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Issues: Acquisition Adjustments; Transaction Costs; Depreciation; AAOs; St Joseph Treatment Plant
Witness: Stephen M. Rackers
Sponsoring Party: MOPSC
Type of Exhibit: Direct Testimony
Case Nos.: WR-2003-0500 and WC-2004-0168
Date Testimony Prepared: October 3, 2003

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

STEPHEN M. RACKERS

MISSOURI-AMERICAN WATER COMPANY

CASE NOS. WR-2003-0500 AND WC-2004-0168

Jefferson City, Missouri
October 2003

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the General Rate Increase for Water and Sewer Service Provided by Missouri-American Water Company.	)))	Case No. WR-2003-0500

Staff of the Missouri Public Service Commission,	)	
	)	Case No. WC-2004-0168
Complainant,	)	
	)	
v.	)	
	)	
Missouri-American Water Company,	)	
	)	
Respondent.	)	

AFFIDAVIT OF STEPHEN M. RACKERS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Stephen M. Rackers, is, of lawful age, and on his oath states: that he has participated in the preparation of the following Direct Testimony in question and answer form, consisting of 16 pages to be presented in the above case; that the answers in the following Direct 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.

Stephen M. Rackers

Stephen M. Rackers

Subscribed and sworn to before me this 2nd day of October 2003.

D SUZIE MANKIN
Notary Public - Notary Seal
STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. JUNE 21,2004

D Suzie Mankin

Notary Public

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MISSOURI-AMERICAN WATER COMPANY

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AND WC-2004-0168

Q. Please state your name and business address.

A. Stephen M. Rackers, 1845 Borman Court, Suite 101, St. Louis, Missouri 63146.

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

A. I am a Regulatory Auditor V with the Auditing Department in the St. Louis office for the Missouri Public Service Commission (Commission).

Q. Please describe your educational background.

A. I graduated from the University of Missouri-Columbia, in 1978, with a Bachelor of Science degree in Business Administration, majoring in Accounting.

Q. What has been the nature of your duties while in the employ of this Commission?

A. I have supervised and assisted in audits and examinations of the books and records of public utility companies operating within the State of Missouri. I have listed cases in which I previously filed testimony on Schedule 1.

Q. With reference to Case No. WR-2003-0500, have you made an examination of the books and records of Missouri-American Water Company (MAWC or Company)?

A. Yes, in conjunction with other members of the Commission's Staff (Staff). I specifically examined information provided by the Company in response to Staff's data requests, portions of the Company's general ledger, as well as workpapers supplied by MAWC to support its rate case filing. I also examined Board of Directors Meeting Minutes, Annual Reports to Shareholders and other information contained on the Company's Website.

Q. What is your primary responsibility in this case?

A. My primary areas of responsibility in this case are acquisition adjustments, acquisition transaction costs, Accounting Authority Orders (AAOs), depreciation expense, recovery of the "old" St. Joseph Treatment Plant (SJTP) undepreciated balance and disallowance of plant capacity related to the "new" SJTP.

Q. What knowledge, skill, experience, training or education do you have in these matters?

A. I have acquired general knowledge of these topics through my experience and analyses in prior rate cases and merger cases before this Commission. I have also acquired knowledge of these topics through review of Staff workpapers for prior rate cases brought before this Commission relating to MAWC and its newly acquired operating districts (i.e., Jefferson City Waterworks Company (Jefferson City) and St. Louis County Water Company (County Water)). I have also reviewed prior Commission decisions with regard to these areas. I have reviewed the Company's testimony, workpapers and responses to Staff's data requests addressing these topics. In addition, my college coursework included accounting and auditing classes. Finally, I successfully passed the Certified Public Accountants Exam, which included sections on accounting practice and theory, as well as, auditing. I currently hold a license to practice in Missouri.

