

Exhibit No.:
Issues: *Accounting Authority Orders,
Property Taxes*
Witness: *Trisha D. Miller*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Surrebuttal Testimony*
Case Nos.: *ER-2004-0034 and HR-2004-0024
(Consolidated)*
Date Testimony Prepared: *February 13, 2004*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

TRISHA D. MILLER

AQUILA, INC.

**d/b/a AQUILA NETWORKS-MPS (Electric)
AND AQUILA NETWORKS-L&P (Electric & Steam)**

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

*Jefferson City, Missouri
February 2004*

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

AFFIDAVIT OF TRISHA D. MILLER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Trisha D. Miller, of lawful age, on her oath states: that she has participated in the preparation of the following surrebuttal testimony in question and answer form, consisting of 25 pages to be presented in the above case; that the answers in the following surrebuttal testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.



Trisha D. Miller

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





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

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1 A. AAOs are applications made by a utility to account for specific events or
2 items in a manner that differs from the Federal Energy Regulatory Commission's (FERC)
3 prescribed Uniform System of Accounts (USOA) in some manner. Most often, AAOs are
4 used to "defer" on the utility's balance sheet a cost that would otherwise be charged to
5 expense currently on the utilities' income statement. This treatment allows a utility to seek
6 rate recovery of the deferred item in a subsequent rate case, even if the cost in question was
7 not incurred within the test year ordered for that rate proceeding. The Commission has
8 usually reserved deferral treatment of expenses for "extraordinary items." Extraordinary
9 items are defined as costs that are unusual in nature and infrequent in occurrence.

10 Q. Can capital items be the subject of AAOs as well as expense items?

11 A. Yes, if the capital expenditure has the nature of an extraordinary item. In that
12 instance, depreciation expense, property tax expense and carrying charges associated with the
13 extraordinary capital asset may be given deferral treatment through a Commission authorized
14 AAO. The Commission has granted capital cost AAOs on several occasions, including the
15 before-mentioned cases involving the MPS Sibley rebuild project and the MPS Sibley
16 western coal conversion.

17 Q. Once costs are deferred pursuant to the Commission granting an AAO, are the
18 deferred costs subsequently allowed recovery in rates?

19 A. Yes, if the Commission finds rate recovery to be appropriate. As a standard
20 practice, the Commission has reserved all ratemaking questions concerning costs deferred
21 through AAO applications to subsequent rate proceedings. If the Commission does approve
22 recovery of deferred costs, that recovery generally takes the form of an expense amortization

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1 over periods that have ranged from five to twenty years. The Commission may or may not
2 grant rate base treatment to the unamortized balance of the AAO deferral.

3 Q. Is the Staff recommending rate recovery of the ice storm AAO deferral?

4 A. Yes. Staff is recommending rate recovery of the deferred costs associated
5 from the winter ice storm that occurred on the MPS system during the end of January in
6 2002.

7 Q. Is the Staff recommending rate base treatment of the unamortized balance of
8 the ice storm AAO?

9 A. No. The Staff disagrees with the treatment of the unamortized balance the ice
10 storm AAO proposed by the Company witness, Mr. Williams, as set out in his rebuttal
11 testimony.

12 Q. Please explain why the Staff disagrees with Mr. Williams' rebuttal testimony
13 on this issue.

14 A. The Staff's disagreement with Mr. Williams' position relates to his statement
15 on page 12, line 15 of his rebuttal testimony that "the Company is not financially made
16 whole" if the unamortized balance of the AAO is not given rate base treatment.
17 Mr. Williams' statement reveals his philosophy that the Company should be able to recover
18 all of its expenses, and that in essence the shareholder should be shielded from the entire risk
19 of owning an electrical transmission and distribution system that from time to time is
20 subjected to winter elements and other forces of nature. It is the Staff's opinion that risk is
21 inherent for utilities, including the risk of natural disaster or "acts of God." By providing rate
22 base treatment for the unamortized balance of the AAO, as well as recovery of the deferred
23 costs through amortization, the Company will be completely shielded from the financial risk

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1 of a natural disaster. Events such as severe ice storms are extraordinary events that occur
2 infrequently in the course of business, and not only the Company's customers but also the
3 Company's shareholders should share the risk of such occurrences.

4 Q. Mr. Williams states on page 12, line 8 of his rebuttal testimony that MPS has
5 already incurred and expended costs to repair broken lines, utility poles, electric meters and
6 other items damaged by the ice storm in January 2002. He also states on page 12, line 6 that
7 these costs are in the public interest of "providing safe and reliable service" and therefore
8 should be included in rate base. Why does the Staff disagree with the Company's position
9 that the unamortized portion of these extraordinary maintenance costs should be included in
10 rate base?

