Exhibit No.:	
Issues:	*Merger Savings* *Prepaid Pension Asset* *Straight-line Tax Depreciation*
Witness:	*Steve M. Traxler*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case Nos.:	*ER-2004-0034 and* *HR-2004-0024* *(Consolidated)*
Date Testimony Prepared:	*January 26, 2004*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

STEVE M. TRAXLER

AQUILA, INC.
d/b/a AQUILA NETWORKS-MPS (Electric)
and AQUILA NETWORKS-L&P (Electric & Steam)

CASE NOS. ER-2004-0034 AND HR-2004-0024
(Consolidated)

Jefferson City, Missouri
January 2004

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila Networks L&P and Aquila Networks MPS to implement a general rate increase in electricity.	)))	Case No. ER-2004-0034
In the matter of Aquila, Inc. d/b/a Aquila Networks L&P to implement a general rate increase in Steam Rates.	)))	Case No. HR-2004-0024

AFFIDAVIT OF STEVE M. TRAXLER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Steve M. Traxler, of lawful age, on his oath states: that he has participated in the preparation of the following rebuttal testimony in question and answer form, consisting of 21 pages to be presented in the above case; that the answers in the following rebuttal testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Steve M. Traxler

Subscribed and sworn to before me this 30th day of January 2004.

TONI M. CHARLTON
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

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

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STEVE M. TRAXLER

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REBUTTAL TESTIMONY

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STEVE M. TRAXLER

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AND AQUILA NETWORKS-L&P (ELECTIC & STEAM)

CASE NOS. ER-2004-0034 AND HR-2004-0024

(Consolidated)

Q. Please state your name and business address.

A. My name is Steve M. Traxler, and my business address is Noland Plaza Office Building, Suite 110, 3675 Noland Road, Independence, Missouri 64055.

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

A. I am a Regulatory Auditor for the Missouri Public Service Commission (Commission).

Q. Are you the same Steve M. Traxler, who previous filed direct testimony in this case?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?

A. My testimony will address the direct testimony of Aquila witnesses Vern J. Siemek on the issue of sharing merger savings and the testimony of H. Davis Rooney on the issues of pension cost and the tax deduction for book depreciation – straight-line tax depreciation.

PROPOSED SHARING OF MERGER SAVINGS

Q. Please summarize Mr. Siemek's proposed adjustments to share merger savings from the acquisition of the former St. Joseph Light & Power Company (SJLP or Aquila Networks-L&P (L&P)).

A. Mr. Siemek's proposed sharing of merger savings for Aquila Networks-MPS (MPS) includes three areas, which appear on page 2 of his direct testimony:

1) Reduced fuel costs from the joint dispatch of the MPS and L&P generating units.
2) Reduced allocation to MPS of Aquila's corporate general plant facilities which are allocated to all Aquila divisions.
3) Reduced allocation of Aquila's corporate overhead (operations & maintenance) to MPS.

However, Mr. Siemek's proposed sharing of merger savings for L&P is limited to only:

1) Reduced fuel costs from the joint dispatch of the MPS and L&P generating units.

Q. Were you involved in the Staff's review of the Aquila – SJLP merger in the merger case?

A. Yes. I was responsible for reviewing the merger savings and costs resulting from the merger in Case No. EM-2000-292. I was also involved with the Staff's review of the Aquila - Empire District Electric Co. (Empire) merger in Case No. EM-2000-369. The merger with SJLP closed on December 31, 2000. The merger with Empire did not take place.

I also filed testimony relating to the Aquila - SJLP merger in the last MPS general rate case, Case No. ER-2001-672.

Q. Was Mr. Siemek the primary witness on projected merger savings in the Aquila - SJLP merger case, Case No. EM-2000-292?

A. Yes. Mr. Siemek's testimony summarized all of the merger "costs" and "savings" projected to result from the acquisition of the St. Joseph Light & Power Company.

