BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

The Office of the Public Counsel, Complainant, v. Aquila, Inc., d/b/a Aquila Networks-MPS and Aquila Networks-L&P, Respondent.	))))))))))	Case No. EC-2006-0171

STAFF'S INITIAL RESPONSE TO COMPLAINT AND MOTION FOR EXPEDITED TREATMENT

Comes now the Staff of the Missouri Public Service Commission (Staff) and respectfully submits Staff's Initial Response to Complaint:

1. On October 14, 2005, the Office of the Public Counsel (Public Counsel) filed its Complaint against Aquila, Inc., d/b/a Aquila Networks-MPS and Aquila Networks-L&P (Aquila).

2. In this Complaint, Public Counsel alleges that Aquila has failed to fund its Other Post Employment Benefits (OPEB) obligations in 2003, 2004 and 2005 and thereby has violated Section 386.315[1] and Missouri Public Service Commission (Commission) Orders in Case Nos. ER-97-394 and EM-2000-292 (Public Counsel Complaint at p. 2-3). Public Counsel further alleges that Aquila's failure to fund OPEB since 2003 is a continuing violation of Section 386.315 and applicable Commission Orders (Public Counsel Complaint at p. 4). Public Counsel states that the total Aquila funding deficiency is $8,465,161 (Public Counsel Complaint at p. 4).

3. On October 14, 2005, Staff Witness Steve M. Traxler, prefiled testimony verified by affidavits in two pending Aquila rate cases, Case Nos. ER-2005-0436 and HR-2005-0450. In his sworn testimony in both cases, Mr. Traxler discussed Staff's evidence on the issue of Aquila's 2003 decision to discontinue funding for its Missouri FAS 106 obligation and steps already taken by Staff in those cases including adjustments in Staff's audit. In his Executive Summary of this matter in each of these prefiled testimonies, Mr. Traxler stated:

> In response to Staff Data Request No. 263, Aquila admitted that a decision was made in 2003 to discontinue funding for its Missouri FAS 106 obligation. Aquila's explanation to the Staff is that this decision was made based upon an incorrect internal communication. Section 386.315, RSMo, requires funding for FAS 106 post-retirement benefit costs collected in rates. Aquila has committed verbally to correcting the $7 million funding deficiency by year-end 2005.
>
> Aquila's book FAS 106 cost for the test year 2004 was adjusted to reflect the 2005 level and remove the impact of the funding deficiency explained above.

(Direct Testimony of Steve M. Traxler, Case No. ER-2005-0436 at p. 4 and Direct Testimony of Steve M. Traxler, Case No. HR-2005-0450 at p. 4). Mr. Traxler's testimony in both cases further analyzes the issue (Direct Testimony of Steve M. Traxler, Case No. ER-2005-0436 at p. 7-14 and Direct Testimony of Steve M. Traxler, Case No. HR-2005-0450 at p. 7-13) (Attached hereto as Exhibits 1 and 2 and incorporated herein by reference).

4. Staff suggests that this Complaint is unusual in that substantial evidence regarding the substance of the Complaint already exists. The only thing lacking is Aquila's official response. Staff submits that a prompt prehearing should be set in this case to coincide with the prehearing in Case Nos. ER-2005-0436 and HR-2005-0450, which is currently scheduled for October 31-November 4, 2005. Staff believes that such a prehearing would allow all of the

[1] All statutory citations are to RSMo 2000, unless otherwise noted.

Parties to this case to discuss the matter and possibly resolve it. Otherwise, substantial time would elapse before this process even begins.

5. Staff requests Expedited Treatment of this matter pursuant to 4 CSR 240-2.080 (16). Staff submits that the Commission should set a Prehearing Conference in this case commencing at 10 a.m. on November 1, 2005 to coincide with the prehearings in Case Nos. ER-2005-0436 and HR-2005-0450. Staff requests that the Commission shorten time for response to this Motion and rule by October 28, 2005. The harm that will be avoided is the delay that would ordinarily elapse between the filing of a Complaint and further proceedings. In this case, substantial evidence already exists on the Complaint and all of the Parties will be present to discuss the substance of the Complaint which is also an issue in Case Nos. ER-2005-0436 and HR-2005-0450. Accordingly, it is appropriate to include discussion of the Complaint in this case. There will be no negative effect on Aquila's customers or the general public since a later separate hearing will be averted. This pleading was done as soon as it could have been done in that this Complaint was filed on October 18, 2005.

