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Compensation for Services
MAWC Provided to AWR*
Witness: *John P. Cassidy*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

JOHN P. CASSIDY

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2007-0216

Staff Exhibit No. 10
Case No(s). WR-2007-0216
Date 8-14-07 Rpt. PC

*Jefferson City, Missouri
July 2007*

STAFF-10

In the Matter of Missouri-American Water)
Company's request for Authority to) Case No. WR-2007-0216
Implement a General Rate Increase for)
Water Service provided in Missouri)
Service Areas)

STATE OF MISSOURI)
)
COUNTY OF COLE) ss.


John P. Cassidy

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

Suzie Hankin
Notary Public

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1 companies because test analysis represents a more accurate measurement of the actual work
2 that is being performed at the Belleville Lab facility. The Staff will also demonstrate how
3 adherence to Mr. Grubb's proposed allocation of Belleville Lab costs, using customer counts,
4 creates situations where MAWC, as well as other operating companies, are unfairly placed in
5 the position of subsidizing testing costs for other American Water operating companies.
6 Finally, the Staff will explain why its proposed inclusion of revenue in the cost of service
7 calculation is appropriate in order to compensate MAWC for the services that it has provided
8 to its non-regulated affiliate, AWR. The services that MAWC has provided to AWR have
9 allowed it to profit from those MAWC customers who have signed up with AWR for a water-
10 line, sewer-line or in-home plumbing protection plan offering. Staff's compensation proposal
11 results in a more equitable sharing of resulting profits between MAWC and its ratepayers and
12 AWR, in contrast to the compensation that Company witness Grubb suggests might be
13 appropriate.

14 **ALLOCATION OF BELLEVILLE LAB COSTS TO MAWC**

15 Q. Why did the Staff propose its allocation methodology of distributing
16 non-direct Belleville Lab costs by using a five-year average of actual test analyses performed?

17 A. The Staff's test analysis allocation methodology best represents the true nature
18 of work that is performed at Belleville Lab for MAWC and for all of the other
19 American Water operating companies. The Staff used an average of the test analysis that was
20 performed on water samples by Belleville Lab over the last five calendar years ending
21 December 31, 2006. As will be explained later in this surrebuttal testimony, the Company's
22 proposed method of allocating Belleville Lab costs using customer counts results in the
23 situation where Missouri ratepayers are forced to subsidize the testing work that is being

1 performed for customers residing in operating companies located in other states. The Staff's
2 proposed methodology of allocating non-direct Belleville Lab costs using an average of actual
3 test analysis for all of the operating companies taking service from Belleville Lab results in a
4 more accurate assignment of cost to each operating company because it appropriately reflects
5 the work that is performed at Belleville Lab. Using a measure of the actual work performed
6 at Belleville Lab will result in a more accurate matching of cost-causers to costs than simply
7 using customer counts.

8 Q. In making its adjustment is the Staff suggesting that MAWC reduce the
9 amount of testing and sampling that is now performed at Belleville Lab?

10 A. No. The Staff is in no way suggesting that the MAWC, or any other operating
11 company, reduce its level of testing and sampling that is required by the
12 Environmental Protection Agency's federal water quality standards that are duly enforced by
13 the Missouri Department of Natural Resources. The Staff encourages the Company to
14 maintain strict adherence to all of its water quality testing requirements. Staff's
15 recommendation only addresses the allocation of cost among the entities receiving service
16 from Belleville Lab, not the performance or quantity of testing for any specific entity.

17 Q. How does the Staff respond to Mr. Grubb's assertion that the Staff's allocation
18 method is somehow flawed because an operating company's total samples can vary from one
19 year to the next because of source water conditions, contamination events and regulations
20 (Grubb Rebuttal page 14, lines 28-32)?

21 A. The Staff disagrees with Mr. Grubb's implication that the potential variability
22 from year to year makes the Staff's test analysis method incorrect. The Staff believes that
23 these types of conditions clearly underscore why the Staff's methodology is better.

