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Plan Compensation/
Special Accounting
Treatment for
Capitalized Business
Transformation Costs
Lafferty/Rebuttal
Public Counsel
WR-2011-0337

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Case No.:

REBUTTAL TESTIMONY
OF
SHAWN LAFFERTY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

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Denotes Highly Confidential information that has been redacted

January 19, 2012

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**REBUTTAL TESTIMONY
OF
SHAWN LAFFERTY**

**MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2011-0337**

1 **I. INTRODUCTION**

2 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

3 A. Shawn Lafferty, PO Box 2230, Jefferson City, Missouri 65102-2230.

4

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

6 A. I am employed by the Missouri Office of the Public Counsel ("OPC" or "Public
7 Counsel") as a Public Utility Accountant III.

8

9 Q. WHAT IS THE NATURE OF YOUR CURRENT DUTIES AT THE OPC?

10 A. Under the direction of the OPC Chief Public Utility Accountant, Mr. Ted
11 Robertson, I am responsible for performing audits and examinations of the books
12 and records of the public utilities operating within the state of Missouri.

13

14 Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND OTHER
15 QUALIFICATIONS.

16 A. I graduated in May, 1984, from The University of Iowa in Iowa City, Iowa, with a
17 Bachelor of Business Administration Degree in Accounting. In November of

1 1984, I took and passed the Uniform Certified Public Accountant Examination,
2 and I obtained Certified Public Accountant ("CPA") certification from the state of
3 Missouri in 1985. My CPA certificate number is 10203. I am not currently a
4 licensed CPA. After graduation I spent over six years in public accounting
5 working for both regional and national CPA firms. I joined Sprint in 1991 and
6 held a series of progressive financial and product management / operations
7 positions over 18 plus years. I joined the Office of the Public Counsel in
8 November, 2010.

9
10 Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE MISSOURI PUBLIC
11 SERVICE COMMISSION ("COMMISSION" OR "MPSC")?

12 A. Yes. I previously submitted testimony in Case No. ER-2011-0004 and Case No.
13 GU-2011-0392.

14
15 **II. PURPOSE OF TESTIMONY**

16 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

17 A. The purpose of my testimony is to address the following issues:

- 18 • The amount of incentive compensation and related expenses, per the annual
19 incentive plan ("AIP"), that are included in the calculation of Missouri-
20 American Water Company's ("Company") revenue requirement for this case.

- 1 • The Company's proposal to delay in-service treatment of capitalized Business
2 Transformation costs until the effective date of rates in a subsequent rate
3 proceeding.
4

5 **III. INCENTIVE COMPENSATION**

6 Q. IS AIP COMPENSATION INCLUDED IN THE PUBLIC SERVICE COMMISSION
7 STAFF AND COMPANY CALCULATIONS OF THE COMPANY'S REVENUE
8 REQUIREMENT?

9 A. Yes. Public Service Commission Staff ("Staff") expert Ms. Casey Westhues
10 prepared work papers in support of Staff's recommended amount of AIP
11 compensation, which is briefly described on pages 51 through 53 in Staff's
12 Report on Cost of Service dated November 17, 2011. In addition, Staff expert
13 Mr. Keith Foster prepared work papers supporting the recommended amount of
14 AIP compensation that pertains to Service Company Management Fees, which is
15 briefly discussed on page 39 in Staff's Report on Cost of Service.

16 The Company prepared work papers that support its proposed labor and labor
17 related expenses, which includes AIP compensation. Ms. Gina Tierney briefly
18 describes the Company's proposed labor and labor related expenses on pages 4
19 through 7 of her direct testimony. In addition, Ms. Michi Chao briefly describes
20 Service Company support costs on pages 3 and 4 of her direct testimony.
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Q. CAN YOU BRIEFLY SUMMARIZE THE POSITIONS OF STAFF AND THE COMPANY REGARDING AIP COMPENSATION?

A. Yes. Staff's position is outlined in lines one through five on page 52 in the Cost of Service Report (Staff expert: Ms. Westhues), which states the following:

There are three basic components to the AIP: financial, operational and individual. Staff has proposed an adjustment to remove the portion of the award based on the Company achieving financial goals. Staff also removed any goals associated with the percentage-based Customer Satisfaction Survey and Customer Service Quality Survey goals and any individual goal which was based upon lobbying activities and charitable activities.

Page 39 in the Cost of Service Report explains Staff's position on AIP compensation included in Service Company Management Fees (Staff expert: Mr. Foster):

Staff removed a portion of the amount of Annual Incentive Plan (AIP) amounts included in the Service Company costs. After reviewing the AIP, Staff eliminated all incentives related to financial goals. Staff made these adjustments at the Service Company level to stay consistent with the adjustments that were made at the MAWC level for the financial goals.

