Exhibit No.:	
Issue:	Return on Equity, Acquisition Adjustment, Cash Working Capital
Witness:	Billie S. LaConte
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Missouri Energy Group
Case No.:	WR-2003-0500
Date Testimony Prepared:	October 3, 2003

Missouri American Water Company

2003 Rate Case

Before the
Missouri Public Service Commission

Direct Testimony of Billie S. LaConte

on Behalf of the
Missouri Energy Group

Project 031300
October, 2003

Missouri American Water Company

Public Service Commission
2003 Rate Case

Affidavit of Billie S. LaConte

STATE OF MISSOURI)
)
COUNTY OF ST. LOUIS)

Billie S. LaConte, being of lawful age and duly affirmed, states the following:

1. My name is Billie S. LaConte. I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.

2. Attached hereto and made a part hereof for all purposes is my Direct Testimony consisting of Pages 1 through 15, Appendix A and Schedules 1 through 5 filed on behalf of the Missouri Energy Group.

3. I have reviewed the attached Direct Testimony and schedules and hereby affirm that my testimony is true and correct to the best of my knowledge and belief.

Billie S. LaConte

Billie S. LaConte

Duly affirmed before me this 3rd day of October, 2003.

Sheryl M. Fenelon

Notary Public

My commission expires on December 29, 2006.

Notary Seal
SHERYL M. FENELON
St. Louis County
My Commission Expires
December 29, 2006

Missouri American Water Company

Public Service Commission
2003 Rate Case

<u>Direct Testimony of Billie S. LaConte</u>

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Billie S. LaConte, 8000 Maryland Avenue, Suite 1210, St. Louis, Missouri.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.

Q PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

A These are given in Appendix A.

Q ON WHOSE BEHALF ARE YOU SUBMITTING THIS TESTIMONY?

A I am presenting it on behalf of the Missouri Energy Group (MEG). Members of the MEG served by the Missouri American Water Company are: Barnes-Jewish Hospital, Emerson Electric Company, SSM Healthcare and St. John's Hospital. These members have facilities located in the St. Louis County District and the St. Charles District.

Q WHAT TOPICS ARE COVERED IN THIS TESTIMONY?

A This testimony covers revenue requirements issues. The issues are: the rate of return on equity; the acquisition adjustment; and certain cash working capital items.

Q WHAT ARE THE MAIN POINTS OF THIS TESTIMONY?

A The main points of this testimony are:

- Risk reducing factors should be taken into account in setting return on equity;
- Non-cash items should not be included in cash working capital;
- Negative cash working capital amounts should be used in determining rate base; and
- MAWC should not be allowed to receive a return on or a return of its acquisition adjustment until it can prove measurable merger savings to its customers.

Q MAWC HAS OTHER PROPOSALS THAT YOU HAVE NOT ADDRESSED, SUCH AS THE INCREASE IN OPERATING AND MAINTENANCE COSTS AND THE RETURN ON AND OF SECURITY COSTS; DO YOU AGREE WITH THEIR PROPOSALS?

A I have not commented on these proposals in my testimony. The lack of comment or recommendation does not imply that I agree with MAWC's other proposals.

MAWC's Rate Increase

Q WHAT IS MAWC'S REQUESTED RATE INCREASE?

A For the total Company, MAWC is requesting a $20 million increase in water rates or 12.2%. For the St. Louis County District the increase is $15.5 million or 13.4%. For the St. Charles District, the increase is $0.5 million or 5.3%.

Q WHAT IS THE REASON GIVEN FOR THESE INCREASES?

A The Company states that the increase is due to:

? Significant capital expenditures related to its security initiatives;

? Increases in the Company's pension and health insurance costs;

? An increase in its utility plant in service (UPIS); and

? Inflationary pressures on operating expenses.

Return on Equity

Q WHAT IS THE RETURN ON EQUITY (ROE) THAT MAWC IS REQUESTING?

A MAWC is requesting an 11.0% ROE.

Q WHAT IS THE BASIS FOR THIS LEVEL OF RETURN?

