

EXHIBIT

Exhibit No.:
Issue(s): Accounting Authority Orders/
Senior Management Compensation
Witness/Type of Exhibit: Robertson/Rebuttal
Sponsoring Party: Public Counsel
Case No.: ER-2007-0004

REBUTTAL TESTIMONY

OF

TED ROBERTSON

Submitted on Behalf of
the Office of the Public Counsel

FILED
MAY 3 2007
Missouri Public
Service Commission

**AQUILA, INC. D/B/A AQUILA NETWORKS-MPS
AND AQUILA NETWORKS-L&P**

** _____ **
Denotes Highly Confidential Information that has been Redacted

Case No. ER-2007-0004

OPC Exhibit No. 406-NP
Case No(s) ER-2007-0004
Date 4/4/07 Rptr NV

February 20, 2007

NP

**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)
Aquila Networks—MPS and Aquila Networks—)
L&P Missouri Service Areas.)

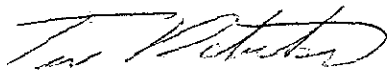
Case No. ER-2007-0004
Tariff No. YE-2007-0001

AFFIDAVIT OF TED ROBERTSON

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Ted Robertson, of lawful age and being first duly sworn, deposes and states:

1. My name is Ted Robertson. I am a Public Utility Accountant for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.




Ted Robertson, C.P.A.
Public Utility Accountant III

Subscribed and sworn to me this 20th day of February 2007.



JERENE A. BUCKMAN
My Commission Expires
August 10, 2009
Cole County
Commission #05754036



Jerene A. Buckman
Notary Public

My commission expires August 10, 2009.

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1 **REBUTTAL TESTIMONY**
2 **OF**
3 **TED ROBERTSON**

4
5 **AQUILA INC.**
6 **d/b/a**
7 **AQUILA NETWORKS - MPS**
8 **AND**
9 **AQUILA NETWORKS - L&P**

10
11 **CASE NO. ER-2007-0004**

12
13 **I. INTRODUCTION**

14 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

15 A. Ted Robertson, PO Box 2230, Jefferson City, Missouri 65102-2230.

16
17 Q. ARE YOU THE SAME TED ROBERTSON THAT HAS PREVIOUSLY FILED
18 TESTIMONY IN THIS CASE?

19 A. Yes.

20
21 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

22 A. The purpose of this testimony is to present the Public Counsel's rebuttal on the issues of
23 accounting authority order ("AAO") costs and Aquila's senior management team
24 compensation costs.

II. ACCOUNTING AUTHORITY ORDERS

Q. WHAT IS THE ISSUE?

A. The issue relates to the ratemaking treatment of AAO costs in the MPS rate base and expense.

Q. HAS COMPANY, AND THE MPSC STAFF, APPROPRIATELY PROVIDED FOR THE AAO COSTS IN RATE BASE?

A. No. Company, and the MPSC Staff, in their respective direct testimony, recommended rate base treatment for the unamortized deferred balances, and associated deferred income tax, of the accounting authority orders for the Sibley Rebuild and Western Coal Conversion deferrals, but neither included the unamortized deferred balance, or associated deferred income tax, of the Ice Storm AAO authorized in Case No. EU-2002-1053. Public Counsel opposes the inclusion of the unamortized AAO deferred cost balances in rate base and supports the reduction of rate base for the associated deferred income tax component of all three AAOs.

Q. DOES PUBLIC COUNSEL KNOW THE CORRECT AMOUNT OF DEFERRED INCOME TAX, ASSOCIATED WITH EACH OF THE AAOs, THAT SHOULD BE SUBTRACTED FROM RATE BASE?

A. Company failure to maintain the proper financial records for AAO-related deferred income tax has been a factor in the tracking of these particular costs at least as far back as its 1993 electric rate case; however, it is my belief that a reasonable surrogate for the deferred tax amounts to subtract from rate base can be determined by multiplying the jurisdictional

1 portion of the unamortized AAO deferred balances at December 31, 2006 by Company's
2 effective income tax rate.

3
4 Q. HAS COMPANY, AND THE MPSC STAFF, INCLUDED IN THE PROPOSED COST
5 OF SERVICE AN APPROPRIATE AMOUNT OF EXPENSE AMORTIZATION FOR
6 THE AAOs?

7 A. Public Counsel does not believe that there is an issue regarding the annual expense
8 amortization associated with the Sibley Rebuild and Western Coal Conversion deferrals;
9 however, we do oppose the expense amortizations proposed by both Company and the
10 MPSC Staff for the Ice Storm AAO.

11
12 Regarding the Ice Storm AAO expense amortization, it is my understanding that the
13 Company has included in its cost of service an annual level of expense that represents a full
14 twelve months of expense, while the MPSC Staff has proposed a slightly lower level of
15 expense amortization based apparently on a remaining unamortized balance that does not
16 match with the Commission's Order for the AAO. Public Counsel believes that both
17 amounts are inappropriate because, according to the Commission's Order in the
18 authorization for the AAO, the amortization is scheduled to end on or about February 2007
19 (approximately one month after the end of the ordered known and measurable period for the
20 instant case). Commission authorization of either the Company or MPSC Staff proposal
21 would allow it to recover in its cost of service an annual level of expense that far exceeds the
22 cost balance that I understand remains to be amortized.

