Exhibit No.:
Issues: Net Salvage,
Corporate Depreciation,
Tax Depreciation &
Pension
Witness: H. Davis Rooney
Sponsoring Party: Aquila Networks-MPS
& L&P
Case No.: ER-

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

H. Davis Rooney

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

Q. Please state your name and business address.

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

Q. What is your occupation?

A. I am employed by Aquila, Inc. ("Aquila" or "Company") as Director of Financial Management.

Q. Would you briefly describe your educational training and professional background?

A. I graduated from the University of Kansas. I received a B.A., with distinction, in Mathematics (1982), and a B.S., with distinction, in Business (1983), with majors in Accounting and Business Administration and a concentration in Computer Science. I obtained my Certified Public Accountant certificate in 1983 and practiced in public accounting from 1983 to 1992. In 1992 I joined Aquila as Controller of its WestPlains Energy division and have held several positions focused on financial management and analysis.

Q. What is the purpose of your testimony in this proceeding?

A. I will provide support for the Company's position on 1) net salvage, 2) the corporate depreciation adjustment, 3) prepaid pension, and 4) the tax straight-line depreciation deduction.

Net Salvage

Q. What do you mean by the term "net salvage?"

A. The definition of net salvage can be found in the FERC uniform system of accounts. "Net salvage value means the salvage value of property retired less the cost of removal" (18 CFR Part 101 Definitions (19)).

Q. What is the Company's position on net salvage?

A. The Company's position is for rate base treatment of net salvage. I understand that rate base treatment is the traditional approach of the Missouri Public Service Commission ("Commission"). Rate base treatment is the inclusion of net salvage in depreciation rates and rate base. The Company believes rate base treatment is the most appropriate treatment of net salvage.

Q. Why is rate base treatment of net salvage appropriate?

A. Salvage and net salvage are components of investment. As such they are entitled to rate base treatment. This Commission has for over 50 years recognized that salvage and net salvage are components of investment. Both the Federal Energy Regulatory Commission ("FERC") rules and the published rules of this Commission recognize that salvage and net salvage are components of investment. In fact, these rules are a tightly woven net of checks and balances to protect the ratepayer against paying more than the cost of investments made by the Company for their benefit.

Q. How has salvage and net salvage been included in depreciation rates?

A. Company witness Ron E. White addresses the process of how net salvage has been included in depreciation rates. He has included in depreciation rates amounts to allocate the benefits of salvage and the costs of removal over the life of the assets.

Q. What is the result of the traditional ratemaking treatment afforded to net salvage?

A. The result is intergenerational equity. The proper costs of investment are charged over the life of the investment to those customers benefiting from that investment. Under this traditional treatment, net salvage impacts rates over the entire life of a piece of property such that all customers that benefit from that property share in the costs and benefits of that property. This process of spreading the net salvage over the entire life of the property avoids cost spikes that must then be subsequently reflected in rates. This process promotes both stability of rates and intergenerational equity by spreading the net salvage to the customers that benefit from that property.

Q. What are the amounts of net salvage included in depreciation rates in this case?

A. Company witness Ron E. White addresses in his testimony the amounts included in depreciation rates.

Corporate Depreciation Adjustment

Q. What is "corporate depreciation?"

A. Aquila owns assets that support operations in a number of regulated jurisdictions including Missouri. Corporate depreciation is the depreciation on those assets included in this case.

Q. Why is an adjustment to corporate depreciation necessary?

A. The corporate assets support operations in a number of regulated jurisdictions. As such, each of these regulated jurisdictions may from time to time order different depreciation rates for these common assets. The depreciation rates ordered by one jurisdiction may differ from the rates ordered in another jurisdiction. This adjustment is to properly reflect the impact on accumulated depreciation of the Missouri depreciation rates.

Q. How does Aquila reflect corporate depreciation?

A. We charge depreciation expense to the various jurisdictions based on one set of corporate depreciation rates. We then adjust the depreciation expense in those jurisdictions that have ordered depreciation rates different than the depreciation rates used at corporate. Accounting entries are two sided. One side of this entry adjusts depreciation expense the other side adjusts accumulated depreciation.

Q. Why is an adjustment necessary in Missouri?

A. Depreciation expense is reduced in Missouri because the rates used for corporate assets are higher than the rates approved in Missouri.

Q. What is the impact of this adjustment?

A. The impact of this adjustment on the recommended depreciation rates is reflected in Ron E. White's testimony and included in his "2003 Depreciation Rate Study – Aquila Corporate Assets (Missouri Operations)".