A MAWC hired an expert consultant, Ms. Pauline Ahern of AUS Consultants – Utility Services, to produce a recommended return on equity. Ms. Ahern calculated ROEs ranging from 10.0% (using the DCF method) to 13.6% (using the comparable earnings method). She then recommended a range of 11.75% to 12.0%. However, MAWC chose not to use her recommendation and instead chose 11.0%. The Company stated:

> *The decision to instead utilize a return on equity of 11% for purposes of the filing was a collaborative decision made by MAWC's senior management team. It was made after balancing the interest of MAWC's shareholders with the rate impact the return on equity utilized would have on MAWC's customers.* (MEG-MAWC-2)

Q WHAT METHOD HAS THE COMMISSION PREFERRED IN THE PAST WHEN DETERMINING ROE?

A The DCF method. In MAWC's latest rate case, the Commission stated:

> *The Commission has for many years judged the DCF method to be the most reliable for calculating a utility's cost of equity.* (In the Matter of St. Louis County Water Company for Authority to file Tariffs Reflecting Increased Rates for Water Service, Case No. WR-2000-844, Conclusions of Law, Section 3)

And in another water rate case:

> *The Commission has consistently found Discounted Cash Flow (DCF) analyses to be appropriate for determining a rate of return on equity.... This is because it is relatively simple to apply and measures investor expectations for a specific company. [T]he DCF analysis is considerably more systematic and allows this Commission to treat all utilities it regulates in a consistent manner.* (In the Matter of the Joint Application of Missouri Cities Water Company, 26 Mo.P.S.C. (N.S.) 1, 26-27 (1983))

Q ARE THERE OTHER FACTORS TO CONSIDER WHEN DETERMINING THE COMPANY'S ROE?

A Yes, the Company's risk profile.

Q PLEASE COMMENT ON THE COMPANY'S RISK PROFILE.

A Risk refers to the variability in income. To the extent that such variability is small or has been reduced by other means, the need for a risk premium is lower than for other enterprises or lower than before.

Q HOW DO YOU EVALUATE THIS RISK?

A One way is to examine the variation in sales. I have compared MAWC's sales to those of Laclede Gas, a company serving the same area. MAWC's sales have fluctuated, but not as much as Laclede's. Gas sales will vary depending upon the weather. Weather variations have less of an effect on water sales. This lower variation in income reduces the risk to MAWC.

Table 1

Historical Sales

		MAWC (gallons)	Laclede Gas Therms
1998		61,694,249	1,121,349
1999		66,207,645	1,025,935
	% chg.	7.32%	-8.51%
2000		64,222,109	1,035,152
	% chg.	-3.00%	0.90%
2001		64,946,107	1,118,660
	% chg.	1.13%	8.07%
2002		64,827,357	1,060,454
	% chg.	-0.18%	-5.20%

Q HOW ELSE CAN RISK BE REDUCED?

A Rate design has an effect on risk. The Company has proposed an increase in its minimum monthly charge. For the St. Louis County District, the average increase is 12.2%, but the minimum charge is increasing by 0-171% for its Rate A, D and J customers. This rate design change will also lower the variability in the Company's income and lower its risk to:

Table 2

St. Louis District Rates A, D and J Minimum Charges

Description	Current	Proposed	% Increase
5/8"	$6.15	$8.50	38.2%
3/4"	6.87	8.70	26.6%
1"	8.31	9.70	16.7%
1-1/2"	11.90	14.00	17.6%
2"	16.20	16.20	0.0%
3"	27.68	56.00	102.3%
4"	40.59	110.00	171.0%
6"	76.48	201.00	162.8%
8"	119.54	261.00	118.3%
10"	176.96	380.00	114.7%
12"	234.36	532.00	127.0%

Q ARE THERE ANY OTHER FACTORS THAT WILL AFFECT MAWC'S RISK?