Q. What is the purpose of your testimony?

A. My testimony will sponsor and explain the following adjustments and amounts appearing in Staff's Schedules:

New St. Joseph Treatment Plant Disallowances	P-31.1 and R-31.1
Elimination of Transaction Costs	P-1.1, S-11.2 and S-14.2
Depreciation on Contributed Capital	S-15.3 and R-59.1
Amortization of the Security AAO	S-16.2

I am also sponsoring a portion of the contributions in aid of construction balance and the deferred income tax balance in Staff Accounting Schedule 2 – Rate Base.

Q. What are the results of the Staff's audit of MAWC?

A. Based on the Staff's audit, the Company's current earnings are excessive. The Staff's determination of revenue requirement indicates that the Company's current rates produce a revenue excess of approximately $20 million at the Staff's midpoint rate of return, on a total company basis, after an allowance for true-up.

Q. Is the Staff filing a complaint?

A. Yes. In Case No. WC-2004-0168, the Staff is recommending that the Commission reduce the Company's rates in the range of approximately $19 to $21 million on a total company basis after an allowance for true-up.

Q. Why is the Staff filing a complaint case at this time?

A. The Staff believes that its determination of the excess earnings produced by the Company's current rates will continue to be significant, even after a partial or complete resolution of the issues during the prehearing conference. Also, in its Suspension Order And Notice, effective June 8, 2003, the Commission authorized the Staff to file a complaint seeking a reduction in the Company's revenues if its audit reflected that the Company's earnings were excessive. Therefore, it is appropriate for the Staff to immediately file a complaint case to address the Company's excess earnings in an expeditious manner.

ACQUISITION ADJUSTMENTS

Q. Has MAWC acquired the service area of other water systems since its last rate case?

A. Yes. MAWC acquired the assets owned and the customers served by the municipally owned water systems of Webster Groves, Florissant and Valley Park (Municipalities). The Company also acquired the assets and customers served by United Water Systems (United), in Jefferson City (Jefferson City).

Q. Did MAWC acquire these service areas at net book value, original cost of plant in service less accumulated depreciation?

A. No. MAWC paid in excess of net book value and incurred positive acquisition adjustments for Webster Groves, Florissant and Jefferson City. The Company paid less than net book value and incurred a negative acquisition adjustment for Valley Park.

Q. Please explain the term "acquisition adjustment."

A. An acquisition adjustment is incurred when the assets of another utility are purchased at a price above or below the net book value. If a utility pays an amount in excess of net book value, it incurs a positive acquisition adjustment, or acquisition premium. If a utility pays an amount below net book value, it incurs a negative acquisition adjustment, or acquisition discount.

Q. Has the Commission historically recognized acquisition premiums or discounts in the determination of rates?

A. No. The Commission has consistently rejected an increase in rates to recover acquisition premiums or a reduction in rates to reflect an acquisition discount. Recognition of acquisition premiums and discounts would be counter to the Commission's adherence to recovery of only the original cost of the investments made by utilities that provide service to ratepayers. Recognition of acquisition premiums and discounts would also be counter to the Commission's historical position of allowing utility shareholders to retain any gains, or bear any losses, associated with the sale of utility property. The Commission has consistently recognized that any deviation from original cost, associated with transactions engaged in by utility companies, is the responsibility of the shareholders.

Q. Is the Staff opposed to the inclusion of acquisition adjustments in the determination of revenue requirements for establishing rates in this case?

A. Yes. The Staff advocates that the Commission adhere to its traditional practice of using only the original cost of the plant in service net of the associated accumulated depreciation reserve in the determination of rates.

Q. Did the Commission have jurisdiction over the purchase of the Municipalities?

A. No. The Commission was not required to approve, and MAWC did not seek approval of, the purchases of the municipal systems. Since the Commission had no jurisdiction over the purchase transaction, it did not approve the purchase or have control over any premium or discount that was incurred by MAWC for the municipal systems. It is inappropriate to attempt to recover acquisition adjustments that result from a business transaction over which the Commission has no jurisdiction.

Q. Does an acquisition adjustment represent a new investment in or a reduction in the value of utility assets?

A. No. There is no new investment in plant or reduction in the value of the assets serving ratepayers. The same assets will be serving the same customers.

