Exhibit No.:
Issue: FAS 106 Funding Deficiency; Deferred Income Tax Debits
Witness: Steve M. Traxler
Sponsoring Party: MoPSC Staff
Type of Exhibit: Surrebuttal Testimony
Case No.: ER-2005-0436
Date Testimony Prepared: December 13, 2005

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

STEVE M. TRAXLER

AQUILA, INC.
d/b/a AQUILA NETWORKS-MPS (Electric) and AQUILA NETWORKS-L&P (Electric)

CASE NO. ER-2005-0436

Jefferson City, Missouri
December 2005

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	)	Case No. ER-2005-0436
Retail Electric Service Provided to Customers	)	Tariff No. YE-2005-1045
in Its MPS and L&P Missouri Service Areas.	)	

AFFIDAVIT OF STEVE M. TRAXLER

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Steve M. Traxler, being of lawful age, on his oath states: that he has participated in the preparation of the following Surrebuttal Testimony in question and answer form, consisting of 9 pages to be presented in the above case; that the answers in the following Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Steve M. Traxler

Steve M. Traxler

Subscribed and sworn to before me this 2nd day of December 2005.

Toni M. Charlton

Notary

TONI M. CHARLTON
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

TONI M. CHARLTON
Notary Public - State of Missouri
My Commission Expires December 28, 2008
Cole County
Commission #04474301

TABLE OF CONTENTS

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

Q. Please state your name and business address.

A. Steve M. Traxler, Fletcher Daniels State Office Building, Room G 8, 615 East 13th Street, Kansas City, Missouri 64106.

Q. Have you prefiled direct testimony in this proceeding?

A. Yes, I have.

Q. What is the purpose of your surrebuttal testimony?

A. Because the Staff now has information from Aquila that allows it to do so, I quantify an adjustment to Aquila's FAS 106 funding deficiency for loss of investment earnings that I identified in my prefiled direct testimony. Aquila agrees with this adjustment. I also respond to rebuttal testimony of AARP witness David J. Effron related to Aquila's FAS 106 funding deficiency and the elimination of specific deferred income tax debits from rate base.

<u>FAS 106 FUNDING DEFICIENCY</u>

Q. Have you addressed Aquila's existing funding deficiency related to Aquila's FAS 106 obligation before in this case?

A. Yes. On pages 8 – 10 of my prefiled direct testimony I address the funding deficiency that resulted from Aquila's failure to comply with the funding requirement under Section 386.315 RSMo.

Q. Has the Staff made any adjustments based on Aquila's funding deficiency?

A. Yes. On pages 13 and 14 of my prefiled direct testimony I explain the adjustments made to the FAS 106 cost calculation, for the MPS and L&P divisions, to eliminate the funding deficiency's detrimental impact on the 2005 FAS 106 calculation of postemployment benefits other than pensions (OPEB costs).

Q. How did the Staff calculate its adjustments, included in the Staff's direct filing, to eliminate the detrimental impact of the funding deficiency on Aquila's 2005 FAS 106 calculation?

A. One of the components of the FAS 106 calculation is the expected rate of return assumption. The expected rate of return represents the estimated earnings on investing the funded assets. The investment earnings are used to offset the current year estimate for the OPEB benefits earned in the current year by employees. The higher the investment earnings the lower the net FAS 106 cost will be. In its direct filing, the Staff computed the expected rate of return assuming that the funding deficiency did not exist, using the same investment return used by Aquila's actuary – 7%. The 7% rate of return was applied to the accumulated funding deficiency and used to reduce the 2005 FAS 106 calculation.

Q. Is that adjustment sufficient to eliminate the detrimental impact of the funding deficiency?

A. No. An additional adjustment is required to reflect the loss of earnings on the funding deficiency. If Aquila had made the required annual contributions to the VEBA trust, additional funds would have accumulated due to additional investment earnings.

Q. Did the Staff include this loss of investment earnings adjustment in its direct filing?

A. No. The Staff did not have sufficient information when that filing was made to quantify the adjustment. I noted in my prefiled direct testimony that the Staff had issued Staff Data Request No. 430 to obtain that information, but that that data request had not been answered prior to the Staff's direct filing.

