

Exhibit No.:

**66**

Issues: Pensions; Interest  
Synchronization

Witness: Doyle L. Gibbs

Sponsoring Party: MoPSC Staff

Type of Exhibit: Surrebuttal Testimony

Case Nos.: WR-2003-0500  
and WC-2004-0168

Date Testimony Prepared: December 5, 2003

**MISSOURI PUBLIC SERVICE COMMISSION**

**UTILITY SERVICES DIVISION**

**SURREBUTTAL TESTIMONY**

**OF**

**DOYLE L. GIBBS**

**FILED<sup>3</sup>**

JAN 23 2004

Missouri Public  
Service Commission

**MISSOURI-AMERICAN WATER COMPANY**

**CASE NOS. WR-2003-0500  
AND WC-2004-0168**

*Jefferson City, Missouri  
December 2003*

Exhibit No. 66  
Case No(s) WR-2003-0500  
Date 12/16/03 Rptr SULLM


**BEFORE THE PUBLIC SERVICE COMMISSION**  
**OF THE STATE OF MISSOURI**

In the Matter of the General Rate Increase for	)	
Water and Sewer Service Provided by Missouri-	)	Case No. WR-2003-0500
American Water Company.	)	
Staff of the Missouri Public Service Commission,	)	
Complainant	)	Case No. WC-2004-0168
	)	
v.	)	
	)	
Missouri-American Water Company,	)	
Respondent	)	
	)	

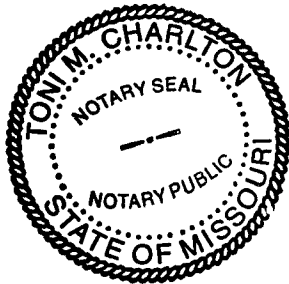
AFFIDAVIT OF DOYLE L. GIBBS

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Doyle L. Gibbs, 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 9 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.

  
 \_\_\_\_\_  
 Doyle L. Gibbs

Subscribed and sworn to before me this 3<sup>rd</sup> day of December 2003.



  
 \_\_\_\_\_

TONI M. CHARLTON  
 NOTARY PUBLIC STATE OF MISSOURI  
 COUNTY OF COLE  
 My Commission Expires December 28, 2004

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**DOYLE L. GIBBS**  
**MISSOURI-AMERICAN WATER COMPANY**  
**CASE NOS. WR-2003-0500**  
**AND WC-2004-0168**

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1                                       **SURREBUTTAL TESTIMONY**  
2   **OF**  
3   **DOYLE L. GIBBS**  
4   **MISSOURI-AMERICAN WATER COMPANY**  
5   **CASE NOS. WR-2003-0500**  
6   **AND WC-2004-0168**

7           Q.     Please state your name and business address.

8           A.     Doyle L. Gibbs, 1845 Borman Court, Suite 101, St. Louis, Missouri 63146.

9           Q.     Are you the same Doyle L. Gibbs that previously filed direct testimony in this  
10 case?

11          A.     Yes, I am.

12          Q.     What is the purpose of your surrebuttal testimony?

13          The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of  
14 Missouri-American Water Company (MAWC or Company) witnesses Edward J. Grubb and  
15 William J. Williamson. In particular I will address Mr. Grubb’s rebuttal testimony regarding  
16 pensions and interest synchronization, and Mr. Williamson’s rebuttal testimony concerning  
17 pensions.

18       **PENSIONS**

19          Q.     Please summarize the pension issue between the Staff and Company.

20          A.     The Company is proposing the use of Statement of Financial Accounting  
21 Standard (FAS) 87 as the basis to determine pension expense and the Staff is proposing a  
22 pay-as-you-go method.

