Exhibit No.:
Issues: Pension Expense-FAS 87, Pension Liability, OPEBS-FAS 106, Deferred OPEB Asset, New St. Joseph Treatment Plant Phase-In, AFUDC
Witness: *STEPHEN M. RACKERS*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Direct Testimony*
Case Nos.: *WR-2000-281 and SR-2000-282*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

STEPHEN M. RACKERS

MISSOURI-AMERICAN WATER COMPANY

CASE NOS. WR-2000-281 and SR-2000-282

Jefferson City, Missouri
March, 2000

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DIRECT TESTIMONY

OF

STEPHEN M. RACKERS

MISSOURI-AMERICAN WATER COMPANY

CASE NOS. WR-2000-281 & SR-2000-282

Q. Please state your name and business address.

A. Stephen M. Rackers, 815 Charter Commons Drive, Suite 100 B, Chesterfield, Missouri 63017.

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

A. I am a Regulatory Auditor V in the Accounting Department, in the St. Louis Office, for the Missouri Public Service Commission (Commission).

Q. Please describe your educational background.

A. I graduated from the University of Missouri-Columbia, in 1978, from which I received a Bachelor of Science degree in Business Administration, majoring in Accounting. I have passed the Uniform Certified Public Accountant examination and I am currently licensed in the State of Missouri.

Q. What has been the nature of your duties while in the employ of this Commission?

A. I have supervised and assisted in audits and examinations of the books and records of public utility companies operating within the State of Missouri. I have listed cases in which I previously filed testimony on Schedule 1.

Q. With reference to Case Nos. WR-2000-281 and SR-2000-282, have you made an investigation of the books and records of Missouri-American Water Company (MAWC or Company)?

A. Yes, with the assistance of other members of the Commission Staff (Staff).

Q. What is the purpose of your direct testimony?

A. My direct testimony will discuss the following items:

1) The Staff's recommendation regarding rate base balances and expense adjustments, included in Staff Accounting Schedules 2 - Rate Base and 10 - Adjustments To Income Statement, for pension expense calculated according to Financial Accounting Standard (FAS) 87 and other post-retirement benefits (OPEBs) expense calculated according to FAS 106.

2) The Staff's recommendation regarding the phase-in of the revenue requirement associated with the new St. Joseph Treatment Plant (SJTP).

3) The Staff's recommendation regarding the appropriate rate and amount for allowance for funds used during construction (AFUDC) accumulated since the Company's last rate case.

Q. Please list the Accounting adjustments and schedule balances you are sponsoring.

A. I am sponsoring the following adjustments and schedule balances:

Accounting Schedule 10	**Adjustments to Income Statement**
S-13.7 and S-13.16	Annualization of Pension Expense FAS 87
S-13.5 and S-13.15	Annualization of OPEB Expense FAS 106

Accounting Schedule 2	**Rate Base**
Pension Liability	Rate Base Offset
Deferred OPEB Asset	Rate Base Addition

PENSION EXPENSE – FAS 87

Q. Please provide a brief description of FAS 87.

A. FAS 87, Employers' Accounting for Pensions, provides the accrual accounting method used in determining the annual expense and liability associated with providing pensions. This statement was issued by the Financial Accounting Standards Board (FASB) and is considered to be in conformance with Generally Accepted Accounting Principles (GAAP) for financial reporting purposes.

Q. What is the basis for the Staff's recommended pension expense level in this case?

A. In response to Staff Data Request No. 63, MAWC provided the calculation currently being used to determine pension expense under FAS 87. This calculation was performed by the actuarial firm of Towers Perrin.

Q. Please explain the Staff's calculation of its annualization adjustment.

A. Adjustment S-13.7 begins with the actuary's pension expense calculated for the entire American Water Works Company (AWWC) system. The MAWC portion of this amount was determined based on the valuation earnings of the Company in relationship to the total AWWC system valuation earnings. The MAWC portion was then multiplied by the Staff's payroll operation and maintenance (O&M) factor, to determine the amount that is charged to expense, as opposed to being capitalized. The Staff's O&M factor was determined based on the amount of annualized total payroll charged to expense. Pension expense allocated from the American Water Works Service Company was then added to the MAWC O&M portion to determine the total annualized pension expense. From this amount, the test year expense was subtracted to calculate the adjustment.