1 Q. WHAT DO THE AAO DEFERRED COSTS REPRESENT?

2 A. The accounting authority orders granted MPS by the Commission allow the utility to depart
3 from traditional methods of accounting by permitting Company to defer various costs
4 included in one accounting period for possible rate recovery in another accounting period.
5 By allowing the AAOs, the Commission authorized MPS to defer depreciation expense,
6 other expenses (e.g., property taxes, ice storm repairs), and carrying costs for plant
7 additions. In the absence of the Commission's accounting authorization, the normal
8 accounting practice would have been to charge the depreciation, and other costs, to expense
9 in the period incurred, and to cease the accrual of the carrying costs (i.e., allowance for
10 funds used during construction ("AFUDC")) at the time the plant goes into service. (The
11 capitalization of the carrying charges is the equivalent of accruing AFUDC after the plant
12 goes into service.)
13

14 Q. WHY DOES THE PUBLIC COUNSEL OPPOSE RATE BASE INCLUSION OF THE
15 UNAMORTIZED AAO DEFERRED BALANCES?

16 A. Public Counsel believes that the AAO process has the effect of protecting Company from
17 negative regulatory lag and that that protection should not be all encompassing for the risks
18 it causes. In Missouri Public Service Co., Case Nos. EO-91-358 & EO-91-360, the
19 Commission stated:
20

21 Lessening the effect of regulatory lag by deferring costs is beneficial to a
22 company but not particularly beneficial to ratepayers. Companies do not
23 propose to defer profits to subsequent rate cases to lessen the effects of
24 regulatory lag, but insist it is a benefit to defer costs. Regulatory lag is a
25 part of the regulatory process and can be a benefit as well as a detriment.

1 Lessening regulatory lag by deferring costs is not a reasonable goal unless
2 the costs are associated with an extraordinary event.
3

4 Maintaining the financial integrity of a utility is also a reasonable goal.
5 The deferral of costs to maintain current financial integrity, though, is of
6 questionable benefit. If a utility's financial integrity is threatened by high
7 costs so that its ability to provide service is threatened, then it should seek
8 interim rate relief. If maintaining financial integrity means sustaining a
9 specific return on equity, this is not the purpose of regulation. It is not
10 reasonable to defer costs to insulate shareholders from any risks. 1 Mo.
11 P.S.C. 3d 200, 207 (1991).
12
13

14 The Commission has recognized that lessening the effect of regulatory lag by deferring costs
15 is beneficial to a utility but not particularly beneficial to ratepayers. Companies do not
16 propose to defer profits to subsequent rate cases to lessen the effects of regulatory lag, but
17 insist it is a benefit to defer costs. Regulatory lag is a part of the regulatory process and can
18 be a benefit as well as a detriment.
19

20 Q. WHY DID THE MPSC STAFF INCLUDE THE UNAMORTIZED AAO DEFERRED
21 BALANCES IN RATE BASE?

22 A. Beginning on page 19, line 8, of Staff witness, Mr. Phillip K. Williams, direct testimony, he
23 states:
24

25 Q. Please describe the unamortized Accounting Authority Order (AAO)
26 balances included in rate base.
27

28 A. Unamortized AAO balances at September 30, 2006 were included in
29 rate base, to reflect a return on the unamortized balance of the AAO deferrals
30 authorized by the Commission in Case Nos. ER-90-101, EO-91-247 and ER-
31 93-37. These AAO deferrals are the MPS Sibley rebuild project, Case No.
32 ER-90-101, and the MPS Sibley Western Coal Conversion, Case No. ER-93-
33 37. The Commission has included the unamortized balance associated with

1 the Sibley rebuild project and the Sibley Western Coal Conversion in every
2 rate case since Case No. ER-93-37.

3
4 Q. Did the Staff include expense amortizations of the deferrals for each
5 of the above AAOs?
6

7 A. Yes. The Staff adopted the test year amortization for the Sibley
8 rebuild and the Sibley Western Coal Conversion deferrals. Staff adjusted the
9 test year amortization of the Case No. EU-2002-1053 ice storm deferral as
10 determined in Case No. ER-2004-0034.
11

12 Staff has included the expense amortization for a 2003 ice storm that
13 resulted in significant costs to restore Aquila's transmission and distribution
14 systems. However, Staff did not include the unamortized balance for the ice
15 storm in rate base. Allowing the recovery (expense amortization) of the cost
16 of the 2003 ice storm in cost of service, without rate base recognition for the
17 unamortized balance, results in a sharing of the abnormal cost between
18 ratepayers and shareholders.
19
20

21 Q. MR. WILLIAMS TESTIMONY STATES THAT THE COMMISSION HAS INCLUDED
22 THE UNAMORTIZED BALANCE ASSOCIATED WITH THE SIBLEY REBUILD
23 PROJECT AND THE SIBLEY WESTERN COAL CONVERSION IN EVERY RATE
24 CASE SINCE CASE NO. ER-93-37. IS THAT AN ACCURATE STATEMENT?

