Exhibit No.:
Issues: Payroll,
Payroll Taxes,
Incentive,
Restructuring,
Current Taxes,
Deferred Taxes &
Unamortized
Investment Tax Cr.
Witness: Ronald A. Klote
Sponsoring Party: Aquila Networks-MPS
[redacted]
Case No.: ER-

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

Ronald A. Klote

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI
DIRECT TESTIMONY OF RONALD A. KLOTE
ON BEHALF OF AQUILA, INC.
D/B/A AQUILA NETWORKS-MPS
CASE NO. ER-_____

Q. Please state your name and business address.

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

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

A. I am employed by Aquila, Inc. ("Aquila" or "Company"), as a Senior Regulatory Analyst.

Q. Please briefly describe your duties and responsibilities as a Senior Regulatory Analyst for Aquila.

A. I am responsible for the preparation of financial and other statistical data in connection with filings before regulatory bodies having jurisdiction over Aquila's operations.

Q. Please describe your educational background and experience.

A. In 1992, I received a Bachelor of Science Degree in Accountancy from the University of Missouri-Columbia. I am a Certified Public Accountant holding a certificate in the State of Missouri. In 1992, I joined Arthur Andersen, LLP holding various positions of increasing responsibilities in the auditing division. I conducted and led various auditing engagements of company financial statements. In 1995, I joined Water District No. 1 of Johnson County as a Senior Accountant. This position involved extensive operational and financial analysis of water operations. In 1998, I joined Overland Consulting, Inc. as a Senior Consultant. This position involved special accounting and auditing projects in

the electric, gas, telecommunications and cable industries. In 2002, I joined Aquila in my current position.

Q. Have you previously testified before any regulatory bodies?

A. Yes. I have testified before the California Public Utilities Commission and the Public Utilities Commission of Colorado.

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

A. The purpose of my testimony is to describe certain accounting adjustments made to Aquila Networks – MPS ("MPS") cost of service filing.

Q. Please identify the schedules and any adjustments that you are sponsoring.

A. I am sponsoring the following cost of service (operational) adjustments:

- CS – 5 Payroll Annualization Adjustment (MPS)
- CS – 6 Incentive Annualization Adjustment (MPS)
- CS – 10 Restructuring Adjustment (MPS)
- CS – 83 Write-off of Pre-2002 Miscellaneous Expenses Adjustment (MPS)
- CS – 85 Payroll Taxes Adjustment (MPS)
- TAX – 10A Current & Deferred Income Tax Expense Adjustment (MPS)

In addition, I am sponsoring the following rate base adjustments:

- RBO – 30 Accumulated Deferred Income Taxes Adjustment (MPS)
- RBO – 31 Accumulated Deferred Income Taxes – AAO Adjustment (MPS Only)
- RBO – 50 Unamortized Investment Tax Credit Adjustment (MPS Only)

Payroll Annualization Adjustment (CS – 5)

Q. Please explain the payroll annualization adjustments.

A. The payroll annualization adjustments include employee headcount and annualized wage levels through the known and measurable period.

Q. Please explain how the adjustments were calculated.

A. Base salaries and wages, as of January 30, 2003, were obtained for all departments directly charging MPS and departments that are allocated to MPS . The base salaries and wages represented annual salaries of all applicable full-time and part-time employees.

Q. Why was January 30, 2003 employee salary and wage levels selected to annualize payroll costs?

A. In order to allow for proper analysis and preparation of the payroll annualization adjustment, data was required to be selected from a period in advance of the actual rate case filing. Employee data from January 30, 2003 was the most current available at the time of my analysis.

Q. Please continue with your explanation of the payroll annualization adjustments.

A. Base salaries and wages were added to "Other Than Standard" earnings that were actually paid during the test period January 1, 2002 to December 31, 2002.

Q. What are examples of "Other Than Standard" earnings?

A. "Other Than Standard" earnings categorize labor costs that are price extras on an employee's standard pay. Examples include shift differential, overtime and call out pay.

Q. Please continue with your explanation.

A. Employee base salaries and wages and "Other Than Standard" earnings totals by department were directly assigned to MPS operations where possible. When it was not possible to directly assign these costs, cost assignments were made based upon January 2003 corporate cost allocation factors. Please see the direct testimony of Aquila witness Beverlee Agut for the explanation of corporate cost allocations. The resulting amounts either directly charged or allocated by department were multiplied by scheduled pay increases during the known and measurable timeframe to arrive at a total payroll annualization amount for MPS .

