

Exhibit No.:

Issues: Payroll,
401k,
Misc. Payroll,
ESOP,
Restructuring,
Incentives &
Payroll Tax

Witness: Ronald A. Klote

Sponsoring Party: Aquila Networks-MPS
[REDACTED]

Case No.: ER-2004-0034 &
[REDACTED]
[REDACTED]

Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

Ronald A. Klote

**TABLE OF CONTENTS OF
REBUTTAL TESTIMONY OF
RONALD A. KLOTE
AQUILA, INC. D/B/A AQUILA NETWORKS-MPS
[REDACTED]
CASE NOS. ER-2004-0034 [REDACTED]
[REDACTED]**

PAYROLL EXPENSE.....2

401K BENEFITS MATCHING EXPENSE.....5

ESOP (PROFIT SHARING PLAN) CONTRIBUTION EXPENSE.....7

PAYROLL TAX EXPENSE ADJUSTMENT.....8

RESTRUCTURING (SEVERANCE) ADJUSTMENT.....10

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
REBUTTAL TESTIMONY OF RONALD A. KLOTE
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS [REDACTED]
CASE NOS. ER-2004-0034 [REDACTED]**

1 Q. Please state your name and business address.

2 A. My name is Ronald A. Klotte and my business address is 10700 East 350 Highway,
3 Kansas City, Missouri.

4 Q. Are you the same Ronald A. Klotte who sponsored direct testimony in this proceeding
5 before the Missouri Public Service Commission (“Commission”) on behalf of Aquila,
6 Inc. (“Aquila” or “Company”)?

7 A. Yes

8 Q. What is the purpose of your rebuttal testimony?

9 A. The purpose of my rebuttal testimony is to respond to various direct testimony and
10 calculations completed by witnesses for the Commission Staff (“Staff”) and the Office of
11 Public Counsel (“OPC”). The following issues will be discussed in my rebuttal:

- 12 • Payroll Expense
- 13 • 401K Benefits Matching Expense
- 14 • ESOP (Profit Sharing Plan) Contribution Expense
- 15 • Payroll Tax Expense
- 16 • Restructuring (Severance) Costs

Payroll Expense

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Q. Please explain the payroll annualization method used by Staff witness Dana Eaves to compute ongoing salary and wage levels for Aquila Networks-MPS [REDACTED]

[REDACTED]

A. The payroll annualization method employed by Staff witness Dana Eaves is identical to Aquila's payroll annualization method except for two differences. The method consistent between Aquila and Staff included obtaining current headcount and annualized standard earnings by department as of September 30, 2003. In addition, other than standard earnings for the 12 months ended September 30, 2003 (consisting mainly of overtime pay) was added to the annualized standard earnings level to arrive at total salary and wages by department. Each department's annual salary and wages were directly assigned or allocated to MPS [REDACTED] divisions based on the August 2003 ESF and IBU allocation method.

Q. Please identify the two differences between Aquila's method and Staff's method referred to above.

A. Staff witness Dana Eaves made the following two changes in computing the payroll annualization levels for MPS [REDACTED]. First, he did not include the 3% union increase for MPS union employees that is effective April 1, 2004. Secondly, he adopted Staff witness Charles Hyneman's corporate restructuring operations adjustment (p. 27 of witness Hyneman's testimony). This adjustment entailed eliminating an arbitrary percent of the payroll costs from certain corporate departments deemed to be related to corporate restructuring activities. The departments and percentage of time eliminated is as follows:

- Dept 4035 CFO 75% Elimination

- 1 • Dept 4040 Chairman and CEO 75% Elimination
- 2 • Dept 4030 Chief Operating Officer 50% Elimination
- 3 • Dept 4031 General Counsel 50% Elimination
- 4 • Dept 4043 Board of Directors Management 50% Elimination
- 5 • Dept 4183 Corporate Financial Reporting 25% Elimination
- 6 • Dept 4194 Tax Income Team 25% Elimination
- 7 • Dept 6131 Global Networks Group Financial Mgmt 25% Elimination
- 8 Q. Did OPC Witness James Dittmer include a similar adjustment eliminating certain
- 9 corporate payroll and nonpayroll costs associated with restructuring activities?
- 10 A. Yes. OPC witness Dittmer included the arbitrary elimination of 50% of all costs of
- 11 certain corporate departments. However, Mr. Dittmer simply based his adjustment on per
- 12 books amounts recorded during the test year. This can be distinguished from Staff
- 13 witness Hyneman's adjustment which was based on the annualized levels of payroll,
- 14 payroll taxes and benefit amounts.
- 15 Q. Who will address the corporate restructuring operations adjustments proposed by Staff
- 16 witness Hyneman and OPC witness Dittmer described above?
- 17 A. Aquila witness Jon Empson will discuss the corporate restructuring operations adjustment
- 18 in his rebuttal testimony.
- 19 Q. Please explain the reasons provided why Staff witness Dana Eaves did not include the 3%
- 20 MPS union increase.
- 21 A. Staff witness Dana Eaves' direct testimony did not include any explanation on why the
- 22 3% MPS union increase was not included in the payroll annualization method. He simply

1 states that his payroll expense adjustment includes actual employees and their authorized
2 wage levels as of September 30, 2003.

3 Q. Please explain why the Commission should include the 3% MPS union increase effective
4 April 1, 2004 in the payroll annualization expense.

5 A. The MPS union increase is a known and measurable amount which will become effective
6 before the expected decision date of this case in June 2004. Union pay increases are
7 known and measurable amounts included in the MPS union contract titled Working
8 Agreement, Aquila, Inc. dba Missouri Public Service, IBEW Local Union No. 814,
9 October 1, 2002 through March 31, 2005 which was ratified and signed by the union on
10 July 12, 2003. By including the 3% wage increase that will be in effect before the
11 expected decision date of this case, the impacts of regulatory lag can be minimized. As
12 Staff witness Charles Hyneman's states in his testimony on page 24 "..(regulatory lag) is
13 created by the delays inherent in the ratemaking process." Aquila believes that every
14 effort should be made to eliminate or significantly reduce regulatory lag in rate case
15 proceedings. The inclusion of a known and measurable amount two months prior to the
16 expected decision in this rate case proceeding accomplishes this goal.

17 Q. Has the Staff historically recommended including historical pay increases outside the
18 known and measurable update period?

19 A. Yes. In the last MPS rate case, Case No. ER-2001-672, Staff used a test year ending
20 December 31, 2000 with known and measurable changes through June 30, 2001. In
21 direct testimony in Case No. ER-2001-672, Staff witness Graham Vesely describes, on
22 page 3 of his testimony, that a union pay increase of two percent effective October 1,
23 2001 and an estimated pay increase of 3.98% for ESF departments effective January 1,

1 2002 were included in the payroll annualization amounts. Both of these recommended
2 wage increases were outside the known and measurable period in the case.

3 Q. Did the previous MPS rate case, Case No. ER-2001-672, include a true-up?

4 A. Yes. The Commission ordered a true-up through January 31, 2002.

5 Q. Does the fact a true-up has not been requested in this rate case proceeding change your
6 view of including the 3% MPS union payroll increase in the payroll expense
7 annualization?

8 A. No. Once again Aquila is simply attempting to reduce the regulatory lag in this case for a
9 known and measurable item identified at September 30, 2003, which will be in effect
10 before the expected issuance of a decision in this rate case proceeding.

11 Q. What is the dollar impact of excluding the 3% MPS union payroll increase to the payroll
12 expense annualization?

13 A. The dollar amount associated with excluding the 3% MPS union payroll increase
14 effective April 1, 2004 from the MPS cost of service filing is \$370,873.

15 Q. What is the dollar impact of the adjustment proposed by Staff to eliminate a certain
16 percent of corporate department payroll costs attributable to restructuring activities?

17 A. The dollar amount eliminated by Staff's corporate department restructuring adjustment
18 totals \$550,769 for MPS electric cost of service filing and \$180,662 for L&P electric cost
19 of service filing.