A Yes. The recent passage of RSMo Sections 393.1000, 393.1003 and 393.1006 (HB-208, 2003), allowing MAWC to seek an Infrastructure System Replacement Surcharge (ISRS), will reduce the Company's risk. With the new legislation, MAWC may request, through a surcharge, expedited recovery of prudently incurred costs for infrastructure system replacements. The Commission must make a recommendation on an ISRS within 120 days, instead of the eleven-month period for regular rate increases. When the Commission considers the petition, it may not examine the Company's other revenue requirements or ratemaking issues. Requesting an ISRS does not prevent the company from requesting a general rate increase. The Company will receive revenues to cover its costs on an expedited basis. Since the Commission cannot examine other revenues or ratemaking issues under the ISRS, the Company would retain the benefit of any cost decreases in other areas. All in all, the new legislation decreases the chance of a delay in the recovery of higher costs and increases the potential for higher earnings, compared to past practice. In short, there is reduced risk to MAWC as a result of this new treatment. MAWC has recently filed an ISRS application with the Commission (Case No. WO-2004-0116).

Cash Working Capital

Q WHAT ARE THE ISSUES WITH MAWC'S CASH WORKING CAPITAL CALCULATIONS?

A First, MAWC has included non-cash items such as depreciation and deferred income taxes in its cash working capital (CWC) amount. Second, in the districts that MAWC has calculated the cash working capital amounts to be negative, it has set them to zero in its rate base calculations.

Q WHY SHOULDN'T DEPRECIATION AND DEFERRED INCOME TAXES BE INCLUDED IN THE CASH WORKING CAPITAL CALCULATION?

A The purpose of cash working capital is to cover normal day-to-day expenses. Depreciation and deferred income taxes are non-cash items and don't affect the Company's day-to-day cash flows.

Other Commissions have also determined that these non-cash items should not be included in the cash-working capital calculations.

> *The purpose of the working capital allowance is to recognize that in normal business operations, investors must supply capital to finance the day-to-day expenses ,i.e., normal cash flow. Non-cash expenses have no cash flow associated with them and should not be incorporated into the calculation of a cash working capital allowance.* (Re: Green Mountain Power Corporation 184PUR4th1,49)

> *Consumer Advocate complained that U S West effectively included non-cash items such as depreciation expense, deferred income taxes, and return on common equity in its calculation of cash working capital. The*

Board agrees that cash working capital should not include such non-cash items. (Re U S West Communications, Inc. 152PUR4th446,457)

Therefore, the Commission concludes that non-cash items should not be included in the lead/lag study as proposed by IP. In excluding non-cash items from the working capital allowance, the Commission emphasizes that the purpose of including a working capital component in rate base is to compensate the investor for the cash contributions required for the day-to-day business operations between the time that service is provided and revenues associated with that service are received. (Re Illinois Power Company 131PUR4th1,19)

Q **WHAT IS THE EFFECT OF REMOVING NON-CASH ITEMS FROM CASH WORKING CAPITAL?**

A It would lower the rate base by $5.0 million.

Table 3

Effect of Non-Cash Items on Claimed Rate Base

District	Depreciation	Deferred Taxes	Total
Brunswick	$4,838	($302)	$4,536
Jefferson City	43,083	14,582	57,665
Joplin	106,511	57,177	163,688
Mexico	36,357	5,840	42,197
Parkville Sewer	310	41	351
Parkville Water	41,707	36,086	77,793
St. Charles	126,542	65,150	191,692
St. Joseph	283,711	62,464	346,175
St. Louis	3,590,540	529,811	4,120,351
Warrensburg	40,143	11,106	51,249
Total	$4,273,742	$781,955	$5,055,697

Q **HOW DID MAWC EXCLUDE NEGATIVE CASH WORKING CAPITAL FROM ITS RATE BASE?**

A In Districts where the lead/lag study produced a total cash working capital amount that was negative, the Company used zero. For example, in the St. Charles

District, the lead/lag study calculated the total cash working capital as *negative* $99,026, but the total cash working capital used is zero (Missouri American Water Company Schedule CAS-7 SCH). Eliminating the negative amounts increases rate base by $437,000. The cash working capital for all districts is:

Table 4

Cash Working Capital by District (rounded)

District	CWC as Determined by Lead/Lag Study	CWC Claimed in Rate Base	Difference
Brunswick	$8,000	$8,000	
Jefferson City	49,000	49,000	
Joplin	136,000	136,000	
Mexico	(14,000)	-	
Parkville Sewer	1,000	1,000	
Parkville Water	(94,000)	-	
St. Charles	(99,000)	-	
St. Joseph	(218,000)	-	
St. Louis	7,313,000	7,313,000	
Warrensburg	(12,000)	-	
Total	$7,070,000	$7,507,000	$437,000

From Schedules CAS-7-XXX.

