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Compensation for Services
MAWC Provided to AWR*
Witness: *Paul R. Harrison*
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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

PAUL R. HARRISON

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2008-0311

*Jefferson City, Missouri
October 2008*

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A. Paul R. Harrison, 200 Madison Street, Suite 400, Jefferson City, Missouri

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

Q. Are you the same Paul R. Harrison who participated in the audit and preparation of the Commission Staff's Cost of Service Report in this case?

EXECUTIVE SUMMARY

A. The purpose of this surrebuttal testimony is to respond to the rebuttal testimony of Company witness Edward J. Grubb with regard to two issues: the allocation of Belleville Lab costs to MAWC and the appropriate inclusion of compensation for the services provided by Missouri-American Water Company (MAWC or Company) to its affiliate, American Water Resources Inc. (AWR). The Staff will explain why its proposal to use the number of test analyses performed, rather than the Company's method of using customer counts, to allocate Belleville Lab costs results in a more accurate assignment of costs to each

1 of the American Water Works Company, Inc. (American Water) operating companies. This
2 is because test analysis represents a more accurate measurement of the actual work that is
3 being performed at the Belleville Lab facility than use of a customer number based allocation.
4 The Staff will also demonstrate how adherence to Mr. Grubb's proposed allocation of
5 Belleville Lab costs, using customer counts, creates situations where MAWC, as well as other
6 operating companies, are unfairly placed in the position of subsidizing testing costs for other
7 American Water operating companies. Finally, regarding the AWR revenue issue, the Staff
8 will explain why its proposed inclusion of revenue in the cost of service calculation is
9 appropriate in order to compensate MAWC for the services that it has provided to its non-
10 regulated affiliate, AWR. The services that MAWC has provided to AWR have allowed it to
11 profit from those MAWC customers who have signed up with AWR for a water-line, sewer-
12 line and in-home plumbing protection plan offering. The Staff's compensation proposal
13 results in a more equitable sharing of resulting profits between MAWC, its ratepayers and
14 AWR, in contrast to the level of compensation that Company witness Mr. Grubb suggests
15 might be appropriate.

16 **ALLOCATION OF BELLEVILLE LAB COSTS TO MAWC**

17 Q. Why did the Staff propose its allocation methodology of distributing
18 non-direct Belleville Lab costs by using a five-year average of actual test analyses performed?

19 A. The Staff's test analysis allocation methodology best represents the true nature
20 of work that is performed at Belleville Lab for MAWC and for all of the other American
21 Water operating companies. The Staff used an average of the test analysis that was performed
22 on water samples by Belleville Lab over the last five calendar years ending
23 December 31, 2007. As will be explained later in this surrebuttal testimony, the Company's

1 proposed method of allocating Belleville Lab costs using customer counts results in the
2 situation where Missouri ratepayers are forced to subsidize the testing work that is being
3 performed for customers residing in operating companies located in other states. The Staff's
4 proposed methodology of allocating non-direct Belleville Lab costs using an average of actual
5 test analysis for all of the operating companies taking service from Belleville Lab results is a
6 more accurate assignment of cost to each operating company because it appropriately reflects
7 the actual work that is performed at Belleville Lab. Using a measure of the actual work
8 performed at Belleville Lab will result in a more accurate matching of cost-causers to costs
9 than simply using customer counts, which is an indirect measurement of relative cost
10 responsibility at best.

11 Q. In making its adjustment is the Staff suggesting that MAWC reduce the
12 amount of testing and sampling that is now performed at Belleville Lab?

13 A. No. The Staff is in no way suggesting that the MAWC, or any other operating
14 company, reduce its level of testing and sampling that is required by the Environmental
15 Protection Agency's federal water quality standards that are duly enforced by the Missouri
16 Department of Natural Resources. The Staff encourages the Company to maintain strict
17 adherence to all of its water quality testing requirements. The Staff's recommendation only
18 addresses the allocation of cost among the entities receiving service from Belleville Lab, not
19 the performance or quantity of testing for any specific entity.