Q. Is the Staff recommending any adjustment to the method used by Towers Perrin to determine FAS 87 pension expense?

A. Yes. The Staff is recommending a five-year amortization of the average balance of unrecognized gains and losses in the FAS 87 calculation of pension expense.

Q. Please explain the Staff's methodology.

A. Based on the FAS 87 actuarial calculations for the last five years, the Staff computed an average balance of the unrecognized gains and losses. This average balance was then amortized over a five-year period. The value determined by use of the Staff's methodology is reflected in Adjustment S-13.16.

Q. Why is the Staff recommending an average balance?

A. An average balance is being recommended, instead of the current year-end balance, in order to eliminate any excessive volatility (annual fluctuation) in calculating FAS 87 pension expense. This method will smooth any significant historical fluctuation in annual gain/loss activity experienced by MAWC. This method was also used in calculating OPEBs expense under FAS 106.

Q. What method is being used by the Company to amortize the unrecognized gains and losses in the FAS 87 calculation of pension and FAS 106 calculation of OPEBs expense allocated to MAWC?

A. The corridor method is currently being used to amortize unrecognized gains and losses in the FAS 87 and FAS 106 calculation of OPEBs calculation of pension expense. This method only amortizes the amount of gains and losses in excess of 10% of the greater of the total value of plan assets or the accumulated benefit obligation. Any excess gains or losses above the 10% corridor are then amortized over the average remaining service period of the active plan participants. This amortization period is approximately 17 years, but only for the amount of gains in excess of the 10% corridor. The implied amortization period may be extremely long when comparing the amount amortized with the total amount of unrecognized gains.

Q. What flexibility does the Company have in determining the number of years to be used in amortizing the net gains and losses balance under FAS 87 and FAS 106?

A. Paragraph 33 of FAS 87 explains the wide flexibility allowed in choosing the amortization period for gains and losses:

> **Any systematic method of amortization of unrecognized gains and losses may be used in lieu of the minimum specified in the previous paragraph provided that (a) the minimum is used in any period in which the minimum amortization is greater (reduces the net balance by more), (b) the method is applied consistently, (c) the method is applied similarly to both gains and losses, and (d) the method used is disclosed.** (emphasis added)

Paragraph 60 of FAS 106 contains similar language.

Q. What is the basis for the Staff's recommendation to amortize all of the unrecognized gains and losses over five years?

A. An examination of the unrecognized net gains and losses balance for AWWC shows that the unrecognized balance is a net gain. This net gain balance is primarily due to the fact that expected return on plan assets used in calculating pension expense under FAS 87 is less than the actual return earned on the pension fund assets.

It is the Staff's position that pension and OPEB expense included in cost of service should be calculated based upon the most accurate information available. Timely recognition of the actual income earned on fund assets as well as the actual experience in relation to actuarial assumptions is necessary in order to meet this objective. Deferred recognition of actual experience for a period exceeding five years does not result in accurate pension and OPEB expense under FAS 87 and FAS 106, for ratemaking purposes.

Q. Please explain why the Staff is not recommending an amortization period less than or greater than five years.

A. The Staff's recommendation of five years for amortizing gains and losses under FAS 87 and FAS 106 is based upon the following:

1) Timely recognition of actual results is necessary for determining accurate pension and OPEB expense for inclusion in rates. The Staff considers five years to be a reasonable time period to meet this objective.

2) The federal government enacted legislation in 1987 that reduced the amortization period for asset gains and losses from fifteen years to five years for pension funding requirements. The Omnibus Budget Reconciliation Act of 1987, Section 412 (b)(2)(B) of the Internal Revenue Code requires that gains and/or losses from pension plan assets be amortized over a five-year period. A five-year amortization would treat asset gains and losses consistently for pension expense under FAS 87 and funding requirements under ERISA/Internal Revenue Service (IRS) Regulations.

3) A five-year amortization period is consistent with this Commission's long-standing precedent of amortizing abnormal, significant, expenses over five years for inclusion in rates.

Q. Is the recommendation to use a five-year amortization period for unrecognized gains and losses consistent with the Staff's treatment of, and Commission Orders for, other Missouri utility companies, regarding FAS 87 and FAS 106?

