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Rate Design  
Donald Johnstone  
Surrebuttal Testimony  
AGP  
WR-2011-0337  
February 2, 2012

Missouri American Water Company  
WR-2011-0337

Surrebuttal Testimony of  
**Donald E. Johnstone**

on behalf of

AG PROCESSING INC, A COOPERATIVE

February, 2012



**BEFORE THE  
PUBLIC SERVICE COMMISSION OF MISSOURI**

In the Matter of Missouri-American Water )  
Company's Request for Authority to )  
Implement a General Rate Increase for ) WR-2011-0337  
Water Service Provided )  
in Missouri Service Areas )

**Affidavit of Donald E. Johnstone**

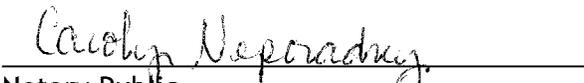
State of Missouri )  
County of Camden ) SS

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 is my testimony 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 shows the matters and things it purports to show.

  
\_\_\_\_\_  
Donald E. Johnstone

Subscribed and sworn to this 2<sup>nd</sup> day of February, 2012.

  
\_\_\_\_\_  
Notary Public



CAROLYN NEPORADNY  
My Commission Expires  
August 30, 2013  
Camden County  
Commission #09452654

Competitive Energy  
DYNAMICS

Missouri American Water Company

WR-2011-0337

Surrebuttal Testimony of Donald E. Johnstone

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1 Missouri American Water Company

2  
3 WR-2011-0337

4 Surrebuttal Testimony of Donald E. Johnstone  
5  
6

7 INTRODUCTION

8 Q PLEASE STATE YOUR NAME AND ADDRESS.

9 A Donald E. Johnstone. My address is 384 Black Hawk Drive, Lake Ozark, MO 65049.

10 Q ARE YOU THE SAME DONALD JOHNSTONE THAT SUBMITTED DIRECT AND REBUTTAL  
11 TESTIMONIES IN THIS PROCEEDING?

12 A I previously submitted rate design direct and rebuttal testimonies in this docket.

13 Q PLEASE PROVIDE AN OVERVIEW OF YOUR TESTIMONY.

14 A As explained in my earlier direct testimony, the rates for MAWC water service in each  
15 district should reflect the cost of the water services provided in each district for each  
16 rate class for the reasons set forth in that testimony. In my rebuttal testimony I  
17 responded to the proposal of the Staff to create what are characterized as "Hybrid"  
18 districts. A part of my response was a counterproposal that would group the smaller  
19 districts according to cost/price, thereby consolidating while preserving a cost basis  
20 for the rates charged.

21 In this surrebuttal testimony I respond to the MAWC testimonies of Dr.  
22 McDermott on the matter of MAWC's consolidated tariff proposal and Mr. Herbert's  
23 testimony regarding rate design.

24 I am aware that several parties address revenue requirements issues. Silence  
25 on any issue at this time should not be construed as either support or opposition.

1 SUMMARY OF TESTIMONY AND RECOMMENDATIONS

2 Q GIVEN DR. MCDERMOTT'S REBUTTAL TO THE PARTIES OPPOSING THE MAWC  
3 CONSOLIDATED TARIFF PROPOSAL, WOULD YOU PLEASE PROVIDE A SUMMARY OF  
4 YOUR SURREBUTTAL OF DR. MCDERMOTT?

5 A

- 6 • Dr. McDermott would have the Commission turn away from the reality of  
7 present rates and the history of district-specific costs, revenue requirements  
8 and rates.
  
- 9 • Dr. McDermott criticizes accounting costs and several analyses submitted on  
10 behalf of Staff, OPC, MIEC, and AGP that document wide cost variations among  
11 districts. The criticisms ignore that these same types of costs are the basis for  
12 rates presumed to be just and reasonable.
  
- 13 • Dr. McDermott talks about "economic costs" and "marginal costs" that he  
14 would have the Commission use to rationalize the consolidated tariff proposal.  
15 While providing no study of MAWC economic or marginal costs, he asserts that  
16 marginal costs are similar among the districts. However, he fails to reconcile  
17 any marginal costs with the embedded accounting costs that form the revenue  
18 requirement, and he provides no determination of marginal costs for MAWC, for  
19 the districts, or for the customer classes.
  
- 20 • Dr. McDermott disputes the longstanding practice of setting rates based on  
21 allocations of accounting costs, with such rates being consistent with just and  
22 reasonable rates devoid of undue discrimination or disadvantage or preference  
23 for any locality.

24 Q PLEASE PROVIDE A SUMMARY OF YOUR SURREBUTTAL OF MR. HERBERT.

25 A

- 26 • Mr. Herbert complains that I did not do an analysis that he suggests would lead  
27 to a recommendation of a rate that would be the same or similar for small  
28 commercial customers and small industrial customers.
  