6. Staff also notes that one of the remedies sought by Public Counsel is not appropriate and should be stricken from its pleadings or properly amended. In its prayer, Public Counsel asks that the Commission direct its General Counsel to seek criminal penalties pursuant to Section "286.580." Staff did not find a Section 286.580 RSMo, but assumes that Public Counsel meant to cite Section 386.580 RSMo regarding criminal penalties. Staff submits that although a charge under this section may be appropriate, the statute does not authorize the Commission to direct its General Counsel to prosecute an entity or individual criminally, and in fact, no such authority exists. Criminal prosecution in this matter is solely the duty of the Prosecuting Attorney in the appropriate jurisdiction. Section 56.060 RSMo.

WHEREFORE, Staff respectfully requests that the Commission grant Expedited Treatment to Staff's Motion pursuant to 4 CSR 240-2.080 (16), require pleadings responsive to Staff's Motion be filed by October 28, 2005, grant Staff's Motion for a Prehearing Conference on November 1, 2005 at 10 a.m. pursuant to 4 CSR 240-2.080 (16) and direct Public Counsel to make a filing about its pleadings on criminal penalties.

Respectfully submitted,

DANA K. JOYCE
General Counsel

/s/ Robert V. Franson
Robert V. Franson
Senior Counsel
Missouri Bar No. 34643

Attorney for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-6651 (Telephone)
(573) 751-9285 (Fax)
email: robert.franson@psc.mo.gov

Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record this 19th day of October 2005
.

/s/ Robert V. Franson

Exhibit No.	
Issues:	*Income Tax-Straight Line Tax; Depreciation; Post-Retirement Benefit Costs*
Witness:	*Steve M. Traxler*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Direct Testimony*
Case No.:	*ER-2005-0436*
Date Testimony Prepared:	*October 14, 2005*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

STEVE M. TRAXLER

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

CASE NO. ER-2005-0436

Jefferson City, Missouri
October 2005

Exhibit 1

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail Electric Service Provided to Customers in Its MPS and L&P Missouri Service Areas.	))))	Case No. ER-2005-0436 Tariff No. YE-2005-1045

AFFIDAVIT OF STEVE M. TRAXLER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Steve M. Traxler, being of lawful age, on his oath states: that he has participated in the preparation of the following Direct Testimony in question and answer form, consisting of 14 pages to be presented in the above case; that the answers in the following Direct Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Steve M. Traxler

Subscribed and sworn to before me this 13th day of October 2005.

Notary

TONI M. CHARLTON
Notary Public - State of Missouri
My Commission Expires December 28, 2008
Cole County
Commission #04474301

TONI M. CHARLTON
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

3) Appropriate level of FAS 106 expense to be included in cost of service in this case.

Straight line tax depreciation is the tax deduction for annualized book depreciation included in cost of service for ratemaking purposes. As part of the settlement of income tax issues in Case No. ER 2004-0034, Aquila committed to a comprehensive tax study in order to calculate a more accurate straight line tax depreciation result. The tax study has not been completed at this time. The method used in this case, Case No. ER-2005-0436, to calculate the straight-line tax depreciation deduction is consistent with the method used by the Staff in prior cases for both the MPS and L&P divisions.

In response to Staff Data Request No. 263, Aquila admitted that a decision was made in 2003 to discontinue funding for its Missouri FAS 106 obligation. Aquila's explanation to the Staff is that this decision was made based upon an incorrect internal communication. Section 386.315, RSMo, requires funding for FAS 106 post-retirement benefit costs collected in rates. Aquila has committed verbally to correcting the $7 million funding deficiency by year-end 2005.

Aquila's booked FAS 106 cost for the test year 2004 was adjusted to reflect the 2005 level and remove the impact of the funding deficiency explained above.

