

Exhibit No.: **68**
Issues: AFUDC; Dues and Donations;
St. Joseph Waste Disposal Expense;
Transportation Expense; Property Tax
Witness: Lisa K. Hanneken
Sponsoring Party: MoPSC Staff
Type of Exhibit: Surrebuttal Testimony
Case Nos.: WR-2003-0500 AND WC-2004-0168
Date Testimony Prepared: December 5, 2003

MISSOURI PUBLIC SERVICE COMMISSION
UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY **FILED**³
OF JAN 23 2004
LISA K. HANNEKEN Missouri Public
Service Commission

MISSOURI-AMERICAN WATER COMPANY

CASE NOS. WR-2003-0500
AND WC-2004-0168

Jefferson City, Missouri
December 2003

Exhibit No. 68
Case No(s) WR-2003-0500
Date 12/16/03 Rptr SLM

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the General Rate Increase for)
Water and Sewer Service Provided by Missouri-) Case No. WR-2003-0500
American Water Company.)

Staff of the Missouri Public Service Commission,)
Complainant) Case No. WC-2004-0168
v.)
Missouri-American Water Company,)
Respondent)

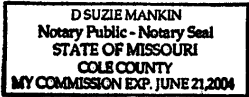
AFFIDAVIT OF LISA K. HANNEKEN

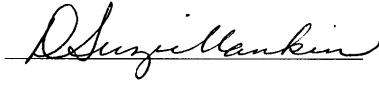
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Lisa K. Hanneken, being of lawful age, on her oath states: that she has participated in the preparation of the following Surrebuttal Testimony in question and answer form, consisting of 24 pages to be presented in the above case; that the answers in the following Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.


Lisa K. Hanneken

Subscribed and sworn to before me this 3rd day of December 2003.





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LISA K. HANNEKEN
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1 **SURREBUTTAL TESTIMONY**

2 **OF**

3 **LISA K. HANNEKEN**

4 **MISSOURI-AMERICAN WATER COMPANY**

5 **CASE NOS. WR-2003-0500 AND WC-2004-0168**

6 **(Consolidated)**

7
8 Q. Please state your name and business address.

9 A. Lisa K. Hanneken, 1845 Borman Court, Ste. 101, St. Louis, Missouri
10 63146-4138.

11 Q. Are you the same Lisa K. Hanneken who previously filed direct testimony in
12 this case?

13 A. Yes, I am.

14 Q. What is the purpose of this surrebuttal testimony?

15 A. The purpose of this testimony is to rebut the testimony of Missouri-American
16 Water Company (Company or MAWC) witnesses Edward J. Grubb, Douglas M. Lehman, and
17 Frank Kartmann regarding the issues of allowance for funds used during construction
18 (AFUDC), dues and donations, waste disposal expense for the St. Joseph district,
19 transportation expense, and property taxes.

20 **ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC)**

21 Q. In Mr. Grubb's rebuttal testimony, on page 1, lines 28-30, he states that the
22 Staff's method for calculating AFUDC applies short-term debt first, and to the extent the

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1 construction work in progress (CWIP) exceeds short-term debt, the overall cost of capital is
2 applied. Is this an accepted method for calculating AFUDC?

3 A. Yes. The Federal Energy Regulatory Commission (FERC) is an authoritative
4 body that provides a code of regulations which sets forth the method of calculating AFUDC
5 for gas and electric utilities. The method that they endorse is included in the following
6 excerpt from the FERC Code of Federal Regulations, Uniform System of Accounts (USOA):

7 The formula and elements for the computation of the allowance for
8 funds used during construction shall be:

$$A_i = s(S/W) + d(D/D+P+C)(1-S/W)$$

$$A_e = [1-S/W][p(P/D+P+C) + c(C/D+P+C)]$$

11 A_i = Gross allowance for borrowed funds used during construction rate

12 A_e = Allowance for other funds used during construction rate

13 S = Average short-term debt

14 s = Short-term debt interest rate

15 D = Long-term debt

16 d = Long-term debt interest rate

17 P = Preferred stock

18 p = Preferred stock cost rate

19 C = Common equity

20 c = Common equity cost rate

21 W = Average balance in construction work in progress (CWIP)

22 This formula requires that short-term debt be exhausted before any other capital components
23 are applied to CWIP.

24 Q. Does the USOA for water utilities, provided by the National Association of
25 Regulatory Utility Commissioners (NARUC), provide a specific formula to use for the
26 calculation of AFUDC?

27 A. No, it does not. The NARUC USOA states the following in regards to
28 AFUDC:

29 "Allowance for funds used during construction" includes the net cost
30 for the period of construction of borrowed funds used for construction
31 purposes and a reasonable rate on other funds when so used. No

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1 allowance for funds used during construction shall be included in these
2 accounts upon expenditures for construction projects which have been
3 abandoned.