Q. Would you please explain the Staff's calculation of the loss of investment earnings adjustment?

A. Aquila's response to Staff's Data Request No. 430 provided the actual investment returns earned from investing the assets in Aquila's VEBA trust. The Staff used this data to calculate the loss of earnings on the funding deficiency, which would have accrued in the fund, had Aquila timely made all required fund contributions. Adjustments S-84.12 and S-85.13 have been updated to reflect this change for the L&P and MPS divisions, respectively. Aquila has agreed to these updated adjustments.

EFFRON REBUTTAL – FAS 106 FUNDING DEFICIENCY

Q. On page 4 of his rebuttal testimony, Mr. Effron states that the "Staff has not recognized the time value of money to Aquila from its failure to fund its OPEB obligation, as required by Missouri law." Do you agree with this assertion?

A. No, I do not. The "time value of money" concept has been addressed by the additional adjustments explained above. The Staff has restated the expected rate of return assumption in Aquila's 2005 FAS 106 calculation to reflect, both:

1) the assumption that the funding deficiency had not occurred and was available for investment with the expected earnings used to reduce the 2005 FAS 106 cost; and

2) the assumption to also include the additional earnings that would have accrued on the funding deficiency in prior years, had these amounts been funded on an annual basis and been available for investment.

Q. Does Mr. Effron's proposed adjustments to address the "time value of money" have anything to do with restating Aquila's 2005 FAS 106 cost for the purpose of eliminating the detrimental impact resulting from Aquila's failure to fund its FAS 106 obligation as required under Section 386.315 RSMo?

A. No. Mr. Effron is proposing to flow back $260,000 to MPS ratepayers and $402,000 to L&P ratepayers over a three-year period. These amounts represent the value to Aquila for having had the use of the funding deficiency amounts, as a result of collecting these amounts in rates, but not making annual contributions of these monies to fund its FAS 106 obligation. Mr. Effron has used the Staff's midpoint rate of return, grossed up for income taxes, to compute the value to Aquila of having had the use of the funding deficiency monies through December 31, 2005. Mr. Effron's proposed adjustments are not necessary to restate Aquila's 2005 FAS 106 cost for the purpose of eliminating the detrimental impact resulting from the funding deficiency.

Q. How would you characterize Mr. Effron's "time value of money" adjustments?

A. Mr. Effron's proposed time value of money adjustments can be fairly characterized as a penalty to Aquila for having failed to comply with the funding requirement of Section 386.315 RSMo. Since Mr. Effron's time value of money adjustments are not necessary to restate Aquila's 2005 FAS 106 cost, in order to eliminate the impact of the funding deficiency, they represent a penalty to Aquila for not having made the required annual contributions to fund its FAS 106 obligation.

Q. How should any penalty to Aquila, for its failure to comply with Section 386.315 RSMo be addressed?

A. The Office of the Public Counsel (OPC) has filed a complaint, Case No. EC-2006-0171, against Aquila for its failure to comply with Section 386.315 RSMo. It is the Staff's view that any penalties, resulting from the violation of the funding requirement under Section 386.315 RSMo, must be addressed in Case No. EC-2006-0171.

EFFRON REBUTTAL - ELIMINATION OF SPECIFIC DEFERRED TAX DEBITS FROM RATE BASE

Q. What additional section of the rebuttal testimony of AARP witness David Effron do you wish to respond to?

A. On pages 5-8 of his rebuttal testimony, AARP witness David Effron proposes to eliminate specific Deferred Income Tax Debit balances from Rate Base. Adoption of Mr. Effron's proposal will reduce MPS's rate base by $6.7 million and reduce L&P's rate base by $4.5 million. I will express the Staff's agreement on elimination of some of the specific deferred tax balances addressed by Mr. Effron, and disagreement on others.

Q. On pages 5 and 6 of his rebuttal testimony, Mr. Effron asserts that the deferred tax debit balance related to Aquila's FAS 106 OPEB liability should be eliminated from Rate Base because it results from Aquila's failure to fund its FAS 106 obligation. What is the Staff's view on this recommendation?

A. The Staff agrees with Mr. Effron's argument that the deferred tax debit, related to FAS 106 OPEB costs, should be excluded from Rate Base because it resulted from Aquila's failure to fund its FAS 106 costs collected in rates. If Aquila had made annual contributions to its VEBA trust equal to its annual FAS 106 cost, a deferred tax debit would not exist.

Q. On pages 7 and 8 of his rebuttal testimony, Mr. Effron identifies specific deferred tax debits, in Account 190, that in his view should be removed from Rate Base. Does the Staff agree with these recommendations?

