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MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION

UTILITY SERVICES

REBUTTAL TESTIMONY

OF

PAUL R. HARRISON

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

Jefferson City, Missouri
January 2012

Staff Exhibit No. 8
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1 **EXECUTIVE SUMMARY**

2 Q. In summary, what does your Rebuttal Testimony cover?

3 A. My testimony will respond to Public Counsel's proposal that the Commission
4 should depart from its consistent practice of reflecting the net book value of the acquired
5 properties in MAWC's rate base as proposed by MAWC and recommended by Staff.
6 Public Counsel proposes that the Commission use either the purchase price or the book value
7 of acquired assets to determine the amount of rate base, dependent upon whichever method
8 earns a lower return on the valuation of the purchased assets.

9 I will also respond to MAWC's requested continuation of the Company's current
10 tracker mechanism for pension expense, unmodified. MAWC's request ignores a flaw in the
11 tracker related to a mismatch in how the amount of MAWC's rate recoveries for pension
12 expense is currently determined, and how the amounts of its pension cash trust fund
13 contributions are calculated. I will provide Staff's recommendation to correct the problem in
14 the current case and on a going forward basis.

15 **MAWC'S ACQUISITIONS**

16 Q. What properties has MAWC acquired since its last rate case?

17 A. MAWC has purchased Loma Linda (File No. WO-2011-0015), AQUA
18 Missouri (File No. WO-2011-0168), and Roark Water and Sewer (File No. WO-2011-0213).

19 Q. Were the three Acquired Properties mentioned above regulated entities under
20 the Missouri Public Service Commission authority at the time of acquisition?

21 A. Yes.

22 Q. How did Staff value the rate base for each of the acquired properties in the
23 acquisition cases?

1 A. Staff included the rate base amount that was included on the books and records
2 of the each entity at the time of the acquisition by MAWC.

3 Q. What records did Staff use to determine the amount of rate base for the
4 acquired properties in the current MAWC rate case?

5 A. Staff reviewed the plant records from MAWC's acquisition cases, the
6 Acquired Properties' previous rate cases, general ledgers, and sampled invoices and the
7 Acquired Properties' available continuing property records (CPR's) to determine the proper
8 amount of rate base for the Acquired Properties.

9 Q. What analysis did Staff perform to update the records of the Acquired
10 Properties for the current MAWC rate case?

11 A. Staff reviewed MAWC's general ledgers, sampled invoices, and reviewed the
12 available CPRs for each property up through December 31, 2010, the test year, to determine
13 the proper amount of rate base for inclusion in this case.

14 Q. What is an acquisition premium or discount?

15 A. An acquisition premium occurs when the purchase price is greater than net
16 book value of the assets. An acquisition discount is the opposite of the acquisition premium
17 in that it means that the purchase price was less than net book value of the assets.

18 Q. What is Staff's position on inclusion of acquisition premiums or acquisition
19 discounts in utility rate base?

20 A. Staff has taken a consistent position to value acquired assets in rate base at net
21 original cost to the initial owner of the assets, and has opposed efforts to recognize either
22 acquisition premiums or acquisition discounts in utility rate base.

1 Q. Why has Staff taken the position not to recognize acquisition premiums or
2 acquisition discounts in utility rate base?

3 A. Staff deems this position to be good practice. The net original cost is the most
4 objective and verifiable method to value rate base assets. Differences in the purchase price
5 and net book value of utility assets often relate to expectations of future efficiencies or
6 savings in the utility's operations caused by the new owners of utility assets, but the existence
7 and the amount of such efficiencies and savings are often very difficult or impossible to
8 "prove up" in rate proceedings.

9 Q. Did Staff include an acquisition premium or discount adjustment in rate base
10 for any of the acquired properties in this case?

11 A. No.

12 Q. How did Public Counsel witness Robertson value the assets for the three
13 acquired properties?

14 A. For the Loma Linda's properties, on page 10, lines 13 through 18 of his Direct
15 Testimony, Mr. Robertson states the following:

16 Q. Does Public Counsel recommend that the Acquisition
17 Premium be disallowed in the valuation of Loma Linda's rate
18 base and the determination of rates in the current case?