1 Company's customer count methodology will never take into account conditions such as
2 source water conditions, state specific regulations or contamination events because customer
3 counts have nothing to do with these types of events. Similarly, they do not address
4 differences in source of supply and numbers of connections to the systems that exist between
5 operating companies. However, Staff's methodology of using testing analysis is directly
6 correlated to each of these specific conditions.

7 Q. Does Belleville Lab currently track test analyses to be performed for each
8 operating company?

9 A. Yes. Belleville Lab requires each operating company to submit a list of the
10 number and frequency of water analyses that each operating company expects the lab to
11 perform during the upcoming calendar year. These lists are received by the lab in the mid-
12 November through early December time period. Ms. Cheryl Norton, director of the Belleville
13 Lab, indicated to the Staff that these lists are used to send out sample bottles and to prepare
14 for the work to be performed by the lab in the upcoming year. In addition, Ms. Norton
15 indicated to the Staff that the lab maintains a 12-year history of actual test analysis that it
16 performs. The existence of this test analysis history demonstrates that this basis for the
17 allocation of the Belleville Lab costs is readily available and more indicative of the work
18 performed than a basis that relies on customer counts.

19 Q. Please respond to Mr. Grubb's assertion that use of Staff's method "could vary
20 widely from one year to the next" (Grubb Rebuttal page 14, lines 31-32) and that the use of
21 "customer counts are much less variable" (Grubb Rebuttal page 15, lines 1-3).

22 A. The Staff recognizes that its method could result in more variability, but
23 believes this could be alleviated by using a multi-year average of test analyses as the basis of

1 allocation. However, the consequences of continuing to use the Company's method of relying
2 on customer counts results in a significant and continuous overcharge for
3 MAWC's customers. This continued significant subsidy of other systems by MAWC erodes
4 the savings that the Company's customers are supposed to achieve as a result of centralizing
5 the laboratory function. The following chart reflects the test analysis allocations for
6 California-American for the five calendar years ending December 31, 2006 as well as the
7 customer allocation percentages for the same time period:

12 Months	Test Analysis	Customer Count
<u>YTD</u>	<u>Allocation Percentage</u>	<u>Allocation Percentage</u>
12/31/02	14.3%	5.8%
12/31/03	42.4%	5.8%
12/31/04	23.2%	5.4%
12/31/05	15.9%	5.3%
12/31/06	17.86%	5.4%

16 As can be seen from the chart above, California-American has consistently
17 required Belleville Lab to perform more test analyses and use more laboratory resources than
18 would be indicated by an allocation method that relies on customer counts. This example
19 demonstrates that using the Company's proposed customer allocation method results in
20 California-American ratepayers consistently paying less for Belleville Lab costs than is
21 appropriate. This means that all other American Water operating companies, including
22 MAWC, are put in the position of subsidizing California-American's testing requirements.
23 California-American customers have been getting a discount for water testing at the expense
24 of ratepayers from other American Water operating companies.

25 Q. Do you have another example that would demonstrate that the use of
26 customers as an allocation basis is improper?

A. Yes. In January 2002, MAWC purchased the City of Florissant Water System (Florissant). Prior to this, Florissant operated as a wholesale customer of MAWC. Upon completion of the sale, Florissant customers became retail ratepayers of MAWC. The sale also resulted in a change in MAWC's customer numbers from one wholesale customer to approximately 14,500 retail customers. As a result of this sale, MAWC was allocated more Belleville Lab cost based on the Company's method of using customer counts as the basis for allocation. However, the actual number of test analysis required for MAWC did not change.

Q. What has Missouri's historical test analysis experience been in comparison to customer counts?

A. The following chart shows a historical comparison of the MAWC percent of test analysis versus customers for the five calendar years ending December 31, 2006.

