

Exhibit No.:

Issues: AFUDC, Working Capital,  
Pensions, Belleville Lab  
Costs, Property Taxes, St.  
Joseph Plant Retirement,  
AWR Customer Lists,  
Security AAO, Credits and  
Billing Adjustments, Fuel  
and Power and Chemicals,  
CAM, Affiliated  
Transactions, Lobbying Costs  
Interest Synchronization  
Witness: Edward J. Grubb  
Exhibit Type: Rebuttal Testimony  
Sponsoring Party: Missouri-American Water Company

Case No.: WR-2003-0500  
Date Filed: November 10, 2003

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. WR-2003-0500**

**REBUTTAL TESTIMONY**

**OF**

**EDWARD J. GRUBB**

**ON BEHALF OF**

**MISSOURI-AMERICAN WATER COMPANY**

**JEFFERSON CITY, MISSOURI**

BEFORE THE PUBLIC SERVICE COMMISSION

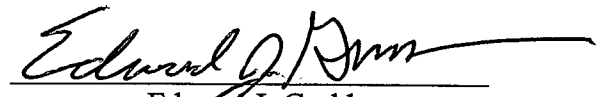
OF THE STATE OF MISSOURI

IN THE MATTER OF MISSOURI-AMERICAN  
WATER COMPANY FOR AUTHORITY TO FILE  
TARIFFS REFLECTING INCREASED RATES  
FOR WATER SERVICE

) CASE NO. WR-2003-0500  
)  
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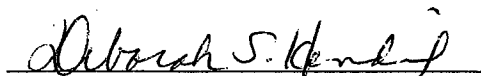
AFFIDAVIT OF EDWARD J. GRUBB

Edward J. Grubb, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Edward J. Grubb"; that said testimony and schedules were prepared by him and/or under his direction and supervision; that if inquires were made as to the facts in said testimony, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge.

  
Edward J. Grubb

State of Missouri  
County of St. Louis  
SUBSCRIBED and sworn to  
before me this 6th day of November 2003.

DEBORAH S. HENDRIX  
Notary Public-Notary Seal  
STATE OF MISSOURI  
St. Louis County  
My Commission Expires: Aug. 11, 2007

  
Notary Public

My commission expires: 8/11/07

REBUTTAL TESTIMONY  
EDWARD J. GRUBB  
MISSOURI-AMERICAN WATER COMPANY  
CASE NO. WR-2003-0500

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1 **WITNESS INTRODUCTION**

2

3 **Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.**

4 A. Edward J. Grubb, Director Rates and Revenue for Missouri-American Water Company, 535  
5 N. New Ballas Road, St. Louis, Missouri 63141.

6

7 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?**

8 A. Yes, I have submitted direct testimony in this proceeding.

9

10 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

11 A. The purpose of my rebuttal testimony is to address and respond to various adjustments and  
12 recommendations to the Company's proposed revenue increase. The adjustments and  
13 recommendations were made by the Missouri Commission Staff ("Staff"), Office of Public  
14 Council ("OPC") and the Missouri Energy Group ("MEG"). The specific issues that I am  
15 addressing can easily be seen in the table of contents.

16

17 **METHODOLOGY CHANGE IN CALCULATING AFUDC**

18

19 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS ISSUE?**

20

21 A. Staff witness Hanneken has recommended to the Commission that the Company's AFUDC  
22 for the test year be reduced by \$481,699 and that the Company be ordered to adjust its method  
23 of calculating AFUDC in the future.

24

25 **Q. HOW DOES THE STAFF PROPOSE TO CALCULATE AFUDC FOR THE**  
26 **PURPOSE OF AMOUNTS ALREADY ON MAWC'S BOOKS?**

27

28 A. Staff is recommending to recalculate test year AFUDC by using short-term debt as the sole  
29 source of computing the calculation unless the level of CWIP exceeds the level of short-term  
30 debt. In that case, the overall cost of capital rate would be used to calculate AFUDC.

1 **Q. WHAT ARE SOME OF THE PROBLEM WITH STAFF'S CALCULATION OF THE**  
2 **COMPANY'S AFUDC RATE?**

3  
4 A. There are a number of problems with the calculation of the AFUDC rate. First, Staff assumes  
5 that the Company can separate its cash between cash working capital and internal generated  
6 funds. Secondly, even if we assume the Staff can separate the cash, Staff should deduct the  
7 Company's cash working capital allowance in the last rate case from the short-term debt  
8 outstanding for one element of the AFUDC rate. The third problem is in applying the rate of  
9 return on rate base approved in the Company's last rate order to the excess of Construction  
10 Work in Progress (CWIP) over short-term debt. The excess piece of CWIP should be based  
11 on the weighted cost of common equity rate approved in the Company's last rate order.  
12

13 **Q. WHY DO YOU BELIEVE THE WEIGHTED COST OF COMMON EQUITY RATE**  
14 **SHOULD BE USED AS THE OTHER ELEMENT TO DETERMINE THE AFUDC**  
15 **RATE?**

16  
17 A. The Company's long-term debt and preferred stock financing normally are for plant in service  
18 at the time of the financing. The excess of CWIP over short-term debt net of Cash Working  
19 Capital allowance in the company's last rate case can only be equity dollars. Therefore, the  
20 correct rate is the weighted cost of common equity approved in the Company's previous rate  
21 order.  
22

23 **Q. DO YOU BELIEVE THAT THE STAFF'S ADJUSTMENT IN THE CURRENT CASE**  
24 **REPRESENTS RETROACTIVE RATEMAKING?**

25  
26 A. Yes, I do. This Commission, along with other commissions, has provided guidance to the  
27 utilities that they regulate as to what AFUDC is appropriate to use to capitalize debt and  
28 equity for construction projects. This Commission in the past has allowed MAWC to use the  
29 overall cost of capital authorized. In the last MAWC rate case (WR-2000-281), the  
30 Commission made a change in prior AFUDC treatment by adjusting the cost of the St. Joseph  
31 Treatment Plant. The Commission adjusted the cost of the new plant by \$1,289,674 to reflect

1 the actual carrying costs of MAWC's \$35 million in short-term debt as a result of the  
2 construction of the plant. While it made an adjustment to the cost of the St. Joseph Treatment  
3 Plant (single project adjustment), the remainder of the Company's AFUDC rate was left in  
4 tact.

5  
6 **Q. WHAT IS THE FINANCIAL CONSEQUENCE OF THE STAFF'S PROPOSED**  
7 **CHANGE TO AFUDC AMOUNTS THAT ARE ALREADY ON THE COMPANY'S**  
8 **BOOKS?**

9  
10 A. The Company would be forced again to incur a write-off of an asset. Therefore, making this  
11 adjustment now and applying it back into the test year is in the Company's view, retroactive  
12 ratemaking.

13  
14 **Q. IF THE COMMISSISON WERE TO MAKE A CHANGE TO THE AFUDC**  
15 **CALCULATION, HOW SHOULD IT IMPLEMENT SUCH A CHANGE?**

16  
17 A. The Company believes that if the Commission orders a change to the AFUDC capitalization  
18 policy, the change should be made prospectively and not retroactively. Changing a  
19 Commission policy and applying it in a way that results in a retroactive asset write-off is  
20 unfair and unreasonable and not good regulatory policy.

21  
22 This adjustment reminds me of the Staff's recent proposals for pension expense. There is a  
23 continued effort to change regulatory treatment in order to lower rates and at the same time  
24 cause the Company to under recover costs or to write-off assets. In a response to Company  
25 data request 79, Staff stated that a consistent approach to ratemaking issues is important in the  
26 setting of just and reasonable rates for Missouri utilities. Staff also noted that as  
27 circumstances change and Commission rulings change, the Staff may change its position. The  
28 Company agrees that circumstances can change. However, to change Commission regulatory  
29 policy should require something more than the opportunity to gouge the utility. These types of  
30 adjustments that the Staff is recommending are inconsistent with sound regulation.

1 **Q. IF THE COMMISSION DECIDES TO CHANGE THE POLICY REGARDING THE**  
2 **CALCULATING OF AFUDC, WHAT IS THE COMPANY'S RECOMMENDATION?**

3  
4 A. First the change should be made on a prospective basis.

5  
6 Second, the calculation of AFUDC should be first based on deducting from the short-term  
7 debt the level of working capital allowed in rate base. Then to the extent that short-term debt  
8 is equal to or less than the CWIP, then the short-term debt rate should be used. If the level of  
9 CWIP exceeds the level of short-term debt less working capital, then the last allowed  
10 weighted cost of common equity should be used.

11  
12 And finally, because of timing issues of calculating this each month and the closing process  
13 for our accounting records each month, the calculation of the AFUDC rate needs to be done in  
14 arrears and used in the subsequent month.

