Exhibit No.:	
Issues:	*Corporate Allocations, Security AAO, New Sewer Treatment Plants and Preferred Stock*
Witness:	*Stephen M. Rackers*
Sponsoring Party:	*MO PSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No:	*WR-2007-0216*
Date Testimony Prepared:	*July 31, 2007*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

STEPHEN M. RACKERS

MSSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2007-0216

Jefferson City, Missouri
July 2007

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 Service provided in Missouri Service Areas	)))))	Case No. WR-2007-0216

AFFIDAVIT OF STEPHEN M. RACKERS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Stephen M. Rackers, being of lawful age, on his oath states: that he has participated in the preparation of the following Surrebuttal Testimony in question and answer form, consisting of 8 pages to be presented in the above case; that the answers in the following 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.

Stephen M. Rackers

Stephen M. Rackers

Subscribed and sworn to before me this 31st day of July, 2007.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

D Suzie Mankin

Notary Public

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STEPHEN M. RACKERS

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STEPHEN M. RACKERS

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2007-0216

Q. Please state your name and business address.

A. Stephen M. Rackers, 9900 Page Avenue, Suite 103, Overland, Missouri 63132.

Q. Have you previously filed testimony in this case?

A. Yes. I previously filed Direct, Rebuttal and Supplemental True-up Direct testimony on behalf of the Staff of the Missouri Public Service Commission (Staff).

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony will address the following issues and witnesses:

Corporate A&G Allocations	Leslie Jones, City of Joplin
Security AAO	Edward J. Grubb, MO-American Water Co. (MAWC)
New Sewer Treatment Plants	James M. Jenkins and Alan J. DeBoy, MAWC

I will also discuss the tax deductibility associated with the preferred stock included in the Staff's trued-up capital structure. I have received responses to data requests concerning this item that were outstanding when I filed supplemental true-up direct testimony.

<u>CORPORATE ADMINISTRATIVE AND GENERAL ALLOCATIONS</u>

Q. On page 2 of her testimony, City of Joplin witness Leslie Jones states that an allocation factor based on "length of the mains" is the most appropriate factor to use for allocating Corporate Administrative and General Expenses (Corporate A&G) to the operating districts of Missouri-American Water Company (MAWC or Company). Do you agree?

A. No. Of all the allocation factors used by the Staff, Ms. Jones has conveniently selected the one which would allocate the least amount of Corporate A&G to Joplin.

Q. As her basis for selecting this allocation factor, Ms. Jones asserts that "the amount of usage of corporate services is directly tied to the actual infrastructure on the ground in an utilities environment". Do you agree with this rationale?

A. No. Even if it was deemed to be appropriate to use an allocation factor based on a plant statistic to distribute all Corporate A&G expenses among the districts, there is no reason to limit the basis to only transmission and distribution mains, as Ms. Jones suggests. There is no reason to believe that operating districts would not seek corporate services associated with the rest of the plant facilities. I believe that the construction, operation and maintenance of the facilities used to collect and treat water are just as important and require more oversight for the continued functioning of the district operations as compared to the facilities that deliver the water. Building and operating new water collection and treatment facilities has been a significant concern in recent years with the addition of facilities in the St. Joseph, Warren County, Joplin and Cedar Hill districts. In the near future, December 2008, a new water treatment plant will be added in the Joplin district.

Q. Are there other deficiencies with the allocation factor selected by Ms. Jones?

A. Yes. A significant amount of the expense charged to Corporate A&G is related to payroll costs. These costs are for the supervision of employees in the operating districts and employee benefits for all employees of MAWC. The Staff has allocated these costs to the districts based on the amount of operating district payroll. The Staff sees no direct connection between these types of costs and the length of mains in a specific district.

SECURITY AAO

Q. Please briefly explain this issue.

A. The Company proposes to include the unamortized balance of the Security AAO costs in rate base and receive a "return on" these deferred costs, as well as a "return of" the deferred costs through an amortization. The Staff opposes any "return on" the unamortized balance and has not included it in rate base. Staff is recognizing a "return of" the deferred Security AAO costs through an amortization.

Q. On pages 5 and 6 of his rebuttal testimony, Company witness Edward J. Grubb says that the Company incurred the security costs for the sole purpose of providing safe and adequate service to its customers. Do you agree with his characterization?

A. No. As Mr. Grubb states on page 5 of his rebuttal testimony, the Company incurred these costs to provide security to its operating facilities and employees. The assets are owned exclusively by the shareholder. These assets represent investments made by the shareholder in the Company's plant facilities. Therefore, costs incurred to protect shareholder investments are clearly benefiting shareholders. In addition, if employees are hurt while at these facilities, the company will be liable, not the customers.

