Exhibit No.:	
Issues:	*Pensions; Interest Synchronization*
Witness:	*Doyle L. Gibbs*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case Nos.:	*WR-2003-0500 and WC-2004-0168*
Date Testimony Prepared:	*December 5, 2003*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

DOYLE L. GIBBS

MISSOURI-AMERICAN WATER COMPANY

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

Jefferson City, Missouri
December 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, Complainant v. Missouri-American Water Company, Respondent	))))))))	Case No. WC-2004-0168

AFFIDAVIT OF DOYLE L. GIBBS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Doyle L. Gibbs, 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.

Doyle L. Gibbs

Doyle L. Gibbs

Subscribed and sworn to before me this 3RD day of December 2003.

Toni M Charlton

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

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MISSOURI-AMERICAN WATER COMPANY

CASE NOS. WR-2003-0500

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Q. Please state your name and business address.

A. Doyle L. Gibbs, 1845 Borman Court, Suite 101, St. Louis, Missouri 63146.

Q. Are you the same Doyle L. Gibbs that previously filed direct testimony in this case?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Missouri-American Water Company (MAWC or Company) witnesses Edward J. Grubb and William J. Williamson. In particular I will address Mr. Grubb's rebuttal testimony regarding pensions and interest synchronization, and Mr. Williamson's rebuttal testimony concerning pensions.

PENSIONS

Q. Please summarize the pension issue between the Staff and Company.

A. The Company is proposing the use of Statement of Financial Accounting Standard (FAS) 87 as the basis to determine pension expense and the Staff is proposing a pay-as-you-go method.

Q. Is the Staff's pay-as-you-go method based on the Employee Retirement

Income Security Act of 1974 (ERISA)?

A. Yes, it is. Staff's method reflects the actual payments that are required to be made to the pension fund.

Q. Mr. Grubb states in his rebuttal testimony that by proposing to establish pension expense based on ERISA that "the Staff is taking a narrow view of the issue and has not considered the long-term impact on their decision." Do you agree with that statement?

A. No, I do not. In fact, it is my opinion that the Company is looking at it in the short-term based on what it perceives the ERISA minimum contributions to be for the next five years, in comparison to the estimated FAS 87 expense, based on its actuary's estimates. The Company's actuary and witness, Mr. William J. Williamson, even states on page 3 of his rebuttal testimony that the FAS 87 cost and the minimum contribution required by ERISA will differ from year to year, but will not differ over the long-term.

Q. When speaking of the comparison of the perceived minimum ERISA contributions and FAS 87, are you referring to the table on page 11 in Mr. Grubb's rebuttal testimony?

A. Yes. The information in that table, at least for American Water Works (AWW), was extracted from the information provided to the Company from Mr. Williamson in correspondence with Mr. Grubb. That correspondence has been attached as Schedule EJG – 4 to the rebuttal testimony of Mr. Grubb.

Q. Do you have any reservations with regards to the estimated minimum required contributions and the estimated pension costs calculated by Mr. Williamson?

A. Yes, I do. The calculations made by Mr. Williamson may be mathematically correct, but they rely significantly on the assumptions he has used. History shows that what actually occurs is often substantially different from estimated results based on assumptions. Since each succeeding year's calculations are driven by the previous year's results, variations due to a difference between what actually occurs and what was assumed to occur, could have a compounding effect on subsequent calculations.

Q. Historically, how have the actual results varied from the calculations based on assumptions?

A. Schedule 1 attached to my surrebuttal testimony includes actual data from 1992 to present for FAS 87 and ERISA. Differences between actual results and the amounts calculated using actuarial assumptions are reflected in the actuarial reports as unrecognized gains or losses and are shown in the next to last column on Schedule 1. As can be seen, the unrecognized gains and losses (the variance between actual and assumed results) are substantial. The final column of this schedule calculates the percent change from year to year in the unrecognized gains and losses balance.