11 A. It is the function of the Company to provide safe and adequate service to its
12 customers as part of its obligation to serve its customers. However, this does not mean that
13 the Company should be guaranteed total recovery of all expenses. Extraordinary expenses
14 associated with "acts of God" by their very nature should be shared between shareholders
15 and ratepayers. This treatment has been the consistent policy in Missouri for many years.
16 The Staff's allowance of recovery of the cost, without rate base treatment, is still a benefit
17 that a non-regulated firm would not receive. "Acts of God," not protected by insurance, must
18 be borne entirely by shareholders of a non-regulated firm.

19 Q. Mr. Williams believes the shareholders would not be completely shielded
20 from the risks of the ice storm under the Company's proposed rate base treatment. Why do
21 you disagree?

22 A. There are three points Mr. Williams tries to make to support his belief that the
23 shareholders have made a significant contribution to the ice storm costs and, therefore,

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1 deserve rate base treatment. The first relates to the amortization of the deferral that began
2 February 2002, several months prior to the operation-of-law date in MPS's current case, Case
3 No. ER-2004-0034. Mr. Williams states in his rebuttal testimony on page 12, line 9: "To
4 date, nearly two years after the effects of the ice storm, the financial impact of the ice storm
5 is not reflected in the utility rates that MPS charges its electric customers." In response, the
6 Staff maintains the position that it is just as likely that the Company will ultimately over-
7 recover this item in rates as that it will under-recover this item in rates, if rates are not
8 immediately reduced when the ice storm AAO amortization expires. In fact, it is unlikely
9 that the expiration of an amortization amount being recovered in rates exactly matches the
10 operation-of-law date for new rates. There is a good example of this in the current case. The
11 Company will almost certainly over-recover the costs for the L&P AM/FM AAO because
12 that amortization ends October 2004. Since the AM/FM AAO amortization terminates
13 outside the test year update period of September 30, 2003, used in this case, the Staff has
14 proposed to continue to reflect the existing amortization for this item in rates.

15 Q. What is the second point that Mr. Williams attempts to make to justify to why
16 the Company should receive rate base treatment for the unamortized balance for the ice storm
17 AAO?

18 A. Mr. Williams' states his second point, on page 12, line 13 of his rebuttal
19 testimony: "By not allowing the unamortized balance in rate base, the Company is penalized
20 from earning a reasonable return on its plant investment, and the Company is not financially
21 made whole." This statement is misleading. All capital expenditures made to replace plant
22 investment due to the ice storm have been capitalized to plant in service, and will receive a
23 reasonable return in rate base. The amounts expended for the ice storm associated with

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1 repairs of lines, poles, meters, and other items are considered maintenance expenses and are
2 included in the unamortized balance of the ice storm AAO. By denying rate base treatment
3 for the unamortized balance for the maintenance expenses associated with the AAO, the
4 Company is actually receiving the traditional expense recognition for maintenance expenses
5 in rates.

6 For example, if the Company performs maintenance on the distribution system or
7 repairs on a transmission line in the normal course of maintaining its electrical system, the
8 costs are typically expensed with no rate base treatment of the expenditures. Only the
9 amounts relating to capital expenditures for replacement of facilities such as the replacement
10 of an electric pole receive rate base treatment. Thus, the position of including capitalized
11 amounts in rate base relating to the ice storm restoration and expensing those costs that are
12 not considered capitalized in nature is consistent with denying rate base treatment for the
13 unamortized balance of the AAO.

14 It is important to note that the AAO unamortized balance consists of only
15 extraordinary maintenance expenses, not expenditures that were capitalized. To include the
16 unamortized balance of the AAO in rate base would inappropriately allow expense items to
17 receive the same treatment of capitalized expenditures.

18 Q. Please continue.

19 A. Mr. Williams' third contention on how the Company shareholders will not be
20 made totally whole under his proposed rate base treatment can be found on page 10, line 9 of
21 his rebuttal testimony. There, Mr. Williams states that the Company has gone nearly two
22 years after the effects of the ice storm without an increase in rates. However, in
23 recommending an AAO for MPS's ice storm costs, it was not the Staff's intent to cure

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1 regulatory lag. Rather, the AAO is intended as a vehicle to give some rate recognition to
2 these extraordinary costs. As previously mentioned, AAOs are often used to “defer” on the
3 utility’s balance sheet a cost that would otherwise be charged to expense currently on the
4 utility’s income statement. It is totally up to the Company’s discretion as when to file a rate
5 case. Therefore, it is totally up to the Company when costs from an AAO amortization can
6 be included in rates.

7 Q. Please summarize the reasons for the Staff’s position of not including the
8 unamortized portion of the ice storm AAO in rate base.

9 A. AAO recovery for extraordinary events allows the return of expended dollars
10 that the Company incurred to restore the utility system back to service. By not allowing the
11 unamortized balance in rate base for these expenditures, the Company is not provided a
12 return on the costs, or in other words is not allowed a carrying charge for those costs. By
13 allowing rate base treatment of the unamortized balance of the ice storm AAO the Company
14 is provided recovery of the actual expenses incurred to restore the utility system, but is
15 denied recovery of carrying costs. In essence, this treatment allows a sharing of costs
16 between the ratepayers and the Company.

