Exhibit No.:	
Issues:	*Pension and Other Post-Retirement Employee Benefits Costs, Annual Incentive Plan Pay-out Based Upon Meeting Financial Goals and Customer Satisfaction Survey, Labor and Labor-Related Expenses, Rate Case Expenses, Insurance Other than Group, and Waste Disposal Expense*
Witness:	*Dana E. Eaves*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.	*WR-2008-0311*
Date Testimony Prepared:	*October 16, 2008*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

DANA E. EAVES

MISSOURI-AMERICAN WATER COMPANY

CASE NOS. WR-2008-0311 & SR-2008-0312

Jefferson City, Missouri
October 2008

****<u>Denotes Highly Confidential Information</u>****

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SURREBUTTAL TESTIMONY

OF

DANA E. EAVES

MISSOURI AMERICAN WATER COMPANY

CASE NO. WR-2008-0311

Q. Please state your name and business address.

A. Dana E. Eaves, PO Box 360, Suite 440, Jefferson City, MO 65102.

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

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

Q. Are you the same Dana E. Eaves who participated in the audit and preparation of the Commission Staff's cost of service recommendation in this case?

A. Yes, I am. On August 18, 2008 the Staff filed its Cost of Service Report in this proceeding.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to address the rebuttal testimony of Missouri American Water Company (the Company; MAWC) witnesses Edward P. Grubb, Dennis R. Williams, Donald J. Petry, Peter J. Thakadiyil, and Edward L. Spitznagel. In particular, I will address the following points respectively:

- Should the Company continue with the Pension and Other Post-Retirement Employee Benefits (OPEB) approach stipulated in its last rate proceeding or change methodology in this case?

- Should certain deferrals of prior OPEBs costs be reflected in cost of service in this proceeding?
- Should ratepayers be responsible for the expense associated with the Annual Incentive Plan (AIP) payouts associated with financial goals and the results from a customer satisfaction survey?
- Should rate case expense be normalized or amortized, and should rate case expense associated with prior rate cases be recovered in this rate case?
- What is the appropriate methodology in calculating the ongoing level of overtime expense and associated payroll taxes?
- Is the proposed Staff adjustment that excludes the allocated premium cost for Directors & Officers (D & O) and Kidnap & Ransom (K & R) insurance coverage from allowable expenses appropriate?
- What should be the appropriate capitalization rate to apply to insurance other than group (general liability)?
- What should be the appropriate level of waste disposal expense included for the Warren County Sewer District?

PENSION AND OTHER POST-RETIREMENT EMPLOYEE BENEFIT COSTS

Q. Is the Staff recommending a change in accounting treatment for pension and OPEB expense from that stipulated by the Company and other parties in the prior case (WR-2007-0216)?

A. No. The Staff's proposed methodology is the same as stipulated to by the Company in the prior case. In fact, the general approach stipulated to by MAWC in the prior rate case is also currently in use for all other major utilities in the State, per my understanding.

Q. What was the stipulated approach to pensions and OPEBs in MAWC's last rate case?

A. The approach agreed to in the prior case is as follows:

1) Use of the FAS 87 approach to develop pension expense and the FAS 106 approach to determine OPEBs expense;

2) Amortization of pension and OPEB trust fund gains and losses using a ten-year period and elimination of the "corridor approach; and

3) Use of trackers to quantify the differences between the pension and OPEBs expense amounts included in the Company's rates and their actual incurred expense levels, with the difference being amortized to cost of service over a five-year period in subsequent rate proceedings.

Q. Has anything changed with in the regulatory environment since the last rate case that would precipitate the need for a change in the accounting treatment for these items from that described above?

A. No.

Q. Mr. Grubb specifically recommends use of the so-called "corridor approach" in determining pension expense for ratemaking purposes. What is the corridor approach?

A. The corridor approach is a smoothing mechanism (the "corridor") for recognizing actuarial (unrecognized) net gains and losses of pension and OPEB plans. Recognition (i.e., amortization) of unrecognized gains and losses is only required under generally accepted accounting principles if the unrecognized net gains and losses are greater in aggregate than 10 percent of the projected benefit obligation or the market-related value of plan assets, whichever is greater. If amortization is required, the minimum amortization shall be that excess divided by the average remaining service period of active employees expensed to receive benefits under the plan.

Q. Is use of the corridor approach mandatory for utilities in preparing their financial statements?

A. No. As discussed above, use of the corridor approach only defines a minimum amortization amount for recognition of pension and OPEB fund gains and losses. However, companies are free under GAAP to choose to amortize unamortized gains and losses in a greater amount than that defined using the corridor approach.