Q WHY DID MAWC EXCLUDE NEGATIVE CASH WORKING CAPITAL?

A The Company stated that "the use of negative working capital in rate base may recognize the results of the Lead/lag Study but it will also penalize the Company for initiating steps to improve its cash flow" (MEG-MAWC-9).

Q WHAT DOES A NEGATIVE CASH WORKING CAPITAL SIGNIFY?

A It means that MAWC's customers in those districts have, on average, compensated the Company for expenses *before* the expenses were incurred. This produces surplus funds on which MAWC can earn income.

Q HAVE OTHER COMMISSIONS ALLOWED NEGATIVE CASH WORKING CAPITAL?

A Yes. The Montana Public Service Commission stated:

> *To include working capital adjustments only when the results of the lead/lag study are positive would be totally inconsistent and unfair to MPC's ratepayers who have, on average, contributed significant cash working capital balances to the operations of the Company.* (Re: Montana Power Company 125PUR4th30,45)
>
> * * *
>
> *The Commission disagrees with MPC's claim that a negative cash working capital adjustment would penalize the Company. Rather, to not reflect such an adjustment would clearly penalize ratepayers because it would ignore the contributions of a significant amount of capital over and above the amount required for day-to-day cash operations.* (Re: Montana Power Company 125PUR4th30,45)

The Louisiana Public Service Commission stated:

> *A negative allowance is required when ratepayers are providing funds to the utility, on average, before the Company is required to make cash expenditures.* (Re: South Central Bell Telephone Company, 103PUR4th26,33)
>
> * * *
>
> *The results of the (lead/lag) study indicated that, on average, intrastate ratepayers were providing 15.3 days of working funds to the Company. Therefore, an adjustment to rate base is necessary to deduct these non-investor supplied funds.* (Re: South Central Bell Telephone Company, 103PUR4th26,33)

The California Public Utility Commission stated:

> *. . . A zero working cash allowance would be detrimental to ratepayers in this case if the working cash calculated by the model turned out to be negative. Similarly, it would be unfair to PG&E if we adopted a zero allowance and the model calculated a positive working cash requirement.* (Re: Pacific Gas & Electric Company, 199PUR4th177,392)

Q WHAT DO YOU PROPOSE?

A MAWC should include negative cash working capital when determining rate base. By disallowing the negative working capital, the customers will be penalized for providing additional capital above the amount needed for daily expenses. The calculation of the cash working capital and rate base isn't based on a reward/penalty system, but is determined by the results of the lead/lag study, whether positive or negative.

Q HAVE YOU CALCULATED THE EFFECT OF CHANGING BOTH THE NON-CASH ITEMS AND NEGATIVE CASH WORKING CAPITAL ON RATE BASE?

A Yes. The effect by district is:

Table 5

Effect of Both Non-Cash Items and Negative CWC on Rate Base (\$000)

District	MAWC CWC	Recommended CWC	Effect on Rate Base
Brunswick	$8.0	$3.0	$(5.0)
Jefferson City	49.0	(8.4)	(57.4)
Joplin	136.0	(27.5)	(163.5)
Mexico	-	(56.5)	(56.5)
Parkville Sewer	1.0	0.3	(0.7)
Parkville Water	-	(171.9)	(171.9)
St. Charles	-	(291.0)	(291.0)
St. Joseph	-	(564.4)	(564.4)
St. Louis	7,313.0	3,192.8	(4,120.2)
Warrensburg	-	(63.4)	(63.4)
Total	$7,507.0	$2,013.0	$5,494.0)

Acquisition Adjustment

Q PLEASE DESCRIBE MAWC'S ACQUISITION ADJUSTMENT.