Q. Please explain how the calculations in one year affect the calculations in subsequent years.

A. Schedule 2, attached to this surrebuttal testimony, consists of 3 pages from the American Water Works 2003 Actuarial Report that calculates FAS 87 expense for the year ending December 31, 2003 and the ERISA funding requirements for the year ending June 30, 2003. Focusing initially on FAS 87, Schedule 2-2 shows the components that make up pension cost for the year 2003 and the prior year, 2002. Note that the total pension cost for 2002 reflects an expected return (9%) on the 2002 assets of approximately $25 million. However, on Schedule 2–1, the value of the assets as of January 1, 2002 have been reduced by $21 million to reflect a 7.6% negative return on investment rather than a 9.0% return that was assumed in the 2002 FAS 87 calculation. All other things remaining equal, the difference between expected and actual return on investment in 2002 would have the effect of reducing the expected return on assets for 2003 by $4 million (the difference between the estimated return and the actual return, times the assumed 8.75% return on assets), due to the reduced asset value, thereby increasing FAS 87 costs by the same amount.

As explained on page 2 in the rebuttal testimony of Mr. Williamson, the ERISA actual funded percentage determines if a contribution to the pension fund is required. Whereas the asset value is a key element in the FAS 87 expense calculation, the asset value under ERISA is a key element in the determination of the funded percentage. Schedule 2-3 reflects the calculations of the funded positions under the actuarial accrued liability (AAL) and the current liability (CL) methods discussed in the rebuttal testimony of Mr. Williamson. The asset values used in the calculations are found in Schedule 2–1. Like FAS 87, Schedule 2-3 asset values have been reduced by the negative return earned on the assets during the prior year. And again, as with FAS 87, the variance between the assumptions used and what actually occurred will affect the calculations of the funded percentage for subsequent years.

Q. On Schedule 2-3, the AAL funded percentage is stated to be 109.3% and on page 2 of Mr. Williamson's rebuttal testimony he states that no contribution is required if the plan's assets exceed the AAL. Yet, on the first page of Schedule EJG–4, attached to the rebuttal testimony of Mr. Grubb, it is indicated that there was an actual contribution of $12.4 million for this period. Have you been provided with an explanation for this discrepancy?

A. Yes, I have. ERISA has an alternative calculation to the Schedule 1 calculation for the AAL funded percentage. Under the AAL method, ERISA requires that the funded percentage will be the lesser percentage of the actuarial value and the market value. Using the market value of the assets shown on Schedule 2-3, the AAL funded percentage is 91%, therefore requiring a contribution to the pension fund.

Q. How much of the required $12.4 million AWW contribution is attributable to MAWC?

A. Approximately $377,000, or 3% was attributable and allocated to MAWC. The Staff has included this amount in the determination of pension expense in its cost of service. The minimum ERISA calculation of $12.4 million from the 2003 actuarial report, a portion of which has been attached as Schedule 2, does not include the former St. Louis County Water Company (SLCWC). The SLCWC plan for this period required no contributions to its pension fund. For ERISA purposes, the SLCWC pension plan will be "rolled into" the AWW plan effective July 1, 2003 for the plan year ending June 30, 2004.

Q. Do you know what the impact the St. Louis County plan will have on the AWW plan?

A. No. I do not. However, since no contributions are currently due, the St. Louis County plan appears to be adequately funded. The combination of the AWW and SLCWC plans should not cause a detrimental impact. In fact, there is the possibility that when the plans are combined that a benefit may accrue to the AWW plan. The Staff will be able to better determine this when the Company provides the St. Louis County actuarial report for 2003.

Q. Mr. Grubb has indicated that the Staff has changed its methodology to calculate pension cost in each of the last four Company rate cases, including this case, and further states on page 11 of his rebuttal testimony:

> Since the Staff has shown a clear history of making expense reducing adjustments to the pension cost that are not consistent from rate case to rate case, will the Staff move back to FAS 87 or will Staff attempt to adjust ERISA cost on some arbitrary basis to lower future pension cost as it did in prior cases?

