Exhibit No.: 124
Issues: *AAO for LSLR*
Incentive Compensation,
Rate Base
Amortization Expense
Witness: *Amanda C. McMellen*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Surrebuttal Testimony*
Case No.: *WR-2017-0285*
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MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

AUDITING DEPARTMENT

SURREBUTTAL TESTIMONY

OF

AMANDA C. MCMELLEN

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2017-0285

Jefferson City, Missouri
February 2018

TABLE OF CONTENTS

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OF

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AMANDA C. MCMELLEN

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2017-0285

Q. Please state your name and business address.

A. Amanda C. McMellen, 200 Madison Street, Suite 440, Jefferson City, Missouri 65101.

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

A. I am a Regulatory Auditor V with the Missouri Public Service Commission ("Commission").

Q. Are you the same Amanda C. McMellen who has previously provided testimony in this case?

A. Yes. I contributed to Staff's Cost of Service Report filed in this case on November 30, 2017, and rebuttal testimony filed on January 17, 2018.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony in this case is to respond to the rebuttal testimonies of Office of the Public Counsel ("OPC") witness Keri Roth and Missouri-American Water Company ("MAWC" or "Company") witness James M. Jenkins on the rate-making treatment of the Accounting Authority Order (AAO) for customer-owned lead service line replacements (LSLR); MAWC witness Nikole L. Bowen on performance based compensation (incentive compensation); and MAWC witness Brian W. LaGrand on rate base items [net utility plant in service, net contributions in aid of construction ("CIAC") and regulatory deferrals] and amortization expense.

AAO FOR LEAD SERVICE LINE REPLACEMENTS (LSLR)

Q. What is Mr. Jenkins proposing for cost recovery and accounting treatment of the LSLR AAO?

A. Mr. Jenkins, on page 37 lines 6 through 15 and page 39 lines 10 through 18, proposes to include the cost in the Uniform System of Accounts (USOA) plant account 345-Services which includes cost installed of service pipes and accessories. Mr. Jenkins further states that these costs are similar in nature to incidental restoration costs which are associated with pavement disturbed, damages, or disruption of others' property during the restoration process.

Q. Does Staff agree with Mr. Jenkins' proposal?

A. No. In Staff's opinion, the costs associated with these replacements should be included in the USOA Account 186 – Miscellaneous Deferred Debits as ordered by the Commission in its Report and Order in Case No. WU-2017-0296, which became effective December 10, 2017. The service lines that are being replaced are customer-owned service lines and will remain the customer's property after the replacement. Since MAWC will not ever own or be responsible for maintaining these lines, the costs should not be included in plant in service. These costs are not the same as incidental restoration costs such as replacing pavement. These are costs associated with doing major replacements of customer-owned service lines at significant costs. This issue is further addressed in the surrebuttal testimony of Staff witness James A. Merciel, Jr.

Q. Does Mr. Jenkins propose to depreciate or amortize these costs?

A. On page 40 lines 10 through 15, Mr. Jenkins proposes to depreciate these costs at the current approved rate for Account 345 of 2.92%.

Q. Does Staff agree with Mr. Jenkins' proposal?

A. No. In Staff's opinion and as described above, these costs are not plant in service and therefore should not be depreciated. As stated in my rebuttal testimony on page 3 lines 11 through 13, these costs should be included in rate base and amortized over a 10-year period beginning with the effective date of the Report and Order in this case.

Q. Does Staff agree with Mr. Jenkins' proposal for recording additional sources of funding for the LSLR project as stated in his rebuttal testimony on page 41 lines 3 through 9?

A. No. While Staff agrees additional sources of funding should be recorded, Staff disagrees with Mr. Jenkins' proposed treatment. It is Staff's position that if MAWC does receive any grant funding, those amounts should be recorded as an offset to account 186, instead of a liability and CIAC as suggested by Mr. Jenkins, since these costs are not included in plant in service.

Q. Does OPC witness Ms. Roth agree with Staff's opinion that the LSLR costs should be booked in Account 186?

A. Yes. In Ms. Roth's rebuttal testimony on page 12 lines 12 through 25, she confirms Staff's opinion that these costs are not associated with plant in service as defined in the USOA that only plant owned by the utility can be recorded as plant in service.