Q. Is Mr. Siemek's proposed adjustment to share merger savings in Case Nos. ER-2004-0034 and HR-2004-0024, consistent with his presentation to the Commission in the Aquila - SJLP merger case, Case No. EM-2000-292?

A. No it is not. Mr. Siemek's presentation in the Aquila - SJLP merger case was based upon a showing that merger savings exceeded merger costs resulting in a "net" savings to SJLP's customers. However, in Case Nos. ER-2004-0034 and HR-2004-0024, Mr. Siemek is proposing to share joint dispatch savings for L&P, without considering in his determination of saving to be shared, the significant increase in cost of service to L&P as a result of the allocation to L&P of Aquila's corporate general plant. The decrease in merger savings resulting from the allocation of Aquila's corporate general plant has been completely ignored by Mr. Siemek, in his calculation of the net merger savings to be shared under his savings sharing proposal.

Consistency with Mr. Siemek's "net savings" presentation to the Commission in justifying the Aquila - SJLP merger in Case No. EM-2000-292 would require that the joint dispatch savings be reduced by the known merger costs resulting from L&P's allocated share of Aquila's corporate general plant costs.

Q. Have you prepared a schedule below that compares L&P's revenue requirement increase resulting from the allocation of Aquila's general plant to the joint dispatch savings identified by Mr. Siemek?

A. Yes. The schedule reflected below compares the L&P revenue requirement increase, resulting from Aquila's allocation of corporate general plant to L&P, to the revenue requirement reduction resulting from Aquila's allocation of joint dispatch savings to L&P for Case No. ER-2004-0034.

Q. Please explain the schedule that appears below.

A. Line 3 reflects SJLP's net general plant as of December 31, 2000, the last measurement date prior to being merged with Aquila. SJLP's net general plant investment for its electric operations was $ 13.3 million.

Line 9 reflects L&P net general plant as of September 30, 2003, the update period for Case No. ER-2004-0034. The net general plant for L&P is now $27.5 million as of September 30, 2003. This represents an increase, due to the merger, of $14.2 million shown on line 14. The $14.2 million increase in general plant represents a 108% increase as a result of the merger with Aquila.

Q. What is the revenue requirement impact on L&P of the $14.2 million increase in general plant?

A. Line 15 reflects Aquila's recommended 13.22% gross of tax rate of return for Case No. ER-2004-0034. The revenue requirement impact for the increase in general plant, as a result of the merger, is reflected on line 16 to be $1,882,493 for Case No. ER-2004-0034.

Analysis of SJLP General Plant – Post-Merger

1	SJLP General Plan – December 31, 2000			
2	Total General Plant	FERC Form 1		$ 31,969,051
3	Reserve for General Plant	FERC Form 1		$ 18,719,253

4	Net Plant			**$ 13,249,798**
5	**ER-2004-0034 – L&P – Gen. Plant as of Sept. 30, 2003**			
6	L&P General Plant			$ 3,535,828
7	L&P Common Plant – Elec.			$ 14,575,180
8	UCU – Allocated General Plant			$ 16,425,562

9	Total L&P General Plant			$ 34,536,570
10	Depr. Reserve – General Plant			$ 6,768,735
11	Depr. Reserve – Common Plant			$ 273,133

12	Total Depr. Reserve – Gen. Plant – ER-2004-0034			$ 7,041,868
13	Net General Plant – ER-2004-0034			**$ 27,494,702**
14	Increase in General Plant			$ 14,244,904
15	Aquila's Gross of Tax Rate of Return			13.22

16	**Increased Revenue Requirement – Rate of Return**			**$ 1,882,493**

17	Depreciation Expense – Pre-Merger – 2000	FERC Form 1		$ 591,084
18	Depreciation Expense – Aquila Filing – ER-2004-0034			$ 2,511,203

19	**Increased Revenue Requirement – Depreciation Expense**			**$ 1,920,119**

20	**Total Post-Merger Revenue Requirement Increase – Gen. Plant**			**$ 3,802,612**
				==========
21	Aquila's Synergies Adjustment for Joint Dispatch Savings		100%	**$ 2,676,396**

22	**Excess of General Plant Increase over Joint Dispatch Savings**			**$ 1,126,216**
				=========

Q. What additional merger costs result from the increase in the L&P division's general plant due to the merger?

A. The increase in general plant due to the merger also results in an increase in depreciation expense due to the merger. Line 19 reflects a $1,920,119 increase in depreciation expense related to the increase in general plant due to the merger.

