

**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 NOS. ER-2004-0034 AND HR-2004-0024 (CONSOLIDATED)**

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 Commission Staff  
9 (“Staff”) witnesses as to the ratemaking treatment of pensions, the straight-line tax  
10 depreciation deduction, and the ratemaking treatment of net salvage (salvage and cost of  
11 removal).

12 **PREPAID PENSION**

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

14 A. This section of my surrebuttal testimony will address the rebuttal testimony of Staff  
15 witness Steve M. Traxler regarding the calculation of the prepaid pension asset to be  
16 included in Staff’s proposed amortization of that asset.

17 Q. Does Staff accurately address Company’s position?

18 A. No. Company’s position, is foremost, that in prior stipulations the issue of recoverability  
19 of prepaid pensions was resolved through negotiation in favor of the Company’s position.

1 Staff attempts to characterize the issue based on when the Commission first ordered FAS  
2 87, ignoring prior stipulations concerning this issue.

3 Q. What are those prior orders and stipulations?

4 A. As described in my rebuttal testimony, for L&P, it was Case No. ER-94-163. In that case  
5 L&P was authorized to both adopt FAS 87 for ratemaking and reverse the regulatory  
6 liability it had previously recorded to remove from rate base its prepaid pension balance.  
7 For MPS, the case was ER-93-37. That case has a stipulation and agreement that says in  
8 part: “Signatories agree that Company’s accounts shall reflect pension costs equal to  
9 contributions made to its established pension funds, discontinuing its previous practice  
10 under FAS 87 effective June 29, 1993.” (Case No. ER-93-37, Stipulation and  
11 Agreement).

12 Q. Can these agreements be characterized as “accounting” not “ratemaking” agreements?

13 A. No. In L&P’s case, the express purpose was to agree that the regulatory liability for  
14 pensions would not be used in future ratemaking. In particular the order states “In setting  
15 rates in future SJLP electric rate cases, the Commission shall not consider the following  
16 items existing on the books of SJLP as of the effective date of the tariff sheets authorized  
17 in this case: (i) any regulatory liability balance related to FAS 87,...” (Report and Order,  
18 Case No. ER-94-163, Attachment 1). This is clearly a ratemaking agreement. In MPS’s  
19 case the agreement is authorization to record a regulatory liability beginning with that  
20 case. It clearly recognizes that MPS had not recorded a regulatory liability to that date.  
21 The agreement did not require a regulatory liability as of that date. Recording a  
22 regulatory liability as of that date for the existing FAS 87 balance would have resulted in  
23 a “write off”. In Case No. ER-93-41, it was Staff witness Steve Traxler’s testimony, that

1 SJLP need not write off its prepaid pension balance, noting that in the recent MPS Case  
2 No. ER-93-37, there was no write-off suggested. (Case No. ER-93-41, Hearing Transcript  
3 dated 4/21/93, page 363, lines 4-13). Clearly, it was not MPS's or Staff's understanding  
4 at the time, after the stipulation in MPS Case No. ER-93-37, that there was a difference  
5 between the ratemaking and financial balance of prepaid pensions. If there had been a  
6 difference between the ratemaking and financial balance of prepaid pensions, it would  
7 have required a write off, through the establishment of a regulatory liability. If there had  
8 been a difference between the ratemaking and financial balance of prepaid pensions, Staff  
9 would not have agreed to the wording regarding prior accounting, and Staff would not  
10 have testified in the L&P case that no write off was needed for MPS.

11 Q. Is there a difference between Staff's adjustment and a regulatory liability?

12 A. No. Both Staff's adjustment and a regulatory liability reduce rate base. Both a Staff  
13 adjustment and a regulatory liability assert there is a difference between ratemaking and  
14 financial reporting prepaid pension. L&P and MPS both negotiated stipulations regarding  
15 the recording of regulatory liabilities regarding prepaid pensions.

16 Q. If the Staff's position is upheld, would this result in the re-establishment of the same  
17 regulatory liability described in the Stipulation and Agreement in L&P Case No. ER-94-  
18 163?

19 A. Yes.

20 Q. Does the Report and Order in L&P Case No. ER-93-41, cited by Staff, support their  
21 position?

22 A. No. The Commission noted that FAS 87 had not been adopted by the Commission for  
23 L&P and that the prior cases had been stipulated without designating the ratemaking

1 treatment. The Commission then concluded, “The Commission, therefore, is of the  
2 opinion that the application of a funding cash contribution **should not result in a write**  
3 **off** as advocated by SJLPC.” (emphasis added). A write off would have recognized: 1) a  
4 difference between ratemaking and financial reporting prepaid pensions; and, 2) that  
5 future recovery would be denied. In any event, L&P recorded the write off then  
6 negotiated the prepaid pension balance back into ratemaking in their following L&P Case  
7 No. ER-94-163.

8 Q. Has Staff considered the Stipulation in L&P Case No. ER-94-163?

9 A. No. Staff was made aware of the stipulation in discovery in Data Request MPSC-0481  
10 and again through Data Request MPSC-0523. Staff seeks to have the Commission  
11 overturn the stipulation and agreement and the Commission’s order approving that  
12 stipulation. Given that the parties bargained to what they believed was a fair arrangement  
13 at the time, it is unfair now to overturn a portion of that agreement. The same is true for  
14 MPS’s stipulation and agreement in Case No. ER-93-37. As noted in the L&P ER-93-  
15 163 Stipulation and Agreement, “9. This Stipulation and Agreement has resulted from  
16 extensive negotiations among the signatories and the terms hereof are interdependent.”

17 Q. How does Staff describe ratemaking policy for pensions prior to 1987?

18 A. Staff states it was not GAAP but a contribution method.

19 Q. What was Staff’s position on pensions between 1987 and 1993?

20 A. With regard to pensions, Staff has at various times since 1987 proposed that ratemaking  
21 for pensions expense be based on Financial Accounting Standard (FAS) 87, ERISA  
22 minimum, or no (zero) pension expense. Following is a table of when Staff has taken  
23 those positions:

|   |                           |   |
|---|---------------------------|---|
| 1 | Ameren Case No. EC-87-114 | Ordered FAS 87                                |
| 2 | L&P Case No. GR-88-115    | Direct Position not opposed to FAS 87 Expense |
| 3 | MPS Case No. GR-88-194    | Direct Position Pension Expense of \$0        |
| 4 | KPL Case No. GR-90-50     | Recommended FAS 87 Expense                    |
| 5 | MPS Case No. ER-90-101    | Direct Position FAS 87 Expense                |
| 6 | MPS Case No. ER-93-37     | Direct Position ERISA Minimum                 |
| 7 | SJLP Case No. ER-93-43    | Direct Position ERISA Minimum                 |
| 8 |                           |   |

9 Q. How much of the amount at issue is cash contributions deferred on the balance sheet?

10 A. Included in the \$7,473,024 at issue for MPS, is \$5,246,730 of cash contributions. Almost  
11 all of the \$5 million of cash contributions would be deferred on the balance sheet (not  
12 included in rates) under all of Staff's positions noted above.

13 Q. Did Staff's direct positions in MPS's gas Case No. GR-88-194 or MPS's electric Case  
14 No. ER-90-101 allow any of the test year contributions in rates?

15 A. No. In the gas case, Staff eliminated all pension costs. In the electric case Staff proposed  
16 FAS 87 negative expense.

17 Q. Are you aware of any case prior to 1987 ordering contribution rate treatment for MPS?

18 A. No. I reviewed rate orders for MPS back to 1955. I found no order prior to 1987 that  
19 authorized or described a deviation from GAAP for pension ratemaking.

20 Q. Is it your understanding that prior to 1987, the accrual pension amounts required to be  
21 expensed were determined according to FAS 87's predecessor accounting standard APB  
22 8?

23 A. Yes.

24 Q. Is it your understanding that contributions prior to 1987 were determined by funding the  
25 APB 8 expense amount?

1 A. Yes. This is disclosed in the Company's annual reports prior to 1987. The footnotes in  
2 the MPS annual report state, "The company's policy is to fund current pension costs  
3 accrued and prior service costs which are being amortized over 30 years." (Missouri  
4 Public Service Company 1984 Annual Report – Note 7 Retirement Plans). Similar  
5 statements are in the years I reviewed from 1983 through 1986. This indicates that MPS  
6 was funding to the pension plan the accrual (APB 8) expense amount.

7 Q. How does this impact the issue at hand?

8 A. When FAS 87 was introduced and replaced APB 8, Company and Staff disagreed  
9 whether pension contributions prior to 1987, that were substantially equal to the expenses  
10 required under Generally Accepted Accounting Principles (GAAP), constituted  
11 ratemaking on contributions or ratemaking on GAAP.

12 Q. In the absence of an order to the contrary, how are Missouri utilities expected to keep  
13 their books and records?

14 A. "Regulated utilities are required to follow the standards promulgated by the FASB for  
15 financial reporting purposes, unless the utility seeks authorization from its applicable  
16 regulatory body to deviate from FASB's Generally Accepted Accounting Principles  
17 (GAAP), in which case the authorization must also meet the requirements of FAS 71,  
18 Accounting for The Effects of Certain Types of Regulation." (Report and Order on  
19 Remand, MPS Case No. ER-93-37).

20 Q. How were these issues resolved?

21 A. Staff implies that the only way the FAS 87 prepaid balance can become a valid asset for  
22 ratemaking is to record it after being ordered onto FAS 87 by the Commission. As noted  
23 above, L&P negotiated simultaneous with its return to FAS 87 for ratemaking a

1 stipulation that its prepaid pension balance no longer required an offsetting regulatory  
2 liability. MPS negotiated recognition of its past practices under FAS 87 and  
3 authorization to deviate from FAS 87 in the future. In both cases, a write off of the  
4 prepaid pension balance was not required. Given that the parties bargained in good faith  
5 at the time, it is unfair now to overturn a portion of those agreements.