19
20 A. Yes. It is Public Counsel's recommendation that MAWC
21 should not be allowed to earn a return on a valuation of the
22 purchased assets that exceeds the amount of the net book value
23 of the assets purchased.

24 For the AQUA Missouri properties, on page 15, line 14 through page 16, line 2 of his
25 Direct Testimony, Mr. Robertson states the following:

26 Q. Does Public Counsel recommend that the asset purchase
27 price, rather than the Sellers's booked asset amounts, should be

1 utilized to value the rate base of the AQUA Missouri
2 Acquisitions in the determination of rates for the current case?
3

4 A. Yes. It is Public Counsel's recommendation that the
5 Company be allowed to earn a return on a rate base valuation
6 that matches the consideration paid for the assets purchased. It
7 should not be allowed to earn a return on asset values that
8 exceed their purchase cost.

9 For the Roark Water and Sewer properties, on page 18, line 8 through line 13 of his

10 Direct Testimony, Mr. Robertson states the following:

11 Q. Does Public Counsel recommend that the asset purchase
12 price, rather than the Sellers's booked asset amounts, should be
13 utilized to value the rate base of the Roark Acquisitions in the
14 determination of rates for the current case?
15

16 A. Yes. It is Public Counsel's believe that MAWC should not be
17 allowed to earn a return on purchased assets that exceeds the
18 amount of the purchase price.

19 Public Counsel appears to be arguing that net book value should be used for the Loma
20 Linda properties (for which MAWC paid an acquisition premium) and purchase price should
21 be used for the AQUA Missouri and Roark properties (for which MAWC paid acquisition
22 discounts) to determine the valuation of the assets for the amount of rate base for this case.

23 Q. Is Staff opposed to Public Counsel's proposal to recognize acquisition
24 discounts for MAWC's acquired properties?

25 A. Yes. Staff has consistently taken the position of valuing acquired assets in rate
26 base at net original cost to the initial owner of the assets.

27 Q. What is the total amount of rate base that Staff recommends for inclusion in
28 the current MAWC rate case for the three Acquired Properties, before corporate allocations?

1 A. As of December 31, 2010, the test year, Staff recommends a total rate base as
2 follows for each of the Acquired Properties: for Loma Linda \$245,388, for AQUA Missouri
3 \$3,281,178, for Roark Water \$2,171,874, and for Roark Sewer \$1,108,968.

4 Q. If MAWC did not acquire these three properties, and each one of the entities
5 had filed a rate case at the Commission, what amount of rate base would be included in their
6 individual rate cases?

7 A. Staff would use the net book values for each property, which is the same
8 amount that Staff is recommending in this rate case.

9 Q. Is MAWC requesting recovery of the acquisition premium associated with
10 Loma Linda?

11 A. No. MAWC, along with Staff, consistently used the net book value of each of
12 the Acquired Properties in this case.

13 **MAWC'S PENSION TRACKER MECHANISM**

14 Q. When was the Financial Accounting Standard (FAS) 87 pension tracker
15 mechanism for MAWC first established?

16 A. The initial pension tracker was established as a result of a Nonunanimous
17 Stipulation and Agreement, filed August 9, 2007, as referenced in *Appendix E to the Missouri*
18 *American Water Tracker Mechanism OPEBs and Pensions in Case No. WR-2007-0216* and
19 reads in part as follows:

20 The Pensions tracker mechanism represents the difference
21 between the allocated FAS 87 cost, as calculated by the
22 Company's actuary, and the recalculated and allocated FAS 87
23 cost included in rates in this case. A Regulatory asset or
24 liability will be established to accumulate the amount of the
25 tracker and the balance will be an addition or reduction to rate
26 base in the next general rate proceeding. The continuation of the

1 tracker and disposition of amounts accumulated will be
2 reviewed in the next general rate proceeding. Over time, the
3 regulatory asset and liability balances are expected to offset
4 each other.