Review of Company prepared work papers indicates the Company has not excluded financial related AIP compensation in its calculation of labor and labor related expenses.

1 Q. WHAT IS STAFF'S RATIONALE FOR REMOVING THE PORTION OF THE AIP
2 AWARD BASED ON THE COMPANY ACHIEVING FINANCIAL GOALS?

3 A. Staff explains the rationale for removing incentives related to financial goals on
4 page 52 of the Staff Report on Cost of Service as follows:

5 MAWC's financial goal is based on American Water's operating income,
6 which is defined by the Company as earnings before interest, taxes and
7 other non-operating expenses. The performance level was determined at
8 both the corporate level and the Divisional/Regional/State level. Thus, an
9 employee could be eligible for AIP for both the corporate financial goal
10 and the Divisional/Regional/State level financial goal. Staff typically
11 disallows recovery of this portion of incentive compensation in rates. Staff
12 finds no connection between such financial results and any benefits to
13 MAWC's ratepayers. Staff's approach to incentive compensation is long-
14 standing. In the *Report and Order* issued in Case No. TC-89-14 et al.,
15 Southwestern Bell Telephone Company (SWB), the Commission stated:

16
17 In the Commission's opinion the results of the parent corporation,
18 unregulated subsidiaries, and non-Missouri portions of SWB, are only
19 remotely related to the quality of service or the performance of SWB in the
20 state of Missouri. Achieving the goals of SBC [the parent company] and
21 unregulated subsidiaries is too remote to be a justifiable cost of service for
22 Missouri ratepayers. Accordingly, the Staff's proposed disallowances in
23 the senior management's long term and short-term incentive
24 plans...should be adopted.
25

26 Q. DOES PUBLIC COUNSEL AGREE WITH STAFF'S RECOMMENDATION TO
27 REMOVE AIP COMPENSATION RELATED TO FINANCIAL GOALS?

28 A. Yes. For this reason, OPC contends that the Missouri Public Service
29 Commission should disallow the entire amount of AIP compensation in the
30 revenue requirement for this case.
31

1 Q. WHAT IS THE BASIS FOR PUBLIC COUNSEL'S POSITION?

2 A. Public Counsel's position is based upon review of American Water's **

3 ** provided in response to Staff's data

4 request No. 62. The brochure indicates **

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6 **

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8 Q. PLEASE BRIEFLY EXPLAIN THE ELEMENTS OF THE PLAN.

9 A. According to the **

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1 Q. WHY DOES OPC BELIEVE THE ENTIRE AIP AWARD SHOULD BE
2 DISALLOWED?

3 A. According to the **

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5

6 ** (emphasis added)

7

8 In short, **

9

** and thus the entire

10 amount of awards should be disallowed.

11

12 Q. BASED ON THE FUNDING CRITERIA, COULD MISSOURI-AMERICAN WATER
13 HAVE OUTSTANDING PERFORMANCE RELATIVE TO CUSTOMER SERVICE
14 QUALITY AND YET AIP ELIGIBLE EMPLOYEES RECEIVE NO AIP AWARD?

15 A. Yes. If **

16

**, regardless of an individual's performance rating or the

17

performance of Missouri-American Water Company in regard to customer service

18

quality, safety, or other factors.

19

1 Q. CONVERSELY COULD MISSOURI-AMERICAN WATER BE PROVIDING VERY
2 POOR SERVICE TO ITS CUSTOMERS, YET AIP ELIGIBLE INDIVIDUALS
3 STILL RECEIVE AN AIP AWARD?

4 A. Yes. Although Missouri-American Water's poor service quality could influence
5 the overall amount of AIP funding, **

6
7 **

8
9 Q. ARE THERE OTHER AIP RELATED EXPENSES THAT SHOULD ALSO BE
10 DISALLOWED?

11 A. Yes. According to the Company provided work papers and the Company's
12 response to OPC data request No. 1032, AIP compensation is subject to the
13 following labor related costs:

- 14 • Federal Insurance Contribution Act (Social Security and Medicare).
- 15 • Company 401k match.
- 16 • Some amount of Pension cost.

17
18 Q. DOES OPC KNOW THE AMOUNT OF THESE OTHER COSTS THAT SHOULD
19 ALSO BE DISALLOWED?

20 A. According to the Company's response to OPC data request No. 1038, the 2010
21 cost for MAWC employees for these items are:

- 1 • Federal Insurance Contribution Act - \$60,679
- 2 • Company 401k match - \$2,297
- 3 • Pension Cost – the Company was unable to calculate the costs related to AIP
- 4 for the FAS 87 pension expense.

5 OPC will need to obtain this information for AIP compensation included in Service
6 Company management fees and also determine whether any other benefit costs
7 pertaining to AIP should be disallowed.