15  
16 **WORKING CAPITAL REQUIREMENT**

17  
18 **Q. MR. GRUBB, PLEASE DISCUSS THE ISSUES REGARDING WORKING CAPITAL.**

19  
20 A. There are two issues regarding working capital. The first issue is regarding the appropriate lag  
21 for Management Fees in the Lead/Lag Study. The second is the Staff's and the Missouri  
22 Energy's (MEG) recommendation to exclude Depreciation and Deferred Taxes from the  
23 Lead/Lag Study.

24  
25 **Q. WHAT IS THE ISSUE RELATED TO THE LAG FOR MANAGEMENT FEES?**

26  
27 A. Both the Company and Staff used a Lead/Lag Study approach in determining the level of  
28 working capital in rate base. The determination of the amount of working capital for a  
29 specific expense item in the study is calculated by multiplying the daily expense requirement  
30 by the difference between the revenue lag and the expense lag for the category. For the  
31 expense category Management Fees, the Company disagrees with the Staff position related to

1 the expense lag. The Company's expense lag for Management Fees is a negative 4.13 days  
2 and the Staff's lag is a positive 42.30 days.

3  
4 The Staff calculated its lag based on a strict review of the payment dates of the management  
5 fees and did not determine what period of time the payments were applicable to in the  
6 payment process. The management fees are paid in advance and the invoice clearly states this  
7 fact.

8  
9 **Q. HAVE YOU CALCULATED THE LAG UTILIZING THIS INFORMATION?**

10  
11 A. Yes. Marked as Schedule EJG-1 and attached to my rebuttal testimony is the Company's  
12 recalculated lag of a negative 3.31 days. This is slightly different from the Company's initial  
13 rate filing. Due to the time and cost of preparing a Lead/Lag Study, the Company used the  
14 lags from the last rate case with the exception of a few that I discussed in my Direct  
15 Testimony. The lags that were used by the Company were taken from the Staff's  
16 recommendation in the last MAWC rate case.

17  
18 Correcting the lag for management fees would increase Staff's recommended level of  
19 working capital by \$1.04 million.

20  
21 **Q. WHAT IS THE ISSUE REGARDING THE STAFF'S AND MEG'S**  
22 **RECOMMENDATION TO EXCLUDE DEPRECIATION AND DEFERRED TAXES**  
23 **FROM WORKING CAPITAL?**

24  
25 A. Depreciation and deferred taxes are both recognized by this Commission in the setting of  
26 utility rates, both under operating expense and as a rate base reduction through the  
27 accumulated balance sheet accounts. The issue that must be addressed and appropriately  
28 recognized in the rate making process is that the Company experiences a considerable delay  
29 in the recovery of the depreciation and deferred tax expense from the customers. Because of  
30 this delay, a zero lag for depreciation and deferred taxes is required to correctly calculate the  
31 Company's rate base.



1  
2 **Q. WILL YOU PROVIDE US WITH AN ILLUSTRATION OF THE CONSIDERABLE**  
3 **DELAY IN THE RECOVERY OF THE DEPRECIATION CHARGES THAT YOU**  
4 **REFER TO IN YOUR PREVIOUS DISCUSSION?**

5  
6 A. Yes. The investors supply cash to fund investment in the new plant such as mains, hydrants,  
7 pumping equipment, etc. Depreciation expense represents the recovery of those cash  
8 expenditures from customers who are receiving service. The investors are allowed to earn a  
9 return on the plant in service less any depreciation charges that were collected from the  
10 customers (accumulated depreciation). For example, if there is a lag of 63 (STL District  
11 Revenue Lag) days between the time that customers receive service and when they pay for  
12 that service, then depreciation charges will not be collected in cash from the customers until  
13 an average of 63 days after service is provided. If this 63-day lag in the collection of  
14 depreciation charges is not reflected in rate base, then the investors will not have the  
15 opportunity to earn a return on their full investment. For an illustrative example of this issue,  
16 I have attached to my testimony Schedule EJG-2.

17  
18 **Q. WOULD YOU PLEASE EXPLAIN THIS EXHIBIT?**

19  
20 A. Page 1 of 3 illustrates the purchase of an asset on January 1, 2003, at a cost of \$10,000. The  
21 life of the asset is two (2) years. This illustration has been simplified, but the theory is the  
22 same regardless of the cost or the service life of the asset. During this two (2) year life, the  
23 traditional rate base for this asset would be the gross cost less the accumulated depreciation  
24 and deferred taxes that have been recorded on the books. For this illustration, only  
25 depreciation expense is being used in the example.

26  
27 Page 2 of 3 illustrates the timing of the cash collection of the depreciation expense. The asset  
28 was purchased and placed into service on January 1, 2003. The cash collection from the  
29 customer will begin on March 4, 2003, which is 63 days after the asset was placed into  
30 service. Therefore, there is a 63-day lag in the collection of the recorded depreciation. The  
31 asset will be retired on December 31, 2004, and be fully depreciated and excluded from rate

1 base. The last cash collection will be on March 4, 2005.

2  
3 **Q. PLEASE EXPLAIN WHAT PAGE 3 OF SCHEDULE EJG-2 SHOWS?**

4  
5 A. This page illustrates that if rates were set using a rate base at December 31, 2003, the amount  
6 in rate base would be \$5,000, which is the original cost of \$10,000 less the recorded  
7 accumulated depreciation of \$5,000. As shown on page 2 of Schedule EJG-2, there is a lag of  
8 63 days in the collection of the depreciation charges. Therefore, only \$4,137 has been  
9 actually collected from the customers ( $\$5,000 \times [365-63]/365$  days). Because the Company  
10 only collected \$4,137 in depreciation charges, rates should be set on a rate base of \$5,863  
11 (\$10,000 less \$4,137). This would be accomplished through a rate base that included \$5,000  
12 for the net utility plant and a working capital allowance of \$863, which is calculated by  
13 dividing the annual depreciation expense of \$5,000 by 365 days and multiplying that by the  
14 difference in the revenue lag of 63 days and the lag for depreciation expense of zero days.  
15 The result for this illustration is \$863 ( $\$5,000/365 \times [36 - 0]$ ).

16  
17 **Q. DOES THE ABOVE ILLUSTRATION FOR DEPRECIATION EXPENSE ALSO**  
18 **APPLY TO DEFERRED TAXES?**

19  
20 A. Yes, it does. The Company makes cash expenditures for an asset, begins recording deferred  
21 taxes, but must wait 63 days before the deferred taxes are collected from the customers.

22  
23 **Q. WHAT IS THE IMPACT IN RATE BASE OF INCLUDING DEPRECIATION AND**  
24 **DEFERRED TAXES IN THE WORKING CAPITAL CALCULATION AT A ZERO**  
25 **EXPENSE LAG?**

26  
27 A. Based on the Company's original filing, Staff's rate base should be increased by  
28 approximately \$5.055 million to properly state rate base.

29  
30 **PENSION EXPENSE**  
31

1 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS ISSUE?**

2  
3 A. Staff witness Gibbs has recommended to the Commission the recognition in rates of a level of  
4 pension expense based upon the minimum contribution as required under the Employee  
5 Retirement Income Security Act of 1974 ("ERISA"). The Company is proposing a level of  
6 pension expense based on the requirements of the Financial Accounting Standard No. 87  
7 ("FAS 87"). The FAS 87 standard utilizes accrual accounting to reflect the level of pension  
8 expense of the Company. The difference between the Company and Staff on this issue is  
9 approximately \$3.6 million.  
10

11 **Q. WHICH METHODOLOGY HAS BEEN USED BY THIS COMMISSION TO SET**  
12 **RATES IN PRIOR MAWC RATE CASES?**  
13

14 A. This Commission has used the FAS 87 method for setting rates in the last 3 rate cases for  
15 MAWC. However, the Staff has recommended in this case that the ERISA method be used.  
16 Staff witness Gibbs states in his Direct Testimony that Staff supported the FAS 87 cost in  
17 prior rate cases because the approach was consistent with how the costs associated with post-  
18 retirement benefit costs (OPEB) are determined. OPEB costs are required to be based on  
19 Financial Accounting Standard Board No. 106 as the result of Section 386.315, RSMo. FAS  
20 106 is also based on the accrual accounting method for financial statement recognition.  
21

22 **Q. WHY IS STAFF NOW RECOMMENDING CHANGING BACK TO USING ERISA**  
23 **FOR RECOVERY OF PENSION EXPENSE?**  
24

25 A. Staff believes that even with the recent significant devaluation of the stock market, the  
26 amount of the ERISA payments still remains at or near zero. The Company believes that  
27 Staff is taking a narrow view of the issue and has not considered the long-term impact on their  
28 decision to move to using ERISA for rate recovery. I will discuss this part of the issue later in  
29 my rebuttal testimony.  
30

