

Exhibit No.:
Issue: Acquisition Adjustment
Witness: John P. Cassidy
Sponsoring Party: MoPSC Staff
Type of Exhibit: Direct Testimony
Case No.: SM-2004-0275
Date Testimony Prepared: August 10, 2004

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

JOHN P. CASSIDY

**MISSOURI-AMERICAN WATER COMPANY and
CEDAR HILL UTILITY COMPANY, INC.**

CASE NO. SM-2004-0275

*Jefferson City, Missouri
August 2004*

****Denotes Highly Confidential Information****

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

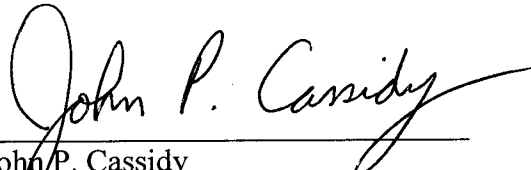
In The Matter of the Joint Application of Missouri-)
American Water Company and Cedar Hill Utility)
Company, Inc., for Authority for Missouri-American)
Water Company to Acquire Certain Assets of Cedar)
Hill Utility Company, Inc., and, in Connection)
Therewith, Certain Other Related Transactions)

Case No. SM-2004-0275


AFFIDAVIT OF JOHN P. CASSIDY

STATE OF MISSOURI)
)
COUNTY OF COLE) ss.

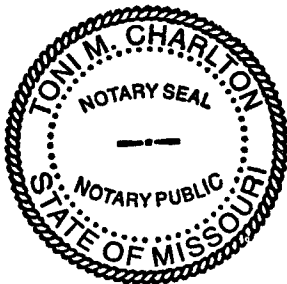
John P. Cassidy, being of lawful age, on his oath states: that he has participated in the preparation of the following direct testimony in question and answer form, consisting of 13 pages to be presented in the above case; that the answers in the following direct testimony were given by him; that he 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.



John P. Cassidy

Subscribed and sworn to before me this  day of August 2004.





TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

1 **DIRECT TESTIMONY**

2 **OF**

3 **JOHN P. CASSIDY**

4 **MISSOURI-AMERICAN WATER COMPANY AND**

5 **CEDAR HILL UTILITY COMPANY, INC.**

6 **CASE NO. SM-2004-0275**

7 Q. Please state your name and business address.

8 A. John P. Cassidy, 1845 Borman Court, Suite 101, St. Louis, Missouri 63146.

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

10 A. I am employed by the Missouri Public Service Commission (Commission) as
11 a Regulatory Auditor.

12 Q. Please describe your educational background.

13 A. I graduated from Southeast Missouri State University, receiving a Bachelor of
14 Science degree in Business Administration, with a double major in Marketing and
15 Accounting in 1989 and 1990, respectively.

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

18 A. Since joining the Commission Staff in 1990, I have assisted with and directed
19 audits and examinations of the books and records of utility companies operating within the
20 state of Missouri. I have also conducted numerous audits of small water and sewer
21 companies in conjunction with the Commission's small company rate increase procedure.

22 Q. Have you previously filed testimony before this Commission?

Direct Testimony of
John P. Cassidy

1 A. Yes, I have. Please refer to Schedule 1, which is attached to my direct
2 testimony, for a list of cases in which I have previously filed testimony. Please refer to
3 Schedule 2, which is attached to my direct testimony, for a list of all other Commission case
4 related activity in which I have been involved.

5 Q. What did you review in relation to the joint application of Missouri-American
6 Water Company (Missouri-American or MAWC) to acquire certain assets of Cedar Hill
7 Utility Company, Inc. (Cedar Hill)?

