Exhibit No.:	
Issue:	*Annual Incentive Plan; Payroll; Cash Working Capital; and Insurance Other Than Group*
Witness:	*Casey Westhues*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*WR-2011-0337*
Date Testimony Prepared:	*February 2, 2012*

MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION

UTILITY SERVICES

SURREBUTTAL TESTIMONY

OF

CASEY WESTHUES

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

Jefferson City, Missouri
February 2012

TABLE OF CONTENTS OF

SURREBUTTAL TESTIMONY OF

CASEY WESTHUES

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR 2011-0337

Executive Summary 1
Incentive Compensation 3
Payroll 9
Cash Working Capital 11
Insurance Other Than Group 13

SURREBUTTAL TESTIMONY

OF

CASEY WESTHUES

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

Q. Please state your name and business address.

A. Casey Westhues, 200 Madison Street, Suite 440, Jefferson City, MO 65101.

Q. By whom are you employed and in what capacity?

A. I am a Regulatory Auditor with the Missouri Public Service Commission (Commission or PSC).

Q. Are you the same Casey Westhues who has contributed to the Missouri Public Service Commission Staff's (Staff) Cost of Service Report and filed Rebuttal Testimony in this case?

A. Yes, I am

Q. What is the purpose of your Surrebuttal Testimony?

A. The purpose of this Surrebuttal Testimony is to address certain aspects of Missouri-American Water Company's (MAWC or Company) and The Office of Public Counsel's (Public Counsel) Rebuttal Testimony regarding the Incentive Compensation, Payroll, Cash Working Capital (CWC), and Insurance Other Than Group.

<u>EXECUTIVE SUMMARY</u>

Q. In summary, what does your testimony cover?

A. This testimony will address Public Counsel witness Shawn Lafferty's and Company witness Maxine Mitch's Rebuttal Testimony concerning Staff's proposed disallowance of MAWC's Annual Incentive Plan (AIP) compensation. Mr. Lafferty believes that Staff is being inconsistent in its disallowance of AIP compensation for MAWC employees and Staff's disallowance of AIP compensation that is being allocated to MAWC by its subsidiary American Water Works Service Company, Inc. (Service Company).

MAWC witness Mitch believes that the AIP plan in place is beneficial to the ratepayers because it gives employees incentives to perform above and beyond their normal job duties, is instrumental in retaining high quality employees, and allows the customers opportunities to learn more about the Company. While Staff agrees that some aspects of the AIP plan may help to retain quality employees and to provide incentives for employees to perform exceptional work, Staff contends that each goal of an individual employee that is established to attain those incentives should be related to the provision of safe and adequate water service. Some AIP goals, while otherwise commendable, are not necessary for providing safe and adequate water service and, therefore, should not be paid for by the ratepayer.

The other issues that I will address in this testimony is Company witness Regina C. Tierney's Rebuttal Testimony concerning the overtime calculation for payroll, the Cash Working Capital (CWC) revenue lag and MAWC's Service Company fee expense lag for CWC.

Staff has made some changes to its payroll overtime calculation in response to Ms. Tierney's Rebuttal Testimony, which I will address later in this testimony.

Regarding the calculation of the revenue lag for CWC, the Company advocates use of test year revenues to calculate the average daily accounts receivable, whereas Staff uses its annualized revenues to calculate the average daily receivables. Staff has reviewed the testimony on this subject and has decided to use the test year revenues in their revenue lag calculation for CWC. I will also address this later in this testimony.

Regarding the Service Company expense lag, the Company prepays for services rendered by the Service Company, therefore; the Company's proposed expense lag is negative and the ratepayer is exposed to a higher cost in rates. Under this prepayment arrangement, Staff maintains that the Service Company is getting favorable payment terms at the expense of MAWC and its ratepayers.

The last issue that I will be addressing in this testimony is the Insurance Other Than Group discussed by Company witness Peter J. Thakadiyil in his Rebuttal Testimony. Mr. Thakadiyil believes that Staff's disallowance of the Directors and Officers liability insurance is inappropriate and should be included in the cost of service because it is necessary to protect the board members from potential litigation. Staff contends that if the board members are acting morally and ethically that there should be no need for litigation, but if MAWC insists on carrying this insurance it should be at the shareholders expense.