INCOME TAX EXPENSE STRAIGHT LINE TAX DEPRECIATION

Q. Please explain the relationship between book depreciation and straight-line tax depreciation.

A. Annualized book depreciation is a result of multiplying the plant investment at June 30, 2005, the Staff's update period, by the book depreciation rates being recommended book depreciation expense included in a cost of service study that should be used as a tax deduction for ratemaking purposes.

Q. What is the current status of Aquila's tax study?

A. The study has not been completed as of this date. Due to the complexity of the study and data required, it was not expected that Aquila would have completed the study at this date.

Q Please summarize your testimony on this issue.

A. The Staff's method, in this case, for calculating the straight-line tax depreciation deduction, is consistent with the method filed by the Staff for the MPS and L&P divisions since 1997 and 1993, respectively. The tax basis used in the calculation includes all vintage property which is still accruing a book depreciation amount includable for rate recovery.

A more precise calculation is anticipated pending the completion and review of the comprehensive tax study, committed to by Aquila for its MPS division, in the Stipulation and Agreement in Aquila's last rate case, Case No. ER-2004-0034. The Staff's recommended method for calculating the straight-line tax depreciation deduction is based upon the best available data at this time.

<u>HISTORICAL RATEMAKING TREATMENT – OPEB COSTS</u>

Q. Please explain Financial Accounting Standard (FAS) 106.

A. FAS 106 is the Financial Accounting Standards Board (FASB) approved accrual accounting method used for financial statement recognition of annual Other Post-Retirement Employee Benefit (OPEB)costs over the service life of employees.

Q. When was the accrual accounting method for OPEB costs, FAS 106, adopted for ratemaking purposes?

A. House Bill 1405 (Section 386.315, RSMo), approved by the Missouri Legislature on August 28, 1994, required the adoption of FAS 106 for setting rates for OPEB costs. In Commission cases following the date that House Bill 1405 became law, the Staff began recommending the use of FAS 106 for determining ratemaking recovery for OPEB costs.

Q. What method was used for setting rates for OPEB costs prior to the effective date of Section 386.315, RSMo?

A. Prior to the effective date of Section 386,315, RSMo, rates were set on a "pay as you go" or "cash" basis for OPEB costs. The utility's actual paid claims for OPEB cost, for current retirees, were included for recovery for ratemaking purposes.

Q. When was FAS 106 adopted for ratemaking purposes for Aquila's L&P and MPS divisions?

A. FAS 106 was adopted for the former St. Joseph Light & Power Co. (SJLP) Company in Case No. ER-94-163. The effective date for the Commission's Order was June 15, 1994.

Aquila and the Staff recommended FAS 106 for Aquila's MPS division in Case No. ER-97-394. The effective date for the Commission's Order for Case No. ER-97-394 was March 6, 1998.

FAS 106 FUNDING DEFICIENCY FOR AQUILA'S MPS AND L&P DIVISIONS

Q. Does Section 386.315, RSMo, include a funding requirement as a prerequisite for the adoption of FAS 106 for ratemaking purposes?

A. Yes. A copy of Section 386.315, RSMo, is attached as Schedule SMT-3. The recognition of FAS 106 for ratemaking purposes is conditioned on a requirement that annual FAS 106 costs collected in rates be funded in a separate funding mechanism to be used solely for the payment of OPEB benefit costs to retirees. Paragraph 2 of Section 386.315 addresses the funding requirement:

> 2. A public utility which uses Financial Accounting Standard 106 shall be required to use an independent external funding mechanism that restricts disbursements only for qualified retiree benefits. In no event shall any funds remaining in such funding mechanism revert to the utility after all qualified benefits have been paid; rather, the funding mechanism shall include terms which require all funds to be used for employee or retiree benefits. This section shall not in any manner be construed to limit the authority of the commission to set rates for any service rendered or to be rendered that are just and reasonable pursuant to sections 392.240, 393.140 and 393.150, RSMo.