31 **Q. IS PENSION EXPENSE A COST THAT RISES AND FALLS FOR THE COMPANY?**

1  
2 A. Yes. Because pension assets are linked to the markets and interest rates, the performance of  
3 pension assets can vary from year to year. Thus, the current ERISA expense is not  
4 necessarily representative of a utility's ongoing costs.  
5

6 **Q. YOU MENTIONED EARLIER THAT IN PRIOR RATE CASES THE COMMISSION**  
7 **HAS REFLECTED THE USE OF FAS 87 IN RATES. DID THEY REFLECT THE**  
8 **APPROPRIATE LEVEL OF FAS 87 COSTS?**  
9

10 A. The Commission in the last three MAWC rate cases has adopted the position of the  
11 Commission Staff either through litigation or stipulation of the issue of the level of pension  
12 costs. In prior rate cases, the Commission Staff adjusted the true FAS 87 costs by using  
13 various adjustments. These adjustments served to reduce the cost of FAS 87. In all cases, the  
14 Company disagreed with the Staff. The use of the Staff's adjustments only served to  
15 artificially lower the true accrued cost of the pension expense in order to achieve the goal of  
16 moving toward a lower cost that would have approximated the ERISA calculation.  
17

18 **Q. WAS THE STAFF CONSISTENT IN APPLYING THE SAME METHODOLOGY IN**  
19 **DETERMINING THE LEVEL OF PENSION EXPENSE IN RATES?**  
20

21 A. I have reviewed the Staff's position in the last three MAWC rate cases and counting the  
22 current case the Staff has supported four different positions and calculations to arrive at their  
23 recommendation for pension expense in the four cases.  
24

25 **Q. DID YOU PREPARE A SCHEDULE SHOWING THE STAFF'S CALCULATION OF**  
26 **PENSION COST UNDER FAS 87 FOR MISSOURI AMERICAN WATER'S LAST**  
27 **THREE RATE CASES AND USING ERISA IN THE CURRENT CASE?**  
28

29 A. Yes. Attached to my rebuttal testimony is Schedule EJG-3  
30

31 **Q. HAS THE STAFF'S CALCULATION BEEN CONSISTENT IN THE LAST THREE**

1           **RATE CASES AND THE CURRENT CASE?**

2  
3   A.    No. As shown on the Schedule EJG-3, the Staff has used a different adjustment methodology  
4       to the FAS 87 cost in calculating pension expense in each of the last three rates cases. In the  
5       current case, they are abandoning entirely the FAS 87 cost and moving to the ERISA method  
6       of calculating pension expense. The ultimate result of each of their calculations was to lower  
7       the cost for ratemaking purposes. Staff has not been consistent and has used differing  
8       adjusting schemes to negatively impact the true cost of the Company's pension expense.

9  
10   **Q.    HOW HAS THE STAFF'S CALCULATION OF PENSION EXPENSE CHANGED?**

11  
12   A.    In the rate case in 1995, Staff proposed an adjustment to the FAS 87 cost by assigning  
13       MAWC's portion of the actual 1994 unrecognized gain in American Water's pension plan.  
14       This adjustment lowered pension expense by 1.2% or \$3,260. In the 1997 rate case, Staff  
15       changed its adjustment by not reflecting or assigning any unrecognized gain to MAWC. In  
16       fact, there was an unrecognized loss in 1996 and not a gain. Had Staff used the same  
17       methodology in the 1997 case as was used in the 1995 case, the pension expense would have  
18       been increased by \$450,081 or over 200%. In the 2000 rate case, the Staff again changed its  
19       adjustment. In the 2000 rate case, Staff used a five-year average of the unrecognized gains  
20       and losses and then assigned a portion of it to MAWC. Had Staff utilized the same  
21       adjustment method in the 2000 rate case that it used in the 1997 rate case, the pension expense  
22       adjustment would have been increased by \$22,061 from the Staff recommendation in the 2000  
23       rate case. Now, in the current case, the Staff is changing for the fourth straight rate case its  
24       adjustment methodology. In this case, the Staff is moving back to ERISA and ignoring any  
25       kind of an adjustment for unrecognized gains or losses.

26  
27       This entire issue has become very frustrating for the Company because the Staff continually  
28       searches for ways to reduce the amount of pension cost that will be included in rates. The  
29       Company believes that consistency is an important characteristic of regulation. The Company  
30       believes that the consistent use of FAS 87 for computing pension cost is the appropriate  
31       manner for rate recovery.

1  
2 **Q. EARLIER IN YOUR DISCUSSION OF THIS ISSUE, YOU TOUCHED ON THE**  
3 **FUTURE LEVEL OF ERISA PAYMENTS. PLEASE ELABORATE.**  
4

5 A. Currently, the Company is expecting that over the next four years, total pension payments  
6 under ERISA will exceed pension cost under FAS 87 for MAWC by \$11,266,228. Shown  
7 below is a table of the projected FAS 87 and ERISA payments anticipated over the next four  
8 years.

9  
10

Year	American Water		Missouri American	
	FAS 87	ERISA	FAS 87	ERISA
2004	\$44,400,000	\$45,850,000	\$6,100,560	\$ 5,726,521
2005	40,000,000	75,200,000	5,496,000	10,115,127
2006	35,000,000	70,450,000	4,809,000	9,679,830
2007	30,700,000	46,350,000	4,218,180	6,368,490

15  
16

17 Marked as Schedule EJG-4 and attached to my rebuttal testimony is a letter that was received  
18 by the Company from our actuaries Towers Perrin. The letter discusses the expected ERISA  
19 payments and the FAS 87 costs over the next four calendar years and was used to arrive at the  
20 numbers for the American Water System. The amounts shown under the columns headed  
21 Missouri American are the expected amounts for the Company based on the amounts shown  
22 for American Water.

23  
24 If the Commission should agree with the Staff's recommendation to move to ERISA in this  
25 case, the question we must ask ourselves is what will the Staff do in the next rate case? Since  
26 the Staff has shown a clear history of making expense reducing adjustments to the pension  
27 cost that are not consistent from rate case to rate case, will the Staff move back to FAS 87 or  
28 will Staff attempt to adjust the ERISA cost on some arbitrary basis to lower future pension  
29 cost as it did in prior cases?

30  
31 We believe that the Commission should consistently apply the FAS 87 method for computing  
32 pension cost. We believe that the future ERISA payments will exceed the FAS 87 costs. If  
33 the Commission adopts the Company's FAS 87 costs, the increase in the ERISA payments in

1 the future will be made by the Company and will serve to reduce the Pension Liability that  
2 Mr. Gibbs discusses in his Direct Testimony.

3  
4 **Q. DO YOU HAVE ANY OTHER COMMENTS?**

5  
6 A. Yes. To help assist the Commission in evaluating the issue and to understand the future  
7 direction of the FAS 87 and ERISA payments, the Company has contracted the services of  
8 Mr. William J. Williamson of Towers Perrin. Mr. Williamson will address the differences in  
9 FAS 87 and ERISA and explain the reasons for the increase in the level of ERISA payments  
10 over the next few years.

11  
12 **BELLEVILLE LAB WATER QUALITY TESTING COST ALLOCATION**

13  
14 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS ISSUE?**

15  
16 A. The purpose of my rebuttal testimony is to briefly discuss the Staff's proposed adjustment to  
17 the Company's test year level of water quality testing that is performed by the Bellville Lab.  
18 First, the Company is using the services of Mr. Pat Baryenbruch to address the issue of  
19 allocation of the costs associated with the Belleville Lab. Mr. Bayenbruch will address the  
20 reasonableness and appropriateness of using a customer count allocation rather than the  
21 number of test samples as recommended by the Staff.

22  
23 The Staff's proposed adjustment reduces water quality testing approximately \$346,000.  
24 Staff's adjustment is based on a comment in Mr. Cassidy's direct testimony that using an  
25 allocation factor of test analyses is more appropriate than a customer count allocation. Mr.  
26 Cassidy makes no assertion as to why the one allocation factor is more appropriate than the  
27 other. Mr. Baryenbruch in his rebuttal testimony will address this issue in further detail.

28  
29 **PROPERTY TAXES**

30  
31 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY AS TO THIS**

1       **ISSUE?**

2

3   A.    The Staff has not reflected the proper level of property taxes resulting from the true-up of

4       utility plant in service. The Company's proposed level of property taxes reflected an

5       adjustment to include property taxes on plant investments through the true-up period.

