Exhibit No.:	_______________
Issue(s):	Affiliate Transactions
Witness/Type of Exhibit:	Schallenberg/Rebuttal
Sponsoring Party:	Public Counsel
Case No.:	WR-2020-0344

REBUTTAL TESTIMONY

OF

ROBERT E. SCHALLENBERG

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2020-0344

January 15, 2021

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American	)	
Water Company's Request for	)	
Authority to Implement General Rate	)	Case No. WR-2020-0344
Increase for Water and Sewer Service	)	
Provided in Missouri Service Areas	)	

VERIFICATION OF ROBERT E. SCHALLENBERG

Robert E. Schallenberg, under penalty of perjury, states:

1. Attached hereto and made a part hereof for all purposes is my rebuttal testimony in the above-captioned case.

2. My answer to each question in the attached rebuttal testimony is true and correct to the best of my knowledge, information, and belief.

/s/Robert E. Schallenberg
Robert E. Schallenberg
Director of Policy
Office of the Public Counsel

REBUTTAL TESTIMONY

OF

ROBERT E. SCHALLENBERG

MISSOURI-AMERICAN WATER COMPANY

CASE NO.: WR-2020-0344
CASE NO.: SR-2020-0345

Q. Who are you?

A. My name is Robert E. Schallenberg.

Q. Have you already testified in this case?

A. Yes. I testified in direct for the Office of the Public Counsel ("OPC") on the topic of the appropriate allowance for funds used for construction ("AFUDC") balance and the AFUDC rate methodology for setting Missouri-American Water Company's ("MAWC") rates in this case and MAWC's AFUDC rate in the future.

Q. Why are you testifying now?

A. I reviewed MAWC's and the Commission Staff's direct filings on AFUDC balance and rates, as well as affiliate transactions. I am presenting my opinions on what I learned from that review of direct testimony and its underlying support, including data request responses.

Q. Who testified in direct testimony on those topics?

A. Jeff Kaiser, Grant Evits, Brian LaGrand, Nikole Bowen, and Patrick Baryenbruch for MAWC, and Amanda McMellen for Commission Staff. I address the direct testimonies of Jeff Kaiser, Grant Evits, Brian LaGrand and Patrick Baryenbrunch regarding the affiliate transactions costs that have been included in their direct cases.

Q. What is the main topic you are addressing?

A. Affiliate transactions, and whether MAWC or Staff have shown that MAWC is not disadvantaged by these non-arms' length transactions.

Q. Would you summarize your review and your opinions regarding MAWC recovering its affiliate transaction costs through its rates?

A. Yes. Since, as OPC witness Geoff Marke briefly testified to in his direct testimony, transactions between affiliates permit, intentionally or unintentionally, the affiliates in the enterprise to maximize the earnings of the enterprise at the expense of particular members, I have reviewed what MAWC and the Commission's Staff did to determine whether MAWC was engaging in such transactions with its affiliates. It would be imprudent for MAWC to engage in these non-arm's length affiliate transaction by creating a greater value to the American Water enterprise by increasing MAWC's revenue requirement and the resultant customer rates to recover the costs of these inefficient utility operations. In other words, determine whether MAWC was agreeing to terms contrary to the efficient operation of its Missouri regulated water and sewer utility businesses, but benefitting the American Water enterprise's best interests.

MAWC relies heavily on the direct testimony of Mr. Patrick Baryenbruch and his analysis (The Study) to show that the dollar amount of MAWC transactions with American Water Works Service Company (AWWSC) is reasonable and prudent. The Study does not address all of AWWSC's transactional costs included in MAWC's proposed revenue requirement for this case, nor does The Study show that the transactions included in the study provide as much or more net benefit than MAWC could realize through arms'-length transactions with non-affiliates. Net benefit is the true benefit factor that needs to be considered as well as quality of service at what costs offered compared to in-house focus on matters important to your customers. MAWC has not supported the prudence of a significant portion of its affiliate transactions. It is my opinion that MAWC has not identified and supported the reasonableness and prudence of the affiliate transaction costs beyond those addressed in The Study. I have verified that these affiliate transactions are not the result of MAWC seeking goods and services in an arms' length manner—e.g., MAWC did not issue requests for proposals to third parties as well as affiliates and select the best response—and I have identified specific transactions that are intended to benefit the American Water enterprise to the detriment of MAWC's water and sewer customers.

Q. Can you provide examples of the specific transactions to which you are referring?

A. Yes. I have chosen nine (9). They are:

1). MAWC's Prepaid Billing and Payment Arrangement with American Water Works Service Company ("AWWSC"). I agree with the Missouri Public Service Commission Staff (Staff)[1] that the revenue requirement for MAWC in this case should not include MAWC's $ five (5) million of working capital costs [2]created by MAWC's preferential treatment towards American Water Works Service Company (AWWSC) in their January 1, 1989 Agreement. MAWC agreed to special billing procedures[3] requiring MAWC to pay estimated costs for the current month and reflecting a true up adjustment for the difference of the prior month's estimate versus its actual costs.[4].