Also, accounting authority orders (AAOs) protect shareholder earning not customers. Costs are deferred so that the expenses do not reduce earnings in the year they are incurred. These costs, if allowed, increase earnings in a subsequent year.

As a result, the Commission's standard of sharing the cost of amounts deferred through an AAO by allowing only a "return of" the amounts deferred and not a "return on" the amounts deferred is entirely appropriate in this situation. This treatment was first prescribed by the Commission in its Order in Case No. GR-98-140 involving Missouri Gas Energy's service line replacement deferrals. In that case, the Commission deemed it proper for the ratepayers and shareholders to share the effect of regulatory lag by allowing the Company to earn a return of, but not a return on, the deferred balance.

Q. Has the Company provided an explanation of the amounts booked to the deferred account after the Commission ordered September 11, 2003 cut-off date?

A. Yes. On July 25, 2007, the Staff received an e-mail response from the Company identifying amounts that were deferred after the September 11, 2003 cut-off date. The Staff is continuing to evaluate this data and reconcile it to the amounts previously identified. Based on this evaluation Staff may need to revise the amount of amortization expense it has included in the cost of service.

NEW SEWER TREATMENT PLANTS

Q. Please briefly describe this issue.

A. MAWC has constructed new sewer treatment facilities in its Warren County and Cedar Hill operating districts. As discussed in the direct and surrebuttal testimony of Staff witness James A. Merciel, 60% of the Warren County facility and 100% of the Cedar Hill facility were disallowed, as not being required to serve current customers.

Q. In their rebuttal testimonies, do Company witness James M. Jenkins and Alan J. DeBoy deny the Staff's assertion that the facilities are for future customers?

A. No. In Mr. Jenkins' rebuttal testimony, he states that the Company will have to write-off the unrecovered cost and due to economies of scale, building a plant to address the future growth of the system is a cheaper alternative than building increments of capacity. However he acknowledges that the ability to meet the needs of future customer growth was addressed by both plants. In Mr. DeBoy's rebuttal testimony, he also cites economies of scale and in addition, justifies the plants by specifically citing the need to address the water supply to future developments.

Q. Does either Mr. Jenkins or Mr. DeBoy recommend including the customers the excess plant was built to serve?

A. No. On page 5 of his rebuttal testimony Mr. DeBoy says there is a developer that has expressed interest in utilizing a portion of the excess plant in Warren County. On page 6 of his rebuttal testimony Mr. DeBoy states that the new treatment plant in Cedar Hill was expanded specifically to address the needs of a future development. However, the Company's case, like the Staff's, does not include customers beyond May 31, 2007, the true-up cut-off period ordered by the Commission. As a result, the Company is asking the current customers to bear the cost of new facilities that are not required to meet their needs, while MAWC reaps the profits associated with the connection of new customers after May 31, 2007. The Customers that will connect after May 31, 2007 are the very customers who the excess plant was built to serve. Yet these customers will not be included in the billing determinants used to design rates in this case. This is clearly inappropriate and skews the relationship between the revenues, expenses and investment that the true-up is designed to maintain.

Q. Are these MAWC witnesses' arguments regarding the economies of scale associated with building larger rather than smaller incremental blocks of capacity valid in the context of setting just and reasonable rates?

A. No. While the Staff realizes that there is a trade-off between the savings associated with economies of scale and the cost of excess capacity, the Company has provided no justification to show that their decision is less costly for ratepayers. The investment cost of building in smaller increments may be higher than building one large plant. However, this does not mean that it will result in a higher cost to ratepayers. Considering the time value of money and the ratepayers' cost of capital, it may be cheaper for the customer to pay for smaller increments of capacity, as needed, rather than paying the cost of significant excess capacity upfront by including the entire cost of the larger plant in rates. In this case, the Company is asking ratepayers to pay upfront for the entire annual cost of a plant, that includes excess capacity, while MAWC retains all the benefits of additional customer growth until the next rate cases.

Q. Does the Staff have a recommendation to address this situation?

A. Yes. The Staff proposes that the Commission authorize the Company to place the excess capacity associated with the new sewer treatment plants back in construction-work-in-progress (CWIP) and allow continued capitalization of accumulated funds used during construction (AFUDC). As new customer are added, incremental amounts will be removed from CWIP and included in plant-in-service. The rates paid by the new customers will provide recovery of the cost of the transfers to plant-in-service.