20 Q. How does the Staff respond to Mr. Grubb's assertion that "an operating
21 company's total samples can vary from one year to the next because of source water
22 conditions, contamination events and regulations? Thus, an operating company's portion of

1 Belleville Lab costs could vary widely from one year to the next” (Grubb Rebuttal, page 26,
2 lines 11-14)?

3 A. The Staff disagrees with Mr. Grubb’s implication that the potential variability
4 in allocation percentages from year to year makes the Staff’s test analysis method incorrect.
5 The Staff believes that these types of conditions clearly underscore why the Staff’s
6 methodology is better. The Company’s customer count methodology will never take into
7 account conditions such as source water conditions, state specific regulations or
8 contamination events because customer counts have nothing to do with these types of events.
9 Similarly, they do not address differences in source of supply and numbers of connections to
10 the systems that exist between operating companies. However, Staff’s methodology of using
11 testing analysis is directly correlated to each of these specific conditions.

12 Q. Does Belleville Lab currently track test analyses to be performed for each
13 operating company?

14 A. Yes. Belleville Lab requires each operating company to submit a list of the
15 number and frequency of water analyses that each operating company expects the lab to
16 perform during the upcoming calendar year. These lists are received by the lab in the mid-
17 November through early December time period. Ms. Linda Henry indicated to the Staff,
18 during a tour of the lab on June 4, 2008, that these lists are used to send out sample bottles
19 and to prepare for the work to be performed by the lab in the upcoming year. In addition,
20 Ms. Henry indicated to the Staff that the lab maintains historic data of actual test analysis that
21 it performs. The existence of this test analysis history demonstrates that this basis for the
22 allocation of the Belleville Lab costs is readily available and more indicative of the work
23 performed than a basis that relies on customer counts.

Q. Please respond to Mr. Grubb's assertion that "there are significant swings in the level of test analyses performed by the various states that highlight the need for consistency" (Grubb Rebuttal, page 27, lines 15-25) and that the use of "customer counts are more stable" (Grubb Rebuttal, page 26, lines 16-18).

A. The Staff recognizes that its method could result in more variability and used a five-year average of test analyses to alleviate this concern in its recommended sample analysis allocation percentage. However, the consequences of continuing to use the Company's method of relying on customer counts results in a significant and continuous overcharge for MAWC's customers. This continued significant subsidy of other systems by MAWC erodes the savings that the Company's customers are supposed to achieve as a result of centralizing the laboratory function. The following chart reflects the test analysis allocations for California-American Water Company (Californian American) for the five calendar years ending December 31, 2007 as well as the customer allocation percentages for the same time period:

12 Months YTD	Test Analysis Allocation Percentage	Customer Count Allocation Percentage
12/31/03	14.3%	5.8%
12/31/04	42.4%	5.8%
12/31/05	23.2%	5.4%
12/31/06	15.9%	5.3%
12/31/07	17.86%	5.4%
5-Year Average	22.73%	5.54%

As can be seen from the chart above, California-American has consistently required Belleville Lab to perform more test analyses and use more laboratory resources than would be indicated by an allocation method that relies on customer counts. This example

1 demonstrates that using the Company's proposed customer allocation method results in
2 California-American ratepayers consistently paying less for Belleville Lab costs than is
3 appropriate. This means that all other American Water operating companies, including
4 MAWC, are put in the position of subsidizing California-American's testing requirements.
5 California-American customers have been getting a discount for water testing at the expense
6 of ratepayers from other American Water operating companies.

7 Q. Do you have another example that would demonstrate that the use of
8 customers as an allocation basis is improper?

9 A. Yes. In January 2002, MAWC purchased the City of Florissant Water
10 System (Florissant). Prior to this, Florissant operated as a wholesale customer of MAWC.
11 Upon completion of the sale, Florissant customers became retail ratepayers of MAWC. The
12 sale resulted in a change in MAWC's customer numbers from one wholesale customer to
13 approximately 14,500 retail customers. As a result of this sale, MAWC was allocated more
14 Belleville Lab cost based on the Company's method of using customer counts as the basis for
15 allocation. However, the actual number of test analysis required for MAWC did not change.
16 This is a good example of how MAWC's proposed allocation method is not based upon actual
17 cost causation principles.