8 A. I reviewed the joint application filed by MAWC and Cedar Hill and all other
9 filings that have been made before the Commission in connection with this case. I also
10 reviewed various accounting records and reports maintained by Cedar Hill as well as Cedar
11 Hill's PSC Annual Reports. I reviewed the Staff's workpapers from the most recent Cedar
12 Hill rate case, as well as the Stipulation and Agreement and Commission Report and Order
13 that resulted from a related financing case. I reviewed contracts between Cedar Hill and
14 other parties. I also attended a PSC inspection of Cedar Hill's operations that was conducted
15 by Staff member Steve Loethen, who works in the Commission's Water and Sewer
16 Department. I have also conducted various meetings in person and by phone with the
17 owners, employees and accountants of Cedar Hill, as well as with employees of MAWC.

18 Q. With reference to Case No. SM-2004-0275, what is the purpose of this direct
19 testimony?

20 A. The purpose of this direct testimony is to provide the Staff's determination of
21 the current ratemaking rate base value of the Cedar Hill system, and the existence and
22 amount of any acquisition premium that may result from the transaction that is the subject of
23 this case and the reasonableness of any such acquisition premium. ** _____

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Q. What knowledge, skill, experience, training or education do you have in these matters?

A. I have analyzed mergers and proposed acquisition adjustments at other utility companies in other proceedings. I have reviewed testimony previously filed before this Commission and its Report and Orders regarding acquisition adjustments. In addition to my work experience at the Commission, I have attended numerous regulatory conferences and in house training sessions, reviewed various journals and trade articles and had numerous interactions with members of other regulatory bodies and entities.

Q. How many customers does Cedar Hill provide service to and what are their current rates?

A. Cedar Hill currently provides sewer service to 687 customers in Cedar Hill, which is located in Jefferson County, Missouri. The customer base is broken down into the following tariffed rate classes:

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<u>Customer Class</u>	<u>Monthly Rate</u>	<u>Customers</u>
Single Family	\$18.00	505
Mobile Homes	\$16.20	94
Multiple Family	\$14.40	26
Commercial minimum (Includes first 6,000 gallons)	\$18.00	62
Commercial commodity	\$2.12/1,000 gallons Over 6,000 gallons	
Total		687

Q. What is Cedar Hill's current rate base value?

A. The Staff's review of Cedar Hill's annual reports and accounting records revealed that Cedar Hill has a current rate base value of \$13,310. This rate base value represents Cedar Hill's net book value, which is the original cost of plant in service less accumulated depreciation and contributions in aid of construction (CIAC). The Staff and MAWC have agreed to this rate base level, but with the condition that Missouri-American will be allowed to propose adjustments to the rate base value recorded for the Cedar Hill system if new information becomes available or if existing assets were not properly recorded on the books of Cedar Hill.

Q. What is the likelihood of this type of rate base change occurring in the future?

A. Based on the Staff's examination of Cedar Hill's books and records and its knowledge of the system, the Staff believes such a change is unlikely. The Staff requested and received copies of the invoices in Cedar Hill's possession pertaining to system capital improvements that were completed and all CIAC that was received since January 1, 1994. The Staff used this date as its starting point, because the Commission established Cedar

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John P. Cassidy

1 Hill's rate base to be zero, on that date, in its Report and Order in Case No. SF-9-33, which
2 became effective February 10, 1995.

3 Also, after completing the inspection of Cedar Hill's facilities, the Staff reviewed the
4 rate base information with the assistance of Cedar Hill's operator, Mr. Bob Shawcross.
5 Mr. Shawcross, who has been Cedar Hill's operator since October 1990, confirmed that the
6 rate base information presented to MAWC by the Staff appeared to fully incorporate all
7 capital improvements that were completed for Cedar Hill and all contributions that were
8 received from January 1, 1994 to present.