6       However, Staff witness Hanneken did not reflect property taxes on true-up plant in her

7       adjustment and instead only proposes to reflect the latest property tax bills to be paid prior to

8       December 31, 2003. The total difference between the Company and the Staff on this issue is

9       approximately \$593,000.

10

11   **Q.    DO YOU AGREE WITH THE STAFF'S ADJUSTMENT?**

12

13   A.    No. The Staff's adjustment ignores the matching of the level of property tax expense to the

14       level of Utility Plant in Service (UPIS) as of the end of the true-up period in this case

15       (November 2003). The level of Utility Plant in Service to be reflected in rates will be the

16       balance recorded on the books as of November 2003. The level of property tax to be

17       recovered in rates as proposed by Staff will be based on UPIS as of December 2002. This is

18       inconsistent with other true-up adjustments that are being proposed.

19

20   **Q.    WHAT ARE THE OTHER TRUE-UP ADJUSTMENTS BEING PROPOSED?**

21

22   A.    The Company and the Staff are proposing to true-up depreciation expense based on UPIS as

23       of November 2003. The Company and Staff are also proposing to true-up chemical and fuel

24       and power expense based on sales after a true-up for actual customers as of November 2003.

25       In all cases, the true-up being proposed relates back to the matching of investment, revenue

26       and expenses as of the end of November 2003. The one exception in the Staff's case is

27       property taxes.

28

29   **Q.    WHAT LEVEL OF PROPERTY TAXES WILL THE COMPANY ACCRUE IN 2004**

30       **BASED ON THE TRUED-UP PLANT?**



1 A. The Company will begin accruing a level of property tax expense starting January 2004 based  
2 on UPIS as of December 31, 2003. The new rates in this case will be based on that level of  
3 UPIS at November 2003. The property tax level to be included in rates should be based on  
4 the UPIS level reflected in rate base as of the true-up.

5  
6 **Q. DO YOU BELIEVE THEN THAT PROPERTY TAXES SHOULD BE INCLUDED IN**  
7 **THE TRUE-UP?**

8  
9 A. Yes. Property taxes can be easily trued-up by calculating a ratio of the actual 2003 property  
10 tax expense, divided by UPIS at December 2002. This ratio would then be multiplied by the  
11 actual true-up UPIS to arrive at the true-up level of property taxes to be recovered in rates.

12  
13 **Q. IN THE PAST, THE STAFF HAS ARGUED THAT THE AMOUNT OF PROPERTY**  
14 **TAXES PAID BY THE COMPANY BEYOND THE TRUE-UP ARE NOT KNOWN**  
15 **AND MEASUREABLE. DO YOU AGREE WITH THIS ARGUMENT?**

16  
17 A. No, I do not. Utility Commissions have the responsibility of setting just and reasonable rates  
18 that are both fair for the ratepayers and the utility. A utility must be given an opportunity to  
19 earn its rate of return. The Staff's proposal for the recovery of property taxes in this case does  
20 not provide the Company an opportunity to earn its authorized return. In fact, the Staff's  
21 property tax adjustment places the Company at a disadvantage before the new rates are even  
22 placed into effect.

23  
24 **Q. REGARDING THIS ISSUE, WHAT DOES THE COMMISSION NEED TO BE ABLE**  
25 **TO DETERMINE THAT THE COMPANY'S PROPOSED LEVEL OF PROPERTY**  
26 **TAXES ARE APPROPRIATE FOR RATE RECOVERY?**

27  
28 A. The Company believes that its proforma level of property taxes is known and measurable.  
29 Therefore, the recovery of this expense in rates is appropriate.

30  
31 First, the level of actual Utility Plant in Service at the end of December 2002 is known.

1 Second, the level of the actual true-up Utility Plant in Service will be known at the end of  
2 November. Third, the actual property taxes for 2003 will be known at the end of November.  
3 Using the actual property tax bills for 2003 and the actual Utility Plant in Service at the end of  
4 2002, a composite property tax ratio can be calculated, which, is then multiplied by the actual  
5 known true-up Plant in Service at November 2003 to calculate an appropriate level of  
6 property taxes for rate recovery. If all components in the above calculation are based on  
7 known and measurable data, then the results for ratemaking purposes should be considered by  
8 this Commission to be a known and measurable calculation in setting rates.  
9

10 **Q. MR. GRUBB, YOU STATED EARLIER THAT THE STAFF'S RECOMMENDATION**  
11 **WOULD NOT PROVIDE THE COMPANY WITH AN OPPORTUNITY TO EARN**  
12 **ITS AUTHORIZED. PLEASE EXPLAIN THIS STATEMENT.**  
13

14 **A.** The setting of rates should be based on the matching principle. In this case, the Utility Plant  
15 in Service is being matched with the actual customers and the level of depreciation expense to  
16 be calculated on the plant. As part of the cost, the Company will be incurring property taxes  
17 on the actual true-up plant of which the Staff is recommending that the Company not recover  
18 in rates at this time.  
19

20 By not allowing the recovery of these property taxes, the Staff's revenue requirement will  
21 cause the Company to immediately earn below the authorized return to be set by the  
22 Commission. Again, not fully matching revenues, expenses and investment in the setting of  
23 rates causes this to occur.  
24

25 **Q. HAVE YOU HAD THE OPPORTUNITY TO PERFORM A HISTORICAL**  
26 **COMPARISON OF THE STAFF METHODOLOGY AND THE METHODOLOGY**  
27 **PROPOSED BY THE COMPANY?**  
28

29 **A.** Yes. Attached is Schedule EJG-5. This schedule compares the Company's methodology and  
30 the Staff's recommended methodology for recovery of property taxes. The schedule's  
31 analysis and comparison uses seven years of data to calculate annual levels of property taxes

1 to be reflected for rate recovery assuming the Company filed annual rate cases. This analysis  
2 shows that using the Company's method, the Company would have under collected in rates  
3 property taxes by \$543,269. Using the Staff's methodology, the Company would have under  
4 collected in rates property taxes by \$3,475,047 (an astonishing 540% difference between the  
5 two methods).

6  
7 Ratemaking is not exact science and once rates are set, many factors and issues can occur that  
8 can cause the Company's revenues and expenses to change. However, the rate setting process  
9 should recognize a level of expenses that will reflect the Company's level of expenses that are  
10 appropriate for recovery. Using the Staff's methodology for calculating property taxes  
11 woefully falls short in meeting the intended objective in the setting of rates. I believe that the  
12 Commission should accept the Company's calculation as the appropriate basis of recovery of  
13 property taxes.

14  
15 **Q. IF THE COMMISSION ADOPTS THE STAFF'S ADJUSTMENT FOR PROPERTY**  
16 **TAXES, SHOULD ANY ADDITIONAL ADJUSTMENT BE INCLUDED IN THE**  
17 **REVENUE REQUIREMENT?**

18  
19 **A.** Yes. If Staff's level of property taxes is used, then an adjustment to working capital must also  
20 be made. The adjustment that is needed should change the payment lag for property taxes to  
21 be consistent with Staff's property tax expense proposal. As previously mentioned, Staff is  
22 proposing to include in rates a level of property tax expense that was paid in December 2003.  
23 Rates in this case will go into effect in April 2003. Therefore, working capital should reflect  
24 the fact that the Company will pay the property taxes in December 2003 and not recover those  
25 taxes until starting in April 2004. The expense lag for property taxes should be changed to  
26 zero to reflect the payment near the start of the rate year. Using Staff's accounting schedules,  
27 this results in an increase in the Staff's recommended rate base by approximately \$5 million.

28  
29 **RECOVERY OF OLD ST JOSEPH TREATMENT PLANT RETIREMENT**

30  
31 **Q. PLEASE DESCRIBE THE DISAGREEMENT RELATED TO THE OLD ST. JOSEPH**

**TREATMENT PLANT.**

A. When the new St. Joseph treatment plant came on-line, the old plant was retired and taken out of service. However, the old plant was not fully depreciated. On the day the old St. Joseph treatment plant was retired, its book value (investment minus depreciation) was \$2,832,906. In Case No. WR-2000-281, the Commission denied MAWC recovery of those undepreciated amounts associated with the retirement of the old St. Joseph treatment plant and directed that the remaining plant balance and the related cost of removal be written off. The actual cost of removal was in the amount of \$344,955.

**Q. IN STAFF WITNESS STEPHEN M. RACKERS' DIRECT TESTIMONY, HE INDICATES THAT RECOVERY OF THE UNDEPRECIATED BALANCE OF THE OLD ST. JOSEPH TREATMENT PLANT IS "INAPPROPRIATE FOR INCLUSION IN THIS CASE." UPON WHAT DOES MR. RACKERS BASE THIS POSITION?**

A. Mr. Rackers states that he has been "advised by Counsel that this matter is the subject of a continued court appeal process of a prior Commission Order."