A. Mr. Effron identifies the specific deferred tax debit balances he is addressing on his rebuttal schedule DJE-2. As previously stated, the Staff agrees with Mr. Effron's recommendation on the Other Post Retirement Benefits shown as the first balance on Effron's rebuttal schedule DJE-2.

The Staff agrees with Mr. Effron's recommendation related to Aquila's Supplemental Retirement Plan because the cost of this plan has not been included in cost of service by the Staff in prior cases. Any tax timing difference and resulting deferred tax balance should also be ignored for ratemaking purposes.

The Staff also agrees with Mr. Effron's recommendation regarding the Employee Bonus Incentive. The deferred tax debit, related to the Employee Bonus Incentive occurs only because of the three-month interval between the accrual on the financial statements in the current year and the actual cash payment to employees approximately three months after the end of the calendar year. There should not be any significant difference between the accrued Employee Bonus Incentive cost on the financial statements and the actual payment three months later. The existing deferred tax debit appears to be due to an abnormal event because the related timing difference is a significant amount for the MPS division. Unless Aquila can demonstrate that the existing timing difference represents an ongoing normal result, this deferred tax debit should be excluded from Rate Base. The Staff has issued additional discovery for an explanation as to why this timing difference is so significant at this time.

Q. What is the Staff's position regarding the deferred tax debit for Allocated Costs listed on Mr. Effron's rebuttal schedule DJE-2?

A. Allocated Costs include pension and OPEB costs allocated from Aquila's corporate headquarter departments to the MPS and L&P divisions. As previously explained, any deferred tax debit related to FAS 106 OPEB costs should be excluded from Rate Base.

The timing difference for pension cost results from using an accrual accounting method, FAS 87, for financial reporting and the ERISA contribution in determining taxable income for IRS purposes. The prior rates for the MPS and L&P divisions were set based upon the ERISA minimum contribution. The rates established in this case, Case No. ER-2005-0436, will also be based upon the ERISA minimum contribution for pension cost. Since the ERISA contribution is also used for IRS purposes, the timing difference related to pension cost has been eliminated for ratemaking purposes. If the deferred tax debit balance for pension cost occurred since the ERISA contribution has been used for setting rates, it is appropriate to exclude the deferred tax balance for pension cost from Rate Base. Staff has requested that Aquila identify the amount of pension cost and OPEB cost which is included in Account 190 – Allocated Costs.

Q. What is the Staff's position regarding the deferred tax debit identified as Maintenance Accruals on Mr. Effron's schedule DJE-2?

A. The Staff disagrees with Mr. Effron's recommendation for the deferred income tax debits balance for Maintenance Accruals.

Q. Why?

A. Deferred income taxes result from normalizing a tax timing difference for the period between the recognition of a cost in the financial statements and recognition of the same cost in determining current income tax liability to the IRS. Normalizing the tax timing difference for Maintenance Accruals means the tax deduction for ratemaking purposes is recognized in the same time period as the expense is recognized in the income statement in cost of service. Because of the annual volatility that occurs in the maintenance area, it makes sense from a ratemaking prospective to normalize the tax timing difference and include the resulting deferred taxes in Rate Base.

Q. How does normalization treatment for maintenance expense address the significant volatility that occurs in the maintenance expense area?

A. Major maintenance projects, such as turbine overhauls, are scheduled to occur every six years for Aquila's large generating units. Assuming the cost is $6 million per overhaul, the tax deduction will be $6 million in the year that the overhaul is done. The other five years will have a tax deduction of $0 for IRS purposes. The Staff reflects major turbine overhaul maintenance in rates using a normalization adjustment, which spreads the $6 million cost over the six-year interval between major overhauls. The expense amount included for rates, $1,000,000 is also used for the tax deduction for ratemaking purposes which eliminates the volatility from the income statement and income tax amounts used for setting rates. The resulting deferred tax debit or credit balance should be included in Rate Base for ratemaking purposes.

Q. Does the timing difference related to Maintenance Accruals always result in a deferred tax debit?

A. No. A deferred tax credit can also occur when the actual cost of a major turbine overhaul exceeds the expense accrued on the income statement for that year. Normalizing the tax timing difference for major maintenance projects eliminates the significant volatility that occurs from year to year. Mitigating annual volatility is beneficial for ratemaking purposes. The related deferred tax balances should be included in Rate Base.

Q. Does this conclude your surrebuttal testimony?

A. Yes it does.