How do you respond?

A. Mr. Grubb's statement indicating that the Staff arbitrarily made adjustments in past cases simply to reduce cost, and the implication Staff will do so in future cases, questions the Staff's integrity. While there will be issues between the Staff and the filing utility in virtually every rate case, the Staff takes seriously its responsibility to develop and present a case that balances the interests of the Company and its ratepayers. The Staff does not arbitrarily make adjustments solely for the purpose of increasing or reducing expenses. With regards to the Staff's "changing" pension methodology, I indicated in my direct testimony that pension expense has been an evolving issue. At the time of Staff's adoption of FAS 87, most pension funds were over funded and substantial unrecognized gains existed. It was the Staff's opinion that if FAS 87 was to be used for pension expense, the issue related to the unrecognized gains needed to be addressed. The additional FAS 87 pension expense related to the unrecognized gains, when coupled with no ERISA required contributions, represented a cash windfall to the utility companies. Staff's first response was to amortize the unrecognized gain balance over five years. To address the volatility issue raised by utility companies for this methodology, the Staff eventually revised its methodology to use a five-year average, a smoothing if you will, of the gains and losses balance. Recent filings by other utilities have indicated that this methodology, due to market conditions beyond the control of the companies, does not adequately address the volatility of pension expense, as calculated under FAS 87. That is why the Staff is recommending a return to minimum ERISA.

INTEREST SYNCHRONIZATION

Q. Do you agree with Mr. Grubb's statement on page 35, beginning on line 12 of his rebuttal testimony, that the Staff used an excessive amount of interest as a deduction in the calculation of income taxes?

A. No, I do not. As stated in my direct testimony, the methodology used by the Staff simply matches the level of interest expense the ratepayer is providing to the Company in rates, with the interest deduction for income taxes. It is purely a mathematical calculation that applies the weighted cost of debt to the rate base.

Q. What methodology did the Company use in its filed case to determine the interest deduction for the calculation of income taxes?

A. The Company, in its filed case, used the same interest synchronization methodology that the Staff has employed.

Q. Mr. Grubb states on page 36 of his rebuttal testimony that interest is synchronized in the calculation of income taxes so that the ratepayers receive the proper tax deduction based on the actual level of debt used to fund rate base. Do you agree with that statement?

A. No. For its income tax calculations, the Staff uses the amount of interest the ratepayer provides to the Company through customer rates based on the weighted debt cost included in the capital structure that is applied to rate base for the determination of revenue requirement. The debt component of the capital structure can, and often is, different from the actual debt recorded by the Company. The "actual level of debt" referenced by Mr. Grubb is not the appropriate amount to use as a tax deduction because revenue requirement is determined based on a rate of return that contains a debt component.

Q. Has the Commission ruled on this issue before?

A. Yes. The Staff is not aware of any Commission decision where interest synchronization was not adopted for ratemaking purposes.

Q. Why has the Company raised an issue in this area if it supports interest synchronization?

A. In Mr. Grubb's response on page 35 of his rebuttal testimony, he states that the excessive amount of interest deduction is due to the use of a consolidated capital structure. Mr. Grubb's dislike for the use of the consolidated capital structure is apparently the source of the dispute on this issue. The Staff contends that the Company's dislike for the consolidated capital structure is the true issue and therefore the interest synchronization issue is merely an extension of the capital structure issue.

Q. If the interest deduction used for income taxes is not determined by multiplying the rate base by the debt component of the capital structure used in the determination of revenue requirement, has interest been synchronized?

A. No. The definition of interest synchronization is using the same debt component to determine the income tax deduction as is used in the debt component of the capital structure to determine the rate of return and revenue requirement. If the same debt component is not used for both calculations, interest synchronization will not be achieved.