<u>Period</u>	<u>Staff Test Analysis Allocation</u>	<u>Company Customer Count Allocation</u>
12 months YTD 12/31/02	8.18%	15.27%
12 months YTD 12/31/03	6.52%	15.27%
12 months YTD 12/31/04	8.97%	14.23%
12 months YTD 12/31/05	6.40%	14.14%
12 months YTD 12/31/06	6.04%	14.10%
Five Year Average	7.04%	14.57%

The Staff proposes to use the five-year test analysis average to smooth out any variability that existed from year to year for purposes of setting rates. On the other hand, the Company's customer count methodology attempts to allocate over 14% of non-direct Belleville Lab costs to Missouri during the test year. By using the customer count methodology the Company is forcing MAWC ratepayers to pay for more than 14% of non-direct Belleville Lab costs while on average only 7.04% of the testing work at Belleville Lab is actually performed for MAWC. The Staff's chart also reveals that MAWC has been

1 consistently overcharged (on average over 100%) for Belleville Lab costs based on the
2 Company's customer count methodology in comparison to actual test analysis.

3 Again, the Staff believes that the fact that test analysis does vary from year to year
4 justifies the need to allocate these indirect costs based on what is actually taking place,
5 namely test analysis. Of course, as Company witness Grubb has suggested in his rebuttal
6 testimony, allocating based on customer counts is "more stable" and will provide much less
7 variability in the allocation of Belleville Lab non-direct costs. However, Mr. Grubb's "more
8 stable" approach does not justify continuing to significantly overcharge MAWC ratepayers.
9 An entity that requires less work performed should receive less cost. Unfortunately, customer
10 counts have nothing to do with testing expenses and therefore result in an inappropriate
11 amount of non-direct Belleville Lab costs being assigned to MAWC. Furthermore, the effect
12 of using the Company's methodology results in MAWC's ratepayers paying for testing and
13 sampling costs that relate to ratepayers who are located in states other than Missouri. As the
14 Staff has pointed out, MAWC's customer counts do not correlate to the work that is being
15 performed at Belleville Lab. Furthermore, the Staff believes that using the number of test
16 analysis instead of customer of counts is also straightforward and understandable.

17 Q. How does the Staff respond to Mr. Grubb's point that because every
18 American Water operating company uses the same allocation method for non-direct charge
19 expenses it creates a system wide consistency? (Grubb Rebuttal, page 15, lines 6-7).

20 A. The Staff believes by adopting the approach of allocating non-direct
21 Belleville Lab charges based on actual test analysis that American Water can improve upon
22 its current allocation process by making it more reflective of the work that is performed at the
23 Lab. Using the method proposed by Mr. Grubb results in a system wide inconsistency

1 between the work being performed at the Belleville Lab and the amount being charged to
2 individual operating companies.

3 Q. How does the Staff respond to Mr. Grubb's contention that consistency from
4 state to state is important? (Grubb Rebuttal page 15, line 17-22).

5 A. Mr. Grubb claims that by using number of customers as its allocation
6 methodology, American Water will be unable to recover all of its Belleville Lab costs.
7 However, Mr. Grubb fails to point out the same problem can exist with the current customer
8 allocation methodology. Customer growth and the purchase or sale of water systems at other
9 operating companies in between various rate cases can create the same situation Mr. Grubb
10 uses to rebut Staff's proposal. Furthermore, Mr. Grubb's claim ignores the fact that customer
11 counts have no correlation to testing and sampling expense. Mr. Grubb's position would
12 force MAWC customers to pay for costs that were not incurred to serve them, but are incurred
13 to serve customers in another state. Therefore, the consistent customer impact results in an
14 inaccurate cost assignment and a subsidy between the various operating companies in each
15 state. In contrast, the Staff's proposed allocation methodology tracks actual test analysis,
16 which represents the majority of the resources and work that is performed at Belleville Lab.
17 The Staff believes that knowing that a current allocation methodology is creating a situation
18 where MAWC is being forced to pay nearly twice as much for testing costs than test analysis
19 would suggest and that also creates inter-company subsidies is inappropriate and should lead
20 to the implementation of test analysis as a consistent standard. The Staff recommends that the
21 Commission adopt the test analysis allocation methodology to determine the non-direct
22 Belleville Lab Service Company costs included in MAWC's cost of service.

