Exhibit No.:	
Issues:	Support Services, Incentive Compensation, Business Transformation, Rate Case Expense
Witness:	Donald J. Petry
Exhibit Type:	Rebuttal
Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2015-0301 SR-2015-0302
Date:	February 11, 2016

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2015-0301
CASE NO. SR-2015-0302

REBUTTAL TESTIMONY

OF

DONALD J. PETRY

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

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 AND SEWER SERVICE	)))))	**CASE NO. WR-2015-0301** **CASE NO. SR-2015-0302**

AFFIDAVIT OF DONALD J. PETRY

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

Donald J. Petry

Donald J. Petry

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 9th **day of** February **2016.**

Donna S. Singler
Notary Public

DONNA S. SINGLER
Notary Public, Notary Seal
State of Missouri
St. Louis County
Commission # 12368409
My Commission Expires July 17, 2016

My commission expires: July 17, 2016

REBUTTAL TESTIMONY
DONALD J. PETRY
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2015-0301
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REBUTTAL TESTIMONY

DONALD J. PETRY

I. <u>INTRODUCTION</u>

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Donald J. Petry, and my business address is 727 Craig Road, St. Louis, MO 63141.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by American Water Works Service Company, Inc. ("Service Company" or "AWWSC") as the Manager of Rates & Regulatory Support. The Service Company is a subsidiary of American Water Works Company, Inc. ("American Water") that provides support services to American Water's subsidiaries, including Missouri American Water Company ("MAWC" or "Company").

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?

A. No, I have not. However, in addition to my rebuttal testimony, I am adopting the direct testimony of MAWC witness VerDouw who has transferred to another position.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE.

A. My background and qualifications are summarized in Rebuttal Schedule DJP-1 of this testimony.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my testimony is to respond to: (1) Staff's and OPC's proposed adjustments to Service Company costs; (2) Staff's and OPC's proposed adjustments to incentive compensation paid to Missouri-American Water Company ("MAWC") and Service Company employees; (3) Staff's and OPC's proposed adjustments to MAWC's Business Transformation ("BT") program costs; and, (4) Staff's treatment of rate case expense.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes, I have.

II. SUPPORT SERVICES

Q. WHAT ADJUSTMENT DID STAFF MAKE TO SUPPORT SERVICES LABOR?

A. Staff began with the Service Company employee count at September 30, 2015, and multiplied the employees' annual salary by the current average percentage of time the employee charged to MAWC to arrive at the labor amount. They then deducted $26,633, for lobbying labor and related expense. The lobbying adjustment is addressed in MAWC witness Tinsley's rebuttal testimony. Staff then applied an O & M percentage to the total payroll to arrive at the expensed amount of payroll. The O & M percentage was also applied to their calculated payroll tax, 401K, ESPP, and group insurance expense.

Q. DOES THE COMPANY AGREE WITH THIS METHODOLOGY FOR CALCULATING SERVICE COMPANY LABOR?

A. No, we do not. While this bottom up approach is effective for calculating labor for MAWC where employees' time is 100% MAWC, it is not as effective for Service Company labor where employees' time is being direct charged or allocated and overheads applied. The Company believes that utilizing the true-up amount of actual annual expense is the best methodology. See Rebuttal Schedule DJP-2 for 2012 through 2015 Service Company labor (including wages, 401K, ESPP, payroll taxes, and group insurance). Staff's pro forma Service Company expense is $10.377M, while 2015 actual expense is $12.953M.

III. <u>INCENTIVE COMPENSATION</u>

Q. PLEASE DESCRIBE THE ADJUSTMENTS PROPOSED BY STAFF AND THE OFFICE OF THE PUBLIC COUNSEL ("OPC") TO THE COMPANY'S EMPLOYEE INCENTIVE COMPENSATION COSTS?

A. Staff recommends disallowing seventy percent (70%), or $510,837, of MAWC's employee annual incentive compensation ("AIP"). OPC recommends disallowing fifty-five percent (55%), or $386,911, of MAWC's employee AIP. In addition, both Staff and OPC recommend disallowing all $842,165 of the Company's long-term incentive compensation ("LTIP"). Further, both Staff and OPC apply this disallowance, not only to MAWC's incentive compensation, but create and apply a similar disallowance to the Support Services charges by assuming that AWWSC salaries should be similarly adjusted for incentive compensation. In aggregate, the proposed adjustments would disallow $2.289 million from the Company's operating expense in this case, approximately $1.663 million of which is allocable to the imputation and disallowance of Service Company charges and approximately $.626 million of which applies to the exclusion of MAWC salary expense for incentive compensation disallowance

Q. DO YOU AGREE WITH STAFF'S AND OPC'S PROPOSED ADJUSTMENTS TO THE COMPANY'S EMPLOYEE INCENTIVE COMPENSATION COSTS?

A. No, I do not, for several reasons. First, as I will explain below, it is inappropriate to adjust Support Services charges for incentive compensation paid to Service Company employees. Second, both with respect to the Support Services charges and to salary expense generally, all expenses, such as labor expense, should be examined for their overall reasonableness. Staff's and OPC's proposed adjustments ignore the evidence in this case that demonstrates the reasonableness of MAWC's overall test year expenses, both as to Support Services charges and as to the overall compensation cost level for the Company's employees who are eligible for incentive compensation.

Q. PLEASE EXPLAIN WHY IT IS INAPPROPRIATE FOR STAFF AND OPC TO REDUCE $1.663 MILLION OF SUPPORT SERVICES CHARGES FOR AN INCENTIVE COMPENSATION ADJUSTMENT.