6 Q. Staff cites several cases in support of their position, are these cases directly applicable to  
7 MPS or L&P?

8 A. No. Staff cites three cases Laclede Gas Company Case Nos. GR-2001-629, GR-2002-  
9 356, and The Empire Electric District Company Case No. ER-2002-424 (Traxler  
10 Rebuttal, page 11, lines 11-13). These were all stipulations agreeing to adopt the ERISA  
11 minimum along with extensive agreements on other issues. These were not litigated  
12 cases. It is unclear what give and take each company achieved in its settlement. These  
13 cases have little applicability to this case. It is interesting that Staff seeks to apply  
14 stipulations from other companies to us, while seeking to undo Company's own  
15 stipulations.

16 Q. The cases cited by Staff all adopted the ERISA minimum. Does Company believe the  
17 ERISA minimum is adequate?

18 A. No. A range of contribution levels should be allowed. Pension plans are required to  
19 contribute at least the minimum.

20 Q. What is Company's position on pensions?

21 A. The key positions are:

- 22 • All of the prepaid pension balance should be included in Staff's amortization  
23 calculation, less the regulatory liability on MPS's books for pensions.

- 1       • Staff’s proposal results in a write off of \$14.3 million by not allowing recovery of all  
2       of the prepaid pension balance, net of the Company’s existing regulatory liability.

3       This write off is contrary to the stated positions of Staff and Company at the time the  
4       MPS ER-93-37 and L&P ER-94-163 stipulations were agreed to.

- 5       • All of the prepaid pension for L&P and MPS should be considered in rate base, less  
6       the existing regulatory liability on MPS’s books for pensions.

- 7       • A range of contributions not just the ERISA minimum should be allowed.

- 8       • The ERISA minimum should be adjusted for the impact of contributions in excess of  
9       the ERISA minimum, which directly reduce the ERISA minimum calculation, and  
10      these contributions in excess of the ERISA minimum should be capitalized as a  
11      regulatory asset, deferred until full recovery is allowed including a return from when  
12      contributed. To do otherwise would take the benefit of lower ERISA minimums  
13      without allowing recovery of the cost incurred which resulted in the lower ERISA  
14      minimum calculation.

15            **STRAIGHT-LINE TAX DEPRECIATION DEDUCTION**

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

17   A.     My surrebuttal testimony on this issue will address the rebuttal testimony of Staff witness  
18     Steve M. Traxler regarding Staff’s method used to calculate the income tax deduction for  
19     depreciation recovered in rates – “straight-line tax” depreciation.

20            Primary Issue – Prior Flow Through Items

21   Q.     What is Staff’s position on the existence of prior flow though items?



1 A. Staff states that “the only material difference between annualized book depreciation  
2 recovered in rates and the related tax deduction for book depreciation is the elimination of  
3 the asset ‘basis difference’ which was previously flowed through in rates in prior years.”  
4 (Traxler Rebuttal, page 11, line 23-page 12, line3).

5 Q. Do you agree with this statement?

6 A. No. Prior orders and prior ratemaking demonstrate that for Aquila Networks-MPS (MPS)  
7 there has been more depreciation related tax deductions flowed through in rates in prior  
8 years than just the basis differences. Aquila’s books and records, as well as common  
9 sense, support that these flow through items are significant. Later in my testimony I will  
10 present the orders and support for the existence and significance of prior flow through  
11 items other than basis differences.

12 Q. Why is the existence of significant prior flow through items other than basis differences  
13 the primary issue?

14 A. Much of Staff’s rebuttal testimony is based on the premise that there are no other flow  
15 through items. Statements based on this premise are incorrect because significant prior  
16 flow through items other than basis differences exist. In particular, for years prior to ER-  
17 97-394, ratemaking has reflected the use of guideline tax straight-line depreciation and  
18 procedures. Secondly, because Staff’s method adjusts only for the basis differences, the  
19 existence of these other significant prior flow through items makes it inappropriate to  
20 follow the method proposed by Staff.

21 Q. What does “tax deductions flowed through” refer to?

1 A. "Tax deductions flowed through" refers to using more tax deduction, in a given year, for  
2 ratemaking than the related expense, in that year, recognized in cost of service for  
3 ratemaking.

4 Q. Can you give an example?

5 A. Consider the total investment in plant. Book depreciation recognizes the cost of this  
6 investment in ratemaking cost of service. Over time, book depreciation will recognize all  
7 and only all of the total cost of the plant investment in cost of service. The same is true  
8 of the tax depreciation deductions. Over time, the total of all the tax deductions for  
9 investment in plant will equal the total of book depreciation, which will equal the total  
10 investment. However, tax generally allows the tax deductions to be taken faster. If the  
11 tax depreciation deductions are reflected in the current year for ratemaking, the difference  
12 between the book and tax depreciation is said to be "flowed through". If ratemaking used  
13 the book depreciation for both cost of service and the depreciation tax deduction for  
14 ratemaking, then there would be no difference and the expense and its ratemaking tax  
15 deduction are said to be "normalized". In the case of plant investment, ratemaking has  
16 taken more tax deductions earlier (flow through) and therefore has less total tax deduction  
17 remaining.

18 Q. What plant related items have been flowed through?

19 A. Ratemaking has flowed through basis deductions, guideline depreciation, and cost of  
20 removal.

21 Q. Which statements by Staff assume there are no prior flow through items other than basis  
22 differences?

1 A. The following is a list of statements by Staff that are incorrect because significant other  
2 prior flow through items exist:

- 3 • Traxler Rebuttal, page 11, lines 22-23 and page 12, lines 1-3 – “under Staff’s  
4 calculation method the only material difference between annualized book  
5 depreciation expense recovered in rates and the related tax deduction for book  
6 depreciation is the elimination of the asset “basis difference” which was  
7 previously flowed through in rates in prior years.” While this statement is an  
8 accurate description of what Staff has calculated, Staff does not adjust for all prior  
9 flow through items. Because of the existence of other significant prior flow  
10 through items, which are not adjusted for in calculation, Staff’s method is not a  
11 correct calculation to use.
- 12 • Traxler Rebuttal, page 12, lines 12-14 – The Staff’s method for calculating the  
13 straight-line tax depreciation deduction applies the tax basis/book basis ratio times  
14 annualized book depreciation in order to avoid taking an additional tax deduction  
15 which has been given to ratepayers in years prior to 1986.” Staff adjusts only for  
16 basis differences previously flowed through. Because other flow through items  
17 exist in prior years, Staff’s method produces an additional (duplicate) tax  
18 deduction for these other items. These duplicate tax deductions are not realizable  
19 by the Company from the IRS. These duplicate tax deductions are not a real tax  
20 benefit to the Company (because the Company cannot get this tax benefit from the  
21 IRS). They are fictional amounts.
- 22 • Traxler Rebuttal, page 14, lines 17-22 – “Q. If in fact, the amount of assets retired  
23 earlier and later than their book depreciation life generally offset one another, will

1           there be any significant difference between book depreciation and straight-line tax  
2           depreciation (other than the basis difference previously discussed)? A. No.”

3           Because straight-line tax depreciation rates were used, not book depreciation  
4           rates, the assumption of offsetting retirements cannot be achieved. Because there  
5           are other significant flow through items, book and straight-line tax will be  
6           different by more than just basis differences.

- 7           • Traxler Rebuttal, page 15, lines 1-5 – “Q. If the amount of assets retired earlier  
8           and later than their depreciation life do not offset one another, can a significant  
9           difference occur between book depreciation and straight-line tax depreciation  
10           when employing the method used by MPS to calculate straight-line tax  
11           depreciation? A. Yes.” The existence of prior flow through items, ordered by the  
12           Commission, other than basis differences creates the difference, but it is  
13           intentionally created by Commission order.
- 14           • Traxler Rebuttal, page 15, lines 7-8 – “Any time that straight-line tax depreciation  
15           is stopped prior to retirement is an example of an asset vintage which is outliving  
16           its book depreciation life.” Because there are significant prior flow through items  
17           such as the use of faster guideline depreciation rates, stopping straight-line tax  
18           depreciation when the vintage is fully depreciated is an example of the available  
19           tax deductions being exhausted faster for straight-line tax than for book.
- 20           • Traxler Rebuttal, page 16, lines 18-21 – “The additional \$.62 in revenue  
21           requirement results from depreciation on plant assets staying in service longer  
22           than the estimated life used to compute the book depreciation with **no**  
23           corresponding tax deduction for the additional book depreciation beginning in

1 year 11 in the example.” Because there are other significant prior flow through  
2 items other than basis differences, the \$0.62 is the result of properly not taking an  
3 additional (duplicate) tax deduction which has already been given to ratepayers.  
4 Staff properly allows the additional \$0.62 for the basis difference flowed through.  
5 Staff should properly allow the additional \$0.62 for the other flow through items.

- 6 • Traxler Rebuttal, page 16, line 22-27 – “Q. What is the Staff recommendation for  
7 calculating straight-line tax depreciation so that the inequity described in your last  
8 answer can be eliminated? A. The additional revenue requirement resulting from  
9 including book depreciation expense in cost of service without a corresponding  
10 tax deduction can be eliminated by continuing to calculate straight-line tax  
11 depreciation for all assets which are still in service consistent with the calculation  
12 of book depreciation”. The “inequity” is that by Commission order the prior  
13 ratepayers received lower rates from the benefits of flow through of other  
14 significant prior flow through items other than basis differences. Staff’s solution  
15 is to take an additional (duplicate) tax deduction for flow through tax deductions  
16 which have already previously been given to ratepayers by Commission order.

- 17 • Traxler Rebuttal, page 18, lines 20-21 – “The Staff’s position on the issue simply  
18 provides for a “**matching**” tax deduction for this additional recovery of book  
19 depreciation expense.” Flow through items are not created by Commission orders  
20 to match book depreciation and ratemaking tax depreciation. Flow through items  
21 are created by Commission orders intended to more closely match tax  
22 depreciation and ratemaking tax depreciation. Because there are significant other  
23 prior flow through items, attempting to now “match” book depreciation and

1           ratemaking tax depreciation, without adjusting for the prior flow through items,  
2           results in additional (duplicate) depreciation deductions.