- 29 • Given an appropriate analysis and a timely proposal by MAWC to change the  
30 design of rates for the St. Joseph District (in a future proceeding), I would  
31 recommend to my client a full review and response. However, in this  
32 proceeding MAWC has no such proposal and I stand by my recommendation for  
33 an equal percentage increase to all rates in the St. Joseph District.

1 SUMMARY OF DR. MCDERMOTT'S REBUTTAL

2 Q PLEASE SUMMARIZE DR. MCDERMOTT'S REBUTTAL ON THE SUBJECT OF A  
3 CONSOLIDATED TARIFF.

4 A MAWC witness Dr. McDermott in his direct testimony supported MAWC's consolidated  
5 tariff proposal and has now offered rebuttal testimony critical of the several  
6 testimonies that stand in opposition to the MAWC consolidated tariff proposal. More  
7 specifically, he was critical of testimonies submitted by Staff witness Busch, OPC  
8 witness Meisenheimer, MIEC witness Gorman, and myself for AGP. As a part of his  
9 criticisms, Dr. McDermott makes numerous references to marginal costs, although he  
10 offers no study in which marginal costs are quantified for MAWC, for any of the  
11 districts separately, or for customer classes across and within districts.

12 Dr. McDermott is critical of virtually every effort to compare costs across the  
13 districts. However, he admits that ". . .it sounds reasonable to suggest that if a new  
14 water treatment plant is built for a particular district, those customers should pay for  
15 that plant. . ." From this admission he goes on to assert: "that conclusion is not based  
16 on economic principles, it is based on regulatory concepts of cost-causation and  
17 fairness." [emphasis supplied] He then rejects the apparent cost-causation and argues  
18 that having other districts pay the cost under consolidated tariff pricing would provide  
19 a "fairer mechanism." (McDermott Rebuttal, p. 13, l. 285-289) After his rejection of  
20 the longstanding regulatory principles of cost causation and fairness he continues to be  
21 in support of the proposed consolidated tariff pricing scheme. He sets about the task  
22 of attempting to undermine the analyses of parties that proceed from the regulatory  
23 concepts of cost-causation and fairness. However, he offers no "economic" cost  
24 study, no "marginal" cost study, no quantification of MAWC economic or marginal cost  
25 similarities or differences between and among districts or customer classes.

1 RESPONSE TO DR. MCDERMOTT'S REBUTTAL TESTIMONY

2 Q DOES DR. MCDERMOTT ACKNOWLEDGE THE USE OF ACCOUNTING COSTS TO  
3 DETERMINE THE ALLOWED REVENUE REQUIREMENT OF MAWC IN A RATE CASE?

4 A Yes. He does not deny that accounting costs must be used to determine the revenue  
5 requirement. Nor does he deny that some of those accounting costs are the result of  
6 accounting costs incurred elsewhere, but then allocated to the jurisdiction.

7 As a matter of fact, accounting costs and allocations of such costs are the  
8 essence of the revenue requirement as determined in a rate case.

9 Q ARE THE PRESENT RATES OF MAWC BASED ON THE COST OF SERVICE AS DEFINED BY  
10 ACCOUNTING COSTS?

11 A The answer to this question is yes, and the explanation fundamentally has two parts.  
12 The first part goes to the revenue requirement for each district. The second part goes  
13 to the rates within each district that are designed to collect the revenue requirement.

14 In all recent cases the Staff developed a revenue requirement for the company  
15 in total that was the sum of the revenue requirements of the districts. The costs that  
16 comprised the revenue requirements in all cases were accounting costs. Some were  
17 incurred locally while others were not local, but were incurred outside of the districts  
18 and became a district cost via a cost allocation. At yet another level, some costs were  
19 incurred outside of the jurisdiction and became a jurisdictional cost via a cost  
20 allocation. In every instance, it was the sum of such accounting costs and a return on  
21 rate base that comprised revenue requirements.

22 Then, once the revenue requirement of each district was determined based on  
23 accounting costs and return, rates in each district were designed to collect the  
24 allowed accounting costs and return. In all recent cases there have been several class

1 cost-of-service studies that have informed the design of the rates that were approved  
2 by the Commission.

3 In the final analysis the present rates, for most purposes, reflect the  
4 accounting costs and return allowed by the Commission in WR-2010-0337.

5 There is one caveat - MAWC acquired new service territories after the last rate  
6 case. The rates for customers in the acquired service areas simply were not a part of  
7 costs, rates, or revenues in the last case, and could not have been. They will,  
8 however, be a part of this and future rate cases.

9 Q WHY ARE THESE FACTS ARISING IN SURREBUTTAL TESTIMONY?

10 A Dr. McDermott would have the Commission ignore, or at least greatly minimize the  
11 weight, of evidence that proceeds from analyses of the accounting costs that have  
12 been presented by several parties. I disagree.