A. As has been explained, the Service Company provides services to American Water's affiliates at cost and at prices that are more advantageous than could be obtained in the market place. The Service Company, for example, provides legal, finance, accounting, engineering, design, environmental, and customer services to MAWC and its regulated utility affiliates. The overall question that a regulator should ask regarding these services is whether they are reasonable when compared with services that the Company can obtain in the market. If, for example, MAWC were to obtain construction services, it would be highly inappropriate, for a regulator to inquire, not only about the level of salaries the contractor paid, but also as to the manner in which they were paid, i.e., how much was straight salary and how much was incentive compensation. The same is true as to the outside legal services or consulting services the Company solicits and pays for. The appropriate question is whether the services were competently provided and in line with market prices.

Q. IS THE TEST YOU JUST MENTIONED EQUALLY APPLICABLE TO SUPPORT SERVICES OBTAINED FROM AWWSC?

A. Yes, it is. AWWSC provides a wide spectrum of cost-effective, value-added services that enable MAWC to fulfill its public utility responsibilities in a more cost effective manner.

Q. HOW DO YOU KNOW THIS TO BE THE CASE?

A. Company's rebuttal witness, Mr. Patrick Baryenbruch, testifies on the value of Service Company costs and demonstrates that they are equal to or less than the costs we would have to pay for equivalent services. Under the circumstances where the Company is obtaining significant benefits from the Service Company and where the Service Company costs are just and reasonable, it would be inappropriate and unreasonable to look into the individual components of that reasonable cost and disallow components because they don't comport with Staff's or OPC's view of employment compensation. This would be directly comparable to disallowing a portion of an outside law firm or engineering firm's cost just because that firm paid incentive compensation to its junior lawyers or engineering associates. If the overall level of the costs is reasonable, there is no basis to "look behind the curtain."

Q. YOU MENTIONED MR. BARYENBRUCH'S TESTIMONY AS AN INDICATION OF THE REASONABLENESS OF THE SERVICE COMPANY'S COSTS. ARE THERE OTHER INDICATIONS OF THE REASONABLENESS OF SERVICE COMPANY COSTS?

A. Yes, the Service Company costs in this case are $1.307 million less than they were in the historic test year ended December 2014, and $1.554 million less than they were in the test year ended December 31 2010 (in the Company's last case). This reflects a considerable savings. Furthermore, this amount was not adjusted for the time value of money. If Service Company costs had simply increased at the rate of inflation from our last rate case, we would be looking at an even greater amount of savings versus the costs in our pro forma test year for AWWSC. Again, it is simply not appropriate to look behind these reasonable costs to pick apart the components. This is especially true where the Support Services costs have declined, thereby adding value to the services provided and enhancing the value of water service that we provide. If the Service Company is providing enhanced value, it is likely due, in no small part, to the way the employees are provided incentives to work smarter and better.

Q. YOU STATED THAT THE COMPANY'S OVERALL EMPLOYEE COMPENSATION COSTS ARE REASONABLE. IS THERE AN OBJECTIVE MEASUREMENT OF THE REASONABLENESS OF MAWC'S TEST YEAR INCENTIVE COMPENSATION COST LEVEL?

A. Yes, there is. The overall reasonableness of our employee compensation can be established through a comparison to what the labor market is paying generally for similar positions. In this regard, the reasonableness of MAWC's overall test year compensation cost level for the Company's employees eligible for incentive compensation is fully supported by a review and assessment conducted by Towers Watson, as explained in the Direct Testimony of Mr. Robert Mustich. Towers Watson is one of the world leaders in employment and compensation benchmarking and surveys. Towers Watson's conducted a comprehensive assessment of benchmark jobs that represent approximately 75% of the population of MAWC's employees as of March 18, 2015, who are eligible for incentive or at-risk compensation. (R Mustich DT, p. 6). The study clearly demonstrates that MAWC's overall test year compensation cost level for employees eligible is between 9-18% *below* the market median. (R Mustich DT, p. 6). In other words, even if the full level of incentive compensation is recognized, MAWC's compensation expense is still below the market median. Moreover, MAWC's test year compensation cost level for employees eligible for incentive compensation would be 19-28% *below* the market median if, as Staff and OPC recommend, MAWC employees did not receive incentive compensation. (R Mustich DT, p. 8). The Towers Watson study, therefore, demonstrates that MAWC's employees, who are eligible for incentive compensation, are below or at the low end of the range of market median for each element of compensation and overall compensation, even when incentive compensation is included. (R Mustich DT, p. 8).

Q. WHAT IS THE SIGNIFICANCE OF TOWERS WATSON'S ASSESSMENT OF MAWC'S COMPENSATION LEVELS?

A. When determining the reasonableness of compensation, the primary focus should be the reasonableness of the Company's overall compensation. In view of the fact that, even when incentive compensation is included, the compensation levels for many of MAWC's employees are below the mid-point of the compensation range for similar positions in the area, there is no evidence that the Company's employees are overpaid. It is the corporate philosophy of American Water that compensation is best set through a combination of base and incentive pay. This philosophy has been informed by experts in the compensation field who advise American Water management on compensation philosophy. Not only is incentive compensation used at American Water, but the Commission, itself, has recognized that incentive compensation is a hallmark of utility compensation plans. Employee compensation is simply an expense, just like every other expense incurred by the Company. If the expense is reasonably incurred and in line with what other industries are paying for a similar service, it is prudently incurred. It should, therefore, go without saying that, if the Company's overall compensation levels are reasonable and in line with or below the market, regardless of the combination of fixed and variable payments that the employees earn, then the Company's overall compensation expense must be reasonable. Given Mr. Mustich's testimony that MAWC's employee costs are lower than the market for such employees, irrespective of incentive compensation, it should be clear that our employee costs are reasonable. Indeed, without our incentive compensation, our costs would arguably be unreasonably below the applicable labor market and insufficient to retain our qualified workforce in the long run. Our incentive compensation plan is not an addition to reasonable compensation; our incentive compensation plan makes our compensation reasonable.