Q. What is the total revenue requirement increase for L&P resulting from the increase in general plant due to the merger?

A. Line 20 reflects that L&P has experienced a total revenue requirement increase of $3,802,612 as a result of the increase in general plant and related depreciation expense due to the merger.

Q. How does the $3.8 million increase in the L&P's cost of service compare to the joint dispatch savings Mr. Siemek is proposing to be shared 50/50 between shareholders and L&P's ratepayers?

A. Line 21 reflects 100% of the joint dispatch savings proposed to be shared in Mr. Siemek's merger savings sharing adjustment. This "merger savings" amount, $2.7 million, is $1.1 million less than the $3.8 million "merger cost" resulting from the increase in general plant due to the merger.

Q. Please summarize your position regarding Mr. Siemek's proposed merger savings sharing adjustment for L&P.

A. Mr. Siemek's adjustment should be rejected because it considers only merger savings from joint dispatch while ignoring a significant merger cost to L&P. Under Mr. Siemek's proposal, L&P's ratepayers are being asked to share 50% of the savings from joint dispatch and at the same time bear 100% of the cost of the post merger increase in general plant. The unfairness of this Aquila proposal is obvious.

Mr. Siemek's proposal is also inconsistent with his own testimony in the Aquila - SJLP merger case, Case No. EM-2000-292, in which he recommended that merger costs be netted against merger savings in determining whether the L&P ratepayers would benefit from the merger.

Q. Why has your testimony on this issue limited to Mr. Siemek's proposed merger savings adjustment for the L&P division ?

A. The Staff's position on Mr. Siemek's proposed merger savings adjustments for both the MPS and L&P divisions is addressed in the rebuttal testimony of Staff witnesses Cary G. Featherstone and Mark L. Oligschlaeger.

PREPAID PENSION ASSET IN RATE BASE

Q. What is the purpose of your rebuttal testimony on this issue?

A. This section of my rebuttal testimony will address the direct testimony of H. Davis Rooney regarding the calculation of the prepaid pension asset to be included in rate base for the MPS & L&P electric and steam divisions of Aquila.

Q. What prepaid pension balance is Mr. Rooney recommending for rate base treatment in this case?

A. Aquila filed its direct case based upon a test year ending December 31, 2002, and has updated for known and measurable changes through September 30, 2003. Aquila's updated cost of service calculation reflects MPS's prepaid pension asset as of September 30, 2003, reduced by a pension cost regulatory liability as of the same date. The prepaid pension asset for the L&P division is based upon the balance as of September 30, 2003.

Q. What is the basis for disagreement between the Staff and the Company regarding the calculation of the prepaid pension asset balance to be given rate base treatment in Case Nos. ER-2004-0034 and HR-2004-0024?

A. The balance of the prepaid pension asset includable in rate base should, in Staff's view, be limited to the balance that reflects the cash flow impact resulting from the prior adoption for ratemaking purposes of Financial Accounting Standard (FAS) 87 for determining pension cost. The Staff's calculation of the prepaid pension asset balance for the

MPS and L&P divisions is based upon the prepaid asset balance which has been recognized since the adoption of FAS 87 for the MPS and L&P divisions.

Mr. Rooney's calculation of the prepaid pension asset assumes that the Commission adopted FAS 87 for ratemaking purposes on the same date that FAS 87 was required for financial reporting in 1987 under Generally Accepted Accounting Principles (GAPP).