4 Q. Mr. Grubb states on page 2, lines 28-29, of his rebuttal testimony that the
5 Commission in the past has allowed MAWC to use the overall cost of capital authorized. Is
6 this an accurate statement?

7 A. While it is true that in some cases in the past the Commission has done so, in
8 the last MAWC rate case, Case No. WR-2001-281, the Commission used the Staff's
9 methodology of the calculation for the Company's AFUDC. The Commission's Report And
10 Order from that case stated the following:

11 The Commission agrees that the actual carrying costs of MAWC's \$35
12 million in short-term debt should be reflected in rates. The use of the
13 actual cost of any item is preferred, where known. The amount of
14 \$1,289,674 shall be deducted from rate base to reflect this change in the
15 capitalization rate of AFUDC.

16 Q. While referring to Case No. WR-2000-281 in his rebuttal testimony, beginning
17 on page 2, line 29, Mr. Grubb contends that the Commission adjusted the cost of the
18 St. Joseph Treatment Plant to reflect the actual carrying costs of the construction of the plant.
19 He then goes on to say "While it [the Commission] made an adjustment to the cost of the
20 St. Joseph Treatment Plant (single project adjustment), the remainder of the Company's
21 AFUDC rate was left intact." Is this an accurate reflection of the issue that was presented in
22 the last rate case?

23 A. No. Neither of these statements accurately reflects the Staff's calculation nor
24 the Staff's proposal in the last case. The Company is well aware that Staff's calculations in
25 the prior case included not only the St. Joseph Treatment Plant, but the rest of the Company's
26 construction projects as well. For the convenience of both the Staff and the Company, the
27 entire adjustment amount was assigned to the St. Joseph Treatment Plant account. This

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1 avoided the difficult task that both parties would have faced in order to assign a portion of the
2 AFUDC adjustment to each project and the related accounts. I have examined the Staff's
3 workpapers from the last case and spoken to the auditor who calculated the adjustment. This
4 review clearly shows that all CWIP projects were considered in the calculation, not just the
5 St. Joseph Treatment Plant. In the current case, the Staff assigned its adjustment to the mains
6 account, rather than trying to make numerous adjustments to numerous accounts based on
7 individual projects.

8 Q. Does Staff feel there is merit to Mr. Grubb's suggestion to calculate the
9 AFUDC by deducting the Company's cash working capital allowance in the last case from the
10 short-term debt?

11 A. No. Staff is unsure why Mr. Grubb makes this suggestion as he fails to justify
12 his rationale for deducting the CWC and to explain why he suggests using the allowance from
13 the last rate case. The FERC AFUDC method does not consider any deduction for cash
14 working capital. However, if the Commission were to adopt the Company's position in this
15 area, the Staff would request that any positive cash working capital requirements be removed
16 from rate base.

17 Q. On page 2, lines 17-21, of his rebuttal testimony Mr. Grubb suggests leaving
18 long-term debt and preferred stock out of the calculation of AFUDC. Do you agree with this
19 calculation?

20 A. No, I do not. The FERC USOA includes these capital components in the
21 calculation of AFUDC. MAWC also includes these capital components in their current
22 calculation. The issue at hand is whether and how to include short-term debt.

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1 Q. Does Staff feel its proposed adjustment is retroactive ratemaking as Mr. Grubb
2 suggests?

3 A. No. The plant to which this AFUDC adjustment relates has not previously
4 been included in the cost of service. Furthermore, all the CWIP associated with the AFUDC
5 rates that I calculated should have been closed to plant in service during the test year and/or
6 update period.

7 Q. Mr. Grubb contends in his testimony that the change in the method of
8 calculation of AFUDC should be on a prospective basis. Does the Staff agree?

9 A. No. If the plant cost is excessive, due to overcapitalization of AFUDC, it
10 should be adjusted before it is included in the cost of service. Staff's position has not changed
11 from the last MAWC rate case, Case No. WR-2000-281, maintaining that not only should an
12 adjustment be made to the test year, but that the Company should follow this methodology on
13 a going forward basis. Based on the events of the last case, the Company cannot maintain that
14 it was not aware of the method for calculating AFUDC proposed by the Staff in this case.

15 **DUES AND DONATIONS**

16 Q. In Mr. Lehman's rebuttal testimony on page 4, lines 13-15, he states that the
17 Company believes that \$35,007 of the \$206,730 that Staff disallowed during the test year are
18 appropriate above-the-line expenses. Do you agree with this?

19 A. No, I do not. In the past it has been the Commission's position to disallow
20 dues and donations that: (1) provided no direct, quantifiable benefit to the ratepayer, (2) were
21 not necessary in providing safe and adequate service to the ratepayer, and (3) represented an
22 involuntary contribution on the part of the ratepayer to an organization. The Staff disallowed

1 certain items because they either met the above criteria, or were eliminated in order to prevent
2 including the expense twice, both of which are discussed in detail below.

3 Q. Did the Company's inability to provide information concerning certain
4 transactions lead to the disallowance of those transactions?