Q. Is Aquila currently in compliance with the funding requirement under Section 386.315, RSMo.?

A. No. In Staff Data Request No. 263, the Staff requested Aquila's annual FAS 106 expense and amounts funded for the last five years for the MPS and L&P divisions. A copy of the response to Staff Data Request No. 263 is attached as Schedule SMT-4 to this direct testimony. In its response, Aquila identified a funding policy change beginning in 2003 stated as follows:

> 2) Prior to 2003 VEBA funding was equal to the annual expense. Starting in 2003, the contributions would be equal to the claims paid less amounts returned from the VEBA trust. There is not a regulatory requirement that Missouri funding be equal to the annual expense.

This statement is an admission by Aquila that it decided, in 2003, to discontinue funding the accrued FAS 106 costs collected in rates. The statement above, indicates that beginning in 2003, Aquila limited its funding for its FAS 106 obligation to the amount necessary to pay its current benefits to existing "retirees." FAS 106 is an accrual accounting method which measures the future cost of benefits for current "employees" after retirement. The total expected OPEB obligation for an existing employee is allocated to expense over the remaining service life of the employee. Since FAS 106 costs represents a recovery in rates today for a future obligation, the intent of the statute was to protect these monies by requiring that they be deposited in a separate fund and available when OPEP benefits require a cash outlay to current employees after they retire.

This decision is a violation of the funding requirement under Section 386.315, RSMo, because Aquila was not funding the accrued FAS 106 costs being recovered in rates.

Q. After receipt of Aquila's response to Staff Data Request No. 263, did you schedule a meeting for the purpose of discussing the funding deficiency issue?

A. Yes. Aquila's current Director of Employee Benefits and HRIS, Philip Beyer, indicated that he was not employed by Aquila in 1998 when FAS 106 became a funding requirement for MPS as a result of the Missouri Commission's order in Case No. ER-97-394. He was also unaware that FAS 106 was adopted for the former SJLP prior to Aquila's acquisition in 2001. Mr. Beyer indicated that he sought guidance from Aquila's regulatory department and was informed verbally that Missouri did not have a funding requirement for FAS 106 costs. Mr. Beyer's decision in 2003 to discontinue funding for FAS 106, for Aquila's Missouri MPS and L&P divisions, was based upon an incorrect internal communication.

Q. How did you calculate the FAS 106 funding deficiency for the MPS and L&P divisions?

A. For the MPS division, I compared MPS's annual FAS 106 cost and Aquila's cash deposits into the external VEBA trusts since the effective date of rates in Case No. ER-

97-394, March 6, 1998. The funding deficiency of ($2,982,099) represents the accumulated difference between MPS's annual FAS 106 costs and Aquila's actual funded amounts since March of 1998.

For the L&P division, I compared L&P's annual FAS 106 cost and Aquila's cash deposits into the external VEBA trusts since Aquila's acquisition of the L&P property in 2001. The funding deficiency of ($4,035,431) represents the accumulated difference between L&P's annual FAS 106 costs and Aquila's actual funded amounts since January of 2001.

Q. Have the Staff and Aquila reached an agreement in principle regarding a solution which will cure the funding deficiency for the MPS and L&P divisions?

A. Yes. Aquila has offered to make an immediate contribution of $4.8 million and an additional contribution by the end of 2005 to address the remaining funding deficiency.

This time frame for curing the funding deficiency is acceptable to the Staff.

FAS 106 CURTAILMENT – L&P DIVISION

Q. What is a curtailment under FAS 106?

A. A curtailment occurs under FAS 106 when it becomes necessary to recognize a material portion of the future OPEB obligation sooner than expected. FAS 106 estimates an employees future OPEB benefits, payable during retirement, and allocates the total expected benefit obligation ratably, as an accrued expense, over the expected working service life of the employee.

Assuming the average expected service life is 15 years, each employee's expected benefits, to be paid during their retirement, is accrued to expense in the financial statements during the 15-year period. At the employee's retirement date, the FAS 106 Accumulated Benefit Obligation will reflect the total expected benefits payable during retirement.