25 A. No, it is not. It is my understanding that the costs were allowed in Case Nos. ER-90-101,
26 ER-93-237 and ER-97-394; however, Mr. Williams fails to identify for the Commission that
27 Company rate cases ER-2001-672, ER-2004-0034 and ER-2005-436, which were all
28 subsequent to MGE Case No. GR-98-140 (which I will discuss further later in this
29 testimony), were "black box" settlements. No costs associated with the AAOs were
30 specifically identified and delineated in the settlement amounts for those cases. Public
31 Counsel could just as easily say Company received neither a return of nor a return on the
32 AAO deferred costs in the those settled cases - but that too would not be an accurate
33 statement.

1 Q. DOES THE PUBLIC COUNSEL BELIEVE THAT COMMISSION CASE NOS. ER-90-
2 101, EO-91-247 AND ER-93-37 ARE VALID WITH REGARD TO THE
3 APPROPRIATENESS OF RATE BASE TREATMENT FOR THE UNAMORTIZED
4 AAO DEFERRED COSTS?

5 A. No. The cases Mr. Williams cites occurred early in the Commission's process of
6 developing, or adopting, what commonly became known as accounting authority orders. In
7 a later case, the Commission recognized that allowing a utility to earn a return on the
8 deferred AAO costs is not an appropriate regulatory policy.

9
10 Q. IN WHICH CASE DID THE COMMISSION PREVIOUSLY DENY
11 AUTHORIZATION FOR A "RETURN ON" AN UNAMORTIZED AAO DEFERRED
12 BALANCE?

13 A. The cost recovery was denied in Missouri Gas Energy ("MGE"), Case No. GR-98-140.
14 In its Report and Order, beginning on page 19, the Commission stated its reasoning for
15 **denying** the utility a "return on" the unamortized deferred safety line replacement costs
16 ("SLRP") it had booked. The Report and Order states:

17
18 **The Commission finds that the unamortized balance of SLRP**
19 **deferrals should not be included in the rate base for MGE.** The AAOs
20 issued by the Commission authorize the Company to book and defer the
21 amount requested but do not approve any ratemaking treatment of
22 amounts from the deferred and booked balances. **AAOs are not intended**
23 **to eliminate regulatory lag but are intended to mitigate the cost**
24 **incurred by the Company because of regulatory lag.**

25
26 (Emphasis added by OPC.)
27
28

1 Q. WHY IS THE POSITION THE COMMISSION ADOPTED IN MGE CASE NO. GR-
2 98-140 IMPORTANT?

3 A. Public Counsel believes that the Commission, in its decision in MGE Case No. GR-98-
4 140, recognized that the sole purpose of accounting authority orders and their deferred
5 cost recovery is to mitigate or lessen the effect of regulatory lag, not to eliminate it nor to
6 protect the Company completely from risk. The Commission decided that a sharing of
7 the risk for the extraordinary costs between shareholders and ratepayers is appropriate.
8 Therefore, the Commission's decision in MGE GR-98-140 is especially relevant to the
9 rate treatment of the AAO deferred costs of the instant case because its decision in that
10 case recognized that even though the SLRP costs were determined to be extraordinary
11 (MGE deferred SLRP costs pursuant to Commission's authorization in AAO Case Nos.,
12 GO-92-185, GO-94-234 and GO-97-301 and it is my understanding that in each of those
13 cases the Commission determined that the costs were extraordinary), MGE's
14 shareholders must share in the risks associated with the negative regulatory lag from
15 which the costs emerged.

16
17 Q. IS IT REASONABLE TO BELIEVE THAT THE AAO COSTS AT ISSUE ARE
18 EXTRAORDINARY?

19 A. Yes. Inherent in the Commission's authorization of any AAO, to defer costs which
20 would normally be expensed when incurred, a utility must convince the Commission that
21 the costs for which it is requesting the specialized accounting treatment are indeed
22 extraordinary. Though investments associated with costs deferred may vary from AAO
23 to AAO, and from utility to utility, the rationale for receiving the abnormal regulatory

1 accounting treatment remains the same. That is, the AAO cost deferral and recovery
2 process is allowed in order to mitigate the effects of regulatory lag on the utility.

3
4 Q. IS IT CORRECT THAT THE AAO COSTS THAT WERE DEFERRED ARE NOT
5 ACTUALLY AN EXPENDITURE FUNDED BY THE COMPANY?

6 A. Yes, that is a true statement. What the Sibley AAOs deferred were the property tax and
7 depreciation incurred after the plant was placed in service along with a carrying charge on
8 those costs (i.e., pseudo-earnings for the utility on the deferred costs). The AAO from Case
9 No. EO-90-114 allowed the Company to defer depreciation expenses, property taxes and
10 carrying costs, while the AAO from Case No. EO-91-358 authorized the deferral of only
11 depreciation expenses and carrying costs. The carrying costs and depreciation expense
12 associated with the deferrals are not actually dollars of investment capital funded by the
13 Company. The costs are merely accounting entries on its financial books. Neither the
14 carrying cost nor the depreciation expense causes the Company to forego any actual outlay
15 of cash. In fact, depreciation expense does not begin to be booked until the plant is actually
16 placed into service. No real dollars are required for its expensing. Thus, depreciation is
17 definitely not a capital cost. However, the dollars associated with these book entries will be
18 recovered from ratepayers through the amortization included in the utility's cost of service.