Q. WHAT ARE STAFF'S AND OPC'S REASONS FOR THEIR PROPOSED ADJUSTMENTS TO BOTH MAWC'S AND THE SERVICE COMPANY'S EMPLOYEE INCENTIVE COMPENSATION COSTS?

A. Both Staff and OPC recommended the removal of fifty-five percent (55%) or $1.447 million of the Company's AIP and all of the Company's LTIP because it is tied to financial performance. Both OPC and Staff allege they: (1) have historically recommended the removal of incentive compensation awards tied to company financial performance; (2) have found no connection between the financial results for which the incentives are awarded and any tangible benefits to MAWC's ratepayers; and, (3) that the Commission does not recognize incentive compensation awards tied to company financial performance. (Staff Report, p. 66-67; Hyneman DT, p. 13-15) Staff further relies on the Commission's Report and Order in the 1989 Southwestern Bell Case. Case No. TC-89-14 et al., *In re Southwestern Bell Telephone Company (SWB)*. Staff Report, p. 66.

Q. DOES IT APPEAR THAT STAFF IS IGNORING SEVERAL KEY FINDINGS IN THE SWB CASE THAT HAVE RELEVANCE HERE?

A. Yes, it appears so. For example, in the SWB case, much was made of the fact that Southwestern Bell had a goal to compensate employees at a level of at least 75 percentile level of those companies with which it competed for employees on a national level. The Commission, found, however, that Southwestern Bell was actually compensating its management employees at the 50% percentile level. Given that evidence, the Commission observed that the aspiration to compensate at the 75% level was irrelevant and the fact that compensation was at the 50% level dispelled claims that the compensation was unreasonable. In this case, it is clear that, even when including incentive compensation, MAWC's management employees are not even at the 50th percentile level. Under the SWB standard invoked by the Staff, MAWC's total compensation (base and incentive) is indisputably reasonable.

Q. IS IT FAIR TO RELY HERE, AS STAFF DOES FOR MAWC, ON THE SWB CASE FOR THE PRINCIPLE THAT "THE RESULTS OF THE PARENT CORPORATION, UNREGULATED SUBSIDIARIES, AND NON-MISSOURI PORTIONS OF SWB, ARE ONLY REMOTELY RELATED TO THE

QUALITY OF SERVICE OR THE PERFORMANCE OF SWB IN THE STATE OF MISSOURI?"

A. No, I do not believe it is fair to do so. For example, Staff extensively discusses the beneficial impact of American Water's Credit Ratings on MAWC (Staff Report, pp. 23–24). By having access to capital at the favorable rates available to American Water Capital Corp. ("AWCC"), MAWC customers directly benefit from the financial performance that permitted the recent credit upgrades to American Water. Staff also disregards MAWC's capital structure and has reflected an American Water Works parent company capital structure. (Staff Report, pp. 24–27); Under the circumstances, Staff's recommendation to remove fifty-five percent of the Company's AIP and all of the Company's LTIP on the basis that financial performance is "only remotely related to the quality of service or the performance of SWB in the state of Missouri" appears to be unsupportable

Q. IS THERE A CONNECTION BETWEEN THE FINANCIAL RESULTS THAT TRIGGER THE FUNDING OF INCENTIVE COMPENSATION AND TANGIBLE BENEFITS TO MAWC'S RATEPAYERS?

A. Yes, there is. Given the capital intensive nature of water and wastewater operations, it is appropriate to consider the impact of financial performance on the availability of internally-generated funds and maintaining credit ratings at a level necessary to access capital at reasonable rates. The use of internal capital or low-cost debt mitigates the Company's financing costs for its substantial ongoing investment in new and replacement facilities. In addition, attention to cost controls is determinative to a considerable extent in achieving financial goals and the resulting positive impact on financial metrics can help the Company mitigate its requested rate increase. Consequently, when financial performance is achieved through efficiency, as is the case for MAWC, the interests of customers and shareholders are aligned.

Q. STAFF'S AND OPC'S RECOMMENDATIONS ASSUME THAT MAWC'S CUSTOMERS OBTAIN NO BENEFIT FROM MAWC'S LONG-TERM INCENTIVE COMPENSATION PLAN. IS THAT ASSUMPTION CORRECT?

A. No, it is not. Both Staff and OPC overlook the principal benefit customers obtain from the Company's LTIP, which is to reduce attrition and retain key employees. Long-term stock-based incentive compensation plans are used by utilities and other companies to reduce the costs and the negative service impacts of excessive rates of attrition among key employees. Long- term stock-based compensation plans, such as American Water's LTIP, achieve that objective at lower cost to customers than simply increasing the base (cash) compensation of those employees.