Q. Please continue with your explanation.

A. The total payroll annualization amounts for MPS were compared to MPS' test year per books amount as of December 31, 2002, to obtain the overall payroll annualization adjustment. The payroll annualization adjustments were then spread to Federal Energy Regulatory Commission ("FERC") accounts based on the percentage of test year per books payroll dollars by FERC account to total payroll dollars.

Q. Explain how the total payroll annualization adjustments for operation and maintenance expenses were determined.

A. After the payroll annualization adjustments were calculated by FERC account, amounts were allocated to electric, gas and steam utilities using product allocations based on FERC account. The electric payroll adjustment was multiplied by a jurisdictional factor to differentiate between expenses applicable to retail and wholesale rates.

Q. In regard to annual wage increases, what percentage of increase was used for union and non-union employees?

A. **MPS**: For MPS union employees, a 5.0% wage increase was used. This represented a retroactive estimated increase of 2.5% applicable to October 2002, as well as, a 2.5% increase applicable to October 2003. The retroactive amount is due to contract negotiations that are not finalized at the time of this writing. For non-union non-exempt employees, a 2.3% increase was used. For non-union exempt employees, no wage increase was included.

Q. How was the percentage of wage increases determined?

A. The percentages for Aquila employees were obtained from the Human Resources department. Union employees' wage increases were obtained from historical union pay increases from union contracts. Non-union employees' increases were based on an average of actual pay increases to be paid.

Q. When are pay increases normally effective?

A. Pay increases for union and non-union employees will be effective during the known and measurable timeframe. Non-union pay increases were effective in March (MPS). Union pay increases are annually scheduled in October for MPS employees .

Q. What were the electric payroll annualization adjustments for MPS ?

A. The MPS electric payroll annualization adjustment was a total increase of $248,718 spread among operation and maintenance expenses.

Incentive Annualization Adjustment (CS – 6)

Q. Describe Aquila's two-factor compensation system and how the incentive plan fits into this system.

A. Aquila maintains a two-factor compensation system which is comprised of a fixed portion and a variable portion. The fixed portion is comprised of base salaries and wages. The variable portion is comprised of incentive pay. By adding together the fixed and variable components, a salary level that is comparable to market rates is obtained. Human resources conducts periodic market surveys to compare compensation levels to market rates.

Q. Please describe the goals of employing a variable compensation plan as the second component of a two-factor compensation system.

A. First, Aquila believes that by linking a portion of an employee's compensation to personal objectives, employees have the incentive to perform at a higher level. Each job within Aquila has base-line expectations. These base line expectations must be consistently met to remain employed by Aquila. The personal objectives tied to the incentive pay plan are designed to drive employees to perform above this base line level. Performance above the base-line level is important to all Company stakeholders – customers, employees and shareholders. The second objective, employee benefit costs are lower in a two-factor

compensation system than they would be in a straight base system. Employee benefits (such as, pension calculation, employee retirement investment plans) are calculated only on base pay amounts. There are no employee benefit costs based on incentive compensation. This approach, in essence, represents a cost containment measure which Aquila views as being beneficial to the customer.

Q. Please explain the different levels of payment included in Aquila's incentive (variable) compensation plan.

A. Aquila's variable compensation plan is broken into four separate bands. Which band an employee resides in is dependent on the employee's position. Each band contains three levels of achievement in which the incentive pool is funded. These include: threshold, target and maximum. The threshold level of achievement represents achieving 50% of the organizational objective (identified below). Target represents achieving 70% of the organizational objective. Maximum represents achieving 90% of the organizational objective. In addition, each individual employee has their own set of personal objectives which are separated between threshold, target and maximum levels. An employees personal objectives are multiplied with the organizational objectives to obtain the employee's incentive compensation amount. As such, depending on the employee's performance different incentive payments are made within each band. Each level of achievement is assigned a maximum incentive payment percentage. This percentage is applied to an employee's base salary and wages to compute the incentive payment amount.

Q. Please identify the organizational objectives in which the threshold, target and maximum incentive levels will be determined.

A. The incentive pay plan beginning in 2003 will be tied to the following organizational objectives which Aquila feels are critical to all stakeholders. They include:

- Customer Service
- Reliability
- Effective Use of Capital
- Safety

Aquila's performance in each of these areas will be measured to determine what incentive level an employee is eligible for during the reporting period. Then, based on the employee's performance in regard to their personal goals, an annual incentive payment is calculated.