18 Q. What has Missouri's historical test analysis experience been in comparison to
19 customer counts?

20 A. The following chart shows a historical comparison of the MAWC percent of
21 test analysis versus customers for the five calendar years ending December 31, 2007.

<u>Period</u>	<u>Test Analysis Allocation Percentage</u>	<u>Company Customer Count Allocation</u>
12 months YTD 12/31/03	6.52%	15.27%
12 months YTD 12/31/04	8.97%	14.23%
12 months YTD 12/31/05	6.40%	14.14%
12 months YTD 12/31/06	6.04%	14.10%
<u>12 months YTD 12/31/07</u>	<u>6.75%</u>	<u>14.08%</u>
Five Year Average	6.85%	14.36%

The Staff proposes to use the five-year test analysis average to smooth out any variability that may exist from year to year for purposes of setting rates. On the other hand, the Company's customer count methodology consistently allocates over 14% of non-direct Belleville Lab costs to Missouri during the test year. By using the customer count methodology the Company is forcing MAWC ratepayers to pay for more than 14% of non-direct Belleville Lab costs while on average only 6.85% of the testing work at Belleville Lab is actually performed for MAWC. The Staff's chart also reveals that MAWC has been consistently overcharged (on average over 100%) for Belleville Lab costs based on the Company's customer count methodology in comparison to actual test analysis.

Again, the Staff believes that the fact that test analysis results do vary from year simply reflects an approach that appropriately allocates these costs based on what is actually taking place, namely test analysis. Of course, as Company witness Grubb has suggested in his rebuttal testimony, allocating costs based on customer counts is "more stable" and will provide much less variability in the allocation of Belleville Lab non-direct costs. However, Mr. Grubb's "more stable" approach does not justify continuing to significantly overcharge MAWC ratepayers for these costs. An entity that requires less work performed should receive less cost. Unfortunately, customer counts have nothing to do with testing expenses and therefore result in an inappropriate amount of non-direct Belleville Lab costs being assigned

1 to MAWC. Furthermore, the effect of using the Company's methodology results in MAWC's
2 ratepayers paying for testing and sampling costs that relate to ratepayers who are located in
3 states other than Missouri. As the Staff has pointed out, MAWC's customer counts do not
4 correlate to the work that is being performed at Belleville Lab. Furthermore, the Staff
5 believes that using the number of test analysis instead of the number of customer is also very
6 straightforward and understandable.

7 Q. How does the Staff respond to Mr. Grubb's point that a "system-wide policy to
8 allocate Service Company expenses on the basis of the number of customers and doing so
9 makes practical sense, is easy to manage and administer, and provides for system-wide
10 consistency over multiple jurisdictions" (Grubb Rebuttal, page 15, lines 6-7)?

11 A. The Staff believes by adopting the approach of allocating non-direct
12 Belleville Lab charges based on actual test analysis that American Water can improve upon
13 its current allocation process by making it more reflective of the work that is performed at the
14 Lab. Using the method proposed by Mr. Grubb results in a system wide inconsistency
15 between the work being performed at the Belleville Lab and the amount being charged to
16 individual operating companies.

17 Q. How does the Staff respond to Mr. Grubb's contention that consistency from
18 state to state is important (Grubb Rebuttal, page 27, lines 8-13)?

19 A. Mr. Grubb claims that by using number of tests as its allocation methodology,
20 American Water will be unable to recover all of its Belleville Lab costs. However, Mr. Grubb
21 fails to point out the same problem can exist with the current customer allocation
22 methodology. Customer growth and the purchase or sale of water systems at other operating
23 companies in between various rate cases can create the same situation Mr. Grubb uses to rebut

