Exhibit No.:	
Witness:	Michael Gorman
Type of Exhibit:	Surrebuttal Testimony
Issues:	Return on Equity, Rate of Return, Cost of Service, and Consolidated Billing
Sponsoring Parties:	Missouri Industrial Energy Consumers
Case No.:	WR-2007-0216

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement a General Rate Increase for Water Service Provided in Missouri Service Areas	)))))	**Case No. WR-2007-0216**

Surrebuttal Testimony of

Michael Gorman

On Behalf of

Missouri Industrial Energy Consumers

July 31, 2007
Project 8751

BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement a General Rate Increase for Water Service Provided in Missouri Service Areas	)))))	**Case No. WR-2007-0216**

STATE OF MISSOURI	)	
	)	**SS**
COUNTY OF ST. LOUIS	)	

Affidavit of Michael Gorman

Michael Gorman, being first duly sworn, on his oath states:

1. My name is Michael Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 1215 Fern Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony, which was prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. WR-2007-0216.

3. I hereby swear and affirm that the testimony is true and correct and that it shows the matters and things that it purports to show.

Michael Gorman

Michael Gorman

Subscribed and sworn to before this 31st day of July, 2007.

TAMMY S. KLOSSNER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Charles County
My Commission Expires: Mar. 14, 2011
Commission # 07024862

Tammy S. Klossner
Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement a General Rate Increase for Water Service Provided in Missouri Service Areas	**)))))**	**Case No. WR-2007-0216**

Surrebuttal Testimony of Michael Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A My name is Michael Gorman and my business address is 1215 Fern Ridge Parkway, Suite 208, St. Louis, MO 63141.

Q ARE YOU THE SAME MICHAEL GORMAN THAT FILED DIRECT AND REBUTTAL TESTIMONIES IN THIS PROCEEDING?

A Yes.

Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A I am appearing on behalf of the Missouri Industrial Energy Consumers (MIEC).

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A The purpose of my surrebuttal testimony is summarized as follows: (1) I respond to Ms. Ahern's criticism concerning my recommended return on equity for Missouri American Water Company (MAWC); (2) I respond to MAWC witness Mr. Herbert's proposed cost of service and rate design for the St. Louis District; and (3) I respond to MAWC witness Edward Grubbs and Office of Public Counsel (OPC) witness Ms. Barbara Meisenheimer's recommendations concerning consolidated billing.

Rate of Return

Q PLEASE ADDRESS MS. AHERN'S CRITICISM CONCERNING MAWC ACCESS TO CAPITAL THROUGH ITS PARENT COMPANY.

A Ms. Ahern's assertion that I was incorrect in stating that MAWC receives all of its capital through its parent company is correct. MAWC does issue some debt capital on its own. I agree with Ms. Ahern's that I did mischaracterize this aspect of MAWC's capital resources.

MAWC does work with some governmental authorities to issue tax-exempt debt. As I understand it, MAWC does pursue this form of debt capital on its own because it is collateralized by MAWC assets or revenues in the provision of regulated utility service within its jurisdictions.

MAWC does receives all new common stock and equity infusions from its parent company, and its corporate bonds are issued through its affiliate American Capital Corporation (ACC). Hence, MAWC access to capital and investment risk are largely mitigated through its affiliation with its parent company and the service company structure.

Q PLEASE ADDRESS MS. AHERN'S COMMENTS CONCERNING YOUR DCF ANALYSES.

A Ms. Ahern's asserts that my recommended return on equity of 9.7% is inappropriate because it is much lower than industry average authorized returns on equity. While her contention that my recommended return on equity from MAWC is lower than the electric and gas industry average is true, her contention that my return on equity is unreasonably low is without merit.

Industry average authorized returns on equity she identifies are for electric and gas utilities. MAWC is a water utility, which has lower risks than either gas, or electric company, which was observed and verified through a Standard & Poor's report that I referenced in my rebuttal testimony at page 3 . Also, , her contention the Industry average authorized returns on equity is around 10.5% is erroneous. The average authorized return on equity for electric and gas companies has been approximately 10.3% most recently, and has been decreasing as illustrated on my Schedule MPG-1. As such, my 9.7% is reasonably considering MAWC's low operating risk, and it reflects the decreasing trend in authorized returns on equity for electric and gas companies experienced over the last several years.