<u>INCENTIVE COMPENSATION</u>

Q. What are the differences between Staff and Public Counsel regarding the disallowance of AIP compensation for MAWC employees?

A. Public Counsel states on page 5 lines 28-30 of Mr. Lafferty's testimony that "OPC contends that the Missouri Public Service Commission should disallow the entire amount of AIP compensation in the revenue requirement for this case." Public Counsel is basing its recommendation on how American Water Works (AWW) establishes the funding of its AIP awards. AWW must meet certain financial and non-financial goals before AIP funds are awarded to MAWC employees, including goals for earnings per share and operating cash flows. Public Counsel is recommending that all individual AIP awards be disallowed since these financial goals are the triggers to release the AIP funds to MAWC. However, Staff recommends disallowance of only certain AIP payments for MAWC employees based on individual goals.

Q. What are "financial triggers?"

A. Financial triggers are Company financial goals that must be met before the Company funds its AIP. AWW's financial triggers or goals are set on a minimum level of earnings per share and operating cash flow. The amount of AIP that each MAWC employee receives is dependent upon the earnings of AWW. AWW bases MAWC's AIP amount upon the AWW financial triggers or goals. If these triggers or goals are met, 70% of the total amount budgeted for the AIP plan is available for disbursement.

Q. Has Staff removed any AIP compensation paid to MAWC employees based upon financial goals?

A. Yes. Staff examined each individual MAWC employee's goals to determine its disallowances for AIP compensation. Staff also looks at each individual MAWC employee's goals to determine if they are appropriate and necessary to providing safe and adequate water service.

Q. Public Counsel claims that Staff used two different methods to calculate disallowances for MAWC and the Service Company. Could you please explain?

A. Staff used the same methods in the current rate case as it did in the past rate cases in determining AIP disallowances. Please refer to Staff witness Keith Foster's Surrebuttal Testimony for an explanation of how the Service Company AIP disallowances were determined.

Q. Why didn't Staff recommend disallowances for the amount of AIP expense tied to attainment of overall earnings targets?

A. Staff asserts that the practice of making incentive compensation payouts contingent upon attainment of overall external triggers is a reasonable and prudent practice that serves to limit the amount of these expenses in some situations. Staff's position is that financial-related incentive compensation goals should be examined at the individual employee level, if possible.

Q. What are the differences between Staff and the Company regarding AIP?

A. The Company asserts in Ms. Mitch's Rebuttal Testimony that all AIP should be included because it motivates employees to perform above and beyond their normal job duties. As stated earlier, Staff proposed individual disallowances for AIP awards related to financial goals, and also proposed disallowances to goals not necessary for safe and adequate water service.

Q. On page 8, line 21 of Ms. Mitch's Rebuttal Testimony she testifies, in relation to elimination of customer service and environmental goals, that "Staff is indicating that the subject goals relate to activities that the Company should not be encouraging and are activities for which the Company should receive no cost recovery." Is the Company correct in stating that Staff does not encourage these types of activities?

A. No. Customer service and some environmental activities are important in the business of providing water service. Only certain individual goals towards obtaining customer service satisfaction and environmental activities cause Staff concern. Ms. Mitch seems to suggest that Staff eliminated all incentives related to these particular categories, which is simply not true. Staff allowed customer service goals related to things such as the

KPI tracking sheet, the inventory storage assessment, and hydrant inspection. Staff also allowed environmental goals related to things such as having no "notices of violation" and training on environmental compliance.

Staff did disallow incentives in those categories that involved having employees participate in activities such as the St. Patrick's Day parade or Earth Day, as these activities are not necessary for providing safe and adequate water service. As Ms. Mitch states in her testimony, these activities may provide customers who choose to attend such events information on pollutants and water quality, but Staff contends these activities are not necessary in ensuring that safe and adequate water service is provided to customers. Ms. Mitch also fails to mention in her testimony what the individual employee criteria for completion of such projects are. In order to receive the incentive for participating in the parade, for example, the employees were to enter a float and provide watering booths for the events. These things have little or nothing to do with providing safe and adequate water service to the customers. Also, participation in such events essentially forces customers to become sponsors of events that they may not wish to support if ratepayer money is being provided to sponsor these events.

