

Exhibit No.:
Issues: Bad Debt Expense
Witness: Peter J. Thakadiyil
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

PETER J. THAKADIYIL

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-2011-0337 CASE NO. SR-2011-0338
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AFFIDAVIT OF PETER J. THAKADIYIL

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



Peter J. Thakadiyil

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 31st day of January 2012.



Notary Public

My commission expires: 6/11/2012

JULIE M. POLZIN
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires 6/11/2012
Commission # 08575308

**SURREBUTTAL TESTIMONY
PETER J. THAKADIYIL
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2011-0337
SR-2011-0338**

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3 **PETER J. THAKADIYIL**

4
5 **I. WITNESS INTRODUCTION AND PURPOSE**

6
7
8 **Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.**

9 A. My name is Peter J. Thakadiyil, Financial Analyst II for American Water
10 Works Service Company (“Service Company”) and my business address is
11 727 Craig Road, St. Louis, Missouri 63141.

12
13 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS**
14 **PROCEEDING ON BEHALF OF MISSOURI-AMERICAN WATER**
15 **COMPANY (“MAWC” OR “COMPANY”)?**

16 A. Yes, I have submitted direct and rebuttal testimony in this proceeding.
17

18 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

19 A. The purpose of my surrebuttal testimony is to respond to the rebuttal
20 testimony of the Missouri Commission Staff (“Staff”) on bad debt expense.
21

22 **II. BAD DEBT EXPENSE**

23
24 **Q. WHAT IS THE ISSUE REGARDING BAD DEBT EXPENSE?**

25 A. The issue between Staff and Company regarding bad debt expense is
26 whether or not there should be a grossing-up of bad debt expense
27 attributable to the additional revenues that result from a rate increase in this
28 case.

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Q. DID STAFF CALCULATE A BAD DEBT EXPENSE ASSOCIATED WITH THE ADDITIONAL REVENUES TO BE RECEIVED AS A RESULT OF A RATE INCREASE IN THIS CASE?

A. No, they did not, even though Staff agrees that bad debt may increase.

Q. PLEASE DESCRIBE STAFF'S ADJUSTMENT TO BAD DEBT EXPENSE?

A. When calculating the adjustment to bad debt expense, Staff utilizes the present rate revenues and applies the revenues to a three year average bad debt expense ratio.

Q. WHAT IS THE FLAW IN THIS METHODOLOGY?

A. These revenues do not reflect the increase in revenues the Company will be authorized to earn after the receipt of a Commission Order. As stated on page 6 of my rebuttal testimony, it is illogical for Staff to use revenues in its calculation of bad debt expense, if it does not recognize that pro forma revenues will change based on any rate increase arising from this case. Staff's methodology for calculating bad debt expense is flawed because it ignores what will ultimately be known and measureable revenues. By using revenues that are not representative on a pro forma basis, Staff does not normalize bad debt expense. If the Company is not allowed a normalized level of bad debt expense, the revenue requirement will be understated thereby diminishing MAWC's opportunity to earn whatever rate of return is ultimately ordered by the Commission.

1 **Q. WHAT IS STAFF'S REASON FOR NOT GROSSING-UP BAD DEBT**
2 **EXPENSE?**

3 A. According to Staff witness Mr. Jermaine Green, after an analysis of bad debt
4 expense and revenues, he could not find a direct relationship between bad debt
5 expense and revenues. In Mr. Green's analysis, he notes that in some cases
6 revenue increases and bad debt expense decreases. Based on this analysis
7 Staff assumes that no adjustment is necessary for the additional revenues
8 granted in this case.

9 **Q. BASED ON STAFF'S ANALYSIS, DOES STAFF REACH A REASONABLE**
10 **CONCLUSION?**

11 A. No. The analysis was simply to determine the past relationship between revenue
12 and bad debt expense. However, there are several problems by applying this
13 analysis to the Company's revenue requirement. Not only does this analysis
14 ignore improvements in the Company's collection processes, but more
15 importantly, Staff is clouding the issue by using an analysis that ignores
16 regulatory theory (or the "regulatory model") and tries to apply a historical
17 analysis to the revenue requirement.

18

19 **Q. MR. THAKADIYIL, COULD YOU PLEASE EXPLAIN WHAT YOU REFER TO**
20 **AS THE REGULATORY MODEL?**

21 A. Yes. The regulatory model is in place to calculate the revenue requirement the
22 Company must achieve in order to earn its authorized return. The formula
23 calculates the Company's required operating income. The required operating
24 income is subtracted by the operating income at present rates, which calculates
25 the operating income deficiency. The operating income deficiency is what the

1 Company must earn in addition to its current operating income. If expenses were
2 to stay the same, after a revenue increase, this would be the rate increase the
3 Company would calculate. However, net income and expenses do not stay static
4 when revenues increase, so the Company must gross-up the revenue
5 requirement in order to achieve its authorized return.

6
7 **Q. DOES STAFF GROSS-UP ANY OTHER EXPENSES?**

8 A. Yes. Staff acknowledges that income taxes must be grossed-up in order for the
9 Company to earn its authorized return.

10
11 **Q. WHY IS IT NECESSARY TO GROSS-UP INCOME TAXES?**

12 A. It is common practice in regulatory environments to gross-up revenues for the
13 effect of income taxes, because when a utility is authorized an increase in
14 revenues, net income increases, thereby increasing income taxes. The gross-up
15 takes into account that there will be an increase in income taxes because of the
16 additional revenues.

