Exhibit No.:	
Issues:	Capital Structure, Joplin CWIP Surcharge
Witness:	James M. Jenkins
Exhibit Type:	Surrebuttal
Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2007-0216 SR-2007-0217
Date:	July 27, 2007

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2007-0216
SR-2007-0217

SURREBUTTAL TESTIMONY

OF

JAMES M. JENKINS

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

IN THE MATTER OF MISSOURI-AMERICAN WATER COMPANY FOR AUTHORITY TO FILE TARIFFS REFLECTING INCREASED RATES FOR WATER AND SEWER SERVICE	)))))	CASE NO. WR-2007-0216 CASE NO. SR-2007-0217

AFFIDAVIT OF JAMES M. JENKINS

James M. Jenkins, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of James M. Jenkins"; that said testimony were prepared by him and/or under his direction and supervision; that if inquires were made as to the facts in said testimony, he would respond as therein set forth; and that the aforesaid testimony are true and correct to the best of his knowledge.

James M. Jenkins

James M. Jenkins

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 24th day of July 2007.

Staci A. Olsen

Notary Public

My commission expires:

Staci A. Olsen
Notary Public - Notary Seal
State of Missouri
St. Charles County
Commission # 05519210
My Commission Expires: March 20, 2009

SURREBUTTAL TESTIMONY
JAMES M. JENKINS
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2007-0216

TABLE OF CONTENTS

SURREBUTTAL TESTIMONY
JAMES M. JENKINS

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.

A. James M. Jenkins, Vice President, 727 Craig Road, St. Louis, Missouri 63141.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?

A. Yes, I have submitted direct and rebuttal testimony in this proceeding.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to rebut certain aspects of the rebuttal testimony of David Murray, witness for the Missouri Public Service Commission Staff ("Staff") concerning capital structure and to respond to the rebuttal testimonies of Mr. Russell W. Trippensee with the Missouri Office of the Public Counsel ("OPC" or "Public Counsel") and Mr. Stephen M. Rackers of the Staff of the Missouri Public Service Commission ("Staff"), concerning the Joplin Plant Improvement Charge. Each of those arguments will be addressed below.

II. CAPITAL STRUCTURE

Q. PLEASE PROVIDE AN EXECUTIVE SUMMARY OF YOUR SURREBUTTAL TESTIMONY RELATED TO CAPITAL STRUCTURE.

A. Mr. Murray's proposed use of American Water's capital structure in this docket instead of MAWC's capital structure is inappropriate. In his effort to support his proposal for using American Water's capital structure, Mr. Murray refers to the facts that MAWC does not currently have a stand-alone credit rating and that the debt obtained through its affiliate, American Water Capital Corporation ("AWCC"), is supported by American Water's creditworthiness. Mr. Murray also makes assertions that MAWC has centralized most of its financing functions through AWCC, MAWC can receive equity infusions through debt raised by American Water, and that American Water is predominately a regulated water utility. In his efforts, Mr. Murray ignores the fact that, unlike in past cases where the Commission has determined that using a consolidated capital structure was appropriate, the utility – in this case, MAWC – is a separate legal entity that is responsible for making its own decisions regarding its sources of financings and its overall capital structure.

In my surrebuttal testimony, I address each of Mr. Murray's points individually and illustrate how some of his underlying assumptions, and thus his overall conclusion on using American Water's capital structure, are not supported by the facts of this docket.

Q. WHAT CAPITAL STRUCTURE DOES MR. MURRAY PROPOSE USING IN THIS PROCEEDING?

A. In his Rebuttal Testimony, page 2, lines 4-11, Mr. Murray states that American Water's capital structure is the appropriate capital structure to use in this docket. The specific points he raises to support this position relate to stand-alone credit ratings, centralized financing functions, equity infusions using debt, the Support Agreement between American Water and AWCC, and American Water as a regulated utility. I will talk about each of Mr. Murray's points individually.

1. <u>STAND-ALONE CREDIT RATING</u>

Q. ACCORDING TO MR. MURRAY, WHY IS IT SIGNIFICANT THAT MAWC CURRENTLY DOES NOT HAVE A STAND-ALONE CREDIT RATING?

A. On page 8, lines 3-8., Mr. Murray states the following in his Rebuttal Testimony:

> S&P does not provide credit ratings for American Water's individual subsidiaries as it does for some other Missouri utilities, such as AmerenUE and Kansas City Power and Light. The credit analysis performed by S&P is based on the consolidated credit risk profile of American Water, which is primarily based on its regulated subsidiaries, but does include some non-regulated operations. Consequently, the cost of capital provided to MAWC is driven by the consolidated operations of American Water.

Q. WHAT IS MR. MURRAY'S CONCLUSION RELATED TO STAND-ALONE CREDIT RATINGS?

A. Mr. Murray concludes that, because MAWC does not currently have a stand-alone credit rating, "it is appropriate to not only use the consolidated capital structure, but also the cost of capital associated with this capital structure for ratemaking purposes" (Mr. Murray's Rebuttal Testimony, page 8, lines 9-11).