Q DO YOU HAVE ANY COMMENTS CONCERNING MS. AHERN'S CRITICISMS OF YOUR DCF GROWTH RATE ESTIMATES?

A Yes. Ms. Ahern's argues that I should have relied only on consensus analysts' growth rate estimates in performing my DCF study. She argues that my proposal to use a two state DCF model is not appropriate in this case. Ms. Ahern's position, however, should be rejected because it is unreasonable and will produce an excessive return on equity award for MAWC.

As I explain in my direct testimony, analyst growth rate estimates are reliable estimates and likely do influence investors and their investment decisions. However, academic research supports the use of rational expectations in estimating investor return requirements. Ms. Ahern's position would ask the commission to ignore informed analyst judgment, and ignore the likelihood that stock prices are based on rational investment decisions, and instead blindly except financial analyst growth rate projections to estimate a utilities equity return. I disagree.

In my testimony, I went through extensive analysis to test the reasonableness of the growth rates, and dividend yields used in my constant growth DCF model in my direct testimony. Based on that evaluation, I found that those growth rates were not reasonable estimates of long-term sustainable growth. Based on that assessment, I propose to use a two-stage DCF growth model. In contrast, Ms. Arhens provided no growth rate reasonableness test in her analysis

In my two-stage model, I used consensus analyst growth rate estimates during the first five years. In the second stage growth, I continue to use analyst growth rate projections but the second growth stage was based on consensus analyst growth rates to GDP. This is reasonable, because EPS growth rate estimates are for the next three to five years. The GDP growth rate I used was for the period 5 and 10 years out.

Q DID YOU REJECT CONSENSUS ANALYSTS GROWTH RATE ESTIMATES AS MS AHERN'S ASSERTS?

A No. Ms. Ahern's comment is incorrect. I do not reject analysts' EPS forecasts. I give an equal weight to the single- and two-stage DCF models, relying on analysts' EPS forecasts. In fact, at page 17 of Appendix B, I state:

> "However, the growth rate is based on consensus analysts' growth rate projections, so it is a reasonable reflection of rational investment expectations over the next three to five years."

Furthermore, the academic research cited by Ms. Ahern actually supports my use of analysts' EPS projections. As mentioned on page 41 of her rebuttal testimony, Grubb and Malkiel suggest reliance on analysts' EPS projections after careful examination of Companies' records, and this is the exact procedure followed in my single-stage and two-stage DCF analysis. As I mentioned in my direct testimony, I have reviewed the risk characteristics of the companies included in my comparable group and concluded that the return produced by the comparable groups will fairly compensate MAWC and its shareholders.

As I will discuss later, the two-stage DCF analysis was proposed to reflect investors more reasonable expectations in the long run. Therefore, Ms. Ahern interpretation of my testimony appears to be incorrect.

Q PLEASE RESPOND TO MS. AHERN'S COMMENTS CONCERNING YOUR TWO-STAGE DCF MODEL AND INVESTOR'S RATIONAL EXPECTATION.

A The use of the two-stage DCF analysis is applicable when the growth rate estimates do not reflect investors' reasonable expectations in the long run. Utility companies go through different cycles, which influence their performance. As I mentioned in my direct testimony, water utilities are currently going through a major construction cycle, which requires additional capital investments. Due to this fact, the current analysts' EPS projections are higher than they have been in the past.

In addition, as I mention in my direct testimony, reasonable growth rate expectations should reflect analysts' projections of the overall growth of the U.S. economy, as measured by the GDP. In order to reflect reasonable growth rate expectation, the DCF results should be adjusted as suggested by academic publications.

For example, in a widely used graduate textbook, Bodie, Kane, and Marcus state:

> "To value companies with temporarily high growth, analysts use a multistage version of the dividend discount model. Dividends in the early high-growth period are forecast and their combined present value is calculated. Then, once the firm is projected to settle down to a steady-growth phase, the constant-growth DDM is applied to value the remaining stream of dividends."

In addition, in his book " New Regulatory Finance", Dr. Morin states:

> "if …dividends are not expected to grow at the same rate as earnings during the transition period, the standard DCF is inapplicable.
>
> The DCF model will now be restated under more plausible and realistic estimates of future dividend growth rates. In essence, the following question will be answered: Given the actual stock price, and given a forecast of growth in dividends for the next n years and subsequent constant normal growth rate thereafter, what is the implied rate of return required by investors?"