Q. When was FAS 87 adopted by the Commission for ratemaking purposes for the two divisions?

A. FAS 87 was adopted for the MPS division in Case No. ER 97-394. The effective date for the Commission's order was March 18, 1998. FAS 87 was adopted for the L&P division in Case No. ER 94-163. The effective date for the Commission's order was June 15, 1994. The Staff's calculation of the prepaid pension asset, to be included in rate base, includes all activity between the date of the Commission's adoption of FAS 87 and the known and measurable date in the current case, September 30, 2003.

Q. Is the Missouri Commission required to adopt GAAP accounting for ratemaking purposes?

A. No. The accounting profession recognizes this distinction in FAS 71, Accounting for the Effects of Certain Types of Regulation issued in 1982. FAS 71 recognizes that regulatory bodies are allowed to deviate from GAAP accounting rules in the setting of rates for public utilities. Mr. Rooney has assumed that the Missouri Commission adopted FAS 87 in 1987, when Aquila adopted FAS 87 for "financial reporting" purposes. This assumption conflicts with the intent of FAS 71 and with prior Commission precedent on this issue.

Q. What prior Commission precedent were you referring to regarding Mr. Rooney' assumption that the Commission adopted FAS 87 in 1987 for Aquila (formerly Utilicorp) and the former St. Joseph Light & Power Company (SJLP)?

A. A company witness for SJLP made a similar claim in Case No. ER-93-41. The Commissions order addressed this claim as follows:

> There is no dispute as to the level of funding in this issue. The dispute centers on the adoption of an accounting method: accrual accounting (FAS 87) as advocated by company or a funding cash contribution (ERISA) as advocated by Staff and Public Counsel. In its case SJLPC takes the position that the Commission has **previously** adopted FAS 87 for ratemaking treatment of SJLPC's pension expense and that if a funding cash contribution is now adopted a turn around of approximately $3.5 million will have to be written off by SJLPC. The Commission finds based upon a review of SJLPC's rate proceedings since 1987 that the Commission **has never adopted** FAS 87 for ratemaking purposes. These proceedings have resulted in **stipulated cases** wherein an overall dollar amount was accepted with **no ratemaking treatment designated for the individual issues**. The Commission, therefore, is of the opinion that the application of a funding cash contribution should not result in a write off as advocated by SJLPC." [emphasis added]

Q. You mentioned previously that the prepaid asset included in rate base should represent the cash flow impact on the utility as a result of the adoption of FAS 87 for ratemaking purposes. Please explain the cash flow impact you are referring to.

A. The cash flow impact resulting from the adoption of FAS 87 is addressed in detail in my direct testimony beginning on line 14, page 13 and continuing on page 14 through line 21.

The prepaid asset represents the accumulated difference between pension expense under FAS 87 for financial reporting and the cash contributions made to the pension fund. Since the recognition of annual pension expense (FAS 87) and cash funding of the plan

(ERISA regulations) measure the same pension liability, any difference between the two (prepaid pension asset or pension liability) should be viewed as temporary timing difference.

The prepaid asset recognized since the adoption of FAS 87 for ratemaking purposes, for the most part, represents the reduction to cost of service as a result of a "negative" pension cost under FAS 87 and a zero (no contribution) funding requirement under ERISA. A negative pension cost occurs under FAS 87 when the earned returns on the funded assets exceed the annual costs for earned benefits (service cost) and the interest cost on the pension liability. The prepaid asset, since the adoption of FAS 87 for ratemaking purposes, represents the accumulated amount of negative pension cost flowed back to customers in rates. The MPS prepaid pension asset also includes MPS's allocated share of a significant pension fund contribution made in 2002.

In summary, the prepaid pension asset recommended for rate base treatment by the Staff does represent an actual cash outlay by the Company since the adoption of FAS 87 for ratemaking purposes. This characterization does not apply to the prepaid pension asset balance being proposed by Mr. Rooney for rate base treatment.