3    Q.    How does Staff say they treat prior flow through items?

4    A.    Staff says its intent is, “**to avoid taking an additional tax deduction which has been**  
5           **given to ratepayers in years prior**”. (Traxler Rebuttal, page 12, lines 12-14) emphasis  
6           added. While Staff notes the importance of adjusting for prior flow through items, Staff  
7           does not adjust for all these items.

8    Q.    What is the financial impact of Staff’s method with regard to the basis differences  
9           previously flowed through?

10   A.    Under Staff’s method the Company is properly allowed to collect \$1,620 for every \$1,000  
11          of book depreciation related to basis differences previously flowed through to ratepayers.  
12          The reason it is proper is because the benefit of the tax deduction for basis differences  
13          was previously provided to ratepayers by being flowed through. Prior ratepayers received  
14          \$620 of benefit for every \$1,000 of tax deduction flowed through. The depreciation of  
15          these basis differences is included in book depreciation but the ratemaking tax deduction,  
16          having been depleted by prior flow through is not available. Therefore, for each \$1,000  
17          of basis difference included in book depreciation, current ratepayers pay an additional  
18          \$620. This is proper ratemaking since the ratepayers, at the time the basis differences  
19          were flowed through, received \$620 of benefit. This same fair treatment should be  
20          provided all prior flow though items, not just basis differences.

21   Q.    Does Staff’s method, in fact “avoid taking an additional tax deduction which has been  
22          given to ratepayers in years prior” (Traxler Rebuttal, page 12, lines 12-14) for all prior  
23          flow through items?

1 A. No. Staff's method avoids taking an addition tax deduction only for basis differences  
2 flowed through. For all other flow through items it actually takes, not avoids, an  
3 additional tax deduction that has already been given to ratepayers in prior years.

4 Q. What should be the proper treatment for flow through items?

5 A. Just as for basis differences, the prior flow through items should be allowed to flow back  
6 (reverse) as originally intended by the Commission. To do otherwise takes an additional  
7 (duplicate) tax deduction. Since the Company does not get the same additional tax  
8 deduction on its tax return, preventing the flow back confiscates the value of the  
9 additional tax deduction from the Company's investors.

10 Q. How can you tell that Staff's method adjusts only for basis differences?

11 A. Staff states that they adjusted only for basis difference when Staff stated, "under Staff's  
12 calculation method the only material difference between annualized book depreciation  
13 expense recovered in rates and the related tax deduction for book depreciation is the  
14 elimination of the asset "basis difference" which was previously flowed through in rates  
15 in prior years." (Traxler Rebuttal, page 11 lines 22-23 and page 12, lines 1-3). Staff's  
16 method is book depreciation with an adjustment only for the amortization, at the book  
17 depreciation rate, of basis differences. The adjustment used by Staff is incorrect because  
18 it does not adjust for all prior flow through items. It is important to understand that  
19 Staff's method is a **change** in method from the method used prior to ER-97-394. It  
20 changes the calculation of straight-line tax from a calculation on a tax basis to a  
21 calculation on a book basis. The design of Staff's method will take additional tax  
22 deductions for any other flow through items that have already been given to ratepayers in  
23 prior years.

1 Q. Can you give an example of a flow through item not considered by Staff?

2 A. Yes. Staff's method does not consider that, for MPS ratemaking, tax straight-line  
3 depreciation based on guideline lives on pre-1981 vintage property was flowed through  
4 until MPS's Case No. ER-97-394.

5 Q. Can you document that guideline life tax straight-line depreciation was flowed through  
6 for ratemaking until ER-97-394?

7 A. Yes. While I will discuss this evidence in greater detail later, the documentation of my  
8 review is provided on Surrebuttal Schedule HDR-1. The evidence supports that for MPS  
9 ratemaking, tax straight-line depreciation based on guideline lives on all pre-1981 vintage  
10 property was flowed through until MPS's Case No. ER-97-394.

11 Q. Is this item significant?

12 A. Common sense indicates that it is. It was an issue in no fewer than four consecutive  
13 litigated MPS rate cases in which the Commission repeatedly ordered flow through  
14 treatment. This does not seem to indicate that the Company, the Staff, or the  
15 Commission considered this item insignificant. Further, in the report and order in MPS  
16 Case No. ER-80-118 on page 32, the values of the flow through issues in that case were  
17 set out. The guideline depreciation issue for that one case and test year was valued at  
18 \$295,430. The basis difference items that Staff does adjust for were valued at \$408,341.  
19 On a relative basis, the item is significant. Additionally, whereas the bulk of the basis  
20 differences were discontinued in 1986 by a change in the tax law, the guideline  
21 depreciation flow through continued for another decade until MPS Case No. ER-97-394.  
22 The additional decade increases the prior guideline depreciation flow though while  
23 holding constant the amount related to basis difference.



1 Q. Have you quantified the cumulative amount of duplicate tax deductions related to  
2 guideline depreciation?

3 A. Yes. We believe that Staff's ratio calculation has provided ratepayers with between \$17  
4 million and \$23 million of duplicate tax deductions since MPS Case No. ER-97-394. On  
5 Data Request No. 310.1, I provided a calculation of the value of this item.

6 Q. Did you meet with Staff to discuss Data Request 310.1?

7 A. Yes. I met with Staff for the first time regarding taxes on November 25, 2003. I supplied  
8 an additional calculation (See Surrebuttal Schedule HDR-2). The additional schedule  
9 provided is intended to substantiate, in a more understandable way, that the prior flow  
10 through items not considered in Staff's method are significant and material to MPS.

11 Q. What does Surrebuttal Schedule HDR-2 show?

12 A. This schedule is an estimate of the amount by which ratemaking has taken the tax  
13 depreciation deduction faster than the expense used for ratemaking book depreciation  
14 included in cost of service. Most of MPS's property is grouped into just two tax classes –  
15 Steam Generation and T&D (Transmission and Distribution). These two classes include  
16 almost all depreciable property except general/common plant accounts (FERC Accounts  
17 390-398). The column titled "Surviving Tax Basis," is the amount of tax basis for tax  
18 purposes (i.e. reported on the tax return). The column titled "SLT Rate" is the guideline  
19 tax straight-line rate used to depreciate these assets for ratemaking purposes until MPS  
20 Case No. ER-97-394. The Steam Generation rate of 3.57% corresponds to the straight-  
21 line guideline life of 28 years for this tax class. The T&D rate of 3.33% corresponds to  
22 the straight-line guideline life of 33 years for this tax class. The columns headed "Book  
23 Depreciation Rates" is the weighted average book depreciation rate representative of the

1 years indicated. Finally, the column titled “Flow Thru Depr” is a calculation of the  
2 excess depreciation generated by the difference between the SLT Rate and the Book  
3 Depreciation Rates. The estimate stops at the earlier of 1997 or when the vintage is fully  
4 depreciated for straight-line tax. It does not include the additional amounts that would  
5 accrue by continuing to depreciate the assets after they are fully depreciated as  
6 recommended under Staff’s methodology. This schedule is an estimate of the amount by  
7 which ratemaking has taken the tax depreciation deduction faster than the expense used  
8 for ratemaking book depreciation included in cost of service.

9 Q. What is the amount of the faster guideline depreciation flow through estimated from the  
10 schedule?

11 A. The total for the Surrebuttal Schedule is \$21.3 million. Company believes that this  
12 estimate is low because it does not include all tax classes or the impact of important other  
13 book/tax procedural differences that are inherent in the guideline straight-line tax  
14 calculation. Company believes \$21.3 million to be both significant and material.

15 Q. Having shown that there was significant prior flow through of depreciation in addition to  
16 basis differences, does Staff’s method “avoid taking an additional tax deduction which  
17 has been given to ratepayers in years prior” for all prior flow through items?

18 A. No. Staff’s method avoids taking an addition tax deduction only for basis differences  
19 flowed through. For all other flow through items it actually takes, not avoids, an  
20 additional tax deduction which has already been given to ratepayers in prior years.

21 Data Request No. 310.1

22 Q. How does Staff respond to the calculation found in Data Request 310.1?

1 A. Staff states “This calculation is unrelated to any difference between a straight-line  
2 calculation, prior to 1997, which was based upon a “guideline rate” as opposed to a “book  
3 depreciation rate” for pre-1981 vintage property.” (Traxler Rebuttal, page 18, lines 1-4).

4 Q. Does the Company’s response to Data Request 310.1, in fact, relate to prior depreciation  
5 flow through, other than basis differences?

6 A. Yes.

7 Q. Please explain.

8 A. See Surrebuttal Schedule HDR-3. Consider a single \$1,000 asset in a single account with  
9 a 10-year actual life and a 10% book depreciation rate. For simplicity, assume no  
10 book/tax basis difference. For book purposes, the asset will be depreciated at \$100 per  
11 year for 10 years and then be retired at the beginning of year 11. At the end of its actual  
12 life, \$1,000 of book depreciation will have been recorded. As a result of its retirement,  
13 the entire \$1,000 of accumulated depreciation will be removed by charging \$1,000 of  
14 original cost to the accumulated depreciation reserve. The key points are total  
15 depreciation is \$1,000, equal to original cost, and the accumulated depreciation reserve is  
16 \$0, after recording the retirement.

17 The calculation of straight-line tax is shown under the columns headed Straight  
18 Line Tax (SLT) on Surrebuttal Schedule HDR-3. Assume that in the first year a faster  
19 guideline life were used for ratemaking straight-line tax. Let us assume the faster rate  
20 produces \$200 of straight-line tax depreciation in the first year, instead of \$100 used for  
21 book depreciation. This is an extra \$100, or a flow through of \$100. Now assume for  
22 years 2-10 Staff’s method is used. There is no book/tax basis difference so, under Staff’s  
23 method, straight-line tax equals 100% of book depreciation. At \$100 per year for 9 years,

1 this is \$900 dollars of depreciation, in addition to the first year depreciation of \$2000.