23          Q.     Is the Staff’s pay-as-you-go method based on the Employee Retirement

Surrebuttal Testimony of  
Doyle L. Gibbs

1 Income Security Act of 1974 (ERISA)?

2 A. Yes, it is. Staff's method reflects the actual payments that are required to be  
3 made to the pension fund.

4 Q. Mr. Grubb states in his rebuttal testimony that by proposing to establish  
5 pension expense based on ERISA that "the Staff is taking a narrow view of the issue and has  
6 not considered the long-term impact on their decision." Do you agree with that statement?

7 A. No, I do not. In fact, it is my opinion that the Company is looking at it in the  
8 short-term based on what it perceives the ERISA minimum contributions to be for the next  
9 five years, in comparison to the estimated FAS 87 expense, based on its actuary's estimates.  
10 The Company's actuary and witness, Mr. William J. Williamson, even states on page 3 of his  
11 rebuttal testimony that the FAS 87 cost and the minimum contribution required by ERISA  
12 will differ from year to year, but will not differ over the long-term.

13 Q. When speaking of the comparison of the perceived minimum ERISA  
14 contributions and FAS 87, are you referring to the table on page 11 in Mr. Grubb's rebuttal  
15 testimony?

16 A. Yes. The information in that table, at least for American Water Works  
17 (AWW), was extracted from the information provided to the Company from Mr. Williamson  
18 in correspondence with Mr. Grubb. That correspondence has been attached as  
19 Schedule EJG - 4 to the rebuttal testimony of Mr. Grubb.

20 Q. Do you have any reservations with regards to the estimated minimum required  
21 contributions and the estimated pension costs calculated by Mr. Williamson?

22 A. Yes, I do. The calculations made by Mr. Williamson may be mathematically  
23 correct, but they rely significantly on the assumptions he has used. History shows that what

1 actually occurs is often substantially different from estimated results based on assumptions.  
2 Since each succeeding year's calculations are driven by the previous year's results, variations  
3 due to a difference between what actually occurs and what was assumed to occur, could have  
4 a compounding effect on subsequent calculations.

5 Q. Historically, how have the actual results varied from the calculations based on  
6 assumptions?

7 A. Schedule 1 attached to my surrebuttal testimony includes actual data from  
8 1992 to present for FAS 87 and ERISA. Differences between actual results and the amounts  
9 calculated using actuarial assumptions are reflected in the actuarial reports as unrecognized  
10 gains or losses and are shown in the next to last column on Schedule 1. As can be seen, the  
11 unrecognized gains and losses (the variance between actual and assumed results) are  
12 substantial. The final column of this schedule calculates the percent change from year to year  
13 in the unrecognized gains and losses balance.

14 Q. Please explain how the calculations in one year affect the calculations in  
15 subsequent years.

16 A. Schedule 2, attached to this surrebuttal testimony, consists of 3 pages from the  
17 American Water Works 2003 Actuarial Report that calculates FAS 87 expense for the year  
18 ending December 31, 2003 and the ERISA funding requirements for the year ending June 30,  
19 2003. Focusing initially on FAS 87, Schedule 2-2 shows the components that make up  
20 pension cost for the year 2003 and the prior year, 2002. Note that the total pension cost for  
21 2002 reflects an expected return (9%) on the 2002 assets of approximately \$25 million.  
22 However, on Schedule 2-1, the value of the assets as of January 1, 2002 have been reduced  
23 by \$21 million to reflect a 7.6% negative return on investment rather than a 9.0% return that

1 was assumed in the 2002 FAS 87 calculation. All other things remaining equal, the difference  
2 between expected and actual return on investment in 2002 would have the effect of reducing  
3 the expected return on assets for 2003 by \$4 million (the difference between the estimated  
4 return and the actual return, times the assumed 8.75% return on assets), due to the reduced  
5 asset value, thereby increasing FAS 87 costs by the same amount.