Q IN HER REBUTTAL TESTIMONY MS. AHERN DISAGREES WITH THE PERIOD USED IN YOUR RISK PREMIUM ANALYSIS. PLEASE COMMENT.

A I agree with Ms. Ahern that the selection of the period is critical when estimating the cost of equity. However, her argument that my period selection is arbitrary is flawed and without merit. As discussed in my direct testimony, I chose the period 1986-2006 to estimate the cost of equity during this period utility stocks were traded at a market-to-book ratio above 1.0, which means that during this period regulatory commissions have authorized returns that allowed utilities to support market prices above book values. Further, the market-to-book ratio indicates that utilities were able to access capital markets and issue stocks without having a negative impact on their existing shareholders. Therefore, Ms. Ahern's argument that my selected period is arbitrary is flawed and should be rejected.

Q DO YOU HAVE ANY COMMENTS CONCERNING MS. AHERN'S ADJUSTMENT TO YOUR RISK PREMIUM ANALYSIS?

A Yes, Ms Ahern's revised risk premium estimate is flawed. The results of Ms. Ahern's risk premium analysis are primarily driven by her exclusive reliance on projected interest rates, rather than current actual interest rates . Ms. Ahern uses analysts' projections of the Aaa-rated corporate bond yields and adjusts them for the period starting the third quarter of 2007 and ending the fourth quarter of 2008. Then, she adds 50 basis points to reflect the spread between "Aaa" corporate yields and A-rated utility yields, which produces her prospective yield on A-rated public utility bond yield of 6.6%. In comparison, actual A rated utility bond yields are about 6.0%. Hence, her RPM is overstated by at least 60 basis points.

Q DO YOU HAVE ANY COMMENTS CONCERNING MS. AHERN'S CRITICISM OF YOUR CAPITAL ASSET PRICING MODEL (CAPM)?

A. Yes. Ms. Ahern suggests the use of the ECAPM. As mentioned in my rebuttal testimony, the ECAPM is applied to raw beta estimates to adjust the betas for their tendency to move towards the market beta of 1.0. Similarly, Value Line adjusts its beta estimates to reflect this tendency, using a formula comparable to the ECAPM. Therefore, the use of the ECAPM with Value Line adjusted beta estimates is inappropriate and it only inflates the fair and reasonable return on equity.

Q MR. AHERN ALSO CRITICIZES YOUR FORWARD-LOOKING CAPM ANALYSIS FOR NOT REALLY REFLECTING FUTURE EXPECTATION. PLEASE COMMENT.

A The total market returns basically represent the total nominal return, which includes real return and inflation. Ibbotson & Associates publish historical returns, which exclude the inflation component. Therefore, using the historical returns adjusted for the consensus analysts' inflation projections will reflect the expected market return.

St. Louis District Rate Adjustment

Q DID MAWC SPONSOR A COST OF SERVICE STUDY FOR THE ST. LOUIS DISTRICT?

A Yes. The Rebuttal Testimony MAWC sponsored the testimony of Paul R. Hebert on class cost of service study for the St. Louis District. Mr. Hebert then supported the company's proposed allocation of its claim 24.9% increase to the St. Louis District as set forth on a Schedule A-STL.

Q IS MR. HEBERT'S PROPOSED INCREASE TO THE ST. LOUIS DISTRICT RATES BASED ON HIS ESTIMATED COST OF SERVICE FOR THE ST. LOUIS DISTRICT?

A No. In fact, Mr. Hebert and the company's proposed increase in the rate class schedules for the St. Louis District is completely contradicted by Mr. Hebert's class cost of service study for the St. Louis District. It is clearly identifiable by Mr. Hebert's proposal to adjust rate "J" to produce $8.2 million of revenue where that rate class cost of service is approximately $6.98 million. Mr. Hebert's proposed, J customers would provide approximately $1.3 million of subsidies to other rate classes in the St. Louis District.

Q WILL MAWC'S PROPOSAL CAUSE RATE J CUSTOMERS TO SUBSIDIZE OTHER RATE CLASSES?

A Yes. Mr. Hebert's proposal is to intentionally adjust rate J customers' rates to provide significant subsidies to other rate classes is discriminatory unreasonable and fails to provide legitimate price signals to customers in the St. Louis District. For these reasons, the company's proposed rate adjustment for customers in the St. Louis District should be flatly rejected.