5 A. Yes. In a few instances an amount was removed from the level of expense due
6 to the Company's inability to provide an explanation or documentation of the item. The Staff
7 issued several data requests and spent numerous hours researching the Company's files in
8 order to reconcile the expenses. In some cases, details of certain transactions were not
9 available. Several of these transactions involved items purchased by an employee with a
10 Company credit card or through petty cash. The employees themselves are responsible for
11 attaching appropriate documentation and explanations for each transaction, and in some cases,
12 assigning the item to an account.

13 Q. In his rebuttal testimony, Mr. Lehman contends that charitable donations are
14 appropriate above-the-line expenses. Do you agree with this?

15 A. No. While it is true that many companies donate to the communities they
16 serve, this does not mean the ratepayers should be forced to make an involuntary contribution
17 to any organization the Company chooses. Dating back to Case No. 17,180, involving
18 Missouri Public Service Company, the Commission established standards relating to
19 donations, and its position on these costs has been consistent over time. Donations and
20 contributions are routinely disallowed and treated as below-the-line expenses on the general
21 grounds that utility ratepayers should not be placed in the position of being 'involuntary'
22 donors to charities or causes forwarded by the utilities. The Staff contends that although the
23 Company's management may choose to make these types of expenditures, the cost, which

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1 provide no benefits to ratepayers and are not necessary for safe and adequate service, should
2 be borne by the shareholder, not the ratepayer.

3 Q. What types of contributions is Mr. Lehman asking the ratepayers to support?

4 A. Mr. Lehman lists donations for such organizations as the Robidoux
5 Accelerated Middle School and the St. Charles Chamber of Commerce for a golf outing, as
6 well as other various donations and sponsorships.

7 Q. Mr. Lehman argues in his testimony that Rotary Clubs and other civic and
8 social clubs should be included in the above-the-line expense level of the Company. Why is
9 this inappropriate?

10 A. To include civic and social clubs in the above-the-line expenses of a Company
11 is inappropriate because they do not meet the criteria set out by the Commission as listed
12 above. Dues to social clubs have traditionally been disallowed on the basis that they are
13 unrelated to the utility business, are not necessary to provide safe and adequate service,
14 provide no benefits to the ratepayer, and if allowed, represent an involuntary contribution by
15 the ratepayers.

16 Q. What expenditures is Mr. Lehman proposing to include for dues and donations
17 related to the category of social and civic clubs?

18 A. The items Mr. Lehman refers to in his rebuttal testimony for this category
19 include Rotary Club, Lion's Club, Soroptimist, and Kiwanis dues, as well as fees for dinners
20 and contributions made to these clubs.

21 Q. Does the Staff feel the expenses related to Chambers of Commerce that
22 Mr. Lehman cites in his testimony should be allowed?

1 A. No. The Staff allowed memberships to all local and state Chambers of
2 Commerce. However, the expenditures that Mr. Lehman would have the ratepayers fund are
3 related to the Company's extracurricular Chamber activities or contributions made to the
4 Chambers.

5 For example, one item is a membership in the St. Joseph Chamber of Commerce
6 Corporate Partnership Program for \$5,000. This is in addition to the \$2,200 allowed for
7 membership dues to this Chamber. The program allows the Company to participate in
8 extracurricular Chamber activities at a discounted rate. Such activities include the annual
9 meeting/banquet, Chairman's breakfasts, the tradeshow, public affairs coffees, lunch and
10 learn seminars, a business report, community exchange and St. Joseph Day at the Capitol.

11 Mr. Lehman also requests that the ratepayers fund a portion of membership related to
12 a donation. The Staff allowed the membership itself, but disallowed the contribution made by
13 the Company to the Chamber.

14 Several of the remaining items that Mr. Lehman is proposing to include in the
15 Company's expense levels are related to Chamber dinners, banquets, retreats, etc. The Staff
16 feels that these activities do not benefit the ratepayer and are not required for the provision of
17 safe and adequate service.

18 Q. Were there any items related to Chambers of Commerce that could not be
19 explained by the Company?

20 A. Yes, there were a few items that the Staff disallowed based on the fact the
21 Company was unable to provide any details concerning the transaction. Staff, to the best of
22 its ability and with the data provided to it, ruled out the possibility that the amounts were dues

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1 to the specific Chambers. The Staff treated these items in the same manner as if they were
2 extracurricular items or donations.

3 Q. Why does the Staff feel that \$1,761 of professional dues should be disallowed?

4 A. The Staff removed these dues from the test year level of expense to prevent the
5 double counting of any item. If for example, an employee paid an annual fee for membership
6 to a professional organization twice during the test year, once in January for 2002, and once in
7 December 2002 for 2003. The Staff removed the amount related to 2002 and allowed the
8 most recent payment as the annual level of expense. This eliminated the inclusion of an item
9 twice in the cost of service.