Q. What is Ms. Roth's proposal for recovery of the costs associated with the LSLR AAO?

A. As stated in Ms. Roth's rebuttal testimony on page 13 lines 4 through 6, OPC proposes no recovery of these costs based on the rebuttal testimony of OPC witness Dr. Geoff Marke.

Q. Does Staff agree with Ms. Roth?

A. No. In Staff's opinion, the costs associated with the LSLR AAO are prudently incurred and should be recovered as described above. Staff witness Merciel explains Staff's disagreements with OPC's proposal in further detail in his rebuttal testimony in this case.

INCENTIVE COMPENSATION

Q. Were you the Staff witness that was responsible for the issue of incentive compensation before filing surrebuttal?

A. No. Staff witness Jennifer K. Grisham was previously responsible for the incentive compensation issue and she is no longer employed by the Commission. I am adopting her prior testimony and am now responsible for this issue.

Q. What changes did Staff make to incentive compensation subsequent to the filing of Staff's Direct Cost of Service Report and supporting Accounting Schedules?

A. Staff inadvertently excluded all costs associated with the Annual Performance Plan (APP). Based on additional details provided by MAWC, Staff has now included an appropriate level of these costs in total payroll.

Q. On page 23 lines 18 through 20 of her rebuttal testimony, MAWC witness Ms. Bowen states "if it is prudently incurred and reasonable in amount, relative to what the industry pays for the same services, it should be recoverable through rates." What is Staff's response to this statement?

A. Ms. Bowen's statement disregards the fact that the part of incentive compensation designed to reach financial goals, if achieved, primarily serve to benefit the shareholder. Staff contends, and the Commission has historically and repeatedly determined, that there is no justification for requiring the funding of incentive compensation payouts that are primarily designed to benefit the shareholder.

Q. In historical rate cases, has the Commission, or Staff, attempted to design a utility's incentive compensation program?

A. No. Overall, the Commission has decided that while the utility has every right to offer whatever compensation packages it wants, those costs should be borne by shareholders if they show no tangible benefit to ratepayers. This point is important while considering MAWC's rebuttal testimony, which expresses concern about exclusion of these costs in rates. However, this concern by MAWC is unfounded; by applying the Commission's past guidance on this issue to the current rate case, Staff is not attempting to reduce the total compensation of MAWC and Service Company employees, only to appropriately assign a portion of incentive compensation costs to shareholders.

Q. In her rebuttal testimony regarding Service Company incentive compensation on page 28 line 21 through page 29 line 4, Ms. Bowen states, "The overall question that a regulator should ask regarding these service is whether they are reasonable when compared with services that the Company can obtain in the market." How does Staff respond?

A. To reiterate, Staff believes it is never appropriate to include incentive compensation payouts that are tied to financial performance measurements that primarily benefit the shareholders. This is a long-standing approach that has been taken by Staff and upheld by the Commission in previous rate cases. Therefore, Staff has made the same adjustment to Service Company employee incentive compensation as it did for MAWC employees.

Q. In her rebuttal testimony found on page 29 line 18 through page 30 line 8, Ms. Bowen states that Staff ignores several key findings in the Southwestern Bell Telephone Company (SWBT) Case No. TC-89-14. Please respond.

A. Unlike the SWBT case, Staff is making no claim that MAWC salaries are unreasonable or imprudent. Staff's contention is that the incentive compensation goals tied to the financial performance of the parent company, American Water, are primarily to the benefit of the shareholders and should not be charged to ratepayers.

Q. On page 33 lines 2 through 4, Ms. Bowen states the following, "MAWC's employees are not overcompensated relative to their peers, even with the inclusion of incentive pay. So it is not appropriate to disallow a portion of their compensation." How does Staff respond?

A. Ms. Bowen's argument is a "red herring"; Staff's position is not premised upon a belief that MAWC's total compensation is unreasonable. Staff's contention is that incentive compensation plans based on financial goals are primarily for the benefit of the shareholders and should not be borne by ratepayers.