AWWSC acquires contract services from third party vendors with standard service terms providing actual market payment terms. AWWSC did not agree to any prepayment terms similar to its agreement with MAWC. The closest term with a third party vendor comparable to MAWC/AWWSC Agreement term is "due upon receipt". Net forty five (45) days was a majority of the third party transaction payment terms.[5]

AWWSC does not require AWWC, its owner/parent company, to reimburse AWWSC on the same terms that MAWC reimburses AWWSC. AWWSC renders a bill to AWWC for all amounts due for services and expenses from the prior month. All amounts billed are paid by AWWC within a reasonable time after receipt of the bill.[6]

Third-party transactions for services decrease working capital needs.[7] If the same terms upon which AWWSC contracts with third parties were applied to MAWC's 2019 AWWSC service payments,[8] they would be less. If one were to examine MAWC's working capital determination on page 1 of 14, lines 15 and 16 of Mr. Brian LaGrand direct testimony

[1] Staff Cost of Service page 37 to 38.
[2] MAWC Worksheet Schedule CAS-7 ($4,869,524) for Y/E 12/31/2019 and ($5,264,183) for Y/E 5/31/2022.
[3] See response to Staff data request 0007-Attachment 2, 1/1/1989 AWWSC AGREEMENT with MAWC, ARTICLE IV. BILLING PROCEDURES AND BOOKS AND RECORDS, paragraph 4.1
[4] Id.
[5] See response to OPC data request No. 1018. 273 third party vendors were identified. 16 required payment upon receipt. 207 (76%) required payment in 45 days.
[6] See response of OPC data request No. 1019. 1/1/1989 Agreement between AWWSC and AWWC paragraph 4.1
[7] MAWC Worksheet Schedule CAS-7 (-$248,068) for Y/E 12/31/2019 and ($-338,201) for Y/E 5/31/2022.
[8] Amount has not been verified as it may exclude other affiliate transactions

Schedule CAS-7., one would see the relationship of working capital needs for the support services from AWWSC compared to the working capital benefit from contracting with third parties. I estimate MAWC's working capital would decrease by $2,037,343[9]. The issue of preferential billing treatment afforded to AWWSC is worth $ 7 million in rate base when the $5 million working capital increase proposed by MAWC is considered. John Riley is addressing the specific working capital details for OPC.

2) Construction Overcharges (AFUDC). MAWC increases its construction costs by emphasizing capitalization of profits for the American Water enterprise in place of the low cost short term debt that is actually being used to fund MAWC's construction projects.

MAWC's construction projects are charged for more than the actual borrowing costs MAWC incurred to fund these projects. MAWC is charging these excessive costs through its Allowance for Funds Used During Construction (AFUDC) process. AFUDC is an overhead cost component charged indirectly to construction projects[10]. MAWC reports that its methodology for AFUDC is:

> "Interest during construction is applied in general to all projects regardless of cost or length of construction period. Effective 1/1/85 the method of computing allowance for funds used during construction was changed to using the equivalent to the weighted cost of capital, as determined in the most recent rate order net of the income tax effect.[11]"

MAWC's methodology virtually eliminates most of the impact of the low actual short-term debt costs on its construction projects, and replaces that short-term debt cost with the most costly form of capital—equity—by how it calculates its AFUDC charges.

To illustrate the issue of inappropriate treatment the short-term debt, focus on the 2019 test year. In 2019, short-term debt funded all of MAWC's construction projects[12] and its excess short-term debt was placed in MAWC's capital structure at a cost of 1.85%[13]. MAWC continues to represent that short-term debt is an offset against construction work-in-progress

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[9] MAWC Worksheet Schedule CAS-7 for Y/E 12/31/2019. Cash Requirement of a negative $248,068 divided by Contracted services amount of $3,966,723 equals 6.35%. This percentage is applied to $32,578,064 of support services.
[10] MAWC 2019 annual report page F-23
[11] Id.
[12] Direct testimony of Brian LaGrand, Schedule BWL-4, page 6 of 15
[13] Id. page 2 of 15

(CWIP)[14] in its rate cases. Thus, the MAWC's AFUDC rate should be its short-term debt rate for 2019.

However, MAWC's methodology fails to implement the correct AFUDC methodology, and consequentially produces excessive amounts of AFUDC charges to its construction projects. On January 1, 1985, MAWC adopted its current methodology to use a weighted cost of capital instead of the short-term debt methodology that it should have utilized. For 2019 MAWC recorded $3,114,126 in its Allowance for Funds Used During Construction Account 420. $844,822 of this amount represented debt credits and the remainder ($2,269,304) represented equity credits placed in plant[15].