6 As explained on page 2 in the rebuttal testimony of Mr. Williamson, the ERISA actual  
7 funded percentage determines if a contribution to the pension fund is required. Whereas the  
8 asset value is a key element in the FAS 87 expense calculation, the asset value under ERISA  
9 is a key element in the determination of the funded percentage. Schedule 2-3 reflects the  
10 calculations of the funded positions under the actuarial accrued liability (AAL) and the  
11 current liability (CL) methods discussed in the rebuttal testimony of Mr. Williamson. The  
12 asset values used in the calculations are found in Schedule 2-1. Like FAS 87, Schedule 2-3  
13 asset values have been reduced by the negative return earned on the assets during the prior  
14 year. And again, as with FAS 87, the variance between the assumptions used and what  
15 actually occurred will affect the calculations of the funded percentage for subsequent years.

16 Q. On Schedule 2-3, the AAL funded percentage is stated to be 109.3% and on  
17 page 2 of Mr. Williamson's rebuttal testimony he states that no contribution is required if the  
18 plan's assets exceed the AAL. Yet, on the first page of Schedule EJG-4, attached to the  
19 rebuttal testimony of Mr. Grubb, it is indicated that there was an actual contribution of  
20 \$12.4 million for this period. Have you been provided with an explanation for this  
21 discrepancy?

22 A. Yes, I have. ERISA has an alternative calculation to the Schedule 1  
23 calculation for the AAL funded percentage. Under the AAL method, ERISA requires that the

1 funded percentage will be the lesser percentage of the actuarial value and the market value.  
2 Using the market value of the assets shown on Schedule 2-3, the AAL funded percentage is  
3 91%, therefore requiring a contribution to the pension fund.

4 Q. How much of the required \$12.4 million AWW contribution is attributable to  
5 MAWC?

6 A. Approximately \$377,000, or 3% was attributable and allocated to MAWC.  
7 The Staff has included this amount in the determination of pension expense in its cost of  
8 service. The minimum ERISA calculation of \$12.4 million from the 2003 actuarial report, a  
9 portion of which has been attached as Schedule 2, does not include the former St. Louis  
10 County Water Company (SLCWC). The SLCWC plan for this period required no  
11 contributions to its pension fund. For ERISA purposes, the SLCWC pension plan will be  
12 “rolled into” the AWW plan effective July 1, 2003 for the plan year ending June 30, 2004.

13 Q. Do you know what the impact the St. Louis County plan will have on the  
14 AWW plan?

15 A. No. I do not. However, since no contributions are currently due, the St. Louis  
16 County plan appears to be adequately funded. The combination of the AWW and SLCWC  
17 plans should not cause a detrimental impact. In fact, there is the possibility that when the  
18 plans are combined that a benefit may accrue to the AWW plan. The Staff will be able to  
19 better determine this when the Company provides the St. Louis County actuarial report for  
20 2003.

21 Q. Mr. Grubb has indicated that the Staff has changed its methodology to  
22 calculate pension cost in each of the last four Company rate cases, including this case, and  
23 further states on page 11 of his rebuttal testimony:



1           Since the Staff has shown a clear history of making expense reducing  
2           adjustments to the pension cost that are not consistent from rate case to  
3           rate case, will the Staff move back to FAS 87 or will Staff attempt to  
4           adjust ERISA cost on some arbitrary basis to lower future pension cost  
5           as it did in prior cases?

6           How do you respond?

7           A.     Mr. Grubb's statement indicating that the Staff arbitrarily made adjustments in  
8           past cases simply to reduce cost, and the implication Staff will do so in future cases, questions  
9           the Staff's integrity. While there will be issues between the Staff and the filing utility in  
10          virtually every rate case, the Staff takes seriously its responsibility to develop and present a  
11          case that balances the interests of the Company and its ratepayers. The Staff does not  
12          arbitrarily make adjustments solely for the purpose of increasing or reducing expenses. With  
13          regards to the Staff's "changing" pension methodology, I indicated in my direct testimony  
14          that pension expense has been an evolving issue. At the time of Staff's adoption of FAS 87,  
15          most pension funds were over funded and substantial unrecognized gains existed. It was the  
16          Staff's opinion that if FAS 87 was to be used for pension expense, the issue related to the  
17          unrecognized gains needed to be addressed. The additional FAS 87 pension expense related  
18          to the unrecognized gains, when coupled with no ERISA required contributions, represented a  
19          cash windfall to the utility companies. Staff's first response was to amortize the unrecognized  
20          gain balance over five years. To address the volatility issue raised by utility companies for  
21          this methodology, the Staff eventually revised its methodology to use a five-year average, a  
22          smoothing if you will, of the gains and losses balance. Recent filings by other utilities have  
23          indicated that this methodology, due to market conditions beyond the control of the  
24          companies, does not adequately address the volatility of pension expense, as calculated under  
25          FAS 87. That is why the Staff is recommending a return to minimum ERISA.