Q. WHAT ARE THE SPECIFIC POINTS THAT MR. MURRAY USES IN AN ATTEMPT TO SUPPORT THIS CONCLUSION?

A. Mr. Murray's specific points are that (a) S&P does not rate MAWC, (b) S&P does provide a rating for American Water based on its consolidated credit risk profile, (c) both American Water and MAWC are engaged primarily in the regulated water and wastewater business, and (d) the risks associated with the consolidated operations of American Water and MAWC are consistent.

Q. DO YOU HAVE ANY COMMENTS ON THE SPECIFIC POINTS UNDERLYING MR. MURRAY'S CONCLUSION?

A. Mr. Murray is correct in stating that neither S&P nor any other rating agency currently maintains a stand-alone credit rating for MAWC. Mr. Murray is also correct that S&P does maintain a stand-alone credit rating for American

Water. And while Mr. Murray is generally correct in that both MAWC and American Water are engaged primarily in the regulated water and wastewater business, it should be noted that MAWC is engaged in "operating" regulated water and wastewater systems. American Water is engaged in "owning" companies that operate water and wastewater systems. Finally, Mr. Murray offers no proof, nor do I agree with his position, that American Water's risk and MAWC's risk are consistent.

Q. DOES THE ABSENCE OF A STAND-ALONE CREDIT RATING FOR MAWC MEAN THAT MAWC'S CREDITWORTHINESS CANNOT BE JUDGED?

A. No. Any potential source of financing for MAWC can perform its own due diligence to determine MAWC's stand-alone credit quality.

Q. HAS MAWC'S CREDITWORTHINESS BEEN JUDGED RECENTLY DESPITE THE LACK OF A STAND-ALONE CREDIT RATING FOR MAWC?

A. Yes. On December 21, 2006, MAWC issued $57.48 million of tax-exempt bonds using the Missouri State Environmental Improvement and Energy Resources Authority ("EIERA") as a conduit. At that point, MAWC did not have a stand-alone credit rating. MAWC provided MAWC-specific materials to and answered questions from Goldman, Sachs & Co., who, as underwriter, conducted its own due diligence to assess the credit quality of MAWC. In addition, MAWC insured the bonds through Ambac so that S&P and Moody's could both rate the bonds as AAA and Aaa, respectively. MAWC-specific financial information was provided to Ambac, S&P, and Moody's so that each could conduct their own due diligence to assess the underlying credit quality of MAWC. At no time during this process, however, was a stand-alone credit rating for MAWC issued.

Q. DOES THE ABSENCE OF A STAND-ALONE CREDIT RATING MEAN THAT MAWC CAN ONLY USE AMERICAN WATER AND AWCC FOR ITS CAPITAL NEEDS?

A. No. MAWC's financing options include the ability to utilize financing sources outside of AWCC or American Water such as, but not limited to, taxable debt issued under MAWC's indenture, tax-exempt debt issued under MAWC's indenture through a governmental conduit such as the EIERA, state revolving fund loans, and / or preferred stock issued to third parties, as well as utilizing retained earnings. Partly in consideration of MAWC's credit quality, the third party financing sources will independently determine under what terms, including interest and/or dividend rates, they would be willing to provide capital to MAWC.

Q. DOES MR. MURRAY BELIEVE THAT THE RELATIVE RISKS OF AMERICAN WATER AND MAWC ARE THE SAME?

A. On page 8, lines 8-11., Mr. Murray states the following in his Rebuttal Testimony:

> As long as the risk associated with the consolidated operations is consistent with MAWC's risk, then it is appropriate to not only use the consolidated capital structure, but also the cost of capital associated with this capital structure for ratemaking purposes.

In the summary of his Rebuttal Testimony, Mr. Murray states the following on page 2, lines 9-11:

> Because American Water is predominately a regulated water utility, it is appropriate to use the parent company's capital structure in this case because it is consistent with the way in which American Water believes its regulated water utility operations should be capitalized.

Since Mr. Murray concludes that "it is appropriate to use the parent company's capital structure" and states that "[a]s long as the risk associated with the consolidated operations is consistent with MAWC's risk" then it is appropriate to use the parent company's capital structure, I can only assume that Mr. Murray believes that the risks for American Water and MAWC are the same.

Q. DOES THE FACT THAT BOTH AMERICAN WATER AND MAWC ARE ENGAGED PRIMARILY IN THE REGULATED WATER AND

WASTEWATER BUSINESS MEAN THAT THE RISKS ASSOCIATED WITH THE CONSOLIDATED OPERATIONS OF AMERICAN WATER AND MAWC ARE CONSISTENT?

A. No. An entity's general business focus is only one of many factors that are considered when judging an entity's credit risk. The investing community's need to evaluate and consider all factors that might impact credit drives the rating agencies' need to issue stand-alone credit ratings for individual businesses, even if those businesses are all engaged in the same general line of business.

Q. IT IS POSSIBLE FOR BUSINESSES IN THE SAME GENERAL LINE OF BUSINESS TO HAVE DIFFERENT CREDIT RATINGS?

A. Yes. In fact, the S&P credit ratings for U.S. Investor-Owned Water Utilities as of July 16, 2007 range from "A-" to "AA".

Q. WHAT ARE SOME OF THE FACTORS OTHER THAN GENERAL BUSINESS FOCUS THAT RATING AGENCIES TAKE INTO ACCOUNT WHEN EVALUATING A BUSINESS' RISK?