9 Q. What is the purchase price that MAWC has proposed for Cedar Hill's assets?

10 A. MAWC has proposed to purchase the assets of Cedar Hill for ** _____
11 _____ **

12 Q. Please explain the terms acquisition adjustment and acquisition premium.

13 A. An acquisition adjustment is a result of a situation where the purchase price
14 does not equal the net book value of the assets of the company being acquired. If a purchaser
15 pays an amount in excess of net book value, it incurs a positive acquisition adjustment, or
16 acquisition premium. Conversely, if a purchaser pays an amount below net book value, it
17 incurs a negative acquisition adjustment, or acquisition discount. ** _____
18 _____
19 _____

20 _____ **

21 Q. Have you read decisions made by the Courts that discuss acquisition premium
22 issues?

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1 A. Yes. I have reviewed the Missouri Supreme Court's decision in AG
2 Processing, Inc. v. Public Service Commission of the State of Missouri and Aquila, Inc. f/k/a/
3 Utilicorp United, Inc. In its decision in that case the Missouri Supreme Court cited the
4 Martigney Creek Sewer Company v. Public Service Commission of the State of Missouri
5 (Martigney) and therefore I also reviewed the Missouri Supreme Court's decision in the
6 Martigney case. In the Martigney case, the Missouri Supreme Court listed certain factors to
7 be used for determining the reasonableness of utility acquisitions and the reasonableness of
8 acquisition adjustments.

9 Q. Please discuss the factors listed in the Martigney case that were cited in
10 assessing the reasonableness of a proposed utility acquisition and acquisition premium.

11 A. In that case, the Court mentioned three factors that may be used to assess the
12 reasonableness of a utility acquisition and acquisition premium. Specifically, these three
13 factors were: (1) was the transaction conducted at an arm's length; (2) did the transaction
14 result in operating efficiencies; and (3) did the transaction result in a desirable integration of
15 facilities.

16 Q. What is the Staff's opinion of these factors?

17 A. These factors should not be relied on to determine whether an acquisition
18 adjustment should be recovered in rates. The first of these three factors may establish that
19 the transaction was reasonable in the sense that it was conducted at arm's length in a fair and
20 ethical business environment and that it achieved certain business goals. However, from the
21 Staff's point of view, these factors do not consider the original cost of the investment, the
22 amount of the actual price paid or the effect on customer rates.

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John P. Cassidy

1 Q. Regardless of the Staff's opinion of the factors mentioned by the Missouri
2 Supreme Court, does the Staff believe that these three factors have been met in relation to
3 MAWC's proposed acquisition of Cedar Hill's assets in this case?

4 A. No. The Staff does not believe that all three factors have been met. The Staff
5 believes that only the first factor has been satisfied. The Staff believes that the transaction
6 was conducted at an arm's length. To the Staff's knowledge, prior to the completion of the
7 transaction, there was no personal or financial relationship between MAWC and Cedar Hill
8 and neither party was coerced or under any duress to engage in the transaction.

9 Q. What is the Staff's reason for concluding that the other two factors have not
10 been met?

11 A. With regard to the second factor, it will not be known until after MAWC
12 actually takes control and operates the Cedar Hill system, whether the transaction results in
13 operating efficiencies, which could reduce the overall cost of service. For example, MAWC
14 may believe that it can operate Cedar Hill more efficiently by incurring reduced levels of
15 expense with regard to the areas of rents, office expenses, accounting or even reduced costs
16 of capital, but these efficiencies may or may not occur in the future. However, after a merger
17 with MAWC, Cedar Hill customers would be certain to experience some level of expense
18 related to rate case expense, which does not presently exist as a result of using the
19 Commission's small company rate increase request procedure. Also, as part of the American
20 Water system, Cedar Hill customers would be allocated Service Company costs, which they
21 do not currently pay.

22 With regard to the third factor, which addresses whether the transaction results in a
23 desirable integration of the facilities, the Staff is unclear as to exactly what this entails. If

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1 this standard means that a physical integration of facilities will take place, then this standard
2 will not be met because the Cedar Hill operations will not be connected to any existing
3 operations currently owned by MAWC. Rather, the Cedar Hill system will be operated as a
4 stand-alone district. Also, if this standard means it would be desirable to integrate Cedar
5 Hill's operations under the ownership of MAWC because Cedar Hill is providing something
6 less than a safe and adequate level of service, as was the case with Warren County Water &
7 Sewer Company (Warren County), then this standard will also not be met because Cedar Hill
8 is providing a safe and adequate level of service to its customers.

