

Exhibit No.: 86
Issue: Return on Equity, Working Capital, Cost Allocation
Witness: Billie S. LaConte
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Missouri Energy Group
Case No.: WR-2003-0500
Date Testimony Prepared: December 5, 2003

Missouri American Water Company

2003 Rate Case

Before the
Missouri Public Service Commission

Surrebuttal Testimony of Billie S. LaConte

on Behalf of the
Missouri Energy Group

FILED³

JAN 2 8 2004

Missouri Public
Service Commission

Project 031300
December 5, 2003

DRAZEN
CONSULTING GROUP

Exhibit No. 86
Case No(s) WR-2003-0500
Date 12/16/03 Rptr SLKM

Missouri American Water Company

Public Service Commission 2003 Rate Case

Affidavit of Billie S. LaConte

STATE OF MISSOURI)
)
COUNTY OF ST. LOUIS)

Billie S. LaConte, being of lawful age and duly affirmed, states the following:

1. My name is Billie S. LaConte. I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.
2. Attached hereto and made a part hereof for all purposes is my Surrebuttal Testimony consisting of Pages 1 through 7 filed on behalf of the Missouri Energy Group.
3. I have reviewed the attached Surrebuttal Testimony and hereby affirm that my testimony is true and correct to the best of my knowledge and belief.



Billie S. LaConte



Duly affirmed before me this 5th day of December, 2003.

Notary Public

My commission expires on December 29, 2006.



SHERYL M. FENELON
St. Louis County
My Commission Expires
December 29, 2006

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Public Service Commission 2003 Rate Case

Rebuttal Testimony of Billie S. LaConte

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A Billie S. LaConte, 8000 Maryland Avenue, Suite 1210, St. Louis, Missouri.

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility economics and regulation and a member of Drazen Consulting Group, Inc.

Q ARE YOU THE SAME BILLIE LACONTE THAT SUBMITTED TESTIMONY PREVIOUSLY IN THIS CASE?

A Yes.

Q PLEASE DESCRIBE THE MAIN POINTS OF YOUR SURREBUTTAL TESTIMONY.

A This testimony will discuss return on equity (ROE), working capital and cost allocation.

Specifically, it will address risk factors that affect MAWC's required ROE, comments made by MAWC's expert witness Pauline Ahern regarding risk due to the Infrastructure System Replacement Surcharge (ISRS), comments of MAWC witness Ed Grubb on including deferred taxes and depreciation in working capital and the testimony of Staff witness Wendell Hubbs about the cost allocation study.

Risk and Return on Equity

Q HOW SHOULD THE COMMISSION DETERMINE MAWC'S ROE?

A First, the Commission needs to determine an acceptable range for return on equity for the Company. Then, the Commission should decide where in the acceptable range MAWC's ROE falls, considering other risk factors that affect the Company's overall risk in providing water service to its customers in Missouri.

Q WHAT RISK FACTORS SHOULD THE COMMISSION CONSIDER?

A Risk factors to be considered include:

- the Company's rate design;
- low variability in sales from year to year; and
- the ISRS.

Q PLEASE DESCRIBE MAWC'S RISK IN RELATION TO RATE DESIGN.

A MAWC's rate design collects the majority of its customer costs in the minimum monthly charge, which lowers the variability in the Company's income and thereby lowers its risk. MAWC has proposed to increase the proportion of revenues collected in the monthly customer charge.

Q HOW DOES THE VARIATION IN SALES AFFECT A UTILITY'S RISK?

A Risk comes from variability in income. Lower variability means lower risk. A water company's sales are less variable than sales of utilities with large temperature-dependent load. For example, a comparison of MAWC's sales to those of Laclede Gas, a company serving the same area, shows that MAWC's sales have fluctuated, but not as much as Laclede's. Gas sales will vary depending upon the weather. Weather

variations have less of an effect on water sales. This lower variation in income reduces the risk to MAWC.

Table 1

Historical Sales

	<u>MAWC (Gallons)</u>	<u>Laclede Gas (Therms)</u>
1998	61,694,249	1,121,349
1999	66,207,645	1,025,935
% chg.	7.32%	-8.51%
2000	64,222,109	1,035,152
% chg.	-3.00%	0.90%
2001	64,946,107	1,118,660
% chg.	1.13%	8.07%
2002	64,827,357	1,060,454
% chg.	-0.18%	-5.20%

Q PLEASE DESCRIBE THE ISRS AND ITS EFFECT ON MAWC'S RISK PROFILE.