A. On page 17, lines 19-28 and page 18, lines 1-2, Mr. Murray quotes the following about an S&P report:

> In a May 31, 2006, S&P research report on American Water, S&P made the following statement:
>
>> American Water's stand-alone credit quality is supported by its '2' (excellent) business risk profile. (Utility business risk profiles are categorized from '1' (excellent) to '10' (vulnerable)). The company's business risk profile benefits from **geographic and regulatory diversity, a large customer base that is mostly residential and commercial, and a generally supportive regulatory environment**. These strengths are slightly offset by the somewhat increased risk from American Water's **nonregulated water and wastewater operations**. (emphasis changed)

Thus, in light of the S&P report that Mr. Murray summarized in his Rebuttal Testimony; geographic diversity, regulatory diversity, number of customers, regulatory environment, and nonregulated operations are at least some of the other factors that S&P considers when evaluating a company's stand-alone credit quality.

Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARDS TO GEOGRAPHIC DIVERSITY?

A. American Water owns operations in over 20 states while MAWC operates only in Missouri. Thus, American Water has more geographic diversity and thus would tend to have less credit risk than MAWC, all else being equal.

Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARDS TO REGULATORY DIVERSITY?

A. American Water owns operations that are regulated in over 20 states while MAWC is regulated only by Missouri. Thus, American Water has more regulatory diversity and thus would tend to have less credit risk than MAWC, all else being equal.

Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARDS TO NUMBER OF CUSTOMERS?

A. American Water's regulated subsidiaries serve over 3,000,000 customers while MAWC serves less than 500,000 customers. Thus, American Water has more customers and thus would tend to have less credit risk than MAWC, all else being equal.

Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARDS TO REGULATORY ENVIRONMENT?

A. This is a subjective question that S&P would need to evaluate using its own criteria.

Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARDS TO NONREGULATED OPERATIONS?

A. American Water has more nonregulated operations. However, it is difficult to discern from the S&P report cited above if it is the amount of nonregulated operations or some other factor related to American Water's specific nonregulated operations that has an impact on American Water's credit risk in the view of S&P at that point in time.

Q. PLEASE SUMMARIZE YOUR COMMENTS TO MR. MURRAY'S TESTIMONY AS IT RELATES TO MAWC NOT HAVING A STAND-ALONE CREDIT RATING.

A. On page 8, lines 3-11, Mr. Murray attempts to make a connection between S&P not currently providing a stand-alone credit rating for MAWC and the costs of capital at MAWC being driven by the consolidated operations of American Water. This connection does not exist. The costs of capital at MAWC are driven by the creditworthiness of MAWC, one measure of this creditworthiness being a stand-alone credit rating by S&P. However, since MAWC is independent of its parent company, its creditworthiness can be and has recently been evaluated on a stand-alone basis. Moreover, based on the criteria outlined in the S&P research report cited by Mr. Murray, it is fair to assume that MAWC's and American Water's business risk profiles are different.

2. CENTRALIZED FINANCING FUNCTION

Q. WHAT DOES MR. MURRAY HAVE TO SAY ABOUT HOW MAWC RUNS ITS FINANCING FUNCTION?

A. On page 5, lines 22 continuing to page 6, lines 5, Mr. Murray states in his Rebuttal Testimony that:

> MAWC no longer issues all of its own debt. This change occurred when American Water created its financing subsidiary American Water Capital Corporation (AWCC). Although there are internal loan documents between MAWC and AWCC, AWCC is the entity that is actually issuing the debt on a consolidated basis for all of the subsidiaries of American Water. Additionally, AWCC is acting as the corporate treasury for American Water, in that it also aggregates all of the cash receipts and disbursement functions for its subsidiaries.

Q. HOW DOES MAWC RUN ITS FINANCING FUNCTION?

A. MAWC, as a separate legal entity, is responsible for making its own decisions regarding its sources of financings and its overall capital structure. These sources of financings include funds from related entities – such as long-term and short-term notes issued to AWCC or equity infused by American Water – and funds from unrelated third parties – such as taxable debt issued under MAWC's indenture, tax-exempt debt issued under MAWC's indenture through a governmental conduit such as the EIERA, state revolving fund loans, and / or preferred stock.

Q. DOES MAWC WORK WITH AWCC WITH RESPECT TO ITS FINANCING FUNCTION?

A. One of the decisions MAWC has made related to financings was to execute a Financial Services Agreement ("FSA") with AWCC whereby AWCC would provide such financial services as MAWC and AWCC may from time to time agree. These financial services could include, and are not limited to, short-term notes, long-term notes, and cash management services. It is important to note that MAWC retains the right to obtain these financial services from other third party sources and is under no obligation to use AWCC if MAWC does not desire to do so.

Q. HAS MAWC RAISED ANY CAPITAL THROUGH SOURCES OTHER THAN AMERICAN WATER OR AWCC?

A. Yes. As of May 31, 2007, over $338 million of MAWC's long-term capital came from sources other than American Water or AWCC. This represents over 60% of MAWC's long-term capital. Following is a capitalization table showing the long-term capital amounts sourced through American Water or AWCC versus the amounts sourced through other means.