Prepaid Pension

Q. What is the purpose of your testimony on the prepaid pension issue?

A. The purpose of my testimony is to further discuss the adjustment to prepaid pensions. Company witness Richard Clayburn, Jr. has presented the calculation of prepaid pension for both Aquila Networks – MPS ("MPS") and Aquila Networks – L&P ("L&P").

Q. Please explain the term "prepaid pension".

A. Under the Statement of Financial Accounting Standards No. 87 ("FAS 87"), in general terms, a prepaid pension asset is established on the balance sheet when the cash contributions to the pension fund plus the investment returns on those contributions exceed the pension cost recorded on the income statement under FAS 87.

Q. Company witness Richard Clayburn used the balance at December 31, 2002 as the starting point for his calculations. Is that appropriate?

A. Yes. In Case No. ER-2001-672 the Commission Staff used the estimated balance at January 31, 2002 as the starting point for their calculation.

Q. Has the Company made an adjustment to the MPS balance at December 31, 2002?

A. Yes. An additional adjustment is necessary to reduce the MPS prepaid pension balance by the amount of the Regulatory Liability – Pensions. The amount of the Regulatory Liability – Pensions is $2,309,530.

Q. What is the nature of the Regulatory Liability – Pensions?

A. This regulatory liability represents the difference between prepaid pension for financial accounting under FAS 87 and prepaid pension for ratemaking.

Q. Did Staff make a similar adjustment in the last case, Case No. ER-2001-672?

A. Yes. The Staff included prepaid pensions that arose under FAS 87. However, due to oversights by both the Company and the Staff, prepaid pension was omitted from both the direct filings of the Company and Staff. This error was identified during surrebuttal and an adjustment was made by Staff. However, Staff in that case incorrectly calculated the Regulatory Liability – Pensions.

Q. Is a similar adjustment for a regulatory liability required for L&P?

A. No. L&P did have a regulatory liability for pensions prior to 1994. In Case No. ER-94-163, L&P was ordered back onto FAS 87 and was authorized to reverse its pension regulatory liability. Therefore, L&P does not have an offsetting liability similar to MPS.

Q. What is the result of these adjustments?

A. The results of these adjustments for MPS and L&P are included in adjustment WC-20, sponsored by Company witness Richard Clayburn, Jr.

<u>Tax Straight-Line Depreciation Deduction</u>

Q. What is the purpose of your testimony on the tax straight-line issue?

A. The purpose of my testimony is to describe the Company's vintage calculation of electric tax straight-line depreciation.

Q. What is tax straight-line depreciation?

A. Tax straight-line depreciation is the ratemaking method of spreading the depreciation tax deductions allowed by the Internal Revenue Code ("IRC") over multiple accounting periods.

Q. Is tax straight-line depreciation different from both book depreciation and tax depreciation?

A. Yes. Book depreciation is based on a system of depreciation and accounting policies ordered by the Commission to spread the <u>costs</u> of an asset over multiple accounting periods for ratemaking. Tax depreciation is based on the system of depreciation and accounting policies permitted by the IRC to spread the <u>tax deductions</u> of an asset over multiple accounting periods. Tax straight-line depreciation is the ratemaking system of spreading the <u>tax deductions</u> of an asset over multiple accounting periods. It is important to note that tax and tax straight-line depreciation relate to the tax deductions, not costs, of an asset.

Q. How did the Company calculate tax depreciation in this case?

A. For each tax vintage, the Company used the tax depreciation system rates and methods originally elected in those vintage years. The systems elected by MPS-Electric are shown below:

Tax Vintage	Tax Depreciation System	Tax Depreciation Method
Pre-1970	Class Life System (CLS)	Straight-line
1970	Class Life System (CLS)	Accelerated
1971-1980	Class Life Asset Depreciation Range (ADR)	Accelerated
1981-1986	Asset Cost Recovery System (ACRS)	Accelerated
1987-2003	Modified Asset Cost Recovery System (MACRS)	Accelerated

Q. How did the Company calculate tax straight-line depreciation?

A. Tax straight-line depreciation is calculated by applying book depreciation rates to the tax basis of depreciable property for vintage years 1981 and after. Until 1998, tax straight-line depreciation for older vintages was calculated by applying Class Life Asset Depreciation Range, Class Life System, or straight-line depreciation rates as appropriate to tax basis. The appropriate tax depreciation rate to apply to a given vintage is dependent on the tax depreciation system originally adopted by the Company for that given vintage. This is consistent with the procedures used and recommended by the Staff in cases prior to 1998. Beginning in 1998, tax straight-line depreciation for older vintages is calculated by applying an average book depreciation rate to the tax basis. Except as reflected in our prior rates, tax straight-line depreciation on these older vintages is stopped when the tax basis is fully depreciated for tax straight-line.