2 The total straight-line tax depreciation is \$1100, \$100 more than the available tax  
3 deduction. This is \$100 of duplicate tax deduction taken by Staff's method when a prior  
4 flow through exists. When the \$1000 asset is retired, the straight-line tax accumulated  
5 depreciation reserve is \$100, because under book procedures, at retirement, original cost  
6 is charged to accumulated depreciation. The asset became fully depreciated for straight-  
7 line tax in year 9. However, since Staff's method does not adjust for the prior flow  
8 through of \$100, Staff's method takes an additional \$100 after the asset was fully  
9 depreciated for straight-line tax.

10 Q. What is Staff's response to the way the duplicate tax deduction is calculated?

11 A. Staff states that "Since Mr. Rooney's support for \$17-\$23 million of alleged duplicate tax  
12 deductions is limited to an analysis from 1997-2002, the results cannot be related to the  
13 use of a "guideline rate" used prior to 1997." (Traxler Rebuttal, page 18, lines 10-12).

14 Q. Is the response to Data Request 310.1 limited to 1997-2002?

15 A. No. The analysis considers vintage accounts fully depreciated for straight-line tax during  
16 the years 1997-2002. In order to determine if a vintage was fully depreciated for straight-  
17 line tax, prior year straight-line tax depreciation, including those years using guideline  
18 tax-straight-line depreciation were considered. Only those vintages using guideline tax-  
19 straight-line depreciation prior to 1997 were considered.

20 As previously noted on Surrebuttal Schedule HDR-3, the amount of the additional  
21 depreciation taken after the asset was fully depreciated for straight-line tax is equal to the  
22 extra \$100 of depreciation flowed through. A guideline rate was not used after the first  
23 year, but also no adjustment was made to the subsequent book-based straight-line tax

1 depreciation to make up for the prior extra \$100 taken. Because Staff's method does not  
2 adjust for this prior flow through, a duplicate amount of the prior flow through is taken.  
3 The duplicate amount taken to date is equal to the amount recorded after the straight-line  
4 tax vintage is fully depreciated. It should be noted that this asset became fully  
5 depreciated before the end of its book life because of the prior flow through not because  
6 the asset outlived its book life.

7 Q. Doesn't Staff have the view that depreciating past zero is necessary to balance early  
8 retired assets and late retired assets?

9 A. As can be seen from the example above, there was only one asset and the book  
10 depreciation was exactly the right amount for the one asset. The book depreciation  
11 balanced itself without the need for other assets. The prior flow through straight-line tax  
12 depreciation was still duplicated. The fact that Staff's method does not correct for the  
13 prior flow through will not be fixed by adding more assets to the example. A process that  
14 doesn't work for only one asset cannot work for more than one asset.

15 Q. How does Company's method adjust for the prior flow through?

16 A. Company's method depreciates all vintage and tax class asset accounts until all of the  
17 available straight-line tax deduction has been recorded through straight-line tax  
18 depreciation. Then we stop. All available straight-line tax deduction is recorded through  
19 the straight-line tax calculation. Stopping the depreciation when the vintage tax class is  
20 fully depreciated is both reasonable, since there is no more tax deduction available, and a  
21 requirement of calculating guideline straight-line tax. (IRC Reg. § 1.167(a)-  
22 11(c)(1)(i)(a)).

1        Tax Straight-Line and Book Depreciation are Different Depreciation Systems

2        Q.     Are book depreciation and straight-line tax depreciation systems the same?

3        A.     Book depreciation and tax straight-line are completely different. Book and straight-line  
4        tax could have been the same. This is called full normalization, but the Commission did  
5        not order full normalization. In prior years in order to provide the greater benefits of flow  
6        through in those prior years, the Commission did not use book depreciation for straight-  
7        line tax. The Commission ordered “tax straight-line” flow through.

8        Q.     What is tax straight-line depreciation?

9        A.     Tax straight-line depreciation (not straight-line tax) is the income tax deduction for  
10       depreciation that would be calculated on the tax return, in accordance the Internal  
11       Revenue Code rules (IRC) under the straight-line method.

12       Q.     Is this calculation similar to the book depreciation calculation?

13       A.     No. It is a tax depreciation deduction calculation using tax guideline lives and tax  
14       depreciation procedures. The tax guideline lives and procedures produce a larger  
15       depreciation deduction in the early years than book rates and methods.

16       Q.     Does the total amount of the straight-line tax depreciation deduction over the life of the  
17       asset differ from total amount of book depreciation?

18       A.     No. When the tax straight-line depreciation is combined with the basis differences that  
19       Staff acknowledges were flowed through, the total deduction is the same as the expense  
20       that will be recorded for book depreciation. However, the timing is different.

21       Q.     How is the timing different?

22       A.     For tax straight-line the guideline lives are generally shorter than book depreciation rates.  
23       Therefore the available tax deduction will be exhausted before the end of the assets actual

1 lives. The tax straight-line depreciation rules for the 1971-1980 vintages also use  
2 different retirement rules than are used for book. Ordinarily, for these vintages,  
3 retirements do not reduce the tax basis. Depreciation continues on these assets. There  
4 are no early retirements to require “balance” with late retirements. “Balance” occurs by  
5 stopping depreciation of the vintage class when it is fully depreciated.

6 Q. Why does the Company stop depreciating fully depreciated vintages for straight-line tax?

7 A. Foremost it is because the total available tax deduction has been exhausted. As  
8 demonstrated above, stopping depreciation of fully depreciated straight-line tax vintages  
9 is the proper procedure that allows the flow back (reversal) of the prior flow throughs and  
10 prevents duplicate tax deductions from occurring.

11 Staff’s Method of Continuing Depreciation is Not Appropriate

12 Q. What is Staff’s primary issue?

13 A. “Whether ratepayers should be given a tax deduction for the book depreciation recovered  
14 in rates on fully depreciated assets.” (Traxler Rebuttal, page 20, lines 7-10)

15 Q. Mr. Traxler spends a considerable amount of time discussing how Staff’s method works.

16 Do you agree with his analysis?

17 A. No. His entire foundation is based on one key premise: that there are no depreciation  
18 flow through items other than basis differences. Stated another way, Staff’s method  
19 assumes that straight-line tax calculations have always used the same depreciation rates  
20 and procedures as book depreciation. There is ample evidence that for years before Case  
21 No. ER-97-394, pre-1981 vintage assets were depreciated using tax guideline  
22 depreciation rates, not book depreciation rates, and because of the use of guideline  
23 depreciation systems, book procedures have not been used.

1 Q. Why does Mr. Traxler say straight-line tax depreciation is stopped?

2 A. Staff states, “Any time that straight-line tax depreciation is stopped prior to retirement is  
3 an example of an asset vintage which is outliving its book depreciation life.” (Traxler  
4 Rebuttal, page 15, lines 7-8)

5 Q. Do you agree with this statement?

6 A. No. Clearly, Mr. Traxler is again assuming that book depreciation rates and book  
7 procedures have been used for straight-line tax over the entire life of the vintage. As  
8 demonstrated above, because there are significant prior flow through items, such as the  
9 use of faster guideline depreciation, stopping straight-line tax depreciation when the  
10 vintage is fully depreciated is an example of the available tax deductions being exhausted  
11 faster for straight-line tax than for book.

12 Q. Did the Commission at the time understand that the benefits of straight-line tax would run  
13 out because of flow through treatment?

14 A. Yes. In 1976, the Commission wrote:

15 “However, the Commission points out that the reverse is true under flow through  
16 where the Company is allowed to collect in rates only its actual tax liability. Eventually,  
17 the Company will use up its depreciation deduction both as far as the Commission and  
18 the IRS are concerned, but its IRS depreciation deduction will be exhausted sooner,  
19 leaving a period of time where the IRS recognizes no expense but the Commission still  
20 does. At that point, the Commission will have to give the Company two dollars to cover  
21 one dollar of depreciation expense, because both dollars will be considered taxable  
22 income by the IRS, half of which the IRS will take.” (Report and Order, MPS Case No.  
23 18,502 E, page 14)

24  
25 Q. What happens if not all prior flow through items are reflected in current rates?

26 A. The current ratepayers receive a benefit from the Company’s investors for a benefit  
27 already provided to prior ratepayers. The Company cannot collect from the IRS a benefit  
28 already provided in ratemaking and already taken on its tax return. Therefore, the benefit



1 would have to be paid to the ratepayers by the Company's investors, reducing the  
2 Company's authorized return.

3 Q. Has Staff made an adjustment for all prior flow through items?

4 A. No.

5 Q. What other aspects of Mr. Traxler's analysis do you disagree with?

6 A. He misstates Company's position and he does not clearly describe mass asset accounting.

7 Q. How has Staff misstated the Company's position?

8 A. Staff states "Both the Staff and the Company have included book depreciation expense in  
9 cost of service for assets which are fully depreciated." Company does not agree with this  
10 statement. Company does not agree that any individual book asset under a mass asset  
11 accounting system can be considered fully depreciated until it is: 1) retired; or, 2) the  
12 entire plant account becomes fully depreciated.

13 Q. What is incorrect about Mr. Traxler's description of mass asset accounting?

14 A. Mr. Traxler has confused an average life of a group of assets with the actual life of an  
15 individual asset. Staff claims that when the actual life of an asset is greater than the  
16 average life assigned to its plant account, the asset is fully depreciated. Staff is incorrect  
17 in this statement.

18 Q. How has Mr. Traxler extended this confusion to the straight-line tax calculation?

19 A. Because the Commission ordered straight-line tax depreciation calculations to be  
20 performed on a tax basis (guideline depreciation) in order to capture the benefits of flow  
21 through, the straight-line tax and book depreciation systems are completely different. For  
22 the straight-line tax system of depreciation, assets can and do become fully depreciated  
23 before the end of their book and actual lives. This is because guideline depreciation is

1 calculated on a tax basis. It is calculated using lives that are shorter than book lives. It is  
2 calculated using vintage accounts, and it is calculated using different retirement  
3 procedures. It is not correct to try and equate the book mass asset system of depreciation  
4 with the tax vintage, tax class depreciation system required to calculate the guideline  
5 depreciation ordered by the Commission.