20 **401k Benefits Matching Expense**

21 Q. Please explain your understanding of the method used by staff witness Dana Eaves to
22 compute an annualized level of 401k benefits matching expense.

1 A. Staff witness Dana Eaves agreed with Aquila's method in computing the annualized level
2 of 401k benefits matching expense. This method included obtaining annualized payroll
3 expense and applying the percentage of base pay being matched by Aquila during the test
4 year. The resulting amount is the annualized level of 401k benefits matching expense.

5 Q. Are the Staff and Aquila adjustments for 401k benefits matching expense different?

6 A. Yes.

7 Q. Why is this so if the methods are the same?

8 A. The difference between Aquila and Staff's 401k benefits matching expenses is the result
9 of Staff adjusting the annualized payroll expense amounts as discussed earlier in my
10 testimony. Staff's 401k expense amount has been lowered as a result of its payroll
11 annualization adjustments.

12 Q. Does Aquila believe that its payroll annualization amounts should be used in the
13 calculation of 401k benefits matching expense calculation?

14 A. Yes. As discussed in my testimony above and as discussed in the rebuttal testimony of
15 Aquila witness Jon Empson, the payroll expense annualized levels as computed by
16 Aquila are reflective of ongoing cost levels. As such, this amount should be used to
17 compute the 401k benefits matching expense adjustment.

18 Q. If the Commission adopts Aquila's payroll annualization expense please quantify the
19 amount of 401k benefits matching expense adjustment that should be made to Staff's
20 calculation for MPS [REDACTED].

21 A. The total difference between Aquila's and Staff's 401K expense adjustment for MPS
22 electric operations is \$36,108. \$18,290 of this adjustment is due to the exclusion of the
23 MPS union contract increase beginning April 1, 2004 in the payroll annualization

1 calculation. \$17,819 of this adjustment is associated with the elimination of certain
2 corporate department payroll amounts identified by Staff to be associated with
3 restructuring activities. [REDACTED]

4 [REDACTED]

5 [REDACTED]

6 [REDACTED]

7 **ESOP (Profit Sharing Plan) Contribution Expense**

8 Q. Please explain your understanding of the method used by Staff witness Dana Eaves to
9 compute an annualized level of ESOP (Profit Sharing Plan) contribution expense.

10 A. Staff witness Dana Eaves agreed with Aquila's method in computing the annualized level
11 of ESOP (Profit Sharing Plan) contribution expense. This method included obtaining
12 annualized payroll expense and applying the percentage of base pay being contributed by
13 Aquila during the test year. The resulting amount is the annualized level of ESOP (Profit
14 Sharing Plan) contribution expense. Staff's computed amount differs from Aquila's.

15 Q. Why are the adjustments for the ESOP (Profit Sharing Plan) contribution expense
16 different between Aquila and Staff if the methods are the same?

17 A. The difference between Aquila's and Staff's ESOP (Profit Sharing Plan) contribution
18 expenses is the result of Staff adjusting the annualized payroll expense amounts as
19 discussed earlier in my testimony. Staff's ESOP (Profit Sharing Plan) expense amount
20 has been lowered as a result of its payroll annualization adjustments.

21 Q. Does Aquila believe that its payroll annualization amounts should be used in the
22 calculation of ESOP (Profit Sharing Plan) contribution expense calculation?

1 A. Yes. As discussed in my testimony above and as discussed in the rebuttal testimony of
2 Aquila witness Jon Empson, we believe that the payroll expense annualized levels as
3 computed by Aquila are reflective of ongoing cost levels. As such, this amount should be
4 used to compute the ESOP (Profit Sharing Plan) contribution expense adjustment.