19
20 Q. WHAT ABOUT PROPERTY TAXES?

21 A. During the construction of the new plant, property tax would normally be added as a cost
22 of the construction up and until such time as the plant is placed into service then, on a
23 going forward basis, any future property tax is treated as a normal income statement

1 expense item. In reality, while the utility would eventually incur a real expenditure for
2 the payment of the property taxes, that payment would likely not occur until the year
3 subsequent to the year the plant is put into service. In any event, neither depreciation
4 expense, property tax expense nor carrying costs Company deferred are capital costs
5 requiring rate base treatment according to normal accounting and ratemaking procedures.
6 The costs deferred are nothing more than expenses and a pseudo-earnings return that the
7 utility would not have recovered, all things being equal, during the lag period between
8 when the new construction was finalized and placed in service and when new rates
9 incorporating the costs associated with that new plant were authorized by the
10 Commission.

11
12 Q. IF THE AAO DEFERRED COST BALANCES ARE INCLUDED IN RATE BASE WILL
13 THAT PERMIT THE COMPANY TO EARN A RETURN ON AMOUNTS FOR WHICH
14 THERE WAS NO ACTUAL INVESTMENT MADE BY THE COMPANY?

15 A. Yes, it would.

16
17 Q. WOULD INCLUDING THE DEFERRED COST BALANCES IN RATE BASE ALSO
18 PERMIT THE UTILITY TO EARN A RETURN ON A RETURN?

19 A. Yes, it would. Allowing the Company to earn a "return on" the deferrals has the same effect
20 of allowing it to earn a return on a return. Stated another way, the Company will recover
21 (receive a "return of") the deferred carrying cost, depreciation expense and other expenses
22 by way of the expense amortization included in rates, and then will earn a "return on" those
23 same amounts. Since the carrying costs deferred represent an earnings return on the

1 investment for the regulatory lag period, rate base treatment would add an additional
2 earnings return on top of those amounts.

3
4 Q. IS THE PURPOSE OF AN AAO TO MAKE THE UTILITY FINANCIALLY WHOLE
5 WITH REGARD TO A POTENTIAL EARNINGS LEVEL?

6 A. No. Had the utility not received authorization for the AAOs, for the Sibley Rebuild and
7 Western Coal Conversion projects, or even the Ice Storm AAO, it is likely it would not
8 have recovered from ratepayers any of the costs it has deferred and now seeks recovery
9 of in this rate case. Unless the utility had filed for a general rate increase that coincided
10 with the in-service dates of the new plant, and/or included a test year wherein the other
11 expenses were incurred, regulatory lag would naturally have occurred preventing it from
12 recovering in rates any of the AAO costs it now requests. Thus, the true purpose of the
13 Sibley Rebuild and Western Coal Conversion AAOs, and the Ice Storm AAO, is to
14 insulate the utility and its shareholders from the risks associated with the negative
15 regulatory lag that occurs when various costs are incurred, and/or construction projects
16 are completed and placed in service, before the operation law date of a general rate
17 increase case. But, that does not mean that the AAOs exist to make the utility
18 "financially whole."

19
20 Q. IF AN AAO IS NOT TO MAKE A UTILITY "FINANCIALLY WHOLE" WHAT
21 PURPOSE DOES IT SERVE?

22 A. The purpose of an AAO is to assist the utility in the **mitigation** of negative regulatory lag
23 associated with extraordinary costs. However, it is interesting to me that no such

1 mechanism has been instituted in the state of Missouri for when a utility enjoys an excess
2 earnings situation - a positive regulatory lag period. Such an important mechanism could
3 have played an important part in MPS Case Nos. ER-97-394 and Case No. ER-2001-672.
4 The result of those two rate cases was Commission recognition that the Company was
5 over-earning significantly during the accounting periods reviewed. The overall rate
6 decreases resulting from the Commission's orders in those cases approximated \$16.9
7 million annually for MPS Case No. ER-97-394, and \$4.25 million annually for MPS Case
8 No. ER-2001-672. What I find most interesting is that Company did not request an AAO
9 to defer its excessive earnings for future refund to ratepayers prior to the Commission
10 ordering the rate reductions. My point being that regulatory lag works both ways for the
11 utility; depending on the circumstances, it can result in either a positive or negative
12 impact to the utility and its shareholders.

13
14 Q. PLEASE EXPLAIN THE CONCEPT OF REGULATORY LAG.

