal Revenue Code Treatment**

10 Q. Has the Internal Revenue Service (IRS) considered the fair treatment of deferred taxes
11 and rate base?

12 A. Yes. The largest deferred taxes relate to plant balances and accelerated depreciation. The
13 IRS has considered plant and accelerated depreciation timing differences extensively.

14 Q. What treatment does the IRS consider appropriate with respect to plant and deferred taxes
15 related to accelerated depreciation?

16 A. With respect to those items subject to normalization, the Internal Revenue Service
17 ("IRS") requires that the treatment of rate base, deferred taxes, depreciation, and tax
18 expense for ratemaking purposes all be handled consistently. In fact the IRS goes so far
19 as to define inconsistent treatment in its regulations at IRC 168(i)(9)(B).

20 Q. Why is the analysis and guidance of the IRS with respect to the largest timing differences
21 frequently ignored for other timing differences?

1 A. The most frequent argument is that the analysis and guidance of the IRS for the largest
2 timing items can be ignored because the normalization statutes are generally limited to
3 plant and accelerated depreciation. In other words, any treatment in other areas, no matter
4 how fair or unfair, can be implemented with the knowledge that at least it will not be illegal
5 under the Internal Revenue Code.

6 Q. Do you think illegality is the proper standard?

7 A. No. The IRS has extensively analyzed normalization of deferred tax timing differences
8 and concluded that consistent treatment in cost of service and rate base is appropriate for
9 depreciation, net plant balances, and accumulated deferred income taxes. I believe
10 similar treatment should be afforded other assets with timing differences that are
11 amortized into rates.

12 Q. What do you conclude regarding this issue?

13 A. OPC's AAO methodology should be rejected by the commission. It is purely a
14 mechanism to create additional disallowances. The justification for including a rate base
15 offset while excluding a rate base increase is based on a faulty premise that funds have
16 been previously provided by rate payers for those deferred taxes, and the utility does not
17 deserve a return on its money.

18 Q. Does this conclude your prefiled surrebuttal testimony?

19 A. Yes.

1 **Surrebuttal Schedule HDR-1**
2 **Illustrative Example of AAO Accounting**
3 **\$10 Million Ice Storm Maintenance**

4			
5	in Millions	<u>No AAO</u>	<u>AAO</u>
6	Income Statement		
7	Revenue	400	400
8			
9	Cost of Service	(340)	(340)
10	Ice Storm	(10)	-
11			
12	Income Before Tax	<u>50</u>	<u>60</u>
13			
14	Income Tax-Current	(20)	(20)
15	Income Tax-Deferred	-	(4)
16			
17	Net Income	<u>30</u>	<u>36</u>
18			
19	Balance Sheet		
20	AAO Deferred Asset	-	10
21	AAO Deferred Income Taxes	-	(4)
22	Plant	390	390
23	Cash	4	4
24			
25	Debt	200	200
26	Equity	194	200

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

County of Jackson)
)
State of Missouri) ss

AFFIDAVIT OF H. DAVIS ROONEY

H. Davis Rooney, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of H. Davis Rooney;" that said testimony was prepared by him and 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.

H. Davis Rooney
H. Davis Rooney

Subscribed and sworn to before me this 13th day of December, 2005.

Terry D. Lutes
Notary Public
Terry D. Lutes

My Commission expires:

8-20-2008



TERRY D. LUTES
Jackson County
My Commission Expires
August 20, 2008