A. Yes. The use of a five-year average amortization in the FAS 87 calculation of pension expense and the FAS 106 calculation of OPEB expense is consistent with the treatment received by other Missouri utility companies. The Commission ordered this methodology after hearings in Case Nos. WR-96-263, GR-96-285 and ER-97-394 involving St. Louis County Water Company, Missouri Gas Energy Company and Missouri Public Service Company, respectively. This methodology was also employed by the Staff and accepted as part of a stipulation and agreement in the following cases: GR-95-160 for United Cities Gas Company, ER-95-279 for Empire District Electric Company, GR-96-193, GR-98-374 and GR-99-315 for Laclede Gas Company and GR-98-140 for Missouri Gas Energy Company.

All major utility companies in Missouri which have had rate cases since legislation was passed in Missouri in 1994 requiring the adoption of FAS 106 for rate making purposes, are amortizing gains and losses under FAS 87 and FAS 106 over a five-year period.

PENSION LIABILITY

Q. Please explain the term pension liability as you are using it.

A. The pension liability represents the difference between the amount of pension expense that has been charged to expense under FAS 87 and the amount that has been contributed to the pension fund.

Q. What treatment is the Staff recommending for this item?

A. The Staff recommends that the portion of the pension liability that has been accumulated since the recognition of FAS 87 in rates should be offset against (reduce) the rate base.

Q. Why is this treatment appropriate?

A. Since the December 5, 1995, effective date of the order in Case No. WR-95-205, pension expense has been recognized in the determination of rates based on FAS 87. However, the amount recognized in rates and provided by customers under the calculation of FAS 87 pension expense has exceeded the amount contributed to the pension fund. Since AWWC has not been permitted to make contributions to its pension fund in recent years, the balance of the pension liability account has continued to increase. Therefore, since December 5, 1995, ratepayers have supplied cash to the Company, which it can use to fund its operations until such time as these monies are contributed to the pension fund. Treating this amount as an offset to rate base is like the treatment afforded deferred taxes. The ratepayer provides cash to the Company associated with deferred income taxes until such time as these funds are paid out to the federal government. As a result, the balance of deferred income taxes is an offset to the rate base.

Q. Is this treatment consistent with the position taken by the Staff in other cases?

A. Yes. The Staff has proposed and the company has accepted this treatment for the pension liability in the last two cases involving St. Louis County Water. In addition, the Staff has proposed consistent treatment with regard to pension assets in several other cases. A pension asset results when the amount recognized in rates and provided by customers under the calculation of FAS 87 pension expense, is less than the amount contributed to the pension fund. In such instances, the pension asset has been included as an increase to the rate base.

OPEBS – FAS 106

Q. Please provide a brief explanation of FAS 106.

A. FAS 106, Employers' Accounting for Post-retirement Benefits Other Than Pensions, provides the accrual accounting method used in determining the annual expense and liability for providing OPEBs. This statement was issued by the FASB and is in conformance with GAAP for financial reporting purposes.

Q. What is the basis for the Staff's recommended level of annualized OPEB expense for this case?

A. In response to Staff Data Request No. 63, MAWC provided a copy of its 1999 actuarial calculation of OPEB costs under FAS 106 as performed by Towers Perrin.

Q. Please explain the Staff's calculation of its annualization adjustment.

A. Adjustment S-13.5 begins with the actuary's OPEB expense calculated for the entire AWWC system. The MAWC portion of this amount was determined based on its number of OPEB recipients in relationship to the total AWWC system recipients. The MAWC portion was then multiplied by the Staff's payroll O&M factor, to determine the amount that is charged to expense. As will be discussed later in my testimony, the

Commission, in Case No. WR-95-205, ordered an amortization of a portion of the contributions made to the Company's OPEB funds prior to the date that FAS 106 was recognized in rates. This annual amortization was added to the MAWC O&M expense portion to produce total annualized OPEB expense. From this amount, the test year expense was subtracted to calculate the adjustment.

Q. Is the Staff recommending any adjustment to the 1999 OPEBs expense calculation?

A. Yes. As with its calculation of pension expense, the Staff is recommending a five-year amortization of the average balance of unrecognized gains and losses in the calculation of OPEBs expense. This treatment was previously addressed as part of the discussion regarding FAS 87.