Q. How has the Commission decided earnings-based incentive compensation in previous rate cases?

A. The Commission has determined that compensation based on corporate earnings is focused on shareholder wealth maximization and should be assigned to the shareholders. Also, corporate based earnings awards provide an incentive for management to focus on the non-Missouri regulated portions of the overall corporate structure (including non-regulated business segments and out-of-state utilities), which could be to the detriment of Missouri-regulated ratepayers. The Commission has expressed concern that an incentive to maximize earnings could compromise service to ratepayers by reducing costs that are related to the quality of service. The Commission noted in the Report and Order in Case No. GR-2004-0209, Missouri Gas Energy:

> 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 the plan should pay the costs of the 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.

The Commission reaffirmed its decision on incentive compensation plans based on financial goals in the Ameren Missouri rate case, No. ER-2008-0318:

> The Commission has frequently disallowed costs relating to incentive programs that are based on measures of the financial return achieved by the utility. It has done so because such measures are based on the level of profits the utility can achieve. At best, a utility's level of profitability has little or no benefit for ratepayers. At worst, an increase in the utility's profitability may be harmful to ratepayers if that profitability is obtained by cutting customer service or system maintenance to cut costs and thereby increase earnings per share. Because eligibility for Ameren UE's long-term compensation plans are based on measures of the financial return achieved by the utility, the cost of those plans should fall on the shareholders who will primarily benefit from the company's increased financial return.

And the Commission stated in the Kansas City Power and Light Company ("KCP&L") rate case, Case No. ER-2007-0291:

> KCPL has the right to tie compensation to EPS. However, because maximizing EPS could compromise service to ratepayers, such as by reducing maintenance, the ratepayers should not have to bear that expense. What is more, because KCPL is owned by Great Plains Energy, Inc., and because GPE has an unregulated asset, Strategic Energy L.L.C., KCPL could achieve a high EPS by ignoring its Missouri ratepayers in favor of devoting its resources to Strategic Energy. Even KCPL admits it is hard to prove a relationship between earnings per share and customer benefits. Nevertheless, if the method KCPL chooses to compensate employees shows no tangible benefit to Missouri ratepayers, then those costs should be borne by shareholders, and not included in the cost of service.

Q. Please summarize Staff's position on incentive compensation.

A. Missouri ratepayers should not be required to pay the cost of an incentive compensation plan that is primarily for the benefit of the shareholders. Ms. Bowen's arguments regarding total compensation levels do not address in any way Staff's true issue with the incentive compensation plan.

RATE BASE

Q. Has Staff made any changes to plant in service since filing rebuttal testimony?

A. Yes. Staff has removed the prior adjustments to exclude plant related to MAWC's Wardsville acquisition. MAWC has provided additional documentation to support the additional plant discovered after the acquisition occurred.

Q. Did you specifically address MAWC 13-month average rate base included in the future test year as mentioned in the rebuttal testimony of Mr. LaGrand on page 22 lines 13 through 16?

A. No. Staff witness Mark L. Oligschlaeger discussed in Staff's Cost of Service Report and in his rebuttal testimony why using a future test year in this case is inappropriate. Therefore, I did not address the 13-month average future test year amounts for any rate base items.

Q. Has Staff made any changes to CIAC since filing rebuttal testimony?

A. Yes. Staff agrees with MAWC witness LaGrand as stated in his rebuttal testimony on page 24 lines 4 through 10. The CIAC amount included in rate base should not reflect CIAC on construction work in progress and Staff has made adjustments to exclude the related balances.

Q. What is Mr. LaGrand's proposal for the rate base treatment of the assets acquired for Jaxson Estates?

A. Mr. LaGrand in his rebuttal testimony on page 25 line 5 through page 26 line 2 proposes to include investment in Jaxson Estates in rate base and not as additional CIAC.

Q. Does Staff agree with Mr. LaGrand's proposal?

A. No. In Staff's opinion, as previously stated in the Staff Cost of Service Report on page 49, the plant is fully contributed. Therefore, the CIAC and CIAC Reserve balances should match the plant in service and depreciation reserve balances for a net of zero for Jaxson Estates rate base.

Q. What is Mr. LaGrand's proposal for rate base treatment of the unamortized balance for Emerald Pointe?

A. As stated on page 29, lines 9 through 10, Mr. LaGrand proposes to include all costs associated with the acquisition of Emerald Pointe in rate base.