Q DO THE RESULTS OF MR. HERBERT COST OF SERVICE STUDY FOR THE ST. LOUIS DISTRICT SUPPORT YOUR PROPOSED ALLOCATION OF THE REVENUE DEFICIENCY IN THIS PROCEEDING?

A Yes. In my direct testimony on rate design, I proposed to spread the St. Louis District's revenue deficiency using the following methodology.

- Roll in current ISRS revenues into each rate classes' base rates; and
- Spread the remaining base revenue deficiency using an equal percent change to each rate classes.

Mr. Herbert's cost of service study supports this proposal.

Q CAN YOU PROVIDE A SCHEDULE THAT DEMONSTRATES THAT THE COMPANY'S COST OF SERVICE WOULD SUPPORT YOUR PROPOSED ALLOCATION OF THE REVENUE DEFICIENCY IN THIS PROCEEDING?

A Yes. This is shown on my Exhibit MPG, Schedule 2 and 3. As shown on Schedule MPG-2, I compare MAWC proposed rate class revenue to each rate class' cost of service. In column 4, I should the percentage above/(below) each class revenue is in comparison to its COS. Under the MAWC proposed allocation of the rate increase, rate J customers' rates would be 17.6 % above their COS.

As shown on Schedule MPG-3, using my proposed allocated method, rate J would be only 10.24%% above cost of service. In fact, most rate classes would be closer to cost of service under my proposed rate increase methodology compared to the company's recommendation.

Because my proposed revenue allocation results in a better allocation of rate increase relative to COS, I recommend my methodology be adopted and the Company's rejected.

Consolidated Billing

Q HAVE YOU REVIEWED THE REBUTTAL TESTIMONY OF MS. BARBARA A. MEISENHEIMER ON BEHALF OF THE OFFICE OF PUBLIC COUNSEL (OPC)?

A Yes, I have.

Q WHAT IS HER RECOMMENDATION WITH RESPECT TO CONSOLIDATED BILLING?

A At page 8 of her testimony, she testifies that without evidence of corresponding cost savings to support the bill reductions to customers who elect consolidated billing, the Company will likely look to other customers to assume greater cost responsibility. She further testifies that OPC opposes the proposal unless it can be designed and implemented in a manner that avoids shifts in cost recovery between classes.

Q HOW DO YOU RESPOND TO HER RECOMMENDATION?

A An eligible customer who elects consolidated billing will indeed see cost savings as a result of eliminating over-recovery of distribution main costs. However, the savings to eligible customers are justified under cost of service principles since the Company's proposal will correctly allocate the cost of distribution mains to customers in all classes.

A customer in any class with contiguous properties does not require additional distribution mains to provide service to two or more accounts at the same location.

Currently, customers with contiguous properties are over-allocated the cost of distribution mains, and thus overpaying for distribution mains, since the only additional cost to serve these customers is the cost of each additional service line, meter, and meter reading.

Q WOULD THE COMPANY DETERMINE THE IMPACT ON ITS REVENUE REQUIREMENT AND CLASS BILLING DETERMINANTS AS A RESULT OF IMPLEMENTING CONSOLIDATED BILLING?

A As I testified in my direct testimony, the Company's claimed revenue deficiency for provision of the consolidated billing tariff will likely come from its largest customers. It is reasonable to expect that the Company can reasonably estimate the customers that will qualify for the Consolidated Billing Tariff, and thus estimate adjustments to each rate class billing determinants and revenue requirement.

Q HAS MIEC NOTIFIED THE COMPANY OF ANY CUSTOMERS LIKELY TO APPLY FOR THE CONSOLIDATED BILLING TARIFF?

A Yes. MIEC has notified the Company of three customers who plan to apply for the Consolidated Billing Tariff.

Q HAVE YOU REVIEWED THE TESTIMONY OF COMPANY WITNESS EDWARD J. GRUBB WITH RESPECT TO CONSOLIDATED BILLING?

A Yes, I have. In his rebuttal testimony, Mr. Grubb explains his understanding of my proposed language change for the Consolidated Billing Tariff. At lines 5-6 on page 25 of his rebuttal testimony, he testifies that he does not understand the additional text of "except for Rate J" as shown on line 8 of my direct testimony.

Q COULD YOU PLEASE CLARIFY THE "EXCEPT FOR RATE J" TEXT REFERENCED ABOVE?