17 Q. Mr. Williams states at page 14, line 12 that “all of the data requests mentioned
18 in Ms. Miller’s direct testimony were answered and received by Staff prior to filing its direct
19 testimony on December 9, 2003.” Is additional information still needed by the Staff to
20 further analyze the recovery of the costs associated with the ice storm AAO?

21 A. No. Certain data requests pertaining to the ice storm were received four days
22 prior to filing. Due to internal deadlines for the direct filing, there was not sufficient time to
23 analyze and verify all of the information provided in Staff Data Request Nos. 544 and 564

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1 prior to the filing of my direct testimony. Since the direct filing, the Staff has been able to
2 determine the level of Company's normal operating costs based on the responses to these
3 data requests. The Staff is now satisfied with the supporting documentation and is in
4 agreement with the Company's quantification of the level of incremental expenses caused by
5 the ice storm that are reflected in the ice storm AAO deferral.

6 **THE SIBLEY REBUILD PROJECT AAO AND THE SIBLEY WESTERN COAL**
7 **CONVERSION AAO**

8 Q. What is the past history of rate base treatment for the Sibley rebuild project
9 AAO and the Sibley western coal conversion AAO deferrals for MPS?

10 A. The Commission has consistently allowed MPS both a return "of" and return
11 "on" the MPS Sibley rebuild project AAO and the MPS Sibley western coal conversion
12 project AAO. The unamortized balances of these deferrals have been given rate base
13 treatment in each of MPS' rate cases filed by the Company since the Commission first
14 authorized recovery of these deferrals in Case No. ER-90-101. The subsequent rate cases
15 were Case Nos. ER-93-37, ER-97-394 and ER-2001-672.

16 Q. Please describe OPC witness Robertson's position on the treatment of the
17 unamortized balances of the Sibley rebuild project and the Sibley western coal conversion
18 AAOs.

19 A. OPC is recommending that the unamortized balances of the Sibley rebuild
20 project AAO and the Sibley western coal conversion AAO be excluded from rate base.

21 Q. Does the Staff agree with OPC's position?

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1 A. No. The Staff's position in this case is to continue to include in rate base the
2 unamortized balances associated with the MPS Sibley rebuild project AAO and the MPS
3 Sibley western coal conversion AAO consistent with the original treatment authorized by the
4 Commission in 1990.

5 Q. Please state OPC's reasoning for excluding the unamortized balances
6 associated with the MPS Sibley rebuild project and the MPS Sibley western coal conversion.

7 A. Mr. Robertson states on page 9, line 15 of his rebuttal testimony that "the
8 cases Ms. Miller cites occurred early in the Commission's process of developing, or
9 adopting, what commonly became known as accounting authority orders. In later cases, the
10 Commission recognized that allowing a utility to earn a return on the deferred costs was not
11 an appropriate regulatory policy."

12 Q. Please describe the "later cases" Mr. Robertson is referring to above.

13 A. Mr. Robertson is referring to the Missouri Gas Energy (MGE) natural gas rate
14 case, No. GR-98-140. Prior to this case the Commission had allowed MGE as well as its
15 predecessor company Western Resources, Inc. (WRI), both a return "of" and return "on" its
16 Service Line Replacement Program (SLRP) deferrals in rates over 20 years. In the MGE
17 case, the Commission determined that rate base treatment of the unamortized balance of
18 SLRP deferrals was no longer appropriate, since it was accelerating the amortization period
19 from the original 20-year period to 10 years. The Commission stated in its Report and Order,
20 at page 20: "Given that the Company will recover the amortized amount of the SLRP
21 deferral at the AFUDC rate in ten years, instead of the previous 20 years' amortization
22 period, it is proper for the ratepayers and shareholders to share the effect of regulatory lag by

1 allowing the Company to earn a return of the SLRP deferred balance but not a return on the
2 SLRP deferred balance.”

3 Q. Did the Company (MGE) propose less than a 20-year amortization period in
4 Case No. GR-98-140?

5 A. Yes. MGE proposed a ten-year amortization period for the SLRP deferrals.
6 In the previous MGE rate case, Case No. GR-96-285, MGE proposed a three-year
7 amortization period for the unrecovered amortization relating to the SLRP deferrals.

8 Q. Is MPS proposing a different amortization period than ordered in prior rate
9 cases for the Sibley rebuild project AAO and the Sibley western coal conversion AAO?

10 A. No. The Company is proposing the same amortization period of twenty years
11 for the Sibley rebuild project AAO and the Sibley western coal conversion AAO as first
12 determined in MPS’ rate case, Case No. ER-90-101, and then continued in subsequent rate
13 cases.