Q. Please explain why the prepaid pension asset balances recommended by Mr. Rooney don't represent a cash investment.

A. As stated previously, a prepaid asset occurs when pension cost for ratemaking purposed is calculated under FAS 87 and is less than cash contributions made to the pension fund. Prior to the adoption of FAS 87 for ratemaking purposes, these lower pension costs, reported on the financial statements under FAS 87, did not benefit customers through lower rates. Customer rates were based upon the higher costs resulting from the use of cash contributions to the pension fund. The only beneficiary of the lower FAS 87 costs on the

financial statements were the Company's stockholders by way of higher reported net income. The prepaid pension asset, prior to the adoption of FAS 87 for ratemaking purposes, does not represent a cash outlay for flowing negative FAS 87 pension expense back in rates or an unrecovered cash contribution to the pension fund. Therefore, it cannot be considered in the regulatory process to be an investment made by the Company. Allowing pension asset amounts in rate base, which occurred prior to the adoption of FAS 87, will provide a return on an investment which was never made from a regulatory perspective.

Q. Has the Staff's recommended method for calculating the prepaid pension asset to be included in rate base been agreed to by any other Missouri utility companies?

A. Yes. The Staff's method for calculating the prepaid pension asset, included in rate base, has been accepted in recent settled cases involving Laclede Gas Company, Case Nos. GR-2001-629 and GR-2002-356 and Empire Electric District Company, Case No. ER-2002-424.

STRAIGHT-LINE TAX DEPRECIATION DEDUCTION

Q. What is the purpose of your rebuttal testimony on this issue?

A. My rebuttal testimony on this issue will address the direct testimony of Aquila Inc. witness, H. Davis Rooney, regarding the method used to calculate the income tax deduction for book depreciation recovered in rates - straight-line tax depreciation.

Q. What is the straight-line tax depreciation deduction?

A. The term, straight-line tax depreciation deduction, refers to the amount of book depreciation assumed to be tax deductible in calculating income tax expense for ratemaking purposes. As explained in my direct testimony on pages 3 and 4, under the Staff's calculation method the only material difference between annualized book depreciation

expense recovered in rates and the related tax deduction for book depreciation is the elimination of the asset "basis difference" which was previously flowed through in rates in prior years.

Prior to the 1986 Tax Reform Act, payroll taxes, interest and pensions charged to construction (capitalized on the books) were allowed to be taken as current tax deductions by the Internal Revenue Service (IRS). For most companies including MPS and the former SJLP Company, these book/tax timing differences were flowed through (taken as current deductions consistent with IRS treatment) for ratemaking purposes. The value of plant investment for tax purposes (tax basis) is lower than the value of plant investment on the financial records (book basis) as a result of treating these timing differences as expenses in the current year in the income tax calculation.

The Staff's method for calculating the straight-line tax depreciation deduction applies the tax basis/book basis ratio times annualized book depreciation in order to avoid taking an additional tax deduction which has been given to ratepayers in years prior to 1986.

Q. What is the primary issue between the Staff and the Company regarding the calculation of the straight-line tax depreciation deduction?

A. Both the Staff and the Company have included book depreciation expense in cost of service for assets which are fully depreciated. The Staff's method for the straight-line tax depreciation deduction assumes that ratepayers should be given a tax deduction, for ratemaking purposes, for this additional depreciation recovery that occurs under "mass asset" accounting for book depreciation.

Mr. Rooney is recommending that no tax deduction should be reflected for the additional book depreciation recovered, under mass asset accounting, on fully depreciated

assets. Under the Staff's method, ratepayers are required to pay $1 in rates for every dollar of book depreciation allowed on fully depreciated assets. Under Mr. Rooney's proposed method, ratepayers are required to pay $1.62 for every dollar of book depreciation on assets which are fully depreciated.

Q. How did MPS compute straight-line tax depreciation for this case?

A. MPS applied a weighted average book depreciation rate to the tax basis for each class of assets by vintage (year acquired) for vintages after 1980. For pre-1981 vintages, MPS is recommending that a guideline life rate be used.