A Under the Company's current Rate J, customers pay a minimum bill charge that is calculated using the commodity rate times the greater of:

1. 60% of the maximum usage during any of the months of June, July, August, or September in the twelve (12) month period preceding the month for which the bill is to be rendered; or
2. 60,000 cubic feet or 450,000 gallons; or
3. actual usage as registered by the meter.

Under the Company's proposal for consolidated billing, the Company states that customers qualifying for bill consolidation will be charged the applicable minimum customer charge under the tariff. I added the text "except for Rate J" after the minimum customer charge language in the tariff to clarify that for Rate J customers consolidated consumption volumes would be used to calculate the tariff's 60% ratchet feature. The intent of my text in the Consolidated Billing Tariff is to clarify that Rate J customers' minimum bills are based on consolidated volumes and that the tariff is consistent with respect to both the 60% ratchet and consumption volumes.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes, it does.

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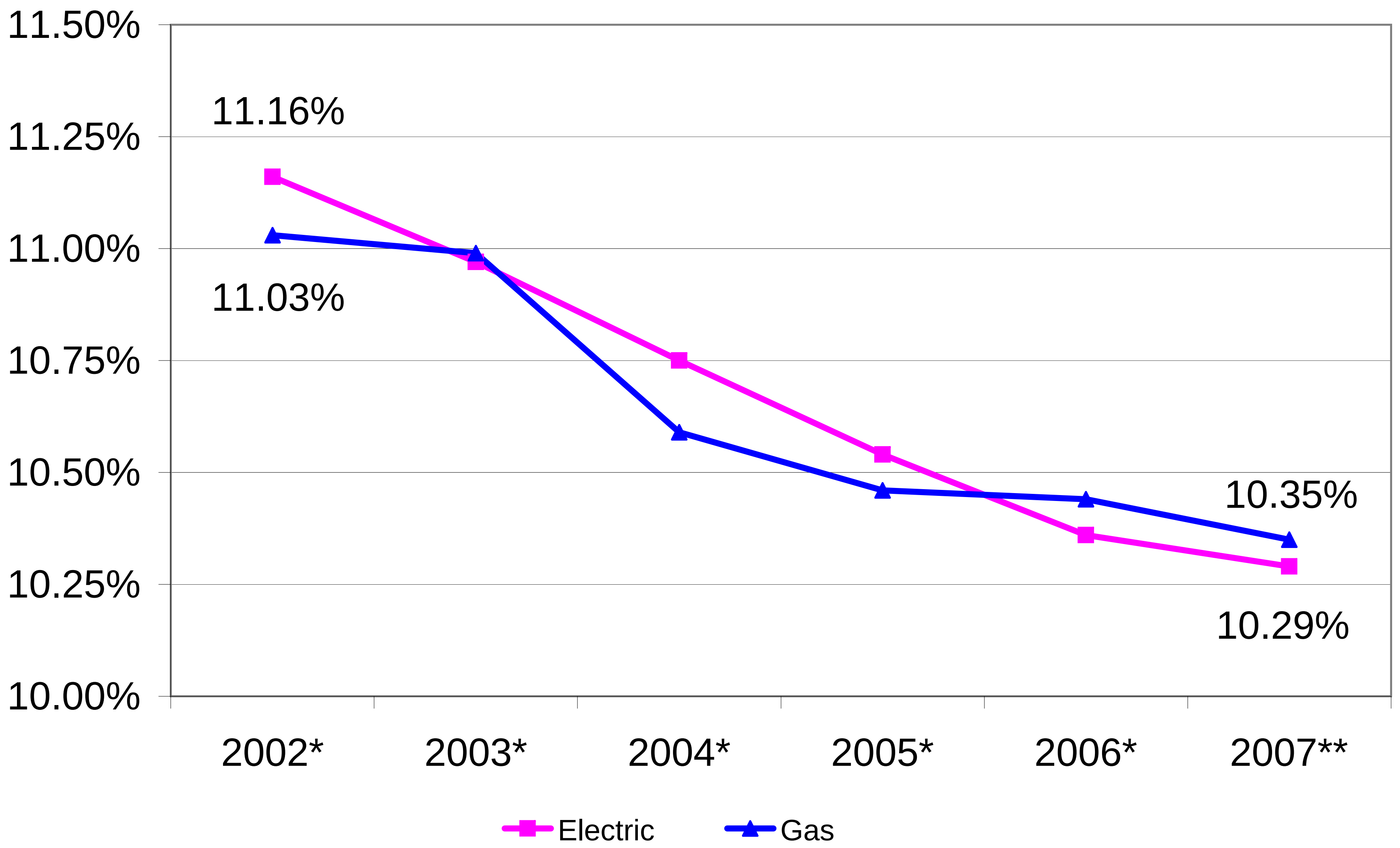
Missouri-American Water Company