Q. How should the AFUDC rate be calculated?

A. The Staff recommends that the AFUDC rate utilized by MAWC be calculated as discussed below. This is the method used by electric and gas utilities. It was also found to be appropriate for MAWC by the Commission in Case No. WR-2000-281.

1) The AFUDC rate should first reflect all of the outstanding amount of short-term debt available to the Company as the primary source of financing for construction.

2) The rate associated with any construction balance in excess of the outstanding amount of short-term debt should then be calculated based on the composite rate of the outstanding amounts of other sources of financing available to the Company (long-term debt, equity and preferred stock) during the construction period.

Q. Have you prepared an example of your recommendation regarding transfers from CWIP to plant-in-service as new customers are added in the Warren County and Cedar Hill districts?

A. Yes. Schedule 1 attached to my surrebuttal testimony illustrates the Staff's recommendation regarding the inclusion of the excess capacity in CWIP and subsequent transfers to plant-in-service as customers are added.

Q. What is your response to Mr. Jenkins' statements on page 18 of his rebuttal testimony, regarding the possible write-off associated with Staff's disallowance of the excess capacity?

A. If the recommendation I discussed above does not address the concern expressed by Mr. Jenkins and the entire cost of the plants must be included in this case to prevent a write-off, then I recommend the inclusion in plant-in-service of the excess capacity and the customers it was designed to serve, in the determination of rates in this case. Although these customers are not yet taking service from MAWC, this recommendation would match the investment in excess capacity with the revenues from the customers it was designed to serve. The level of these customers, by district appears on Schedule 1 to this testimony.

Q. Do either of your recommendations address the capacity charge requested by the Company in Case No. ST-2007-0443?

A. No. In Case No. ST-2007-0443, the Company has requested a capacity charge for new customers that hook-up to the sewer systems in Warren County and Cedar Hill. Based on the Commission's decision in that case, the Company could receive additional funds to offset the cost of its investment in the new treatment plants, as new customers hook-up to these systems.

PREFERRED STOCK

Q. In your supplemental true-up direct testimony, you discuss the possible tax deductibility of the dividends on the preferred stock the Staff has included in its capital structure. Have you been able to verify whether the dividends are tax deductible?

A. Yes. The Company provided the Staff with tax records that show that all but a very small percentage of the dividends on the preferred stock included in the Staff's trued-up capital structure are tax deductible. As a result the return on preferred stock (trust-preferred stock) is treated like the return on debt in the calculation of income taxes; both are tax deductible.

The return on investment portion of the cost of service is determined through the application of a rate of return multiplied by rate base. The Staff's rate of return includes components for common equity, trust-preferred stock, long term and short-term debt. The return on trust preferred stock and debt, dividends and interest, are tax deductible and must be recognized as such in the calculation of income taxes. Only the return on common equity, is not tax deductible and needs to be factored up for income taxes. If the tax deductibility of the trust preferred stock and debt is not recognized in the calculation of income taxes, a higher return on equity will be realized by the utility than the level ordered by the Commission. The synchronization of the tax deductibility associated with the components recognized in the cost of capital and the calculation of income taxes is a concept that has been recognized and ordered by the Commission.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

Missouri-American Water Company
WR-2007-0216
Illustration Of Staff Recommendation For Excess Sewer Plant Investment

Sewer District	CWIP Sewer Plant	Design New Customers	Investment Per Customer	Sewer Plant -In Service
Cedar Hill	$ 2,192,626	192	$ 11,420	
Additional AFUDC	153,484			
Total	2,346,110	192	12,219	
Customer Additions	(1,099,739)	(90)		1,099,739
Total	1,246,371			1,099,739
Additional AFUDC	87,246			
Total	1,333,617	102	13,075	
Customer Additions	(915,227)	(70)		915,227
Total	418,390			2,014,966
Additional AFUDC	29,287			
Total	447,677	32	13,990	
Customer Additions	(447,677)	(32)		447,677
Total	0	0		2,462,643
Total Plant And AFUDC	2,462,643			

Sewer District	CWIP Sewer Plant	Design New Customers	Investment Per Customer	Sewer Plant -In Service
Warren County	$ 1,632,246	307	$ 5,317	
Additional AFUDC	114,257			
Total	1,746,503	307	5,689	
Customer Additions	(682,672)	(120)		682,672
Total	1,063,831			682,672
Additional AFUDC	74,468			
Total	1,138,299	187	6,087	
Customer Additions	(639,152)	(105)		639,152
Total	499,147			1,321,824
Additional AFUDC	34,940			
Total	534,088	82	6,513	
Customer Additions	(534,088)	(82)		534,088
Total	0	0		1,855,912
Total Plant And AFUDC	1,855,912			

Schedule 1