When the accumulated straight-line tax reserve equals the tax basis of the property, MPS discontinues (stops) straight-line tax depreciation. For example, assume that a vintage (specific year when property is placed in service) had depreciable plant additions of $100,000 and the weighted average book depreciation rate was 10%. MPS would recognize $10,000 in straight-line tax depreciation annually for ten years. At the end of year ten, the accumulated straight-line tax reserve would be equal to the tax basis of the property. No additional straight-line tax depreciation would be recognized in year 11 even though the plant investment was still in use and continuing to accrue (recognize) $10,000 in book depreciation for financial reporting and ratemaking purposes.

Q. Why does book depreciation, under mass asset accounting, continue to accrue on assets even though the vintage tax records indicates full recovery of depreciation?

A. Book depreciation is computed by applying a depreciation rate to all assets in a specific Federal Energy Regulatory Commission (FERC) account. No attempt is made to track the accumulated book depreciation reserve by vintage or specific asset. Book depreciation continues to be accrued and recovered for financial accounting and ratemaking

purposes until the entire FERC account (all vintage year additions) has an accumulated book depreciation reserve which equals the total plant balance in the account and the Commission orders a zero (0) depreciation rate for that account. This method is often referred to as the Mass Asset accounting method.

Q. Why is book depreciation computed on a mass asset balance (all vintages) instead of an individual vintage basis used in computing tax depreciation and straight-line tax depreciation?

A. The mass account method, under FERC accounting rules, used for book depreciation simplifies the accounting process. When an asset is retired, no attempt is made to determine the actual accumulated depreciation reserve for that asset.

If you retire a $100,000 plant asset, the book depreciation reserve is reduced by the same $100,000 amount. The theoretical basis for assuming that the asset is always fully depreciated when retired is that some assets will be retired sooner than their depreciable life and some will be retired later than their depreciable life. The underlying assumption is that in the aggregate, assets being retired early will be offset by an equal amount of assets being retired later.

Q. If, in fact, the amount of assets retired earlier and later than their book depreciation life generally offset one another, will there be any significant difference between book depreciation and straight-line tax depreciation (other than the basis difference discussed previously)?

A. No. The mass asset accounting method and the vintage method would produce depreciation amounts which would not be significantly different.

Q. If the amount of assets retired earlier and later than their depreciation life do not offset one another, can a significant difference occur between book depreciation and straight-line tax depreciation when employing the method used by MPS to calculate straight-line tax depreciation?

A. Yes. As discussed earlier, MPS is proposing to stop recognizing straight-line tax depreciation when the accumulated straight-line tax reserve equals the tax basis of the property. Any time that straight-line tax depreciation is stopped prior to retirement is an example of an asset vintage which is outliving its book depreciation life. Since the asset is still in service, book depreciation is continuing to be accrued and recovered in rates. As an example, assume $1,000,000 in assets with a 10% book depreciation rate. At the end of year ten, the accumulated straight-line tax reserve would be equal to the tax basis of the property of $1,000,000 ($100,000 annually for ten years).

Under MPS's method, straight-line tax depreciation would be zero (0) in year 11 and book depreciation would continue to be $100,000 because the asset is still in service and no attempt is made under mass asset accounting to discontinue book depreciation on fully depreciated assets.

Q. Referring to the example in your previous answer, what are the ratemaking implications when a utility continues to recover book depreciation on assets, which are living longer than their depreciable life, and at the same time making the assumption that the additional book depreciation is no longer tax deductible for ratemaking purposes?

A. Straight-line tax depreciation represents the tax deduction for book depreciation for ratemaking purposes. Referring to the example in my last answer, book depreciation in year 11 was $100,000 and the straight-line tax deduction was zero (0). The

additional revenue requirement of the MPS proposed method to ratepayers is calculated below:

	MPS Year 11	**Staff Year 11**
1. Book Depreciation	$ 100,000	$ 100,000
2. Income before Income Tax	($100,000)	($100,000)
Add back:		
3. Book Depreciation	$100,000	$100,000
Subtract:		
4. Straight Line Tax Depreciation	0	($100,000)
5. Taxable Income – Line2+3+4	0	($100,000)
6. Income Tax – 38% of Line 5	0	($ 38,000)
7. Net Income – Line 2–6	($100,000)	($ 62,000)
8. Tax Conversion Factor	1.62	1.62
9. Revenue Requirement	$162,000	$100,000

