

Exhibit No.:  
Issue:

Conditions on  
Acquisition Approval  
Donald Johnstone  
Surreb. Testimony  
AGP  
WA-2012-0066  
June 5, 2012

Witness:  
Type of Exhibit:  
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Case Number:  
Date Prepared:

**Missouri American Water Company  
WA-2012-0066**

**Surrebuttal Testimony of  
Donald E. Johnstone**

on behalf of  
AG PROCESSING INC, A COOPERATIVE

June 5, 2012



**BEFORE THE  
PUBLIC SERVICE COMMISSION OF MISSOURI**

In the Matter of Missouri-American Water )  
Company for a Certificate of Convenience )  
and Necessity Authorizing it to Install, Own, ) WA-2012-0066  
Acquire, Construct, Operate, Control, )  
Manage and Maintain Water and Sewer )  
Systems in Christian and Taney Counties, )  
Missouri. )

**Affidavit of Donald E. Johnstone**

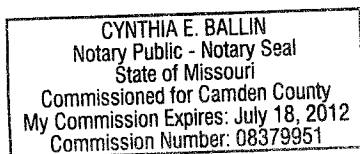
State of Missouri )  
County of Camden ) SS


Donald E. Johnstone, being first duly sworn, on his oath states:

1. My name is Donald E. Johnstone. I am a consultant and President of Competitive Energy Dynamics, L. L. C. I reside at 384 Black Hawk Drive, Lake Ozark, MO 65049. I have been retained by AG PROCESSING INC, A COOPERATIVE.
2. Attached hereto and made a part hereof for all purposes are my testimony and schedules in written form for introduction into evidence in the above captioned proceeding.
3. I hereby swear and affirm that my testimony is true and correct and show the matters and things they purport to show.

  
Donald E. Johnstone

Subscribed and sworn to this 6th day of June, 2012.



  
Notary Public

Competitive Energy  
DYNAMICS

**Missouri American Water Company**

**WA-2012-0066**

**Surrebuttal Testimony of Donald E. Johnstone**

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Missouri American Water Company

WA-2012-0066

Surrebuttal Testimony of Donald E. Johnstone

1 Q PLEASE STATE YOUR NAME AND ADDRESS.

2 A Donald E. Johnstone. My address is 384 Black Hawk Drive, Lake Ozark, MO 65049. I  
3 previously submitted direct testimony in this proceeding.

4 STAFF RATE COMPARISON - DIVERGENT PROPOSALS

5 Q DID STAFF COMPARE ITS PROPOSED RATES TO THOSE PROPOSED BY MAWC?

6 A Yes. Mr. Merciel provides a table with the most current rate proposals in his rebuttal  
7 testimony.

8 Q IS THERE A LARGE DISPARITY BETWEEN THE RATE PROPOSALS OF THE STAFF AND  
9 THE PROPOSALS OF MAWC?

10 A Yes. As illustrated by Mr. Merciel, the existing water bills for small users would go up  
11 by 165% under his proposal and they would go up by 227% under the MAWC proposal.  
12 For larger water users the increase is 101% under Mr. Merciel's proposal and 104%  
13 under the MAWC proposal. (Schedule JAM water use 4000 and 18000)

14 The sewer rate proposals of Staff and MAWC diverge even more than their  
15 water rate proposals. As illustrated by Mr. Merciel, the sewer bills for small users  
16 would go down by 42% under his proposal while they would go up by 18% under the

1 MAWC proposal. For larger sewer usages the increase is 8% under Mr. Merciel's  
2 proposal and 84% under the MAWC proposal. (Schedule JAM sewer use 4000 and 10000)

3 **EXISTING SUBSIDIES**

4 Q GIVEN THE COMMENTS IN THE REBUTTAL TESTIMONIES OF MR. WILLIAMS AND MR.  
5 MERCIEL, DO YOU HAVE ANY DOUBT ABOUT THE EXISTENCE OF SUBSIDIES FLOWING  
6 FROM THE LARGER DISTRICTS TO THE SMALLER DISTRICTS UNDER EXISTING RATES?