LTIP vesting occurs in three equal installments over a prospective three-year period, hence the basis for their inclusion in a "long-term" incentive plan. In addition to tying the value an eligible employee can realize to American Water's performance, stock options produce a significant benefit by creating incentives for highly qualified employees to remain with the Company in order to realize the vesting of their option awards. That, in fact, is a major benefit to customers and, through phased vesting of stock options, that benefit can be delivered efficiently and at lower cost than simply increasing cash compensation. The benefit to employee retention created by stock option grants is well-known and well-accepted in both the utility industry and broader industry groups. Employee attrition at the level of those employees who qualify for stock-based compensation is a significant issue and when it occurs it can, and frequently does; increase costs and negatively impact a utility company's ability to efficiently and effectively deliver service to customers.

Q. WHAT OTHER BENEFITS DO MAWC'S CUSTOMERS OBTAIN FROM MAWC'S LONG-TERM INCENTIVE COMPENSATION PLAN?

A. Staff further overlooks the fact that a material portion of the Company's and AWWSC's LTIP compensation is tied to achieving internal performance goals, including operational efficiency improvements. And, again, contrary to assumptions underlying Staff's and OPC's testimony, satisfying key financial objectives provides significant benefits to customers, not just to shareholders of American Water. Satisfying key financial metrics will enable MAWC's financing affiliate, AWCC, which obtains debt financing on behalf of MAWC and its utility affiliates, to continue to obtain access to capital at reasonable rates. Satisfying those financial metrics also produces internally generated funds as an additional low-cost source of capital. Strong financial performance can also reduce the amount of base rate increases.

Q. DO STAFF AND OPC OVERLOOK ANY OTHER TANGIBLE BENEFIT OF THE INCENTIVE COMPENSATION PLAN?

A. Yes. Both Staff and OPC overlook the tangible benefits delivered by tying some portion of our employees' compensation to achieving results, including financial performance. MAWC's O&M expenses in the test year ending December 31, 2014, are about $7.1 million less than they were in 2010 (offset by $3.6M of new O&M costs related to acquisitions since the last rate case), which was the last general rate case test year. (Kartman DT, p. 11_) This improved O&M efficiency is the result of having a workforce that is incented to find smarter, more efficient ways to deliver water services. On the basis of inflation alone, our O&M expense should have been higher, all other things being equal. Instead, our O&M expense is lower. This is the direct result of our employees working smarter and harder; doing more with less. This is the very definition of productivity and efficiency gains. Our employees should be rewarded for these achievements which directly reduce costs for our customers. The tie between the two – providing incentives to our employees to work harder and smarter and the resulting benefits to customers is self-evident.

Q. OPC WITNESS HYNEMAN CLAIMS THAT THE COST OF STOCK-BASED COMPENSATION SHOULD NOT BE INCLUDED AS AN OPERATING EXPENSE FOR RATEMAKING PURPOSES BECAUSE IT IS NOT A CASH EXPENSE AND THERE IS NO WAY TO ACCURATELY MEASURE THE

DOLLAR AMOUNT OF ACTUAL COMPENSATION REFLECTED IN STOCK COMPENSATION. PLEASE RESPOND.

A. The Company is required to expense stock and stock options on its financial statements under Generally Accepted Accounting Principles, specifically, Accounting Standards Codification 718. Furthermore, it is not a valid objection to rate recovery that an expense that must be recognized for accounting and financial reporting purposes does not require a cash outlay. If that were the case, utilities would not be permitted to recover annual depreciation accruals, which are also "non-cash" expenses. The Commission should recognize all of the reasonable costs of providing utility service that directly bear on its utility operating income. Stock-based compensation, just like annual depreciation accruals, meets that criterion.

Q. DID STAFF ALSO RECOMMEND REMOVAL OF FIFTEEN PERCENT, OR $217,048, OF THE COMPANY'S INCENTIVE COMPENSATION COSTS RELATING TO THE CUSTOMER SERVICE METRICS?

A. Yes. Staff also recommended disallowing any incentive compensation amounts relating to the customer service and quality surveys that make up 15% of the Company's and AWWSC's incentive compensation because it questioned MAWC's sample size. Staff Report, p. 67. The Company's sample sizes are sufficient to achieve a 95% confidence level, a 0.5 standard deviation and a margin of error of +/- 5%. A 95% confidence level is more than sufficient to assure Staff, and this Commission, that the sample sizes are representative and the customer service and quality of service information is reliable.

Q. PLEASE SUMMARIZE WHY IT IS FAIR AND APPROPRIATE THAT THE COSTS OF THE COMPANY'S INCENTIVE COMPENSATION BE INCLUDED IN RATES.

A. The Company's incentive compensation plans contain tangible goals that are designed to do several things. First, they measure and reward employees for performance based on delivering clean, safe, reliable and affordable water service and providing good customer service when doing so. The operational components measure performance that can most directly influence customer satisfaction, health and safety, environmental performance, and operational efficiency. Customers derive a direct benefit from our focus on these key measures in the plan. Further, well-grounded financial measures keep the organization focused on improved performance at all levels of the organization, particularly in increasing efficiency, decreasing waste, and boosting overall productivity.

By rewarding superior performance in every function, all of these aspects of overall performance provide direct and tangible benefits to our customers. MAWC's incentive compensation is not only a means of focusing its employees on the organization's goals, but also a means of measuring attainment of those goals.

To the extent that a financially healthy utility focused on efficiency and customer satisfaction is able to attract the capital investments necessary to provide safe and reliable service and to maintain the technological expertise necessary to operate the company and comply with increasing water quality standards. A financially healthy utility is very much in the interest of MAWC's customers, as it helps ensure MAWC the ability to provide safe and reliable service at the lowest reasonable cost.[1]

Most important, the evidence in this case demonstrates that, even with incentive payments, our overall non-bargaining unit compensation is below the 50th percentile ranking. Consequently, all of our incentive performance is necessary to attract and retain employees. Furthermore, the LTIP component is vital to retain employees who might otherwise seek higher compensation elsewhere but who are provided an incentive to remain with the Company.