In summary, under MPS's proposed method, every dollar of book depreciation included in cost of service with no corresponding straight-line tax deduction results in $1.62 cash outlay from ratepayers. The additional $.62 in revenue requirement results from depreciation on plant assets staying in service longer than the estimated life used to compute the book depreciation with **no** corresponding tax deduction for the additional book depreciation beginning in year 11 in the example.

Q. What is the Staff recommendation for calculating straight-line tax depreciation so that the inequity described in your last answer can be eliminated?

A. The additional revenue requirement resulting from including book depreciation expense in cost of service without a corresponding tax deduction can be eliminated by continuing to calculate straight-line tax depreciation for all assets which are still in service consistent with the calculation of book depreciation under the mass asset

method used under FERC rules. This method is reflected in the second column in the previous example.

Q. On page 7, line 5 and continuing on page 8 to line 9, Mr. Rooney asserts that the Staff's current method has been in use since 1998 and that his proposed method in this case was in use prior to 1998. Do you agree with his assertion?

A. I am aware, based upon evidence introduced during my deposition, that a guideline rate was used in lieu of a book rate for pre-1981 vintages in Case No. ER-80-118. I have not attempted to review every MPS and SJLP rate case between 1981 and 1998. The MPS Case No. ER-93-37 was stipulated and the order did not address this issue. The direct testimony of the Staff witness did not identify the use of a guideline rate for the straight-line tax depreciation calculation. I have not seen evidence supporting Mr. Rooney's assertion for years between 1982 and 1998 for the MPS and former SJLP.

Q. On page 9, lines 16-19, Mr. Rooney asserts that the Staff's straight-line tax depreciation method has resulted in between $17 million and $23 million in duplicate tax deductions resulting from the flow through of guideline depreciation. Did you request a calculation supporting Mr. Rooney's alleged duplicate tax deductions?

A. Yes. I requested a calculation of the alleged $17-$23 million in duplicate tax deductions in Staff Data Request No. 310.1.

Q. Does the response to the Data Request support Mr. Rooney's claim that $17-$23 million in duplicate tax deductions have occurred as a result of the prior flow through of "guideline depreciation"?

A. No it does not. The response to Data Request No. 310.1 calculates the additional straight-line tax depreciation deduction which has resulted from the continuation

of a straight-line deduction for fully depreciated vintages since 1997. This calculation is unrelated to any difference between a straight-line calculation, prior to 1997, which was based upon a "guideline rate" as opposed to a "book depreciation rate" for pre-1981 vintage property.

The continuation of straight-line tax depreciation deduction related to the recovery in rates of book depreciation on fully depreciated assets is the primary issue between the Staff and the Company. The rationale for the Staff's method has been addressed in this rebuttal earlier in this testimony. The Staff's current method for calculating straight-line tax depreciation, in effect since at least 1997 according to Mr. Rooney, **has not** used a guideline rate for pre-1981 vintage property. Since Mr. Rooney's support for $17-$23 million of alleged duplicate tax deductions is limited to an analysis from 1997-2002, the results cannot be related to the use of a "guideline rate" used **prior to 1997**.

Q. Would it be fair to say that MPS has also recovered additional book depreciation expense between $17 and $23 million since 1997, on fully depreciated assets, as a result of the mass asset assumption used in calculating book depreciation under FERC accounting rules?

A**.** Yes. This fact puts this issue in the proper perspective. The Staff's position on this issue does not eliminate the **cash flow advantage**, to a regulated utility that results from recovery of book depreciation on fully depreciated assets under FERC accounting rules. The Staff's position on the issue simply provides for a "**matching**" tax deduction for this additional recovery of book depreciation expense. Under the Staff's straight-line method the cost to ratepayers for every $1,000 in book depreciation, recovered on fully depreciated assets, is approximately $1,000. Under the straight-line method proposed by Mr. Rooney,

every $1,000 in book depreciation, recovered on fully depreciated assets, cost ratepayers $1,620 based on the current federal and state effective tax rate of 38.39%.