Q. Does Staff agree with Mr. LaGrand's proposal?

A. No. Staff's opinion, as stated in my rebuttal testimony on page 4 lines 4 through 22, is that a section of the pipeline is owned and maintained by the City of Hollister. It would be inappropriate to include any amount for assets MAWC does not own or maintain.

Q. Does Staff agree with Mr. LaGrand that the unamortized balance of the cost of the pipeline was given rate base treatment in previous cases as stated in his rebuttal testimony on page 30?

A. Yes. The costs for this section of pipeline were erroneously included in rate base by Staff in the Emerald Pointe rate case (Case No. SR-2013-0016), and further erroneously kept in the calculation of rate base for the asset transfer case from Emerald Pointe to MAWC (Case No. SO-2014-0416). It is important to note that this rate base treatment was never discussed in the *Notice of Company/Staff partial Agreement Regarding Disposition of Revenue Increase Request And Request For Hearing* that was filed in the Emerald Pointe rate case, nor is there any discussion found in the Auditing Unit Recommendation Memo for that case. In addition, the treatment is not discussed in any filed testimony nor was it a litigated issue in the rate case. In the last MAWC rate case (WR-2015-0301), Staff corrected this error and maintains today that the inclusion in rate base for the unamortized balance related to pipeline that was donated to the City of Hollister was a mistake on Staff's part.

Q. What is Mr. LaGrand's proposal for rate base treatment of the unamortized balance for Hickory Hills?

A. Mr. LaGrand proposes on page 32 lines 3 through 6 to include the full purchase price of the Hickory Hills system.

Q. Does Staff agree with Mr. LaGrand's proposal?

A. No. As stated in my rebuttal testimony on page 6 lines 13 through 22, the unamortized balance is not capital in nature, not associated with costs that are amortized over a long period of time, and is not significant to MAWC.

Q. What is capitalized O&M depreciation, and why does Staff make an adjustment for this item?

A. Depreciation expense is calculated on all MAWC-owned plant in service. For certain plant accounts, such as power-operated equipment, Staff recommends that a portion of depreciation expense should be capitalized during the year when those assets are partly used for capitalized construction projects. For projects in which the same power-operated equipment is used for maintenance work, the depreciation should be recorded as an expense. Staff's position is that that portion of depreciation expense for these assets that is applicable to the time that those assets were used for construction projects should be capitalized by MAWC on a going forward basis.

Q. Please indicate all MAWC USOA plant in service accounts that Staff proposes to adjust to exclude from the depreciation expense annualization an appropriate portion of ongoing capitalized depreciation.

A. Staff proposes to remove a capitalized portion from the annualization of depreciation expense from the following USOA plant in service accounts: 392, 392.1, 392.2, 392.3, 392.4 for transportation equipment; account 393 for stores equipment; account 394 for tools, shop, and garage equipment; and account 396 for power-operated equipment. Again, Staff performed this adjustment to address the fact that for a portion of time during any given year, MAWC uses these assets for capital projects rather than entirely for O&M projects.

Q. Does Staff calculate this adjustment for all regulated utilities or just water utilities?

A. It has been Staff's practice to calculate this adjustment for all utility types. For instance, at a minimum Staff has reflected this adjustment in its cost of service calculation in recent cases involving Union Electric Company d/b/a Ameren Missouri, Liberty Utilities (Midstates Natural Gas), Laclede Gas Company and their Missouri Gas Energy operating unit, Kansas City Power & Light Company, KCP&L-Greater Missouri Operations Company, Empire District Electric Company and Raytown Water Company.

Q. In general, how does Staff determine the ongoing amount of capitalized depreciation that should be removed from the annualization of depreciation expense?

A. In other rate cases, Staff submits a data request to the utility that it is auditing seeking the amount of depreciation expense that has been booked to each account and will ask for that amount to be divided amongst the amount of time those assets were spent being used for construction, expense, and non-utility for a specified time period.