5 Q. If the Commission adopts Aquila's payroll annualization expense please quantify the
6 amount of ESOP (Profit Sharing Plan) contribution expense adjustment that should be
7 made to staff's calculation for MPS [REDACTED]

8 A. The total difference between Aquila's and Staff's ESOP (Profit Sharing Plan)
9 contribution expense adjustment for MPS electric operations is \$19,492. \$9,858 of this
10 adjustment amount is associated with the exclusion of the 3% increase in MPS union
11 contract wages. \$9,634 of this adjustment amount is associated with the elimination of
12 certain corporate departments identified by Staff to be associated with restructuring
13 activities. [REDACTED]

14 [REDACTED]
15 [REDACTED]
16 [REDACTED]

17 **Payroll Tax Expense Adjustment**

18 Q. Please explain your understanding of the method used by Staff witness Dana Eaves to
19 compute an annualized level of payroll tax expense.

20 A. Staff witness Dana Eaves annualized payroll tax expense by creating subtotals of
21 annualized payroll expense subject to the limits of social security tax ("FICA"), federal
22 unemployment tax ("FUTA"), state unemployment tax ("SUTA") and Medicare. The
23 appropriate tax rates were applied to each subtotal creating annualized payroll tax

1 expense for each tax classification. This method is similar to the method employed by
2 Aquila, yet performed at a more detailed individual level. The resulting amounts are
3 different.

4 Q. Why are the adjustments for payroll tax annualization expense different between Aquila
5 and Staff if the methods are similar?

6 A. The difference between Aquila's and Staff's payroll tax annualization expense is the
7 result of Staff adjusting the annualized payroll expense amounts as discussed earlier in
8 my testimony. Staff's payroll annualization amount has been lowered as a result of its
9 adjustments. In addition, other differences exist due to the summary approach used by
10 Aquila, as opposed to the detailed individual approach used by Staff.

11 Q. Does Aquila believe that its payroll annualization amounts should be used in the
12 calculation of payroll tax expense calculation?

13 A. Yes. As discussed in my testimony above and as discussed in the rebuttal testimony of
14 Aquila witness Jon Empson, we believe that the payroll expense annualized levels as
15 computed by Aquila are reflective of ongoing cost levels. As such, this amount should be
16 used to compute the payroll tax expense adjustment.

17 Q. If the Commission adopts Aquila's payroll annualization expense please quantify the
18 amount of payroll tax expense adjustment that should be made to Staff's calculation for
19 MPS [REDACTED]

20 A. The amount of payroll tax expense associated with the 3% MPS union contract exclusion
21 from the payroll annualization calculation is \$26,703. The amount of payroll tax expense
22 associated with the MPS electric operations exclusion of certain corporate departments
23 identified by staff to be associated with restructuring activities is \$39,655. [REDACTED]

1 [REDACTED]
2 [REDACTED]
3 [REDACTED]

4 Restructuring (Severance) Adjustment

5 Q. By way of background, please briefly summarize the restructuring (severance) adjustment
6 as presented by Aquila in direct testimony.

7 A. During the test year 2002, Aquila Networks implemented a restructuring plan to move
8 from a functional organization structure to a state-based structure providing utility
9 services in seven states. This restructuring initiative resulted in significant costs to
10 Aquila Networks divisions due to the termination of a portion of its workforce.
11 Severance charges were incurred as a result of this restructuring initiative. As a result,
12 Aquila requested in MPS [REDACTED] adjustment CS-10 in this rate case proceeding, to
13 amortize the restructuring costs over a period of three years to match the costs of the
14 restructuring effort with periods it will benefit.

15 Q. Please identify the direct testimony filed by Staff and OPC regarding restructuring costs
16 incurred by Aquila during the test period.

17 A. Staff witness Charles Hyneman (p. 23 of direct testimony) and OPC witness James
18 Dittmer (p. 6 of direct testimony) provide testimony associated with the restructuring
19 (severance) adjustment issue. Both parties state in their testimonies that restructuring
20 (severance) costs should be eliminated from MPS [REDACTED] rate case filings in this
21 proceeding.

22 Q. Please summarize your understanding of the points made by witness Hyneman and
23 witness Dittmer in their direct testimony.

1 A. Staff witness Hyneman provides the following reasons for not including restructuring
2 (severance) costs in the rate case filings in this proceeding:

- 3 • Staff has historically not included severance costs in rate case filings.
- 4 • Costs are not extraordinary in nature. Thus, not part of an AAO filing.
- 5 • Regulatory lag has benefited the Company since the termination date until the next
6 regulatory order.

