

Exhibit No.:  
Issues: Consolidated Tariff Pricing  
Witness: Karl A. McDermott  
Exhibit Type: Surrebuttal  
Sponsoring Party: Missouri-American Water Company  
Case No.: WR-2011-0337  
SR-2011-0338  
Date: February 2, 2012

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. WR-2011-0337  
CASE NO. SR-2011-0338**

**SURREBUTTAL TESTIMONY**

**OF**

**KARL A. MCDERMOTT**

**ON BEHALF OF**

**MISSOURI-AMERICAN WATER COMPANY**

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

<b>IN THE MATTER OF MISSOURI-AMERICAN )</b>	
<b>WATER COMPANY FOR AUTHORITY TO )</b>	
<b>FILE TARIFFS REFLECTING INCREASED )</b>	<b>CASE NO. WR-2011-0337</b>
<b>RATES FOR WATER AND SEWER )</b>	<b>CASE NO. SR-2011-0338</b>
<b>SERVICE )</b>	

**AFFIDAVIT OF KARL A. MCDERMOTT**

Karl A. McDermott, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of Karl A. McDermott"; 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 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.

  
\_\_\_\_\_  
Karl A. McDermott

**City of Champaign  
State of Illinois  
SUBSCRIBED and sworn to  
Before me this 1 day of February 2012.**

  
\_\_\_\_\_  
Notary Public

**My commission expires:**



1                                   **MISSOURI PUBLIC SERVICE COMMISSION**

2                                   **CASE NO. WR-2011-0337**

3                                   **SURREBUTTAL TESTIMONY**

4                                   **OF**

5                                   **KARL A. MCDERMOTT**

6                                   **I.     INTRODUCTION**

7   **Q1.    Would you please state your name and business address.**

8    A.    My name is Karl A. McDermott and my business address is 875 North Michigan  
9          Avenue, Suite 3650, Chicago, Illinois 60611.

10 **Q2.    Are you the same Karl A. McDermott that submitted pre-filed direct and**  
11 **rebuttal testimony in this matter?**

12    A.    Yes.

13                               **II.    PURPOSE AND SUMMARY OF TESTIMONY**

14 **Q3.    What is the purpose of your rebuttal testimony?**

15    A.    I have been asked by Missouri-American Water Company (MAWC or Company)  
16          to respond to the rebuttal testimony of certain parties in this case regarding the  
17          Company's proposed Consolidated Tariff Pricing (CTP). In particular I will  
18          respond to, or comment on, parts of the rebuttal testimonies from Ms. Barbara A.  
19          Meisenheimer (Meisenheimer, Reb.), Mr. Donald E. Johnstone (Johnstone, Reb.)  
20          and Mr. Michael P. Gorman (Gorman, Reb.).

21

22

23 **Q4. What were your conclusions in your direct and rebuttal testimonies**  
24 **concerning the Company’s proposed CTP?**

25 A. I concluded that CTP provides significant public policy benefits to consumers,  
26 MAWC, and to the Missouri Public Service Commission (MPSC or Commission)  
27 and should be approved.

28 **Q5. Have any parties raised any new arguments concerning CTP?**

29 A. No. The parties still largely stick to their concerns that CTP does not follow cost  
30 of service principles; however, all parties are supporting, or supporting in the  
31 alternative, some degree of consolidation (Johnstone Reb., 3:11-17;  
32 Meisenheimer Reb., 2:14-19; Gorman Reb., 6:5-15)

33 **Q6. Has any of the testimony provided by the witnesses you cited above changed**  
34 **your opinion that the Company’s proposed CTP should be approved?**

35 A. No. Indeed, in addition to what I discuss below, all of my comments in my  
36 rebuttal testimony apply here.

37 **III. THE PARTIES ALTERNATIVE CONSOLIDATION IS BASED ON**

38 **FAULTY POLICY LOGIC**

39 **Q7. Would you please briefly explain the parties’ alternative consolidation**  
40 **proposals?**

41 A. Yes. Each of the three witnesses that I am responding to all propose some form of  
42 “small-system” consolidation. Ms. Meisenheimer proposes to retain the larger  
43 districts but consolidate Joplin and Loma Linda as well as create three districts  
44 that would include the smaller districts. (Meisenheimer Reb. 11:15-12-7). Mr.  
45 Gorman suggests that all districts with a cost of service exceeding \$1M remain

46 separate with Warren County included in the St. Louis Metro District. The  
47 remaining districts would be consolidated into one “Small District System.”  
48 (Gorman Reb., 6:5-15). Mr. Johnstone makes a similar recommendation with the  
49 largest districts remaining separate and the remaining smaller districts  
50 consolidated into one district with four rate levels with a phase-in of rates over  
51 time. (Johnstone Reb., 5:11-6:19)

