Exhibit No.:	
Issues:	*Payroll Expense; Incentive Compensation; Employer Health, Dental and Vision Expense*
Witness:	*Dana E. Eaves*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case No.	*GR-2004-0072*
Date Testimony Prepared:	*February 13, 2004*

MISSOURI PUBLIC SERVICE COMMISSION
UTILITY SERVICES DIVISION

REBUTTAL TESTIMONY

OF

DANA E. EAVES

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

CASE NO. GR-2004-0072

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-MPS and Aquila Networks-L&P, Natural Gas General Rate Increase	)))	Case No. GR-2004-0072

AFFIDAVIT OF DANA E. EAVES

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Dana E. Eaves, being of lawful age, on his oath states: that he has participated in the preparation of the following Rebuttal Testimony in question and answer form, consisting of 16 pages to be presented in the above case; that the answers in the following Rebuttal 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.

Dana E. Eaves

Dana E. Eaves

Subscribed and sworn to before me this 9th day of February 2004.

D SUZIE MANKIN
Notary Public - Notary Seal
STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. JUNE 21,2004

D Suzie Mankin

Notary

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CASE NO. GR-2004-0072

Q. Please state your name and business address.

A. Dana E. Eaves, PO Box 360, Suite 440, Jefferson City, MO 65102.

Q. By whom are you employed and in what capacity?

A. I am a Utility Regulatory Auditor for the Missouri Public Service Commission (Commission or PSC).

Q. Are you the same Dana E. Eaves who has previously filed direct testimony in this case?

A. Yes, I am. On January 6, 2004 I filed direct testimony on the subject of payroll and payroll related expenses in of this case. I have also filed direct, rebuttal and surrebuttal testimony in Case No's. ER-2004-0034 and HR-2004-0024 related electric and steam cases.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to address the direct testimony of Company witness Ann L. Stichler who sponsors the inclusion of an April 1, 2004 union salary increase. This testimony will also address the direct testimony of Company witness Richard G. Petersen who sponsors the Company's adjustment (CS-6) to incentive compensation and payroll taxes. The Staff would characterize these isolated “out of period” adjustments as being unique and unusual. These adjustments are not proper ratemaking adjustments to the test year and violate the “known and measurable” principle as practiced by this Commission in the past.

Q. Please explain the Staff’s positions that will be addressed in this testimony.

A. The Staff is ***not*** recommending the inclusion of an April 1, 2004 union salary increase or the incentive compensation adjustment requested by the Company. The Staff is proposing and supporting an adjustment to the self-insured portion of the Employer Health, Dental and Vision expenses.

Q. What test year is being utilized in this case?

A. On August 1, 2003, Aquila, Inc. filed this rate increase application seeking to increase existing revenues. The Commission’s Suspension Order and Notice for these proceeding states, “the parties propose the 12-month period ending December 31, 2002, as the test year.” Therefore, the test year being used in this case is the 12-months ending December 31, 2002. The Commission Ordered that a test year update period, also known as a “known and measurable” period, be used to reflect material changes to the revenue requirement that occur subsequent to the test year through September 30, 2003.

Q. What is the purpose of the test year?

A. The purpose of a test year is to identify a 12-month period to serve as the starting point for review and analysis of the utility’s operations to determine the reasonableness and appropriateness of the rate filing. The test year forms the basis for any adjustments necessary to remove abnormalities that have occurred during the period and to reflect any increase or decrease to the utility’s accounts. Adjustments are made to the test year level of revenues, expenses and investments to determine the proper level of investment on which the utility is allowed the opportunity to earn a return. After the recommended rate of return is determined for the utility, a review of existing rates is made to determine if any additional revenues are necessary. If the utility's earnings are deficient, rates need to be increased. In some cases, existing rates generate earnings in excess of authorized levels, which may indicate the need for rate reductions. The test year and known and measurable update periods are the vehicles used to evaluate and determine the proper relationship between revenue, expense and investment at a point in time. Establishing a proper relationship between these three revenue requirement elements is essential in determining the appropriate ongoing level of earnings for the utility.