15 A. The concept of regulatory lag is based on a difference in the timing of a decision by
16 management, and the Commission's recognition of that decision, and its effect on the rate
17 base/rate of return relationship in the determination of a utility's revenue requirement.
18 Management decisions that reduce or increase the cost of service without changing rates
19 result in a change in the rate base/rate of return relationship. This change either increases
20 or decreases the profitability of the utility in the short-run until such time as the
21 Commission reestablishes rates to properly match the new level of service cost. Utilities
22 are allowed to retain cost savings (i.e., excess profits during the lag period between rate
23 cases) and are forced to absorb cost increases. When faced with escalating costs,

1 regulatory lag places pressure on management to minimize the change in the relationship
2 because it cannot be recognized in a rate increase until the Commission approves such in
3 a general rate proceeding.
4

5 Q. DOES THE COMPANY RECOGNIZE THAT ITS SHAREHOLDERS ARE BEING
6 INSULATED FROM REGULATORY LAG?

7 A. When the AAOs at issue were first initiated it did. In the Commission's Report and Order,
8 MPS, Case No. EO-91-358, page 9, its states:
9

10 **MPS presented four considerations it believes are the benefits of**
11 **allowing deferral of the costs requested. These are rate stability,**
12 **avoidance of rate case expense, lessening the effect of regulatory lag, and**
13 **maintaining the financial integrity of the utility.**
14

15 (Emphasis added by OPC.)
16
17

18 It would appear, from the language in the Report and Order, that the MPS witnesses who
19 fought to have the AAO authorized in the first place believed the insulation of
20 shareholders from regulatory lag was an important benefit.
21

22 Q. SHOULD RATEPAYERS BE REQUIRED TO PROVIDE MPS WITH A
23 GUARANTEED RETURN ON THE SIBLEY REBUILD AND WESTERN COAL
24 CONVERSION EXPENDITURES JUST BECAUSE THE COMPANY'S
25 MANAGEMENT CHOOSES NOT TO EXERCISE ITS PLANNING AND
26 OPERATING RESPONSIBILITIES?

1 A. No, ratepayers should not be required to fund such a return. Planning and operation of
2 the Company's construction projects are a fundamental responsibility of utility's
3 management. It is the utility's management that has complete access and control of the
4 data and resources necessary to fulfill these responsibilities, and as such, management is
5 the only party that has the wherewithal to implement a construction program that
6 minimizes the effects of regulatory lag on its finances.

7
8 Q. PLEASE SUMMARIZE THE PUBLIC COUNSEL'S RECOMMENDATIONS
9 REGARDING THE AAO DEFERRED COSTS.

10 A. Public Counsel recommends that an appropriate level of expense amortization associated
11 with the three AAOs be allowed in the MPS cost of service. However, Public Counsel
12 recommends that the Company's rate base be computed so that MPS will not earn a
13 "return on" the unamortized AAO deferred balances nor inappropriately benefit from the
14 associated deferred income tax that the cost deferrals created.
15
16 Public Counsel believes that guaranteeing the utility a "return of" and "return on" the
17 unamortized AAO deferred balances is not a fair allocation of regulatory lag implications
18 resulting from the Company's construction projects or the occurrence of natural disasters.
19 My recommendation is based on the most recent Commission decision wherein this issue
20 was fully litigated. In that litigated case, the Commission recognized and ordered that the
21 unamortized deferred balances associated with AAOs should not be afforded rate base
22 treatment. The Commission has stated that the AAOs it authorizes allow a utility to book
23 and defer certain costs but does not approve any ratemaking treatment of the deferred

1 balances. It has also stated that the purpose of an AAO is not to eliminate regulatory lag but
2 instead is intended only to mitigate costs normally absorbed by the utility because of
3 regulatory lag. In essence, the purpose of an AAO is to lessen the effect of the regulatory
4 lag upon the utility, not to eliminate it nor to protect a utility's shareholders completely from
5 risk.

6
7 Public Counsel understands that the purpose of the AAO authorization is to mitigate the
8 negative implications of regulatory lag upon the utility, not to eliminate all risks
9 encountered by a utility. By not allowing MPS a "return on" the unamortized AAO
10 deferred balances, the utility's management and shareholders appropriately share in some
11 of the responsibility for the risk of the costs incurred. Excluding the unamortized AAO
12 deferred balances from rate base allows the risk associated with regulatory lag to be shared
13 between the shareholder and the ratepayer. The utility will still recover the actual amounts it
14 is allowed to defer, but it simply will not be allowed to earn a return on those same costs.

15
16 In addition, with regard to the Sibley Rebuild and Western Coal Conversion AAOs,
17 Public Counsel's position is supported by the fact that the utility's management is
18 responsible for planning and operating the activities of the Company. If the utility's
19 management is unable to or chooses not to implement processes and procedures that
20 would limit the effects of negative regulatory lag on its finances, the shareholders should
21 not be protected by the Commission with a guaranteed recovery of both the costs deferred
22 and an earnings return on those costs. The deferral and recovery of deferred costs to
23 maintain current financial integrity or to sustain a specific return on equity is of questionable

1 benefit and certainly not, in my opinion, appropriate. If a utility's financial integrity is
2 threatened by occurrence of high or unexpected costs so that its ability to provide service is
3 endangered, then it has the ability to and should seek interim rate relief from the
4 Commission. Shareholders should not be insulated from all risks associated with the failure
5 of a utility's management to adequately perform its duties.

