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Valuation
Witness: M.J. Hamilton
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Sponsoring Party: Missouri-American Water Company
Case No.: WR-2000-281
SR-2000-282
Date: May 25, 2000

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2000-281

CASE NO. SR-2000-282

SURREBUTTAL TESTIMONY

OF

MICHAEL J. HAMILTON, CPA

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

FILED

MAY 25 2000

**Missouri Public
Service Commission**

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)	CASE NO. WR-2000-281
FOR WATER AND SEWER SERVICE IN THE)	CASE NO. SR-2000-282
MISSOURI SERVICE AREA OF THE COMPANY)	

County of New York


State of New York

AFFIDAVIT OF MICHAEL J. HAMILTON, CPA

Michael J. Hamilton, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of Michael J. Hamilton, CPA", 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.


Michael J. Hamilton, CPA

SUBSCRIBED and sworn to
before me this 24th day of May 2000.


Mary C. Noonan
Notary Public

MARY C. NOONAN
Notary Public, State of New York
No. 31-4875529
Qualified in New York County
Commission Expires Nov. 3, 2000

SURREBUTTAL TESTIMONY
MICHAEL J. HAMILTON
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2000-281
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WITNESS INTRODUCTION

Q. Please state your name and business address.

A. My name is Michael J. Hamilton, and my business address is 1301 Avenue of the Americas, New York, NY 10036.

Q. By whom are you employed?

A. I am a partner in the international accounting firm of PricewaterhouseCoopers LLP ("PricewaterhouseCoopers") where I serve as the North American Theatre Leader-Utilities.

Q. Please briefly state your educational background and business experience.

A. I received a degree in accounting from St. Francis College in Loretto, Pennsylvania, and I am a Certified Public Accountant ("CPA"), licensed in Illinois, Connecticut, New York, New Jersey, Pennsylvania and the District of Columbia.

I have worked full-time in the utility industry for more than 25 years. In addition to my work as an independent public accountant and consultant at PricewaterhouseCoopers and in the regulatory practice of another accounting firm, I have 7-1/2 years of direct utility industry employment experience working for Potomac Electric Power Company ("PEPCO"). While at PEPCO, I was responsible, at one time or another, for the activities of the company related to financial reporting, general accounting, fuel accounting, revenue requirements, financial forecasting and planning and property and plant accounting.

Q. Please describe the firm of PricewaterhouseCoopers and your responsibilities there.

A. PricewaterhouseCoopers is a global network of firms practicing in more than 150 countries and territories. The U.S. firm consists of approximately 115 offices and 37,000 employees. PricewaterhouseCoopers professionals work together to provide accounting, auditing, tax and technology consulting, as well as litigation support and

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1 business advisory services. The U.S. firm has an extensive utility clientele for whom
2 we provide the aforementioned services. In addition, with respect specifically to our
3 utility clients, we provide economic and rate case strategy consulting, depreciation
4 studies, financial modeling, securities registration services, and bankruptcy and
5 restructuring services.

6
7 As the North American Theatre Leader-Utilities, I am ultimately responsible for the
8 scope and quality of all of the services my firm provides to the utility industry in the
9 United States. My personal practice includes corporate finance assignments (e.g.,
10 mergers and acquisitions, restructurings, bankruptcy work, etc.), and a wide range of
11 testimony and rate case strategy assignments. In my role as the utilities theatre leader,
12 I am consulted on numerous accounting issues for our clients and am responsible for
13 coordinating the consistent application of accounting principles on all of our utility
14 clients.

15
16 I also have partner responsibilities for several audit clients, including American Water
17 Works Company, Inc., which is the sole owner of Missouri-American Water Company
18 ("Missouri-American") common equity.

19
20 **Q. Have you presented testimony previously?**

21 A. Yes. I have testified in rate proceedings on financial matters before the Federal Energy
22 Regulatory Commission ("FERC"), before a number of state regulatory commissions,
23 and in Bankruptcy Court.

24
25 **PURPOSE**

26 **Q. What is the purpose of your testimony in this proceeding?**

27 A. I have reviewed the rebuttal testimony of certain non-company witnesses in this
28 proceeding and will address the accounting that would result from recommendations
29 they made concerning phase-in plans and plant disallowances (also referred to as

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1 “prudence” and “used and useful” disallowances). Specifically, I will explain that
2 generally accepted accounting standards prohibit Missouri-American from recording a
3 regulatory asset for the revenue deferrals that would result from the recommended
4 phase-in plans and would require the immediate write-off of any amount of plant
5 disallowed from rate base.

ACCOUNTING IMPACTS

6
7
8 **Q. As a CPA, what other involvement have you had with issues relating to phase-in**
9 **plans and cost disallowances?**

10 A. Independent public accountants issue opinions on financial statements as to the fairness
11 of the presentation, including the appropriate accounting for commission orders related
12 to phase-in plans and plant disallowances. These opinions are issued in accordance
13 with rules published by the Securities and Exchange Commission and professional
14 standards promulgated by the Financial Accounting Standards Board and American
15 Institute of Certified Public Accountants.