17
18 **Q. MR. THAKADIYIL, HAVE YOU PERFORMED AN ANALYSIS OF INCOME
19 TAXES IN RELATION TO REVENUES?**

20 A. Yes. I have performed a five year analysis of the relationship between income
21 taxes and revenue, which is attached to my surrebuttal testimony as Schedule
22 PJT-1. As illustrated in Schedule PJT-1, income taxes can vary significantly from
23 year to year. In one year, income taxes actually decrease when revenues
24 increase. Also, income taxes can increase at a higher rate than the amount that
25 revenues increase. Furthermore, the ratio of income taxes to revenue varies

1 from a high of 6.27% to a low of 3.58%.

2
3 **Q. HOW DO INCOME TAXES RELATE TO BAD DEBT EXPENSE?**

4 A. Schedule PJT-1 shows the historical relationship between revenues and income
5 taxes. This is the same methodology that Mr. Green included in his rebuttal
6 testimony, except Mr. Green used bad debt expense instead of taxes. As I
7 stated earlier, grossing-up for the effect of taxes is common in the regulatory
8 environment. Grossing-up taxes is necessary because the Company would not
9 earn its authorized return if the Company could not realize the additional income
10 tax expense in its revenue requirement for the increase in revenues. I am not
11 suggesting that grossing-up for taxes should be discontinued. However, my
12 analysis points out the flaw in Mr. Green's assertion that because he could not
13 find a direct relationship between revenues and bad debt expense, there should
14 be no need to gross-up bad debt expense. Even without a direct relationship,
15 there is still an additional cost associated with bad debts and if this additional
16 cost is not addressed by the Commission, MAWC's opportunity to achieve its
17 approved rate of return will be diminished.

18
19 **Q. MR. THAKADIYIL, CAN YOU FURTHER EXPLAIN WHY IT IS NECESSARY**
20 **TO GROSS-UP BAD DEBT EXPENSE?**

21 A. Yes. As an example, take a customer who does not pay their \$30 water bill
22 during the test year. The Company would not earn this revenue in the test year.
23 This bill is based on rates that were authorized in the Company's last rate case.
24 Now, say the Company is awarded a 10% increase in rates as part of the present
25 rate case. The customer's bill would increase to \$33 and the Company would

1 still not earn this revenue. Thus, the on-going or normalized level of bad debt
2 expense would be \$33. This is the same manner in which Staff would apply
3 wage increases to labor or price adjustments for chemicals.

4
5 **Q. HAS THE MISSOURI PUBLIC SERVICE COMMISSION EVER APPROVED**
6 **THE GROSS-UP OF BAD DEBT EXPENSE?**

7 A. Yes. Below is an excerpt from the Commission's Report and Order in a Kansas
8 City Power and Light rate case (File No. ER-2006-0314):

9 **Bad Debts**

10 *Should the bad debt percentage be applied to reflect the total revenues,*
11 *including any rate increase in Missouri jurisdictional retail revenues awarded in*
12 *this proceeding?*

13 KCPL and Staff agree that KCPL should apply a 0.61% bad-debt write-off
14 factor to KCPL's Missouri jurisdictional revenue. The contested issue between
15 these parties is what that Missouri jurisdictional revenue should be.

16 KCPL asserts that the Commission should apply that factor to the actual
17 Missouri jurisdictional revenue that the Commission finds appropriate for this
18 case. In contrast, Staff objects, maintaining that such treatment harms ratepayers
19 because there is no demonstrable correlation between the level of retail sales
20 and the percentage of bad debts. Instead, Staff appears to argue that the
21 Commission should apply the bad debt percentage write-off to its pro forma
22 revenue requirement in its case, rather than the actual revenue requirement the
23 Commission decides.

24 The Commission finds that the competent and substantial evidence supports
25 KCPL's position, and finds this issue in favor of KCPL. The Commission
26 understands Staff's argument that there is not a perfect positive correlation
27 between retail sales and the percentage of bad debts. While it's possible that
28 KCPL's bad debt expense could decrease, the Commission finds it more
29 probable, and therefore just and reasonable, that an increase in the amount of
30 revenue that KCPL is allowed to collect from its Missouri retail ratepayers will
31 result in a corresponding increase in bad debt expense.
32

33 **Q. IN YOUR EXPERIENCE, ARE YOU AWARE OF ANY UTILITY COMMISSIONS**
34 **THAT FOLLOW THE PRACTICE OF GROSSING-UP BAD DEBT EXPENSE?**

35 A. Yes. The Indiana Utility Regulatory Commission and the Public Utilities

1 Commission of Ohio both gross-up bad debt as a part of the rate calculation
2 process.

3

4 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

5 A. Yes.

Missouri American Water
WR-2011-0337
Income Tax and Revenue Analysis

				Change	
	Revenue	Taxes	Ratio	Revenue	Taxes
2006	\$170,853,331	\$10,199,296	5.97%		
2007	\$179,899,724	\$10,297,845	5.72%	\$9,046,393	\$98,549
2008	\$181,050,984	\$6,486,843	3.58%	\$1,151,260	(\$3,811,002)
2009	\$203,781,530	\$10,910,353	5.35%	\$22,730,546	\$4,423,510
2010	\$224,608,250	\$14,087,898	6.27%	\$20,826,720	\$3,177,545