7 OPC witness Dittmer provides the following reasons for not including restructuring
8 (severance) costs in the rate case filings:

- 9 • Restructuring costs are non-recurring.
- 10 • Regulatory lag has benefited the Company since the employee's termination date until
11 the next regulatory order.
- 12 • It is impossible for Aquila to quantify the amount of efforts during the
13 decentralization effort and right-sizing the Company.

14 Q. After reading the testimony of Staff witness Hyneman and OPC witness Dittmer has
15 Aquila changed its position on this issue?

16 A. No.

17 Q. Please explain why.

18 A. The restructuring initiative began, as stated in my previous direct testimony and the
19 previous direct testimony of Keith Stamm in this proceeding, in November 2001. It was
20 an effort to become a more focused and more efficient state based operation. In order to
21 accomplish this, Aquila needed to restructure its operations resulting in the termination of
22 employee positions. This came at a significant cost to the utility. Witness Hyneman
23 states in his testimony that the restructuring costs were non-recurring and not identified as

1 extraordinary in nature; thus, not part of an accounting authority order (“AAO”)
2 (Hyneman p. 24). I agree that these costs were non-recurring in nature, but in fact these
3 costs were significant and extraordinary to the utility due to the large number of
4 terminations associated with the restructuring. During the test year, MPS-electric
5 operations incurred severance related costs of approximately \$2.7 million. [REDACTED]
6 [REDACTED] As such, Aquila
7 did not seek deferral of these costs through an AAO, but instead proposed a 3 year
8 amortization included within the cost of service filing in this proceeding (the reasons for
9 this are provided later in my testimony). Whether Aquila mistakenly did not request an
10 AAO associated with these costs or included an amortization amount within this cost of
11 service filing should not be a reason to disallow recovery of these costs. Through this
12 rate case filing, the Commission can determine and provide the ruling on how these costs
13 should be treated for ratemaking purposes.

14 Q. Due to the significance of severance costs and their non-recurring characteristic why has
15 Aquila asked for recovery of these costs over a three-year period?

16 A. Aquila has requested that the severance related costs be amortized over a three-year
17 period. This time period was chosen to spread the costs of the restructuring activity over
18 the periods in which customers will reap the benefits of reduced payroll expenses. These
19 reduced payroll expenses are reflected in the annualized payroll expense amounts
20 calculated as of September 30, 2003 for this proceeding. Had Aquila not embarked on
21 such an aggressive restructuring plan, payroll costs of the terminated employees would be
22 reflected in the payroll annualization as of September 30, 2003. Therefore, customers
23 will enjoy the benefits into the future of the identified efficiencies captured by the

1 restructuring initiative. Aquila is matching the costs incurred to create the savings with
2 the periods in which the savings will be realized.

3 Q. Witness Dittmer states that it is impossible to quantify the costs involved in the
4 decentralization restructuring effort. Do you agree?

5 A. No. Aquila was able to quantify and track the individuals who were severed as part of the
6 decentralization effort. The decentralization effort has been distinguished from the
7 restructuring/divestiture occurring in Aquila's non-regulated businesses. This
8 decentralization effort began and positions were identified long before the decision to exit
9 its energy trading and other non-regulated businesses. In order to track these costs,
10 Aquila established a separate account to track the restructuring efforts associated with
11 Aquila Network restructuring. Although some of the employees terminated were
12 involved in positions that were common ESF/IBU corporate functions, many of those
13 functions eliminated benefited the majority of regulated businesses among our seven state
14 operating territory. In addition, a significant amount of positions directly assignable to
15 regulated operations were terminated. Witness Dittmer attempts to draw the conclusion
16 that terminations included common positions and thus could be the result of a non-
17 regulated restructuring effort to "right size" the Company. Yet, this is simply not the
18 case, many of the positions identified and terminated were positions that solely supported
19 regulated utility operations in our seven state region. Thus, a conclusion stating since
20 some positions are common in nature and the reason for termination are undeterminable
21 between regulated restructuring efforts and non-regulated restructuring efforts, the total
22 costs cannot be quantified and thus restructuring severance payments should be
23 disallowed is simply not accurate. Employees were identified exclusively associated with

1 the Networks restructuring effort with the vast majority directly assignable to regulated
2 operations or exclusively allocated between regulated jurisdictions. As such, any non-
3 regulated restructuring/divestiture efforts would not involve the treatment of regulated
4 employees directly assignable or allocated between regulated jurisdictions.