Q. In her Rebuttal Testimony on pages 11-13, Ms. Mitch discusses two surveys related to customer service that she asserts are adequate in determining customer service satisfaction. Did Staff review these surveys, and if so, why did Staff recommend disallowances to incentives based on these surveys?

A. Yes, Staff has reviewed these surveys. The measure for meeting customer service goals was based on two different surveys: the Customer Satisfaction Survey and Customer Service Quality Survey. Staff addressed these surveys in its Cost of Service Report on page 52, lines 23-28. Due to such small sampling for the surveys, Staff determined the surveys were not a sufficient indicator of good customer service. Staff further asserts that working towards positive survey results is not a specific enough goal or an adequate motivator for an AIP award. There is no apparent specific task for the employee to achieve this goal, other than hope for positive survey results.

Q. On page 13, lines 8-14 of her Rebuttal Testimony, Ms. Mitch testifies that Staff did not do an analysis of the statistical sample size or method used by the Company to determine customer satisfaction levels. She also indicates that this information is available from the Company. Please comment.

A. Staff did not do an analysis of the statistical sample size used by the Company, nor did the Company provide this information as support to its Rebuttal Testimony. Regardless of how the sample size was determined, Staff still contends that basing AIP funds on the results of a survey is too broad of a goal and doesn't provide the employee with specific activities to perform to achieve a target level of performance and, therefore, should not be included in the cost of service.

Q. What are some other individual goals related to customer service and environmental activities that Staff excluded and why did Staff exclude these goals?

A. Staff excluded goals relating to helping individuals or departments on an "as needed" basis, attending meetings, meeting with resale customers at least three times, and participating in at least one to three environmental activities such as highway clean-up. Staff excluded these goals because they are overly broad and vague in nature. "Attending meetings" is very vague. There are no specific topics to discuss or projects to accomplish during those meetings. The environmental activities goal is also very vague. This goal could include a multitude of activities and may not have any relationship to providing safe and adequate water service to customers.

Q. The Company indicated that Staff incorrectly excluded all financial related goals on the grounds that they have no customer benefit. Please comment.

A. Staff initially excluded all financial related goals from the cost of service. After further review, Staff decided to allow financial goals that relate to cost reduction and efficiency improvements. Staff determined that cost reduction and efficiency improvements benefit the ratepayer and should be included in the cost of service. Those financial goals which relate to net income or return will continue to be excluded from the cost of service because Staff sees no direct benefit to ratepayers. When goals are geared towards maximizing profits for a company it is the shareholder that benefits. When a company is trying to meet specific income targets it potentially increases the value of the company for shareholders.

Q. On page 6 of her Rebuttal Testimony, Maxine Mitch alludes to the assumption that Staff would include all of the AIP awards in the current case had the AIP all been in base salary and not placed "at risk." Is this true?

A. No, it is not true. Staff is not opposed to a portion of an employee's salary being placed "at risk" and included in the cost of service if MAWC shows that this approach is based upon goals and objectives that result in ratepayer benefits. If all of the AIP would have been included as base salary, Staff would still evaluate each MAWC employee's overall salary expense in an effort to determine whether the salary is reasonable and comparable with other utilities. Base salaries and incentive compensation are distinct types of employee compensation, and the Commission has historically applied specific criteria before allowing incentive compensation to be included in rates. This criterion has been based upon whether attainment of a Company's goals would provide a benefit to its customers, and whether the goals are designed to improve employee and company performance. All of the Company's individual incentive plan components in this case were analyzed using this criterion.