5 The ratemaking treatment agreed to in Case No. WR-2007-0216 for pensions and
6 OPEBs was continued in Stipulation and Agreements reached in MAWC's subsequent rate
7 cases, Nos. WR-2008-0311 and WR-2010-0131.

8 Q. Please describe FAS 87 as it relates to pension costs.

9 A. FAS 87, *Employers' Accounting for Pensions*, is the accrual accounting
10 method for calculating pension cost for financial reporting purposes.

11 Q. Please explain how this tracker functioned in the previous three MAWC
12 rate cases.

13 A. As a result of those Stipulation and Agreements, MAWC was authorized to use
14 an accounting mechanism that would "track" the difference between the ongoing allocated
15 FAS 87 expense, as calculated by the Company's actuary, and the allocated FAS 87 expense
16 included in the rate cases. The net balance of the FAS 87 tracker was amortized to expense
17 over a five year period, with an unamortized tracker balance included in rate base as a
18 regulatory asset or liability, as appropriate.

19 In addition to the FAS 87 tracker amount discussed above, Staff also included in
20 MAWC's rate base a "pension asset/liability" that measured the difference between MAWC's
21 recorded pension expense on its books and MAWC's allocated share of its parent company's,
22 American Water Works Company, Inc. (AWW), actual cash contribution to its pension trust
23 funds. This value as of December 31, 2010 was included in rate base as a liability, meaning
24 that MAWC has recognized more pension expense on its books than its allocated share of

1 pension contributions to trust funds. This asset/liability inadvertently has not been amortized
2 to expense in previous MAWC rate cases.

3 Q. What is the flaw Staff has identified in the operation of the Company's current
4 tracker mechanism for the FAS 87 pension expense?

5 A. The current tracker mechanism does not result in an accurate rate base
6 valuation of MAWC's ongoing pension fund investment. American Water Works Company,
7 Inc. does not fund its pension plan on a FAS 87 basis, and instead uses an alternative
8 approach, minimum Employee Retirement Income Security Act of 1974 (minimum ERISA),
9 to calculate its pension funding amounts, and that amount is in turn allocated to AWW's
10 affiliates, including MAWC.

11 The problem in the operation of the current FAS 87 tracker mechanism is that it is
12 based upon fluctuations in the Company's ongoing FAS 87 expense as compared to the
13 amount of FAS 87 included in MAWC's rate levels. However, if the amounts of MAWC's
14 allocated annual trust fund contributions are not based upon a FAS 87 expense measurement
15 (and, as previously explained, currently they are not), then there is no cash investment
16 required of either MAWC or its ratepayers caused by fluctuations in booked FAS 87 pension
17 expense. A financial accounting difference that has no impact on a Company's or its
18 customers' cash investment requirements should not be included in a utility's rate base.

19 The "pension asset/liability" also included in MAWC's rate base, is a better surrogate
20 calculation of the Company's or customers' pension funding cash requirements. The pension
21 asset/liability arises from the difference between the results of a FAS 87 expense calculation
22 on the Company's books and the amount of its minimum ERISA trust fund contributions.
23 However, even this item is not a direct measurement of rate base investment associated with

1 pension funding, as the pension asset/liability is a measurement of the *difference* between
2 current FAS 87 expense and minimum ERISA funding, not the amount of FAS 87 expense
3 included in MAWC's customer rates. In any case, inclusion of both a FAS 87 rate base
4 difference and a pension asset/liability in rate base will most likely result in either an
5 overstatement or an understatement of MAWC's actual pension tracker for rate base.

6 Q. Please explain when and how Staff became aware of the flaw in the operation
7 of the Company's current pension tracker mechanism.

8 A. During the beginning of this rate case, Staff conducted several meetings with
9 the Company in order to better understand the Company's books and records for the
10 development of MAWC's Cost of Service. During one of the pension and Other Post
11 Employee Benefit meetings, Staff discovered that MAWC's current pension tracker
12 mechanism was set up and operated differently from other utilities pension tracker
13 mechanisms within the State. During further investigation, Staff identified a flaw in the
14 pension tracker and this testimony will address Staff's recommendations to fix this tracker in
15 the current case and on a going forward basis.