52 **Q8. Do any of these proposals have merit?**

53 A. No. First, the consolidation of the small water systems into one or a small number  
54 of districts defeats the purpose of consolidation. Consolidation makes sense from  
55 a policy perspective when investments can be spread over a large number of  
56 customers. Excluding the largest districts from consolidation removes the  
57 advantage of a larger customer base and creates a disincentive for further  
58 investment in Missouri’s smaller systems by MAWC. Second, all of these  
59 proposals suffer from the same problems I noted with district-specific pricing in  
60 my rebuttal testimony. There is no reason to believe that the marginal cost of  
61 serving customers is much different among the districts and that implies there is  
62 no good economic reason to keep the districts separate. Third, the evidence  
63 supporting district-specific pricing is weak, at best. While all of the parties claim  
64 to support their proposal using some form of “cost” the variety of outcomes from  
65 these alleged “cost-based” approaches is broad. (*See e.g.*, Williams Dir., Herbert  
66 Sur., illustrating the differentials in rates at various usage levels.) It simply can’t  
67 be that everybody’s proposal is cost-based. Indeed none of the parties uses an  
68 economic definition of cost to support their conclusions. Rather, they all use some

69 version of accounting and allocated costs that, as I have testified to in my rebuttal  
70 testimony, are not accurate enough to justify the sweeping claims that the parties  
71 make. While I understand that regulators need to have some form of a cost  
72 standard to use to guide ratemaking, the cost standard should not be so narrowly  
73 defined as to defeat legitimate policy goals. Fourth, these proposals are overly  
74 complex as they retain a significant number of districts. The Company would  
75 continue to maintain at least seven sets of rates and the implications for customer  
76 confusion and other customer-service related issues is unknown. Not only does  
77 the Commission and its its customer complaints office have to deal with a large  
78 number of tariffs for the same utility, the Company's customer service function  
79 must deal with the wide variety of tariffs. Finally, Mr. Johnstone's proposal adds  
80 the additional complexity of a phased-in rate structure.

#### 81 **IV. CTP CAN PRODUCE JUST AND REASONABLE RATES**

82 **Q9. Do any of the parties claim that CTP would produce unjust and**  
83 **unreasonable rates?**

84 A. This is unclear. While such a decision is a legal conclusion, it is my understanding  
85 that public utility commissions have wide latitude to determine the legality of  
86 rates. So long as the rates are not unjust or unreasonable, the Commission can  
87 choose any mechanism that achieves a balancing of the interests of the public;  
88 there is no single formula or cost basis to determine just and reasonable rates.

89 **Q10. Doesn't cost factor into that decision?**

90 A. Yes, but there is no one accepted definition of "cost." Indeed, while the parties in  
91 this case do agree on the audited accounting costs standard, they do not agree on

92 the allocation of those costs to customer classes, jurisdictions, and rate elements  
93 which is essential to define the cost of service for customers. Moreover, I submit  
94 that there may not be a single regulated utility rate in place today in the United  
95 States, with the possible exception of real-time electricity rates, which is (strictly)  
96 cost-based. Furthermore, as I testified in my rebuttal testimony, the metrics (e.g.,  
97 geography, source of supply, etc.) used by the parties to differentiate the different  
98 districts could just as easily be applied within a district and be consistent with  
99 cost-causation principles.

100 **Q11. What do the parties rest their case on if this is true?**

101 A. Largely historical accident and the allocation of overhead costs. The revenue  
102 requirement is based on historic depreciated costs; that is, today's capital costs in  
103 rate base are largely a function of the arbitrary timing, need, and original cost of  
104 the assets. These factors are all basically random in the following sense: "When"  
105 the assets were put in place is a function of past decisions that have nothing to do  
106 with today's cost causation. "Why" the assets were put in place is related to past  
107 forecast demand on the system. Of course, the original cost is a function of when  
108 the assets were put in place. Marginal cost, on the other hand, is not so sensitive  
109 to such arbitrary factors. As it is a forward-looking cost it is almost completely  
110 independent of past decisions. Further, as I noted in my rebuttal testimony much  
111 of the difference in operating costs is a result of allocating overhead costs. The  
112 allocation of overhead costs is hardly what one might call a science. Largely due  
113 to these well-known maladies of the historic depreciated cost standard, regulators  
114 have been given wide latitude to determine what is in the public interest.

115 **Q12. Why then should the Commission accept any rate based on embedded cost?**

116 A. Embedded costs are the traditional way that regulators have viewed costs in the  
117 water industry and, for determining the rates in a single system, one could argue  
118 they do a reasonable job of guiding ratemaking.

119 **Q13. Are there other factors, beyond cost, that influence the Commission's**  
120 **determination of just and reasonable rates?**

121 A. Yes and other parties have noted that fact. (*See e.g.*, Meisenheimer Reb., 1:25-  
122 2:3) For example, as Mr. Moser testifies, for small communities that may be in  
123 the unfortunate situation of declining population, CTP will help provide rate relief  
124 or at least rate moderation while providing the remaining citizens clean water.  
125 (Moser Reb., 2:8-23) Indeed, CTP may be the only economic option for such  
126 situations. My concern is that by focusing too narrowly on embedded cost for  
127 policy making, the Commission may travel down a path in which there are  
128 multiple standards of service for water in the state and, perhaps, private water  
129 companies would not wish to invest further in the state or may be slow to invest.  
130 (Mr. Busch makes similar conclusions concerning the ability of small water  
131 companies to invest and the need for private companies, such as MAWC, to  
132 undertake the investment. (Busch Dir., 8:21-9:7))

133 **Q14. Does this complete your surrebuttal testimony?**

134 A. Yes.