8
9 Q. IF THE COMMISSION DOES NOT CONCUR WITH OPC'S POSITION, BUT
10 RATHER BELIEVES ONLY A PORTION OF THE AIP COMPENSATION IS
11 FINANCIAL RELATED, DOES OPC STILL HAVE SOME CONCERN WITH
12 STAFF'S APPROACH?

13 A. Yes, although OPC believes the entire amount of AIP compensation and related
14 expenses should be excluded in the calculation of the Company's revenue
15 requirement. Should the Commission not concur, OPC believes at a minimum,
16 Staff is inconsistent in determining the amount of the award that is related to
17 financial goals.

18
19 Q. HOW IS STAFF INCONSISTENT IN DETERMINING THE AMOUNT OF THE
20 AIP AWARD THAT IS RELATED TO FINANCIAL GOALS?

1 A. In reviewing Staff's work papers, OPC notes that when calculating the amount of
2 AIP compensation associated with Service Company Management Fees, Mr.
3 Foster disallowed ** ** of the incentive compensation as pertaining to
4 financial related goals. While Ms. Westhues appears to have disallowed slightly
5 more than ** ** of AIP compensation pertaining to Missouri-American Water
6 Company employees, and this disallowance includes other factors as noted in
7 Staff's Cost of Service Report.

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9 Q. WHAT DO YOU BELIEVE IS THE BASIS FOR THIS INCONSISTENCY?

10 A. According to the AIP plan highlights, **
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Mr. Foster appears to use the financial related goals for the funding of the plan as the basis for disallowing ** ** of the AIP compensation included in Service Company Management Fees.

Ms. Westhues, on the other hand, reviews the individual objectives for each Missouri-American Water AIP eligible employee, and renders a professional judgment as to whether each individual objective is financial related or not. Although OPC does not call into question Ms. Westhues judgment when reviewing the individual objectives, OPC believes this approach ignores the fact that **

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Thus, if the Commission rejects OPC's argument that the entire AIP award should be disallowed, at a minimum, OPC believes ** ** of the Company and Service Company AIP award pay-out is financial related and should be disallowed.

IV. BUSINESS TRANSFORMATION

Q. WHAT IS BUSINESS TRANSFORMATION?

1 A. In summary, American Water Works Service Company (“AWWS”) undertook a
2 comprehensive review and analyses of its information technology systems, and
3 developed recommendations for their improvement. The review, termed the
4 Comprehensive Planning Study (“CPS”), identified proposed investments
5 necessary to replace and upgrade applicable information technology systems.
6 Business Transformation (“BT”) is the collective body of work required to achieve
7 this replacement and upgrade.

8
9 Q. WHAT IS THE COMPANY’S REQUEST OF THE COMMISSION REGARDING
10 SPECIAL ACCOUNTING TREATMENT FOR BUSINESS TRANSFORMATION
11 COSTS?

12 A. On page 37 of Mr. Dennis Williams’ direct testimony he itemizes three specific
13 requests pertaining to the treatment of Business Transformation capital costs.

14 OPC is focusing on the second and third requests, which per Mr. Williams are:

15 2. The Company requests that the Commission authorize it to delay the
16 onset of depreciating the Business Transformation asset until the effective
17 date of rates that include the depreciation thereon. This will more
18 appropriately match cost recovery with expense incurrence.

19
20 3. In order to provide the Company the opportunity to earn a reasonable
21 return on its investment, MAWC requests that the Commission authorize it
22 to continue the accumulation of AFUDC on Business Transformation
23 assets until those assets are included for recovery in rates.
24

25 Q. WHAT IS OPC’S POSITION ON THIS ISSUE?

1 A. OPC recommends the Commission deny the Company's request, and treat BT
2 capital projects similar to other capital projects, which are placed in service when
3 they become used and useful, and depreciation thereon commences accordingly.
4

5 Q. WHY IS OPC OPPOSED TO THE COMPANY'S REQUEST?

6 A. OPC does not believe the BT capital projects costs should receive special
7 accounting treatment for the following reasons:

- 8 • Inconsistency with terms of prior Stipulation and Agreement.
- 9 • Significant annual capital expenditures and wide fluctuations therein,
10 regardless of BT.
- 11 • Mitigating factors to "regulatory lag".
- 12 • Investment in information technology is not a unique, unusual and non-
13 recurring event.
14

15 Q. IS THE SPECIAL ACCOUNTING TREATMENT REQUESTED CONSISTENT
16 WITH TERMS OF THE STIPULATION AND AGREEMENT THE COMPANY
17 ENTERED INTO IN THE LAST RATE CASE?