16 Q. How does Staff recommend addressing the current problem with MAWC's
17 FAS 87 pension tracker in the current case?

18 A. Staff's ability to fully correct for this recently-discovered past inaccuracy of
19 including the non-cash FAS 87 tracker in rate base is limited by the last Stipulation and
20 Agreement (WR-2010-0131) requiring recognition of the current FAS 87 tracker amounts in
21 rate base and in expense through an amortization.

22 For that reason in this case, if inclusion of both the FAS 87 tracker difference and the
23 pension asset/liability differences in rate base lead to either an overstatement or

1 understatement of MAWC's current cash investment regarding pension contributions, Staff
2 recommends adjusting the amount of the balance of the pension asset/liability as necessary
3 until either the combined rate base allowance equals MAWC's current cash requirement, or
4 the balance of the pension asset/liability is reduced to zero, whichever occurs first.

5 Q. How does Staff recommend fixing the MAWC's FAS 87 pension tracker on a
6 going forward basis?

7 A Staff recommends that on a going forward basis the Commission modify
8 MAWC's pension's tracker mechanism so that it is a direct measurement of the Company's
9 ongoing pension cash investment in its trust fund compared to its rate recovery of pension
10 expense. This would require a direct comparison between the amount of MAWC's rate
11 allowance for pension expense (currently calculated on a FAS 87 basis) and the amount of its
12 allocated cash contribution to the pension trust fund (currently calculated on a minimum
13 ERISA basis). This can be accomplished in one of two ways, either MAWC can agree to
14 make cash contributions based upon a FAS 87 calculation and continue to include in rates the
15 FAS 87 pension cost, or the Company's pension costs included in rates can be calculated on a
16 minimum ERISA basis to match the Company's present minimum ERISA funding.

17 The Company and Staff are currently attempting to reconcile the difference between
18 the FAS 87 pension costs, as calculated by the Company's actuary, the calculated FAS 87 cost
19 included in rates, and the amount of its minimum ERISA trust fund contributions in order to
20 determine the appropriate pension tracker amount for the current case. Staff is willing to
21 continue to work with the Company and other parties to this proceeding to determine a more
22 appropriate method of establishing a tracker mechanism for MAWC's pension costs on a
23 going forward basis.

1 Q. What does the Commission need to include in its order to effectuate the
2 recommendations you described in this Rebuttal Testimony?

3 A. The Commission's order should: (1) include the net book value of each of the
4 acquired properties in MAWC's rate base, (2) adjust the amount of the balance of the pension
5 asset/liability as necessary until either the combined rate base allowance equals MAWC's
6 current cash requirement, or the balance of the pension asset/liability is reduced to zero,
7 whichever occurs first, and (3) modify operation of the existing FAS 87 pension's tracker to
8 match the Company's present minimum ERISA funding, if MAWC does not agree to make
9 cash contributions based upon a FAS 87 calculation.

10 Q. Does this conclude your Rebuttal Testimony?

11 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

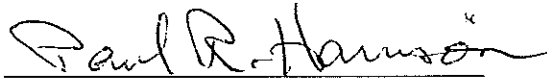
In the Matter of Missouri-American Water)
Company's Request for Authority to)
Implement A General Rate Increase for Water)
and Sewer Service Provided in Missouri)
Service Areas)

Case No. WR-2011-0337

AFFIDAVIT OF PAUL R. HARRISON

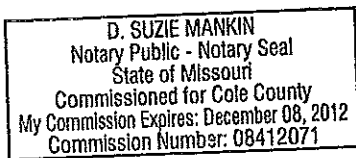
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

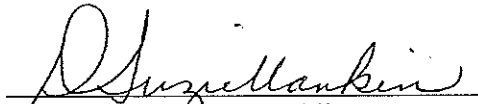
Paul R. Harrison, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, consisting of 11 pages to be presented in the above case; that the answers in the foregoing Rebuttal Testimony were given by him; that he has 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

Subscribed and sworn to before me this 18th day of January, 2012.




Notary Public