MAWC Stand-Alone Capital Structure at 5/31/2007

Sources of Financings:

Class of Capital	American Water or AWCC	Other Amount	Total Amount
Long-Term Debt	56,000,000	213,045,000	269,045,000
Preferred Stock		2,644,000	2,644,000
Common Equity	166,758,791	122,318,598 (a)	289,077,389
Total Long-Term Capitalization	$ 222,758,791	$ 338,007,598	$ 560,766,389
Short-Term Debt	43,891,343	-	43,891,343
Total Capitalization	$ 266,650,134	$ 338,007,598	$ 604,657,732

(a) Retained Earnings accrued by MAWC since inception.

Q. HAS MAWC RECENTLY RAISED ANY CAPITAL THROUGH SOURCES OTHER THAN AMERICAN WATER OR AWCC?

A. Yes. On December 21, 2006, MAWC issued $57.48 million of tax-exempt bonds using the Missouri State Environmental Improvement and Energy Resources Authority ("EIERA") as a conduit.

Q. DO YOU AGREE WITH MR. MURRAY'S ASSERTION ON PAGE 2, LINES 5-7 OF HIS REBUTTAL TESTIMONY THAT MAWC "HAS CENTRALIZED MOST OF ITS FINANCING FUNCTION THROUGH ITS AFFILIATE, AMERICAN WATER CAPITAL CORPORATION, (AWCC)"?

A. No. Mr. Murray has confused the issue. Stated clearly, MAWC is responsible for making all of its financing decisions. AWCC is a potential source of financial services which MAWC may choose to use as it sees fit.

3. <u>EQUITY INFUSIONS USING DEBT</u>

Q. WHAT DOES MR. MURRAY STATE ABOUT AMERICAN WATER'S SOURCE OF FUNDS FOR EQUITY INFUSIONS INTO MAWC?

A. On page 2, line 7, Mr. Murray states in his Rebuttal Testimony that:

> MAWC...can receive equity infusions through debt raised at American Water...

Further, on page 8, lines 16-23, Mr. Murray states in his Rebuttal Testimony that:

> For example, Staff discovered during its interview in MAWC's last rate case that of $1.2 billion of debt issued on November 6, 2001, American Water borrowed $450 million for equity infusions into certain subsidiaries (page 36, lines 8-15). If American Water's subsidiaries had truly independent capital structures, then the debt incurred for this acquisition would have been carried at the subsidiary level. By carrying some of this debt at the parent company level rather than at the subsidiaries, American Water is able to produce subsidiary capital structures that are more heavily weighted in equity, which would not be the case otherwise.

Q. IN HIS REBUTTAL TESTIMONY, HAS MR. MURRAY IDENTIFIED SPECIFIC INSTANCES WHERE HE BELIEVES THAT MAWC HAS RECEIVED EQUITY INFUSIONS THROUGH DEBT RAISED AT AMERICAN WATER?

A. Notwithstanding that the source of funds for equity infusions is irrelevant to the form that capital takes in an independent subsidiary's capital structure, I am not aware of any statements in Mr. Murray's Rebuttal Testimony where he cites specific instances where he believes that MAWC has received equity infusions through debt raised at American Water.

Q. HAS MAWC RECEIVED AN EQUITY INFUSION FROM AMERICAN WATER RECENTLY?

A. Yes. In April 2007, MAWC received an equity infusion totaling $68,000,000.

Q. WHAT WAS THE FINANCING THAT AMERICAN WATER COMPLETED NEAREST APRIL 2007?

A. In March 2007, American Water received an equity infusion of $650,000,000 from RWE.

Q. WHEN AMERICAN WATER MAKES AN EQUITY INFUSION INTO MAWC DOES MAWC HAVE ANY OBLIGATIONS TO MAKE A REGULAR FIXED PAYMENT TO AMERICAN WATER, SIMILAR TO AN INTEREST PAYMENT?

A. No. MAWC is not obligated to make any payments to American Water as a result of an equity infusion by American Water.

Q. WHEN AMERICAN WATER MAKES AN EQUITY INFUSION INTO MAWC DOES MAWC HAVE ANY OBLIGATIONS TO RETURN THAT CAPITAL TO AMERICAN WATER AT SOME FIXED DATE IN THE FUTURE, SIMILAR TO A PRINCIPAL REPAYMENT RELATED TO DEBT ISSUANCES?

A. No. MAWC is not obligated to return the capital associated with the equity infusion to American Water as a result of an equity infusion by American Water.

Q. IF AMERICAN WATER IS NOT GUARANTEED A REGULAR PAYMENT, SIMILAR TO AN INTEREST PAYMENT, AND IT IS NOT GUARANTEED A RETURN OF THE CAPITAL IT HAS INVESTED, WHY WOULD IT MAKE AN EQUITY INFUSION INTO MAWC?

A. Similar to any investor who provides equity to an entity, American Water makes the equity infusion into MAWC on the expectation that the potential dividends and / or appreciation in value in that investment will provide American Water with a return commiserate to the risk it takes when making that equity infusion.

Q. DOES AMERICAN WATER TAKE MORE RISK WHEN IT MAKES AN EQUITY INFUSION INTO MAWC AS COMPARED TO WHEN AWCC OR ANY OTHER ENTITY LOANS MONEY TO MAWC?