A MAWC purchased the stock of United Water Jefferson City and the assets of Valley Park, the City of Florissant and the City of Webster Groves. The acquisition adjustment is based on the amount over (or under) book value that MAWC paid for these water systems. The Company stated:

> *Based on the operational and financial review, agreements with the other parties resulted in acquiring the United Water Missouri, Webster Groves and Florissant systems above book value and Valley Park below book value*. (MEG-MAWC-3)

The amount of the acquisition adjustment included in rate base is $7.6 million. The amount that the Company will amortize annually is $211,224.

Table 6

Acquisition Adjustment
($000)

	United Water Jeff City	Valley Park	Webster Groves	Florissant	Total
Purchase price	$10,132	$393	$9,500	$14,500	$34,525
Original cost	9,017	1,289	6,512	9,810	26,628
UPAA	1,115	(896)	2,988	4,690	7,897
Accum. Amort. at 12/02	(27)	35	(40)	(64)	(96)
Amort. of UPAA through true up	(25)	21	(73)	(117)	(194)
Proposed Rate Base for UPAA	1,063	(839)	2,875	4,509	7,608
Annual deprec.	($27)	$23	($79)	($128)	($211)

From Schedule EJG-2.

Q WHY DOES MAWC WANT TO RECOVER THE ACQUISTION ADJUSTMENT?

A MAWC states that its customers will benefit from the acquisitions through increased economies of scale. By increasing its customer base the Company can spread out fixed costs. Furthermore, the Company states that its customers will benefit through merger savings. The amount the customers will save is $530,000 in payroll costs associated with the United acquisition (MEG-MAWC-4).

Q HOW WILL THE ACQUISITION ADJUSTMENT AFFECT RATES?

A It will increase rates for its customers.

Q IS THIS THE INTENDED EFFECT?

A No. MAWC has stated that by growing the business it will be able to reduce or delay rate increases for customers. However, MAWC is requesting an increase in rates, yet claims that this increase is lower than it would have been due to growth in revenues. Specifically, the Company states:

> *The cost pressures noted above are being mitigated by an overall growth in the Company's revenues since the last rate cases were finalized. This increase in overall growth is important because it has mitigated the level of the increase request in this case. The districts with the larger increases have experienced reduced sales and/or loss in sales since the last rate case.* ***This highlights the need for initiative and cooperation in an effort to increase sales (grow the business) so that levels of rate increases can either be reduced or at the very least delayed.*** (Grubb Direct Testimony, Page 8, Lines 9-16, emphasis added)

Q DO YOU AGREE THAT MAWC SHOULD INCREASE SALES TO REDUCE OR DELAY RATE INCREASES?

A MAWC should increase sales if it benefits customers, not only as a way to dilute increased costs. MAWC has increased sales at a cost above book value. Now MAWC is requesting that the customers pay for the premium. MAWC did state that the acquisition saved the Company $530,000, but this is outweighed by the acquisition adjustment it is asking customers to absorb.

Table 7

Annual Cost/Savings from Acquisition Adjustment

Proposed rate base for UPAA	$7,607,696
Proposed rate of return	8.3%
Return on UPAA	631,439
Annual depreciation cost of UPAA	211,224
Annual cost	842,663
Annual savings from merger	530,000
(Cost)/savings to customers	($312,663)

Notes: Figures from MEG 0016, file UPAA.xls, tab Proforma UPAA and Table 6 above.

Q HOW SHOULD THE COMMISSION TREAT THE ACQUISITION ADJUSTMENT?

A The Commission should disallow the return of and on the acquisition adjustment until the Company can prove that there is a measurable benefit to its customers of acquiring these properties at a price above book value.

Effect of Recommended Changes

Q HOW DO YOUR RECOMMENDATIONS AFFECT THE REVENUE REQUIREMENT OF THE ST. LOUIS COUNTY AND ST. CHARLES DISTRICTS?

A Using an ROE of 10.0%, the revenue requirement for the St. Louis County District would decrease by $4.0 million. The revenue requirement for the St. Charles District would decrease by $288,000 (see Schedules 5-STL and 5-SCH, respectively).

Q DOES THAT CONCLUDE YOUR TESTIM0NY?

A Yes.