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Incentive Plan Allocations,
Belleville Lab Allocation,
Chemicals, Fuel and Power
Expense*
Witness: *Keith D. Foster*
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MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION

UTILITY SERVICES

SURREBUTTAL TESTIMONY

OF

KEITH D. FOSTER

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

Jefferson City, Missouri
February 2012

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1 **SURREBUTTAL TESTIMONY OF**

2 **KEITH D. FOSTER**

3 **MISSOURI-AMERICAN WATER COMPANY**

4 **CASE NO. WR-2011-0337**

5 Q. Please state your name and business address.

6 A. Keith D. Foster, 200 Madison Street, Suite 440, Jefferson City, MO 65101.

7 Q. Are you the same Keith D. Foster who participated in the preparation of the
8 Staff's Cost of Service Report, filed November 17, 2011, for this case?

9 A. Yes.

10 Q. What is the purpose of your Surrebuttal Testimony?

11 A. My Surrebuttal Testimony addresses the Rebuttal Testimonies of Missouri-
12 American Water Company (MAWC or Company) witnesses Maxine Mitch, regarding the
13 allocation of American Water Works Service Company, Inc. (Service Company)
14 Annual Incentive Plan (AIP) payments; Dennis R. Williams, regarding the allocation of
15 Belleville Lab costs; Peter J. Thakadiyil, regarding chemical expense; and Regina C. Tierney,
16 regarding fuel and power expense.

17 **EXECUTIVE SUMMARY**

18 Q. Briefly summarize the topics addressed in your testimony.

19 A. I will address Staff's recommendation to disallow a percentage of Service
20 Company Annual Incentive Plan costs allocated to MAWC. I will also address the reasons
21 the Commission should use Staff's allocation of Belleville Lab costs based on test analyses
22 performed versus the Company's allocation based on customer counts. Additionally, I will

1 discuss why Staff did not use 2012 chemical costs in its Chemical Expense adjustment. And,
2 finally, I will discuss Staff's agreement to include the Company's heating expense
3 adjustment.

4 **SERVICE COMPANY ANNUAL INCENTIVE PLAN ALLOCATIONS**

5 Q. In Company witness Ms. Mitch's Rebuttal Testimony, page 17, line 29 through
6 page 18, line 2, she states that in treating Service Company Annual Incentive Plan (AIP)
7 payments in prior rate cases Staff "made the assumption that the percentage of AIP excluded
8 for MAWC employees should approximate the percentage exclusion for Service Company
9 employees." What is Staff's response to this comment?

10 A. Staff has neither, in this rate case, nor in prior rate cases, applied the same
11 percentage of AIP excluded for MAWC employees to the amount of AIP excluded for Service
12 Company employees. Staff, however, will demonstrate in the discussion that follows, that
13 Staff has been consistent in its determination of the amount of AIP payments to exclude for
14 Service Company employees from MAWC's prior rate case to this proceeding.

15 Q. What is Staff's position on the inclusion in MAWC rates of allocated payments
16 to Service Company employees through MAWC's parent company, American Water
17 Works Company Inc.'s, (AWW) Annual Incentive Plan (AIP) based upon achievement of
18 financial goals?

19 A. Staff has not included any AIP compensation paid out to any Service Company
20 employees that was based upon AWW meeting certain financial goals, as the incentives'
21 purpose is to improve the Company's bottom line for shareholders, versus a focus on
22 customer benefits. This includes goals based upon the parent company's financial goals or

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Keith D. Foster

1 the divisional/regional/state financial goals. The Commission has consistently excluded
2 incentive plan payouts to employees for meeting financial goals in prior rate proceedings.
3 For example, in the Report and Order for Case No. GR-2004-0209, et. al., Missouri Gas
4 Energy (MGE), the Commission stated:

5 The Commission agrees with Staff and Public Counsel that the
6 financial incentive portions of the incentive compensation plan
7 should not be recovered in rates. Those financial incentives
8 seek to reward the company's employees for making their best
9 efforts to improve the company's bottom line. Improvements to
10 the company's bottom line chiefly benefit the company's
11 shareholders, not its ratepayers. Indeed, some actions that
12 might benefit a company's bottom line, such as a large rate
13 increase, or the elimination of customer service personnel,
14 might have an adverse effect on ratepayers.

15 If the company wants to have an incentive compensation plan
16 that rewards its employees for achieving financial goals that
17 chiefly benefit shareholders, it is welcome to do so. However,
18 the shareholders that benefit from the plan should pay the costs
19 of the plan. The portion of the incentive compensation plan
20 relating to the company's financial goals will be excluded from
21 the company's cost of service revenue requirement.