1 **INTEREST SYNCHRONIZATION**

2 Q. Do you agree with Mr. Grubb's statement on page 35, beginning on line 12 of  
3 his rebuttal testimony, that the Staff used an excessive amount of interest as a deduction in the  
4 calculation of income taxes?

5 A. No, I do not. As stated in my direct testimony, the methodology used by the  
6 Staff simply matches the level of interest expense the ratepayer is providing to the Company  
7 in rates, with the interest deduction for income taxes. It is purely a mathematical calculation  
8 that applies the weighted cost of debt to the rate base.

9 Q. What methodology did the Company use in its filed case to determine the  
10 interest deduction for the calculation of income taxes?

11 A. The Company, in its filed case, used the same interest synchronization  
12 methodology that the Staff has employed.

13 Q. Mr. Grubb states on page 36 of his rebuttal testimony that interest is  
14 synchronized in the calculation of income taxes so that the ratepayers receive the proper tax  
15 deduction based on the actual level of debt used to fund rate base. Do you agree with that  
16 statement?

17 A. No. For its income tax calculations, the Staff uses the amount of interest the  
18 ratepayer provides to the Company through customer rates based on the weighted debt cost  
19 included in the capital structure that is applied to rate base for the determination of revenue  
20 requirement. The debt component of the capital structure can, and often is, different from the  
21 actual debt recorded by the Company. The "actual level of debt" referenced by Mr. Grubb is  
22 not the appropriate amount to use as a tax deduction because revenue requirement is  
23 determined based on a rate of return that contains a debt component.

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1 Q. Has the Commission ruled on this issue before?

2 A. Yes. The Staff is not aware of any Commission decision where interest  
3 synchronization was not adopted for ratemaking purposes.

4 Q. Why has the Company raised an issue in this area if it supports interest  
5 synchronization?

6 A. In Mr. Grubb's response on page 35 of his rebuttal testimony, he states that the  
7 excessive amount of interest deduction is due to the use of a consolidated capital structure.  
8 Mr. Grubb's dislike for the use of the consolidated capital structure is apparently the source of  
9 the dispute on this issue. The Staff contends that the Company's dislike for the consolidated  
10 capital structure is the true issue and therefore the interest synchronization issue is merely an  
11 extension of the capital structure issue.

12 Q. If the interest deduction used for income taxes is not determined by  
13 multiplying the rate base by the debt component of the capital structure used in the  
14 determination of revenue requirement, has interest been synchronized?

15 A. No. The definition of interest synchronization is using the same debt  
16 component to determine the income tax deduction as is used in the debt component of the  
17 capital structure to determine the rate of return and revenue requirement. If the same debt  
18 component is not used for both calculations, interest synchronization will not be achieved.

19 Q. What is the result of using a different debt component to determine the income  
20 tax deduction than the one used in the capital structure to determine rate of return and revenue  
21 requirement?

22 A. Using different debt components will result in a revenue requirement that is  
23 based on a different return on equity than that being order by the Commission. If less interest

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1 is used as a deduction for income taxes than is paid by the ratepayer, the return on equity  
2 included in rates will be higher than the return on equity order by this Commission in this  
3 case. This occurs because the equity portion of the return must be factored up for taxes, while  
4 the debt portion of the return is tax deductible. Using a lower tax deduction results in more of  
5 the authorized rate of return being treated like equity, thus generating a higher revenue  
6 requirement.