6 Q. Can you provide an example?

7 A. Yes. See Surrebuttal Schedule HDR-4. Columns one and two show two assets of \$1000  
8 each with actual lives of 5 years and 15 years, respectively. The average life for a plant  
9 account containing only these two assets is 10 years and a depreciation rate of 10%  
10 (ignoring net salvage). Staff claims that a book asset that survives past 10 years is fully  
11 depreciated. One has only to look at the accumulated depreciation reserve to see that is  
12 not the case. If asset two had been the only asset in the account, Staff states that the  
13 Commission at the end of year 10, to reflect that the entire account was fully depreciated,  
14 would have rightfully stopped depreciation. (Traxler Rebuttal, page 13, line 22 to page  
15 14, line 3). Staff's example of "over depreciating" mass assets is improbable.

16 Q. Does Mr. Traxler contradict his claim that mass asset accounting permits assets to be over  
17 depreciated?

18 A. Yes. He states that under mass asset accounting, "No attempt is made to track the  
19 accumulated depreciation reserve by vintage **or specific asset.**" (Traxler Rebuttal, page  
20 13, lines 21-22). At the same time, he provides an example of a specific asset and  
21 associates a portion of the accumulated depreciation reserve with that specific asset in  
22 order to claim the asset is fully depreciated. The same would be true if Staff's example  
23 was for a specific group of assets that is less than the mass asset depreciable group.

1 Q. How else does Mr. Traxler contradict his claim that mass accounting permits assets to be  
2 over depreciated?

3 A. He states, “If you retire a \$100,000 plant asset, the book depreciation reserve is reduced  
4 by the same \$100,000.” Mass asset accounting clearly does not consider any individual  
5 asset to be fully depreciated before it is retired. Rather an individual mass asset is only  
6 considered fully depreciated when it is retired.

7 Q. Is the reason provided by Staff for considering a retired asset fully depreciated accurate?

8 A. No. Staff states, “The underlying assumption is that in the aggregate, assets being retired  
9 early will be offset by an equal amount of asset being retired later.” (Traxler Rebuttal,  
10 page 14, lines 14-16). While this statement may be true for book depreciation rates and  
11 book depreciation systems, it is not true of a depreciation system for the same assets that  
12 uses different depreciation rates or different procedures. If the straight-line tax  
13 depreciation rate, such as a fixed rate based on a tax guideline life, is not based on a study  
14 that is adjusted for the actual lives, then the “offsetting” feature of mass asset accounting  
15 will not work.

16 Q. What would be the result of continuing straight-line tax depreciation if a faster guideline  
17 life had been used?

18 A. See Surrebuttal Schedule HDR-5. This example shows the same book plant account as  
19 on Surrebuttal Schedule HDR-4 opposite a faster straight-line tax guideline life for a pre-  
20 1970 vintage. Pre-1970 tax vintage retirements are treated essentially the same as book  
21 retirements. The plant account has an average book life of 10 years. The early  
22 retirements and later retirements precisely balance out over the actual lives of the assets.  
23 This results in all and only all the total investment of \$2000 being recovered over the life

1 of the longest asset (15 years). On the other hand, because a faster life of 8 years was  
2 used for straight-line tax, all of the depreciation deduction was used up by the end of Year  
3 11. Year 11 is the year in which the straight-line tax accumulated depreciation in column  
4 (g) equals the plant in service in shown in column (b). To continue to calculate straight-  
5 line tax depreciation past the point when the account is fully depreciated for straight-line  
6 tax is to provide ratepayers a tax depreciation deduction that is more than what is  
7 available to the Company.

8 Q. What about Staff's claim that there are offsetting deductions with other shorter-lived  
9 assets?

10 A. Staff's claim is based on book rates and book procedures being used for straight-line tax.  
11 Since tax guideline rates and procedures, not book rates, have been used for pre-1981  
12 assets, there can be no "balancing" offsetting assets. The guideline rates are not designed  
13 to produce offsetting results, as book rates are. The example on Surrebuttal Schedule  
14 HDR-3 shows that if faster guideline rates were ever utilized for straight-line tax, Staff's  
15 method of calculating will produce excess (duplicate) tax deductions. The amount of the  
16 duplicate deductions created under Staff's method will be the balance of the accumulated  
17 depreciation reserve in the straight-line tax vintage account in excess of the basis.

18 Q. How does the Company correct for the fact that there are no compensating offsetting  
19 retirements when guideline life depreciation rates have been use for straight-line tax?

20 A. In accordance with the rules for the tax straight-line systems being used, we stop  
21 depreciating the straight-line vintage when all the available tax deduction has been  
22 provided to the ratepayer. This is the proper mechanism to recover the higher ratemaking  
23 taxes resulting from the early depletion caused by the prior flow through items. As noted

1 above, the Commission was fully aware of the ratemaking impacts that flow through  
2 posed to future revenue requirements. The earlier flow through of tax benefits  
3 predictably and inevitably left us with less ratemaking tax deductions now.

4 Staff's Method is a Change in Method

5 Q. Is Staff's method a switch from the tax based straight-line system of depreciation used  
6 prior to 1997 to a book based system of depreciation?

7 A. Yes. As noted above, and as described by Staff, Staff's method is book depreciation with  
8 an adjustment only for basis difference flowed through. It is essentially a change to full  
9 normalization with a partial adjustment for prior flow through items.

10 Q. Has the issue of switching from a tax based straight-line system of depreciation to a book  
11 based system of depreciation, as proposed by Staff, been addressed before?

12 A. Yes. In the late 1970's, FERC ordered the utilities under its jurisdiction to embrace full  
13 normalization and use book depreciation for tax straight-line. The existence of prior flow  
14 through items became the source of much litigation over the proper way to flow back the  
15 prior flow throughs and whether the methods proposed met the legal requirements of  
16 normalization of the IRC. Ultimately, the IRS issued Revenue Ruling 83-37 (Surrebuttal  
17 Schedule HDR-7). The ruling concluded that an annual addback was required to  
18 compensate for the prior flow through items. Key to their conclusion was the statement:  
19 "Were it not for (the) addback, it is apparent that the annual adjustments would cause the  
20 deferred tax account balance to be reduced in violation of section 1.167(l)-1(h)(2)(i) of  
21 the regulations" (Rev. Rul. 83-37)

22 Q. Can you translate this revenue ruling to apply to MPS?

1 A. I will paraphrase excerpts of the ruling, changes in italics to represent the current  
2 situation, emphasis added:

3 The *Staff's Method* goes beyond requiring prospective full normalization of all  
4 book-tax timing differences. It requires *the Company* to normalize not only book-  
5 tax differences for assets placed in service after the adoption of such method but  
6 also for assets placed in service when normalization was not required or when  
7 normalization of only some book-tax timing differences was required *for*  
8 *ratemaking*.

9 **The *Staff's Method* does not compute the amount of federal tax deferral**  
10 **with respect to any particular asset or class of assets, as would normally be**  
11 **done in computing under section 1.167(l)-1(h)(1)(i) of the regulations the**  
12 **amount of federal income tax deferral.** Rather, it focuses on the total plant  
13 investment. By computing the annual additions to the deferred tax reserve on the  
14 basis of the annual aggregate differences between book and tax depreciation for  
15 the entire plant, **applying *Staff's method* to property which flow-through**  
16 **accounting has previously been used allows current deductions to the**  
17 **deferred tax reserve with respect to property for which book depreciation**  
18 **now exceeds tax depreciation even though *lesser or no* amounts were added**  
19 **to the reserve when tax depreciation was higher than *tax straight line***  
20 **depreciation because such differences were flowed through to ratepayers (*i.e.***  
21 ***guideline depreciation*).** However, the method attempts to counter the effects of  
22 having flowed through prior book-tax differences rather than having normalized  
23 them by providing for an addback, which increases the tax expense for ratemaking  
24 purposes during the remaining book life of all the taxpayer's plant. *However this*  
25 *addback is not sufficient because it only addresses one of several items flowed*  
26 *through.*

27 ***Because the addback proposed by Staff does not address all prior flow***  
28 ***through items, it is apparent that the annual adjustments proposed by Staff***  
29 **would cause the deferred tax account balance to be reduced in violation of**  
30 **section 1.167(l)-1(h)(2)(i) of the regulations.** However, if the previously flowed  
31 through amounts were added back at a rate assuring that sufficient amounts were  
32 added **annually** to counteract the effect of normalizing for property for which  
33 benefits had been previously flowed through, the *Staff's Method* would be  
34 acceptable, since the annual additions to the deferred tax account would equal on  
35 a composite basis the amount required by section 167(l) of the Code and the  
36 amount needed to normalize all other book-tax timing differences.

37 **If the addback in a given year for previously flowed-through amounts is**  
38 **too low, the addition to the deferred tax account for that year with respect to**  
39 **section 167(l) differences would be less than the required amount. This would**  
40 **cause a reduction of the deferred tax account for reasons other than those**

1 **specified in section 1.167(l)-1(h)(2)(i) of the regulations and, because of this**  
2 **violation of section 167(l), the taxpayer would lose the right to use**  
3 **accelerated depreciation.**

4 Therefore, to assure that section 167(l) of the Code is not violated in a  
5 particular case by the use of the *Staff's Method*, the *Company* who previously used  
6 flow-through accounting must compute, during each year in which an addback is  
7 required, the minimum addition required by section 167(l). **This is done by**  
8 **calculating for each public utility property the difference between**  
9 **accelerated depreciation taken on the taxpayer's return and the amount that**  
10 **would have been taken as depreciation if the taxpayer had used a straight**  
11 **line method (on the tax return) instead.** The amount that would have been taken  
12 as straight line depreciation should be computed by reference to the tax basis, not  
13 the book basis, of the property at the time that normalization was adopted with  
14 respect to the property. For each year in which an addback is required, the balance  
15 in the deferred tax reserve must equal or exceed the amount that would have been  
16 in the account if only book-tax differences addressed by section 167(l) had been  
17 normalized.