Q. You said your calculation is consistent with calculations prior to 1998. How are your calculations different from those calculations used in after 1998?

A. In Case No. ER-97-394 Staff proposed and the Company, on the advice of its tax expert, did not oppose a change in the calculation of tax straight-line depreciation. In that case it was considered a small dollar item. This calculation takes a percent of book depreciation for tax straight-line (ratio calculation). The calculations are not performed on a vintage basis (vintage calculation).

Q. Why have you not continued this calculation?

A. The ratio calculation greatly oversimplifies what is really rather complex. We recently began to understand the extent of the problems in the ratio calculation. While Staff's original argument for this calculation may have had some merit, we now believe that those arguments were both overstated and overwhelmed by the problems in the ratio calculation.

Q. What are the problems?

A. One key problem is that the ratio calculation ignores all tax deduction items previously flowed through to the ratepayer, except for basis differences flowed through.

Q. Why is this a problem?

A. By ignoring tax deductions previously flowed through, the ratio calculation will provide those same tax deduction benefits to the ratepayer a second time. The Company will be "double dipped."

Q. Are there flow through items other than basis differences?

A. Yes. From 1971 to 1997, ratemaking calculated tax straight-line depreciation tax deductions on CLS and ADR vintages according to the maximum extent permitted by the IRC tax guidelines. These higher depreciation deductions were flowed through. This was referred to as "book and guideline depreciation" differences.

Q. What is the short-term impact of these problems?

A. We believe that ratemaking tax expense is being understated.

Q. What is the long-term impact of this?

A. This understatement of expense accumulates on the balance sheet in rate base as a reduction of accumulated deferred taxes. As long as it accumulates in rate base, neither the ratepayer nor the Company will be economically harmed in the long run. However, the Company will be deprived of much needed cash currently, and future ratepayers will pay for a benefit provided current ratepayers in error. This intergenerational inequity continues to accumulate each year that the ratio calculation of tax straight-line depreciation is made.

Q. What do you believe the size of the problems to be?

A. Just on the flow through of guideline depreciation, we believe that the ratio calculation has provided current ratepayers with between $17 million and $23 million of duplicate tax deductions. To the extent this is not offset by items in the ratepayers' favor, future ratepayers will pay these amounts.

Q. Are there other problems?

A. Yes, but we are just in the process of identifying, studying and quantifying them. We believe that some of these issues, when resolved, may ultimately benefit current ratepayers, but many others will not.

Q. How would you propose to handle these duplicate deductions?

A. This is a rather complex issue. If our study were complete, and the guideline depreciation issue were the only issue, we would be seeking to amortize these duplicate deductions back through rates.

Q. What are you proposing?

A. We are proposing that 1) the Commission at least temporarily return us to a vintage calculation; 2) we be allowed to complete our study of taxes; 3) that a member of Staff be made available to review our findings and narrow our differences; and 4) that the Staff and Company make joint recommendations to Commission in a subsequent rate case regarding both the resolved and unresolved issues.

Q. How would you summarize your position?

A. My key points are:

- The tax and ratemaking treatment of tax deductions and their normalization have varied by tax vintage.
- Vintage calculations are required to properly account for amounts previously flowed through to the ratepayer.
- Any calculation that ignores a prior flow through item will provide for a second time a benefit that the ratepayer has already received.
- The Commission ordered flow through of book and tax guideline differences.
- Now calculating book depreciation on these fully depreciated pre-1981 vintages ignores the prior flow through of the tax-timing difference between book and guideline depreciation.
- The Company's cash flow is being inappropriately reduced.

Q. Does this conclude your direct testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks-L&P, for authority to file tariffs increasing electric rates for the service provided to customers in the Aquila Networks-MPS and Aquila Networks-L&P area	))))))	Case No. ER-_________

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF H. DAVIS ROONEY

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

____
H. Davis Rooney

Subscribed and sworn to before me this ______ day of ___________________, 2003.

____
Notary Public

My Commission expires:

____