A. Yes. Since MAWC is not obligated to make any payments related to the equity infusion nor is it obligated to return the capital associated with the equity infusion, an equity infusion is a more risky investment for AWCC than a debt investment made by AWCC or any other entity to MAWC.

Q. ALL ELSE BEING EQUAL, SHOULD AMERICAN WATER'S RETURN ON INVESTMENT FROM ITS EQUITY INFUSION INTO MAWC BE GREATER THAN AWCC'S OR ANY OTHER ENTITY'S RETURN ON INVESTMENT WHEN THEY LOAN MONEY TO MAWC?

A. Yes. American Water is taking more risk by making an equity infusion than AWCC or any other entity takes when it loans money to MAWC, American Water should earn a higher return from the investment.

Q. WHAT IS FUNDAMENTALLY WRONG WITH MR. MURRAY'S SUGGESTION THAT THE COMMISSION SHOULD LOOK AT THE SOURCE OF FUNDS TO DETERMINE THE CAPITAL STRUCTURE TO USE FOR RATEMAKING PURPOSES??

A. Mr. Murray is ignoring the fact that the cost of capital, regardless of how that capital is supplied, is based on the risks associated with that capital. Regarding the true cost of capital, Morin[1] states:

> Financial theory clearly establishes that the cost of equity is the risk-adjusted opportunity cost to the investors and not the cost of the specific capital sources employed by investors. The true cost of capital depends on the use to which the capital is put and not on its source.

Q. ARE THERE OTHER ISSUES WITH MR. MURRAY'S SUGGESTION THAT THE COMMISSION SHOULD LOOK AT THE SOURCE OF FUNDS TO DETERMINE THE CAPITAL STRUCTURE TO USE FOR RATEMAKING PURPOSES?

A. Since it is unlikely that the source of funds of individual investors would be scrutinized if they were the owners of the equity in a utility, Mr. Murray's proposal is arbitrary and discriminatory, based solely on who the owner of the equity is. Following are a few examples, provided by Morin[2], that illustrate the potential illogical outcomes that accompany Mr. Murray's approach if that

---

[1] Roger A. Morin, New Regulatory Finance, Public Utilities Reports, Inc., 2006, page 523.
[2] Id., at pages 523-524.

approach was applied to an entity whose equity was owned by individual investors:

> To illustrate, let us say that an individual investor borrows money at the bank at an after-tax cost of 8% and invests the funds in a speculative oil exploration venture. Clearly, the required return on the oil venture investment is not the 8% cost but rather the return foregone in speculative projects of similar risk, say 20%. Yet, under the double leverage approach, the individual's fair return on this risky venture would be 8%, which is the cost of the capital source, and not 20%, which is the required return on investments of similar risk. Double leverage implies that for all investors who inherited stock or received stock as a gift, the allowed return on equity would be zero, since the cost of the stock to the investors is zero.

In addition, by following Mr. Murray's proposal, if a subsidiary of a company was sold to individual investors, the cost of capital would change the next morning for no other reason than who the owner of the subsidiary is.

Q. DO YOU BELIEVE THAT MR. MURRAY'S ASSERTION THAT "MAWC…CAN RECEIVE EQUITY INFUSIONS THROUGH DEBT RAISED AT AMERICAN WATER…" IS A BASIS FOR USING AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE INSTEAD OF MAWC'S CAPITAL STRUCTURE?

A. No. MAWC's capital structure is independent of American Water's capital structure. As illustrated in the previous series of questions, the risks investors take when providing capital to MAWC is dependent on the form of their investment, not on the source of funds used to fund that investment.

4. SUPPORT AGREEMENT

Q. WHAT DOES MR. MURRAY STATE ABOUT SUPPORT PROVIDED TO AWCC FROM AMERICAN WATER?

A. On page 2, line 8, Mr. Murray states in his Rebuttal Testimony that "...the debt provided by AWCC is supported by American Water's creditworthiness."

Q. HOW IS THE DEBT PROVIDED BY AWCC SUPPORTED BY AMERICAN WATER'S CREDITWORTHINESS?

A. American Water and AWCC have entered into a support agreement (the "Support Agreement". The Support Agreement provides that American Water will cause AWCC to have at all times a positive tangible net worth and will provide to AWCC liquidity, as required, if AWCC is unable to make timely debt service payments.

Q. DOES THIS SUPPORT AGREEMENT HAVE ANY IMPLICATIONS TO MAWC?

A. No. MAWC is not a party to this Support Agreement.

Q. SHOULD THE PRESENCE OF THE SUPPORT AGREEMENT BE USED IN DETERMINING WHAT CAPITAL STRUCTURE TO USE FOR MAWC FOR RATEMAKING PURPOSES?

A. No. MAWC is not a party to this agreement and makes its own financing decisions. Thus, the Support Agreement is irrelevant in determining what capital structure to use for MAWC for ratemaking purposes.

5. REGULATED UTILITY

Q. WHAT DOES MR. MURRAY STATE ABOUT THE TYPE OF COMPANY AMERICAN WATER IS?

A. On page 2, line 9, Mr. Murray states in his Rebuttal Testimony that "American Water is predominately a regulated water utility…".