3) MAWC's long term borrowing costs for financing from AWCC exceed AWCC's actual net borrowing costs with third parties for the funds it uses to lend to MAWC. Consequently, American Water's non-regulated operations are long-term funded from AWCC on terms more advantageous than the net costs incurred by AWCC from its long term borrowings from third party lenders. MAWC, advised by AWWSC employees, borrows at the highest interest rate with the longest terms components of AWCC actual long term borrowings. By doing so, MAWC frees AWWC to take advantage of the shorter term lower interest rate borrowing component with a shorter maturity date for funding other activities.

This relationship of MAWC with AWWC is an issue for MAWC's customers because it commits MAWC to paying higher interest rates for approximately a decade with the hope that refinancing costs will be greater in 10 years than the MAWC 30 year interest rate by a margin sufficient to offset the initial higher payment of the first 10 years. In the event refinancing costs are less than MAWC 30 year current interest rate, the result is an increasing amount of excessive interest costs over the level of higher interest payments MAWC paid in the initial 10 years

MAWC is being charged the higher costs of its affiliate financier's, American Water Capital Corp. (AWCC), borrowings. The MAWC loans reflect terms above the AWCC net borrowing costs specified in their financial services contract. These financial arrangements

[14] Id. pages 3 of 15 thru page 5 of 15.
[15] MAWC 2019 annual report to the Commission, page F-41

allow the American Water non-regulated financier, AWCC, to lend to the parent company, American Water Works Corp. (AWWC), at guaranteed lower interest rate for approximately ten (10) years with the requirement to refinance after that time. MAWC guarantees AWCC that MAWC will be paying a higher interest rate to the benefit of its parent for approximately ten (10) years and is gambling that the interest rates in ten years will be higher than the initial rate locked in by a margin that offsets the rate differential MAWC pays. There are six such borrowings that came to my attention.

4) $ 4 million unpaid, unsupported, unique charge to MAWC expense. AWWSC has an accounting entry for a $4,112,876 accrual and adjustment in MAWC's account for outside services (923) for the end of the 2019 test year. The charge is unexplained, unsupported, and unique. The expense is unprecedented from charges reported to this account in prior years. This is the first such charge in the period 2002 through 2019.[16]

MAWC objected to my inquiry for the details of this charge, asserting that the information is not relevant to the case, proportional to the needs of the case considering the totality of the circumstances, reasonability calculated to lead to the discovery of admissible evidence in that MAWC's 2019 Annual Report has been submitted, reviewed, and any deficiencies corrected. [17] MAWC indicated that without waiving its objection, it would attempt to provide a response, but needed three (3) additional days to provide a response. The data request was OPC DR 1110 and was issued to MAWC on November 2, 2020.[18]. At this time, I recommend that the $4,112,876 be excluded from the revenue requirement used to establish customer rates for MAWC in the case because of MAWC's failure to supply information supporting this multi-million dollar charge to MAWC. Note that accruals do not represent actual cash payments; but are estimates of a future liability, which can be changed or reversed.

5) Parent Company Officer expense charged to MAWC. MAWC was charged $755,883 in 2019 and $574,822 year to date ending August 2020 for AWWC's officers'

[16] See selected pages from 2002 through 2019 MAWC annual reports with account specifics and total dollars recorded in the 923 outside services account showing
[17] See 11/12/2020 letter from Dean Cooper to Caleb Hall regarding MAWC objections to multiple OPC data requests including 1110 regarding this matter.
[18] Id.

expense.[19] At the same time, MAWC has reported that it had its own officers.[20] There is no apparent need for additional officers and no justification for the validity of these charges. In fact, MAWC has two Assistant Treasurers and Assistant Comptroller officer positions with only one of those four (4) officer position listing St. Louis, Missouri, as their principal business address. The other three (3) officer positions list Camden, NJ as their principal business address.[21]

6) MAWC first adjustment to increase support service costs[22]. This is an adjustment proposed by AWWSC to transfer the charging of costs presently being charged directly to MAWC to be changed to a method where AWWSC will charge these costs as support services to MAWC. I have asked about the details but received no assurance that there is a cost reduction in this case to completely offset the increase MAWC proposes to be included in AWWSC's support service costs. Since I have not verified a cost offset in the case, I recommend the *status quo* be maintained until the offset is made to MAWC's revenue requirement has been verified to offset the higher AWWSC costs.