Q. How can historical test year be adjusted to reflect the ongoing prospective nature of ratemaking?

A. The Staff proposes annualization and normalization adjustments to the test year for this purpose.

Q. What are annualization adjustments?

A Annualization adjustments pertain to events that have occurred within the test year and will continue to occur subsequent to the test year. Annualization adjustments reflect the forward-looking dollar impact of recurring test year events. They are generally used whenever the data for a revenue or expense component shows a definite trend upward or downward within a test year. In that situation, an annualization adjustment would normally be proposed to reflect the most recent values within the test year for that revenue or expense component for inclusion in rates.

Q. What are normalizations adjustments?

A. Normalization adjustments reflect the removal of events or items within the test year that are non-recurring, or exhibit a fluctuation from the level, which would be normally expected to occur. Normalization adjustments need to be made to the test year to achieve the appropriate forward-looking focus of the investment/revenue/expense relationship.

Q. Did the Company propose a true-up in this case?

A. No. The Company did not propose a true-up in this case. Instead the Company has proposed isolated adjustments to its case that represent "out-of-period" adjustments that will be addressed later in this testimony.

Q. What is the purpose of a true-up?

A. A true-up audit involves the adjustment of historical test year figures for known and measurable revenue requirement changes subsequent to the test year and update period.

A true-up is intended to capture very significant events that occur beyond the known and measurable update period but prior to the effective date for rates for the proceeding. An example of a significant event justifying a true-up has been the addition of a new generating station with an in-service date after end of the update period. As with the update period, a true-up audit requires that all significant costs of service components be measured as of the true-up date in order to maintain the matching of revenues, expenses, rate base investment and cost of capital.

Q. What is the "known and measurable" concept, as that term is used in the ratemaking process?

A. The concept of "known and measurable" refers to setting of rates based on actual items or events that occur related to providing utility service, that result in material changes to the revenue requirement. These actual events have a material impact on the revenue, expense and rate base investment relationship that the Commission has consistently used in determining the rates that utilities operating in the state of Missouri can charge their customers for utility service. These changes take place as of the end of the update period and must be "known," or certain to occur; and must be quantifiable, or capable of being "measured" by an audit process (i.e., that the item or event can be quantified). The Commission has maintained that an item or event is known and measurable when an event has occurred, is measurable as to quantification and can be documented through support by a verification or audit process. An example of the sort of documentation would be the books and records of the company, in particular the audited financial statements of the company.

Q. Did the Commission stress the importance of maintaining proper balance between the costs of service items in these cases?

A. Yes. In the Suspension Order and Notice issued August 30, 2003, the Commission stated at page 2 that the Commission will not consider a true-up of isolated adjustments, but will examine only a "package" of adjustments designed to maintain the proper revenue-expense-rate base match at a proper pointing [sic] in time." [Re Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104, 110 (1983)]

PAYROLL ANNUALIZATION

Q. Where did you obtain the payroll information that you used for the payroll annualization?

A. The information was obtained from data requests submitted in the electric and steam cases, No.'s ER-2004-0034 and HR-2004-0024. The Company's response to Data Request No.75 updated to September 30, 2003 Corporate, Corporate allocated and Direct employee levels which were used to formulate the annualized payroll.

Information from the electric cases was used because much of the payroll analysis related to the annualization of payroll on a total company basis and allocating payroll costs between the various Aquila entities. As such, in conjunction with the electric case filed by the Company, I performed the work related to the payroll area for the natural gas operations in the context of Case No. ER-2004-0034.

Q. Is the Company requesting to seek the inclusion of a union salary increase outside of the test year and update period?

A. Yes, the Company has included a union salary increase due to take effect April 1, 2004.

Q. Did the Staff include any payroll increases for the Company in its payroll annualization?

A. Yes. The Staff included March 1, 2003 salary increases of 2.77% for non-union employees, an April 1, 2003 MPS union salary increase of 2.5% and an August 1, 2003 of 3.5% for L&P union employees. Because of the use of the latest known actual payroll information, including wage rates, as of September 30, 2003, the payroll calculation has in effect included these salary increases in the Staff's annualized payroll adjustments. These increases have actually occurred so the Staff has been able to verify that they occurred and can calculate the actual effect the increases have to the payroll annualization. The Staff annualization of payroll considered the actual salary and wage rates were applied to actual level of employees as of September 30, 2003. Thus, the payroll annualization was based on "known and measurable" concepts.