14 Q. Please summarize the Staff’s position relating to OPC’s regarding rate base
15 treatment for the Sibley rebuild project AAO and the Sibley western coal conversion AAO.

16 A. Staff is proposing the traditional amortization period and rate base treatment
17 for the unamortized balances as set in past MPS and L&P proceedings before the
18 Commission. By this time, the Sibley rebuild project AAO and the Sibley western coal
19 conversion AAO have both been amortized over more than half of their designated
20 amortization period of 20 years. In the case of the Sibley rebuild project AAO, the deferral
21 has been amortized for almost 14 years, with six years remaining. In the case of the Sibley
22 western coal conversion AAO, recovery in rates started in mid 1993. Therefore, over 10
23 years of rate recovery have occurred to this point with another 10 years remaining. These

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1 projects represent major capital additions to plant in service, as opposed to extraordinary
2 maintenance expenditures resulting from an extraordinary occurrence such as the ice storm.

3 Q. Does the Staff agree with OPC's position that the unamortized balance of the
4 ice storm AAO should not be included in rate base?

5 A. Yes, for the reasons previously discussed.

6 Q. Please describe the Staff's reasoning for denying rate base treatment to the
7 unamortized balance of the ice storm AAO, but allowing rate base treatment for the
8 unamortized balances of the Sibley Rebuild Project AAO and the Sibley western coal
9 conversion AAO.

10 A. The amounts included in the ice storm AAO were considered extraordinary
11 repair and maintenance expenditures. These extraordinary costs were incurred to restore
12 service under emergency conditions to normal operating conditions. In contrast, the amounts
13 included in the Sibley rebuild project AAO and the Sibley western coal conversion AAO
14 were costs associated with the capital expenditures made to extend the life of three
15 generating units and resulted in closer compliance with the Clean Air Act standards.

16 Q. Did the Staff originally oppose the AAOs relating to the Sibley rebuild
17 program and the Sibley western coal conversion?

18 A. Yes. A review of the Report and Order in Case No. ER-90-101 indicates that
19 the Staff opposed the AAO treatment for the Sibley projects. However, in recognition of the
20 possibility that the Commission might authorize rate treatment for the AAO's, the Staff
21 identified the process that should be used to quantify any such recovery. This quantification
22 method related to what is referred to as "construction accounting." This treatment was
23 identified in detail in Case No. ER-90-101 to ensure that proper accounting and ratemaking

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1 processes would be used should the Commission approve the AAO recovery, as MPS was
2 advocating in that case.

3 Q. What is “construction” accounting?

4 A. The USOA has a prescribed method for accounting for construction
5 expenditures while a plant item is being built or constructed. The USOA accounts used for
6 construction accounting are described below, in the order that the expenditures are accounted
7 for, as the expenditures are ultimately booked into plant in service:

8 Q. What is Construction Work In Progress (CWIP)?

9 A. These are amounts booked into Account 107 Construction Work In Progress
10 Electric. This account includes all direct material, indirect materials, direct labor, indirect
11 labor and property taxes associated with all items in construction, and etc. As a project is
12 completed, placed in service and therefore used and useful, the amount of materials, labor,
13 property taxes and etc. associated with the construction project are transferred into
14 Account 101, Electric Plant in Service. Any expenditure associated with a project that has
15 not been completed will remain in Account 107 until the project is completed. It is not
16 uncommon for a company of MPS’s size to continuously have a balance in Account 107
17 since construction projects are being started and completed on a continuous basis.

18 Q. What costs are booked in the Plant in Service Account?

19 A. Account 101, Electric Plant in Service, reflects the capitalized cost of all plant
20 owned by the utility that is used and useful at original cost, per the costs transferred from
21 Account 107 associated with the construction project that produced the plant in service.
22 When costs are transferred into this account, depreciation expense begins to be accrued on
23 the asset.

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1 Q. Please give the USOA definitions for Account 101, Electric Plant in Service
2 and Account 107, Construction Work in Progress-Electric.

3 A. Account 101 Electric Plant in Service is defined by the USOA as:

4 This account shall include the original cost of electric plant, included
5 in accounts 301 to 399, prescribed herein, owned and used by the
6 utility in its electric utility operations, and having an expectation of life
7 in service of more than one year from date of installation, including
8 such property owned by the utility but held by nominees.

9 A. Account 107 Construction Work in Progress--Electric is defined by USOA as:

10 This account shall include the total of the balances of work orders for
11 electric plant in process of construction.

12 Work orders shall be cleared from this account as soon as practicable
13 after completion of the job.

14 Q. Please describe the ratemaking issue that developed with the Sibley rebuild
15 project and the Sibley western coal conversion.