10 The Staff also removed \$605 of dues that were paid for memberships for
11 Maxine Mitch. This employee is no longer with the Company and the Company has not filled
12 her position. It would be inappropriate to allow the Company to recover costs that are no
13 longer being incurred.

14 Q. In Mr. Lehman's testimony he shows the Staff's disallowance of \$321 for
15 water industry association dues. Why did Staff disallow this amount?

16 A. The Staff allowed all water industry dues with the exception of any amounts
17 that were removed to prevent double counting of any particular membership. To this end,
18 Staff disallowed dues for three employees who, during the test year, paid individual
19 membership dues to the American Water Works Association (AWWA), as well as being
20 listed as members on the corporate membership form. Dues in the amount of \$14,890 were
21 paid for a corporate membership that included Eric Thornburg and 18 other listed employees.
22 To include both memberships would be a double counting of a membership to the same
23 organization.

1 Q. Mr. Lehman lists \$10,880 related to employee expenses in his rebuttal
2 testimony that he believes should be allowed by the Staff. Does the Staff agree with these
3 items?

4 A. No. The items listed include amounts related to several employee appreciation
5 luncheons and breakfasts, various employee parties, giveaway items with the Company's
6 logo, and incentive awards given to employees to reward them for making a donation to the
7 United Way. In addition, this category contains items for which the Company was unable to
8 provide any details regarding the expenditure.

9 Q. Mr. Lehman contends in his rebuttal testimony that some of the amounts are
10 for work-related meals. Has the Company been able to provide any records to this effect?

11 A. No. The Staff has not been provided any evidence that would support this
12 claim. In the Company's response to Staff's Data Request No. 469, Mr. Lehman states that
13 the credit card system used to trace these transactions does not allow him to identify specific
14 instances of meals provided for working late. However, even if the Company were to provide
15 supporting documentation, Staff does not believe the expense should be included in the cost
16 of service. Certainly, the Staff recognizes that it is appropriate to provide reimbursement for
17 meals while traveling away from the office or outside of an employee's domicile. However,
18 working late in your own office is not sufficient justification for the provision of meals by the
19 Company.

20 **ST. JOSEPH WASTE DISPOSAL EXPENSE**

21 Q. On pages 3-4 of Mr. Kartmann's rebuttal testimony, he recommends inclusion
22 of an annualized level of waste disposal expense related to the operation of the St. Joseph

1 District's water treatment plant. Why would an inclusion in rates for the waste disposal costs
2 attributable to the St. Joseph District's water treatment plant be inappropriate at this time?

3 A. Inclusion of these costs in the rates for the St. Joseph District would be
4 inappropriate at this time because it would represent an expense that the Company cannot
5 accurately quantify, and which the Company is not and will not incur expense for, until
6 sometime in the future. Based on the storage capacity available, I have calculated that the
7 Company will not incur costs for waste disposal at the St. Joseph plant until at least 6.7 years
8 into the future, if not longer. The Staff believes it is inappropriate to prepay in rates now for
9 an expense that will not be incurred until that far into the future.

10 Q. Why does the Staff believe the Company is unable to quantify the costs
11 associated with the removal of the waste generated in the St. Joseph district?

12 A. It has attempted to do so to some extent. During the fall of 2003, the Company
13 hired a firm to remove a small percentage of the sludge that had accumulated to date in an
14 attempt to determine a cost associated with removal of waste disposal for the rate case. For
15 that project, the Company had approximately 7% of the total capacity of its two residue
16 collection ponds removed. Mr. Kartmann shows in his rebuttal testimony that the total cost of
17 \$76,266 included \$2,074 for a mobilization/demobilization/General Condition cost, as well as
18 a unit cost of \$17.66 per cubic yard. However, the Company does not have a contract in place
19 for this or any other amount. Since this 'sample' removal was for such a small quantity, it is
20 unknown if a volume discount would apply when the Company begins actually disposing of
21 the waste, when the collection ponds approach full capacity. In addition, as the actual
22 removal would occur in the future, it is hard to predict the actual amount that would be
23 charged for removal or if other less costly methods of removal may become available.

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1 Q. In his rebuttal testimony on page 4, lines 28-29, Mr. Kartmann indicates that
2 the Company has been unable, to date, to locate an agricultural facility willing to purchase the
3 residue. Could this situation change in the future?

4 A. Yes. At such time as removal becomes necessary a purchaser may be located.
5 Any revenue generated would then offset the cost of removal.

6 Q. Mr. Kartmann states on page 4, lines 21-23, of his rebuttal testimony that the
7 Commission should accept an annualized level of waste disposal expense of \$165,452 in this
8 case. Is this an appropriate level to be included in the rates set in this case?