Q. How were the incentive pay adjustments computed?

A. The incentive pay adjustments were assigned to applicable employees included in the payroll annualization adjustments described above. For each employee included in the incentive plan, the employee's base salary and wage as of January 30, 2003, was multiplied by the employee's target level of achievement percentage. This represented an annualized level of incentive payments paid to applicable employees either directly assigned or allocated to MPS . The total target level of incentive payments directly assigned or allocated to MPS were spread to FERC accounts based on the same ratio as test year per book payroll amounts (ie. Same methodology as payroll annualization adjustments described above.) The annualized level of incentive payments

were compared to test year per book amounts to compute the incentive annualization adjustments.

Q. Explain how the total incentive annualization adjustments for operation and maintenance expenses were determined.

A. After the incentive annualization adjustments were spread to FERC accounts, amounts were allocated to electric, gas and steam utilities using product allocations based on the FERC account. The adjustments assigned or allocated to the electric product were multiplied by the jurisdictional factor based on FERC account.

Q. Why was the target level of achievement selected to compute the incentive annualization adjustment?

A. The target level of achievement represents the middle level of possible incentive payouts in a normal year. Depending on each employees personal level of achievement, some incentive payments are higher based on the maximum level of achievement and some incentive payments are lower based on the threshold level of achievement. As such, by selecting the target level of achievement, the middle band of payments associated with incentive payments are annualized for both the MPS jurisdictions.

Q. What were the electric incentive annualization adjustments for MPS ?

A. MPS electric incentive annualization adjustment totaled $533,899 spread among various FERC accounts.

Restructuring Adjustment (CS – 10)

Q. Please explain the restructuring adjustments.

A. In November 2001, Aquila began implementing a restructuring plan to move from a functional organizational structure to a state-based structure. This initiative was enacted as a way to cut costs throughout the Aquila Networks organization. The majority of the restructuring was completed by September 2002. It resulted in the reduction of staff levels spreading across many departmental functions. A cost of making such a significant company restructuring included severance payments made to employees that were terminated. The restructuring adjustments quantify all restructuring related severance payments and associated benefit and payroll taxes and amortizes the costs over a three year period for both MPS .

Q. How were costs for the restructuring adjustment obtained?

A. All restructuring costs for MPS were obtained from a separate restructuring account in which all costs associated with the restructuring were segregated. These included severance costs for employees who were either directly assigned to MPS or who were allocated to MPS . The severance payments, including the associated payroll taxes, benefits and outplacement services, were identified and assigned to the appropriate state jurisdiction.

Q. Please continue your explanation.

A. Total electric restructuring costs directly assigned and allocated to MPS were identified and amortized over a three year period. The resulting annual amortization of electric restructuring costs was compared to total electric restructuring costs recorded during the test year ending December 31, 2002. The difference was multiplied by the

appropriate jurisdictional factor to obtain the electric jurisdictional restructuring adjustment recorded in various FERC accounts.

Q. Why was a three-year period selected to amortize restructuring costs?

A. The restructuring costs are one-time charges which occurred during the test period. The restructuring activities will provide benefits (ie. cost savings) over future periods. The associated severance costs are being amortized over this period to associate the costs with periods it will benefit. In addition, a three-year period is a reasonable time frame between rate case filings for MPS .

Q. What were the electric restructuring adjustment for MPS ?

A. The net MPS electric restructuring adjustment was a total decrease of $1,329,340 spread among various FERC accounts.

Write-Off of Pre-2002 Miscellaneous Expense Adjustment (CS – 83)

Q. Please explain the write-off of pre-2002 miscellaneous expenses adjustment?

A. During the test period ending December 31, 2002, various costs sitting in liability and asset clearing accounts associated with payroll withholdings, employee expense advances and miscellaneous expenses were written off. The costs were allocated to MPS and recorded in Account 921 Office Supplies and Expense. This adjustment removes the write-off of these amounts from the test year since they are not costs associated with on-going levels of operation. In addition, the majority of the costs are associated with periods prior to the test period ending December 2002.

Q. What is the impact of these adjustments on MPS jurisdictions?

A. The MPS electric jurisdictional adjustment reduced Account 921 by $1,358,071.

Payroll Taxes Adjustment (CS – 85)

Q. What type of payroll taxes are included in the payroll tax adjustments?

A. Included in the payroll taxes adjustments are adjustments for Social Security Tax ("FICA") and Medicare.

Q. How were the payroll tax adjustments calculated?

A. **FICA**

During 2003, only the first $87,000 of an employees compensation is taxed at the FICA tax rate of 6.2%. Therefore, FICA payroll tax ratios were computed and applied to the total payroll annualized amounts. The ratios were computed by using the salary and wage database as of January 30, 2003. All salary and wage dollars up to a limit of $87,000 were totaled and divided by the total salary and wage dollars to obtain the FICA payroll tax ratios. The ratios computed were applied to the annualized payroll amounts to

compute an annualized FICA tax amount. The FICA tax adjustments were the difference between the computed annualized FICA payroll taxes and test year per book FICA payroll and incentive taxes. The appropriate jurisdictional factors were applied to the adjustments to arrive at the electric jurisdictional amounts.