[1] MAWC's incentive compensation plans meet the criteria established in the Commission's Report and Order for *In re Union Electric Co.*, Case No. EC-87-114: "…an acceptable management performance plan should contain goals that improve existing performance, and benefits of the plan should be ascertainable and reasonably related to the plan." 29 Mo. P.S.C. (N.S.) 313, 325 (1987).

The retention of a highly trained and demonstrably effective and productive workforce is, without question, in the best interest of our customers.

Again, it is important for the Commission to view compensation as a whole. As MAWC witness Mustich explains, MAWC's total compensation today (base plus incentive pay) results in employee compensation levels that are either at, or below the market median. In other words, MAWC's employees are not overcompensated relative to their peers, even with the inclusion of incentive pay. So, it is not appropriate to disallow a portion of their compensation. Further, where, as I've explained, both the financial performance and the individual metrics provide benefits to our customers, and the resulting overall compensation levels are also demonstrably reasonable, it would not be just or reasonable to disallow a portion of those expenses. To do so would both result in a labor expense that is understated, and deprive MAWC and its customers of an important tool that has produced clear and proven gains in productivity and efficiency improvements. Moreover, as Mr. Baryenbruch confirms, the Service Company charges are demonstrably reasonable and are below the levels of the past. Accordingly, it is inappropriate to reduce them, whether directly or through the artifice of a reduction for incentive compensation.

IV. <u>BUSINESS TRANSFORMATION INVESTMENT AND RELATED ANNUAL DEPRECIATION</u>

Q. HAS THE COMPANY PREVIOUSLY DESCRIBED THE BUSINESS TRANSFORMATION PROGRAM AND WHY IT WAS UNDERTAKEN?

A. Yes. MAWC Witness Gary VerDouw provided a detailed description of the BT program at pages 12 - 22 of his direct testimony. In summary, the BT initiative included the development and system-wide deployment of new, integrated information technology systems and the process of aligning business practices to realize the full value and functionality of those systems.

The Company undertook the BT initiative because its existing technology systems had become antiquated and reached the end of their lives. Additionally, the existing technology consisted of several "stand-alone" systems that were designed for specific departments or functions and, therefore, isolated information within separate, non-integrated "silos." An integrated, enterprise approach was needed. Finally, current service needs and customers' expectations as to the availability and timeliness of billing and service-related information required added functionality that the existing systems could not deliver.

Q. HAS MAWC ALSO PREVIOUSLY DESCRIBED THE PRINCIPAL PROJECTS THAT COMPRISE THE BT PROGRAM?

A. Yes, Mr. VerDouw also described the projects within the BT program in his direct testimony (pages 12 - 13). In summary, three projects comprised the core of the BT program:

- Enterprise Resource Planning ("ERP") is used to manage the human resource, finance and accounting functions and the supply chain process (how goods and services are procured).
- Enterprise Asset Management ("EAM") addresses the management of utility assets over their entire lifecycle, from design, construction and commissioning through operation and maintenance and, ultimately, through decommissioning (retirement) and replacement. It is also used to manage field work for customer services, such as initiating service, conducting leak inspections and responding to other customer service calls, and to manage the full range of work performed on water transmission and distribution pipelines and wastewater collection systems.
- The Customer Information System ("CIS") addresses utility customer billing requirements and the management of customer-specific data, including applicable rates, water consumption, charges for utility service, and meter information. It is also used to manage interactions between the Company and its customers by, for example, giving customer service

representatives access to up-to-date billing information to address customer inquiries and complaints.

All of the components of the BT initiative were designed, developed and implemented specifically to meet the needs of the water and wastewater utility subsidiaries of American Water Works Company, Inc. ("American Water"). In fact, the information technology and enterprise software used by a number of other utility companies was carefully considered before American Water decided to proceed with the concept and design embodied in the BT initiative.

Q. WHAT BT PROGRAM COSTS HAVE BEEN INCURRED BY MAWC?

A. Of the $326.2 million system-wide BT program costs, approximately $46.5 million was allocated to MAWC, capitalized by the Company, and included in its rate base in this case. The remainder consists of costs for plant leased to the Service Company. Those costs are not included in MAWC's rate base claim and MAWC pays only its allocable share of associated lease expenses. As Mr. VerDouw explained in his direct testimony (p. 23), MAWC's share of BT costs is based on a 14.24% allocation factor, which was determined in accordance with the Service Agreement between MAWC and the Service Company. As explained in Mr. VerDouw's direct testimony, approximately $19.260 million was incurred with respect to the BT initiative from 2009 through the end of 2011, which was included in the Company's claims in prior base rate cases. Additional costs of $17.062 million and $9.146 million were incurred in 2012 and 2013, and the Company has claimed $1.003 million in BT costs incurred in 2014.

Q. HAVE ANY PARTIES PROPOSED ADJUSTMENTS TO THE COMPANY'S CLAIMS FOR BT COSTS IN THIS CASE?

A. Yes. OPC witness Smith has proposed adjustments to the Company's BT-related claims.

Q. PLEASE ADDRESS MR. SMITH'S ALLEGATION OF BT "COST OVERRUNS."

A. Mr. Smith contends that the total cost of the BT program ($326.2 million) exceeds the initial estimate of the cost of the program ($280 million) by $46.2 million, which he attributes to "cost overruns." Based on that assumption, Mr. Smith proposes that 14.24% of $46.2 million, or $6.579 million of the BT costs borne by MAWC, be disallowed and borne by American Water's shareholders, unless MAWC can satisfactorily explain the reasons for the $46.2 million difference.