9 A. No, it is not. According to Mr. Kartmann, one of the residue collection ponds
10 has a capacity of 31,422 cubic yards and the other 31,552 cubic yards; resulting in a total
11 capacity of 62,974 cubic yards. Mr. Kartmann states in his rebuttal testimony on page 3,
12 lines 10-11 that on an annualized basis the St. Joseph operation generates 9,337 cubic yards of
13 residue. The simple calculation of 62,974 cubic yards divided by 9,337 cubic yards/year,
14 shows that the Company has enough capacity to last 6.7 years. Since these ponds were put in
15 service in the fall of 2001, the Company should not require removal of the residue until 2008
16 even disregarding the Company's removal of 4,200 cubic yards of residue in the fall of 2003.
17 Predicting removal of residue in 2008 would occur before the residue collection ponds have
18 reached their full capacity. In addition, as shown in the study done by Gannett Fleming, the
19 chemical process by which the water is now being treated reduces the amount of waste. If the
20 Company continues to file a rate case at least every three years, which it must do to continue
21 to qualify for the use of the recently implemented infrastructure system replacement surcharge
22 process, there will be ample opportunity to address this item in the future when the Company
23 is actually removing the residue from the holding lagoons and the costs of doing so are

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1 known. The Staff would encourage the Commission not to recognize an expense, which is
2 clearly beyond the test year and update period and will not be incurred until at least 2008.

3 Q. On Page 4, lines 2-5, of his rebuttal testimony, Mr. Kartmann suggests that the
4 Staff's approach to this expense should be the same for the St. Joseph District as it is for
5 certain other of the Company's operating districts. Is there a distinction here that should be
6 noted?

7 A. Yes, there is. In the other operating districts that Mr. Kartmann references, the
8 costs of removal are known and measurable since the residue removal activities are actually
9 taking place on a routine basis. As noted previously, residue removal activities in the
10 St. Joseph District will not be necessary for quite some time into the future, and thus there are
11 no expenses to recover.

12 Q. On page 5, lines 9-14, of his rebuttal testimony, Mr. Kartmann complains that
13 the Staff is accepting the Company's proposed reduction in chemical expense related to the
14 water treatment process at the St. Joseph water treatment plant, but is not accepting the
15 Company's proposed recovery of the residue disposal expense. Please respond.

16 A. First, it is not at all clear that these two items should be considered together.
17 While the change in the water treatment processes may result in changes to both the chemical
18 expenses and the amount of residuals produced, the two do not seem to be directly tied
19 together. Second, and perhaps most importantly, the reduction in chemical expenses is an
20 item that is currently being experienced, is known and measurable and should be recognized
21 in the current case. As noted previously, the costs related to the residue removal will not be
22 incurred until quite some time into the future and should thus not be recognized in the current
23 case.

1 **TRANSPORTATION EXPENSE**

2 Q. In Mr. Lehman's rebuttal testimony on page 6, lines 2-3, he states that a
3 three-year average is a more appropriate measurement of transportation expense since the
4 expense varies significantly from year to year. Does Staff agree with Mr. Lehman's
5 statement?

6 A. Yes, however, what Mr. Lehman did not explain is that the expense shift has
7 been on a declining trend. In the three years Mr. Lehman is referring to, the amount of
8 transportation expense declined steadily as shown in this table:

<u>2000</u>	<u>2001</u>	<u>2002</u>
1,766,494	1,578,499	1,014,817

9
10
11 Because of this trend, Staff feels the last known and measurable level is the more appropriate
12 approach to this expense. Therefore, Staff calculated an adjusted amount of \$1,101,989 for
13 the test year amount to be included in the cost of service. This amount is the original test year
14 expense amount of \$1,014,817 plus the amount of Staff's adjustment related to the write-off
15 of the maintenance reserve account of \$87,172. The Company has accepted the portion of the
16 Staff's adjustment related to the write off of the reserve maintenance reserve.

17 Q. Was the Company able to explain the downward trend it experienced for
18 transportation expense?

19 A. The Company, in response to Staff's Data Request No. 291, stated that the
20 trend was related to increased capitalization, lower gasoline prices, and the elimination of the
21 vehicle maintenance reserve account. Of the actual test year amount of \$1,014,817, only a
22 small portion, \$130,758, was related to the write-off of the reserve account and Staff's
23 adjustment relating to this item has increased expense \$87,172. In addition, at page 5 of
24 Mr. Jenkins' rebuttal he indicates that construction levels will remain high, which should keep

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1 the capitalization of transportation expense at its current level. Based on the information
2 provided by the Company, the Staff is unable to verify the effect of gasoline prices on the
3 decrease in the level of transportation expense.

4 Q. On page 6, lines 9-10, of Mr. Lehman's rebuttal testimony he states that the
5 October year-to-date transportation expenses were \$1,311,080, which would equate to an
6 annual amount of \$1,575,000. Does Staff agree with the amounts Mr. Lehman utilizes in his
7 calculation?