Q. Why does pension and OPEB trust fund gain and loss experience lead to potential volatility concerns?

A. Pension and OPEB trust funds are generally heavily invested in the stock markets and stocks are volatile by nature, as current events in the financial markets amply demonstrate. If recognized as incurred, fluctuations in financial markets could cause extreme fluctuations in reported pension and OPEB expense from year to year. For this reason, it is appropriate to normalize or "smooth out" the impact of these gains and losses for rate purposes over an extended period of time.

Q. Why does the Staff oppose use of the corridor approach for purposes of calculating pension expense?

A. In most circumstances, use of the corridor approach will eliminate any consideration in determining annual pension and OPEB expense of the actual financial gains and losses over time experienced by pension and OPEB funds. The Staff believes pension and OPEB expense should be reflected in rates in a manner that balances an accurate accounting for the current funded status of the plans with the need to mitigate annual fluctuations in expense in a reasonable manner. In this sense, while it would clearly be inappropriate to reflect pension and OPEB fund gains and losses fully in rates in the year they are experienced since this approach could lead to extreme fluctuations in expense in any given year due to changes in the stock market or other financial markets, it would be equally inappropriate to totally ignore the actual funded status of utility pension and OPEB trust funds in setting rates The latter approach, advocated by MAWC, would give undue weighting to a perceived need to eliminate annual volatility in expense by totally disregarding the actual funded status of pension and OPEB trust funds. The Staff believes a ten-year amortization of pension and OPEB gains and losses properly balances volatility and accuracy concerns for ratemaking purposes.

Q. Does the Commission employ the corridor approach in setting pension and OPEB expense for any of its major utilities?

A. No, it does not. The Staff believes elimination of the corridor approach in setting rates for utilities in this State is a long-settled practice.

Q. Does the Staff have comments regarding proposed amortization of regulatory assets associated with prior deferrals of OPEB costs for St. Joseph, Joplin and St. Louis County Water district, as discussed by Mr. Grubb at page 17 of his Rebuttal Testimony?

A. Yes. The Staff has researched and reviewed these two proposed OPEB deferrals. The first deferral mentioned by Mr. Grubb was a result of a prior Missouri-American rate case, No. WR-95-205. In that proceeding, the Commission ordered a 20-year amortization of an OPEB deferral relating to the St. Joseph and Joplin districts.

Consistent with that Order, the Staff has recognized and included $31,901 into the Company's OPEB expense level in this case. However, the Staff could not find any similar evidence of Commission ordered rate treatment for the second OPEB deferral in the amount of $844,643 mentioned by Mr. Grubb, which he states is associated with the St. Louis County District. The only discussion of this deferral that the Staff found was in Case No. WR-94-166 (St. Louis County Water Company) by the Company witness J. Jenkins in his Direct Testimony, pages 44-45. The Staff can find no evidence that his proposal to include this amortization in cost of service was adopted in either the Stipulation and Agreement or the Commission Order for that case. If the Company could provide evidence showing this adoption by the Commission in that or subsequent rate cases, the Staff would consider including this amortization in its OPEB expense calculation.

ANNUAL INCENTIVE PLAN PAY-OUT BASED UPON MEETING FINANCIAL GOAL AND CUSTOMER STATISFACTION SURVEY

Q. What is the Staff's position on inclusion in rates of payments to employees through the Company's Annual Incentive Plan (AIP) based upon achievement of financial goals?

A. The Commission has consistently excluded incentive plan for payouts to employees for meeting certain financial goals in prior rate proceedings. For example, in the Report and Order for Case No. GR-2004-0209, et. al., Missouri Gas Energy (MGE), the Commission stated:

> The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's

> shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.
>
> If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement

Q. Has the Company described the Financial Component of the AIP?

A. Yes. In its response to the Staff Data Request 47.1, the Company provided a document titled; "American Water the 2007 Annual Incentive Plan Rewarding Achievement." On page three of this document, the **Financial** component of the plan is defined as follows:

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Q. Does the Staff still support its proposed adjustment in the amount of $207,669 to eliminate the amount associated with the financial component of the 2007 AIP payout?

A. Yes, as this adjustment is consistent with past Commission precedent.

Q. Does the Staff still support the proposed adjustment in the amount of $96,075 that eliminates the amount associated with the customer service component of the 2007 AIP payout discussed by Mr. Grubb at page 17 and Mr. Spitznagel at page 7 of their rebuttal testimony?

A. No. After reviewing the Company witness's rebuttal testimony and discussing the underlying issues with the Company within the settlement conference, the Staff is no longer proposing this adjustment.

LABOR AND LABOR-RELATED EXPENSES

Q. What are the Staff's comments relating to Peter J. Thakadiyil Rebuttal Testimony relating to labor and labor-related expenses?

A. The Staff will address the appropriate normalization of overtime hours and associated payroll taxes.

Q. Please describe why normalization is often necessary for the calculation of overtime compensation includable in rates?