Q. How does that determination work based on that information?

A. In general, this division is determined by an assignment of labor costs to capital and expense items. Once the Staff receives the response to this data request, Staff will adopt this assignment if appropriate or develop a ratio of how much of the depreciation expense should be designated for construction purposes. Staff will then apply that ratio to each account mentioned above, and that ratio will reflect the amount of the adjustment that will be removed from annualized depreciation expense. That portion which is removed from annualized depreciation expense is the amount that is expected to be capitalized based on Staff's evaluation of the actual historical usage of the investment being examined.

Q. Did Staff seek the capitalized depreciation information from MAWC through a data request in this proceeding?

A. Yes. Staff submitted Data Request No. 0159 seeking this information for the 12 months ending December 31, 2016, with an update through June 30, 2017. MAWC's response did not provide the information regarding depreciation expense dollars broken out amongst construction, expense, and non-utility for which the assets were used during the 12 months or update period. After discussions with MAWC, Staff was informed that MAWC does not capitalize any depreciation expense.

Q. What is Staff's rationale for making this adjustment?

A. Staff maintains that MAWC should follow the guidelines given in the 1976 Revisions of Uniform System of Accounts for Class A & B Water Utilities 1973 National Association of Regulatory Utility Commissioners guide. On page 98, under account 403 Depreciation Expense, the USOA states: "Note B – Depreciation Expense applicable to transportation equipment, shop equipment, tools, work equipment and power operated equipment and other general equipment may be charged to clearing accounts as necessary in order to obtain a proper distribution of expenses between construction and operation."

Q. Is there additional guidance that confirms the above treatment for utilities in other sectors?

A. Yes. The Federal Energy Regulatory Commission (FERC) USOA for Electric Utilities also states on page 399 under section 403 depreciation "Note B: Depreciation Expense applicable to transportation equipment, shop equipment, tools, work equipment and power operated equipment and other general equipment may be charged to clearing accounts as necessary in order to obtain a proper distribution of expenses between construction and operation."

Q. Does Staff propose a capitalized depreciation adjustment in this case?

A. Yes. Although MAWC has not been tracking the use of assets in accounts 392, 393, 394 and 396, Staff made an adjustment based on Staff's overall capitalization ratio. In Staff's opinion in this case and the last MAWC rate case (Case No. WR-2015-0301), MAWC should be tracking the distribution of expenses between construction and expense. Therefore, Staff recommends that the Commission order MAWC to begin tracking the amount of time the assets in USOA accounts 392, 393, 394, and 396 are being used for expense versus capital purposes and capitalize a proportionate amount of depreciation expense associated with the use of those assets in capital projects on a going forward basis.

Q. Does Staff agree with Mr. LaGrand that capitalizing depreciation causes intergenerational equity issues?

A. No. In Staff's opinion by capitalizing depreciation, current and future customers are paying their proportionate share of this cost.

AMORTIZATION EXPENSE

Q. Does Staff agree with Mr. LaGrand, as stated on page 36 of his rebuttal testimony, that the regulatory assets for AFUDC being amortized should be included in this case?

A. No. To Staff's knowledge, no utility has ever proposed these type of regulatory assets to the Staff nor has any been approved by the Commission. MAWC has not shown why these regulatory assets are appropriate.

Q. Does Staff agree with Mr. LaGrand, as stated on page 37 lines 11 through 14 of his rebuttal testimony, that cost associated with the low-income pilot program should be included in this case?

A. Yes. Staff inadvertently omitted from its direct filing the unamortized regulatory asset balance as of June 30, 2017, and associated amortization for the low-income pilot program which are now included in the Staff's current revenue requirement. The balances will be updated as part of the true-up in this case. Staff recommends continuation of treatment of these costs until the next general rate case where further analysis can be done.

Q. Does this conclude your surrebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement General Rate Increase for Water and Sewer Service Provided in Missouri Service Areas	)))))	Case No. WR-2017-0285

AFFIDAVIT OF AMANDA C. McMELLEN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW AMANDA C. McMELLEN and on her oath declares that she is of sound mind and lawful age; that she contributed to the foregoing Surrebuttal Testimony; and that the same is true and correct according to her best knowledge and belief.

Further the Affiant sayeth not.

Amanda C McMellen

AMANDA C. McMELLEN

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 8th day of February, 2018.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2020
Commission Number: 12412070

D Suzie Mankin

Notary Public