A FAS 106 curtailment will occur in the previous example when a significant number of employees retire sooner than "expected" resulting in the need to recognize the amount of their total expected FAS 106 benefits which have not been accrued / recognized as of the date of their retirement. For example assume that an early retirement program results in a significant number of employees retiring with 10 years of service as opposed to the 15-year "assumption" used in estimating annual FAS 106 costs to date. The FAS 106 cost, which was expected to be recognized / accrued in years 11-15, must now be recognized immediately under FAS 106.

Q. Did the L&P division experience a FAS 106 curtailment in 2001 as a result of Aquila's decision to offer an early retirement program at the time of L&P acquisition in 2001?

A. Yes. A FAS 106 curtailment cost was recognized in the financial statements in 2001 for $1,447,631.

Q. Why is the L&P curtailment, recognized in 2001, relevant to this case, Case No. ER-2005-0436?

A. The Staff's testimony in the UtiliCorp United/St. Joseph Light & Power (UCU/SJLP) merger case, Case No. EM-2000-0292, included a recommendation for the recovery of transition costs required to consummate the merger. The FAS 106 curtailment in 2001 for the L&P division is included in this case as a transition cost subject to recovery in rates. Staff witness Charles R. Hynemen is sponsoring an adjustment in this case for an amortization of transition costs related to the UCU/SJLP merger.

Q. Is there an additional FAS 106 funding requirement as a result of amortizing the 2001 curtailment cost as a transition cost in this case?

A. Yes. Section 386.315, RSMo, requires that all costs collected in rates for OPEB costs, calculated under FAS 106, be funded in an external funding mechanism. During verbal discussions with Aquila they have indicated agreement with the Staff's position that the annual recovery of the 2001 L&P FAS 106 curtailment will require funding of this amount in their existing VEBA trusts.

ANNUALIZED FAS 106 COSTS

Q. Please explain Staff adjustments S-85.12 and S-84.11.

A. Adjustments S-85.12 and S-84.11 adjust the MPS and L&P 2004 test year costs for FAS 106 to reflect the more current costs for 2005.

Q. Are additional adjustments required to eliminate the FAS 106 funding deficiency impact on the 2005 FAS 106 costs for the MPS and L&P divisions?

A. Yes. One of the components, used in a FAS 106 calculation, is the expected rate of return to be earned on funded assets. The expected annual earnings on the funded assets offsets the current year service, transition obligation amortization and interest costs included in the FAS 106 calculation. The funding deficiency previously discussed for the MPS and L&P divisions results in higher 2005 FAS 106 cost, as a result of the lower earnings expectation, due to the funding deficiency.

In order to avoid recognizing excessive FAS 106 costs in this case, the expected rate of return assumption was recalculated assuming that the funding deficiency did not exist. This adjustment may require further refinement based upon the response to outstanding Staff Data Request No. 430.

Q. Please explain Staff adjustments S-85.13 and S-84.12.

A. Staff adjustments S-85.13 and S-84.12 reduce the 2005 MPS and L&P FAS 106 costs to eliminate the impact of the funding deficiency previously discussed.

Q. Does this conclude your direct testimony?

A. Yes, it does.

Exhibit No.	
Issues:	*Income Tax-Straight Line Tax; Depreciation; Post-Retirement Benefit Costs;*
Witness:	*Steve M. Traxler*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Direct Testimony*
Case Nos.:	*HR-2005-0450*
Date Testimony Prepared:	*October 14, 2005*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

STEVE M. TRAXLER

AQUILA, INC.
d/b/a AQUILA NETWORKS-L&P-STEAM

CASE NO. HR-2005-0450

Jefferson City, Missouri
October 2005

Exhibit 2

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Tariff Filing of Aquila, Inc., to Implement a General Rate Increase for Retail SteamHeat Service Provided to Customers in Its L&P Missouri Service Area.	))))	Case No. HR-2005-0450 Tariff No. YH-2005-1066

AFFIDAVIT OF STEVE M. TRAXLER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Steve M. Traxler, being of lawful age, on his oath states: that he has participated in the preparation of the following Direct Testimony in question and answer form, consisting of 13 pages to be presented in the above case; that the answers in the following Direct Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Steve M. Traxler

Subscribed and sworn to before me this 13th day of October 2005.