Q. What kind of costs do acquisition costs represent?

A. Acquisition adjustments, like transaction costs, which are discussed later in my testimony, are ownership costs. The decisions about whether to engage in the transaction and the amount to be paid were made by the owners of MAWC, United and officials representing the Municipalities. The transactions would not have taken place without the approval of these individuals. Ratepayers, as customers, have no ownership rights in utility assets, no vote in the decision to be part of a purchase and no influence in the structure of the terms and conditions of the purchase. Therefore, these costs should not be directly reflected in the Company's utility rates, which are borne by MAWC's customers.

TRANSACTION COSTS

Q. What are the "transaction costs" you are discussing in this testimony?

A. The Company incurred costs to complete the purchases of the Municipalities. These costs include a study to determine the original cost of the plant purchased, a study to analyze the financial condition of the system purchased and costs associated with informing the customers of the change in ownership.

Q. How did the Company account for these costs?

A. The costs were incurred in 2001 and 2002. MAWC expensed a portion of the costs and capitalized the remaining amounts.

Q. What treatment is the Staff proposing for these amounts?

A. The Staff is proposing no recovery of the transaction costs. Transaction costs are those costs necessary to complete the purchase or merger transaction. They include a variety of expenses, such as legal fees, consulting fees and the cost of informing customers of the change in ownership. Transaction costs are not related to providing utility service more efficiently, but are only incurred to protect the financial interests of the shareholders.

These are ownership expenditures incurred in consummation of the purchase. The Staff believes these ownership costs should be borne by the shareholders. Transaction costs are not necessary to provide safe and adequate service. These costs do not achieve efficiencies and/or reduce operating costs. These costs are involved in consummating the purchase and changing the identity of the owner rather than creating a more efficient operating entity. The Staff believes these costs should stay with the owners of the Company and be excluded from the cost of service.

Q. Has the Company experienced recovery of the acquisition adjustments and transaction costs?

A. Yes. MAWC has received recovery of both the acquisition adjustments and the transaction costs. MAWC previously served the Municipalities through wholesale tariffs. Following the purchase, MAWC experienced an increase in the revenues received as a result of collecting retail rate revenues from the individual customers instead of wholesale rates from the Municipalities. In its response to Staff Data Request No. 418, the Company provided the annual difference in revenue that will be realized by serving the Municipalities through retail rates for individual customers as opposed to wholesale rates. Based on this data, from the date of the purchase until the date rates will change as a result of this case, the Company will realize $4,613,345 of additional revenues from Florissant, $3,313,671 from Webster Groves and $522,778 from Valley Park.

With regard to the purchase of Jefferson City, the Company also experienced recovery of the acquisition adjustment and transaction costs. Just prior to the purchase of Jefferson City, the Commission approved a substantial increase in rates. The net income generated by the Jefferson City system, including the effects of the rate increase, was passed on to MAWC following the purchase. In response to Staff Data Request No. 168, the Company identified a reduction of over $500,000 in payroll costs that was achieved as a result of the purchase of the Jefferson City system. These payroll costs were included in the rates established by the Commission just prior to the purchase, and continue to be paid by ratepayers today. MAWC has enjoyed these savings since the purchase and will continue to keep this benefit until April 2004, when rates are changed as a result of the current case. These savings provide recovery of acquisition adjustments and transaction costs. From the date of purchase until the date rates from this case become effective, MAWC will realize $1,237,132 of payroll cost savings.

In total, MAWC will realize over $9.5 million in additional revenues and expense savings. The total transaction costs and acquisition adjustments associated with the Municipalities and Jefferson City is $7,934,245. Therefore, the Company has completely recovered the transaction costs and acquisition adjustments related to these purchases.

<u>DEPRECIATION</u>

Q. Please explain this section of your testimony.

A. This section of my testimony will discuss the following two depreciation-related topics:

1) The affect of the Infrastructure System Replacement Surcharge (ISRS) for the County Water service area (now part of MAWC) on the determination of depreciation rates in this case; and

2) The regulatory treatment that should be afforded the depreciation fund ordered by the Commission in the last County Water rate case, Case No. WR-2000-844.