Staff's proposal. Furthermore, Mr. Grubb's claim ignores the fact that customer counts have no correlation to testing and sampling expense. Mr. Grubb's position would force MAWC customers to pay for costs that were not incurred to serve them, but are incurred to serve customers in another state. Therefore, the consistent customer impact results in an inaccurate cost assignment and a subsidy between the various operating companies in each state. In contrast, the Staff's proposed allocation methodology tracks actual test analysis, which represents the majority of the resources and work that is performed at Belleville Lab. If a test analysis based allocation was to be used consistently by American Water for all of its water divisions, this approach would allow American Water an opportunity for full cost recovery based upon a fair and cost-driven allocation basis. The Staff believes that MAWC's current allocation methodology is creating a situation where MAWC is being forced to pay nearly twice as much for testing costs as compared to its actual cost using the Staff's test analysis allocation process. In addition, this would suggest that the Company's allocation methodology creates inter-company subsidies and is inappropriate. The Staff recommends that the Commission adopt the test analysis allocation methodology to determine the non-direct Belleville Lab Service Company costs included in MAWC's cost of service.

COMPENSATION FOR SERVICES PROVIDED BY MAWC TO AWR

Q. Does the fact that MAWC last used its name and logo during March 2004 regarding its communications with customers about AWR offerings, as described in Mr. Grubb's rebuttal testimony (page 22, lines 10-12) somehow absolve MAWC from its responsibility to seek compensation for these endorsements and marketing activities?

A. No. As the Staff has already described in its direct testimony, MAWC has made it possible for AWR to successfully offer the water-line, sewer-line and in-home

1 plumbing protection programs not only because it has supplied updated customer lists to
2 AWR, but because of the endorsements it provided in the past. MAWC has provided on six
3 occasions a signed letter of endorsement by Mr. Thornburg, a previous MAWC President,
4 promoting the water line protection program. The letterhead on the letter, as well as the
5 mailing envelope contained the trusted name of MAWC as well as its logo. The Staff
6 contends that these MAWC marketing activities have created a significant amount of
7 credibility for the services offered by AWR. This establishment of credibility and trust lends
8 tremendous value to AWR's offerings for which MAWC should be fairly compensated. Just
9 because MAWC stopped engaging in those promotional activities in March 2004, does not
10 undo the linkage that has been created in the utility customer's mind between AWR and
11 MAWC, nor does it diminish the trust and credibility that has been established between the
12 two entities. The Staff maintains that the credibility and trust established with the water line
13 protection plan naturally extends to AWR's sewer line protection plan as well as its in-home
14 plumbing protection plan. Furthermore, MAWC continued to provide AWR with updated
15 mailing lists that were used for marketing all three of these programs up through June 2007.

16 Q. Are there any other ways MAWC is involved in the AWR program?

17 A. Yes. If a customer experiences a water leak, they are instructed to:

18 "...call the toll free number shown on their water bill
19 from Missouri-American Water Company. In the event
20 Missouri-American determines the leak is to the
21 customer-owned water line. They will arrange to have
22 an approved independent contractor call them to set up a
23 time...to arrange for repair of the customer-owned water
24 line."

1 This statement indicates that AWR enlists the involvement of MAWC employees to inspect
2 and determine the source of any leaks. Currently, AWR does not compensate MAWC for the
3 use of its employees who determine the source of water leaks.

4 Q. Please respond to Mr. Grubb's comment that imputed revenues for ratemaking
5 purposes to MAWC "should be something less than \$7,559." (Grubb Rebuttal, page 24,
6 lines 5-6).

7 A. The Staff disagrees with Mr. Grubb's proposal. His quantification is based
8 upon a contract MAWC currently has with the St. Louis County Public Works Department
9 (SCPWD) for billing and collection services. Mr. Grubb is attempting to compare the billing
10 and collection assistance that MAWC performs for the SCPWD with the promotional
11 assistance that MAWC has provided to its affiliate AWR. The Staff believes that these two
12 programs are significantly different. The SCPWD program is mandated by Section 66.405
13 RSMO (along with a subsequent vote of the people) and requires no marketing by the
14 Company. AWR would likely not have realized the market penetration it experienced if not
15 for the endorsements provided by MAWC. The Staff has requested additional information
16 concerning the agreement between the SCPWD and MAWC and will analyze this data when
17 received.