7 A No. While there may be limited disagreements about the precise quantification, I am  
8 aware of no cost of service studies that have been submitted by any party to the  
9 recent MAWC general rate proceeding that could dispel the conclusion that there are  
10 substantial subsidies. In fact, the subsidy from sewer to water was an explicit part of  
11 both the MAWC and Staff proposals. I chose to rely on the last update to the Staff EMS  
12 runs as the basis for the quantification of the subsidies. The estimates are reasonable  
13 and illustrative of a significant ongoing problem. The problem should not be ignored  
14 and cannot be solved by equivocating about the calculation.

15 **CONDITIONS TO AVOID DETRIMENT**

16 Q HAVE YOUR RECOMMENDATIONS BEEN ADDRESSED?

17 A They have been addressed by MAWC and by Staff.

18 Q What was your first recommendation?

19 A It was: "In a general sense, the Saddlebrooke rates should be set at the cost of  
20 service. While this is not a general rate case, as a practical matter rates for the  
21 Saddlebrooke water and sewer customers are a necessary result. Moreover, rates set  
22 at cost-of-service levels will convey accurate cost information to the Saddlebrooke  
23 customers. Otherwise there is a serious potential that they could be misled. Of

1 course the rates must be just and reasonable.

2 **Q WHAT HAS BEEN THE RESPONSE?**

3 A Staff states that it is difficult to know certain aspects of cost of service for various  
4 reasons, including the fact that service was not previously regulated. Staff also  
5 defends an “incremental” approach for certain costs, which holds the costs and, in  
6 turn, the rates below what they would otherwise be. While I understand the concept  
7 of incremental, this is not an appropriate use. It would set the costs and rates at a  
8 lower level temporarily. That then would feed the problem of large increases for  
9 small district in subsequent rate cases.

10 **Q DID YOU HAVE A RECOMMENDATION REGARDING STAFF’S PROPOSED EXCESS**  
11 **CAPACITY ADJUSTMENT?**

12 A Yes. It was: If there is to be an excess capacity adjustment, then a process should be  
13 defined for resolving the excess capacity over time. There must either be an explicit  
14 voluntary agreement to the process or the Commission should establish the process as  
15 a condition of approval of the acquisition.

16 **Q WHAT HAS BEEN THE RESPONSE?**

17 A Staff explains how the adjustment could continue to be applied. However, there is no  
18 commitment from Staff or MAWC to do so.

19 **Q DID YOU HAVE A RECOMMENDATION REGARDING THE VALUATION OF RATE BASE?**

20 A Yes. It was: It is my understanding that MAWC and Staff will be supporting a rate  
21 base valuation that exceeds the price to be paid by MAWC for the assets. This is an  
22 issue that will have immediate as well as ongoing rate implications. In due course I

1 may address the matter further.

2 **Q WHAT HAS BEEN THE RESPONSE?**

3 A OPC has addressed the AGP concerns in Mr. Robertson's testimonies. I agree with the  
4 OPC position and fail to see any convincing justification the customers of MAWC to  
5 provide a return to MAWC based on monies never invested by MAWC in the water or  
6 sewer utilities. The Staff position appears to be based in part on the mistaken notion  
7 that the Commission cannot protect ratepayers both in the instant situation and when  
8 there is an acquisition premium. All that is issue here whether the rate base should be  
9 inflated to a level that exceeds the amount of money being invested by MAWC. If the  
10 assets in reality had a value equal to the book value, MAWC would have had to pay  
11 more. MAWC did not see the value. MAWC did not pay for the higher value. Rates  
12 should not be based on a valuation of rate base that is controverted by the very  
13 transaction that gives rise to the proceeding.

14 **Q WHAT WAS YOUR RECOMMENDATION REGARDING THE \$31,000 OF DNR MANDATED**  
15 **EXPENSES?**

16 A My initial recommendation was: Another concern is an expense of roughly \$31,000  
17 that I understand to be required by DNR as a condition of the acquisition. It is difficult  
18 to comprehend why rates for Saddlebrooke customers should not reflect this expense  
19 and why the existing customers should be at risk for the detrimental effect.