16 A. As described above, when these projects were completed, the costs were
17 transferred from the construction work in progress account to the plant in service account as
18 required by the USOA, and depreciation expense began to incur on the assets when these
19 assets went into service. MPS incurred this expense and carrying costs related to the project
20 without the expenses being reflected in rates. The costs associated with the plant in service
21 began to "hit" the income statement without corresponding revenues. Therefore, MPS
22 sought to protect its earnings level after these projects went into service through the AAO
23 mechanism. The Commission ruled in Case No. ER-90-101 that it was appropriate to allow a
24 deferral and later recovery of the carrying costs, depreciation and property taxes relating to
25 the interim period of time between when the plant investment is completed and placed in
26 service and when that plant is reflected in rates. The Commission eased the gap of time

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1 between when construction was completed and then placed in service, to when the Company
2 was allowed to recover the plant costs in rates.

3 Q. How were these costs treated in Case No. ER-90-101?

4 A. The depreciation, property taxes and return component related to these
5 completed projects formed the basis for the deferral that the Commission decided to amortize
6 over a 20-year period.

7 Q. Did the Commission deviate from the USOA accounting in allowing these
8 deferrals?

9 A. Yes. USOA accounting does not allow for these types of costs to be
10 capitalized after construction is completed, thus the need for AAO accounting treatment to
11 allow the deferral. The reasoning for the Commission's decision to deviate from the USOA
12 is stated below as taken from the Report and Order, in Case No. ER-90-101:

13 The final matter to be addressed on this issue involves the length of
14 time over which these deferred rates should be amortized and whether
15 the unamortized portion of these costs should be reflected in rate base.
16 Staff/Public Counsel contend that, if these costs are to be reflected in
17 rates, they should be amortized over 20 years, the extended life of the
18 Sibley Generating Station with the unamortized costs not reflected in
19 rate base. Staff/Public Counsel support this viewpoint by stating that
20 the Commission has afforded such costs this treatment in prior similar
21 instances.

22 Company contends that these costs should be amortized over a three-
23 year period which is the approximate length of time for completing
24 these projects. Company believes this approach would match the
25 recovery of costs with the enjoyment of benefits arising from these
26 projects. Company maintains that the unamortized portion of these
27 costs should be included in rate base in order that Company may be
28 compensated for the value of the money for the time occurring
29 between the spending of the funds and their ultimate recovery.

30 The Commission determines that these costs should be amortized over
31 20 years which is the approximate extended life of the plant. The
32 Commission finds that this approach matches the payments of the
33 costs by the ratepayers for the rebuilding with their enjoyment of its
34 benefits. The Commission further determines that the unamortized

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1 costs should be reflected in rate base. This is the usual practice when
2 capital costs are amortized. The cases cited by Staff/Public Counsel
3 deal with extraordinary maintenance costs and therefore, are not
4 applicable.

5 **L&P AM/FM AAO**

6 Q. What is OPC witness Robertson's position on the L&P AM/FM AAO?

7 A. OPC opposes both the amortization and rate base treatment of the
8 unamortized balances for this item. This is based on OPC's argument as stated on page 13,
9 line 9 of Ted Robertson's rebuttal testimony: "the unamortized deferred balance, as identified
10 by the utility, is nearing zero."

11 Q. Please describe why Staff disagrees with OPC witness Robertson's position
12 on the L&P AM/FM AAO.

13 A. The Staff maintains its position, based on traditional ratemaking principles, to
14 allow an amortization to expense and rate base treatment of the unamortized balance of the
15 L&P AM/FM AAO. OPC's position violates principles of good ratemaking.

16 Q. Please describe the principles of ratemaking that OPC is violating in their
17 argument to exclude the unamortized balance and amortization for the L&P AM/FM AAO
18 from rates.

19 A. OPC is violating the ratemaking principles of "test year" and "matching."
20 The test year is a 12-month period, which is used as the basis for the audit of any filing or
21 complaint case. The test year is the time period that is used to evaluate and determine the
22 proper relationship between revenue, expense and investment. The test year in this case is
23 the calendar year 2002, updated for known and measurable events through September 30,

1 2003. The final month of amortization for the L&P AM/FM system is October 2004. This
2 date clearly falls outside of the update period, September 30, 2003.

3 The matching principle maintains the proper revenue-expense-rate base match at a
4 point in time. The Commission has stressed the importance of maintaining proper balance
5 between the costs of service items in this case by stating on page 2 of the Suspension Order
6 and Notice issued July 22, 2003, that “[t]he Commission will not consider a true-up of
7 isolated adjustments, but will examine only a “package” of adjustments designed to maintain
8 proper revenue-expense-rate base match at a proper pointing [sic] in time.” OPC’s
9 adjustment would produce a result that is not consistent with the revenue-expense-rate base
10 match.

11 Q. Please summarize the Staff’s position on the inclusion of the unamortized
12 AAO balance in rate base and the associated test year amortization.