Q. DO YOU AGREE WITH MR. MURRAY'S STATEMENT THAT "AMERICAN WATER IS PREDOMINATELY A REGULATED WATER UTILITY"?

A. No. American Water itself is not a regulated utility. In fact, the Missouri Commission specifically found in its Order Closing Case issued December 13, 2001, in Case No. WO-2002-206 as follows:

> American Water Works Company owns Missouri American Water Company, a Missouri corporation that operates as a regulated utility in Missouri. American Water is not a regulated water corporation or a public utility, nor is RWE.

Although, many of American Water's wholly-owned subsidiaries are regulated utilities within the state in which they do business, these subsidiaries, each a separate legal entity, have the independence to adjust their business practices to meet the regulatory requirements and other unique aspects of doing business within their respective states.

6. <u>SUMMARY OF CAPITAL STRUCTURE SURREBUTTAL</u>

Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY AS IT RELATES TO CAPITAL STRUCTURE.

A. I have illustrated how some of Mr. Murray's underlying assumptions, and thus his overall conclusion on using American Water's capital structure, are not supported by the facts of this docket. More specifically:

- I have shown that MAWC's creditworthiness can be judged on a stand-alone basis without having a current stand-alone credit rating, thus its stand-alone costs of capital can be determined.

- I have shown that MAWC alone is responsible for its financing function and provided a recent example to that affect.

- I have shown that the cost of capital is determined by its form and not its source.

- I have shown that American Water's support for debt raised at AWCC is irrelevant to this proceeding.

- I have shown that American Water is not regulated utility.

<u>III. JOPLIN CWIP SURCHARGE</u>

1. <u>THE JOPLIN PLANT IMPROVEMENT CHARGE DOES NOT CONSTITUTE SINGLE ISSUE RATEMAKING.</u>

Q. BEGINNING ON PAGE 4, LINE 18, OF HIS REBUTTAL TESTIMONY, MR. TRIPPENSEE ARGUES THAT THE JOPLIN PLANT IMPROVEMENT CHARGE CONSTITUTES SINGLE ISSUE RATEMAKING. SIMILARLY, ON PAGE 4 OF HIS REBUTTAL TESTIMONY, MR. RACKERS MAKES THE SAME ARGUMENT. DO YOU AGREE?

A. No. When a regulatory commission determines the appropriateness of a rate or charge that a utility seeks to impose on its customers, the standard practice is to review and consider all expenses, investment, cost of capital, and revenues of a utility in a test period. Single issue ratemaking, on the other hand, occurs outside of a rate case where counterbalancing savings in another area cannot be recognized. However, MAWC's proposal for the Joplin Plant Improvement Charge is being made in the context of a rate case, where all costs and revenues, including the effects of the Joplin Treatment Plant, are being reviewed and considered.

The Joplin Plant Improvement Charge is not single issue ratemaking any more than Mr. Racker's phase-in proposal is single issue ratemaking. (See Racker rebuttal testimony, page 6, lines 16-19). Mr. Racker proposes a phase-in as a way to reduce the size of the rate increase resulting from placing the Joplin Treatment Plant into service, and that is similarly the purpose of the Joplin Plant Improvement Charge. Although a phase-in is not feasible because of financial accounting standards (which will be more fully discussed herein), the fact is that under both alternatives all costs will have been examined, and the only issue will be the timing of recovery of costs.

2. <u>NO INTER-GENERATIONAL INEQUITIES WILL RESULT.</u>

Q. ON PAGES 2 AND 3 OF HIS REBUTTAL TESTIMONY, MR. TRIPPENSEE EXPRESSES CONCERN REGARDING THE INCLUSION OF PLANT NOT YET IN SERVICE. BEGINNING ON PAGE 12, LINE 25, MR. TRIPPENSEE ARGUES THAT THE JOPLIN PLANT IMPROVEMENT CHARGE WILL CREATE AN INTER-GENERATIONAL INEQUITY. SIMILARLY, ON PAGE 4, LINES 5-6, MR. RACKERS NOTES HIS OPPOSITION TO THE

MECHANISM BECAUSE IT WOULD RECOGNIZE PLANT IN RATES THAT IS NOT COMPLETED AND IN SERVICE. HOW DO YOU RESPOND TO THESE ARGUMENTS?

A. First, as I described in my direct testimony, page 18, lines 3-21, it is important to re-emphasize that both alternatives are simply dealing with the recovery of financing costs on the plant. Prior to the in-service date, customers would be paying only the financing costs of the project, not the principal cost of the project itself. A fundamental utility regulatory concept is that customers should be charged only for those costs of facilities from which benefit is derived. Implied in this idea is the principle that costs incurred by a utility in financing construction must be charged to the ultimate beneficiaries, that is, the customers who use the facilities. Mr. Trippensee and Mr. Rackers argue that the allowance of CWIP in rate base violates this concept because the burden of interest payments is shifted partially from future to present customers. However, that argument has no validity where the construction work is short-term and is primarily designed to improve present service, as is the case here. There is clearly a nexus between the present Joplin District customers and the need for the Joplin Project, which purpose is to refurbish and modernize the water treatment plant, increase its efficiency, and update it to comply with environmental requirements.

Q. ON PAGE 3, LINES 1-15, OF HIS REBUTTAL TESTIMONY, MR. TRIPPENSEE ARGUES THAT THE JOPLIN PLANT IMPROVEMENT

CHARGE VIOLATES THE INTENT OF THE PEOPLE OF MISSOURI WITH REGARD TO PAYING FOR PLANT PRIOR TO THE PLANT BEING PLACED IN SERVICE. DO YOU AGREE?