Q. What are the differences between Staff and Company regarding Long-Term Incentive Plan (LTIP) awards?

A. The Company believes that all of the LTIP should be included in its cost of service. Staff proposes to disallow LTIP awards for the following reasons: (1) the awards are based on measures that primarily benefit shareholders, such as shareholder return (maximizing the dividends paid to shareholders) and stock price goals (the value of the stock increasing over time); (2) the granting of these stock options is not associated with any increase in duties or achievement of goals and are not tied to any specific level of employee performance; and (3) the stock options are equity-based compensation that does not result in cash outlays from the Company and should not be recovered in cash through rates.

Q. Please explain that last point further.

A. When a stock option is granted to an employee, no cash is exchanged. The stock-related grant gives the receiver of the grant an option (right) to purchase stock at a discount from its market value at a future date. No cash is paid out by MAWC at the time of the grant/option or when the employee exercises the grant/option to acquire Company stock. When the grant/option is exercised, the grant/option-holder pays cash to the Company and the company issues stock. MAWC does not pay out cash to the grant/option holder at either point.

<u>PAYROLL</u>

Q. What differences do Staff and Company have regarding payroll?

A Differences exist between Staff and Company for open positions, union wage increases that fall outside of the test year, overtime, and group insurance.

Q. In her Rebuttal Testimony, page 9, lines 9-11 concerning payroll, Ms. Tierney testifies that the open positions, union increases, and group insurance should be resolved in the true-up phase of this proceeding. Do you agree?

A. Yes. The differences in open positions, union wage increases, and group insurance are all a matter of timing. As of the end of the test year, some positions were not filled and certain wage increases had not yet been implemented. Once the true-up calculations are made, these issues should be resolved. Staff and the Company's payroll and group insurance will be matched at the same point in time. There was no group insurance expense for MAWC's recently acquired properties during the test year. Staff will be able to make the necessary adjustments to this issue at true-up.

Q. The Company also sites overtime as an issue between Staff and the Company. The Company believes the difference is because of an error made by Staff. How do you respond?

A. Staff has taken another look at the data used by MAWC for payroll overtime and has agreed to correct its calculation for payroll. Staff used the information provided by Ms. Tierney in her Rebuttal Testimony and recalculated MAWC's overtime for payroll based upon an average of overtime expenses for the three most current years.

Q. Is this consistent with the Company's overtime calculation?

A. Yes. Staff and Company have now calculated overtime using the same three- year average and the same data.

CASH WORKING CAPITAL

Q. What are the disagreements between Staff and the Company regarding Cash Working Capital (CWC)?

A. Staff and the Company disagree on how the expense lag for the Service Company and the revenue lags for each district should be calculated.

Q. How does the Company suggest the Service Company expense lag should be treated?

A. The Company suggests that the Service Company expense lag should be a negative 10.61 days as stated in Ms. Tierney's Rebuttal Testimony starting on page 6, line 8. The Company's rationale for this suggestion is based on the fact that the Company prepays for estimated services to be performed. This in turn causes the ratepayers to pay a return on a higher rate base amount.

Q. Why did Staff calculate a positive 40.27 days as the expense lag for the Service Company when the Company actually prepays these bills?

A. The Service Company is an affiliated entity who provides services to MAWC. The affiliated service company requires that MAWC prepay for services. This arrangement provides the most favorable payment terms for the Service Company. The ratepayer should not have to provide the excess cash working capital requirements associated with unreasonable billing terms offered by an affiliated company for services provided. The Service Company should be treated as a normal third party vendor entering into an arm's length transaction. MAWC pays the Service Company for <u>estimated</u> services before they are performed. Some of the services that MAWC pays for may not actually be performed in the next month or at all. Therefore, the ratepayer may pay for services that may not be performed. Additionally, the ratepayer will not receive reimbursement if the services are not rendered.

Q. Is it normal to pay for goods and services received in arrears; i.e., after the services are provided?

A. Yes. Also, most of the expense lags in Staff's CWC Accounting Schedule feature positive expense lags. Staff asserts that if MAWC receives less favorable payment terms from the Service Company, this is because this is an affiliated transaction and MAWC is not in a position to negotiate for more normal payment terms.