18 Because *Staff's Method* applies to property placed in service before 2001,  
19 when **some or all** book-tax differences had been flowed through to ratepayers, it  
20 also **requires an annual addback** to the cost of service, which is designed to  
21 generally offset the effect of normalizing with respect to property previously  
22 accounted for under a flow-through method.

23  
24 Q. This ruling twice refers to a normalization violation under section 1.167(l)-1(h)(2)(i).

25 What is section 1.167(l)-1(h)(2)(i)?

26 A. Section 1.167(l)-1(h)(2)(i) states in part:

27 **(i)** The taxpayer must credit the amount of deferred Federal income tax  
28 determined under subparagraph (l)(i) of this paragraph for any taxable year to a  
29 reserve for deferred taxes, a depreciation reserve, or other reserve account. The  
30 taxpayer need not establish a separate reserve account for such amount but the  
31 amount of deferred tax determined under subparagraph (l)(i) of this paragraph  
32 must be accounted for in such a manner so as to be readily identifiable. With  
33 respect to any account, the aggregate amount allocable to deferred tax under  
34 section 167(l) shall not be reduced except to reflect the amount for any taxable  
35 year by which Federal income taxes are greater by reason of the prior use of  
36 different methods of depreciation under subparagraph (l)(i) of this paragraph.

37 Q. What does this mean?

1 A. Deferred taxes arise from the difference between tax depreciation and ratemaking  
2 straight-line depreciation. Deferred taxes are tracked by tax account. A vintage and class  
3 account is an account. When tax depreciation for an account is greater than ratemaking  
4 straight-line depreciation, additions are made to the deferred tax reserve. When tax  
5 depreciation for an account is less than ratemaking straight-line depreciation, deductions  
6 are made from the reserve. When accounts are fully depreciated for both tax depreciation  
7 and ratemaking straight-line depreciation, all of the reserve additions will have been  
8 deducted. The reserve for the account will be zero. To continue ratemaking straight-line  
9 depreciation on the account after it is fully depreciated for tax and fully depreciated for  
10 ratemaking straight-line tax will result in a deduction to the reserve (tax depreciation at  
11 zero is less than the continued ratemaking straight-line depreciation). Since no prior  
12 additions remain in the reserve for that account, a reduction in the reserve is made for  
13 which there are no prior additions.

14 Q. Can you describe this more simply?

15 A. Yes. It says that for any account (vintage and class account) the deferred income tax  
16 reserve may not be reduced except by the reversal of what was previously put into the  
17 reserve. You cannot take out what you did not put in.

18 Q. Isn't the common view of normalization that if ratemaking straight-line tax depreciation  
19 is no more than book depreciation there can be no problem?

20 A. This is an over simplified view. It is true only when book depreciation rates and  
21 procedures are used for both book and ratemaking straight-line tax depreciation and have  
22 been consistently applied from the beginning. This simplified view does not look at the  
23 accumulated result of tax depreciation compared to ratemaking straight-line tax



1 depreciation. As demonstrated earlier, if there is any additional flow through, the proper  
2 procedure is to stop depreciating the straight-line tax vintage account when it is fully  
3 depreciated.

4 Other Flow Through - Guideline Depreciation

5 Q. What is guideline life depreciation?

6 A. Guideline life depreciation refers to two tax methods of tax depreciation allowed by the  
7 tax code. Guideline life depreciation refers to both pre-1971 vintage property using the  
8 IRC Class Life System (CLS) and 1971 to 1980 vintage property using the IRC Class Life  
9 Asset Depreciation Range (also called Asset Depreciation Range or ADR). Under these  
10 two tax depreciation systems, assets must be placed in vintage accounts with only one  
11 class of asset in an account. (IRC Reg. 1.167(a)-11(b)(3)). Additionally the IRC rule for  
12 guideline life depreciation requires that “no account may be depreciated below the  
13 reasonable salvage value of the account”(IRC Reg. 1.167(a)-11(c)). Salvage value here  
14 means gross salvage, not net of removal costs.

15 Q. How is this related to ratemaking straight-line tax depreciation?

16 A. Prior to 1970, ratemaking was permitted to flow through (use for ratemaking) all tax  
17 deduction benefits in the same year they occurred in the Company’s tax return, including  
18 tax depreciation taken under CLS. Beginning in 1970, the tax rules changed. In order for  
19 regulated utilities to be eligible to use “accelerated methods” on their tax returns, utilities  
20 that used a straight-line depreciation method for calculating book depreciation, also had  
21 to use a straight-line method for calculating ratemaking tax deductions. This did not  
22 mean that the ratemaking tax depreciation expense (straight-line tax) had to be the same,  
23 only that it had to be calculated using a similar (straight-line) method. Straight-line tax

1 depreciation could be faster than book depreciation, as long as it was calculated straight-  
2 line. The IRC placed a limit on how much faster straight-line tax could be. Straight-line  
3 tax depreciation (ratemaking) could be no faster than the depreciation allowed on the tax  
4 return using the straight-line method (tax straight line) (IRC Section 1.167(l)-1(h)(1)(iii).

5 Q. Have you reviewed the history of tax normalization for MPS?

6 A. Yes. I made a review of rate orders and supporting documents. A description of the  
7 documents I reviewed is on Schedule HDR-1.

8 Q. With respect to the Missouri Commission and MPS, can you summarize your findings?

9 A. With the exception of parts of 1976-1978, MPS ratemaking has reflected flow through  
10 treatment of guideline tax straight-line depreciation. I will describe documentation that  
11 prior to 1970 MPS was on full flow through (all depreciation tax deductions were used to  
12 reduce current rates to ratepayers). From 1970 to 1976, MPS was on flow through of all  
13 unprotected items (partial normalization). In four consecutive rate cases from 1978 to  
14 1982, the Company was ordered to flow through tax straight-line guideline life  
15 depreciation, and that the Commission established a policy of allowing normalization of  
16 these items only in cases of cash flow difficulties. In 1983, the Company was allowed to  
17 normalize its post-1980 property vintages in accordance with the requirements of the  
18 Economic Recovery Tax Act of 1981. I found no evidence or order after 1982 indicating  
19 a change in treatment for the pre-1981 vintages. To the contrary, I reviewed testimony  
20 and other supporting documents of both Staff and Company in MPS Case Nos. ER-83-40,  
21 GR-88-194, ER-90-101, and ER-93-37 indicating that guideline tax straight-line  
22 depreciation was used to calculate straight-line tax depreciation and the use of this  
23 guideline tax straight-line depreciation was not a disputed issue.

1        Review of Evidence of Prior Flow Through

2    Q.    What is the purpose of this section?

3    A.    The purpose of this section is to provide evidence that for MPS ratemaking has reflected  
4        the flow through of other items besides just basis differences. In particular, guideline tax  
5        straight-line depreciation has been flowed through.

6    Q.    Why is this testimony necessary?

7    A     Staff says, “The Staff’s method for calculating the straight-line tax depreciation deduction  
8        applies the tax basis/book basis ratio times annualized book depreciation in order to avoid  
9        taking an additional tax deduction which has been given to ratepayers in years prior...”

10        (Traxler Rebuttal, page 12, lines 12-14). While acknowledging that prior flow through  
11        items require an adjustment, Staff denies there are any prior property related flow through  
12        items, other than basis differences. Staff states the “the only material difference between  
13        annualized book depreciation recovered in rates and the related tax deduction for book  
14        depreciation is the elimination of the asset “basis difference” which was previously  
15        flowed through in rates in prior years.” (Traxler Rebuttal, page 11, line 23-page 12,  
16        line3). Staff appears to be unaware of the Commission’s long standing policy to flow  
17        through tax timing differences except when a utility is experiencing significant cash-flow  
18        problems. Staff’s testimony in GR-88-194 listed seven MPS electric and gas cases and  
19        one Missouri Cities Water case in support of the Commission’s policy history. (See MPS  
20        Case No. GR-88-194, Tooley, Direct, pages 7-8). The purpose of this section is to show  
21        that ratemaking straight-line tax depreciation flowed through Guideline Tax Straight-line  
22        depreciation and cost of removal for years prior to ER-97-394.

1 Q. What rate orders establish that more than just basis differences have been flowed through  
2 for ratemaking?

3 A. MPS had four consecutive rate case rulings from 1978 to 1982 ordering us to flow  
4 through guideline life depreciation and cost of removal. Additionally, the report and  
5 order in MPS Case No. 18,502, page 15 notes that prior cases have result in only “two  
6 utilities being granted normalization of FPC-530 items” (guideline life depreciation and  
7 basis differences). The four MPS Report and Orders were:

8 Case No. ER-78-29 “The Company’s cash flow, interest coverage, and internally  
9 generated funds will remain adequate if it is allowed to normalize only the tax  
10 timing differences related to accelerated depreciation, repair allowances,  
11 investment tax credit, and injuries and damages.”  
12

13 Case No. ER-79-60 “The Company’s cash flow, interest coverage, and internally  
14 generated funds will remain adequate if Company is allowed to normalize  
15 investment tax credit, accelerated depreciation, amortization of extraordinary  
16 purchased power costs and numerous quick turn around items.”  
17

18 Case No. ER-80-117 “Staff’s position is consistent with the decision consistent  
19 with the decision of the Commission rendered in the last two rate cases involving  
20 the Company.... In the Commission’s opinion the Company’s cash flow, interest  
21 coverage and internally generated funds have not been shown to be inadequate to  
22 the extent that flow-through treatment should not be afforded the six items at issue  
23 here.” The items included Booked to Guideline Depreciation Lives and Removal  
24 Costs, in addition to basis differences.  
25

26 Case No. ER-82-39, page 23 “The tax-timing differences at issue in this case will  
27 be flowed through to the Company’s ratepayers, as proposed by Staff.” The same  
28 six items were at issue as the last case. The items included Booked to Guideline  
29 Depreciation Lives and Removal Costs, in addition to basis differences.