Return On Equity Trend



Source:
* Regulatory Research Asssociates, Major Rate Case Decisions, Juanuary 1985-December 2006.
** Schedule PMA-25, Page 2 of 2

Schedule MPG-1

MISSOURI-AMERICAN WATER COMPANY

Company Proposed Allocation
St. Louis District

Line	Rate Class	Cost of Service (COS) * (1)	Company Proposed Revenue * (2)	Proposed Revenue above/(below) COS (3)	Percent of Proposed Revenue above/(below) COS (4)
1	Rate A	$ 117,947,777	$ 125,324,774	$ 7,376,997	6.25%
2	Rate B	2,126,085	2,573,864	447,779	21.06%
3	Rate J	6,976,887	8,204,798	1,227,911	17.60%
4	Rate G	-	-	-	-
5	Other	-	-	-	-
6	Rate F	1,023,737	1,772,725	748,988	73.16%
7	Rate E	10,430,697	8,103,606	(2,327,091)	(22.31)%
8	Total Rate Class	$ 138,505,183	$ 145,979,767	$ 7,474,584	5.40%
9	Total Other Revenue	$ 4,403,825	$ 4,404,339	$ 514	0.01%
10	Total	$ 142,909,008	$ 150,384,106	$ 7,475,098	5.23%

Source:
* Rebuttal Testimony of Paul R. Herbert, Schedule A-STL

MISSOURI-AMERICAN WATER COMPANY

MIEC Proposed Allocation
St. Louis District

Line	Rate Class	Cost of Service (COS) * (1)	MIEC Proposed Revenue ** (2)	Proposed Revenue above/(below) COS (3)	Percent of Proposed Revenue above/(below) COS (4)
1	Rate A	$ 117,947,777	$ 125,458,105	$ 7,510,328	6.37%
2	Rate B	2,126,085	2,482,197	356,112	16.75%
3	Rate J	6,976,887	7,691,273	714,386	10.24%
4	Rate G	-	-	-	-
5	Other	-	-	-	-
6	Rate F	1,023,737	1,656,211	632,474	61.78%
7	Rate E	10,430,697	7,596,076	(2,834,621)	(27.18)%
8	Total Rate Class	$ 138,505,183	$ 144,883,863	$ 6,378,680	4.61%
9	Total Other Revenue	$ 4,403,825	$ 5,500,243	$ 1,096,418	24.90%
10	Total	$ 142,909,008	$ 150,384,106	$ 7,475,098	5.23%

Source:
* Rebuttal Testimony of Paul R. Herbert, Schedule A-STL
** Direct Testimony of Michael Gorman on Rate Design Issues, Exhibit MPG-RD-1

MISSOURI-AMERICAN WATER COMPANY

MIEC Proposed Allocation

St. Louis District

Line	Rate Class	Present Base Revenues (1)	Present ISRS Revenues ** (2)	Present Base & ISRS Revenues * (3)	MIEC Proposed Percent Increase (4)	Total Adjusted Revenues (5)
1	Rate A	$ 94,084,089	$ 6,365,199	$ 100,449,288	24.90%	$ 125,458,105
2	Rate B	1,931,713	55,683	1,987,396	24.90%	2,482,197
3	Rate J	6,158,095	-	6,158,095	24.90%	7,691,273
4	Rate G	-	-	-	-	-
5	Other	-	-	-	-	-
6	Rate F	1,326,062	-	1,326,062	24.90%	1,656,211
7	Rate E	6,081,874	-	6,081,874	24.90%	7,596,076
8	Total Rate Class	$ 109,581,833	$ 6,420,882	$ 116,002,715	24.90%	$ 144,883,863
9	Total Other Revenue	$ 4,383,998	$ 19,827	$ 4,403,825	24.90%	5,500,243
10	Total Operating Revenue	$ 113,965,831	$ 6,440,709	$ 120,406,540	24.90%	$ 150,384,106

Source:

* Rebuttal Testimony of Paul R. Herbert,
Schedule A-STL

** Direct Testimony of Michael Gorman on Rate Design Issues,
Exhibit MPG-RD-1