13 A. The Staff is consistently applying the principles of ratemaking, whether it
14 should produce a negative or positive revenue requirement. OPC’s position would result in
15 possible consideration of all revenue-expense-rate base items that are “known and
16 measurable” outside of the test year and update period.

17 **PROPERTY TAXES**

18 Q. Does the Staff agree with Mr. Williams’ rebuttal testimony on page 23 where
19 he describes his understanding of the Staff’s adjustment to annualize property tax expense?

20 A. No. The Staff examined property tax payments made in 2000, 2001 and 2002
21 to determine the trend in property taxes paid. The Staff determined that property taxes paid
22 over the three-year period had decreased from year to year. The Staff calculated the

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1 adjustment by developing a property tax rate to be applied to total electric plant in service as
2 of December 31, 2002. The Staff developed the property tax rate by dividing the amount of
3 total company (MPS and L&P) property taxes paid in 2002 by the total property as of
4 December 31, 2001. This property tax rate was then applied to total plant in service at
5 December 31, 2002, to arrive at annualized property taxes. From this amount, the amount of
6 property taxes charged to construction (capitalized) was deducted to arrive at annualized
7 property tax expense. The annualized property tax expense was then subtracted from test
8 year property tax expense to arrive at the adjustment.

9 Q. At page 23 of Mr. Williams' testimony, he indicated that the Company
10 disagrees with the Staff's amount of property tax expense included in the test year audit. Do
11 you agree with Mr. Williams' criticism that the Staff's property tax annualization ignores
12 property that was placed in service during the test year update, January 1 through
13 September 30, 2003?

14 A. No. As stated earlier, the Staff calculated property taxes based upon the
15 actual property tax payments at December 31, 2002, the end of the Staff's test year. This
16 payment of tax is based on the value of the property owned as of December 31, 2001, which
17 is the date property is assessed for taxing purposes. The relationship reflects how tax
18 payments are actually determined by the taxing authorities.

19 Q. Why is the December 31/January 1 (January 1) assessment date important?

20 A. The state and local taxing authorities use January 1 as the assessment date to
21 determine the appraised value of the property, which forms the basis of the property tax
22 liability owed the state and political subdivisions for the calendar year. Any plant additions
23 or property that are completed and booked to plant in service during the period of January 2

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1 through December 31 of any given calendar year will not be assessed for property tax
2 purposes until January 1 of the following year. In essence, the property tax liability
3 associated with this plant is not due to the state and local taxing authorities until November-
4 December of the subsequent year. Thus, unless the property was in-service on January 1, the
5 taxes will not be owed until November-December of the following year.

6 As an example, any plant additions that MPS or L&P added to its plant in service on
7 January 2, 2003, will not be assessed by the taxing authorities until January 1, 2004; the taxes
8 will not be billed until November-December of the following year; and the taxes will not
9 actually be paid until December 31, 2004.

10 Q. Mr. Williams states at page 24, lines 12 through 14 of his rebuttal testimony
11 “Using Staff’s calculation methodology, Aquila is being denied recovery of property tax
12 expense amounts associated with property that was placed in service during the known and
13 measurable time frame.” Does the Staff agree?

14 A. No. Mr. Williams is attempting to persuade the Commission that the Staff’s
15 calculation of property taxes is in some way mismatched with the Staff’s other
16 normalizations and annualizations throughout the rest of its case. The Staff has calculated
17 the property tax annualization based upon how the taxing authorities assess and how Aquila
18 ultimately pays these taxes. Because of the unique nature of how property taxes are
19 determined and ultimately paid, the typical normalization and annualization process used by
20 both the Company and the Staff for other expense items is not appropriate for property tax
21 expense.

22 The previous example of plant additions included in plant in service on January 2,
23 2003, is an illustration of the unique nature of property taxes. Unlike a payroll or revenue

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1 annualization, which the Staff attempts to include through an end of the test year, the end of
2 an update to the test year period, or the end of a true-up period, the January 2, 2003, plant in
3 service balances will not be included in the Company's booked property tax expenses until
4 January 2004. Indeed, Aquila will not accrue a property tax expense for any of the plant
5 additions through the end of the update period of September 30, 2003, until January of 2004.
6 This accrual will only be an estimate because the Company will not know the actual amount
7 of property tax payments until late in 2004, when the taxing authorities distribute the tax
8 bills, usually in November or December of that year. The property tax amounts will not
9 actually be paid until December 31, 2004, the due date for property taxes.

10 Q. Does the Staff's method of determining property taxes include plant
11 investments as of September 30, 2003?

12 A. Yes. To the extent that plant investment was in service as of January 1 of
13 2003, these plant dollars would be assessed and paid for by the end of the year 2003.
14 Aquila's proposed calculation for property taxes includes all plant additions from the
15 beginning of the year through September 30, 2003.

16 Q. When would Aquila have to pay the property taxes on the September 30,
17 2003, plant additions that Mr. Williams is proposing in rates?