30 Q. What evidence do you have that ratemaking after 1982 included flow through of more  
31 than basis differences?

32 A. I obtained and reviewed our response to Staff Data Request 465 in Case No. ER-97-394.

33 This response was a print out of our straight-line tax records for vintages 1970 and after.

1 It shows by vintage, by tax class, by calendar year the amount of tax depreciation and  
2 straight-line tax depreciation associated with the tax basis in each tax class. It also shows  
3 the tax and straight-line tax depreciation rates applied. The entire data response is very  
4 large. I have attached the pages for one vintage year (1974) as Surrebuttal Schedule  
5 HDR-8, however data for all vintage years is available.

6 Q. What were the straight-line tax depreciation rates for the 1970 to 1980 vintages?

7 A. I observed that for these guideline life vintages, the straight-line tax depreciation rates for  
8 each calendar year from the year placed in service until 1997 are the tax straight-line  
9 guideline life rate, and not book rates.

10 Q. How did you use this schedule?

11 A. I reviewed the Staff's tax work papers supplied to us during MPS Case No. ER-93-37. I  
12 noted that Staff's work papers for the straight-line tax calculation were based on a  
13 schedule by vintage year of the total tax depreciation and straight-line tax depreciation for  
14 the ER-93-37 test year. This schedule is attached as Surrebuttal Schedule HDR-9. I  
15 noted:

- 16 • Tax depreciation on the schedule for the pre-1970 vintage equaled the straight-line tax  
17 depreciation. This is the expected result when tax depreciation is flowed through for  
18 pre-1970 vintages, as permitted by the IRC. MPS elected tax straight-line CLS for  
19 our pre-1970 vintage tax depreciation.
- 20 • Straight-line tax depreciation for each and every electric property vintage year 1970 to  
21 1980 agreed with the total of the straight-line tax depreciation for the electric classes  
22 of property for the 1993 year shown on our response to Staff Date Request 465 in  
23 Case No. ER-97-394.

1 Q. What did you conclude regarding Case No. ER-93-37?

2 A. After noting that Company and Staff testimony did not contain disagreements regarding  
3 the method of calculating straight-line tax depreciation, I concluded that Staff's approach  
4 in ER-93-37 was consistent with Company's and Company's records. In particular,  
5 guideline depreciation was used for pre-1981 vintages and book rates were applied to  
6 post-1980 vintages.

7 Q. Did you review MPS Case No. ER-83-40?

8 A. Yes. I reviewed the Staff's testimony. I also reviewed Staff's tax work paper supplied to  
9 us during Case No. ER-83-40, attached as Surrebuttal Schedule HDR-10, and our  
10 response to Staff Data Request 298 in Case No. ER-83-40 that was included with Staff's  
11 tax work papers, attached as Surrebuttal Schedule HDR-11. This was the first case after  
12 the four cases that ordered flow through. It is the first case in which the Company did not  
13 bring tax normalization to hearing.

14 Q. What did you observe in Staff's testimony?

15 A. In testimony, Staff refers to an adjustment 15 identified as "Excess Tax Depreciation and  
16 Guideline Tax Depreciation – Based upon Plant at 12-31-82. Excess tax depreciation is  
17 calculated on book to guideline tax for pre '81 and from book to ESL on post '80  
18 vintages" (ER-83-40, Tooley Direct, page 7). In his testimony he further describes the  
19 adjustments as "The adjustment amounts are the difference between per books Deferred  
20 Tax and Deferred Taxes resulting from the normalization of the excess of actual tax  
21 depreciation over Tax Straight-Line Depreciation." (ER-83-40, Tooley Direct, page 8).

22 Q. What did you observe in Staff's tax work papers?

1 A. Staff's tax work paper is attached as Surrebuttal Schedule HDR-10. Included with the  
2 Staff's tax work papers for Case No. ER-83-40 was the Company's response to Staff's  
3 data request 298, attached as Surrebuttal Schedule HDR-11. In response to this data  
4 request, MPS provided schedules of 1983 tax depreciation, 1983 guideline straight-line  
5 tax depreciation, and 1983 equivalent straight line (ESL) depreciation. Staff's tax work  
6 papers show that the tax straight-line amount derives from the guideline straight-line tax  
7 schedule for vintages before 1981. ESL is used for the post 1980 vintages. I also noted  
8 that for the 1974 vintage, the electric property 1983 tax depreciation and the 1983  
9 Guideline Straight Line Depreciation amounts on Surrebuttal Schedule HDR-11 agreed,  
10 except for one small adjustment, with the corresponding amounts for 1983 in Company's  
11 response to Staff Date Request 465 in Case No. ER-97-394 (1974 vintage schedules  
12 attached as Surrebuttal Schedule HDR-8).

13 Q. What is equivalent straight-line (ESL) depreciation?

14 A. ESL depreciation is book depreciation rates multiplied by the same tax basis as used for  
15 tax depreciation for vintage years after 1980.

16 Q. What did you conclude regarding Case No. ER-83-40?

17 A. The hearing memorandum states the following:

18 "The Commission has previously established a generic docket, Case No. 00-83-  
19 220 to consider the issue of tax normalization. Company requests that a schedule  
20 of proceedings be established in that docket in order that a resolution of that issue  
21 can be had as expeditiously as possible." (Hearing Memorandum, ER-83-40, page  
22 14).

23  
24 After reviewing this hearing memorandum, coupled with Staff's testimony and work  
25 papers, I concluded that the case outcome and Staff's approach in ER-83-40 were  
26 consistent with Company's records. In particular, guideline depreciation was used for

1 pre-1981 vintages and book rates were applied to post-1980 vintages. Cost of removal  
2 flow through was also not changed by this case.

3 Q. Did you review MPS Case GR-88-194?

4 A. Yes. I reviewed Staff's tax testimony in MPS case GR-88-194 noting it was also  
5 consistent with Company's view that there are flow through items other than basis  
6 differences. Staff states:

7 "Tax straight-line depreciation is calculated by applying book depreciation rates to the tax  
8 basis of the depreciable property for vintage years 1988 through 1981. Tax straight-line  
9 depreciation for older vintages is calculated by applying Class Life Asset Depreciation  
10 Range, Class Life System, or straight-line depreciation rates as appropriate to the tax  
11 basis of the depreciable property." (GR-88-194, Tooley Direct, page 4, lines 11-16).

12  
13 "Staff is proposing flow-through treatment on the book /tax timing differences associated  
14 with 1) vacation accrual, 2) cost of removal, and 3) book to tax straight-line depreciation.  
15 The Company has proposed normalization of vacation accrual and cost of removal."  
16 (GR-88-194, Tooley Direct, page 6, lines 17-20)

17  
18 Q. What do you conclude regarding Case No. GR-88-194?

19 A. Staff's testimony confirms that as of the late 1980's there has been no-change in Staff or  
20 Commission's policy for MPS in the handling of guideline life depreciation flow through  
21 or cost of removal flow through.

22 Q. Did you review MPS Case ER-90-101?

23 A. Yes. I reviewed Company's tax testimony in MPS case ER-90-101 noting it was also  
24 consistent with Company's view that there are flow through items other than basis  
25 differences. Company Witness Dennis Williams states:

26 "...full normalization of tax timing differences results in the most proper  
27 allocation of costs to the consumer. However, except in extraordinary  
28 circumstances, this Commission has historically allowed only normalization of  
29 those items which are statutorily protected...For purposes of this proceeding, we  
30 have determined to seek normalization of only those items historically provide  
31 such treatment by this Commission." (ER-90-101, Williams Direct, page 3).



1 On pages 4-6 of Mr. Williams' testimony, he describes the tax treatment of the various  
2 items. These include normalizing only the protected accelerated tax depreciation and  
3 protected advances and contributions in aid of construction. Cost of removal was treated  
4 as flow through.

5 Q. What did you conclude regarding Case No. ER-90-101?

6 A. After noting that Company and Staff rebuttal and surrebuttal testimony did not contain  
7 disagreements regarding the method of calculating straight-line tax depreciation, I  
8 concluded that Staff's approach in ER-90-101 was consistent with Company view  
9 reflected in MPS's straight-line tax records. In particular, guideline depreciation was  
10 used for pre-1981 vintages and book rates were applied to post-1980 vintages.

11 Q. What evidence did you review regarding flow through treatment of guideline tax straight-  
12 line depreciation prior to 1976?

13 A. I noted that the Report and Order in MPS's 1976 Case No. 18,502E, the Commission,  
14 discussing whether to normalize more than the protected amount of guideline  
15 depreciation (an "FPC-530" item), states:

16 "Prior rate cases have resulted in two utilities being granted normalization of  
17 FPC-530 items because both had cash flow problems and one utility being denied  
18 normalization because it did not." (Case No. 18,502E, Report and Order, page  
19 15)

20  
21 The flow through treatment of tax straight-line depreciation is also evident in MPS's  
22 1968 Case No. 16,569. The hearing memorandum and Staff Schedule D, referred to in  
23 the hearing memorandum, the test year net operating income in the hearing memorandum,  
24 and the test year net operating income in the report and order, all reflect that the excess of  
25 tax depreciation over book depreciation was flowed through. This can be seen on Staff

1 Schedule D that the excess of tax depreciation over book depreciation was used to reduce  
2 ratemaking tax expense in the same manner as the flowed through basis deductions of  
3 “taxes charged construction” and “pension costs to construction”. Finally, flow through  
4 treatment of tax depreciation is consistent with both our straight-line tax records and our  
5 1970 FERC Form 1. Ratemaking depreciation deferred taxes arise from a difference  
6 between tax and ratemaking straight-line tax depreciation. These deferred taxes are  
7 recorded in FERC account 282. If there is full flow through, there are no deferred taxes.  
8 Page 227 of our 1970 FERC Form 1 shows the beginning balance in account 282 is zero.  
9 This is consistent with the Company’s records showing full flow through of pre –1970 tax  
10 depreciation.