COMPENSATION FOR SERVICES PROVIDED BY MAWC TO AWR

Q. Does the fact that MAWC last used its name and logo, during March 2004, regarding its communications with customers about AWR offerings, as described in Mr. Grubb's rebuttal testimony (page 2, lines 22-32) somehow absolve MAWC from its responsibility to seek compensation for these endorsements and marketing activities?

A. No. As the Staff has already described in its direct testimony, MAWC has made it possible for AWR to offer the water-line, sewer-line and in-home plumbing protection programs not only because it has supplied updated customer lists to American Water Resources Inc (AWR), but because of the endorsements it provided in the past. MAWC has also provided on six occasions a signed letter of endorsement by Mr. Thornburg, a previous MAWC President, promoting the water line protection program. The letterhead on the letter, as well as the mailing envelope contained the trusted name of MAWC as well as its logo. The Staff contends that these MAWC marketing activities have created a significant amount of credibility for the services offered by AWR. This establishment of credibility and trust lends tremendous value to AWR's offerings for which MAWC should be fairly compensated. Just because MAWC stopped engaging in those promotional activities in March 2004, does not undo the linkage that has been created in the utility customer's mind between AWR and MAWC, nor does it diminish the trust and credibility that has been established between the two entities. The Staff maintains that the credibility and trust established with the water line protection plan naturally extends to AWR's sewer line protection plan as well as its in-home plumbing protection plan. Furthermore, MAWC continues to provide AWR with updated mailing lists that are used for marketing all three of these programs.

1 Q. Are there any other ways MAWC is involved in the AWR program?

2 A. Yes. If a customer experiences a water leak, they are instructed to "...call the
3 toll free number shown on your water bill from Missouri-American Water Company. In the
4 event Missouri-American determines the leak is to your customer-owned water line. We will
5 arrange to have an approved independent contractor call you to set up a time...to arrange for
6 repair of your customer-owned water line." This statement indicates that AWR enlists the
7 involvement of MAWC employees to inspect and determine the source of any leaks.
8 Currently, AWR does not compensate MAWC for the use of its employees who determine the
9 source of water leaks.

10 Q. Please respond to Company witness Grubb's statements (Rebuttal testimony
11 page 3, lines 11-13) that there is "not a great amount" of value associated with "the mailing
12 list that AWR does receive..." and that "a mailing list by zip code can be purchased from
13 third party vendors for the areas where AWR sends advertisements."

14 A. Mr. Grubb's likening of MAWC's utility customer list to a marketing mailing
15 list compiled by zip code is unfounded. AWR is not offering its services on the open market.
16 Instead its services are being targeted to captive utility customers. Furthermore, the Staff's
17 research shows that AWR cannot obtain customer lists on the open market that provide the
18 targeted customers that MAWC continually provides on an updated basis to AWR. A mailing
19 list by zip code, as referenced by Mr. Grubb, would not replicate the list that is continuously
20 updated by MAWC. In order to reach all of its intended customers, AWR would need to
21 purchase multiple lists for all the various zip codes that exist not only for each of the
22 operating districts where these promotional offerings are being made, but also for multiple zip
23 codes that might exist in each of these various operating districts. Generic lists compiled by

1 zip code would also create problems because they would include thousands of residents who
2 are not MAWC customers. A list by zip code would result in AWR mailings being sent to
3 non-MAWC customers who might be customers of municipalities, homeowner associations or
4 other utilities creating a great deal of questions and confusion. As a result of having a
5 free targeted list that only MAWC can provide, AWR representatives are able to avoid these
6 types of customer service nightmares. Obtaining generic customer lists by zip code most
7 likely would not be as current or fully inclusive of all MAWC customers, creating further
8 customer confusion within the ranks of MAWC's own customers. Finally, even Mr. Grubb
9 concedes that purchased lists by zip code "would be somewhat larger" and that "the cost of
10 having more names would ...be the mailing and production cost associated with mailing some
11 number of extra advertisements." (Grubb Rebuttal page 3, lines 20-23).