18 The Staff contends that AWR is in the business of offering its water and sewer service
19 line and in-home plumbing protection programs in order to earn a profit. For this reason, the
20 firm is soliciting thousands of MAWC customers. Many have already signed up for the
21 various programs. However, AWR would not have easily generated a profit without the use
22 of the MAWC logo, MAWC endorsements and its customer lists that MAWC ultimately
23 provided free of charge. MAWC has never sought any compensation for all its assistance. If

1 MAWC was truly acting in its own best financial interests, it would have negotiated a better
2 deal than to receive absolutely no compensation for all of the marketing services it provided
3 to AWR. The Staff doubts that MAWC would voluntarily give this information or this type
4 of assistance to a non-affiliated company without seeking compensation.

5 Q. What would be the impact if American Water was to offer this protection plan
6 program to its customers instead of allowing AWR to offer it?

7 A. The Staff believes, from its perspective, that American Water would rather
8 have its non-regulated affiliate company AWR offer the program instead of the regulated
9 MAWC. This would allow AWR to keep all of the profits and at the same time use the time
10 and resources of the utility to target its service offerings free of charge. If MAWC were to
11 offer the program, the profits it earned from such a program would help to reduce rates that
12 ratepayers in Missouri would have to pay. As it stands, by offering the program through an
13 affiliate, AWR can shield all of the profits from MAWC's ratepayers. The Staff contends that
14 since the program is offered through an affiliated company and MAWC is not acting in the
15 best interests of its ratepayers, some adjustment needs to be made to properly compensate
16 MAWC and its ratepayers. The Staff believes that MAWC should not have provided the
17 customer lists and all of the aforementioned services without compensation from AWR for the
18 Missouri ratepayers who have been solicited for the program. Certainly all of the MAWC
19 assistance and the continually updated customer lists have much more value than the
20 approximate \$7,559 that is suggested by Mr. Grubb.

21 Q. What compensation is the Staff attempting to recover in making its
22 adjustment?

1 A. The Staff adjustment to increase MAWC's revenues by \$67,826 annually is
2 attempting to recover a portion of the profits that AWR will generate annually from offering
3 the water line, sewer line and in-home plumbing protection programs in Missouri. To date,
4 the Staff has only received information regarding the revenues that AWR generated from
5 MAWC customers. MAWC objected to providing the Staff with the level of expenses AWR
6 has experienced in relation to serving MAWC customers for the three programs. This
7 prevented the Staff from determining the exact AWR profits that have resulted from
8 transactions with MAWC customers. In the absence of the objected-to-AWR expense and
9 profit information relevant to MAWC customers, the Staff assumed a 50% profit margin for
10 the water, sewer and in-home plumbing protection programs that are being offered to MAWC
11 customers. The Staff believes that MAWC is fairly entitled to 25% of AWR's estimated
12 profits associated with the water line program, which results in \$41,158 of compensation to
13 MAWC, and 12.5% of AWR's estimated profit associated with its sewer line program and in-
14 home plumbing programs, which results in \$20,760 and \$5,908 of compensation to MAWC,
15 respectively. The Staff's proposal attempts to more equitably share profits between AWR and
16 MAWC ratepayers so they will both profit from these programs. The Staff does not believe
17 that Mr. Grubb's proposal to include only one percent of gross revenue, or approximately
18 \$7,559, represents fair compensation to MAWC for opening the door for AWR to potentially
19 earn significant unregulated profits.

20 Q. Does this conclude your surrebuttal testimony?

21 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water)
Company's request for authority to)
implement a general rate increase for water)
and sewer service provided in Missouri)
Service Areas)

Case No. WR-2008-0311

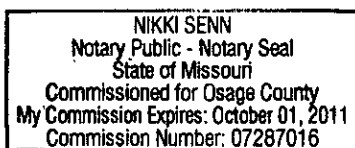
AFFIDAVIT OF PAUL R. HARRISON

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Paul R. Harrison, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 13 pages to be presented in the above case; that the answers in the foregoing Surrebuttal 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.

Paul R. Harrison
Paul R. Harrison

Subscribed and sworn to before me this 15th day of October, 2008.



Nikki Senn
Notary Public