**Q. ARE YOU FAMILIAR WITH THE "COURT APPEAL PROCESS" TO WHICH MR. RACKERS REFERS?**

A. Yes. The Cole County Circuit Court opinion that reversed the Commission's decision in Case No. WR-2000-281 as to this issue is discussed in my Direct Testimony on pages 17-20.

**Q. WHAT ARE THE IMPLICATIONS OF THE EXISTING CIRCUIT COURT ORDER THAT REVERSES THE COMMISSION'S DECISION?**

A. I believe that is a legal matter that is best suited for the legal briefs and attorneys.

**Q. FROM A RATE MAKING PERSPECTIVE, WHAT DO YOU BELIEVE THE COMMISSION SHOULD DO WITH THE DEPRECIATION AND COST OF**

**REMOVAL ASSOCIATED WITH THE OLD ST. JOSEPH TREATMENT PLANT?**

A. I believe that the Commission should provide for a recovery of these amounts.

**Q. WHY?**

A. The very existence of these amounts is a function of the depreciation rates set by the Commission. To not allow recovery of the amounts would allow the Commission to in essence “trap” MAWC’s investment and deny recovery of prudent investment.

**Q. IN AN IDEAL WORLD, WOULD THERE EVER BE UNDEPRECIATED AMOUNTS AT THE CLOSE OF THE USEFUL LIFE OF A PIECE OF UTILITY PLANT?**

A. No. As the Commission stated in its decision in Case No. WR-2000-281, “If the accounting convention were perfect, an asset would be fully depreciated at the time it is actually retired, that is, removed from service. . . . In the case of the old St. Joseph treatment plant, the accounting convention yielded an imperfect result and the plant was not yet fully depreciated at the moment of its retirement.” (Report and Order, p. 50). Because of the estimates and unknowns involved with depreciation analysis, it is not unheard of for the depreciation rates to miss their goal to some extent. In this case, the Commission’s past analysis proved incorrect and the depreciation rates failed to match capital recovery with capital consumption.

**Q. HOW ARE DEPRECIATION RATES SET FOR RATE MAKING PURPOSES?**

A. A water corporation, such as MAWC, must utilize the depreciation rates which are established by the Commission. Section 393.240, RSMo 2000. Thus, the “imperfect result” as to the old St. Joseph treatment plant depreciation is the result of the Commission ordered depreciation rates and a failure to match depreciation to the life of the plant is based upon the Commission’s own decisions. A denial of the amounts at issue requires MAWC to suffer the consequences of the inadequacy of Commission established depreciation rates. This is not reasonable.

1  
2 **Q. SHOULD THE COMMISSION HAVE BEEN AWARE OF THE POTENTIAL FOR**  
3 **THIS MISMATCH PRIOR TO CASE NO. WR-2000-281?**  
4

5 A. Yes. In the Company's last rate case before Case No. WR-2000-281, the potential for  
6 unrecovered depreciation amounts as to the old St. Joseph treatment plant was specifically  
7 raised as an issue by the Commission Staff. *In the Matter of Missouri-American Water*  
8 *Company's Tariff Designed to Increase Rates for Water Service*, Case No. WR-97-237  
9 (1997). In Case No. WR-97-237, the Commission Staff highlighted the fact that the value of  
10 the old plant would not be depreciated by the time the new St. Joseph treatment plant came on  
11 line and, thus, suggested that a depreciation reserve deficiency existed.<sup>1</sup> The Staff  
12 recommended that the Commission authorize a ten year amortization of this reserve  
13 deficiency in order to smooth the impact on ratepayers. At the urging of the OPC and other  
14 intervenors, the Commission chose to not address the deficiency in Case No. WR-97-237  
15 stating "Presumably, MAWC will have made a start on the new St. Joseph plant by the time  
16 of its next rate case. At that time the Commission may have evidence to support such an  
17 amortization proposal." *Id.* As a result, the Commission was instead faced with the actual  
18 retirement and the resulting reserve deficiency in Case No. WR-2000-281.  
19

20 **Q. WHAT DID THE COMMISSION FIND AS TO THE NEW ST. JOSEPH**  
21 **TREATMENT PLANT?**  
22

23 A. The Commission found that MAWC's decision to construct the new plant and facilities was  
24 reasonable. It stated that the "management of MAWC did use due diligence to address all  
25 relevant factors and information known or available to it when it assessed the situation and  
26 reached the decision to build a new treatment plant and develop a new ground water source of  
27 supply in St. Joseph. Consequently, the Commission must conclude that the decision to build

---

<sup>1</sup> In Case No. WR-97-237, the Staff had prepared a depreciation study which reflected the then  
St. Joseph treatment plant being retired within the next three to four years. (Salser Sur., Ex. 8,  
p. 3).

1 the new plant and related facilities was not imprudent.” (Case No. WR-2000-281, Report and  
2 Order, p. 45-46).

3  
4 **Q. WHAT ARE THE POLICY IMPLICATIONS FOR UTILITIES IF A UTILITY WILL**  
5 **BE FORCED TO LOSE ANY UNDEPRECIATED AMOUNTS WHEN PROPERTY IS**  
6 **REPLACED?**

7  
8 A. If the Commission is going to disallow recovery of the amount of a utility’s investment that  
9 has not been fully depreciated, the Commission will send a strong message that decisions as  
10 to new construction should not be based on needs of its customers, but rather, on the status of  
11 depreciation accounts.

12  
13 **Q. ARE YOU FAMILIAR WITH THE TERMS “RETURN ON” AND “RETURN OF”?**

14  
15 A. Yes. There are generally two types of recovery associated with a public utility’s rates. A  
16 public utility receives both a “return on” its reasonable investments, as well as a “return of”  
17 its reasonable expenses.

18  
19 **Q. WHAT TYPE OF RETURN IS MAWC SEEKING IN REGARD TO THE OLD ST.**  
20 **JOSEPH TREATMENT PLANT AMOUNTS?**

21  
22 A. MAWC, as earlier specified in my Direct Testimony, is only seeking a “return of” the  
23 amounts at issue. MAWC proposes to receive this return of the amounts through the use of a  
24 20-year amortization. Using this approach results in an annual amortization of \$158,893.

25  
26  
27  
28 **INPUTTED REVENUES FROM AWR FOR CUSTOMER LISTS**

29  
30 **Q. MR. CASSIDY RECOMMENDS A DISALLOWANCE OF \$100,000 TO**  
31 **REFLECT THE VALUE OF MAWC’S SERVICES RENDERED TO AWR IN**

1       **CONNECTION WITH THE AWR SERVICE LINE PROTECTION**  
2       **PROGRAM OFFERING TO MAWC'S CUSTOMERS. WHAT SERVICES**  
3       **DID MAWC PERFORM FOR AWR IN THIS REGARD?**

4  
5       A.   MAWC provided a list of customers, which AWR used for four mailings in 2003.  
6       MAWC's president, Mr. Eric Thornburg, also provided a cover letter that  
7       accompanied the AWR brochure in these mailings.

8  
9       **Q. IS MAWC IN ANY WAY INVOLVED IN THE PROVISION OF THIS**  
10       **SERVICE BY AWR?**

11  
12       A.   No. Customers with this service who experience a service line leak must contact  
13       AWR. AWR then arranges for an independent contractor to perform the repair.  
14       MAWC plays no role in this process.

15  
16       **Q. DO YOU AGREE WITH MR. CASSIDY'S ADJUSTMENT, AND IF NOT,**  
17       **WHY?**

18  
19       A.   The adjustment is inappropriate for several reasons:

- 20  
21           • MAWC's limited involvement in the offering of this program was a public  
22           service to customers and the promotion of a solution to a customer service  
23           problem, for which the demand of compensation would have been  
24           inappropriate.
- 25  
26           • The arbitrary value independent of customer benefit that Mr. Cassidy ascribes  
27           to MAWC's involvement is grossly excessive.



1     **Q.   IN WHAT RESPECT IS MAWC’S INVOLVEMENT IN THIS PROGRAM**  
2     **BENEFICIAL TO ITS CUSTOMERS?**

3  
4     A.   This AWR program is not something unrelated to customer satisfaction with utility  
5     service.   The problem of customer ownership of service lines and concurrent  
6     responsibility for repair of those lines has been a consistent and serious cause of  
7     customer dissatisfaction for many years.   So much so, in fact, that in the St. Louis  
8     entity, the Staff filed multiple Complaint cases attempting to force the Company to  
9     address the customer repair responsibility problem, and even went so far as to sue the  
10    Company in an unsuccessful attempt to force the Company to maintain service lines.  
11    St. Louis County Water Company v. Public Service Commission, 579 S.W.2d 633  
12    (Mo.App. E.D. 1979).