16
17 **Q. Mr. Hamilton, specifically, whose rebuttal testimony did you review in this**
18 **proceeding?**

19 A. I reviewed the testimony of: Russell W. Trippensee, testifying on behalf of Office of
20 the Public Counsel; James A. Busch, testifying on behalf of Office of the Public
21 Counsel; Stephen M. Rackers, testifying on behalf of the Missouri Public Service
22 Commission (“MoPSC” or “Missouri Commission”) staff; and James A. Merciel, Jr.,
23 testifying on behalf of the MoPSC staff.

24
25 **Q. What are the parties identified above proposing in terms of rate design for**
26 **Missouri-American?**

27 A. The parties that I have identified above are proposing mechanisms to moderate
28 Missouri-American’s initial rate increase requested to include its full investment in the
29 St. Joseph water treatment plant and related facilities (“the St. Joseph Plant”) in rate
30 base.

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1
2 Mr. Trippensee testifies that he believes that a portion of the cost of the St. Joseph Plant
3 was not prudently incurred. He further testifies that he believes only a portion of the St.
4 Joseph Plant is used and useful. He recommends that the amount of St. Joseph Plant
5 costs included in rate base be limited to the used and useful percentage of the St. Joseph
6 Plant's capacity multiplied by the amount of prudently incurred costs. He also testifies
7 that he believes Missouri-American's revenue requirement should be phased-in over
8 three to six year periods for various districts.

9
10 Mr. Busch supports Mr. Trippensee's testimony in recommending a phase-in of rates
11 on a district-by-district basis and allocates such rates to customer classes.

12
13 Mr. Rackers recommends a five-year phase-in of the revenue requirement associated
14 with the return and depreciation on the St. Joseph Plant.

15
16 Mr. Merciel testifies that certain components of the new St. Joseph Plant are of excess
17 capacity and that the value of those components should not be included in rate base.

18
19 **Q. What are the common characteristics of all of these recommendations?**

20 A. All of these recommendations have the effect of either delaying (phase-in) or denying
21 (disallowance) full capital recognition in an attempt to moderate the initial rate increase
22 necessary to include the St. Joseph Plant in rate base. As a result, if a phase-in or plant
23 disallowance adjustment is adopted by the Missouri Commission, there will be
24 financial accounting issues to be dealt with in the financial statements of Missouri-
25 American.

26
27 **Q. What financial effects related to the phase-in plan and plant disallowance**
28 **proposals would have to be recorded in the financial statements of Missouri-**
29 **American?**

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1 A. If the Missouri Commission were to accept any of these proposals, there would be an
2 immediate write-off required of the deferrals created through a phase-in plan and/or the
3 loss arising from the disallowance of rate base accomplished through a plant
4 disallowance adjustment. In other words, Missouri-American would be required to
5 recognize a loss immediately in its financial statements of the entire amount of any
6 prudence or used and useful plant disallowance. A phase-in would require the
7 Company to recognize a loss in any period full recovery is not provided for. Thus, the
8 economic effect of adopting either a phase-in plan or a plant disallowance adjustment
9 would be written off in the financial statements of Missouri-American in the period that
10 the Commission order was issued.

11
12 **Q. Are the effects of rate regulation required to be recorded and reported in the**
13 **financial statements of Missouri-American Water Company?**

14 A. Yes. Missouri-American is a public utility, regulated by the MoPSC, which maintains
15 its accounting policies and records in accordance with generally accepted accounting
16 principles and accounting procedures prescribed by the MoPSC.

17
18 Missouri-American is subject to the accounting requirements of Statement of Financial
19 Accounting Standards No. 71 ("FAS 71"), "Accounting for the Effects of Certain
20 Types of Regulation." The requirements of FAS 71 apply to the general purpose
21 external financial statements of an enterprise that has regulated operations that meet all
22 of the following criteria:

- 23
24 a. The enterprise's rates for regulated services or products provided to its
25 customers are established by or are subject to approval by an independent,
26 third-party regulator or by its own governing board empowered by statute or
27 contract to establish rates that bind customers.

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b. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.

c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

Missouri-American meets the requirements of FAS 71, as defined above. Accordingly, the effect of regulation must be recorded and reported in the financial statements of Missouri-American.

Q. Is it appropriate to evaluate the effects of a regulatory order for Missouri-American in terms of its effect on the financial statements of Missouri-American or in terms of its parent, American Water Works Company, Inc.?

A. The effects of any regulatory order received by Missouri-American must be evaluated in terms of the related effect on its financial statements, not on the consolidated financial statements of its parent company. Although the effect of the order will also be reflected in the consolidated financial statements of American Water Works Company, Inc., the stand-alone financial statements of Missouri-American are required to reflect the effects of its regulation. The financial statements of Missouri-American are used by the MoPSC as well as by the independent security holders of Missouri-American and by its parent, American Water Works Company, Inc. and, therefore, must accurately reflect the effects of regulation in accordance with FAS 71.