9 Q. Does the Staff believe that there are other factors that the Commission should
10 consider when determining the reasonableness of an acquisition premium as it pertains to its
11 potential recovery in rates?

12 A. Yes. The Staff believes that there are other factors to consider. To my
13 knowledge, the Commission has consistently rejected an increase in rates based upon
14 attempts by utility companies to recover acquisition premiums and discounts in rate cases.
15 Also, to my knowledge, recovery of an acquisition premium through customer rates would be
16 counter to the Commission's general adherence to recovery of only the original cost of the
17 investments made by utilities that provide service to ratepayers. In addition, recovery of an
18 acquisition premium through customer rates would be a departure from the Commission's
19 historical position of allowing utility shareholders to retain any gains, or bear any losses,
20 associated with the sale or purchase of utility property. Lastly, the Commission has
21 consistently recognized that any deviation from original cost, associated with transactions
22 engaged in by utility companies, is the responsibility of the shareholders.

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John P. Cassidy

1 Q. What is the basis for using original cost, as opposed to subsequent sale price,
2 in determining rate base value?

3 A. The use of original cost prevents the situation where ratepayers are forced to
4 pay for the same plant investment more than once.

5 Q. In your opinion, is there any reason to deviate from the original cost standard
6 in this case?

7 A. No. The argument for adherence to this original cost standard is not
8 invalidated by any circumstances that exist in the current case. For example, Cedar Hill's
9 customers currently receive safe and adequate service as they would under MAWC
10 ownership.

11 Q. If recovery of only the original cost of Cedar Hill's assets is not utilized as the
12 standard in this case, but rather the sales price of those assets is included in the ratemaking
13 rate base in the future, what would be the consequences for the ratepayers of Cedar Hill?

14 A. In a subsequent rate case, the ratepayers would be forced to ** _____

15 _____
16 _____ **

17 Q. What other disadvantages are there for not using the original cost standard in
18 determining ratemaking rate base?

19 A. If recovery of an acquisition premium were allowed, there would be no
20 incentive to negotiate the best price for the acquired property because the additional cost
21 would be passed on to the ratepayers. In addition, the approval of the recovery of an
22 acquisition premium would place the Commission in the position of having to determine the
23 prudence of the acquisition price paid by the purchasing utility.

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1 Adherence to the original cost of investment also provides an incentive for utilities to
2 operate the acquired system in the most efficient manner. Revenue increases and cost
3 savings that are realized from the time the system is acquired until the next rate case are
4 retained by the utility that acquires the assets. Therefore, any cost savings can be used as a
5 mechanism for recovery of any acquisition premium incurred by the acquiring utility until it
6 files a subsequent rate case.

7 Q. Does an acquisition premium represent a new investment in the value of
8 utility assets?

9 A. No. An acquisition premium does not represent a new investment in plant nor
10 does it increase the value of the assets serving the ratepayers. The same assets will be
11 serving the same customers.

12 Q. What kinds of costs do acquisition premiums represent?

13 A. Acquisition premiums are ownership costs. The decisions about whether to
14 engage in the transaction and the amount to be paid were made by the owners of MAWC and
15 Cedar Hill. This transaction would not have taken place without the approval of these
16 individuals. On the other hand, ratepayers have no ownership rights in utility assets, no vote
17 in the decision to be part of a sale or purchase of utility assets and no influence on the
18 structure or terms and conditions of the purchase. ** _____

19 _____
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22 _____ ** For all of these reasons, the Staff's position is
23 that the Commission should continue to adhere to its practice of using only the original cost

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John P. Cassidy

1 of the plant in service net of the associated accumulated depreciation reserve and CIAC as it
2 has traditionally done in the determination of customer rates.

3 Q. Is there a recent example of a Commission regulated water utility attempting
4 to recover an acquisition premium in connection with the purchase of another regulated
5 utility?

6 A. Yes, there is. Case No. WM-2004-0122, which involved MAWC's proposed
7 purchase of Warren County, is the most recent example of a water utility attempting to obtain
8 recovery of an acquisition premium.