Q. What is the result of using a different debt component to determine the income tax deduction than the one used in the capital structure to determine rate of return and revenue requirement?

A. Using different debt components will result in a revenue requirement that is based on a different return on equity than that being order by the Commission. If less interest is used as a deduction for income taxes than is paid by the ratepayer, the return on equity included in rates will be higher than the return on equity order by this Commission in this case. This occurs because the equity portion of the return must be factored up for taxes, while the debt portion of the return is tax deductible. Using a lower tax deduction results in more of the authorized rate of return being treated like equity, thus generating a higher revenue requirement.

Q. By advocating use of a lower interest component for income taxes than for the determination of rate of return and revenue requirement, does Mr. Grubb advocate a higher actual return on equity than the nominal level ordered by the Commission in this case?

A. Yes. He will not be proposing interest synchronization and will thus in effect be proposing a higher return on equity.

Q. What is your recommendation to the Commission for dealing with this issue?

A. Both the Company and Staff filed their cases based on the interest synchronization methodology. Interest synchronization means using the same debt component to determine the income tax deduction as is used to determine the rate of return and revenue requirement. Therefore, the Commission should continue to synchronize its revenue requirement and income tax expense findings consistent with its decision on capital structure. Any other course of action will not result in the return on equity prescribed by the Commission in this case.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

Missouri-American Water Company
Case No. WR-2003-0500

American Water Works FAS 87 and Minimum ERISA Comparison

Year End	June 30 ERISA[1]	% Change	June 30 Minimum ERISA	% Change	December 31 FAS 87		% Change	FAS 87 Funded %	Unrecognized (Gain)/Loss	% Change
Actual										
1992			0		6,026,065			137.7%	22,599,000	
1993			0		5,364,402		-10.98%	129.9%	13,346,000	-40.94%
1994			0		9,744,625		81.65%	109.8%	50,262,000	276.61%
1995	10,006,609		9,249,305		7,493,372		-23.10%	123.0%	(562,000)	-101.12%
1996	10,365,338	3.58%	2,045,668	-77.88%	6,524,463		-12.93%	122.1%	15,904,000	-2929.89%
1997	9,893,170	-4.56%	0		5,652,084		-13.37%	129.7%	(21,012,000)	-232.12%
1998	10,108,286	2.17%	0		6,160,968		9.00%	124.6%	(10,458,000)	-50.23%
1999	10,118,740	0.10%	0		6,205,643		0.73%	119.0%	(4,661,000)	-55.43%
2000	10,749,723	6.24%	0		146,941	[2]	-97.63%	135.8%	(90,018,000)	1831.30%
2001	10,913,184	1.52%	0		10,763,520		7225.06%	127.1%	1,117,000	-101.24%
2002	11,740,902	7.58%	0		17,369,508		61.37%	120.4%	42,921,000	3742.52%
2003	12,813,381	9.13%	12,432,374		32,628,000		87.85%	81.2%	128,304,000	198.93%
Projected										
2004			15,100,000	21.46%	44,400,000		36.08%			
2005			76,600,000	407.28%	40,000,000		-9.91%			
2006			73,800,000	-3.66%	35,000,000		-12.50%			
2007			67,100,000	-9.08%	30,700,000		-12.29%			
2008			25,600,000	-61.85%	28,900,000		-5.86%			

		Minimum ERISA	FAS 87	FAS 87/Minimum ERISA Difference
1992 thru 2003		23,727,347	114,079,591	90,352,244
2004 thru 2008		258,200,000	179,000,000	(79,200,000)
1992 thru 2008		281,927,347	293,079,591	11,152,244
1995 thru 2003	96,709,333	23,727,347	92,944,499	69,217,152

[1] Normal cost and interest

[2] 2001 actuarial report indicates amount was revalued as $3,421,166 as a result of First Allmerica settlement. As a result, above percent changes would be -44.87% and 214.62%