Notary

TONI M. CHARLTON
Notary Public - State of Missouri
My Commission Expires December 28, 2008
Cole County
Commission #04474301

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI method used by the Staff in prior cases for both the Aquila Networks MPS (MPS) & Aquila Networks L&P (L&P) divisions.

In response to Staff Data Request No. 263, Aquila admitted that a decision was made in 2003 to discontinue funding for its Missouri FAS 106 obligation. Aquila's explanation to the Staff is that this decision was made based upon an incorrect internal communication. Section 386.315, RSMo. requires funding for FAS 106 post-retirement benefit costs collected in rates. Aquila has committed verbally to correcting the $7 million funding deficiency by year-end 2005.

Aquila's booked FAS 106 cost for the test year 2004 was adjusted to reflect the 2005 level and remove the impact of the funding deficiency explained above.

OVERVIEW OF STEAM RATE CASE

Q. Please provide a brief explanation the L&P steam operations.

A. L&P's Lake Road generating station consists of three separate systems: a 900-pound system, an 1,800 pound system and a combustion turbine (CT) system. The 900-pound system provides both electric and steam service. Steam service is provided to seven industrial customers for use in their production facilities. Staff witness Janice Pyatte, with the Economic Analysis Section of the Energy Department, will address the annualization of steam revenues. Staff witness David Elliott, with the Engineering Analysis Section of the Energy Department, will provide an explanation of how the Lake Road fuel costs are allocated between L&P's electric and steam customers.

Q. As a result of the joint-use nature of the Lake Road plant, are most of the plant and expenses for the L&P steam operations determined by some form of allocation method?

tax depreciation, 98.31% for L&P, estimates that ratepayers have already received a tax deduction, in prior years, for 1.69% respectively, of the book basis of depreciable plant.

Q. Please explain how ratepayers received the benefit of a tax deduction in prior years equal to 1.69% of the book basis of depreciable plant at June 30, 2005.

A. Prior to the Tax Reform Act of 1986, property taxes, interest, pensions and payroll taxes were capitalized as overheads for financial reporting (book) purposes, but deducted for tax purposes in the current year. The Staff used flow–through tax accounting for these tax-timing differences prior to the 1986 Tax Reform Act.

Flow–through accounting means that the tax deduction of these capitalized overhead costs was reflected in the current year for both federal income tax and ratemaking purposes. The Tax Reform Act of 1986 eliminated this tax timing difference by capitalizing these overhead costs for both book and tax reporting. The Tax basis/Book basis ratio used by the Staff to calculate straight-line tax depreciation properly excludes the annualized book depreciation related to the basis difference flowed through in rates prior to 1986:

Q Please summarize your testimony on this issue.

A. The Staff's method, in this case, for calculating the straight-line tax depreciation deduction, is consistent with the method filed by the Staff for the MPS and L&P divisions since 1997 and 1993, respectively. The tax basis used in the calculation includes all vintage property which is still accruing a book depreciation amount includable for rate recovery.

HISTORICAL RATEMAKING TREATMENT – OPEB COSTS

Q. Please explain Financial Accounting Standard (FAS) 106.

A. FAS 106 is the Financial Accounting Standards Board (FASB) approved accrual accounting method used for financial statement recognition of annual Other Post-Retirement Employee Benefit (OPEB) costs over the service life of employees.

Q. When was the accrual accounting method for OPEB costs, FAS 106, adopted for ratemaking purposes?

A. House Bill 1405 (Section 386.315, RSMo.), approved by the Missouri Legislature on August 28, 1994, required the adoption of FAS 106 for setting rates for OPEB costs. In Commission cases following the date that House Bill 1405 became law, the Staff began recommending the use of FAS 106 for determining ratemaking recovery for OPEB costs.

Q. What method was used for setting rates for OPEB costs prior to the effective date of Section 386.315, RSMo.?

A. Prior to the effective date of Section 386,315, RSMo., rates were set on a "pay as you go" or "cash" basis for OPEB costs. The utility's actual paid claims for OPEB costs, to existing retirees, were included for recovery for ratemaking purposes.