A. No. Mr. Trippensee references Section 393.135 RSMo 1986 that discusses the ratemaking treatment of electric CWIP. As Mr. Trippensee correctly observes, "This statute is specific to electric utilities..." Nevertheless, Mr. Trippensee improperly attempts to expand the applicability of this electric statute across all utility industries. The initiative vote that resulted in Section 393.135 RSMo 1986 was a reaction to the Callaway nuclear plant, and it was explicitly limited to electric utilities. A water treatment plant can hardly be grouped in the same category as a nuclear generating station, yet that is what Mr. Trippensee attempts to represent. Second, and perhaps most compelling, is that the voters did not initiate a vote on the ratemaking treatment of water utility CWIP, although they had the right to do so. Thus, it is not appropriate for Mr. Trippensee to attempt to represent that this is the voters' viewpoint.

3. <u>THE CWIP BALANCES THAT FORM THE BASIS FOR THE JOPLIN PLANT IMPROVEMENT CHARGE MAY BE SUBJECT TO AUDIT.</u>

Q. ON PAGE 5, LINES 6-9, OF HIS REBUTTAL TESTIMONY, MR. TRIPPENSEE ARGUES THAT THE PROJECTED CWIP BALANCE THAT FORMS THE BASIS FOR THE JOPLIN PLANT IMPROVEMENT CHARGE

WILL NOT BE SUBJECT TO AUDIT OR SCRUTINY BY THIS COMMISSION, THE STAFF, OR ANY PARTY TO THIS CASE. PLEASE RESPOND.

A. MAWC proposed to calculate the Joplin Plant Improvement Charge based on projected levelized CWIP balances for the sake of administrative convenience and simplicity. See Schedule JMJ-3, footnote (1). MAWC's original intent was to project the levelized CWIP balances for the Joplin Plant Improvement Charge calculations such that it would always be lower than the actual CWIP balances.[3] As such, MAWC did not see a need for audit or scrutiny by the parties. However, MAWC is not opposed to doing so.

To alleviate Mr. Trippensee's concerns, MAWC would be willing to formally commit to use the lower of the actual CWIP balance or the projected levelized CWIP balance, consistent with MAWC's original intent. MAWC would also be willing to allow the Commission Staff and Public Counsel to audit or scrutinize the actual CWIP. Since AFUDC will accrue on the "shortfall" between the actual and projected levelized CWIP, this effectively serves to reconcile any inaccuracies in the projected levelized CWIP amounts.

[3] As Schedule JMJ-3 states, AFUDC would continue to accrue on the difference between the actual CWIP balance and the levelized CWIP amount used in the calculation.

4. <u>THE JOPLIN PLANT IMPROVEMENT CHARGE IS NOT MORE COSTLY FOR RATEPAYERS.</u>

Q. BEGINNING ON PAGE 15, LINE 18, OF MR. TRIPPENSEE'S REBUTTAL TESTIMONY, MR. TRIPPENSEE ARGUES THAT MAWC'S PROPOSAL FOR THE JOPLIN IMPROVEMENT CHARGE IS NOT LESS COSTLY FOR RATEPAYERS. SIMILARLY, BEGINNING ON PAGE 4, LINE 20, MR. RACKERS ARGUES THE SAME POINT. PLEASE RESPOND.

A. Mr. Trippensee presented a net present value of revenue requirement ("NPVRR") analysis on Schedule RWT-5. Although Mr. Trippensee calculated the NPVRR under both rate alternatives for years 10 through 40 (see lines 41 through 72), only the net present value for year 40 (line 72) is meaningful.[4] According to Mr. Trippensee's Schedule RWT-5, the NPVRR for the two alternatives (see year 40, line 72) are as follows:

CWIP (Traditional Approach)	$41,907,125
Joplin Surcharge	$41,949,431

In other words, according to Mr. Trippensee's own analysis, the NPVRR's of the two alternatives are virtually identical, i.e. the overall cost to customers is virtually the same under both ratemaking alternatives.

Q. DO YOU HAVE ANY COMMENTS WITH RESPECT TO MR. TRIPENSEE'S NPVRR ANALYSIS?

---

[4] The NPVRR for years 10 through 39 is meaningless because a NPVRR analysis must consider all relevant amounts for the life of the asset. The NPVRR for years 10 through 39 ignores the revenue requirements occurring after each respective year, which renders them meaningless.

A. Yes. Mr. Trippensee has overstated the discount rate used in his analysis. Mr. Trippensee used MAWC's proposed weighted cost of capital (rate of return on rate base) as his discount rate, which is incorrect. While that may be the appropriate discount rate for utility capital budgeting, it is not the appropriate discount rate for an NPVRR analysis. The appropriate discount rate for an NPVRR analysis would be the customers' opportunity cost of capital, which would be significantly lower than the company's cost of capital. If, for instance, the discount rate was lowered to, say, 7.00%, the Joplin Plant Improvement Charge would have a more favorable net present value by $260,453, as shown on Schedule JMJ-5.