DEFERRED OPEB ASSET

Q. Please explain the term "deferred OPEB asset."

A. The deferred OPEB asset represents contributions made to the OPEB fund prior to the time FAS 106 was recognized in rates. The Commission ordered that the amount contributed to the fund associated with the original MAWC districts from July 1, 1993 through June 30, 1994, and the amount contributed to the fund associated with the old Missouri Cities Water Company districts from January 1, 1994 through November 30, 1995, should be permanently included in rate base. In addition, the amount contributed to the fund associated with the original MAWC districts from July 1, 1994 through November 30, 1995, was included in rate base and ordered to be amortized over a period of 17.25 years.

Q. What treatment has the Staff afforded this item in its calculation of revenue requirement?

A. The Staff has included the permanent and unamortized balances in rate base. The annual amortization is included in expense as a component of the Staff's calculation of annualized OPEB expense, as previously discussed.

NEW ST. JOSEPH TREATMENT PLANT PHASE-IN

Q. Please discuss the Staff's recommendation regarding the recognition of the revenue requirement associated with the new SJTP.

A. The Staff is recommending a five-year phase-in of the revenue requirement associated with the return and depreciation on the new SJTP.

Q. Why is this treatment appropriate?

A. The SJTP represents approximately a 100% increase in the total rate base of MAWC and a 300% increase in the rate base of the St. Joseph district. A phase-in will partially mitigate the "rate shock" associated with this extremely large plant addition.

Q. Discuss what you mean by the term "rate shock."

A. The term "rate shock" has been used to characterize the extremely significant increase that would result from reflecting the entire first-year revenue requirement associated with the SJTP in rates. The revenue requirement associated with the return on investment and depreciation expense on the SJTP is approximately $10 million in the first year. This reflects approximately a 30% increase in total company revenues and a 100% increase in the revenues of the St. Joseph district.

Q. Has the Staff proposed similar treatment in the past for extremely significant plant additions?

A. Yes. The Staff proposed phase-ins when the nuclear plants owned by Ameren/UE and Kansas City Power and Light Company were included in rates. Recognizing the entire revenue requirements of these plant additions immediately would have had the same relative effect on rates as immediate recognition of the entire SJTP.

Q. Why is the Staff proposing a five-year time period?

A. A five-year time period reduces the level of the first year rate increase to a significant, but not extreme, level of approximately 12%, on a total company basis to MAWC and on a stand-alone basis, to the St. Joseph district. Although the Staff views this level of increase as significant, considerable mitigation has occurred from the extreme levels previously discussed. Subsequent annual increases to fully reflect the SJTP in rates are also in the 12% range. In addition, phasing-in the plant over only five years should provide a higher level of confidence to the Company with regard to recovery of the deferred amounts.

Q. Please explain the Staff's phase-in methodology.

A. The Staff's method defers a portion of the revenue requirement associated with the SJTP. These deferrals earn a return equal to the rate of return recommended by the Staff in this case. The accumulated deferrals are recovered in the future through additional rate increases in years two through five. By the end of year five, the plant will be fully reflected in rates and all prior phase-in deferrals will be recovered.

Q. How will the Company effectuate the rate increases in years two through five?

A. The Staff recommends that the Commission approve all four of the subsequent rate increases as part of its order in this case. These rate increases will take effect automatically on the annual anniversary of the effective date of the rates from this case. However, if the Company files a rate case, or a complaint case is filed against the Company prior to the end of the phase-in, the appropriateness of all subsequent increases will be examined during that proceeding. This statement does not imply that the deferrals will not be recovered if a rate proceeding is filed, but that the method or term of the recovery may change.

Q. Will the Staff track the Company's earnings during the phase-in?

A. Yes. The Company should be ordered by the Commission to provide annually a Phase-In Monitoring Report. This report would provide a 12-month per book total water cost of service calculation.

AFUDC

Q. Please define this issue.

A. AFUDC is the carrying cost that utilities are allowed to capitalize as an additional cost of a construction project. The Staff recommends that the Commission order the Company to adjust the AFUDC rate it has used since the effective date of the rates in the last case. The method the Staff is proposing should also be used by the Company to determine the AFUDC rate in the future.