13  
14    **Q.   HAS THE STAFF OR THE COMMISSION COMMENTED ON THE VALUE**  
15    **TO CUSTOMERS OF A WATER SERVICE LINE PROTECTION**  
16    **PROGRAM?**

17  
18    A.   Yes.   Both the Staff and the Commission have acknowledged this.   When the Missouri  
19    Legislature enacted legislation that put into effect the mandatory program in St. Louis  
20    County, there was a Staff Complaint case contesting the question of whether the  
21    charge was to be imposed on all customers or just on property owners.   In that Case,  
22    the Commission stated in its Report and Order validating the imposition of the charge  
23    on all customers that, “In general, a water service line replacement program is very  
24    beneficial to property owners, who might otherwise find themselves responsible for  
25    extremely costly repairs.”   In testimony in that case   Mr. Hubbs of the Staff argued  
26    that primary benefits were to owners as opposed to renters, but he also conceded that,  
27    “...I do not say this to imply that there are no benefits to the residential customer who  
28    rents from the residential landlord.   The stability of continued water service, and of

1 possibly not having to move because of a dramatic change in the residential landlord's  
2 economic position, can both be significant benefits to the renter. (Surrebuttal  
3 Testimony, Case WC-2002-146, W.R. Hubbs, Ex. 2, p. 22).

4  
5 **Q. WHAT THEN WAS THE COMPANY'S MOTIVE FOR ASSISTING AWR**  
6 **WITH THE PROGRAM OFFERING?**

7  
8 A. We did this because customer dissatisfaction with failing service lines is a significant  
9 source of customer concern, and to the extent that we can eliminate that through a  
10 repair program, it both helps the customers and ultimately reduces the calls and  
11 complaints associated with service line failures.

12  
13 **Q. WITH RESPECT TO MR. CASSIDY'S DETERMINATION THAT THIS**  
14 **SHOULD RESULT IN A \$100,000 REDUCTION IN THE COMPANY'S**  
15 **REVENUE REQUIREMENT, DO YOU UNDERSTAND WHERE AND HOW**  
16 **HE CAME UP WITH \$100,000?**

17  
18 A. He indicates that the \$100,000 is an "estimate" but does not describe how he  
19 developed the amount. It is obvious that the figure is completely arbitrary.

20  
21 **Q. WHY DO YOU SAY THAT IT IS OBVIOUS THAT THE FIGURE IS**  
22 **"ARBITRARY?"**

23  
24 A. MAWC provided AWR with a mailing list. The \$100,000 amount is grossly in excess  
25 of the cost of similar lists on the open market. Our research shows that customer lists  
26 can be purchased for \$37 to \$75 per 1,000 customers. For MAWC with 112,000  
27 customers outside of the St. Louis district, that totals to between \$4,200 and \$8,400.  
28 We believe the \$8,400 valuation is appropriate because it represents the price at which

1 a purchaser could use the list an unlimited number of times. AWR has sent four  
2 mailings to MAWC customers (April 3, 2003, June 16, 2003, August 11, 2003, and  
3 October 15, 2003). Mr. Cassidy's \$100,000 valuation translates into a cost of almost  
4 \$900 per 1,000 customers. This is more than ten times the market price.

5  
6 **Q. DO YOU ATTRIBUTE ANY VALUE TO THE NOTE FROM MAWC**  
7 **PRESIDENT MR. ERIC THORNBURG THAT ACCOMPANIED THE AWR**  
8 **MAILING?**

9  
10 A. No. There was absolutely no incremental cost to MAWC in connection with this  
11 letter. There is no reasonable way to place a value on Mr. Thornburg's letter.

12  
13 **Q. WHY DID MR. THORNBURG SEND THIS LETTER PROMOTING A**  
14 **SERVICE OFFERED BY AWR?**

15  
16 A. The letter was sent as a convenience to customers. We know from the experience  
17 with our St. Louis County district that service line protection is a service that  
18 customers value. We wanted to make other MAWC customers aware of the  
19 opportunity to receive the same service from a trustworthy provider. We believe that  
20 customers who want the peace of mind associated with service line protection were  
21 very happy to have this arrangement presented to them.

22  
23 **SECURITY COST AAO**  
24

25 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS**  
26 **ISSUE?**

27 A. Staff witness Rackers has recommended to the Commission that the Company not be allowed  
28 to recover: 1) legal costs associated with the security accounting authority order (AAO)  
29 proceedings (Case No. WO-2002-273); 2) deferred carrying costs associated with the security

1 AAO resulting from a proposed change in the methodology for calculating Allowance for  
2 Funds Used During Construction (AFUDC); and, 3) the costs associated with a return on the  
3 unamortized balance of the AAO costs. The Staff is recommending to the Commission that  
4 the AAO cost be recovered over a 10-year period.

5  
6 OPC witness Bolin has recommended that the Company not be permitted to receive a "return  
7 on" of the unamortized costs associated with the Security AAO Deferral.

8  
9 **Q. PLEASE BRIEFLY DISCUSS THE SECURITY AAO.**

10  
11 A. In Case No. WO-2002-273, the Commission authorized the Company to defer certain costs  
12 associated with security measures taken by the Company in the aftermath of the September  
13 11, 2001 terrorist attacks. The Company was authorized to defer the costs for a two-year  
14 period ending on September 11, 2003. The Company was also authorized to amortize the  
15 costs over a 10-year period. The Company began amortizing the costs in December 2002  
16 upon receipt of the Commission's Report and Order. The Company stopped deferring costs  
17 associated with the one-time costs and the capital expenditures placed into service after  
18 September 11, 2003.

19  
20 **Q. DO YOU AGREE WITH THE PROPOSED ADJUSTMENTS MADE BY STAFF OR**  
21 **THE OPC?**

22  
23 A. No, I do not.

24  
25 **Q. WHY DO YOU DISAGREE WITH THE STAFF RECOMMENDATION?**

26  
27 A. First, it seems inherently unfair to not recover the costs associated with a proceeding before  
28 the Commission in one fashion or another. All of the legal fees for the AAO proceeding were  
29 prudently incurred and should be recovered. These types of legal fees are similar to the legal  
30 fees incurred by a utility to litigate a rate proceeding before the Commission. They are costs  
31 associated with the fact that the Company is regulated by the Commission and must

1 participate in regulatory proceedings before the Commission. Because it is a corporation,  
2 MAWC is required by Commission Rule 4 CSR 240-2.040 to appear before the Commission  
3 through licensed attorneys. Prudently incurred legal fees associated with a rate case have  
4 historically been recognized in rates via an amortization. The Company believes these costs  
5 are similar and therefore should be recovered as part of the AAO costs or part of the rate  
6 proceeding costs, since it is this proceeding that will determine what level of the AAO  
7 deferral will be recovered in rates.

8  
9 Second, the Company believes that the adjustment to the amount of the deferral related to the  
10 calculation of the carrying costs is inappropriate. I have discussed this issue in further detail  
11 in the section of my rebuttal testimony labeled Methodology Change in Calculating AFUDC.

12  
13 Finally, Staff has recommended that the unamortized balance be excluded from rate base. Mr.  
14 Rackers makes this recommendation based on a Commission decision involving Missouri Gas  
15 Energy ("MGE") (GR-98-140). The issue in that case was a service line replacement deferral.  
16 The Company believes that costs associated with the security AAO are different from the  
17 issue in the MGE case. The Company incurred the costs to provide security to its production  
18 and distribution systems, its offices, its customers and its employees. The Company incurred  
19 these costs with the sole purpose continuing to provide safe and adequate water service to its  
20 customers. In the MGE case, the AAO was done to replace assets that had been in place and  
21 providing service to its customers for years and were now worn out.

22  
23 In prior AAO cases, the Commission has found that the exclusion of the deferral from rate  
24 base represents a sharing of the costs. The Company believes that the Commission can use  
25 this standard if the deferral represents amounts that are both a benefit to the ratepayers and the  
26 shareholders. There are instances where a deferral only benefits the ratepayers while other  
27 deferrals benefit both the ratepayer and the shareholder. In the case of the Security AAO, the  
28 benefits are solely accruing to the ratepayers. The security expenditures were made to protect  
29 our customers and the assets that serve them. Therefore, rate base treatment of the  
30 unamortized balance is appropriate.