Q. PLEASE SUMMARIZE.

A. Mr. Trippensee's analysis shows that the NPVRR of both ratemaking alternatives is approximately identical, even using his erroneously high discount rate. However, when a more correct lower discount rate is used, representing the customers' estimated opportunity cost of capital, the Joplin Plant Improvement Charge becomes a more favorable alternative.

However, the Commission should not lose sight of the fact, as I stated in my direct testimony, that the Joplin Plant Improvement Charge would help mitigate the one-time rate spike to customers that would otherwise occur once the Joplin treatment plant was placed in service.

5. THE JOPLIN PLANT IMPROVEMENT CHARGE MITIGATES FUTURE RATE INCREASES.

Q. ON PAGE 5, LINE 17, THROUGH PAGE 6, LINE 7, MR. RACKERS QUESTIONS WHETHER THE TRADITIONAL RATE BASE TREATMENT OF THE JOPLIN WATER TREATMENT PLANT PROJECT WILL RESULT IN RATE SHOCK. PLEASE RESPOND.

A. Interestingly, Mr. Rackers attempts to avoid concluding that the traditional rate base treatment of the Joplin water treatment plant project would result in rate shock. Mr. Rackers does not dispute that the Joplin water treatment plant project would result in a 65% increase based on current rates, as I discussed on page 15 of my direct testimony. However, Mr. Rackers takes the perplexing position that because customers will be experiencing other future increases, the percentage of the increase would be reduced compared to the increasing base rates.

Q. DOES MR. RACKERS ALSO ARGUE THAT CUSTOMER GROWTH WILL ALLOW THE COST INCREASE TO BE SPREAD OVER A LARGER BASE OF CUSTOMERS?

A. Yes. However, given that the Joplin treatment plant is expected to be placed into service and into rate base in approximately one year, any customer growth during that period would be minimal and would do little to mitigate the 65% impact.

Q. DOES MR. RACKERS ARGUE THAT THE $10.50 PER MONTH INCREASE EXPECTED AS A RESULT OF THE INCLUSION OF THE JOPLIN PROJECT INTO RATE BASE IS INSIGNIFICANT?

A. On page 6, line 5, Mr. Rackers is careful to indicate that the $10.50 bill impact resulting from the inclusion of the Joplin project in rate base is NOT INSIGNIFICANT. However, Mr. Rackers applies the unusual logic that because the other utility increases in heating and cooling costs being experienced by customers are so much larger, this renders the $10.50 increase in the water bill "more manageable." While Missouri-American cannot affect the heating and cooling increases being experienced by its customers, it can help to mitigate the increases in customers' water bills.

6. THE JOPLIN PLANT IMPROVEMENT CHARGE WILL NOT TRANSFER CONSTRUCTION RISK TO RATEPAYERS.

Q. BEGINNING ON PAGE 13, LINE 21, MR. TRIPPENSEE ARGUES THAT THE JOPLIN PLANT IMPROVEMENT CHARGE WILL SHIFT CONSTRUCTION RISK OF THE PROJECT FROM MAWC TO THE RATEPAYER. PLEASE RESPOND.

A. As I discussed on page 19, lines 1-6, of my direct testimony, given that MAWC has the resources and capability to see a project such as this through to completion and, moreover, that the construction is on an existing plant, the chances of customers paying for facilities that do not end up in service are virtually non-existent.

7. <u>A PHASE-IN IS NOT A POSSIBLE METHOD OF DEALING WITH THE RATE INCREASE.</u>

Q. BEGINNING ON PAGE 6, LINES 16-19, MR. RACKERS PROPOSES AN ALTERNATIVE TO REDUCE THE SIZE OF THE RATE INCREASE RESULTING FROM THE JOPLIN PROJECT. COULD MAWC PHASE IN THE PROJECT COSTS OVER SEVERAL YEARS AFTER CONSTRUCTION TO MITIGATE THE IMPACT ON CUSTOMERS?

A. No. As MAWC discussed extensively in its testimony in its 2000 rate case, Case No. WR-2000-281, a phase-in plan would negatively impact the financial position of MAWC. Statement of Financial Accounting Standards No. 92 ("SFAS 92") prohibits capitalization of costs deferred for future recovery under phase-in plans related to plants constructed after January 1, 1988. Since the construction of the Joplin Project did not commence until after January 1, 1988, under generally accepted accounting principles any related phase-in plan deferrals must be expensed for accounting and reporting purposes. Therefore, MAWC's financial statements will be negatively impacted for most of the deferral period. Specifically, earnings each year will be reduced by the amount of the revenue deferral, net of taxes. A phase-in plan would cause MAWC to under-earn its allowed return on equity ("ROE") in the deferral period and over-earn its allowed ROE when higher revenues were permitted in future years.

Q. DID THE PARTIES IN MAWC'S 2000 RATE CASE, CASE NO. WR-2000-281, RECOGNIZE AN ADDITIONAL PROBLEM WITH PHASE-INS?

A. Yes. Parties recognized that any amounts deferred as a result of a phase-in plan must receive a financing cost in order to ensure that MAWC receives in present dollars, the full value of its rate increase over the phase-in period. There was a recognition that at some point the length of a phase-in period becomes counterproductive in that the financing costs become more than the actual revenues to be deferred and create a substantial burden that may outstrip the revenues to be deferred.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.