13 Q WHY DO YOU DISAGREE?

14 A The accounting costs that comprise the MAWC revenue requirement are the essence of  
15 the rate case and constitute the reality of the costs that will form the revenue  
16 requirement and the "rate increase." Moreover, rates will necessarily be designed to  
17 collect these costs and the "rate increase." To denigrate the importance of these  
18 accounting costs is to depart from the reality of the rate case.

19 Q DOES DR. MCDERMOTT INTRODUCE MARGINAL COSTS AS A MATTER FOR  
20 CONSIDERATION BY THE COMMISSION?

21 A Yes and no.

22 The answer is yes in that he opines that accounting costs are of no importance

1 in an "economic" sense. According to Dr. McDermott, the world would presumably be  
2 operate more equitably and efficiently if rates were based on marginal costs instead  
3 of accounting costs. While he provides no study of the level of marginal costs (no  
4 studies of MAWC, district, or class marginal costs) he nevertheless asserts that  
5 marginal costs, whatever their actual value, ought to be relied on to rationalize the  
6 MAWC consolidated tariff proposal.

7 The "no" part of my answer arises because there are no marginal cost  
8 numbers. Instead, Dr. McDermott merely assumes or asserts results for the marginal  
9 costs. Nor does he suggest that MAWC should recover the marginal costs as the  
10 revenue requirement. He provides no bridge from his theories to the costs that must  
11 be recovered. Nevertheless, it seems that at every step he finds ways to be critical of  
12 the work of the parties so that he can fall back to his incomplete analysis of marginal  
13 costs as a basis for the MAWC consolidated tariff proposal.

14 **Q ARE THE EXISTING DISTRICT-SPECIFIC RATES OF MAWC UNJUST OR UNREASONABLE?**

15 **A** The existing rates reflect accounting costs, allocations of those costs to the  
16 jurisdiction, to the districts, and to the classes, and a design of rates that was  
17 approved by the Commission. While I am not a lawyer and offer no legal opinion, the  
18 current rates, by my understanding, have followed a process that is consistent with  
19 the manner in which just and reasonable rates are determined in Missouri. Thus, my  
20 answer as a rate analyst is that existing district-specific rates are entitled to a  
21 presumption that they are just and reasonable.

1 Q IN THIS RATE CASE IS THERE A PROCESS FOR DETERMINING THE MAWC REVENUE  
2 REQUIREMENT AND RATE INCREASE THAT WILL AGAIN RELY ON ACCOUNTING  
3 COSTS?

4 A Yes. The underlying Staff process is the same. Staff determined the revenue  
5 requirement and rate increase for each district based on accounting costs and  
6 allocations of those costs, and of course a return on rate base.

7 Q ARE THERE AGAIN WIDE VARIATIONS IN COSTS AMONG THE DISTRICTS IN THIS RATE  
8 CASE?

9 A Yes. The wide variations have been illustrated in several ways by several witnesses.  
10 On the other hand, there is no study that would support the conclusion that the wide  
11 variations in present rates were a mistake. While Dr. McDermott alleges that  
12 "economic" and/or "marginal" costs are similar across districts, no study has been  
13 submitted to provide evidence that even this subset of costs that are important to Dr.  
14 McDermott are the same across districts and customer classes.

15 **RESPONSE TO MR. HERBERT'S REBUTTAL TESTIMONY**

16 Q HAVE YOU REVIEWED THE REBUTTAL TESTIMONY OF MAWC WITNESS HERBERT?

17 A Yes. Mr. Herbert complains that I did not recommend a rate that would be the same  
18 or similar for small commercial customers and small industrial customers.

19 Q HAVE YOU ADDRESSED THIS ISSUE IN PAST MAWC CASES?

20 A In past cases, among other things, I testified in support of a single rate schedule  
21 applicable for commercial and industrial customers, consistent with the principle that  
22 rates for customers with similar usage characteristics should be the same. I did not

1           prevail. In this case I did not contest the presumption of the present rates as just and  
2           reasonable, and did not undertake the burden of demonstrating the need for any  
3           improvement, including the one belatedly suggested by Mr. Herbert.

4    Q       DO YOU ACKNOWLEDGE MR. HERBERT'S POINT TO THE EXTENT THAT HE IS  
5           SUGGESTING THAT SIMILARLY SITUATED CUSTOMERS WITH SIMILAR USAGE  
6           CHARACTERISTICS SHOULD PAY THE SAME RATE?

7    A       Yes. Given a timely proposal by MAWC to improve the design of rates for the St.  
8           Joseph District (in a future proceeding), I would recommend to my client a full review  
9           and response. The first task would be to test the usage characteristics of the groups  
10           to determine if they are indeed similar, or not. That has not been done. Also, at this  
11           point there is no MAWC proposal to change the design of the rates for the St. Joseph  
12           District. MAWC proposes only its consolidated tariff. I stand by my recommendation  
13           of an equal percentage increase to each of the rates for the St. Joseph District.

14   Q       DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?

15   A       Yes it does.