Exhibit No.: 1047
Issues: Payroll,
401k,
Misc. Payroll,
ESOP,
Restructuring,
Incentives &
Payroll Tax
Witness: Ronald A. Klote
Sponsoring Party: Aquila Networks-MPS
[redacted]
Case No.: ER-2004-0034 &
[redacted]

Before the Public Service Commission
of the State of Missouri

Rebuttal Testimony

of

Ronald A. Klote

TABLE OF CONTENTS OF
REBUTTAL TESTIMONY OF
RONALD A. KLOTE
AQUILA, INC. D/B/A AQUILA NETWORKS-MPS
[redacted]

CASE NOS. ER-2004-0034 [redacted]

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

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. Are you the same Ronald A. Klote who sponsored direct testimony in this proceeding before the Missouri Public Service Commission ("Commission") on behalf of Aquila, Inc. ("Aquila" or "Company")?

A. Yes

Q. What is the purpose of your rebuttal testimony?

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

- Payroll Expense
- 401K Benefits Matching Expense
- ESOP (Profit Sharing Plan) Contribution Expense
- Payroll Tax Expense
- Restructuring (Severance) Costs

Payroll Expense

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

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

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

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

- Dept 4035 CFO 75% Elimination

• Dept 4040 Chairman and CEO	75% Elimination
• Dept 4030 Chief Operating Officer	50% Elimination
• Dept 4031 General Counsel	50% Elimination
• Dept 4043 Board of Directors Management	50% Elimination
• Dept 4183 Corporate Financial Reporting	25% Elimination
• Dept 4194 Tax Income Team	25% Elimination
• Dept 6131 Global Networks Group Financial Mgmt	25% Elimination

Q. Did OPC Witness James Dittmer include a similar adjustment eliminating certain corporate payroll and nonpayroll costs associated with restructuring activities?

A. Yes. OPC witness Dittmer included the arbitrary elimination of 50% of all costs of certain corporate departments. However, Mr. Dittmer simply based his adjustment on per books amounts recorded during the test year. This can be distinguished from Staff witness Hyneman's adjustment which was based on the annualized levels of payroll, payroll taxes and benefit amounts.

Q. Who will address the corporate restructuring operations adjustments proposed by Staff witness Hyneman and OPC witness Dittmer described above?

A. Aquila witness Jon Empson will discuss the corporate restructuring operations adjustment in his rebuttal testimony.

Q. Please explain the reasons provided why Staff witness Dana Eaves did not include the 3% MPS union increase.

A. Staff witness Dana Eaves' direct testimony did not include any explanation on why the 3% MPS union increase was not included in the payroll annualization method. He simply states that his payroll expense adjustment includes actual employees and their authorized wage levels as of September 30, 2003.

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

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

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

A. Yes. In the last MPS rate case, Case No. ER-2001-672, Staff used a test year ending December 31, 2000 with known and measurable changes through June 30, 2001. In direct testimony in Case No. ER-2001-672, Staff witness Graham Vesely describes, on page 3 of his testimony, that a union pay increase of two percent effective October 1, 2001 and an estimated pay increase of 3.98% for ESF departments effective January 1, 2002 were included in the payroll annualization amounts. Both of these recommended wage increases were outside the known and measurable period in the case.

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

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

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

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

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

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

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

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

401k Benefits Matching Expense

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

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

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

A. Yes.

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

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

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

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

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

A The total difference between Aquila's and Staff's 401K expense adjustment for MPS electric operations is $36,108. $18,290 of this adjustment is due to the exclusion of the MPS union contract increase beginning April 1, 2004 in the payroll annualization calculation. $17,819 of this adjustment is associated with the elimination of certain corporate department payroll amounts identified by Staff to be associated with restructuring activities. [redacted]

ESOP (Profit Sharing Plan) Contribution Expense

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

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

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

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

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

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

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

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

Payroll Tax Expense Adjustment

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

A. Staff witness Dana Eaves annualized payroll tax expense by creating subtotals of annualized payroll expense subject to the limits of social security tax ("FICA"), federal unemployment tax ("FUTA"), state unemployment tax ("SUTA") and Medicare. The appropriate tax rates were applied to each subtotal creating annualized payroll tax expense for each tax classification. This method is similar to the method employed by Aquila, yet performed at a more detailed individual level. The resulting amounts are different.

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

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

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

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

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

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

[redacted]

Restructuring (Severance) Adjustment

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

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

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

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

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

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

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

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

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

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

A. No.

Q. Please explain why.

A. The restructuring initiative began, as stated in my previous direct testimony and the previous direct testimony of Keith Stamm in this proceeding, in November 2001. It was an effort to become a more focused and more efficient state based operation. In order to accomplish this, Aquila needed to restructure its operations resulting in the termination of employee positions. This came at a significant cost to the utility. Witness Hyneman states in his testimony that the restructuring costs were non-recurring and not identified as extraordinary in nature; thus, not part of an accounting authority order ("AAO") (Hyneman p. 24). I agree that these costs were non-recurring in nature, but in fact these costs were significant and extraordinary to the utility due to the large number of terminations associated with the restructuring. During the test year, MPS-electric operations incurred severance related costs of approximately $2.7 million. [redacted] As such, Aquila did not seek deferral of these costs through an AAO, but instead proposed a 3 year amortization included within the cost of service filing in this proceeding (the reasons for this are provided later in my testimony). Whether Aquila mistakenly did not request an AAO associated with these costs or included an amortization amount within this cost of service filing should not be a reason to disallow recovery of these costs. Through this rate case filing, the Commission can determine and provide the ruling on how these costs should be treated for ratemaking purposes.

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

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

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

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

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

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

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

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

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

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

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

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

Q. Does this conclude your rebuttal 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] [redacted] area	))))))	Case No. ER-2004-0034
[redacted]	))))	[redacted]

County of Jackson)
) ss
State of Missouri)

AFFIDAVIT OF RONALD A. KLOTE

Ronald A. Klote, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Ronald A. Klote;" that said testimony was prepared by him and under his direction and supervision; that if inquiries were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge, information, and belief.

Ronald A. Klote

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

Notary Public
Terry D. Lutes

My Commission expires:

8-20-2004

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