8 A. No. The amount of October year-to-date expense that Mr. Lehman bases his
9 calculation on is the total amount of expense for all MAWC districts. The amount of expense
10 that the Company filed in this case, and that was examined by the Staff, is for the St. Louis
11 County district only. The reason for the exclusion of the other districts is because
12 transportation expense is only capitalized in the St. Louis district. Therefore, the amount in
13 Mr. Lehman's rebuttal testimony should not be compared to the amount that Staff and the
14 Company filed in their direct testimonies. Staff has calculated the 2003 annualized
15 transportation expense for the St. Louis District using the Company's response to Staff Data
16 Request No. 455 (DR 455) and the test year operations and maintenance (O&M) factor.
17 Based on this data the Staff would argue that the 2003 level of transportation expense
18 (St. Louis District) is \$1,101,195, which is less than the amount included by the Staff of
19 \$1,101,989. Other than the maintenance reserve adjustment agreed to by the Staff and the
20 Company, there is no justification for an increase above the Staff's proposed level of expense.

21 Q. What O&M factor is shown on DR 455?

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1 A. The factor that is used by the Company in the response is an O&M factor of
2 71.88%. This factor is extremely high compared to the history of the factor as shown in the
3 table below:

<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
56.92%	58.04%	54.80%	54.38%	56.05%	71.88%

6 Based on the table above the O&M factor provided in DR 455, is clearly not representative of
7 the test year, or the historical experience of the Company. The Company has not provided
8 adequate explanation as to the reason for the huge increase in the O&M factor for 2003 shown
9 in DR 455.

10 Q. Attached to Mr. Lehman's rebuttal testimony is schedule DML-3. Does Staff
11 agree with this schedule?

12 A. No. First, the amount of gross transportation expense that Mr. Lehman shows
13 for the test year is not the amount provided in the Company's response to Staff's Data
14 Request No. 1 (DR 1), the supporting workpapers for the Company's filing. In addition,
15 Mr. Lehman has used a different O&M percentage in his schedule than was presented in
16 DR 1. Since all calculations performed by Mr. Lehman utilize these two numbers, any
17 resulting amounts for the test year are incorrect.

18 Q. Does Staff feel Mr. Lehman's rebuttal testimony has any merit in regards to
19 transportation expense?

20 A. No. Because Mr. Lehman incorrectly used amounts related to all districts, or
21 amounts that are inconsistent with the amounts provided to the Staff and filed by the
22 Company, any calculations or arguments based on those calculations have no value.

1 **PROPERTY TAX**

2 Q. On page 13, lines 13-18, of Mr. Grubb's rebuttal testimony, he indicates that
3 the Company disagrees with Staff's calculation of property taxes, and states that the Staff
4 ignores the matching of property taxes to the level of plant. Do you agree with this criticism?

5 A. No. The Staff will include the actual tax bills received by the Company for the
6 2003 tax year in the cost of service, as part of its true-up. This level of tax is based on the
7 level of plant at January 1, 2003. This relationship reflects how tax payments are actually
8 determined by the taxing authority and is a proper match between the latest tax payment that
9 will occur through the true-up period and the assessment associated with that payment.

10 Q. How do the taxing authorities calculate the tax payments?

11 A. On page 15, lines 21-22, of my direct testimony, I state that property tax is
12 paid in December of the tax year, and is calculated on the amount of investment assessed on
13 January 1 of the tax year.

14 Q. Why is the January 1 assessment date important?

15 A. The state and local taxing authorities use January 1 as the assessment date to
16 determine the appraised value of the property, which forms the basis of the property tax
17 liability owed to the state and political subdivisions for the calendar year. Any additions or
18 reductions in plant that are completed and booked to plant in service during the period of
19 January 2 through December 31 of any given calendar year will not be assessed for property
20 tax purposes until January 1 of the following year. The property tax payment associated with
21 this plant is not due to the state and local taxing authorities until December of the subsequent
22 year.

23 For example any plant additions or reductions to the Company's plant in service on
24 January 2, 2003, will not be reflected in the assessment by the taxing authorities until

1 January 1, 2004 and property taxes based on this assessment will not be due until
2 December 2004. Therefore, the change in plant would actually not be reflected in property
3 taxes due until almost two full years after the occurrence.

4 Q. On page 13 of Mr. Grubb's rebuttal testimony he states that other proposed
5 true-up adjustments such as depreciation, chemicals, and fuel and power expense matches the
6 investment, revenue and expenses, but that property tax expense does not. Does his
7 comparison have merit?

8 A. No. The annualization of property taxes is based upon how the taxing
9 authorities makes their assessments and how the Company actually pays property taxes.
10 Because of the unique nature of how property taxes are determined, the typical normalization
11 and annualization process used by both the Company and the Staff for other expense items is
12 not appropriate for property tax expense.