In addition, regulatory decisions should be made based on the economic facts of the entity that is regulated by the MoPSC and not some other entity. All effects of the

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1 MoPSC's actions with regard to this rate case should be measured in terms of the
2 effects that those actions will have on Missouri-American and not some other entity.
3

4 **Q. Are there rules that apply specially to prudence disallowances and phase-in plans?**

5 A. Yes. Statement of Financial Accounting Standards No. 90, entitled "Regulated
6 Enterprises-Accounting for Abandonments and Disallowances of Plant Costs ("FAS
7 90") and Statement of Financial Accounting Standards No. 92, entitled "Regulated
8 Enterprises-Accounting for Phase-in Plans ("FAS 92").
9

10 **Q. Why were FAS 90 and FAS 92 developed?**

11 A. The Securities and Exchange Commission (the "SEC") is responsible for the protection
12 of investor interests through its administration and enforcement of federal securities
13 laws. Subsequent to the issuance of FAS 71, the SEC became concerned with the
14 significant deferrals arising from phase-in plans as well as the fact that regulatory
15 commissions were disallowing costs of newly completed plants, yet the financial
16 statements of those companies were not reflecting those write-offs. In concept, the
17 SEC was (and remains today) concerned that if current costs could not be collected
18 currently, deferring these costs to the future raised significant questions as to the
19 ultimate collectibility of these costs. As a result, the SEC requested that the Financial
20 Accounting Standards Board (the "FASB"), which is primarily responsible for
21 development of accounting principles in the United States, amend FAS 71 to address
22 these deficiencies. As a result of this request, the FASB issued FAS 90 and FAS 92.
23

24 The overall effect of FAS 90 was to require the immediate write-off of disallowed plant
25 costs and the overall effect of FAS 92 was to severely restrict the ability to record
26 phase-in plans for plants for which substantial physical construction had been
27 performed prior to January 1, 1988. FAS 92 also eliminated phase-in accounting
28 relating to plants where substantial physical construction had not been performed prior
29 to January 1, 1988.
30

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1 **Q. Please define a phase-in plan and a plant disallowance.**

2 A. A phase-in plan is any regulatory method that defers the rates intended to recover
3 allowable costs of a newly completed plant beyond the period in which those costs
4 would be charged to expense under generally accepted accounting principles applicable
5 to enterprises in general. In this case, a phase-in plan would defer a portion of the costs
6 of the St. Joseph Plant proposed to be collected in this rate case to a future period for
7 collection.

8
9 Plant disallowances arise when a regulator excludes a portion of a completed plant
10 from rate base, regardless of what future plans may exist for that excluded portion.
11 Thus, excluding a portion of the St. Joseph Plant and including it in plant held for
12 future use would not prevent a write-off of that amount of excluded plant in the
13 financial statements of Missouri-American.

14
15 **Q. Is the accounting for phase-in plans described in FAS 92 available to Missouri-**
16 **American to account for the St. Joseph Plant?**

17 A. No. The accounting for phase-in plans described in FAS 92 is not available to
18 Missouri-American. The accounting described in FAS 92 was available only to plants
19 which had substantial physical construction performed prior to January 1, 1988. Since
20 construction on the St. Joseph Plant did not commence until well after January 1, 1988,
21 the accounting described in FAS 92 is not available to Missouri-American.

22
23 **Q. Are you aware of any regulatory commissions that have ordered a phase-in plan**
24 **after a contested case and after the transition period required by FAS 92 ended?**

25 A. No, I am not.

26
27 **Q. If a phase-in plan were ordered for the St. Joseph Plant, how would Missouri-**
28 **American account for that order?**

29 A. Any difference between the costs allowed for recovery under a phase-in plan ordered
30 by the regulator and the costs expensed under generally accepted accounting principles

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1 applicable to enterprises in general would be expensed for accounting and reporting
2 purposes. In other words, Missouri-American would not be permitted to recognize for
3 accounting and reporting purposes the deferrals of costs ordered by the regulator for
4 recovery in future periods.

5
6 **Q. What is the required accounting for any portion of the cost of the St. Joseph Plant**
7 **which is not included in rate base?**

8 A. FAS 90 provides the relevant guidance for accounting for any portion of the cost of the
9 St. Joseph Plant which is not included in rate base. FAS 90 requires that when it
10 becomes probable that part of the cost of a recently completed plant will be disallowed
11 for rate-making purposes and a reasonable estimate of the amount of the disallowance
12 can be made, the estimated amount of the probable disallowance shall be deducted from
13 the reported cost of the plant and recognized as a loss.

14
15 **Q. Would exclusion of the St. Joseph Plant from rate base for a period of time**
16 **require a loss for accounting purposes to be recorded and reported?**

17 A. Yes. Any exclusion of a portion of the cost of the St. Joseph Plant from rate base for a
18 period of time would require that a loss be recorded and reported in accordance with
19 FAS 90. The financial effect of this accounting would be identical to the write-off
20 noted in the answer to the immediately preceding question regarding a permanent
21 disallowance.

22
23 **Q. Does this complete your surrebuttal testimony?**

24 A. Yes, at this time.
25
26
27
28