A. Overtime hours for the Company tend to vary from year to year based on several factors, such as current level of employees, scheduled and unscheduled construction and maintenance projects, customer usage patterns and other environmental factors not necessarily in the control of the Company. Because of this variability it is important to attempt to smooth-out overtime hours worked in a year to better reflect an ongoing level or normal level of expense.

Q. What normalization approach did the Staff use in its direct filed position?

A. The Staff chose a four-year normalization period by district in an effort to best reflect an ongoing level of overtime hours.

Q. Has the Staff updated its position on the normalization period since its direct filing?

A. Yes. After discussion with the Company during the settlement conference the Staff has chosen to accept a three-year normalization period which is also being recommended by the Company. The Company made the Staff better aware of factors relating to ongoing staffing levels and maintenance issues being faced by the Company that would have an effect on the level of overtime hours on a going forward basis.

Q. Does this change in the normalization period from four years to three years effect payroll taxes associated with overtime?

A. Yes. The Staff will recalculate the payroll tax expense based upon the change in normalization period.

<u>RATE CASE EXPENSES</u>

Q. How has the Staff proposed the treatment of rate case expense in this case?

A. The Staff is proposing to normalize rate case expense over a three-year period. The total amount of rate case expense incurred by MAWC through March 31, 2008 associated with the consolidated Case No. WR-2008-0311 is being allowed at this time. Any additional costs that are reasonably incurred rate case expense will be considered for inclusion later during the true-up period.

Q. How is the Company recommending that rate case expense be handled in this proceeding?

A. The Company witness Dennis R. Williams states in his Rebuttal Testimony, page 5:

> MAWC has proposed deferral of the actual costs incurred to prepare and process this rate case and to amortize those costs to expense over a three year period. In addition, as a result of MAWC's last rate case, $870,853 of rate case expense was deferred. By the end of February 2009, $483,807 will remain unamortized and will represent costs expended that have no been recovered. MAWC's proposed solution to this problem is to amortize the remaining balance of rate case expense from the last rate case over the next three years.

Q. Does the Staff agree with the Company's amortization of rate case expense from MAWC's last case on its financial statements?

A. No. As the Company correctly points out the last case was stipulated, and neither the Stipulation and Agreement or the Commission's Order specified in any way the amount of recovery by individual item or the financial reporting treatment of rate case expense. The Company alone made the decision to defer rate case expense and book an asset for this item. The Staff did not recommend in the last case that rate case expense be treated as an amortization for either rate or financial reporting purposes. The Staff does not agree with the Company's financial reporting methodology for this expense item and would have challenged, if given a vehicle to do so, the Company's claim that amortization of this expense was somehow appropriate for regulatory reporting purposes.

Q. Do you agree with the Company's witness claim that normalization of rate case expense is a new approach from either the Commission or Staff perspective?

A. No. The Commission has had a long history of ordering a normalized level rate case expense to be recovered in rates (for example, Case No. WR-83-14, Missouri Cities Water Company).

Q. Does the Staff agree with the concept of amortizing rate case expense?

A. No. Rate case expenses are not extraordinary expenses which should be amortized, but are ordinary expenses which should be included in the Company's cost of service at a reasonable level calculated upon actual data. The Staff also asserts that to accept the Company's proposal to include prior year expenses in the current rate case could constitute retroactive ratemaking.

Q. Should the Commission attempt to guarantee the Company recovery of rate case expenses associated with prior cases?

A. No, it should not. In the event a company avoids a rate case for a longer period of time than assumed in its prior rate proceeding, then the Company will as a result over-recover rate case expense in its rates. However, there is no mechanism in place to return such over-collections to customers. Likewise, a utility that comes in for a rate increase more quickly than assumed in its prior rate proceeding be not be made whole for its failure to fully collect its prior rate case expense allowance in its rates.

INSURANCE OTHER THAN GROUP

Q. Did the Staff sponsor an adjustment in their direct filed case to eliminate allocated costs associated with Director and Officers (D&O) and Kidnap and Ransom (K&R) insurance coverage?

A. Yes, it did. The amount of the adjustment in aggregate was $18,228.

Q. Is the Staff still seeking to eliminate these allocated cost associated with D&O and K&R insurance coverage?

A. No. After a review of the rebuttal testimony of the Company witness and discussion held in the settlement conference, the Staff is no longer seeking this disallowance.

Q. Is the Staff sponsoring other adjustments in this area?

A. Yes. The Staff is still sponsoring an adjustment reflecting the appropriate capitalization rate that should be applied to the allocated portion of general liability insurance policy.

Q. Please briefly describe what is meant by O&M factor.

A. An O&M factor is the percentage between the level of payroll that is applied to capital construction projects and general operational and maintenance accounts. This percentage can be applied to various categories of expense to recognize the appropriate amount associated with capital expenditures.