Q. Please explain the methodology you employed to determine annualized payroll.

A. The annualized payroll is based upon the Company's employee levels at September 30, 2003. The wage rate and salary levels are based upon straight time wages/salaries according to the most recent information available through the end of September 30, 2003. Hourly wages were computed for hourly workers using 2,080 hours, which represents the number of work hours in a year based on the 12-month period ending September 2003. Salary and wage rates are computed on an annual basis as of September 30, 2003.

Q. Why were these wage/salary rates and employee levels at September 30, 2003, used to calculate the payroll annualization?

A. These levels represent the most current actual information relating to ongoing payroll expense. Using actual information as of September 30, 2003, which is the end of the update period in this case, provides the most current information that is available regarding employee levels, wage rates and salaries. Use of this information at this point in time is consistent with other aspects of this case such as the revenue annualization and rate base investment, and is consistent with the ratemaking principle of maintaining the proper relationship of revenues, expenses and investment at a point in time.

Q. How did you determine total annualized payroll?

A. The sum of the annualized components discussed above (full-time union, non-union hourly, salaried, and part-time payroll) represents the annualized payroll being proposed by the Staff in this case.

Q. How did the Staff determine the allocation of the total payroll costs between total Company expense, construction, retirements, non-regulated activities and clearing accounts within the gas utility operations?

A. The total Company expense allocation was derived from data requested from the Company, which identified the capitalization and expense payroll ratios and the accounts charged.

Q. How did the Staff determine the portion of annualized payroll to be charged to the Company's total company expense?

A. I multiplied total annualized payroll by total Company expense factors to derive total annualized payroll to expense. Total annualized Company payroll was then distributed to expense functions based upon the actual distribution of test year payroll.

Q. Does the Company's proposal to include the April 2004 union salary increase in cost of service represent an "isolated," out of period adjustment?

A. Yes. The Company's proposal does not consider all of the relevant factors that are necessary to make adjustments to the revenue requirement that must also be included in order for a proper relationship of revenues, expenses and rate base to be maintained.

Q. Why is it not appropriate to go outside the known and measurable period and/or true-up period to consider cost increases for inclusion in rates?

A. To do so would violate the "test year" matching concept. It is critical in developing a rate structure to maintain a consistent relationship between the revenues recognized by the Company with the expenses incurred to generate those revenues and the rate base investment needed to serve a customer level at a point in time. Properly reflecting the revenue/expense/rate base relationship at a point in time is known as the "matching" concept. The Staff has maintained this critical relationship in its calculations of the annualizations and normalizations used in developing its recommended revenue requirement in this case. In order to maintain the proper relationship between revenue/expense/rate base investments, the Staff has or will include material changes to all significant components of the revenue requirement determination through the end of the known and measurable period and the up-date period. By including all material known changes in revenues, expense and rate base through the end of these periods, an appropriately matched relationship for these elements of revenue requirement is maintained for purposes of setting rates. Revenues have been normalized and annualized through September 30,2003 (the update period) to reflect the increased number of customers to which the Company provides gas service. Expenses have been updated to reflect costs that will be incurred as of these cut-off dates. The rate base investment included in the Staff's case is consistent with the level needed to serve the customers at the end of the test year update and up-date periods. All the annualization and normalization adjustments made in the case are intended to maintain this critical relationship in establishing rates.

As an example, while the Company is experiencing increases in payroll for salary and wage increases, it may also be experiencing cost reductions in other areas and/or additional revenue from customer growth. The Company's proposed inclusion of the April 2004 payroll increase violates the matching principle because it fails to recognize additional changes to cost of service like revenue growth from October 2003 to April 2004 which would offset the cost of the payroll increase in whole or in part. Both the test year update period and the true-up period are devices traditionally employed by the Commission to reduce regulatory lag, which is the lapse of time between a change in revenue requirement and the reflection of that change in rates.

Q. Has the Staff arrived at a conclusion on the rate treatment of the Company's proposed April 1, 2004 union salary increase?