18 A. No. The request is contradictory to the Stipulation and Agreement between the
19 Company, Staff, OPC and several intervenors dated May 24, 2010 pursuant to
20 Missouri-American Water Company's Request for Authority to Implement a

1 General Rate Increase per Case No. WR-2010-0131. The second paragraph of
2 item No. 19 in that Stipulation states the following:

3 Costs associated with the CPS and the Business Transformation Project
4 shall be accounted for on the books of the Company as construction work
5 in progress (CWIP). In accordance with the National Association of
6 Regulatory Utility Commissioners (NARUC) 1973 Uniform System of
7 Accounts, as revised July 1976, Accounting Instruction No. 3 Subpart (17),
8 the Company shall accrue allowance for funds used during construction
9 (AFUDC) on the related CWIP balances at the Company's monthly
10 calculated AFUDC rate. **The Company shall transfer the CWIP**
11 **balances to Utility Plant in Service when in-service in accordance**
12 **with the NARUC Uniform System of Accounts and, beginning in the**
13 **month immediately following transfer, shall record depreciation**
14 **thereon at the appropriate Commission approved depreciation rate.**
15 (emphasis added)
16

17 The settlement is discussed in the Commission's Report and Order for that case
18 issued June 16, 2010 with an effective date of June 18, 2010. The last sentence
19 in the second paragraph on page eight states, "Therefore, the Commission
20 incorporates the terms of the settlement into this *Report and Order*."
21

22 Q. DOES THE COMPANY EXPERIENCE SIGNIFICANT CAPITAL
23 EXPENDITURES EACH YEAR, REGARDLESS OF BT, AND ARE THERE
24 SUBSTANTIAL FLUCTUATIONS IN THOSE EXPENDITURES?

25 A. Yes. According to the Company's response to OPC data request No. 1128, over
26 the course of the project, BT costs are expected to total nearly **

27 **
28

1 OPC's review of the Company's annual reports filed with the Commission noted
2 that average annual gross additions to utility plant for the five years ending
3 12/31/2010 was \$97.2 million and wide fluctuations exist between years.

Annual Plant Additions (\$ Millions)		Annual Change
2006	\$ 76.4	
2007	\$120.8	\$44.3
2008	\$129.6	\$ 8.8
2009	\$ 69.1	-\$50.5
2010	\$ 89.9	\$20.8
Five Year Avg.	\$ 97.2	

10
11 As can be seen, the amount of funds the Company expends for utility plant varies
12 dramatically from year to year. Missouri-American's estimated total cost for BT is
13 within the normal range of annual fluctuations.

14
15 Q. ARE THERE FACTORS THAT SHOULD MINIMIZE THE COMPANY'S
16 CONCERN REGARDING REGULATORY LAG?

17 A. Yes. Regulatory lag appears to be a key factor in driving the Company's request.
18 However, historically the Company has short time intervals between rate cases,
19 as evidenced by the most recent filings requesting authority to implement a
20 general rate increase. Such intervals minimize the impact of regulatory lag. The
21 last four rate cases were filed as follows:

Rate Case No.	Date Filed	Effective Date of Rates
WR-2007-0216	12/15/06	10/22/07
WR-2008-0311	3/31/08	11/28/08
WR-2010-0131	10/30/09	07/01/10
WR-2011-0337	6/30/11	TBD

7 Q. WILL TIMING OF PLANT ADDITIONS POTENTIALLY MINIMIZE THE IMPACT
8 OF REGULATORY LAG?

9 A. Yes. The various information technology modules, and associated costs will not
10 all be completed simultaneously. According to responses to Staff data request
11 No. 281 and OPC data request No. 1007, and discussions with Company
12 personnel, **

		**

1 Q. DOES THE COMPANY ANTICIPATE BT COULD REDUCE COSTS?

2 A. Yes. **

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Depending upon circumstances, the Company could enjoy the benefits of those savings in rates for some time prior to rates changing. The Company is requesting ratepayers to compensate it for regulatory lag, but such lag can also be a benefit to the Company in the form of potential increases in revenue or decreases in operating costs and depreciation expense that are not reflected in rates.

12

13

14

15 Q. IS BUSINESS TRANSFORMATION AN EXTRAORDINARY ITEM?

16

17 A. No. Business Transformation is a project the Company and its shareholders

18

19 opted to undertake. The Company decided the extent of the upgrade and the

20

21 timing of that upgrade. Information Technology decisions regarding the extent of

22

software and hardware to use, amount of automation versus manual processes,

1 investment in internal IT infrastructure or outsourcing, etc. are not extraordinary,
2 unique or non-recurring, but rather are part of normal operations of businesses,
3 including utilities. As business needs and technology changes, companies
4 evaluate their IT infrastructure and make decisions whether to significantly
5 overhaul those systems on a continued cyclical basis. There were no forced
6 governmental mandates or "acts of God" that drove a need for this initiative.
7 Therefore Public Counsel opposes any special accounting treatment
8 consideration for capitalized BT costs.

9
10 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

11 A. Yes.