Q. In the last County Water rate case, did the Commission accept the Staff's treatment of cost of removal and salvage?

A. No. In Case No. WR-2000-844, the Commission accepted the Company's method of including estimated cost of removal and salvage in the determination of depreciation rates and ordered an increase in depreciation expense to provide cash flow to address the Company's infrastructure problems. In its Order the Commission stated:

> The Commission's decision on this issue is guided by policy. There is ample factual support to allow the Commission to choose either Staff's approach or the Company's. Under the circumstances faced by the Company, including its need for cash flow to address its infrastructure issues, the Commission concludes that using the whole life method and including estimated net salvage is in the public interest. The whole life method collects net salvage cost ratably over the life of plant by customers served by the plant. This approach is equitable based on the circumstances of this case. The Commission's conclusion about the use of the whole life method should not be taken as a final endorsement of it, nor as a condemnation of Staff's approach. Both have merit, and the Commission will use the one that fits the particular circumstances under investigation. The Commission explicitly distinguishes its holding on the net salvage issue here from its holding in Laclede Gas Company's recent rate case, Case No. GR-99-315. The Commission's holding that the Company's use of the whole life method of determining depreciation rates is based on the record in this case, and on the circumstances in which the Company finds itself.

Q. Have the circumstances that guided the Commission's decision in the last County Water rate case changed?

A. Yes. Recently, the Missouri Legislature passed a law allowing MAWC to impose a surcharge to recover costs related to infrastructure system replacement of plant (ISRS), in its County Water service area, outside the context of a rate case. This mechanism allows MAWC to address the circumstances that guided the Commission's decision in the last County Water rate case. This mechanism also allows MAWC to recover the costs of facility relocations through the surcharge.

Q. How does the ISRS address infrastructure replacement?

A. The Company no longer needs to file a rate case, and wait 11 months to start recovering the costs related to infrastructure plant replacements, as well as facility relocations. A surcharge can be filed and become effective in 120 days. This mechanism promptly provides recovery of the cost associated with infrastructure plant replacements and facility relocations and also provides cash flow to address future construction needs.

Q. Please explain your reference to the depreciation fund ordered by the Commission in the last County water rate case.

A. In Case No. WR-2000-844, the Commission ordered County Water to set aside a portion of the additional depreciation expense recoveries in a depreciation fund that could only be used for infrastructure plant replacements. The Commission's Order was later clarified, as part of MAWC's Circuit Court appeal, to require the Company to either set aside in a depreciation fund, or spend, $4,809,134 annually for infrastructure plant replacement. The Company has collected the amounts which are to be set aside in the depreciation fund and has spent $4,809,134 annually for infrastructure plant replacement.

Q. How does the Staff propose to treat the amounts associated with the depreciation fund?

A. In the Staff's opinion, the Commission provided, through additional depreciation expense, cash to address MAWC's infrastructure replacement problems in its County Water service area. This up-front provision of cash is similar to a contribution in aid of construction (CIAC) and should be treated, like CIAC, as a reduction to the rate base and an offset to the net plant in service. The Uniform System of Accounts for Water Utilities provides for the accumulation of contributed capital to offset construction costs in Account 271, Contribution in Aid of Construction. Since CIAC provides cash to the utility to fund construction, it is included in rate base as an offset to the plant in service and results in less return on investment. The CIAC is also amortized as an offset to the depreciation expense of the plant it funded.