13 The previous example of changes in plant in service on January 2, 2003, is an
14 illustration of the unique nature of property taxes. Unlike a payroll or revenue annualization,
15 which the Staff attempts to include through the end of a test year or update period, plant in
16 service balances after January 2, 2003, will not be included in the Company's booked
17 property tax expenses until January through December 2004. Indeed, the Company will not
18 begin accruing a property tax expense for any of the changes in plant for the year 2003
19 identified in the rebuttal testimony of Mr. Grubb until January of 2004. The 2004 accrual will
20 only be an estimate, for the Company will not know the actual amount of the property tax
21 payments until late in 2004, when the property tax bills are distributed by the taxing
22 authorities, usually in November or December 2004.

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1 Q. On page 14, line 28 of Mr. Grubb's rebuttal testimony he states that the
2 Company believes its proforma level of property taxes is known and measurable. Do you
3 agree?

4 A. No. The Company is assuming that all variables in the property tax equation
5 that the Company is utilizing to determine their adjustment will remain constant. A "known
6 and measurable" expense is an expense that is: 1) "known," meaning that the amount did or
7 definitely will be an actually incurred cost, and 2) "measurable," meaning that the rate impact
8 of the change (for example, property tax expense) can be calculated with a high degree of
9 accuracy.

10 The significance of this term is that historically the Commission has only reflected in
11 rates those revenue requirement changes that were known and measurable at the time an audit
12 of the event could be performed. Property taxes associated with the Company's changes in
13 plant in 2003 and beyond, will not be known and measurable until late 2004, and do not
14 constitute an appropriate cost of service for this case.

15 Q. Has this issue, or a similar issue, previously been tried before the Commission?

16 A. Yes. I will give a brief overview of two such cases. First, in Case No.
17 GR-96-285, Missouri Gas Energy (MGE) contended that the most current known and
18 measurable plant balances should be used to calculate an ongoing level of property tax
19 expense. Thus, MGE used a May 30, 1996, plant balance in the annualization of property tax
20 expense. The Staff's position was that the last actual property tax assessment should be used
21 to determine property taxes for revenue requirement purposes. In rejecting MGE's position,
22 the Commission stated:

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1 The Commission finds Staff witness Featherstone's testimony
2 persuasive where he states:

3 MGE will not accrue a property tax expense for any of the plant
4 additions through May 31, 1996 identified in the Rebuttal Testimony of
5 Mr. Kelly until January of 1997. This accrual will only be an estimate
6 for which the Company will not know the actual amount of property
7 tax payments until late in 1997, when the tax bills are distributed by the
8 taxing authorities, usually in November or December of that year.
9 (Ex. 73. p. 4)

10 The Commission finds that MGE's proposal would require waiting
11 until the end of 1997 to account for an item of expense for inclusion in
12 this case because this would be a violation of the test year, updated test
13 year or true-up concepts. Staff's recommendation will be adopted.

14 Likewise, in Case No. WR-2000-844, St. Louis County Water Company, Staff
15 proposed to use the last actual tax payment as the most reliable indicator of future payments.

16 The Company proposed to calculate the ratio of plant in service at December 31, 1999, to the
17 property taxes paid on December 31, 2000, and then apply that ratio to plant in service on
18 December 31, 2000, the plant included through the true-up cut-off date. The property tax on
19 the December 31, 2000, plant was not due until December 31, 2001. This is the exact same
20 proposal being made by the Company in the current case. The Commission stated in its

21 Report And Order:

22 The Commission traditionally, and properly, allows recovery of the
23 cost increases that are projected to occur after the end of the test year
24 (including any adjustment periods) only if those costs are known and
25 measurable. A cost increase is "known" if it is certain to occur, and it
26 is "measurable" if the Commission is able to determine the amount of
27 the increase with reasonable precision. The Company's projected
28 property tax increases are neither known nor measurable. While it is
29 probable that the Company will experience an increase in property tax
30 expense at the end of the year, it is by no means certain. Even more
31 damaging to the Company's proposal is the fact that its best estimate of
32 the amount of any increase is based on an assumption that finds no
33 support in the record. Company's proposed property tax calculation
34 assumes that the tax rates for 2000 will be the same as the tax rates for
35 1999. Because any increase in the Company's property tax expense is
36 not known and measurable, the Commission will not adopt the

1 Company's proposal. Staff's proposal to use a known amount (the last
2 amount actually paid), while probably not a perfectly accurate
3 representation of the property taxes that will be paid in the future, at
4 least avoids the speculation inherent in Company's proposal.

5 In both cases the Commission has stated that an expense must be known and measurable to be
6 included in the case.

7 Q. How does the Company propose to determine its level of proforma property
8 tax expense?

9 A. The Company proposes to use property tax bills for 2003 and the plant in
10 service at the end of 2002 to arrive at a composite property tax rate. MAWC then proposes to
11 multiply this rate by the trued-up plant in service at November 2003 to calculate the level of
12 property taxes for rate recovery in this case.