12 Q. Please respond to Mr. Grubb's comment that imputed revenues for ratemaking
13 purposes to MAWC "should be something less than \$7,500.87." (Grubb Rebuttal page 4,
14 lines 31-33 and page 5, lines 1-4).

15 A. The Staff disagrees with Mr. Grubb's proposal. Mr. Grubb is attempting to
16 compare the billing and collection assistance that MAWC performs for the St. Louis County
17 Public Works Department with the promotional assistance that MAWC has provided to its
18 affiliate AWR. The Staff believes that these two programs are significantly different.
19 The St. Louis County program is mandated and requires no marketing by the Company.
20 AWR would likely not have realized the market penetration it experienced if not for the
21 endorsements provided by MAWC.

22 The Staff contends that AWR is in the business of offering its water and sewer service
23 line and in-home plumbing protection programs in order to earn profit. For AWR to make a

1 profit, the firm is soliciting thousands of MAWC customers. Many have already signed up
2 for the various programs. However, AWR would not easily generate profits without the
3 customer lists that MAWC ultimately provides to it free of charge. MAWC has never sought
4 any compensation for all its assistance. If MAWC was truly acting in its own best financial
5 interests, it would have negotiated a better deal than to receive absolutely no compensation for
6 all of the services it provided to AWR. The Staff doubts that MAWC would voluntarily give
7 these customer lists to a non-affiliated company without seeking compensation.

8 The Staff believes, from its perspective, that American Water would rather have its
9 non-regulated affiliate company AWR offer the program instead of the regulated MAWC.
10 This would allow AWR to keep all of the profits and at the same time use the time and
11 resources of the utility to target its service offerings free of charge. If MAWC were to offer
12 the program, the profits it earned from such a program would help to reduce rates that
13 ratepayers in Missouri would have to pay. As it stands, by offering the program through an
14 affiliate, AWR can shield all of the profits from MAWC's ratepayers. The Staff contends that
15 since the program is offered through an affiliated company and MAWC is not acting in the
16 best interests of its ratepayers, some adjustment needs to be made to properly compensate
17 MAWC and its ratepayers. The Staff believes that MAWC should not have provided the
18 customer lists and all of the aforementioned services without compensation from AWR for the
19 Missouri ratepayers who have been solicited for the program. Certainly all of the MAWC
20 assistance and the continually updated customer lists have much more value than the
21 approximate \$7,500 that is suggested by Mr. Grubb.

22 Q. What compensation is the Staff attempting to recover in making its
23 adjustment?

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1 A. The Staff adjustment to increase MAWC's revenues by \$137,449 annually is
2 attempting to recover a portion of the profits that AWR will generate annually from offering
3 the water line, sewer line and in-home plumbing protection programs in Missouri. To date,
4 the Staff has only received information regarding the revenues that AWR generated from
5 MAWC customers. MAWC objected to providing the Staff with the level of expenses AWR
6 has experienced in relation to serving MAWC customers for the three programs. This
7 prevented the Staff from determining the exact AWR profits that have resulted from
8 transactions with MAWC customers. In the absence of the objected-to-AWR expense and
9 profit information relevant to MAWC customers, the Staff assumed a 50% profit margin for
10 the water, sewer and in-home plumbing protection programs that are being offered to MAWC
11 customers. The Staff believes that MAWC is fairly entitled to 50% of AWR's estimated
12 profits associated with the water line program, which results in \$93,450 of compensation to
13 MAWC, and 25% of AWR's estimated profit associated with its sewer line program and in-
14 home plumbing programs, which results in \$41,132 and \$2,867 of compensation to MAWC,
15 respectively. The Staff's proposal attempts to more equitably share profits between AWR and
16 MAWC ratepayers so they will both profit from these programs. The Staff does not believe
17 that Mr. Grubb's proposal to include only one percent of gross revenue, or approximately
18 \$7,500, represents fair compensation to MAWC for opening the door for AWR to potentially
19 earn significant unregulated profits.

20 Q. Does this conclude your surrebuttal testimony?

21 A. Yes, it does.