6
7 Furthermore, the Ice Storm AAO, though unique, is only slightly different from the
8 Sibley Rebuild and Western Coal Conversion AAOs. The deferred costs associated with
9 this AAO relate to a natural disaster event often referred to as an "act of God." The
10 Commission's past treatment of the incremental costs of such events is unambiguous. In
11 St. Louis County Water Company, Case No. WR-95-145, the Commission decided to
12 allow a utility recovery of the deferred costs related to natural disasters as an expense
13 item, but **did not** include the costs unamortized balance in rate base. The Report and
14 Order in Case No. WR-95-145 stated:

15
16 **The burden of "acts of God" should not have to be borne solely by the**
17 **ratepayers. In the case of a natural disaster, the shareholders should**
18 **not be shielded from the risk, but should share in the cost with the**
19 **ratepayer. Allowing County Water to recover the cost through**
20 **amortization, without inclusion of the unamortized balance in rate**
21 **base, achieves that sharing.**

22
23 (Emphasis added by OPC.)
24
25

26 Therefore, in order that ratepayers and shareholders both share in the financial effects of
27 the negative regulatory lag the utility would have experienced, had the AAOs not been
28 authorized, Public Counsel recommends that MPS be permitted to earn an appropriate

1 "return of" the deferred costs, for all three AAOs, but not earn a "return on" any of the
2 unamortized AAO deferred balances or benefit from their associated deferred income tax.

3
4 **III. SENIOR MANAGEMENT TEAM COMPENSATION**

5 Q. WHAT IS THE ISSUE?

6 A. Public Counsel believes that the Company's proposed cost of service, for both MPS and
7 L&P, includes an excessive amount compensation paid to its Chairman and Chief
8 Executive Officer ("CEO"), Mr. Richard C. Green Jr.

9
10 Q. PLEASE CONTINUE.

11 A. During the Commission ordered test year, and update period, Mr. Green received or
12 benefited from various forms of remuneration provided by the Company. The
13 remuneration included items such as base salary, bonus payment, lump sum - perquisite
14 contribution, country club dues, restricted stock releases and other payments related to
15 employee benefits such as, ** _____
16 _____
17 _____

18 _____.** (Source: OPC DR Nos. 1007, 1009, 1010 and 1011)

19 Public Counsel has reviewed the compensation identified above and recommends that a
20 portion of Mr. Green's base salary should be disallowed due to the fact that the level of
21 pay Mr. Green is earning is not in sync with the stated executive compensation
22 philosophy of the Company given the size and nature of its current operations.
23

1 Q. IS COMPANY REQUESTING THAT ITS MISSOURI REGULATED ELECTRIC
2 OPERATIONS SHARE IN THE RESPONSIBILITY FOR THE REIMBURSEMENT OF
3 A PORTION OF ALL OF THE REMUNERATION IDENTIFIED IN THE PRIOR
4 Q&A?

5 A. No. Costs associated with most of the types of remuneration I identified previously are
6 included in the current rate case; however, it is my understanding that some of the costs
7 have been removed by the Company, e.g., country club dues were booked below the line,
8 certain bonus payments were retained at the corporate level, ** _____
9 _____ **, and the costs associated with the restricted
10 stock releases were likely expensed in a prior period. (Source: OPC DR Nos. 1008,
11 1009, 1010 and 1011)
12

13 Q. WHAT ARE THE COMPENSATION COSTS THAT PUBLIC COUNSEL BELIEVES
14 ARE EXCESSIVE?

15 A. During my audit of the Company's books and records I reviewed information relating to
16 compensation paid to the senior management team and Board of Directors' during the test
17 year and update period. The results of my analysis led me to conclude that the base
18 salary paid to Mr. Green is excessive given the Board of Directors stated compensation
19 philosophy of maintaining base salaries of its senior management team at a 50th percentile
20 of a comparison group of peer companies. Mr. Green's base salary, unlike other members
21 of the senior management team, far exceeds that stated goal.
22

23 Q. WHAT IS THE COMPENSATION PHILOSOPHY OF AQUILA?

1 A. Company's response to OPC Data Request No. 1005 provided a copy of the Aquila Inc.,
2 Statement DEF 14A, March 24, 2006, which was filed with the United States Securities
3 and Exchange Commission ("SEC"). The document states the compensation philosophy
4 as,

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25 (Emphasis added by OPC)
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28 Q. PLEASE EXPLAIN AQUILA'S IMPLEMENTATION OF ITS COMPENSATION
29 PHILOSOPHY.

30 A. Company's response to OPC Data Request No. 1012, which referenced its response to
31 MPSC Data Request No. 0016 in Aquila, Inc., Case No. EO-2006-0356, provided several
32 documents which explain the approach and philosophy that Aquila takes toward the issue
33 of executive compensation. The response stated, in part:
34

1 Essentially, the philosophy provides that: 1) **Aquila's compensation and**
2 **benefits practices will target the market 50th percentile of domestic**
3 **regulated utilities most similar to Aquila,** 2) Aquila's compensation and
4 benefits practices will be sufficient to attract and retain the talent
5 necessary to run the business and execute company strategies, and 3)
6 Aquila's compensation and benefits practices will support and reinforce
7 important organizational goals and objectives.
8
9

10 And,
11

12 Aquila's history has an important influence on our current position relative
13 to market as we now define it. While the general approach of the board
14 and consultants (i.e. selecting peers, tracking market practices and trends
15 and recommending strategies reflecting the pay philosophy and corporate
16 performance) remained the same, Aquila's dramatic growth and decline
17 had a significant impact on the compensation practices of the company.
18 **As was appropriate during the period from 1998 to 2002, Aquila**
19 **compared itself to peers of similar size, scope of operations and**
20 **business strategies which at that time were large diversified energy**
21 **companies with international holdings and significant energy**
22 **merchant businesses. And, as outlined in the attachments, those types**
23 **of companies placed a significant emphasis on pay at risk. Aquila**
24 **followed suit. Aquila's compensation philosophy then was to pay at**
25 **the 50th percentile on base pay, but to target total compensation at the**
26 **market 75th percentile in order to emphasize a "pay at risk" culture**
27 **reflective of that business and those times.**
28

29 (Emphasis added by OPC)
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32 Q. DID THE COMPANY SUBSEQUENTLY CHANGE ITS COMPENSATION
33 PHILOSOPHY?