9 However, I do wish to note that Warren County was recognized as a "troubled
10 system" that was mismanaged and provided inadequate levels of service to its customers. In
11 fact, subsequent to a series of events, Warren County has been placed into receivership by
12 the Warren County Circuit Court and is now being operated under the supervision of a court-
13 appointed receiver.

14 Q. What did the Commission state was its position with regard to MAWC
15 attempting to recover an acquisition premium in connection with its acquisition of Warren
16 County in Case No. WM-2004-0122?

17 A. In that case, the Commission stated that it did not have sufficient evidence to
18 determine the original cost of Warren County's assets, and thus could not determine whether
19 an acquisition premium existed. However, the Commission stated that it was able to
20 determine that recognition in rate base of an amount as great as the purchase price to be paid
21 for Warren County, would not, by itself, be detrimental to ratepayers in that situation. The
22 Commission also determined that the issue of recovery of an acquisition premium would be
23 better presented during the course of a rate case when all relevant factors can be considered.

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1 The Commission further clarified its ruling on December 18, 2003 in its Order Granting
2 Clarification by stating the following:

3 The issue of what incentives, including acquisition premiums,
4 should exist for the purchaser of a troubled water or sewer company is
5 an issue that is coming to light across the nation. This Commission
6 does not have a clear set of standards that it can articulate to determine
7 if the recovery of an acquisition premium will be allowed in rates.
8 Because of the problems of the Warren County Water & Sewer
9 system, this case was intended to be settled on an expedited basis. The
10 Commission has not had sufficient opportunity to study all the
11 implications of a policy allowing an acquisition premium might have.
12 Doing so under pressure from a purchaser in order to get relief for the
13 customers of the Warren County Water & Sewer system is not the
14 appropriate way to set such an important policy.

15 Thus, the Commission clarifies its order by stating that it is not
16 guaranteeing an acquisition premium. The Commission is also not
17 ruling out the possibility that if a premium exists, there may be reasons
18 for finding that it should be recovered. The Commission cannot
19 articulate a specific standard at this time for allowing such a recovery.
20 This issue is one of significance, and an issue that the Commission
21 will continue to focus on and analyze in order to set an informed
22 policy.

23 Q. Has Cedar Hill ever been a “troubled system” that has provided inadequate
24 service to its customers, like the situation that exists with regard to Warren County?

25 A. No, it has not. Cedar Hill is currently a well managed and well operated small
26 sewer system. Cedar Hill customers consistently receive safe and adequate service. The
27 situation at Cedar Hill is not comparable to the situation that existed under the previous
28 ownership at Warren County. Please refer to the direct testimony of Staff witness Dale
29 Johansen, Manager of Water and Sewer Department, who addresses both Cedar Hill’s
30 operations and the operations of Warren County.

31 Q. Does the Staff have any other recommendations?

32 A. Yes. If the Commission determines that ** _____

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Direct Testimony of
John P. Cassidy

1 _____ ** then the Staff would request that Missouri-American maintain
2 a complete file of all records that Cedar Hill currently possesses. Such records should
3 include but not be limited to the following:

- 4 1. All checking account information and canceled checks for all accounts,
5 including all quick book records
- 6 2. Copies of all invoices
- 7 3. All payroll records and time sheets
- 8 4. All billing records
- 9 5. Tap on fee reports
- 10 6. State and Federal Income Tax Returns
- 11 7. All other correspondence, records and documentation in Cedar Hill's
12 possession that pertains to the utilities operations.