Q. Please comment on this secondary issue raised by Mr. Rooney, namely the use of a guideline rate instead of a book rate on pre-1981 vintage property for years prior to 1997 for MPS.

A. As stated previously it is Mr. Rooney's position that the straight-line tax depreciation deduction, used in setting rates, prior to 1997 for MPS used a guideline rate (allowed under IRS rules) as opposed to a book rate for pre-1981 vintage assets. Since the guideline rates exceeded the book rate, a higher straight–line tax deduction was used in setting rates. I have yet to see hard evidence supporting Mr. Rooney's claim for all years between 1982 and 1997. In any event, it is Mr. Rooney's assertion that the use of a guideline rate assumption in prior years results in a duplicate tax deduction now under the Staff's current method even though the current method is based entirely on "book" depreciation rates. Since the Staff's current method does not rely on the use of a guideline rate, we are having difficulty justifying an adjustment for ratemaking treatment which occurred at least 8 years ago for MPS if we accept Mr. Rooney's position on the ratemaking treatment in effect at this time. As stated previously, the support provided for the value of the "guideline rate" issue in response to Data Request No. 310.1 most certainly does not measure the "incremental impact" of the difference between a guideline rate and book depreciation rate assumption in years prior to 1997.

Q. What has the ratemaking impact been since 1997 for MPS from the fact that the Staff's current method does **not** use a guideline rate assumption for pre-1981 vintage property?

A. The result is the reverse of what Mr. Rooney is asserting for years prior to 1997 for MPS. Since the guideline rate exceeds the book rate, the Staff's current method for straight-line tax depreciation has a produced a "lower" straight-line tax depreciation amount for ratemaking purposes. The obvious question is whether any inequity has occurred for higher straight-line deductions prior to 1997 given the fact that lower straight-line deductions have occurred after 1996 for pre 1981 vintage property.

In any event, it is important to keep in mind that this issue is a secondary issue to the primary issue discussed at length in this rebuttal testimony – that being whether ratepayers should be given a tax deduction for the book depreciation recovered in rates on fully depreciated assets. The $4.7 million annual value of the straight-line tax depreciation issue in this case is being driven by Mr. Rooney's recommendation of **not** reflecting a straight-line tax deduction for the recovery of book depreciation on fully depreciated assets.

Q. On page 10 beginning on line 5, Mr. Rooney summarizes the Company's position on the issue. Please comment on his summary recommendations.

A. Mr. Rooney is recommending that the Commission eliminate the current use of the Staff's method for calculating straight-line tax depreciation until a complete study of the prior historical treatment can be conducted. First of all, the primary issue, whether ratepayers should be given a tax deduction for the recovery of book depreciation on fully depreciated assets, has little to do with a historical study to reconcile all basis differences flowed through in prior years or to determine the incremental impact of the difference between a guideline rate and book rate assumption in prior years.

A complete reconcilement of all accumulated basis difference between the tax basis of depreciable plant and book basis of depreciable plant could either increase or decrease the

tax/book basis ratio used in the Staff's calculation. The fact that MPS cannot produce a complete reconcilement for all accumulated tax/book basis differences does not support Mr. Rooney's recommendation that rates be increased $ 4.7 million to reflect the discontinuation of the Staff's method for calculating straight-line tax depreciation. Secondly there is no excuse for MPS's failure to do such a study prior to filing this rate case. The Staff's straight-line tax depreciation method has been in use since 1997. This is not a new issue for MPS.

This issue is an equity issue that can and should be addressed and decided now as it was in the Commission's order for the former SJLP Company in Case No. ER-93-41.

Q. Does this conclude your rebuttal testimony?

A. Yes it does.