22 Q. Is the above approach outlined in the Commission's Report and Order in Case
23 No. GR-2004-0209 consistent with how Staff determined the amounts to disallow for Service
24 Company AIP costs allocated to MAWC in this rate case?

25 A. Yes.

26 Q. Is this approach consistent with how Staff determined the amounts to
27 disallow for Service Company AIP costs allocated to MAWC in the previous rate case,
28 Case No. WR-2010-0131?

29 A. Yes.

30 Q. Was there any difference between the Company's AIP for this case and the
31 prior rate case?

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1 A. Yes. In the prior rate case, Case No. WR-2010-0131, Staff used the 2008
2 American Water Annual Incentive Plan for which the Corporate Financial component of the
3 AIP was 30% for all AIP eligible employees. For the remaining 70% of the AIP, the other
4 AIP components, Individual, Divisional/Regional/State Financial, and Operational, varied in
5 percentage based on whether an employee worked in a Business Center,
6 Division/Region/State office, Shared Services Center, or Customer Service Center. In the
7 current rate case, Staff used the 2010 American Water Annual Incentive Plan for which the
8 Financial Performance component was 70% and the Non-financial Performance component
9 was 30% for all AIP eligible employees irrespective of where the employees worked. The
10 Non-financial Performance component included the subcomponents of Safety, Customer
11 Satisfaction Survey, Environmental Compliance, and Customer Service Quality each
12 representing 7.5% of the 2010 AIP.

13 Q. How did Staff determine the amounts to disallow for Service Company AIP
14 costs allocated to MAWC in the previous rate case, Case No. WR-2010-0131?

15 A. For each Business Center, Division/Region/State office, Shared Services
16 Center, or Customer Service Center AIP costs allocated to MAWC, Staff determined the
17 dollar amount of the AIP attributed to each AIP component (Corporate Financial,
18 Divisional/Regional/State Financial, Individual, and Operational) based on the percentage
19 assigned to the component in the 2008 AIP. Staff then disallowed all incentives related to
20 financial goals, individual goals, and operational goals related to the customer satisfaction
21 survey and service quality for a total of \$830,451 or 81.9% of the \$1,013,773 Service
22 Company incentives allocated to MAWC.

23 Q. How does this compare to what Staff disallowed in the current rate case?

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1 A. Staff disallowed the Financial Performance component of the AIP, 70% of the
2 \$1,654,860 total Service Company AIP expenses allocated to MAWC or \$1,161,958.

3 Q. Was there any inconsistency in what Staff disallowed in this case compared to
4 the prior rate case?

5 A. Yes. Staff overlooked potential disallowances of 7.5% for Customer
6 Satisfaction Survey and 7.5% for Customer Service Quality, for a total of \$248,229 in this
7 case. If these amounts would have been proposed to be disallowed in this proceeding that
8 would have made the total disallowance 85%, more in line with the 81.9% disallowed in the
9 prior rate case. Staff, however, is not seeking to modify the Service Company AIP
10 adjustment in Staff's direct case by incorporating any additional allowances at this time.

11 Q. What is Staff's conclusion regarding Ms. Mitch's assertions in her Rebuttal
12 Testimony regarding alleged inconsistencies between Staff's treatment of allocated Service
13 Company AIP costs and MAWC AIP costs?

14 A. In the prior rate case, Case No. WR-2010-0131, as well as the current case, and
15 as Ms. Mitch acknowledged in her Rebuttal Testimony, page 17, lines 30-32, Staff did not
16 review the individual AIP objectives for each Service Company employee. Instead, Staff
17 used the percentages provided in the AWW Annual Incentive Plans as addressed in this
18 testimony to determine the Service Company AIP disallowance. In Case No. WR-2010-0131
19 and this current case, Staff did have access to the individual AIP results for MAWC
20 employees and made its proposed adjustments at an employee level. Please see Staff witness
21 Casey Westhues' Surrebuttal Testimony for clarification. Contrary to Ms. Mitch's allegation,
22 Staff did not aggregate these adjustments and apply the percentage disallowed for MAWC
23 AIP costs to the Service Company AIP allocated costs to calculate Staff's recommended

1 Service Company AIP disallowance. Other than overlooking the potential disallowance of
2 Service Company AIP amounts for Customer Satisfaction Survey and Customer Service
3 Quality in this case, Staff has been consistent in its treatment of Service Company AIP in both
4 rate cases.

5 **BELLEVILLE LAB ALLOCATION**

6 Q. Why did Staff propose its allocation methodology of distributing indirect
7 Belleville Lab costs by using a five-year average of actual test analyses performed?