Asset Values

Asset Values for Calculating Pension Cost

Fair value, excluding contributions receivable:

▸ As of January 1, 2002	$ 286,100,020
▸ Contributions	6,150,000
▸ Aquarion spin-off	(10,340,644)
▸ Northwest Indiana transfer receivable as of December 31, 2002	14,476,701
▸ Disbursements	(4,591,784)
▸ Investment return	(21,247,884)
▸ As of January 1, 2003	$ 270,546,409
▸ Rate of return	(7.6)%

Market-related value:

▸ As of January 1, 2002	$ 286,100,020
▸ As of January 1, 2003	270,546,409
▸ Rate of return	(7.6)%

Asset Values for Calculating Employer Contributions

Market value, including contributions receivable:

▸ As of July 1, 2001	$ 292,277,678
▸ Contributions	0
▸ Aquarion spin-off	(10,114,042)
▸ Disbursements	(4,503,012)
▸ Investment return	(14,631,416)
▸ As of July 1, 2002	$ 263,029,208
▸ Rate of return	(5.1)%

Actuarial value:

▸ As of July 1, 2001	$ 319,920,187
▸ As of July 1, 2002	315,635,049
▸ Rate of return	3.3%
▸ Rate of return (assuming mid-year cash flow) for Schedule B of Form 5500	3.3%

Pension Cost

	Fiscal 2003	Fiscal 2002
Pension Cost		
Service cost	$ 18,984,540	$ 15,862,597
Interest cost	31,505,447	27,191,066
Expected return on assets	(23,924,127)	(25,042,045)
Amortization:		
▸ Transition obligation (asset)	(4,853)	(1,362,761)
▸ Prior service cost (credit)	318,729	306,101
▸ Net loss (gain)	5,748,700	414,550
Pension cost	$ 32,628,436	$ 17,369,508
Percent of covered pay	15.2%	8.8%
Per active participant	$ 7,813	$ 4,176

Change in Pension Cost	
Pension cost for fiscal 2002	$ 17,370,000
Change from fiscal 2002 to fiscal 2003:	
▸ Expected based on prior valuation including full reflection of the New England Operations divestiture	1,748,000
▸ Loss (gain) from noninvestment experience	1,013,000
▸ Loss (gain) from asset experience	7,368,000
▸ Change in discount rate	4,314,000
▸ Change in expected return on assets rate	683,000
▸ Plan amendments	0
▸ Merger of Northwest Indiana Water Company	132,000
Pension cost for fiscal 2003	$ 32,628,000

Basic Results for Employer Contributions

	July 1, 2002*	July 1, 2001
Normal Cost and Liabilities		
Normal cost	$ 11,755,395	$ 10,771,470
Actuarial accrued liability [AAL]	288,890,229	265,802,556
Current liability [CL]:		
▸ Selected interest rate	294,866,061	305,125,322
▸ Highest allowable interest rate	294,866,061	305,125,322
Assets		
Market value	$ 263,029,208	$ 292,277,678
Unrecognized investment losses (gains)	52,605,841	27,642,509
Actuarial value [AV]	$ 315,635,049	$ 319,920,187
Funded Position		
Unfunded actuarial accrued liability [AAL – AV]	$ (26,744,820)	$ (54,117,631)
AAL funded percentage [AV ÷ AAL]	109.3%	120.4%
CL funded percentage:		
▸ Selected interest rate	107.0%	104.9%
▸ Highest allowable interest rate	107.0%	104.9%
Key Economic Assumptions		
Discount rate for normal cost and actuarial accrued liability	9.00%	9.00%
Current liability interest rate:	6.80%	6.09%
Salary increase rate	Age-graded scale averaging 5.00%	Age-graded scale averaging 5.00%

* All values are as of July 1, 2002 and therefore do not reflect the merger of the Northwest Indiana Pension Plan except for normal cost which includes a pro rata portion of the merged plan.