Exhibit No.:
Issues: Payroll,
Payroll Taxes,
Incentive,
Restructuring,
Current Taxes,
Deferred Taxes &
Unamortized
Investment Tax Cr.
Witness: Ronald A. Klote
Sponsoring Party: Aquila Networks-L&P
Case No.: HR-

Before the Public Service Commission
of the State of Missouri

Direct Testimony

of

Ronald A. Klote

Exhibit No. 46
Case No(s). ER-2004-0034
Date 2/23/04 Rptr XF

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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-L&P
CASE NO. HR-________

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

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

- RBO – 30 Accumulated Deferred Income Tax Adjustment

Payroll Annualization Adjustment (CS – 5)

Q. Please explain the payroll annualization adjustment.

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

Q. Please explain how the adjustment was calculated.

A. Base salaries and wages, as of January 30, 2003, were obtained for all departments directly charging L&P and departments that are allocated to L&P. 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 adjustment.

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 L&P 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 L&P.

Q. Please continue with your explanation.

A. The total payroll annualization amount for L&P was compared to L&P's test year per books amount as of December 31, 2002, to obtain the overall payroll annualization adjustment. The payroll annualization adjustment was 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 adjustment for operation and maintenance expenses was determined.

A. After the payroll annualization adjustment was calculated by FERC account, amounts were allocated to electric, gas and steam utilities using product allocations based on FERC account.

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

A. For union employees, a 3.5% wage increase was used. This represented a scheduled increase on August 1, 2003 per the union contract currently in effect. 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 employee's wage increases were obtained from union pay increases from union contracts. Non-union employee's 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 are annually scheduled in March. Union pay increases are annually scheduled in August.

Q. What was the steam payroll annualization adjustment for L&P?

A. L&P steam payroll annualization adjustment was a total decrease of $1,983 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 4 separate bands. Which band an employee resides in is dependent on the employee's position. Each band contains three levels of achievement. 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 L&P. The total target level of incentive payments directly assigned or allocated to L&P were spread to FERC accounts based on the same ratio as test year per pook 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 adjustment.

Q. Explain how the total incentive annualization adjustment for operation and maintenance expenses was determined.

A. After the incentive annualization adjustment was spread to FERC accounts, amounts were allocated to electric, gas and steam utilities using product allocations based on the 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 the L&P jurisdiction.

Q. What were the steam incentive annualization adjustment for L&P?

A. L&P steam incentive annualization adjustment was a reduction of $1,789 spread among various FERC accounts.

Restructuring Adjustment (CS – 10)

Q. Please explain the restructuring adjustment.

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 adjustment quantifies all restructuring related severance payments and associated benefit and payroll taxes and amortizes the costs over a three year period for L&P.

Q. How were costs for the restructuring adjustment obtained?

A. All restructuring costs for L&P 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 L&P or who were allocated to L&P. 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 steam restructuring costs directly assigned and allocated to L&P were identified and amortized over a three year period. The resulting annual amortization of steam restructuring costs was compared to total steam restructuring costs recorded during the test year ending December 31, 2002.

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 L&P.

Q. What is the steam restructuring adjustment for L&P?

A. The net L&P steam restructuring adjustment was a total decrease of $4,550.

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 L&P 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 ongoing levels of operation and are associated with periods prior to the test period ending December 2002.

Q. What is the impact of these adjustments on L&P?

A. The L&P jurisdictional adjustment reduced Account 921 by $11,727.

Payroll Taxes Adjustment (CS – 85)

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

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

Q. How was the payroll tax adjustment calculated?

A. <u>**FICA**</u>

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.

<u>**Medicare**</u>

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 difference is the annualized medicare adjustment.

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 adjustment on L&P steam operations?

A. Payroll taxes for the L&P steam jurisdiction decreased $2,009.

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

Q. Please explain current income tax expense adjustment.

A. This adjustment is the calculation of the provision for current income taxes for the adjusted test year. This adjustment begins 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 the tax effected timing difference between tax straight-line depreciation expense and tax depreciation expense as required by normalization rules.

Q. Where can the current and deferred income tax calculation be found for L&P steam operations?

A. The current and deferred income tax calculation can be found in Schedule 8 of the L&P steam 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 L&P 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 L&P 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 L&P's 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.

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.

Q. What is the total steam accumulated deferred income tax rate base offset for L&P?

A. The L&P steam accumulated deferred income tax rate base offset totals $644,534.

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-L&P, for authority to file tariffs	)	
Increasing steam rates for the service provided	)	Case No. HR-________
To customers in the Aquila Networks-L&P area	)	

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
Ronald A. Klote

Subscribed and sworn to before me this 27th day of June, 2003.

Terry D. Lutes
Notary Public
Terry D. Lutes

My Commission expires:

8-20-2004

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