Medicare

The medicare tax rate of 1.45% does not contain a payroll dollar ceiling. Therefore, the medicare tax rate of 1.45% was applied to annualized payroll amounts. The result was compared to Medicare taxes recorded for the 12 months ending December 31, 2002. The resulting differences are the annualized medicare adjustments. The appropriate jurisdictional factors were applied to the adjustments to arrive at the electric jurisdictional amounts.

Q. What is the capitalization ratio, and how is it used in the payroll tax annualization adjustment?

A. The capitalization ratio represents the portion of expense that is not operational or maintenance in nature. Included in these expenses are all capital and balance sheet accounts and other income/deduction ("below-the-line") accounts. Since a portion of payroll tax dollars are capitalized, the payroll tax annualization adjustment is decreased by a factor of one minus the capitalization ratio to arrive at only the portion of payroll taxes that should be expensed in the test year.

Q. What is the impact of the payroll tax adjustments on MPS ?

A. Payroll taxes for MPS electric jurisdiction increased $42,973.

Current & Deferred Income Tax Expense Adjustment (TAX – 10A)

Q. Please explain current income tax expense adjustments.

A. These adjustments are the calculation of the provision for current income taxes for the adjusted test year. These adjustments begin with adjusted net income with various adjustments adding to and subtracting from net income to obtain net taxable income for ratemaking. The adjustments are the result of various book versus tax timing differences and their implementation under separate tax methods: flow-through versus normalization. The resulting net taxable income for ratemaking is then multiplied by the appropriate federal and state tax rates to obtain the current provision for income taxes. A federal tax rate of 35% and a state income tax rate of 6.25% were used in this calculation resulting in an overall effective tax rate of 38.3886%. The difference between the calculated current income tax provision and the per book income tax provision is the current income tax provision adjustment.

Q. Please describe the adjustments to net income before taxes.

A. The following are adjustments made to net income before taxes:

- Book depreciation (including transportation depreciation) expense is added to net income. This amount is added back to net income to avoid deducting depreciation amounts twice for income tax purposes. Tax straight-line depreciation replaces book depreciation as a deduction from income for the income tax calculation.
- Schedule M meals and entertainment disallowance as calculated for the 2002 test period has been added back to income. This amount has historically been included as an add back in determining the current income tax provision.

- Interest expense is subtracted from net income before taxes. It is calculated by multiplying net rate base by the weighted average cost of debt proposed in this proceeding. This interest sychronization technique ensures the interest deduction in the income tax expense calculation equals the interest expense provided in rates.
- Tax depreciation is subtracted from net income. It is divided into two components: (1) Tax straight-line depreciation and (2) Tax depreciation in excess of tax straight-line depreciation. Tax straight-line depreciation represents book depreciation expense restated to reflect the tax basis of plant in service. No deferred taxes are provided for tax straight-line depreciation, thus it can be considered a flow through item. Tax depreciation in excess of tax straight-line depreciation is simply the difference between the tax straight-line depreciation calculation and the total tax depreciation deduction. The excess tax depreciation is normalized in this filing, thus the appropriate deferred income tax amounts are provided for in the income tax provision calculation.

Q. Please describe the deferred income tax adjustment.

A. The deferred income tax adjustment is broken down into two components: The first component represents the tax effected timing difference between tax straight-line depreciation expense and tax depreciation expense as required by normalization rules. The second component represents the amortization of prior deferred taxes normalized that are being flowed back to ratepayers. The combination of the above two components make up the amounts recorded as deferred income tax expense.

Q. Where can the current and deferred income tax calculation be found for MPS ?

A. The current and deferred income tax calculation can be found in Schedule 8 of the MPS cost of service filing .

Accumulated Deferred Income Tax Adjustment (RBO – 30)

Q. Please describe the accumulated deferred income tax offset to rate base.

A. The accumulated deferred income tax offset to rate base includes the accumulation of tax effected timing differences between the general ledger and tax accounting records. These items are known as schedule M's in the company's annual tax return. The majority of timing differences included in this filing are from general ledger accounts that include timing differences associated with plant activity. They include MPS directly assigned timing differences, as well as, corporate timing differences which are common to all Aquila jurisdictions.