18 A. The plant additions that occurred through September 30, 2003, will not be
19 assessed until January 1, 2004, and not be paid by the Company until December 31, 2004, a
20 full 15 months past the update period in this case. In fact, these property taxes will not be
21 paid by Aquila until six months past the operation-of-law date for this case of June 2004.

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1 Q. Has the Commission recognized the importance of maintaining the proper
2 relationship between revenues, expenses and rate base in this rate proceeding and previous
3 rate proceedings?

4 A. Yes. In the Suspension Order and Notice the Commission stated: “The
5 Commission will not consider a true-up of isolated adjustments, but will examine only a
6 “package” of adjustments designed to maintain the proper revenue-expense-rate base match
7 at a proper pointing [sic] in time.” Similar language has been used in many other rate
8 proceedings before the Commission.

9 Q. Would it be appropriate to include an accrual/estimate of property taxes to be
10 paid in 2004 in this rate case?

11 A. No. The Staff is considering no other expense item for inclusion in this case
12 anytime in 2004. It is important to note that the property taxes that Aquila paid on or about
13 December 31, 2002, represents the level of plant at January 1, 2002, which is the exact time
14 period which the Staff used to calculate its property tax annualization in this case.

15 Q. Does Aquila’s proposal to include a level of property tax expense based upon
16 plant in service as of September 30, 2003, violate the test year concept?

17 A. Yes. Aquila’s proposed level of property tax expense violates the test year
18 and the test year update periods in this case. This proposal is not consistent with a complete
19 “package” of adjustments that appropriately reflects a consistent revenue-expense-rate base
20 relationship at a point in time. Mr. Williams has only considered one item of expense out to
21 late 2004 with his proposed property tax treatment, while not considering other items such as
22 additional revenues from customer growth during 2004, property insurance, plant additions
23 and retirements, depreciation reserve and possibly other items to the same point in time.

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1 Q. Why is it important to maintain the proper relationship of the individual
2 components that make up the revenue requirement?

3 A. It is very important that all elements of the revenue requirement be considered
4 at a consistent point in time because events occur that result in constant changes in revenues,
5 expenses and rate base that cause changes to the overall revenue requirements. Reflecting
6 changes for only one element of the revenue requirement, in this case property taxes, without
7 consideration of other offsetting changes in other revenue requirement components, will
8 likely lead to setting a distorted level of rates.

9 Q. Is the Company's proposed level of property tax expense "known and
10 measurable?"

11 A. No. Aquila's proposed level of property tax expense is not a known and
12 measurable expense, which can or should be included in the cost of service in this
13 proceeding.

14 Q. Please define the term "known and measurable."

15 A. A "known and measurable" expense is an expense that is 1) "known,"
16 meaning that the amount is certain to occur, did or definitely will be an actually incurred cost
17 and 2) "measurable," meaning that the rate impact of the change (for example, property tax
18 expense) can be calculated with a high degree of accuracy. The significance of this term is
19 that historically the Commission has only reflected in rates the revenue requirement changes
20 that were known and measurable at the time the rate decision was made. Therefore, property
21 taxes associated with the September 30, 2003, plant balance are not "known and measurable"
22 until 2004. The January 1, 2004, assessment date is outside the test year and does not
23 constitute a proper or appropriate inclusion into the cost of service in this case.

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1 Q. If the Company does not “know” what the actual amounts of property tax
2 expense will be until late in a given year, how does Aquila determine the level which it books
3 to expense on a monthly basis?

4 A. Each year the Company will attempt to estimate the appropriate expense level
5 it believes will be incurred in that given year. It may change its estimate from time to time
6 during the course of the year but, ultimately, when the actual property tax payment amount
7 becomes known, Aquila must book a “true up” amount to make the actual property tax
8 payment equal the level recorded for the year on its books and records. These “true up”
9 amounts are generally booked late in the year, usually in November or December. The actual
10 amounts of property taxes associated with the September 30, 2003, plant levels (as well as
11 any level of property tax on plant in service levels during 2003) will be estimated and booked
12 as an expense beginning in January 2004 and will not actually be known until November-
13 December of that year. The property tax “true-up” adjustment to correct the earlier property
14 tax estimates will not be until late in 2004, as it relates to 2003 additions. Thus, Aquila’s
15 proposal regarding property taxes in this case would result in a mismatch of the relationship
16 between revenue, expense, and rate base.

17 Q. Is there a difference between the amounts charged to expense for property
18 taxes for any given year and the property tax payments for that year?

19 A. Property taxes assessed on plant in service are expensed. Property taxes are
20 also assessed on Aquila’s construction activities. The amount of property taxes associated
21 with construction work in process (CWIP) is capitalized. The property taxes expensed are
22 different than the total payment amounts because of the portion that is capitalized on the

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1 utilities books. In other words, the amount of property taxes expensed will be lower than the
2 total property taxes paid because of the capitalized portion of property taxes.