A. Since the parties have not agreed to a true-up allowing for a matched update encompassing all major components of revenue require requirement and the Commission has not ordered one, the Company's proposed isolated adjustment for payroll seven months beyond the update period should be rejected.

INCENTIVE COMPENSATION ADJUSTMENT

Q. Has the Company proposed to include an amount for incentive compensation in the current rate case?

A. Yes. The Company is proposing adjustment (CS-6) for recovery in rates by the Company's ratepayers of total jurisdictional L&P: $7,489 and MPS: $105,973.

Q. What is the Staff position on the incentive compensation adjustments proposed by the Company?

A. The Staff opposes the adjustment based upon two major factors: (1) the proposed adjustment does not meet the "known and measurable" standard; and (2) measurement is based upon improper goals (platforms).

Q. Does Mr. Petersen's adjustment represent an estimate of a future payout of incentive compensation in this case?

A. Yes. Mr. Petersen makes no representation in his direct testimony that the amounts represented in his proposed adjustment will actually be paid out to employees.

Q. Does the Staff agree with how this adjustment was calculated?

A. No. Mr. Petersen's has calculated an estimate based upon all current employees as of September 30, 2003 achieving the middle level of possible incentive payouts in a normal year. Under the Company's scenario, all employees employed at September 30, 2003 would receive the minimum of the mid-level incentive payout regardless of whether the employee met their individual criteria or not.

Q. Did the Company have an incentive compensation plan in effect for the 2002 plan year?

A. Yes, it did have an incentive compensation plan referred to as the 2002 incentive compensation plan.

Q. Did the Company make any incentive compensation awards to employees for the 2002 incentive compensation plan during the test year or the update period?

A. No. The Company made no rewards based on the 2002 incentive compensation plan.

Q. Did the Company suspend the 2002 incentive plan?

A. Based upon the Company's response to Staff Data Request 317.1, the Company suspended the plan.

Q. Has the Company made any statements in regards to why it suspended the 2002 incentive compensation plan?

A. The Company has not made specific statements regarding the cancellation of the employee incentive compensation plan at issue in this case. However, Aquila, Inc.'s 10K

Report to the SEC for the fiscal year ended December 31, 2002, filed by Aquila with the Securities and Exchange Commission on April 15, 2003, addresses the reasons for the cancellation of the executive long term incentive plan. The following statement appears on page 121:

> Our Long-Term Incentive Plan (LTIP) enables the company to reward key executives who have an ongoing company-wide impact. Eligible executives are awarded performance units based on a comparison of out total shareholder return over three years to a specific group of companies with operations similar to ours. Incentives have been paid in cash, restricted stock, restricted stock units or deferred compensation agreements funding stock option grants based on the executives' total shareholdings of the company common stock and their elections. Total compensation expense for the years ended December 31, 2001 and 2000, was $19.6 million and $8.5 million, respectively. Due to the Company's 2002 performance, no awards were earned for the year ended December 31,2002, no new awards were granted in 2002, and potential awards for the year ended December 31, 2003 were suspended.

Q. Has the Company developed a new incentive compensation plan for 2003?

A. Yes. This plan is outlined at pages 10 thru 12 of the direct testimony of Company witness Petersen.

Q. Has the Company meet the "known and measurable" standard as described earlier in testimony for its adjustment to incentive compensation?

A. The amount included in the Company's cost of service as of September 30, 2003, represents an estimated payment. According to recently provided information the actual amount paid out will not be known until late February and distributed to employees March 12, 2004 which is six months beyond the September 30, 2003 update period for this case. Whether the actual payment takes place will not be known until after the hearings for this case. The Staff will have no opportunity to audit the paid amounts as they relate to the incentive measurements platforms included in the plan.

Q. If the Company makes incentive payments to its employees March 12, 2004, should those amounts be included in this case?

A. No. September 30, 2003 has been established as the test year update period that all cost factors and capital assets necessary to serve a customer base as of this point in time. Any payment made in 2004, just like the April 1, 2004 payroll increase should not be reflected in rates determined in this case.

Q. Is the Staff opposed to charging Missouri customers of Aquila for incentive payments relating to achievement of certain financial performance goals?