7) MAWC second adjustment to increase MAWC's support service costs because the Company's owner is selling an affiliate located in the state of New York. The Study concludes that the managerial and professional services AWWSC provides to MAWC are essential to MAWC. While that may be true, MAWC is proposing to increase its support services costs for unrecovered AWWSC costs caused by AWWC's future sale of its regulated water utility subsidiary in New York through by increasing MAWC's allocated share of AWWSC's support service costs.

MAWC's parent company is divesting itself of its New York affiliate, and is proposing to attribute increased service costs to MAWC because of the sale. This would increase water and sewer prices for Missouri customers for an event that was outside the control of MAWC and which provides no incidental benefit to MAWC.[23]

[19] See response to OPC data request 1041.
[20] See MAWC 2019 annual report to Commission, page F-3
[21] Id.
[22] Direct Testimony of Brian LaGrand, Schedule BWL-3, page 3 of 5, line 14.
[23] 10Q or 10K discussion of NY sale

AWWC is totally responsible for a cost recovery problem created by AWWC, with AWWSC's support, selling one of its regulated water utilities. It is also inappropriate for AWWC to increase its gain by shifting this issue onto MAWC customers rather than recognizing these costs as an offset to the sale gain, That AWWSC is losing a major customer and cannot reduce its costs to serve is problematic to the AWWC sale and should be treated as an offset to AWWC's gain on the sale, not a cost that should be passed onto MAWC to recover from its customers.

The amount of costs MAWC seeks to recover from its customers is not known and measurable. The sale has not occurred and the true costs at issue are overstated because AWWSC has not determined that it will have no savings as implied in their adjustment. [24]. MAWC has not insisted that it should not be responsible for, or even consider being responsible for, any such recovery before AWWSC has made a comprehensive effort to reduce its costs. MAWC should not even consider recovery of these costs from its water and sewer customers before doing so. This again demonstrates how the non-arms' length nature of MAWC's affiliate transactions are to MAWC's disadvantage. MAWC is seeking to recover potential stranded costs created by its parent holding company's sale activity to the detriment of MAWC's customers when neither MAWC nor its customer played any role in the transaction. MAWC, and its customers are being asked to pay holding company costs created by a non-regulated sale solely to increase the earnings of the American Water enterprise.

8) MAWC paying AWCC for its Credit Line Fees Charges even though MAWC has no control or access to funds to this line-of-credit. MAWC has no line-of-credit of its own from which it can directly borrow and access funds when it needs them. The credit line fees are a charge to MAWC for AWCC's line-of-credit. And it is AWCC which can borrow from that line-of-credit. The bulk of these charges are for AWCC's cost to have the unused portion of its line-of-credit available to it. MAWC did not determine the maximum amount of credit to which AWCC committed. These costs are charged MAWC based on establishment of a maximum borrowing level available to MAWC, not MAWC's actual

[24] See response to OPC data request No.45.

borrowings. There is no contract between MAWC and AWCC defining MAWC's borrowing limit, what would happen if MAWC does not use the borrowing limit, what would happen if another American Water affiliate needed to borrow above its borrowing limit when MAWC borrowings are below its limit.

There is no contract regarding how another affiliate will reimburse MAWC if it needs to borrow above its borrowing limit. MAWC refuses to provide the information to show that MAWC is only paying its fair share compared to the holding company AWWC non-regulated borrowing activities. MAWC does no audit for compliance. AWCC has no written practice on how to process its short-term borrowings. The American Water enterprise already recovers this cost through its equity substitute for short-term debt in its AFUDC charges to its rate base. A majority of this cost is fees for unused borrowing capacity. MAWC is not the cost causer here as it did not establish the amount debt capacity that AWCC believed it needed for American Water. AWCC has no incentive to be efficient in this matter with regulated water utilities customers picking up the tab. For unused debt capacity AWCC, with AWWSC assistance, is the only entity that can modify the borrowing cap, thus reducing its credit fees.

9) AWWSC's Charges in MAWC's Rate Base that are not addressed by MAWC's witnesses or The Study. AAWSC costs are capitalized or included into MAWC's plant or rate base. These costs are not addressed by The Study. MAWC indicates that these costs are supported on two (2) pages of the direct testimony of Jeff Kaiser, the direct testimony of Grant Evits including his discussions of AMI, Operational Technology, Water Suite and Sample One View, and the direct testimony of Mr. LaGrand which discusses rate base and corporate allocations.[25] In the 2019 test year, MAWC capitalized $13,385,127 of AWWSC charges.[26] AWWSC charges capitalized in prior years are also be included MAWC's rate base in this case. The testimony cited in MAWC's response did

[25] See Response to OPC data request No. 1057
[26] See MAWC 2019 annual report to MoPSC page F-6

not address the reasonableness or prudence of AWWSC's costs that it included in MAWC's rate base.[27]

Q. Does this conclude your rebuttal testimony?

A. Yes

[27] See Direct testimony excerpts of cited material