5 Q. Staff witness Hyneman and OPC witness Dittmer both bring up the issue that Aquila has
6 benefited from regulatory lag regarding severance costs. Please respond to this.

7 A. Aquila does not deny the fact that regulatory lag exists concerning this issue. But, is it
8 not true that regulatory lag is a part of many issues involved in this rate case proceeding
9 with an expected decision date of June 2004. Payroll costs are a very easy example of
10 how regulatory lag exists and can work against a company. Take for instance, salary
11 increases that have gone into effect during 2002, 2003 and will go into effect in the early
12 parts of 2004. These salary increases are currently not reflected in rates since the
13 increases were not reflected in payroll costs ordered in the previous MPS rate case, Case
14 No. ER-2001-672. Earlier in my testimony, I described how Staff has denied the 3%
15 MPS union increase which is effective in April 1, 2004 in accordance with a signed union
16 contract, which is before the expected decision date in this proceeding. Aquila has
17 proposed to include this known and measurable payroll increase in its payroll
18 annualization with the goal of reducing the regulatory lag. Based on the Staff's position
19 on these two issues it appears that if Aquila benefits from regulatory lag it should not be
20 allowed to recoup the associated expenditures, but when the Company suffers from
21 regulatory lag, it is not allowed to minimize the effects of such a lag. The Commission
22 must decide if it is going to gravitate towards the concept of "one issue ratemaking"
23 associated with severance costs disregarding other payroll cost aspects or consider the

1 impacts of all issues in total and apply a consistent methodology towards payroll related
2 issues in this rate case proceeding.

3 Q. What has been the guidance recommended from other state jurisdictions regarding the
4 same restructuring (severance) related costs?

5 A. In Aquila's electric rate case proceeding in the State of Colorado, Docket No. 02S-594E,
6 filed October 2002, the Office of Consumer Counsel witness PB Schechter proposed that
7 severance related expenses be amortized consistent with rate case expense methods.
8 Thus, proposing to allow recovery of the same severance related costs that Staff and OPC
9 are attempting to disallow in this rate case proceeding.

10 Q. In summary, what is the underlying theme behind the restructuring (severance) costs
11 requested in this proceeding?

12 A. As stated previously, Aquila is requesting that significant severance costs recorded during
13 the test year of this rate case proceeding be amortized over a period in which the
14 customers will be enjoying the benefits of the reduced payroll costs. Aquila is simply
15 attempting to match the benefits of a more efficient and focused utility operation with the
16 costs incurred by the company to achieve the savings.

17 Q. Please quantify the amount of restructuring (severance) related costs being requested in
18 this proceeding.

19 A. Staff and OPC are requesting disallowance of all restructuring (severance) costs incurred
20 during the test year. The disallowance amount by Staff and OPC that Aquila believes
21 should be granted recovery in this case for MPS electric operations is \$855,874 [REDACTED]

22 [REDACTED]

- 1 Q. Does this conclude your rebuttal testimony.
- 2 A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila
Networks-MPS [REDACTED]
for authority to file tariffs increasing electric
rates for the service provided to customers in
the Aquila Networks-MPS [REDACTED]
[REDACTED] area

Case No. ER-2004-0034

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

[REDACTED]

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF RONALD A. KLOTE

Ronald A. Klote, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Ronald A. Klote;" 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.

Ronald A Klote
Ronald A. Klote

Subscribed and sworn to before me this 26th day of January, 2004.

Terry D. Lutes
Notary Public
Terry D. Lutes

My Commission expires:
8-20-2004