Q. What time period was used for accumulated deferred income taxes?

A. Accumulated deferred income taxes are based on actual timing differences through December 31, 2002.

Q. Please explain how the accumulated deferred income tax amount was computed.

A. The accumulated deferred income tax amount includes the following components:

- Accumulated deferred income taxes include timing differences recorded in MPS FERC account 190 and 282. Balances in FERC account 190 and 282 at December 31, 2002 include timing differences based on actual tax return filings through December 31, 2001 and estimates for the period ending December 31, 2002. The estimates for the period ending December 31, 2002 were updated based on the

actual tax return filed for the period ending December 31, 2002. Certain timing differences not recoverable in rates were removed from the account balances.

- Accumulated deferred income taxes include MPS allocable share of balances recorded in corporate FERC account 282. As described above, FERC account 282 at December 31, 2002 includes timing differences based on actual tax return filings through December 31, 2001 and estimates for the period ending December 31, 2002. Estimates for the period ending December 31, 2002 were updated with actual tax return filed amounts. Certain timing differences not recoverable in rates were removed from the account balance.
- Accumulated deferred income taxes for MPS include deferred taxes associated with the Greenwood plant addition adjustment. See the direct testimony of Company witness Stephanie Murphy for a description of the Greenwood plant addition.
- Accumulated deferred income taxes for MPS include an adjustment for the revised tax straight-line depreciation calculation as proposed by Staff in Case No. ER-97-394. The general ledger as of December 31, 2002 includes an estimated calculation of approximately $7.2 million. This amount has been subsequently updated and accumulated deferred income taxes includes an adjustment for approximately $10.4 million. See the direct testimony of Company witness Davis Rooney for further discussion of the tax straight-line depreciation method.

Q. How were accumulated deferred taxes allocated between electric, gas and steam utilities?

A. The majority of the tax effected timing differences residing in accumulated deferred income tax balances are associated with different depreciation methods. As such, plant

utility allocation factors were applied to the accumulated deferred income tax balances to allocate between the utilities. The electric accumulated deferred income tax balance was then multiplied by the appropriate jurisdictional factor to obtain the electric jurisdictional accumulated deferred income tax balance.

Q. What is the total electric accumulated deferred income tax rate base offset for MPS ?

A. The MPS electric accumulated deferred income tax rate base offset totals $76,086,041.

Accumulated Deferred Income Tax – AAO Adjustment (RBO – 31)

Q. Describe the accumulated deferred income taxes associated with Accounting Authority Orders ("AAO").

A. Included as an offset to rate base are deferred taxes related to AAO's that have been issued for MPS. AAO's include charges that for book purposes have been deferred and are amortized over a specific period of time, yet for tax purposes the charges are deducted from income in the year of occurrence. These tax affected timing differences are recorded as an offset to rate base.

Q. What AAO's are included in the accumulated deferred income tax calculation for MPS?

A. The 1990 AAO associated with Sibley rebuild and western coal conversion, the 1992 AAO associated with Sibley rebuild and western coal conversion and 2002 AAO associated with ice storm damage.

Q. What is the electric accumulated deferred income tax – AAO rate base offset for MPS?

A. MPS electric accumulated deferred income tax – AAO rate base offset totals $3,763,054?

Unamortized Investment Tax Credit Adjustment (RBO – 50)

Q. What is the investment tax credit?

A. Investment tax credit ("ITC"), recorded in FERC Account 255, was created by the federal government to encourage plant investment in the public sector. It allows a company to directly reduce its taxes payable balance. Over the years, the government offered various percentage levels of investment to be taken as a tax credit. For MPS, the 3% vintage is allowed as a rate base offset.

Q. What time period was used for ITC?

A. ITC as of December 31, 2002 was used.

Q. Please explain the computation of the unamortized ITC amount in this case.

A. This adjustment was only made for the MPS jurisdiction. The unamortized MPS electric portion of FERC account 255001 (ITC) as of December 31, 2002 was obtained. The plant jurisdictional factor was applied to the electric balance to determine the total ITC applicable to MPS electric jurisdictional operations. This amount totaled $77,328 as of December 31, 2002.

Q. Does this conclude your testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

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 "Direct 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

Subscribed and sworn to before me this 26th day of June, 2003.

Notary Public
Terry D. Lutes

My Commission expires:

8-20-2004

TERRY D. LUTES
Jackson County
My Commission Expires
August 20, 2004