3 Q. Did the Staff include property taxes on construction in its case?

4 A. No. Property taxes relating to construction that is assessed on January 1 of
5 any given year is capitalized to construction and captured in the CWIP account or
6 Account 107. The only portion of property taxes that should be included in expense are
7 those property taxes relating to the plant in service balance through the January 1 date, not
8 the plant additions made through September 30, 2003, that will be assessed on January 1,
9 2004.

10 Q. On page 24, lines 1 through 3 of Mr. Williams' rebuttal testimony, he
11 describes how the Company calculated the level of property tax expense that they propose.
12 Do you agree with this calculation?

13 A. I agree that the mathematics are correct, but that calculation is not based on
14 how property taxes are actually assessed. The December 31, 2002, or January 1, 2003, plant
15 balances are used to assess the property, not the September 30, 2003, plant balances. The
16 September 30, 2003, plant balances will never be used for assessment purposes since that is
17 not how the taxing authorities assess for property taxes. The September 30, 2003, balances
18 will be included in the January 1, 2004, balances for assessment purposes. The property tax
19 amount will not be known until approximately November or December 2004 and the
20 payment will not be actually due until December 31, 2004.

21 Q. Has this issue, or a similar issue, previously been tried before the
22 Commission?

1 A. Yes, several times. Recently in Case No. ER-2001-299, the Empire District
2 Electric Company (Empire) proposed a property tax balance of June 30, 2001, in the
3 Company's property tax adjustment calculation, very similar to Aquila's request for
4 September 30, 2003, levels in this case. The June 30, 2001, date was associated with the
5 true-up period of the rate case to include Empire's State Line Combined Cycle Unit in rates.
6 The Commission stated in the Report and Order at page 22:

7 The Commission finds that the arguments of Staff and Praxair
8 regarding the property tax issue are persuasive. Staff's estimate of
9 property taxes is based upon known and measurable factors and
10 preserves appropriate matching of all revenue requirements, and is
11 consistent with the Commission's past practice. Empire's position is
12 not based upon known and measurable factors. In addition, it would
13 be unreasonable for the Company to start charging ratepayers in
14 October 2001 for (estimated) costs that the Company will not start
15 paying until January 2002. The Commission determines that it will
16 not increase the total company revenue requirement to account for
17 property taxes on the additional plant in service.

18 Also, in Case No. GR-96-285, Missouri Gas Energy (MGE) contended that the most
19 current known and measurable plant balances should be used to calculate an ongoing level of
20 property tax expense. Thus, MGE used a May 30, 1996, plant balance in the annualization
21 of property tax expense. The Staff's position was that the last actual property tax assessment
22 should be used to determine property taxes for revenue requirement purposes. The
23 Commission found in favor of the Staff's position on this issue. The Commission stated in
24 its ruling that:

25 MGE will not accrue a property tax expense for any of the plant
26 additions through May 31, 1996 identified in the Rebuttal Testimony
27 of Mr. Kelly until January of 1997. This accrual will only be an
28 estimate for which the Company will not know the actual amount of
29 property tax payments until late in 1997, when the tax bills are
30 distributed by the taxing authorities, usually in November or
31 December of that year. (Ex. 73, p.4)

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1 The Commission finds that MGE's proposal would require waiting
2 until the end of 1997 to account for an item of expense for inclusion in
3 this case because this would be a violation of the test year, updated test
4 year or true-up concepts. Staff's recommendation will be adopted.

5 In Case No. WR-2000-844, St. Louis County Water Company also argued that its
6 property tax expenses should be based on the level of plant in service to be reflected in rates.

7 The Commission in that case ruled:

8 The Commission traditionally, and properly, allows recovery of cost
9 increases that are projected to occur after the end of the test year
10 (including any adjustment periods) only if those costs are known and
11 measurable. A cost increase is "known" if it is certain to occur, and it
12 is "measurable" if the Commission is able to determine the amount of
13 the increase with reasonable precision. The Company's projected
14 property tax increases are neither known nor measurable. While it is
15 probable that the Company will experience an increase in property tax
16 expense at the end of the year, it is by no means certain. Even more
17 damaging to the Company's proposal is the fact that its best estimate
18 of the amount of any increase is based on an assumption that finds no
19 support in the record. Company's proposed property tax calculation
20 assumes that the tax rates for 2000 will be the same as the tax rates for
21 1999. Because any increase the Company's property tax expense is
22 not known and measurable, the Commission will not adopt the
23 Company's proposal. Staff's proposal to use a known amount (the last
24 amount actually paid), while probably not a perfectly accurate
25 representation of the property taxes that will be paid in the future, at
26 least avoids the speculation inherent in Company's proposal.

27 Q. Does this conclude your surrebuttal testimony?

28 A. Yes, it does.