Q. How has the Staff computed the CIAC associated with infrastructure plant replacements?

A. The Staff has used the amount the Commission ordered to be set aside, in a depreciation fund, as the annual amount of CIAC. The Staff included this CIAC in rate base as a reduction to the net plant in service, and amortized it as an offset to the depreciation expense computed on the $4,809,134 of annual infrastructure plant replacements. I have multiplied the $4,809,134 by 2.13 years, the length of time the rates from Case No. WR-2000-844 have been in effect through the Staff's June 30, 2003 update to compute the CIAC balance, $10,250,704. Because the Company has booked the amount associated with the depreciation fund to the accumulated depreciation reserve, I have made an adjustment to reduce the reserve, R-59-1, by the amount of the CIAC balance. The annual amortization of this accumulated CIAC, $171,187, was used as an offset to the annual depreciation expense plant on infrastructure plant replacements through adjustment S-15.3.

SECURITY ACCOUNTING AUTHORITY ORDER (AAO)

Q. Please describe the Security AAO.

A. In Case No. WO-2002-273, the Commission approved the deferral of costs related to the improvement and enhancement of security at MAWC's facilities. The Company was allowed to accumulate the deferral for two years following the terror attacks of September 11, 2001. The Company has deferred various one-time security costs, the depreciation and carrying cost associated with security-related construction projects and the legal cost associated with the case that led to the establishment of the AAO.

Q. Is the Staff proposing recovery of all the cost deferred by MAWC?

A. No. The Staff opposes the recovery of the deferred legal costs and a portion of the carrying costs.

Q. Please explain the Staff's opposition to the inclusion of the legal expenses associated with Case No. WO-2002-273.

A. Ordered Item 5 of the Commission's Report And Order in Case No. WO-2002-273 states, "That Missouri-American Water Company is hereby granted authority to defer and book to Account 186 expenditures relating to security improvements and enhancements beginning September 11, 2001, and continuing through September 11, 2003." The legal costs associated with processing Case No. WO-2002-273 are not expenditures for security improvements or enhancements to MAWC's facilities and should not be included in the deferral.

Q. To the best of your knowledge, have the costs of processing an AAO case ever been included in an AAO deferral?

A. No. The costs included in the deferral are those costs specifically incurred to address the purpose of the AAO. For instance, an application by County Water for an AAO to defer costs related to infrastructure replacement was the subject of Case No. WO-98-223. The costs associated with processing that case were not included in the deferred cost that the Company sought to recover.

Q. Why is the Staff proposing to disallow a portion of the carrying cost associated with the Security AAO?

A. The Company has calculated carrying cost using the allowance for funds used during construction (AFUDC) rates. Staff Witness Lisa K. Hanneken has recommended a change in the methodology the Company uses to calculate AFUDC rates. This same methodology, which utilizes short-term debt as the primary funding source for construction, should also be used to calculate the carrying costs associated with the deferral of security costs.

Q. What regulatory treatment is the Staff recommending for the Security AAO deferred costs it is proposing to allow?

A. The Staff is proposing to amortize the deferred security costs over a 10-year period, with no rate base inclusion of the unamortized deferred balance. The Staff is proposing this treatment, which was first prescribed by the Commission in its Order in Case No. GR-98-140 involving Missouri Gas Energy's (MGE's) service line replacement deferrals. In that case, the Commission approved:

1) A 10-year amortization of the deferrals;
2) No inclusion of the unamortized balance in rate base; and
3) Inclusion of a rate base reduction for the associated deferred taxes.

The Commission deemed it proper for the ratepayers and shareholders to share the effect of regulatory lag by allowing the Company to earn a return of, but not a return on, the deferred balance. The Staff believes this regulatory treatment, which has been accepted by the Commission for other AAOs, should be used as the method for recovery of the security deferrals.

INFRASTRUCTURE REPLACEMENT AAO

Q. Please describe the Infrastructure AAOs.

A. In Case Nos. WR-95-145 and WR-96-263, the Commission approved the deferral of costs related to infrastructure replacement.

Q. What regulatory treatment is the Staff recommending for the Infrastructure Replacement AAOs?

A. The Staff is proposing the same treatment it is recommending for the Security AAO discussed above:

1) A 10-year amortization of the deferrals;
2) No inclusion of the unamortized balance in rate base; and
3) Inclusion of a rate base reduction for the associated deferred taxes.