Q. When was FAS 106 adopted for ratemaking purposes for Aquila's L&P division?

A. FAS 106 was adopted for the former St. Joseph Light & Power Co. (SJLP) Company in Case No.ER-94-163. The effective date for the Commission's Order was June 15, 1994.

<u>FAS 106 FUNDING DEFICIENCY FOR AQUILA'S MPS AND L&P DIVISIONS</u>

Q. Does Section 386.315, RSMo., include a funding requirement as a prerequisite for the adoption of FAS 106 for ratemaking purposes?

A. Yes. A copy of Section 386.315, RSMo is attached as Schedule SMT-2. The recognition of FAS 106 for ratemaking purposes is conditioned on a requirement that annual FAS 106 costs collected in rates be funded in a separate funding mechanism to be used solely for the payment of OPEB benefit costs to retirees. Paragraph 2 of Section 386.315 addresses the funding requirement:

> 2. A public utility which uses Financial Accounting Standard 106 shall be required to use an independent external funding mechanism that restricts disbursements only for qualified retiree benefits. In no event shall any funds remaining in such funding mechanism revert to the utility after all qualified benefits have been paid; rather, the funding mechanism shall include terms which require all funds to be used for employee or retiree benefits. This section shall not in any manner be construed to limit the authority of the commission to set rates for any service rendered or to be rendered that are just and reasonable pursuant to sections 392.240, 393.140 and 393.150, RSMo.

Q. Is Aquila currently in compliance with the funding requirement under Section 386.315, RSMo.?

A. No. In Staff Data Request No. 263, the Staff requested Aquila's annual FAS 106 expense and amounts funded for the last five years for the MPS and L&P divisions. A copy of the response to Staff Data Request No. 263 is attached as Schedule SMT-3 to this direct testimony. In its response, Aquila identified a funding policy change beginning in 2003 stated as follows:

> 2) Prior to 2003 VEBA funding was equal to the annual expense. Starting in 2003, the contributions would be equal to the claims paid less amounts returned from the VEBA trust. There is not a regulatory requirement that Missouri funding be equal to the annual expense."

This statement is an admission by Aquila that it decided, in 2003, to discontinue funding the accrued FAS 106 costs collected in rates. The statement above, indicates that beginning in 2003, Aquila limited its funding for its FAS 106 obligation to the amount necessary to pay its current benefits to existing "retirees." FAS 106 is an accrual accounting method that measures the future cost of benefits for current "employees" after retirement. The total expected OPEB obligation for an existing employee is allocated to expense over the remaining service life of the employee. Since FAS 106 costs represents a recovery in rates today for a future obligation, the intent of the statute was to protect these monies by requiring that they be deposited in a separate fund and available when OPEP benefits require a cash outlay to current employees after they retire.

This decision is a violation of the funding requirement under Section 386.315, RSMo., because Aquila was not funding the accrued FAS 106 costs being recovered in rates.

Q. After receipt of Aquila's response to Staff Data Request No. 263, did you schedule a meeting for the purpose of discussing the funding deficiency issue?

A. Yes. Aquila's current Director of Employee Benefits and HRIS, Philip Beyer, indicated that he was not aware that FAS 106 was adopted for the former SJLP prior to Aquila's acquisition in 2001. Mr. Beyer indicated that he sought guidance from Aquila's regulatory department and was informed verbally that Missouri did not have a funding requirement for FAS 106 costs. Mr. Beyer's decision in 2003 to discontinue funding for FAS 106, for Aquila's Missouri L&P division, was based upon an incorrect internal communication.

Q. How did you calculate the FAS 106 funding deficiency for the L&P division?

A. For the L&P division, I compared L&P's annual FAS 106 cost and Aquila's cash deposits into the external VEBA trusts since Aquila's acquisition of the L&P property in 2001. The funding deficiency of ($4,035,431) represents the accumulated difference between L&P's annual FAS 106 costs and Aquila's actual funded amounts since January of 2001.