34 A. Yes, with regard to level of "pay at risk" compensation earned by employees it appears
35 that Company did make some modification to its stated philosophy. In years 2002, and
36 subsequent, several members of the management team severed their employment with
37 Aquila while others were promoted to senior management positions. The current

1 management team (Richard C. Green Jr., Keith G. Stamm, Jon R. Empson, Leo E.
2 Morton, Christopher M. Reitz and Beth A. Armstrong) is operating in a totally different
3 business environment than what former senior managers of the Company previously
4 experienced. This new business environment resulted in changes in the level of total
5 compensation paid to these executives.

6
7 For example, in its response to MPSC Data Request No. 0016, Aquila, Inc., Case No.
8 EO-2006-0356, Company stated:

9
10 Since 2002, Aquila compensation philosophy and practices have changed
11 dramatically as has our business.
12
13

14 And,

15
16 In 2002, after the decline of the Merchant business, the Board reviewed its
17 options for restructuring the company and the appropriate management
18 team to do it. At that time, they re-appointed Rick Green as CEO and
19 selected the senior managers they felt best qualified to execute the
20 turnaround. **During 2002 and 2003, during the height of the**
21 **restructuring effort the committee and management were in lock step**
22 **in their interpretation of how the company's compensation**
23 **philosophy should apply to the situation. Aquila's historical pay at**
24 **risk approach had resulted in significant payouts for executives and**
25 **employees during record profit years. All agreed that there should be**
26 **no bonuses, awards or grants of any type during the initial years of**
27 **restructuring. All outstanding performance plans were cancelled and**
28 **no new grants provided. The committee decided that in light of the**
29 **decision to eliminate all variable compensation and while facing some**
30 **pressure to retain talent, it was appropriate to maintain the**
31 **leadership team's base rates.**

32
33 (Emphasis added by OPC)
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1
2 Q. HAS THE PEER GROUP OF COMPANIES AQUILA USES TO HELP IT
3 DETERMINE EXECUTIVE COMPENSATION BEEN MODIFIED?

4 A. Yes. Prior to the merchant business collapse, Company compared its executive
5 compensation policies to a peer group which consisted of large growing multinational
6 organizations which, in some cases, operated both regulated and non-regulated lines of
7 business. Subsequent to the downsizing of Aquila's operations, Company selected a
8 different group of peers which it now utilizes to compare its compensation policies. This
9 new peer group is represented by smaller, less complex (than the organizations in the
10 previous peer group utilized), regulated domestic utility organizations located primarily
11 in the mid-west region of the United States.

12
13 Q. DID COMPANY CHANGE ITS COMPENSATION PHILOSOPHY REGARDING
14 UTILIZATION OF THE 50TH PERCENTILE OF THE NEW PEER GROUP?

15 A. No. MPSC Staff Data Request No. 298 requested information on what changes in
16 executive compensation occurred to reflect Aquila's change from a multi-national utility
17 with significant US non-regulated operations to a domestic regulated electric & gas
18 utility. Company response states,

19
20 As provided in other DR's, Aquila changed its compensation philosophy
21 and comparison group in 2002 for executive compensation to reflect the
22 market 50thile of similar sized domestic regulated utilities.
23
24

1 Thus, the new policy resulted in no change in the previously stated compensation
2 philosophy of utilizing the 50th percentile of a peer group comparison to determine
3 executive pay, but the peer group has changed. It now consists of smaller companies that
4 are alleged to be more representative of Aquila's current operations. Furthermore, the
5 Board of Directors and management made the decision that certain incentive pay or
6 compensation described as "pay at risk" was to be reduced and/or eliminated.

7
8 Q. IS PUBLIC COUNSEL PROPOSING ANY ADJUSTMENT TO THE LEVEL OF "PAY
9 AT RISK" COMPENSATION PAID TO SENIOR MANAGEMENT?

10 A. No. It is my understanding that even though the Board of Directors, and consultants
11 hired by the Company to analyze these costs, have indicated that the level of "pay at risk"
12 compensation paid to Aquila's management team is below that of its peer group,
13 management, for the most part, has declined to accept the additional incentive
14 compensation due to the ongoing problems which resulted from the collapse of the
15 Company's non-regulated merchant business.

16
17 Q. ARE THE BASE SALARIES OF AQUILA'S MANAGEMENT TEAM STILL
18 REPRESENTATIVE OF THE 50TH PERCENTILE OF THE NEW PEER GROUP?