A. Yes. In the direct testimony of Mr. Petersen, he describes on page 10, lines 9-12 the incentive performance goals:

> The variable compensation plan is tied to company-wide performance on 4 critical objectives. These are customer service, reliability, effective use of capital and safety, which are important components related to serving our customers.

Q. Mr. Petersen poses the question on page 10, line 22-23 "Is there an objective related to the Company's financial results?" and answers it on page 11, line 1, "No". Do you have a reply to this statement?

A. Yes, I do. The Staff believes the effective use of capital is clearly related to the Company's financial results.

Q. How does the Company define the "effective use of capital"?

A. The Company defined effective use of capital in its response to the Staff Data Request No. 317 [ER-2004-0034] as "budgeted EBITDA less capital expenditures measured by state jurisdiction".

Q. What is "EBITDA?"

A. EBITDA is defined as earnings before interest, income taxes and depreciation and amortization. This is a financial measure that relates to the pre-tax earnings of a company.

Q. Who are the beneficiaries of maximizing cash flow and earnings?

A. The Company's Shareholders. That is why the cost of the incentive compensation plan related to improvement in these areas should be assigned to the shareholders.

Q. What percent of the total estimated payout is related to the "Effective Use of Capital" goal?

A. Twenty-five percent (25%). Even if the Commission were to include an estimate for a future incentive plan payout in rates, the Company's estimate should be reduced 25% to exclude incentives properly assigned to the Company's shareholders. The Staff recommends that no incentive compensation payments based on financial results of the corporate entity Aquila, Inc. be charged to Missouri customers of MPS and L&P. The Staff finds no connection between such financial results and any benefits to MPS and L&P ratepayers. The Staff's approach to the area of incentive compensation is long-standing and reflects previous Commission decisions.

Q. Has the Commission previously expressed views on the appropriate rate treatment of incentive compensation plans?

A. Yes. In the Report and Order issued in Case Nos. TC-89-14, et al., Southwestern Bell Telephone Company (SWB), the Commission stated:

> In the Commission's opinion the results of the Parent Corporation, unregulated subsidiaries, and non-Missouri portions of SWB, are only remotely related to the quality of service or the performance of SWB in the state of Missouri. Achieving the goals of SBC [the parent

> company] and unregulated subsidiaries is too remote to be a justifiable cost of service for Missouri ratepayers. Accordingly, the Staff's proposed disallowances in the senior management's long term and short-term incentive plans…should be adopted.

Q. Has the Commission elsewhere addressed its views on the appropriate rate treatment of incentive compensation plans?

A. Yes. In the Report And Order issued pursuant to Case Nos. TC-93-224, et. al., SWB, the Commission reiterated its position expressed in Case No. TC-89-14, and accepted the Staff's proposed disallowances of both short-term and long-term incentive costs. In particular, with regard to the long-term plan, the Commission stated:

> The structure of the plan provides an implicit incentive for participants to try to increase SBC's stock price. This in turn could encourage senior managers to spend a greater percentage of time on non-regulated companies and discourage time and effort spent on Missouri operations…The likelihood of SBC managers emphasizing whatever they perceive will cause the market to react favorably to SBC stock, including giving priority to unregulated subsidiaries, further convinces the Commission that Missouri ratepayers should not fund the long term incentives.

<u>HEALTH, DENTAL AND VISION INSURANCE</u>

Q. Please explain the Staff's proposed adjustment MPS gas: S-65.1; L&P gas: S-63.1.

A. The Staff's adjustments seek to account for the over-accrual that the Company has experienced in prior years for health, dental and vision insurance compared to actual claims paid for these items. The Company's cost for these benefits is based on both insurance premiums for some of the benefits and a self-insured amount for actual claims paid. The Company's adjustment to test year expense for health, dental and vision expense reflects the self-insured portion of their benefit costs. The Staff's analysis of the Company's prior estimates of claims paid indicates that the Company's estimates have historically been higher than actual claims paid. The Staff adjustment recognizes that while the Company accrues the cost of these plans in its books and records, that accrual is adjusted sometime in the future based upon actual costs incurred by the Company for the payment of medical, dental and vision claims.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.