7 Q. By advocating use of a lower interest component for income taxes than for the  
8 determination of rate of return and revenue requirement, does Mr. Grubb advocate a higher  
9 actual return on equity than the nominal level ordered by the Commission in this case?

10 A. Yes. He will not be proposing interest synchronization and will thus in effect  
11 be proposing a higher return on equity.

12 Q. What is your recommendation to the Commission for dealing with this issue?

13 A. Both the Company and Staff filed their cases based on the interest  
14 synchronization methodology. Interest synchronization means using the same debt  
15 component to determine the income tax deduction as is used to determine the rate of return  
16 and revenue requirement. Therefore, the Commission should continue to synchronize its  
17 revenue requirement and income tax expense findings consistent with its decision on capital  
18 structure. Any other course of action will not result in the return on equity prescribed by the  
19 Commission in this case.

20 Q. Does this conclude your surrebuttal testimony?

21 A. Yes, it does.

Missouri-American Water Company  
Case No. WR-2003-0500

**American Water Works FAS 87 and Minimum ERISA Comparison**

Year End	June 30		June 30		December 31		FAS 87 Funded %	Unrecognized (Gain)/Loss	% Change
	ERISA <sup>[1]</sup>	% Change	Minimum ERISA	% Change	FAS 87	% Change			
Actual									
1992			0		6,026,065		137.7%	22,599,000	
1993			0		5,364,402	-10.98%	129.9%	13,346,000	-40.94%
1994			0		9,744,625	81.65%	109.8%	50,262,000	276.61%
1995	10,006,609		9,249,305		7,493,372	-23.10%	123.0%	(562,000)	-101.12%
1996	10,365,338	3.58%	2,045,668	-77.88%	6,524,463	-12.93%	122.1%	15,904,000	-2929.89%
1997	9,893,170	-4.56%	0		5,652,084	-13.37%	129.7%	(21,012,000)	-232.12%
1998	10,108,286	2.17%	0		6,160,968	9.00%	124.6%	(10,458,000)	-50.23%
1999	10,118,740	0.10%	0		6,205,643	0.73%	119.0%	(4,661,000)	-55.43%
2000	10,749,723	6.24%	0		146,941 [2]	-97.63%	135.8%	(90,018,000)	1831.30%
2001	10,913,184	1.52%	0		10,763,520	7225.06%	127.1%	1,117,000	-101.24%
2002	11,740,902	7.58%	0		17,369,508	61.37%	120.4%	42,921,000	3742.52%
2003	12,813,381	9.13%	12,432,374		32,628,000	87.85%	81.2%	128,304,000	198.93%
Projected									
2004			15,100,000	21.46%	44,400,000	36.08%			
2005			76,600,000	407.28%	40,000,000	-9.91%			
2006			73,800,000	-3.66%	35,000,000	-12.50%			
2007			67,100,000	-9.08%	30,700,000	-12.29%			
2008			25,600,000	-61.85%	28,900,000	-5.86%			
							FAS 87/Minimum ERISA Difference		
1992 thru 2003			23,727,347		114,079,591		90,352,244		
2004 thru 2008			258,200,000		179,000,000		(79,200,000)		
1992 thru 2008			281,927,347		293,079,591		11,152,244		
1995 thru 2003	96,709,333		23,727,347		92,944,499		69,217,152		

[1] Normal cost and interest

[2] 2001 actuarial report indicates amount was revalued as \$3,421,166 as a result of First Allmerica settlement. As a result, above percent changes would be -44.87% and 214.62%

## Asset Values

### Asset Values for Calculating Pension Cost

Fair value, excluding contributions receivable:

▶ As of January 1, 2002	\$ 286,100,020
▶ Contributions	6,150,000
▶ Aquarion spin-off	(10,340,644)
▶ Northwest Indiana transfer receivable as of December 31, 2002	14,476,701
▶ Disbursements	(4,591,784)
▶ Investment return	<u>(21,247,884)</u>
▶ As of January 1, 2003	\$ 270,546,409
▶ Rate of return	(7.6)%

Market-related value:

▶ As of January 1, 2002	\$ 286,100,020
▶ As of January 1, 2003	270,546,409
▶ Rate of return	(7.6)%

### Asset Values for Calculating Employer Contributions

Market value, including contributions receivable:

▶ As of July 1, 2001	\$ 292,277,678
▶ Contributions	0
▶ Aquarion spin-off	(10,114,042)
▶ Disbursements	(4,503,012)
▶ Investment return	<u>(14,631,416)</u>
▶ As of July 1, 2002	\$ 263,029,208
▶ Rate of return	(5.1)%

Actuarial value:

▶ As of July 1, 2001	\$ 319,920,187
▶ As of July 1, 2002	315,635,049
▶ Rate of return	3.3%
▶ Rate of return (assuming mid-year cash flow for Schedule B of Form 5500)	3.3%

## Pension Cost

	Fiscal 2003	Fiscal 2002
<b>Pension Cost</b>		
Service cost	\$ 18,984,540	\$ 15,862,597
Interest cost	31,505,447	27,191,066
Expected return on assets	(23,924,127)	(25,042,045)
Amortization:		
▶ Transition obligation (asset)	(4,853)	(1,362,761)
▶ Prior service cost (credit)	318,729	306,101
▶ Net loss (gain)	<u>5,748,700</u>	<u>414,550</u>
Pension cost	\$ 32,628,436	\$ 17,369,508
Percent of covered pay	15.2%	8.8%
Per active participant	\$ 7,813	\$ 4,176

### Change in Pension Cost

Pension cost for fiscal 2002	\$ 17,370,000
Change from fiscal 2002 to fiscal 2003:	
▶ Expected based on prior valuation including full reflection of the New England Operations divestiture	1,748,000
▶ Loss (gain) from noninvestment experience	1,013,000
▶ Loss (gain) from asset experience	7,368,000
▶ Change in discount rate	4,314,000
▶ Change in expected return on assets rate	683,000
▶ Plan amendments	0
▶ Merger of Northwest Indiana Water Company	<u>132,000</u>
Pension cost for fiscal 2003	\$ 32,628,000

## Basic Results for Employer Contributions

	July 1, 2002*	July 1, 2001
<b>Normal Cost and Liabilities</b>		
Normal cost	\$ 11,755,395	\$ 10,771,470
Actuarial accrued liability [AAL]	288,890,229	265,802,556
Current liability [CL]:		
▶ Selected interest rate	294,866,061	305,125,322
▶ Highest allowable interest rate	294,866,061	305,125,322
<b>Assets</b>		
Market value	\$ 263,029,208	\$ 292,277,678
Unrecognized investment losses (gains)	<u>52,605,841</u>	<u>27,642,509</u>
Actuarial value [AV]	\$ 315,635,049	\$ 319,920,187
<b>Funded Position</b>		
Unfunded actuarial accrued liability [AAL - AV]	\$ (26,744,820)	\$ (54,117,631)
AAL funded percentage [AV ÷ AAL]	109.3%	120.4%
CL funded percentage:		
▶ Selected interest rate	107.0%	104.9%
▶ Highest allowable interest rate	107.0%	104.9%
<b>Key Economic Assumptions</b>		
Discount rate for normal cost and actuarial accrued liability	9.00%	9.00%
Current liability interest rate:	6.80%	6.09%
Salary increase rate	Age-graded scale averaging 5.00%	Age-graded scale averaging 5.00%

\* All values are as of July 1, 2002 and therefore do not reflect the merger of the Northwest Indiana Pension Plan except for normal cost which includes a pro rata portion of the merged plan.