Q Have the Staff and Aquila reached an agreement in principle regarding a solution that will cure the funding deficiency for the L&P division?

A. Yes. Aquila has offered to make an immediate contribution of $4.8 million and an additional contribution by the end of 2005 to address the remaining funding deficiency.

This time frame for curing the funding deficiency is acceptable to the Staff.

FAS 106 CURTAILMENT – L&P DIVISION

Q. What is a curtailment under FAS 106?

A. A curtailment occurs under FAS 106 when it becomes necessary to recognize a material portion of the future OPEB obligation sooner than expected. FAS 106 estimates an employees future OPEB benefits, payable during retirement, and allocates the total expected benefit obligation ratably, as an accrued expense, over the expected working service life of the employee.

Assuming the average expected service life is 15 years, each employee's expected benefits, to be paid during their retirement, is accrued to expense in the financial statements during the 15-year period. At the employees retirement date, the FAS 106 Accumulated Benefit Obligation will reflect the total expected benefits payable during retirement.

A FAS 106 curtailment will occur in the previous example when a significant number of employees retire sooner than "expected" resulting in the need to recognize the amount of their total expected FAS 106 benefits which have not been accrued / recognized as of the date of their retirement. For example, assume that an early retirement program results in a significant number of employees retiring with 10 years of service as opposed to the 15-year "assumption" used in estimating annual FAS 106 costs to date. The FAS 106 cost which was expected to be recognized / accrued in years 11-15 must now be recognized immediately under FAS 106.

Q. Did the L&P division experience a FAS 106 curtailment in 2001 as a result of Aquila's decision to offer an early retirement program at the time of L&P acquisition in 2001?

A. Yes. A FAS 106 curtailment cost was recognized in the financial statements in 2001 for $1,447,631.

Q. Why is the L&P curtailment, recognized in 2001, relevant to this case, Case No. HR-2005-0450?

A. The Staff's testimony in the UtiliCorp United/St. Joseph Light & Power (UCU/SJLP) merger case, Case No. EM-2000-0292, included a recommendation for the recovery of transition costs required to consummate the merger. The FAS 106 curtailment in 2001 for the L&P division is included in this case as a transition cost to be recovered in rates. Staff witness Charles R. Hynemen is sponsoring an adjustment in this case for an amortization of transition costs related to the UCU/SJLP merger.

Q. Is there an additional FAS 106 funding requirement as a result of amortizing the 2001 curtailment cost as a transition cost in this case?

A. Yes. Section 386.315, RSMo, requires that all costs collected in rates for OPEB costs, calculated under FAS 106, be funded in an external funding mechanism. During verbal discussions with Aquila, they have indicated agreement with the Staff's position that the annual recovery of the 2001 L&P FAS 106 curtailment will require funding of this amount in their existing VEBA trusts.

ANNUALIZED FAS 106 COSTS

Q. Please explain Staff adjustment S-84.11.

A. Adjustment S-84.11 adjusts the L&P 2004 test year costs for FAS 106 to reflect the more current costs for 2005.

Q. Are additional adjustments required to eliminate the FAS 106 funding deficiency impact on the 2005 FAS 106 costs for the L&P division?

A. Yes. One of the components, used in a FAS 106 calculation, is the expected rate of return to be earned on funded assets. The expected annual earnings on the funded assets offsets the current year service, transition obligation amortization and interest costs included in the FAS 106 calculation. The funding deficiency previously discussed for the L&P division results in higher 2005 FAS 106 cost, as a result of the lower earnings expectation, due to the funding deficiency.

In order to avoid recognizing excessive FAS 106 costs in this case, the expected rate of return assumption was recalculated assuming that the funding deficiency did not exist. This adjustment may require further refinement based upon the response to outstanding Staff Data Request No. 430.

Q. Please explain Staff Adjustment S-84.12.

A. Staff adjustment S-84.12 reduces the 2005 L&P FAS 106 costs to eliminate the impact of the funding deficiency previously discussed.

Q. Does this conclude your direct testimony?

A. Yes, it does.