20 **Q WHAT HAS BEEN THE RESPONSE?**

21 A The parties remain divided. There seems to be no doubt that the expense will be  
22 incurred almost immediately and no dispute about the magnitude. Given the nature

1 of this certificate case, to deny inclusion of the expense is to introduce a bias to  
2 reduce rates below a reasonable cost level. For this and other reasons raised in  
3 testimonies, I support inclusion of the costs in rates.

4 **Q WHAT WAS YOUR RECOMMENDATION REGARDING THE ALLOCATION OF CORPORATE**  
5 **OVERHEADS?**

6 A My initial recommendation was: MAWC corporate overheads are another concern. An  
7 appropriate level should be included in the cost of service used to design the rates.  
8 Staff expressed concern about the allocations of these costs in its testimony in the  
9 recent MAWC rate case. Certainly the initial rates should reflect an appropriate level  
10 consistent with the cost of service for existing customers. Anything less would be a  
11 preference for Saddlebrooke customers and a disadvantage for existing MAWC water  
12 customers in different localities.

13 **Q WHAT HAS BEEN THE RESPONSE?**

14 A An incremental cost rationale is defended by Staff. This discriminates as compared to  
15 the cost basis for all other customers on the utility systems and will introduce a bias  
16 that will understate the costs and rates with the problems that entails in these  
17 circumstances. For these reasons this is not, in my opinion, an appropriate application  
18 of incremental cost concepts to rates.

19 **Q WHAT WAS YOUR RECOMMENDATION REGARDING RATE BASE AND TAXES?**

20 A My recommendation was: The MAWC return on rate base and taxes are also  
21 important. Assuming the acquisition is approved, the return and income taxes that  
22 flow from it should be even with return and taxes for existing customers.



1 Q WHAT HAS BEEN THE RESPONSE?

2 A The Staff response is unclear. Given the nature of the certificate proceeding, I  
3 continue to recommend consistency with the return and taxes for existing customers,  
4 to the extent practicable.

5 Q IF THE RATES IN THIS PROCEEDING WERE TO BE SET IN A WAY THAT IS  
6 INCONSISTENT WITH THE COST OF SERVICE APPROACH USED FOR EXISTING  
7 CUSTOMERS, WOULD THERE BE ANY PROBLEMS AS A RESULT?

8 A Yes. There should be a consistently developed cost basis between and among districts  
9 and the sewer and water utilities. Absent such consistency the possibility of undue  
10 preference and discrimination among localities arises immediately.

11 Another concern also arises. If the rates are set inappropriately low, the  
12 increase for Saddlebrooke customers in the next case would more likely be sharp or  
13 extraordinary. This is a potential problem as to future impact considerations for  
14 Saddlebrooke customers and a problem for existing customers inasmuch as the  
15 potential for additional subsidies to the small water and sewer systems would arise.

16 Instead, any proposals that would hold Saddlebrooke rates to an artificially low  
17 level should, to the extent possible, be dealt with forthrightly with the development  
18 of just and reasonable rates as a part of this proceeding.

## 19 CONCLUSIONS

20 Q PLEASE SUMMARIZE YOUR CONCLUSIONS AT THIS TIME.

21 A There is a history of detrimental subsidies being provided at the expense of existing  
22 customers as a result of MAWC's acquisitions of smaller utility properties. These  
23 properties now generally comprise District 8 and the sewer districts.

1 Q CAN THE DETRIMENT TO EXISTING CUSTOMERS BE AVOIDED?

2 A Yes. While there are no guarantees, there are several issues that could lead to rates  
3 being set below an appropriate level of costs. The rates will remain in effect for an  
4 unpredictable period, at least for many months and perhaps several years until the  
5 next general rate proceeding. Setting them too low would be discriminatory on its  
6 face and would tend to move the next rate case filing forward, to the detriment of  
7 existing customers. Also, the potential for ongoing subsidies from existing customers  
8 can and should be reduced by avoiding, to the extent possible, approaches that would  
9 hold Saddlebrooke water and sewer rates to an artificially depressed level.

10 Q SHOULD YOUR SILENCE ON ANY ISSUE BE CONSTRUED AS AGREEMENT?

11 A No. Silence does not mean agreement. Other issues may be addressed in due course.

12 Q DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?

13 A Yes it does.