OLD ST. JOSEPH TREATMENT PLANT

Q. Has the Staff included any recovery of the undepreciated balance associated with the old SJTP in its determination of revenue requirement?

A. No.

Q. Has the Commission made a ruling regarding the undepreciated balance associated with the old SJTP in a previous rate case?

A. Yes. In Case No. WR-2000-281, the Commission denied any recovery of the undepreciated balance of the old SJTP.

Q. What is the Staff's position regarding this issue?

A. I have been advised by Counsel that this matter is the subject of a continued court appeal process of a prior Commission Order and is, therefore, inappropriate for inclusion in this case.

NEW ST. JOSEPH PLANT DISALLOWANCES

Q. Please discuss the adjustments for plant disallowances and the associated accumulated depreciation for the new SJTP.

A. In Case No. WR-2000-281, the Commission made the following finding regarding the Staff's proposed adjustment to the cost of the new SJTP included in rate base:

> The Commission concludes that the method proposed by Staff is the better method, because not all items included in rate base are equally susceptible to a straight-line, percentage reduction for excess capacity. The amount of $2,271,756 shall be deducted from the value of the new St. Joseph plant included in rate base.

However, the Company did make this adjustment to its books and records. As a result, depreciation expense has accumulated on this portion of the plant since April of 2001.

Q. Is the Staff recommending an adjustment to the value of the new SJTP in this case?

A. Yes. Staff witness James A. Merciel, Jr. is again sponsoring the Staff's recommendation to deduct $2,271,756 from the value of the new SJTP included in rates. I am sponsoring Adjustment P-31.1 to reflect Staff witness Merciel's recommendation for the disallowance of plant in the Accounting Schedules.

Since the Staff is not recognizing this portion of the new St. Joseph Treatment Plant in its determination of revenue requirement, any associated accumulated depreciation must also be deducted from the depreciation reserve. Adjustment R-31.1 eliminates the accumulated depreciation associated with the Staff's adjustment to the cost of the new SJTP.

Q. Does this conclude your direct testimony?

A. Yes.

RATE CASE PROCEEDING PARTICIPATION

STEPHEN M. RACKERS

Company	Case Number
Bowling Green Gas Company	GR-78-218
Central Telephone Company	TR-78-258
Empire District Electric Company	ER-79-19
Fidelity Telephone Company	TR-80-269
St. Louis County Water Company	WR-80-314
Union Electric Company	ER-81-180
Laclede Gas Company	GR-81-245
Great River Gas Company	GR-81-353
Union Electric Company	ER-82-52
Laclede Gas Company	GR-82-200
St. Louis County Water Company	WR-82-249
Union Electric Company	ER-83-163
Union Electric Company	ER-84-168
Arkansas Power and Light Company	ER-85-20
Kansas City Power and Light Company	ER-85-128
Arkansas Power and Light Company	ER-85-265
Union Electric Company	EC-87-114
Union Electric Company	GR-87-62
Southwestern Bell Telephone Company	TC-89-14
St. Louis County Water Company	WR-89-246
Laclede Gas Company	GR-90-120
Missouri Cities Water Company	WR-91-172
St. Louis County Water Company	WR-91-361
Laclede Gas Company	GR-92-165
Missouri Pipeline Company	GR-92-314
St. Louis County Water Company	WR-92-204
St. Louis County Water Company	WR-94-166
St. Louis County Water Company	WR-95-145
Union Electric Company	ER-95-411

Company	Case Number
Union Electric Company d/b/a AmerenUE	EM-96-149
St. Louis County Water Company	WR-96-263
St. Louis County Water Company	WR-97-382
Laclede Gas Company	GR-99-315
Missouri-American Water Company	WR-2000-281 et al
St. Louis County Water Company	WR-2000-844
Laclede Gas Company	GR-2001-629
Union Electric Company d/b/a AmerenUE	EC-2002-1
Union Electric Company d/b/a AmerenUE	EC-2002-1025
Laclede Gas Company	GR-2002-356