19 A. My analysis of the Company's management team compensation indicates that the base
20 salary of all members, except Mr. Green, is set at approximately the 50th percentile of the
21 current peer group of companies utilized by the now much smaller Aquila organization.
22

1 Q. DOES PUBLIC COUNSEL BELIEVE MR. GREEN'S BASE SALARY IS
2 EXCESSIVE BASED ON COMPANY'S CURRENT COMPENSATION
3 PHILOSOPHY?

4 A. Yes. In its response to OPC Data Request No. 1012, Company provided a document
5 titled, "November 2005 Total Compensation Measurement Report," which provided a
6 comparison of Aquila's executive compensation and that of its current peer group of
7 companies. The information provided shows that the base salary paid to most of the
8 management team members is very close to the 50th percentile of the peer group now
9 utilized. For example, the base salaries for Mr. Stamm, Mr. Empson, Mr. Morton and
10 Mr. Reitz are approximately 107%, 100%, 111% and 91%, respectively, of the current
11 peer group 50th percentile.

12
13 Ms. Armstrong's base salary is about 79% of the peer group 50th percentile; however, her
14 lower base salary may be explained by Company's response to OPC Data Request No.
15 1004 which states that when Mr. Rick J. Dobson, the former Chief Financial Officer, left
16 the Company Ms. Armstrong was promoted Chief Accounting Officer and Executive
17 Band D. It also states that her promotion was not a full replacement for Mr. Dobson's
18 position as some responsibilities of the former CFO were transitioned to employees other
19 than Ms. Armstrong.

20
21 The information provided in the report also allowed me to compare Mr. Green's current
22 base salary (which was set prior to the advent of the merchant business debacle) with his
23 peer group 50th percentile and that comparison identified that Mr. Green is earning

1 several hundred thousand dollars more per year than the amount represented by his
2 position in the peer group. In fact, the current base salary earned by Mr. Green is
3 approximately 147% of the peer group 50th percentile. Therefore, it is my belief that Mr.
4 Green's current base salary is excessive because it is approximately 47% more than it
5 should be based on Aquila's compensation philosophy for the senior management team.
6

7 Q. HOW WAS MR. GREEN'S COMPENSATION DETERMINED?

8 A. Regarding the compensation philosophy of Aquila, and that of the CEO in particular, the
9 Aquila Inc., DEF 14A, March 24, 2006, report filed with the SEC (provided in response
10 to OPC Data Request No. 1005) states,
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21 (Emphasis added by OPC)
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24 Q. IS IT PUBLIC COUNSEL'S POSITION THAT MR. GREEN'S BASE SALARY
25 SHOULD ALSO BE SET AT THE 50TH PERCENTILE OF AQUILA'S CURRENT
26 PEER GROUP?

27 A. Yes. Company has stated that it intends to practice a policy of setting its executive
28 management compensation at a level comparable with the peer group; however, Public

1 Counsel believes that Aquila may treating Mr. Green with improper favoritism, perhaps
2 because of his position and history with the Company.

3
4 Aquila is a significantly different company today than that which existed when Mr.
5 Green's current base salary was first authorized. It continues to go through a very
6 dramatic and significant downsizing wherein it has attempted to return to its historic roots
7 as a regulated monopoly utility rather than a large multinational conglomerate with
8 regulated and non-regulated operations. To that effect that transition, Aquila has sold off
9 all of its international operations and nearly all of its domestic regulated and non-
10 regulated operations. One result of these dramatic changes is that executive "pay at risk"
11 compensation, including Mr. Green's, has been significantly reduced, and/or eliminated
12 entirely in some years, but Mr. Green's base salary, unlike that of the other management
13 team members, has not been adjusted downward to reflect the structural and operational
14 changes that have occurred.

15
16 Q. WHAT IS THE RELATIONSHIP BETWEEN MR. GREEN'S CURRENT BASE
17 SALARY AND THE 50TH PERCENTILE FOR HIS POSITION WITHIN AQUILA'S
18 NEW PEER GROUP?

19 A. Mr. Green's current base salary is approximately \$990,000 per year. However, according
20 to the Company's response to OPC Data Request No. 1012, the 50th percentile for his
21 position within the new peer group is only \$675,300 per year. Thus, Mr. Green is
22 receiving a base salary which is \$314,700 (i.e., 47%) higher than the amount he should be

1 receiving if the Company's compensation philosophy were as applicable to his earnings
2 as it apparently is for the other members of the senior management team.
3

4 Q. PLEASE SUMMARIZE THE PUBLIC COUNSEL'S POSITION ON THIS ISSUE?

5 A. It is my belief that the base salary of the CEO of Aquila, Mr. Richard C. Green Jr., is
6 excessive given the Company's stated philosophy of maintaining executive compensation
7 at a level comparable to a peer group of companies of similar size and operation to the
8 current operations. Public Counsel recommends that the portion of his base salary that
9 exceeds the 50th percentile for his position, relative to the current peer group of
10 companies utilized by Aquila as a comparison for its compensation policy, should be
11 disallowed in the determination of the cost of services for the instant case. On a Missouri
12 jurisdictional basis the adjustment to reduce the MPS and L&P cost of service (not
13 including payroll taxes which should also be reduced accordingly) is (\$132,704) and
14 (\$34,840), respectively.
15

16 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

17 A. Yes, it does.