13 Q. Does Staff agree with this method of proforma calculation?

14 A. No. This method does not recognize the "known and measurable" criteria
15 discussed above. The Company makes an assumption when calculating its proforma level of
16 property taxes. The Company assumes that the tax rates will remain unchanged. A known
17 and measurable calculation cannot be made until this variable is determined. Applying a ratio
18 percentage is taking a universal approach to calculating property tax expense. Simply
19 applying a flat rate, across the board to plant balances does not reflect how property tax
20 expense is actually determined. This method ignores the fact that the relationship between
21 property taxes paid and plant balances vary over time, and cannot be predicted in advance or
22 at any specific period in time.

23 Q. Mr. Grubb's schedule EJG-5 compares the methodology of the Company and
24 the Staff using seven years of historical data. Does Staff feel that this comparison accurately
25 portrays the differences in methodology between the Company and Staff?

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1 A. No. Staff believes that the Company bases its methodology on past variables
2 that are subject to change. In addition, Mr. Grubb includes in his table the substantial increase
3 in property taxes related to the St. Joseph plant. However, he fails to recognize the rate
4 surcharge, which is currently in place to allow the Company to recover its expense related to
5 the increase. The surcharge was put in place in Case No. WR-2000-281 and as of
6 December 31, 2002, the Company has collected \$1,171,021 from this surcharge. Even though
7 the increased amount of taxes were shown on the table, the amount collected though the
8 surcharge was not. In the end, the Company may be able to show that the property tax
9 expense has increased in the past, but that does not change the fact that the actual amounts to
10 be paid in the future are still unknown.

11 Q. On page 16, lines 19-20, of Mr. Grubb's rebuttal testimony he recommends an
12 adjustment be made to working capital if the Staff's level of property taxes are adopted. Is
13 this adjustment necessary?

14 A. No. Mr. Grubb contends that an adjustment to change the expense lag for
15 property taxes should be zero and on lines 21-26, of page 16 he states that:

16 ...Staff is proposing to include in rates a level of property tax expense
17 that was paid in December 2003. Rates in this case will go into effect
18 in April 2004. Therefore, working capital should reflect the fact that
19 the Company will pay the property taxes in December 2003 and not
20 recover those taxes until starting in April 2004. The expense lag should
21 be changed to zero to reflect the payment near the start of the rate year.

22 Staff believes that this is an inaccurate way of calculating the cash working capital related to
23 property taxes because all of the expense lags in the Staff's Cash Working Capital (CWC)
24 accounting schedule are appropriately based on the difference between the average service
25 date of an expense and when payment of an expense is made to a vendor/taxing authority by
26 an utility. In the case of property taxes, the average service date is the midpoint of the tax

1 year and the payment is due on the last day of the tax year. Expense lag days are not based on
2 the date expenses are reflected in the rates approved by the Commission. The Staff believes
3 that Mr. Grubb is attempting to recover in CWC the effects of regulatory lag.

4 Q. Has the issue of working capital as related to property taxes ever been tried
5 before the Commission in a previous case?

6 A. Yes, in the last St. Louis County Water Company case, Case No.
7 WR-2000-844, Mr. Grubb proposed an adjustment like the one discussed above. In the
8 Report And Order for that case, the Commission concluded the following in regards to this
9 matter:

10 The Commission also rejects the Company's proposal to adjust the
11 expense lag for property taxes to zero. Rates are set for the future
12 based on an examination of the test year. Cash working capital is not a
13 reconciliation of actual income received during the test year to actual
14 expenses paid in the future, it is an estimate of the amount of time the
15 Company is likely to have between when it receives cash and when it
16 must pay expenses. In setting rates, the Commission uses a going-
17 forward level of property taxes; it is not reconciling the payment of the
18 actual taxes paid in December 2000 to when the cash was collected for
19 that expense. The Commission adopts Staff's position on property
20 taxes as the best estimate of the level of property taxes during the
21 period when rates set in the case will be in effect. The revenues
22 collected through those rates, including an amount calculated to cover
23 property taxes, will be collected throughout each calendar year, and
24 property taxes will be paid at the end of each calendar year. The fact
25 that the going-forward rates include an amount for property taxes that is
26 identical to the amount paid in December 2000 is (from the standpoint
27 of making adjustments to cash working capital) merely a coincidence.
28 Staff's calculation of 182.5 days' lag for property taxes recognizes this
29 collection period and this payment date. Mr. Grubbs' proposed
30 adjustment to cash working capital is inappropriate and is rejected.

31 Q. Does the property tax issue in this case affect CWC at all?

32 A. Yes. The only valid difference between the Company and the Staff relating to
33 property taxes and CWC is what annualized level of property tax expense should be reflected
34 on Accounting Schedule 8, Cash Working Capital, in this case. Once the Commission

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1 decides this issue, the resulting amount should be included in the annualized expense level for
2 property taxes on the schedule, which is sponsored by Staff witness Roberta A. McKiddy.

3 Q. Does this conclude your surrebuttal testimony in this case?

4 A. Yes, it does.