1 **Q. IN YOUR DISCUSSION ABOVE REGARDING THE SHARING BETWEEN THE**  
2 **RATEPAYER AND THE SHAREHOLDER, HAS THE COMPANY EVER**  
3 **PRESENTED AN OPPORTUNITY FOR THIS COMMISSION TO SHARE A**  
4 **CUSTOMER BENEFIT WITH THE COMPANY?**

5  
6 A. Yes. The Commission had an opportunity to do so in the last St. Louis County Water  
7 Company rate case (Case No. WR-2000-844). In that case, the Company proposed to the  
8 Commission that the customers share the actual savings resulting from the merger/acquisition  
9 with the Company. The Commission denied that request. Since the Commission has denied  
10 this type of request, we believe that a more careful review of rate base treatment for deferrals  
11 should be made with an eye towards affording an opportunity to recover the full cost of  
12 deferrals.

13  
14 **Q. MR. RACKERS HAS RECOMMENDED TO THE COMMISSION THAT THE**  
15 **DEFERRED INCOME TAXES ASSOCIATED WITH THE AAO DEFERRAL**  
16 **SHOULD BE INCLUDED AS A RATE BASE REDUCTION. DO YOU AGREE WITH**  
17 **THIS?**

18  
19 A. No, I do not. Reducing rate base by the amount of the deferred taxes associated with the  
20 Security AAO, when at the same time the Staff is recommending exclusion from rate base the  
21 unamortized balance of the costs, is simply wrong. I know of no other Commission that takes  
22 advantage of shareholder funds that create a tax deduction and then uses that tax deduction in  
23 the form of a deferred tax liability and then takes that liability away from the Company and  
24 use it as a rate base reduction when the associated asset is excluded from rate base. I ask the  
25 Commission to reevaluate its policy. If a deferral is excluded from rate base, then the  
26 associated deferred income taxes should remain with the shareholder and not be used to  
27 reduce rate base. Staff's adjustment is tantamount to double dipping the Company.

28  
29 **Q. DO YOU AGREE WITH THE OPC'S RECOMMENDATION TO DISALLOW A**  
30 **"RETURN ON" OF THE SECURITY AAO COSTS?**

1 A. No. The above discussion of rate base treatment and the return on of a deferral is equally  
2 appropriate in response to OPC witness Bolin's testimony.

3  
4 **REVENUES RELATED TO CREDITS AND BILLING ADJUSTMENTS**

5  
6 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS POINT?**

7  
8 A. The Company, during its review of the Staff's originally filed case, discovered that it  
9 appeared the Staff did not take into consideration in developing its present rate level of  
10 revenues the appropriate level of test year credits and billing adjustments. From the initial  
11 review of the Staff's case, the Company believes that the Staff's revenues were inadvertently  
12 overstated by \$970,000. The Company provided to the Staff during the prehearing conference  
13 week a schedule detailing what it thought the issues were in the Staff's revenue calculation.  
14 Subsequent to the prehearing conference, the Company and the Staff have had discussions  
15 regarding the issues. The Company and Staff have agreed on a number of the required  
16 adjustments but some additional discussions are still needed to determine if the parties  
17 disagree and, if so, in what instances.

18  
19 **Q. WHEN DO YOU THINK THESE ISSUES WILL BE RESOLVED?**

20  
21 A. The Company is hoping that the issues can be resolved by the end of the week of November  
22 10<sup>th</sup>. However, if the issues are not resolved within the very near future, the Company will  
23 seek to file supplemental rebuttal testimony addressing these issues.

24  
25 **FUEL AND POWER AND CHEMICAL EXPENSE**

26  
27 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS POINT?**

28  
29 A. The purpose of my rebuttal testimony is similar to the points made related to revenues and the  
30 related credits and billing adjustments. The Staff and the Company are still working together  
31 to resolve some revenue and billing determinant differences. Once these issues are addressed,

1 the position of the Staff and Company for fuel and power and chemical expense can then be  
2 finalized.

3  
4 **COST ALLOCATION MANUAL (CAM)**  
5

6 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS POINT?**  
7

8 A. The purpose of my rebuttal testimony as to the Cost Allocation Manual (CAM) is to address  
9 the concerns that Staff has relating to the Company's CAM as expressed in the Direct  
10 Testimony of Staff witness John P. Cassidy.  
11

12 **Q. WHAT ISSUES HAS MR. CASSIDY RAISED IN REGARD TO THE CAM?**  
13

14 A. On page 29 of his Direct Testimony, Mr. Cassidy cites "significant problems that plague the  
15 Company's CAM." Mr. Cassidy takes issue with the entire manual by noting it does not  
16 contain every detailed piece of information he needs for his rate case investigation. Mr.  
17 Cassidy confuses the purpose of the CAM with a data request he has made in the rate case.

18 **Q. WHAT DO YOU BELIEVE THE PURPOSE OF THE CAM TO BE?**  
19

20 A. The purpose of the CAM is to act as a reference manual to provide American Water  
21 employees and external parties with a clear understanding of how Service Company expenses  
22 are assigned to affiliate companies. We believe the CAM does that quite effectively.  
23

24 **Q. HOW DID THE COMPANY GO ABOUT CREATING THE CAM?**  
25

26 A. In assembling the CAM, we closely followed the Commission's Order in the last St. Louis  
27 County Water Company rate case (Case No. WR-2000-844). In that case, the Commission  
28 adopted the recommendation of Public Counsel witness Mr. Dittmer and directed St. Louis  
29 County Water Company to "prepare and maintain" "the Cam described by Mr. Dittmer. We  
30 included in the CAM the information Mr. Dittmer specified. The Commission Order did not



1 specify the CAM should include information Mr. Cassidy now finds lacking.

2  
3 By its nature, a reference manual is not meant to be updated each and every month. What Mr.  
4 Cassidy wants is more of a schedule with all supporting workpapers that will allow him to  
5 audit the assignment of actual Service Company expenses to affiliate companies. This does  
6 not belong in the CAM. It should be a data request Mr. Cassidy makes as part of a rate case  
7 investigation.

8 We believe the CAM clearly explains how Service Company expenses are assigned and  
9 complies with the Commission order.

10  
11 **Q. WHAT RECOMMENDATIONS IS STAFF MAKING REGARDING THE CAM?**

12  
13 A. Staff witness Cassidy is making six recommendations. They are found on pages 32 and 33 of  
14 his Direct Testimony.

15  
16 First, Mr. Cassidy wants the CAM to clearly identify the total costs of the Service Company  
17 by month. This is not the purpose of a Cost Allocation Manual. A CAM should be used as a  
18 reference manual to provide employees and external parties with a clear understanding of how  
19 Service Company expenses are assigned to affiliated companies. Mr. Cassidy's request here  
20 should be to make sure that the Company's financial systems could produce such a report for  
21 review by third parties. The Company's financial system can maintain and produce the  
22 information, however, the Company does not believe it is appropriate to include this  
23 information in the CAM.

24  
25 Second, Mr. Cassidy wants the CAM to clearly identify the allocation basis used to distribute  
26 costs each month. The CAM already accomplishes this.

27  
28 Third, Mr. Cassidy wants the CAM to identify the costs borne by each entity taking service  
29 from the Service Company by month. Again, this is not the purpose of a CAM. The financial  
30 system can produce the information but it is not appropriate to include it in the CAM.

1  
2 Fourth, Mr. Cassidy wants the CAM to identify the costs by month and identified by cost pool  
3 with the corresponding allocation basis. Again, this is not the purpose of a CAM. The CAM  
4 would explain how this is done. The financial system would produce the information, but it is  
5 not appropriate to include it in the CAM.  
6

7 Fifth, Mr. Cassidy wants the Commission to Order the Company to provide monthly cost  
8 reports that shows the allocated costs along with the monthly allocation calculations broken  
9 down by Service Company function. The Company does not have an issue with doing this,  
10 however, we would recommend to the Commission that this reporting process be done on an  
11 annual basis. The Company proposes to meet with Staff and discuss the format and timing of  
12 the requested reports on an annual basis.  
13

14 Finally, Mr. Cassidy is recommending that the Company maintain a monthly expense detail  
15 report of the total Service Company expenses that can be examined by Staff to determine if  
16 the expenses being allocated are reasonable and appropriate. The Company believes that this  
17 review is more appropriate in the context of the rate case review process or some other  
18 proceeding before the Commission.  
19

#### 20 **AFFILIATED TRANSACTION ISSUE**

21

22 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS POINT?**  
23

24 **A.** I would like to address the Direct Testimony of Staff witness Cassidy related to his discussion  
25 of affiliated transactions and his ultimate recommendation that the Commission should  
26 promulgate an affiliate transaction rule similar to the one that applies to certain Missouri gas  
27 and electric utilities.  
28