Q. What AFUDC Rate is the Company using?

A. The Company is using the rate of return from the last case to compute the AFUDC carrying cost for any project with a construction period in excess of 30 days.

Q. Why is this rate inappropriate?

A. This rate is inappropriate for two reasons. First, no short-term debt is reflected in the calculation. Second, the amount of debt and equity, as well as the embedded cost of debt, used by the company to fund construction, usually changes over time.

Q. What is the Staff's recommendation?

A. The Staff recommends that the AFUDC rate utilized by MAWC be adjusted in the following ways:

1) The rate should first reflect all of the outstanding amount of short-term debt available to the Company as the primary source of financing for construction.

2) The rate associated with any construction balance in excess of the outstanding amount of short-term debt should then be calculated based on the composite rate of the outstanding amounts of other sources of financing available to the Company (long-term debt, equity and preferred stock) during the construction period.

Q. Why is this appropriate?

A. Short-term debt is traditionally recognized as the primary source of construction financing. For this reason, no short-term debt has been included in the Staff's capital structure. Since the balance of plant under construction currently exceeds the outstanding balance of short-term debt, no short-term debt appears in the Staff's capital structure, although approximately $35 million was outstanding at December 31, 1999. With regard to the other capital components, the current monthly balances outstanding as well as the current embedded costs are a better reflection of the cost of funds available to finance construction.

Q. How will the Staff reflect its adjustment to the AFUDC rate in the cost of service?

A. Although numerous projects have been undertaken by the Company since the last rate case, a large portion of the AFUDC is associated with the SJTP. In addition, a large amount of AFUDC will be capitalized from January through April 2000 as the SJTP Project is completed. Therefore, the Staff will reflect its adjustment as a reduction to the plant investment as part of the true-up audit.

Q. What is the Staff's current estimate of the value of this adjustment to the AFUDC rate?

A. The Staff has calculated approximately a $1,000,000 reduction to the investment in plant. The associated revenue requirement value is approximately $115,000.

Q. Does this conclude your direct testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Tariff Sheets designed to implement general rate increases for water and sewer service provided to customers in the Missouri area of the company.	)))))	Case No. WR-2000-281
In the Matter of Missouri-American Water Company for a general sewer rate increase.	))	Case No. SR-2000-282

AFFIDAVIT OF STEPHEN M. RACKERS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Stephen M. Rackers, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the foregoing Direct 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.

Stephen M. Rackers

Stephen M. Rackers

Subscribed and sworn to before me this 28th day of March, 2000.

Toni M. Willmeno

Toni M. Willmeno
Notary Public, State of Missouri
County of Callaway
My Commission Expires June 24, 2000

TONI M. WILLMENO
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

RATE PROCEEDING PARTICIPATION

STEPHEN M. RACKERS

Company	Case Number
Bowling Green Gas Company	GR-78-218
Central Telephone Company	TR-78-258
Empire District Electric Company	ER-79-19
Fidelity Telephone Company	TR-80-269
St. Louis County Water Company	WR-80-314
Union Electric Company	ER-81-180
Laclede Gas Company	GR-81-245
Great River Gas Company	GR-81-353
Union Electric Company	ER-82-52
Laclede Gas Company	GR-82-200
St. Louis County Water Company	WR-82-249
Union Electric Company	ER-83-163
Union Electric Company	ER-84-168
Arkansas Power and Light Company	ER-85-20
Kansas City Power and Light Company	ER-85-128
Arkansas Power and Light Company	ER-85-265
Union Electric Company	EC-87-114
Union Electric Company	GR-87-62
Southwestern Bell Telephone Company	TC-89-14
St. Louis County Water Company	WR-89-246
Laclede Gas Company	GR-90-120
Missouri Cities Water Company	WR-91-172
St. Louis County Water Company	WR-91-361
Laclede Gas Company	GR-92-165

Company	**Case Number**
Missouri Pipeline Company	GR-92-314
St. Louis County Water Company	WR-92-204
St. Louis County Water Company	WR-94-166
St. Louis County Water Company	WR-95-145
Union Electric Company	ER-95-411
St. Louis County Water Company	WR-96-263
St. Louis County Water Company	WR-97-382
Laclede Gas Company	GR-99-315