Q. What operation and maintenance (O&M) allocation factors are the Company sponsoring and the Staff sponsoring for general liability insurance?

A. The Company is sponsoring a 10% capitalization factor and the Staff is sponsoring a 42.54% capitalization factor.

Q. How did the Company derive this O&M factor?

A. The Company witness Mr. Petry asserts in rebuttal testimony that an analysis was performed after the settlement conference which determined for the period 2005-2007 claims paid relating to capital projects was 3.62% of the total claims paid and, therefore, the proposed 10% capitalization rate is a conservative estimate of risk exposure related to capital projects.

Q. How did the Staff determine its proposed allocation factor for this category of insurance costs?

A. The Staff used labor information provided by the Company. The information provided labor dollars allocated between operational and maintenance expense and capital construction projects and from this information a ratio can be developed. This ratio was applied to the Company's overall salary and wage expense.

Q. Does the Staff agree with the Company's premise that claims paid is an appropriate measure for risk exposure associated with capital additions and activities associated with operating and maintenance expense?

A. No. In the Staff's view general liability insurance premiums are to cover all of the risk exposure the Company faces related to various activities not covered by other types of insurance. This exposure occurs from two major categories, capital construction projects and operation and maintenance related activities which are not covered by other insurance policies. The Staff proposes that matching risk exposure to premiums paid based on the level of activities, which can be measured by dollar, is the most appropriate method of assigning costs for theses activities. The Staff's analysis of MAWC's employee activities in this case indicated that 42.54% of their time is associated with capital functions, as opposed to operating functions. Therefore, this matching is best accomplished by applying the overall Staff annualized O&M factor to the general liability insurance premiums.

Q. Is the Staff's approach on this issue consistent with what it has sponsored in other rate proceedings?

A. Yes, to the best of the Staff's knowledge this methodology is consistent with prior rate proceedings.

<u>WASTE DISPOSAL EXPENSE</u>

Q. Does Company witness Donald J. Petry in his Rebuttal Testimony claim that the Staff failed to include the appropriate level of costs for waste disposal (sludge removal) in their cost of service calculation for the Warren County Sewer District?

A. Yes. Mr. Petry states the Company did not provide the correct level of waste disposal expense to Staff's Data Request No. 129 as the majority of the expense was booked in a non-waste disposal account. Mr. Petry's Rebuttal Schedule DJP-2 shows costs associated with waste disposal expense booked to Account 535.000 in the amount of $26,361 for the 12 months ended 12/31/2007. Currently, the Staff has not made an adjustment to this amount.

Q. Do you agree with Mr. Petry that the amount of $26,361 should be used as an ongoing level for sludge removal?

A. No. Since the Staff was unaware of this amount in a non-waste disposal account the Staff was not able to perform the appropriate analysis to determine its appropriateness.

Q. Why is it not appropriate to include the new proposed test year level in the Cost of Service (COS) for this type of expense?

A. Waste removal is an expense that is likely to vary from year to year. Traditionally, the Staff has used a multi-year average to smooth out (normalize) these variances as it has done with the other districts in this case. Due to the substantial change in the level of expense now being reported by the Company and because the Staff has not had an opportunity to review invoices related to this change, the Staff would normally propose to use a multi-year average to normalize this expense for this district. However, the Company has not provided the information needed to perform this normalization.

Q. What level and annualization method did the Staff propose in the direct filing?

A. The Company reported $1,600 of waste disposal expense for the test year. Due to the small level of waste disposal expense, the Staff proposed no adjustment to this item.

Q. Should the Company have records relating to waste disposal expense for periods other than what has been reported for the 12 months ended 12/31/2007?

A. Yes. As the result of the Commission order issued by the Missouri Public Service Commission in Case No. WM-2004-0122, Missouri-American assumed the responsibility for providing service to Warren County Water & Sewer's customers on September 24, 2004. The Company should have expense history relating to waste disposal from that date forward.

Q. What is the Staff's recommendation at this time concerning waste disposal expense?

A. The Staff is proposing a disallowance of $13,980 to the newly reported waste disposal expense amount for this case. However, the Staff would certainly be open to review any additional information the Company may have relating to the appropriate normalized level of waste disposal expense in this case.

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-2008-0311

AFFIDAVIT OF DANA E. EAVES

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Dana E. Eaves, of lawful age, on his oath states: that he 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 him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Dana E. Eaves

Subscribed and sworn to before me this 15th day of October, 2008.

NIKKI SENN
Notary Public - Notary Seal
State of Missouri
Commissioned for Osage County
My Commission Expires: October 01, 2011
Commission Number: 07287016

Nikki Senn
Notary Public