Q. IS IT CORRECT TO ATTRIBUTE THE DIFFERENCE BETWEEN $280 MILLION AND $320 MILLION TO "COST OVERRUNS"?

A. No, it isn’t. Preliminarily, I would note that Mr. Smith quotes at length from portions of American Water's Securities and Exchange Commission ("SEC") Forms 10-K that, as required, set forth various "risk factors" associated with owning shares of American Water. Specifically, he quotes a portion of the "risk factors" section of Form 10-K that explains there was a possibility of "increased costs" associated with the BT initiative and states that the then-current estimate of "BT expenditures" "could total as much as $280 million." Mr. Smith does not quote anything from American Water's 10-Ks or any other SEC filing suggesting that there was an actual "cost overrun" in BT because, in fact, there was none.

Moreover, the estimates provided in American Water's 10-Ks were as, as noted, of "expenditures." As such, those estimates did not include any provision for an Allowance for Funds Used During Construction ("AFUDC"). AFUDC consists of the cost of funds (mostly interest) used to finance work in progress until the associated plant is actually placed in service. AFUDC is different from a direct "expenditure." It represents financing costs that are capitalized and added to the cost of a project. AFUDC represents approximately one-half of the $46.2 million difference between what Mr. Smith alleges was the original estimate of BT costs ($280 million) and the final incurred costs ($326.2 million).

Q. WHAT IS THE CAUSE OF THE REMAINDER OF THE $46.2 MILLION DIFFERENCE BETWEEN $280 MILLION AND $326.2 MILLION'?

A. The remainder of the $46.2 million difference is attributable to new work that was never within the scope of the original $280 million estimate. Specifically, the remainder of the $46.2 million difference consists, in large part, of costs to procure, develop and implement SAP Governance Risk and Compliance ("GRC") modules to support access controls and process controls that arc needed to comply with the Sarbanes Oxley Act ("SOX"). SOX compliance costs were not part of the original $280 million estimate, but are a necessary cost of regulatory compliance. Thus, it is simply not correct to attribute any portion of the $46.2 million difference between American Water's 2009 estimate of $280 million and the final cost of $320.2 million to a "cost overrun."

Q. DOES OPC RAISE AFFILIATE TRANSACTIONS CONCERNS WITH BT COST ALLOCATIONS AMONG MAWC AND ITS AFFILIATES?

A. Yes. There was an incorrect discovery response provided to OPC that inadvertently led OPC to think that the BT assets were designed for both regulated and non-regulated companies use. MAWC apologizes for this error and has supplemented/corrected its response.

Q. WERE THE BT ASSETS DESIGNED FOR USE BY MAWC'S MARKET-BASED AFFILIATES?

A. No, they were not. As I testified, the BT program was designed to serve the needs of the regulated utility subsidiaries. In certain, limited circumstances, the unregulated subsidiaries of AWW have been permitted to use some BT applications. Where this has been permitted, the unregulated affiliates are charged the full cost of using the technology, as I describe below.

Q. OPC WITNESS SMITH SUGGESTS THAT BT COSTS SHOULD BE SHARED AMONG AMERICAN WATER REGULATED UTILITIES AND NON-REGULATED MARKET-BASED BUSINESSES AND MAWC'S PARENT COMPANY, AMERICAN WATER WORKS COMPANY, INC. DO YOU AGREE?

A. No, I do not. First, BT is a core software platform only for the utility subsidiaries of American Water, for which it was specifically designed and developed. This is evident from the nature of BT programs described above and in Mr. VerDouw's direct testimony, which are tailored to meet the needs of regulated utility operations. Moreover, American Water Enterprises, the subsidiary of American Water that owns and runs its non-utility business enterprises, has its own separate finance, accounting, asset management, billing and strategic management software systems, which were designed and developed to address the specific requirements of those non-utility businesses.

Second, to the extent that a portion of the ERP program, namely, a part of the human resources package that is designated "Success Factors" by the vendor and internally branded by American Water as "*my*Career Solutions," is used by American Water Enterprises. An allocable portion of the cost of that package has already been removed from the BT costs. The cost of developing *my*Career Solutions was approximately $2.1 million when it was put into service in August 2012. Approximately 12% (an allocation based on relative employee counts) of that cost was removed and directly charged to American Water Enterprises, and only the remaining amount was allocated to American Water's utility subsidiaries. The same allocation factor is being used to assign to American Water Enterprises the on-going fees and maintenance costs for myCareer Solutions.

SAP Customer Information System (CIS) - One of the Company's market-based affiliates has been directly billed approximately $1,116,783 by an outside vendor (Accenture) to modify SAP CIS to enable the Company's market–based affiliate to continue the placement of its protection plan services charge on four (4) of the regulated utility companies' billing statements (where approved by state utility commissions). A portion of the ongoing maintenance costs for SAP's Customer Relationship and Billing (CR&B) system are allocated to the Company's market–based affiliates based on the proportionate share of the market-based companies' customer count included on the SAP CR&B system (approximately 10%) to regulated utility companies' customer count (approximately 90%).