13 ** _____

14 _____.**

15 Q. Does this conclude your direct testimony?

16 A. Yes, it does.

17

RATE CASE PROCEEDING PARTICIPATION

JOHN P. CASSIDY

<u>COMPANY</u>	<u>CASE NO.</u>
Missouri Cities Water Company	WR-91-172 & SR-91-174
St. Louis County Water Company	WR-91-361
Southwestern Bell Telephone Company	TC-93-224
Laclede Gas Company	GR-94-220
Empire District Electric Company	ER-95-279
Imperial Utility Corporation	SC-96-247
St. Louis County Water Company	WR-97-382
Laclede Gas Company	GR-98-374
United Water Missouri, Inc.	WR-99-326
Union Electric Company	EC-2000-795
Union Electric Company	GR-2000-512
Laclede Gas Company	GR-2001-629
Union Electric Company, d/b/a AmerenUE	EC-2002-01
Union Electric Company, d/b/a AmerenUE	EC-2002-1025
Laclede Gas Company	GR-2002-356
Laclede Gas Company	GT-2003-0117
Missouri-American Water Company	WR-2003-0500 & WC-2004-0168

Other Case Activity

<u>Utility Name</u>	<u>Description</u>	<u>Year</u>
Continental Telephone Company	Earnings Investigation	1990
Taney County Utilities Corporation	Informal Rate Case	1991
Union Electric Company	ACA, GR-91-131	1991
Imperial Utility Corporation	Informal Rate Case	1991-92
Cat-Pac Waterworks, Inc.	Informal Rate Case	1992
Port Perry Service Company	Informal Rate Case	1993
KMB Utility Corporation	Informal Rate Case	1993
Central Jefferson County Utilities	Informal Rate Case	1993
West Elm Place Corporation	Informal Rate Case	1993
Alltel Missouri Service Corporation	Earnings Investigation	1994
Cedar Hill Utility Company	Informal Rate Case	1994
M.P.B. Inc.	Informal Rate Case	1994
P.C.B. Inc.	Informal Rate Case	1994
Mill Creek Sewer Company	Informal Rate Case	1994
KMB Utility Corporation	Informal Rate Case	1995
Herculaneum Sewer Company	Informal Rate Case	1995
Central Jefferson County Utilities	Informal Rate Case	1995
KMB Utility Corporation	Informal Rate Case	1996-97
KMB Utility Corporation	Davis Receivership	1996-97
West Elm Place Corporation	Informal Rate Case	1997
Gladlo Water and Sewer Company	Informal Rate Case	1997
Central Jefferson County Utilities	Informal Rate Case	1997-98
West Elm Place Corporation	Property Tax Issue	1997-98
Eastern Missouri Utility Company	Informal Rate Case	1998
West Elm Place Corporation	Asset Sale	1998
Imperial Utility Corporation	Asset Sale	1998
Gladlo Water and Sewer Company	Informal Rate Case	1998
Hunter's Ridge Subdivision	WA-2000-142	1999

<u>Utility Name</u>	<u>Description</u>	<u>Year</u>
Missouri-American Water Company	Certificate Cases	1999
AcquaSource Utilities	SM-2000-214	1999-2000
Missouri-American Water Company	WR-2000-281	1999-2000
House Springs Sewer Company	SC-99-135	1999-2003
KMB Utility Corporation	EIERA Loan Audit	2000
L.W. Sewer Corporation	EIERA Loan Audit	2000
Missouri-American Water Company	WA-2000-58	2000
Missouri-American Water Company	WA-2000-59	2000
Missouri-American Water Company	WA-2000-461	2000
Gladlo Water and Sewer Company	Informal Rate Case	2001
Union Electric Company	EC-2001-431,2 nd Earp	2001
Argyle Estates Water System	Informal Rate Case	2001
South Jefferson County Utility Company	Informal Rate Case	2001
KMB Utilities / Davis Water	WM-2001-463, Sale Case	2001
Laclede Gas Company	AX-2002-203	2002
TBJ Sewer Systems	Informal Rate Case	2002
Mill Creek Sewer Company	Informal Rate Case	2002-03
KMB Utility Corporation	Informal Rate Case	2002-03
Cedar Hill Estates Water Company	Informal Rate Case	2002-03
KMB / Cedar Hill Estates Water	WM-2003-0194	2002-03
North Oak Sewer District	Informal Rate Case	2002-03