29 **Q. WHAT DOES MR. CASSIDY DISCUSS IN REGARD TO AFFILIATE**  
30 **TRANSACTIONS?**  
31

1 A. On pages 10-17 of his Direct Testimony, Mr. Cassidy identifies and discusses the corporate  
2 structure of American Water ("AW"), its relationship to the new ownership in RWE, the  
3 relationship of American Water to its subsidiaries and he also discusses the structure and cost  
4 allocation process of American Water Works Service Company, Inc. ("Service Company")  
5

6 **Q. DO YOU AGREE WITH MR. CASSIDY'S TREATMENT OF THESE ISSUES?**  
7

8 A. I agree with his discussion on the referenced pages with the exception of one area of  
9 discussion on page 16. There, Mr. Cassidy alleges that the Service Company costs are not  
10 being charged to American Water's non-regulated companies on an equal and consistent basis  
11 in comparison to AW's regulated operating companies.  
12

13 **Q. WHY DO YOU DISAGREE WITH MR. CASSIDY ON THIS POINT?**  
14

15 A. The Service Company was originally designed to provide services to the regulated entities of  
16 the American System. Offices and functional areas of the Service Company were set-up and  
17 developed to meet the needs of the regulated companies. The labor costs of the Service  
18 Company are billed to the regulated companies either directly or through an allocation process  
19 based on the number of customers that benefit from the services. Overheads for those charges  
20 are then added to the labor costs. The overhead costs are comprised of office costs, support  
21 costs and labor overhead costs such as employee benefits and taxes.  
22

23 When services by the Service Company are performed for the non-regulated companies (there  
24 are only four at the present time, as compared to 20 regulated companies), the Service  
25 Company bills those entities based on the direct billing of labor costs and actual work  
26 performed. Added to the labor costs is the same overhead rate that is used for the regulated  
27 operations which includes office costs, support costs and labor overhead costs such as  
28 employee benefits and taxes. Therefore, I believe that the billing process is fair and  
29 reasonable and that the regulated and non-regulated companies receive an appropriate amount  
30 of billed charges for the services rendered by the Service Company.  
31

1 **Q. WHAT IS THE COMPANY'S RESPONSE TO THE STAFF'S RECOMMENDATION**  
2 **THAT THE COMMISSION PROMULGATE AN AFFILITATE RULE?**

3  
4 A. MAWC does not believe that an affiliate transaction rule is necessary at this time. With the  
5 exception of the relationship with American Water Capital Corp (AWCC), MAWC has no  
6 more or different relationship with the non-regulated businesses of American Water than it  
7 did 10 years ago. MAWC does not transact any business with any American affiliate on an  
8 on-going basis, with the exception of the Service Company and AWCC.

9  
10 **Q. IS MAWC WILLING TO WORK TOWARD AN AFFILIATE TRANSACTION**  
11 **RULE?**

12  
13 A. Yes. The Company does understand the Staff's position on this issue. The Company is  
14 willing to work with Staff and assist the Commission in promulgating an affiliate transaction  
15 rule that is fair and reasonable and does not place undue cost or burden on the Company or its  
16 customers. The rule should provide the Commission and Staff with the comfort they need to  
17 confirm that any transactions that do occur between MAWC and an affiliate is done in a fair  
18 manner so that neither the customers of the Company, nor the Company itself, are advantaged  
19 or disadvantaged inappropriately by the transaction. MAWC believes that this can be  
20 accomplished, but will require something more tailored to the specific situation than merely  
21 adopting the gas and electric rules for the water industry.

22  
23 **LOBBYING EXPENSE**  
24

25 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS ISSUE?**

26  
27 A. Staff witness Hagemeyer has recommended a disallowance of \$55,372 of expenses associated  
28 with the Company's Governmental Affairs department. Mr. Hagemeyer has cited prior  
29 Commission decisions regarding disallowing rate recovery of costs for governmental relations  
30 efforts. The Company believes that governmental relations efforts are a normal business  
31 expense that benefits both the ratepayers and the Company.

1  
2 **Q. WHAT IS THE STAFF'S BASIS FOR ITS ADJUSTMENT?**

3  
4 A. Staff reviewed the Company's job description of the Director of Governmental Affairs and,  
5 based on a literal reading of the job description, concluded that 50% of the activities of that  
6 entire department is related to "lobbying." The Company later responded to Staff Data  
7 Request 264, which requested further clarification of the duties of the Director. The  
8 Company responded to the request, but was not able to give an exact percentage of time that  
9 the Director of Governmental Affairs devotes to "lobbying" efforts. Instead, the Company  
10 discussed the many duties that this individual has. At the prehearing conference, discussions  
11 with Staff indicated that an estimate of the amount of time that the Director devotes to  
12 lobbying would have been sufficient. The Company has since updated the response to Staff  
13 Data Request 264 and indicated that the Director devotes approximately 5% of his time to  
14 actual lobbying efforts.

15  
16 As noted in the Company's response to Staff Data Request 264, the Director Governmental  
17 Affairs devotes a majority of his time to being a liaison between the Company and the 100+  
18 municipalities throughout the State of Missouri. The relationship between Mr. Brown and  
19 the municipalities covers areas such as water service issues, franchise agreements, wholesale  
20 contracts, negotiations for water service to new areas, levy district proposals and construction.  
21 Communication of Company water issues is necessary for providing better service to the  
22 customers of the municipalities. None of these tasks are related to lobbying efforts.

23  
24  
25 **Q. DOES THE COMPANY EMPLOY ANYONE ELSE TO PERFORM LOBBYING**  
26 **EFFORTS FOR THE COMPANY?**

27  
28 A. Yes. The Company uses the firm of Gamble and Schleimer to perform the majority of the  
29 Company's lobbying efforts. The cost of these efforts is recorded below the line in the  
30 Company's financials and is not a part of the rate request.

1 **Q. WHAT IS THE IMPACT TO THE STAFF'S ADJUSTMENT IF THE 5% FACTOR IS**  
2 **USED TO DETERMINE THE EXPENSE DISALLOWANCE?**

3  
4 A. The Staff's disallowance would be reduced from \$55,372 to \$5,537. The Company would not  
5 take issue with the Staff's position in the case, if its adjustment reflected the 5% disallowance  
6 of the Governmental Affairs Department costs, totaling \$5,537.

7  
8 **INTEREST SYNCHRONIZATION**  
9

10 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY ON THIS ISSUE?**  
11

12 A. The purpose of my rebuttal testimony is to highlight for the Commission that the Staff's  
13 income tax calculation has an excessive amount of interest deduction due to the use of a  
14 consolidated capital structure.

15  
16 **Q. WHAT IS THE STAFF'S BASIS FOR ITS INCOME TAX CALCULATION?**  
17

18 A. The Staff used the standard methodology in computing the interest deduction in the  
19 calculation of income taxes. That calculation is the weighted cost of debt times the proposed  
20 rate base.

21  
22 **Q. WHAT IS THE PROBLEM WITH THAT APPROACH IN THIS CASE?**  
23

24 A. The problem with the Staff's calculation is that the weighted cost of debt from the  
25 consolidated capital structure was used. Company witness Ahern is addressing the issue of  
26 the Staff's use of a consolidated capital structure.

27  
28 The Staff's calculation of the interest deduction amounts to approximately \$17,670,000.  
29 Using the Company's weighted cost of debt based on its own capital structure, the amount of  
30 the interest deduction for calculating income taxes is approximately \$15,583,000, or a  
31 difference of \$2,087,000. This additional tax deduction reduces income taxes by

1 approximately \$801,000, which translates into a lower revenue requirement of approximately  
2 \$1.3 million.

3  
4 **Q. WHY IS IT MORE APPROPRIATE TO USE MAWC'S SPECIFIC WEIGHTED**  
5 **COST OF DEBT, RATHER THAN THE CONSOLIDATED WEIGHTED COST OF**  
6 **DEBT?**

7  
8 A. The reason that interest is synchronized in the calculation of income taxes is so that the  
9 ratepayers receive the proper tax deduction based on the actual level of debt used to fund rate  
10 base. Generally speaking, the use of a hypothetical capital structure will result in either too  
11 much or too little of an interest deduction. In this case, Staff is proposing too much of a  
12 deduction because the consolidated capital structure it is using has 67.53% debt, whereas the  
13 Company's capital structure, at November 30, 2003, will only have 56.38% debt.

14  
15 In this case, Staff's use of the consolidated capital structure results in assigning an interest  
16 deduction from one legal entity within the American System, American Water, to another,  
17 MAWC, which results in \$2,087,000 too much of an interest deduction which artificially  
18 reduces income taxes by \$801,000.

19  
20 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

21 A. Yes.