Third, Mr. Smith is wrong to contend that his proposed adjustment is also needed to reflect benefits obtained by American Water from the BT program. American Water is a holding company, and the parent of MAWC, other utility subsidiaries and certain non-utility business enterprises. As such, its only material asset is the stock it holds in its subsidiaries. Additionally, American Water has only three employees. Any benefits of BT to American Water are realized derivatively from the benefits that the program provides, through the Service Company, directly to American Water's utility and non-utility subsidiaries. If the costs of BT are properly allocated among those subsidiaries - as they are by the allocation that underlies the costs claimed by MAWC - then there is no valid basis to consider a separate allocation to American Water. Because any benefits flowing to American Water from BT consist of a consolidation of the benefits already accounted for in the subsidiaries' allocations, there is nothing further to be allocated to American Water.

Q. IS THERE IS A NEED FOR MAWC TO BE SUBJECT TO AFFILIATE TRANSACTION RULES SIMILAR TO THE RULES THE COMMISSION HAS CREATED FOR ELECTRIC AND GAS UTILITIES IN MISSOURI?

A. No, I do not believe such rules are necessary. In many cases the gas and electric companies have affiliates that compete with other, unregulated entities in the marketplace. We have no such similar situation. If one is speaking of the Service Company charges, they are fully audited and auditable by the Commission Staff and OPC. If there is a cogent reason why such rules should be applied to MAWC, I am unaware of it and it has not been presented here. Certainly no case with respect to the BT costs has been made out for such rules.

Q. PURSUANT TO APPENDIX B OF THE STIPULATION THAT WAS APPROVED IN COMMISSION CASE NO. WR-2011-0337, THE BT PROGRAM ASSETS IN ACCOUNT NO. 391.4 - BT INITIAL INVESTMENT WERE ASSIGNED A DEPRECIATION RATE OF 5% WITH DEPRECIABLE LIFE OF 20 YEARS. WHY DOES OPC WITNESS SMITH PROPOSE THAT BT PROGRAM ASSETS CONTINUE TO BE DEPRECIATED USING THE INITIAL INVESTMENT DEPRECIATION RATE OF 5% OVER 20 YEARS?

A. OPC witness Smith claims that MAWC has not provided any evidence that the BT systems will have no use or value after 10 years and has not demonstrated that all of the BT systems will be retired from service in 10 years.

Q. IS, OR SHOULD, PROOF OF "NO USE OR VALUE" OR "RETIRED FROM SERVICE" BE THE APPLICABLE STANDARD FOR DETERMINING THE APPROPRIATE DEPRECIATION RATE OF AN ASSET?

A. No. The value of an asset is determined by its useful life. It is typical to depreciate IT assets over a relatively short period as compared to fixed assets such as pipes and values because of the rapid technological changes that render such assets obsolete in relatively short time periods. Of course, the IT systems might have some value at the expiration of 10 years, just as some pipe with a 60 year life may still be rendering service. That, however, is irrelevant to the issue of the appropriate useful life to assign to an asset.

Q. PLEASE EXPLAIN WHY THE COMPANY BELIEVES THAT THE BT PROGRAM ASSETS SHOULD BE ASSIGNED A DEPRECIATION RATE OF 10% IN THIS CASE?

A. As noted in the direct testimony of Gary VerDouw, the Company's ERP system was deployed in August 2012, and the Company's CIS and EAM systems were deployed to MAWC in May 2013. By the time this case is completed, these information technology systems will have already been in service at MAWC for over 4 and 3 years respectively.

In order to maintain system stability and to insure stable and robust processes, the Company plans and implements SAP upgrades yearly, which incrementally change our system landscape by updating or adding functionality to the system. In addition, we have two major SAP upgrades planned within the next 5 years (HANA and S4 HANA) that will fundamentally change our SAP landscape from a technology and functional perspective. SAP recently announced that will extend mainstream maintenance on its Business Suite (and Business Suite on HANA) applications an additional five years, until 2025, responding to customer requests for stronger commitment to on-premise applications and more time to move to the cloud. It is reasonable to anticipate that the current SAP application will be at end of it useful life 2025.

V. RATE CASE EXPENSE

Q. MAWC WITNESS TINSLEY DISCUSSES THE RECOVERY METHODOLOGY ASSOCIATED WITH DEFERRED RATE CASE EXPENSE IN HER REBUTTAL TESTIMONY. ARE THERE ANY OTHER ISSUES ASSOCIATED WITH DEFERRED RATE CASE EXPENSE?

A. Perhaps. Prior to discussing how to recover rate case expense, there is the base question of what expenses should be considered for recovery.

Q. WHAT TYPES OF DEFERRED RATE CASE EXPENSE WILL MAWC INCUR IN THIS CASE?

A. MAWC will incur rate case expense associated with outside attorneys, outside consultants, and direct charges from the American Water Works Service Company, Inc. (Service Company) associated with the rate case.

Q. HAS STAFF INCLUDED THESE CATEGORIES OF COSTS IN ITS DIRECT CASE?

A. To some extent, yes. Staff has included the actual charges related to outside attorneys and consultants through September 2015. Staff has stated that it intends to update these expenses through the filing of reply briefs in April 2016.

Q. HOW HAS STAFF TREATED THE SERVICE COMPANY CHARGES?

A. Staff has provided a category for those charges, but has not yet included them in its calculation.

Q. DID STAFF PROVIDE ANY NARRATIVE IN ITS REPORT CONCERNING THIS ISSUE?

A. No.

Q. WHAT IS THE NATURE OF THE SERVICE COMPANY CHARGES?

A. Because rate cases are somewhat cyclical, the Service Company employs several persons that work on rate cases in multiple states. By doing this, individual operating companies avoid the need to employ such persons every year, even though rate cases will not take place every year.