A With the new legislation, MAWC may request, through a surcharge, expedited recovery of prudently incurred costs for eligible infrastructure system replacements. The Commission must make a recommendation on an ISRS within 120 days, instead of the eleven-month period for regular rate increases. The Company will receive revenues to cover its costs on an expedited basis. When the Commission considers the petition, it may not examine the Company's other revenue requirements or ratemaking issues. Since the Commission cannot examine other revenues or ratemaking issues under the ISRS, the Company would retain the benefit of any cost decreases in other areas. Requesting an ISRS does not prevent the Company from requesting a general rate increase. All in all, the new legislation decreases the chance of a delay in the recovery of higher costs and increases the potential for higher earnings, compared to past practice. It lowers the risk of regulatory lag to MAWC, by allowing the Company to

receive a return on eligible distribution infrastructure in between rate cases. MAWC has recently filed an ISRS application with the Commission (Case No. WO-2004-0116).

Q HAS ANY OTHER COMMISSION DETERMINED THAT AN ISRS LOWERS THE RISK TO A UTILITY?

A Yes. The Public Service Commission of Delaware determined that the Distribution System Improvement Charge (DSIC), which is similar to the ISRS, *does* have a risk reducing effect. Specifically, the Commission agreed with the Hearing Examiner, who stated:

*. . . [T]he Hearing Examiner notes § 314 of the Code (referring to the Distribution System Improvement Charge), which also has a **positive impact on reducing financial risk to the utilities**. (Re: Artesian Water Company, Inc., 225PUR4th 81,85, emphasis added)*

Q DOES MS. AHERN DISPUTE THIS EFFECT OF THE ISRS?

A No, she agreed that the “existence of the ISRS is risk reducing in the absolute.” Indeed, this absolute should be taken into consideration when determining the appropriate ROE for the Company.

Q WHAT, THEN, IS HER OBJECTION?

A Ms. Ahern states that since a significant number of the water companies used in the proxy groups have an ISRS in place or have one available, the market has already taken into account the effect of an ISRS.

Q DO YOU AGREE?

A No. Not all of the companies have an ISRS (or something similar), either in place or available. At most, the recognition in the market is reduced by using an average.

Working Capital

Q PLEASE COMMENT ON MAWC WITNESS GRUBB'S CONTENTION THAT DEFERRED TAXES AND DEPRECIATION SHOULD BE INCLUDED IN WORKING CAPITAL.

A The purpose of cash working capital is to cover the lag in the recovery of cash expenses. Depreciation and deferred income taxes are non-cash items and don't affect the Company's day-to-day cash flows. These items should be excluded from cash working capital.

Cost Allocation

Q PLEASE COMMENT ON THE CRITIQUE BY STAFF WITNESS HUBBS OF THE COMPANY'S COST ALLOCATION METHODS FOR THE ST. LOUIS COUNTY, JOPLIN AND ST. JOSEPH DISTRICTS LARGE CUSTOMERS.

A Mr. Hubbs disagrees with the Company's method for calculating "Factor 4", which is used to allocate transmission and distribution (T&D) mains net plant return on and of investment and other related T&D costs. The Company calculated Factor 4 in a way

that recognizes that many large customers do not use the small-diameter mains. Mr.

Hubbs states that this is not appropriate because

If certain customers of a defined class have water usage characteristics that differentiate them from the other customer in that class, and if they are contained in an existing class, they should be further subdivided into separate classes to recognize the factors that differentiate them from other customers with regard to cost responsibility. Since the size of the main directly serving the customer appears to be the main service criteria for Mr. Herbert's differentiation of allocation of T&D costs to the customers, the existing industrial class should be broken into two different classes.
(Rebuttal Testimony of Wendell R. Hubbs, Pages 4-5)

It appears that he is recommending that the Company create more Industrial and sales-for-resale classes to better allocate the distribution mains costs used by customers in this class.

Q ARE YOU OPPOSED TO THIS SUGGESTION?

A No. However, at the moment the Company's cost of service study is the best measure of cost of service differences that we have. Although the Company's cost of service study isn't as refined as Mr. Hubbs would like, it still recognizes important cost differences among user classes. The fact that it could be refined doesn't mean it should be rejected.

Q WHAT DO YOU RECOMMEND?

A At this time, the Company's cost of service study is the best information we have. At the next rate case, the Company could refine its study to create more than one industrial and sales-for-resale rate classes.

Q DOES THIS CONCLUDE YOUR TESTIMONY?

A Yes.