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**

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.**

Julie M. Polzin
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
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TABLE OF CONTENTS

SURREBUTTAL TESTIMONY

PETER J. THAKADIYIL

I. WITNESS INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.

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

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING ON BEHALF OF MISSOURI-AMERICAN WATER COMPANY ("MAWC" OR "COMPANY")?

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

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of the Missouri Commission Staff ("Staff") on bad debt expense.

II. BAD DEBT EXPENSE

Q. WHAT IS THE ISSUE REGARDING BAD DEBT EXPENSE?

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

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 ADJUSMENT 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 METHODOLGOY?

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.

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

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

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

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

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

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

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

Q. DOES STAFF GROSS-UP ANY OTHER EXPENSES?

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

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

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

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

A. Yes. I have performed a five year analysis of the relationship between income taxes and revenue, which is attached to my surrebuttal testimony as Schedule PJT-1. As illustrated in Schedule PJT-1, income taxes can vary significantly from year to year. In one year, income taxes actually decrease when revenues increase. Also, income taxes can increase at a higher rate than the amount that revenues increase. Furthermore, the ratio of income taxes to revenue varies from a high of 6.27% to a low of 3.58%.

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

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

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

A. Yes. As an example, take a customer who does not pay their $30 water bill during the test year. The Company would not earn this revenue in the test year. This bill is based on rates that were authorized in the Company's last rate case. Now, say the Company is awarded a 10% increase in rates as part of the present rate case. The customer's bill would increase to $33 and the Company would still not earn this revenue. Thus, the on-going or normalized level of bad debt expense would be $33. This is the same manner in which Staff would apply wage increases to labor or price adjustments for chemicals.

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

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

> Bad Debts
>
> *Should the bad debt percentage be applied to reflect the total revenues, including any rate increase in Missouri jurisdictional retail revenues awarded in this proceeding?*
>
> KCPL and Staff agree that KCPL should apply a 0.61% bad-debt write-off factor to KCPL's Missouri jurisdictional revenue. The contested issue between these parties is what that Missouri jurisdictional revenue should be.
>
> KCPL asserts that the Commission should apply that factor to the actual Missouri jurisdictional revenue that the Commission finds appropriate for this case. In contrast, Staff objects, maintaining that such treatment harms ratepayers because there is no demonstrable correlation between the level of retail sales and the percentage of bad debts. Instead, Staff appears to argue that the Commission should apply the bad debt percentage write-off to its pro forma revenue requirement in its case, rather than the actual revenue requirement the Commission decides.
>
> The Commission finds that the competent and substantial evidence supports KCPL's position, and finds this issue in favor of KCPL. The Commission understands Staff's argument that there is not a perfect positive correlation between retail sales and the percentage of bad debts. While it's possible that KCPL's bad debt expense could decrease, the Commission finds it more probable, and therefore just and reasonable, that an increase in the amount of revenue that KCPL is allowed to collect from its Missouri retail ratepayers will result in a corresponding increase in bad debt expense.

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

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

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

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

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