Q. HOW IS MAWC CHARGED FOR THE WORK OF THESE SERVICE COMPANY EMPLOYEES?

A. MAWC receives direct charges for these rate case services in accordance with a contract that is a part of the Company's Cost Allocation Manual.

Q. HOW MANY EMPLOYEES HAVE CHARGED TIME TO MAWC DEFERRED EXPENSE FOR WORK RELATED TO THIS RATE CASE?

A. The number of employees that have charged time to MAWC for work related to this rate case is twenty-one -- twenty employees from the Rates and Regulatory Support group and one employee from the Financial Planning and Analysis group.

Q. DO THESE EMPLOYEES ALSO CHARGE WORK TO OTHER CASES?

A. Yes.

Q. DO YOU HAVE A SCHEDULE THAT WOULD SHOW HOW THESE PERSONS' TIME HAS BEEN CHARGED TO DEFERRED EXPENSE DURING THE PERIOD OF TIME THEY HAVE WORKED ON THIS CASE?

A. Yes. Attached as Rebuttal Schedule DJP-3 is a spreadsheet that shows on a monthly basis, for all months in which these employees' labor costs were allocated to MAWC for this rate case, the time (in hours) for each such employee and the amount charged.

Q. WHAT EXPENSES MAKE UP THE AMOUNTS THAT ARE CHARGED AS DEFERRED EXPENSE TO MAWC?

A. Expenses charged to MAWC rate case expense are labor and labor related expenses, printing and postage for customer notices, travel, outside consultants and attorneys, and overhead.

Q. WHAT ITEMS OF DEFERRED EXPENSE ARE INCLUDED IN "OVERHEAD?"

A. The items of deferred expense included in overhead are found in Rebuttal Schedule DJP-4 HC.

Q. ARE ANY OF THE DEFERRED EXPENSES DIRECT CHARGED TO MAWC AS RATE CASE EXPENSE INCLUDED IN THE ANNUAL EXPENSE ALLOCATED TO MAWC BY THE SERVICE COMPANY?

A. No.

Q. HOW IS THIS PREVENTED?

A. The billing system does not allow for direct charges to be allocated.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

DONALD J. PETRY

In May 1981, Mr. Petry was awarded a Bachelor of Science Degree in Accounting from Manchester College. In May 1995, he completed a Masters of Business Administration from Tiffin University. He attended the NARUC Utility Rate School sponsored by the National Association of Regulatory Utility Commissioners in September, 2005.

Mr. Petry began his career in 1981 with American Water Works Service Co., Inc. as an Internal Auditor. As an Internal Auditor, he conducted financial and procedural audits of American System operating companies. In 1983, he was promoted to Business Manager of Ohio-American Water Company, Tiffin District. His responsibilities included preparation and management of the annual budget, cash forecasting, and customer service (customer billing, payments and inquiries, meter readers, and field service representatives) for the District. In 1994, he was promoted to Customer Service Superintendent. Responsibilities there included customer billing, cash collections, and the call center for all Ohio-American Districts and supervision of the meter readers and field service representatives of the Marion District.

In January 2001, Mr. Petry was promoted to Manager – Operations and Performance of the national Customer Service Center (CSC) for American Water Works Service Company, Inc. His responsibilities included preparation of the CSC budget, analysis and reporting of the CSC performance, scheduling of the workforce, and operation of the facility. In December, 2002, he was promoted to Manager – Billing & Collections for the CSC where he was responsible for the processing of all billing and collection activities. In November, 2004, he transferred to Manager – Operations for the CSC to become responsible for the budgeting, workforce management, and facilities for the CSC.

In September, 2005, Mr. Petry was appointed Financial Analyst III, Rates & Regulations where he prepared and presented rate applications and supporting documents and executed the implementation of rate orders. In June of 2011, he was promoted to Manager of Rates Support for the Service Company's Eastern Division where he was responsible for rate case preparation and rate order implementation for a nine state area. In November of 2011, he was named Manager of Rates Support for the Central Division, where he was responsible for rate case preparation, regulatory filings, and rate implementation for the seven regulated subsidiaries that comprise the Central Division of American Water Works Company. In 2014, he was appointed to his current position as Manager of Rates and Regulatory Support and provides regulatory support for all of American Water's regulated states.

Mr. Petry's main responsibilities in his current position involve providing the following services to American Water utility subsidiaries:

1) Preparing and presenting regulatory and rate increase applications and supporting documents and exhibits as prescribed by management policies, guidelines and regulatory commission requirements;
2) Preparing rate analyses and studies to evaluate the effect of proposed rates on the revenues, rate of return and tariff structures;
3) Overseeing the preparation of revenue and capital requirements budgets and analyses;
4) Providing support for financial analysis of proposed acquisitions and expansion of service

territory, including preparation of applicable regulatory commission filings.

Mr. Petry has prepared and presented testimony before the Missouri Public Service Commission, Public Utilities Commission of Ohio, and Iowa Utilities Board, the Tennessee Regulatory Authority and the Kentucky Public Service Commission.

Missouri-American Water

Rebuttal Schedule DJP-2

	2012	2013	2014	2015
Labor	$10,039,223	$10,769,707	$11,245,020	$10,314,060
401K	209,691	242,520	276,263	259,413
ESPP	29,837	35,065	32,445	33,403
Group Insurance	707,343	1,569,774	1,547,101	1,412,658
Payroll Taxes	394,218	960,356	1,004,876	934,439
	$11,380,312	$13,577,422	$14,105,706	$12,953,973