Q. Does the Staff agree with the Company's example of equating the Service Company fees to the PSC assessment?

A. No. The Commission assessment covers an annual period from July of one year to June of the next. The Commission gives regulated utilities the option of paying the entire yearly billed amount in one lump sum up until April 15th of the following year or making the payments in quarterly installments. MAWC chooses to make the payments in quarterly installments.

The major difference between the PSC assessment and the Service Company fees is that the payments for the assessment are based upon a set amount due at a set point in time, whereas the Service Company fees are an estimated amount. The Company receives a bill from the PSC for a specific amount and the Company can choose to make quarterly payments or one lump sum payment at the due date. If the lump sum payment option is chosen, it will equate to a positive expense lag for this item. If the utilities choose to prepay the PSC assessment on a quarterly basis, then the resulting expense lag will be negative. However, under either payment option, the utilities will pay neither more nor less for services performed than the actual amount billed. In contrast, the Service Company fees are paid based on an estimate of services to be performed and are not billed for actual services until a later point in time when the Company will either have to pay for additional services performed or be reimbursed for services not rendered.

Q. Why does the Company claim that Staff's revenue calculation lag for all districts was inappropriate?

A. The Company asserts that Staff's revenue lag collection is inappropriate because Staff uses pro-forma annualized revenues in the calculation of the collection lag. On page 4, lines 17-22 of Ms. Tierney's Rebuttal Testimony, she testifies that:

> . . . pro-forma annualized revenues have little correlation to the test year average daily accounts receivable balance used in its calculation. By dividing test year accounts receivable balances that are based on current rates, by pro-forma revenues that are based on future rates, Staff creates a mismatch that mathematically results in an assumption of declining numbers of days that receivables are outstanding. Staff's annualized revenues are an estimate based on pro-forma water delivery.

Q. Based on Ms. Tierney's Rebuttal Testimony has Staff made any changes to the calculation of their revenue lag?

A. Yes. Staff has reviewed Ms. Tierney's Rebuttal Testimony and the work papers and determined that test year revenues should be used instead of Staff's annualized/normalized revenues in calculating the revenue lag for all districts. This will provide better matching of revenues to test year accounts receivable in calculating the lag.

INSURANCE OTHER THAN GROUP

Q. What is the Company's disagreement to Staff's adjustment for Insurance Other Than Group?

A. The Company disagrees with Staff's disallowance of the cost of the Directors & Officers Liability coverage.

Q. Why does the Company assert that the Directors and Officers Liability coverage is necessary?

A. On page 5 of his Rebuttal Testimony, Mr. Thakadiyil testifies that because of regulations implemented by the Securities and Exchange Commission (SEC) and the Sarbanes Oxley Act (SOX) any member of a company board is subject to potential litigation in civil and criminal courts. On page 5, lines 21-25 of his Rebuttal Testimony, he continues to testify that "These many complex and demanding corporate governance obligations are accompanied by potential fines and penalties and possible civil and even criminal liabilities. Any individual taking on such risks will expect and demand insurance coverage for claims that may arise as a result of being in such a position." Continuing on lines 29-31 of the same page, he testifies, "This type of expense is crucial to the Company's ability to recruit and maintain qualified individuals to serve on its Board of Directors and in the capacity as senior Company officers."

Q. Does Staff agree that the Directors' & Officers' insurance expense is appropriate and reasonable to be recovered from ratepayers?

A. No. It is Staff's position that ratepayers should not pay for costs associated with litigation or fines and penalties in the form of an insurance premium for MAWC Board members who may become involved in civil or criminal proceedings. Staff contends that if the Company's Board of Directors abides by the regulations of SOX and the SEC and is competent in the performance of its duties, then there is no need for this type of insurance.

Staff considers this expense to be of no direct benefit to ratepayers in the provision of safe and reliable service and the shareholders should bear this expense.

Q. Does this conclude your Surrebuttal Testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement A General Rate Increase for Water and Sewer Service Provided in Missouri Service Areas	)))))	Case No. WR-2011-0337

AFFIDAVIT OF CASEY WESTHUES

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Casey Westhues, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.

Casey Westhues
Casey Westhues

Subscribed and sworn to before me this 2nd day of February, 2012.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D Suzie Mankin
Notary Public