11 Q. What is your conclusion regarding evidence of prior flow through?

12 A. I concluded that Company’s straight-line tax records reflecting the use of guideline tax  
13 straight-line depreciation for ratemaking are well supported by our ratemaking history.  
14 Claims by Staff that there are no other significant flow through items are unsupported.

15 Other Flow Through Items

16 Q. Are there other prior flow through items?

17 A. Yes. Basis retirement differences and cost of removal in book depreciation rates are two  
18 other items that have historically caused the straight-line depreciation tax deduction to be  
19 higher than the associated book depreciation deductions.

20 Q. Please explain how basis retirement differences arise.

21 A. To calculate guideline tax straight-line depreciation, tax rules are followed. The asset  
22 retirement rules for tax are not identical to the rules for book. One important example of  
23 this relates to ordinary retirements of assets from the 1971 to 1980 vintages. These are

1 known as the Asset Depreciation Range (ADR) vintages. Under tax rules for these  
2 vintages tax basis is not reduced for ordinary retirements until after the vintage is fully  
3 depreciated. (IRC Reg. Section 1.167(a)-11)

4 Q. What is an example of an ordinary retirement?

5 A. Retirements from service due to wear and tear or normal operations would be considered  
6 ordinary. The sale of a system to another utility would not be an ordinary retirement.

7 Q. How does this impact Staff's method?

8 A. Staff's method assumes that straight-line tax calculations have always used the same  
9 depreciation rates, procedures, and methods as book depreciation. Guideline tax straight-  
10 line depreciation is not the same as book. Therefore, applying Staff's method now  
11 produces a different result from book depreciation that is not compensated for. This  
12 retirement rule is clearly different from the book retirement rules that reflect all  
13 retirements. This also contradicts one of Staff's assumptions that depreciation needs to  
14 continue on longer surviving assets to make up for depreciation not taken on shorter lived  
15 assets. This is clearly not the case here. Shorter-lived assets continue to be depreciated  
16 for straight-line tax regardless of whether they are retired for book.

17 Q. What is the impact on the calculation of straight-line tax of not reducing tax basis for  
18 retirements?

19 A. See Surrebuttal Schedule HDR-6. This schedule takes the example from Surrebuttal  
20 Schedule HDR-5 and illustrates an ADR vintage. Under the guideline straight-line tax  
21 method of calculating straight-line tax, the total available tax deduction is depleted in  
22 year 8. The retirement rules of ADR are one feature of tax straight line that provided  
23 prior Commissions the benefits of flow through.

1 Q. How can cost of removal contribute to a depreciation difference?

2 A. Historically, including in our ER-97-394 case, the tax deduction for cost of removal (not  
3 net salvage) has been separately calculated and deducted as a flow through item in the tax  
4 calculation. This has been the case back to the late 1970's. The ratepayer has received  
5 the tax deduction benefit for actual cost of removal in this manner. Book depreciation  
6 rates have historically included a component for a provision for cost of removal. This  
7 means that the depreciation rate and the depreciation amount are larger to allow for a  
8 provision for the cost of removal. To the extent that our book depreciation rates were  
9 used to calculate the tax deduction for depreciation, the depreciation tax deduction has  
10 also been larger to allow for a provision for cost of removal. Since actual cost of removal  
11 has been separately deducted for ratemaking and not charged back against straight-line  
12 tax depreciation, the provision becomes an additional flow through (tax benefit) in  
13 ratemaking. Since it is in the straight-line tax depreciation calculation, it serves to deplete  
14 the available tax deduction somewhat faster than a depreciation rate without a cost of  
15 removal component.

16 L&P Prior Flow through Items

17 Q. Does L&P have the same prior flow through items?

18 A. Yes. For L&P, the issues of guideline life depreciation, cost of removal, and retirement  
19 procedure differences also exist. The relative magnitudes of these issues are different at  
20 L&P and are less in total than at MPS. In particular, based on a less extensive review  
21 than I did for MPS, the difference between L&P's straight-line depreciation rates and  
22 book depreciation rates, appears to be much smaller than at MPS. However, L&P has the  
23 same issue regarding flow through arising from retirement procedures and for cost of

1 removal. The issue of retirement procedures is also an issue in Staff's current method as  
2 the use of actual tax return tax basis will produce additional flow through depreciation.  
3 As with MPS, these prior flow-through items are not properly reflected in Staff's method.  
4 While we disagree with Staff's method, because L&P's issues are smaller than MPS's,  
5 our case reflects L&P's straight-line tax depreciation on Staff's method, using tax basis as  
6 reflected on the tax returns, without reducing tax basis for unreflected ADR retirements,  
7 and without adjusting for cost of removal included in book depreciation rates. Our  
8 understanding is that this is consistent with Staff's calculation in this case.

9 Tax Summary

10 Q. Can you summarize your tax testimony?

11 A. The following are the key points:

- 12 • There are prior flow through items other than basis differences
- 13 • These items are of significant magnitude.
- 14 • The IRC requires vintage accounts to stop depreciation when fully depreciated.  
15 Company's calculation complies with this requirement.
- 16 • If switching to book depreciation (full normalization) when prior flow through  
17 items exist, the IRC requires an adjustment for these prior flow though items.
- 18 • Staff's method does not adjust for all the prior flow through items thereby taking  
19 duplicate (unrealizable) tax deductions unfairly.
- 20 • When the Commission originally ordered flow through, the Commission realized  
21 that flowing through benefits early on to ratepayers would increase rates to future  
22 ratepayers.

- Company's calculation properly complies with IRC requirements and produces the correct tax straight-line result.

**RECORDING OF COST OF REMOVAL AND SALVAGE (NET SALVAGE)**

Q. Staff witness Rosella Schad recommends that interim costs of removal should be expensed (Schad Rebuttal, page 15). Do you agree with her recommendation?

A. No. In order to provide proper protection to both the ratepayer and the Company, interim costs of removal, regardless of the dollar amount of net salvage authorized by the Commission for recovery in rates, should be included in the depreciation rate and provided rate base treatment for ratemaking. As demonstrated in my Rebuttal Exhibits HDR-1 and HDR-2, Staff's expense method does not allow full recovery and creates an under-recovery. Rate base treatment, regardless of the amount authorized, ensures that the ratepayer pays for all and only all actual net salvage costs of the Company. And given that the Commission reviews our depreciation rates periodically through updated depreciation studies, any rate that was too high or too low would be identified. Over time, the ratepayer pays no more than what the Company paid and earns a return through reduced rates in the interim. The Staff's expense method is inequitable in nature and provides no protection to either the ratepayer or the Company.

Q. What is your recommendation?

A. I recommend using the traditional method of incorporating net salvage in the depreciation rate, regardless of the dollar level provided in the rate, and affording rate base treatment as the appropriate ratemaking treatment because:

- Rate base treatment of net salvage equitably compensates both the ratepayer and the Company.



1 Q. Ms. Schad states that the pay as you go method calculated by Staff utilizing a five year  
2 average represents known and measurable amounts and it is the Commission's practice to  
3 set rates based on known and measurable amounts. How do you respond?

4 A. First, incorporating historical averages into ratemaking should not be characterized as  
5 "known and measurable" amounts for future events. Since expenditures will occur at  
6 some future point in time, Staff's method should be characterized as an estimate, just a  
7 different method of estimation as compared to Company's accrual method. The key  
8 difference is that by utilizing the rate base method, ratepayers over time will pay the  
9 actual amounts incurred, because the rate base method provides a mechanism to true-up  
10 to the actual amounts incurred. Under Staff's method, ratepayers always pay an estimated  
11 amount incurred with no true-up mechanism to the actual amounts incurred.

12 Q. Has the pay as you go method been utilized in prior cases?

13 A. Yes. The pay as you go method has been incorporated in depreciation rates in prior rate  
14 orders. Specifically, in MPS Case No. ER-90-101, the Commission adopted Staff  
15 witness Melvin Love's methodology to recover a five-year average level of net salvage  
16 through the depreciation rate. A similar method was adopted in MPS Case No. ER-93-  
17 37.

18 Q. Has the accrual method been utilized in prior cases?

19 A. Yes. Both Company and Staff in MPS Case No. ER-97-394 recommended accrual levels  
20 (ratio of net salvage to plant value of retirements). This method was adopted by the  
21 Commission in MPS Case No. ER-97-394.

22 Q. Why is the accrual method superior?



- 1 A. The accrual method should be adopted by the Commission by incorporating Dr. Ronald  
2 E. White's recommended depreciation rates because:
- 3 • Intergeneration inequity for the ratepayer is minimized through the accrual method.  
4 The cost of providing service is appropriately placed with customers benefiting from  
5 the service, i.e., proper matching occurs.
  - 6 • Minimization of a hidden disallowance will be accomplished through the accrual  
7 method. If the Company is not allowed to collect the true cost of serving current  
8 customers now, there is no guarantee it will be allowed to collect from future  
9 customers for a service previously provided to past customers.
- 10 Q. Ms. Schad references in her rebuttal that the Company's depreciation rates for interim  
11 costs of removal generated over \$14.5 million annually for removal costs. Do you agree?
- 12 A. The Company has outstanding discovery requests on Staff's calculations of the \$14.5  
13 million. Until we receive the information requested, we are not in a position to respond.
- 14 Q. Has Ms. Schad misinterpreted your direct testimony?
- 15 A. Yes. In her testimony she takes exception to my use of the word "benefits." My  
16 testimony refers to the "benefits of salvage." Salvage (gross) is a reduction of the  
17 Company's costs and is given to the ratepayer as a benefit.
- 18 Q. Please summarize the Company's position for the amount of interim cost of removal.
- 19 A. The Company's preference is to utilize the accrual method because this method is more  
20 equitable. Current ratepayers consuming property should have to pay a portion of the  
21 retirement of the property they are consuming. The accrual method is superior to Staff's  
22 pay as you go method because it takes into consideration the future investment or growth

1 in electric plant. The Staff's method is inequitable and fails to take into consideration  
2 future growth and plant investment.

3 Q. Does this conclude your surrebuttal testimony?

4 A. Yes it does.