8 A. Staff's test analyses allocation methodology best represents the true nature of
9 work performed at Belleville Lab for MAWC and for all of the other AWW operating
10 companies. Staff used an average of the number of test analyses Belleville Lab performed for
11 MAWC's water samples compared to the total number of water samples for all AWW
12 operating companies over the last five calendar years ending December 31, 2010 to allocate
13 this cost to MAWC. As will be explained later in this Surrebuttal Testimony, the Company's
14 proposed method of allocating Belleville Lab costs using operating company customer counts
15 results in the situation where Missouri ratepayers are forced to subsidize the testing work
16 being performed for customers of operating companies located in other states. Staff's
17 proposed methodology of allocating indirect Belleville Lab costs using an average of the
18 actual test analyses performed for all of the operating companies taking service from
19 Belleville Lab results is a more accurate assignment of cost to each operating company. This
20 method appropriately reflects the actual work Belleville Lab performed per operating
21 company. Using a measure of the actual work performed at Belleville Lab results in a more

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1 accurate matching of cost-causers to costs than simply using customer counts, which is an
2 indirect measurement of relative cost responsibility, at best.

3 Q. In making its adjustment, is Staff suggesting that MAWC reduce the amount of
4 testing and sampling that is now performed at Belleville Lab?

5 A. No. Staff is in no way suggesting that MAWC, or any other operating
6 company, reduce the level of testing and sampling, especially when it is required by the
7 Environmental Protection Agency's federal water quality standards that are duly enforced by
8 the Missouri Department of Natural Resources. Staff encourages the Company to maintain
9 strict adherence to all of its water quality testing requirements. Staff's recommendation only
10 addresses the allocation of cost among the entities receiving service from Belleville Lab, not
11 the performance or quantity of testing for any specific entity.

12 Q. How does Staff respond to Mr. Williams' assertion in his Rebuttal Testimony,
13 page 9, line 32 through page 10, line 2, that "An operating company's total samples can vary
14 from one year to the next because of source water conditions, contamination events and
15 regulations. Thus, an operating company's portion of Belleville Lab costs could vary widely
16 from one year to the next."?

17 A. Staff disagrees with Mr. Williams' implication that the potential variability in
18 allocation percentages from year to year makes the Staff's test analyses method incorrect.
19 Staff asserts these types of conditions underscore why Staff's methodology is more
20 appropriate. The Company's customer count methodology will never take into account
21 conditions such as source water conditions, state-specific regulations or contamination events
22 because customer counts have nothing to do with these types of events. Similarly, they do not
23 address differences in the source of supply and the numbers of connections to the systems that

1 exist between operating companies. However, Staff’s proposed methodology of using the
2 number of testing analyses performed is directly correlated to each of these specific
3 conditions.

4 Q. Does Belleville Lab currently track test analyses to be performed for each
5 operating company?

6 A. Yes. Belleville Lab requires each operating company to submit a list of the
7 number and frequency of water analyses that each operating company expects the lab to
8 perform during the upcoming calendar year. These lists are received by the lab in the
9 mid-November through early December time period and are used to send out sample bottles
10 and prepare for the work to be performed by the lab in the upcoming year. The lab maintains
11 historic data of actual test analyses that it performs. The existence of this test analysis history
12 demonstrates that this basis for the allocation of the Belleville Lab costs is readily available
13 and more indicative of the work actually performed and the costs thereby incurred than a basis
14 that relies on customer counts.

15 Q. Please respond to Mr. Williams’ assertion that there are “significant swings in
16 the level of test analyses performed by the various states that highlight the need for
17 consistency” Rebuttal Testimony, page 10, line 28, through page 11, line 6, and that the use of
18 “customer counts are much less variable” Rebuttal Testimony, page 10, lines 4-6.

19 A. Staff recognizes its method could result in more variability on a year-to-year
20 basis and used a five-year average of test analyses to alleviate this concern in its
21 recommended test analyses allocation percentage. However, the consequences of
22 continuing to use the Company’s method of relying on customer counts results in a significant
23 and continuous overcharge for MAWC’s customers. This continued significant subsidy of

1 other operating companies by MAWC erodes the savings the Company's customers are
2 supposed to achieve as a result of centralizing the laboratory function. The following chart
3 reflects the percentage of test analyses allocations for California-American Water Company
4 (California-American) for the five years listed, as well as the customer allocation percentages
5 for the same time period:

12 Months	Test Analyses	Customer Count
<u>Ending</u>	<u>Allocation Percentage</u>	<u>Allocation</u>
		<u>Percentage</u>
12/31/06	17.9%	5.4%
12/31/07	11.5%	5.2%
12/31/08	14.5%	5.2%
12/31/09	18.6%	5.2%
12/31/10	19.9%	5.2%
5-Year Average	16.7%	5.2%

15 As can be seen from the chart above, California-American has consistently required
16 Belleville Lab to perform more test analyses and use more laboratory resources than would be
17 indicated by an allocation method that relies on customer counts. This example demonstrates
18 that using the Company's proposed customer allocation method results in
19 California-American's ratepayers consistently paying less for Belleville Lab costs than is
20 appropriate for the work being performed for California-American. This means all other
21 AWW operating companies, including MAWC, are put in the position of subsidizing
22 California-American's testing requirements. Using MAWC's approach, California-American
23 customers will continue to receive a discount for water testing at the expense of ratepayers
24 from other AWW operating companies.

25 Q. Do you have another example that would demonstrate the use of customers as
26 an allocation basis is improper?

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1 A. Yes. In January 2002, MAWC purchased the City of Florissant Water System
2 (Florissant). Prior to this, Florissant operated as a wholesale customer of MAWC. Upon
3 completion of the sale, Florissant customers became retail ratepayers of MAWC. The sale
4 resulted in a change in MAWC's customer numbers from one wholesale customer to
5 approximately 14,500 retail customers. As a result of this sale, MAWC was allocated more
6 Belleville Lab costs based on the Company's method of using customer counts as the basis for
7 allocation. However, the actual number of test analyses required for MAWC did not change.
8 This is a good example of how MAWC's proposed allocation method is not based upon actual
9 cost causation principles.

10 Q. What has Missouri's historical test analyses experience been in comparison to
11 customer counts?

12 A. The following chart shows a historical comparison of the percentage of test
13 analyses performed for MAWC versus the Company's customer count allocation for the five
14 years listed.

<u>Period</u>	<u>Staff Test Analyses Allocation</u>	<u>Company Customer Count Allocation</u>
12 months Ended 12/31/06	6.04%	14.10%
12 months Ended 12/31/07	6.02%	14.08%
12 months Ended 12/31/08	5.51%	13.76%
12 months Ended 12/31/09	4.50%	13.73%
12 months Ended 12/31/10	4.79%	13.55%
5-Year Average	5.29%	13.84%

24 Staff proposes to use the five-year test analyses average to smooth out any variability that
25 may exist from year to year for purposes of setting rates. On the other hand, the Company's
26 customer count methodology consistently allocates around 14% of indirect Belleville Lab

1 costs to Missouri during the test year. By using the customer count methodology, the
2 Company is forcing MAWC ratepayers to pay for approximately 14% of indirect
3 Belleville Lab costs, while on average only 5.29% of the testing work at Belleville Lab is
4 actually performed for MAWC. Staff's chart also reveals MAWC has been consistently
5 overcharged for Belleville Lab costs based on the Company's customer count methodology in
6 comparison to actual test analyses performed.

7 Again, Staff asserts that the fact that the number of test analyses actually do vary from
8 year to year strongly supports an allocation method that appropriately allocates these costs
9 based on what is actually taking place, namely the number of test analyses performed for
10 MAWC customers. Mr. Williams has suggested in his Rebuttal Testimony, page 10, lines 4-6,
11 allocating costs based on customer counts is "more stable" and will provide much less
12 variability in the allocation of Belleville Lab indirect costs. However, Mr. Williams' "more
13 stable" approach does not justify continuing to significantly overcharge MAWC ratepayers
14 for these costs. An entity that requires the performance of less work should be allocated less
15 cost. Unfortunately, customer counts have nothing to do with testing expenses and therefore
16 result in an inappropriate amount of indirect Belleville Lab costs being assigned to MAWC.
17 Furthermore, the effect of using the Company's methodology results in MAWC's ratepayers
18 paying for testing and sampling costs that relate to ratepayers who are located in states other
19 than Missouri. As Staff has pointed out, MAWC's customer counts do not correlate to the
20 work that is actually being performed for MAWC at Belleville Lab. Staff believes a method
21 using the number of test analyses performed instead of the number of customers is also very
22 straight forward and understandable.

1 Q. How does Staff respond to Mr. Williams’ point in his Rebuttal Testimony,
2 page 10, lines 9-12, “It is a system-wide policy to allocate Service Company expenses that
3 cannot be direct charged to operating companies on the basis of the number of customers.
4 Doing so makes practical sense, as it is easy to manage and administer and it provides for
5 system-wide consistency over multiple jurisdictions.”?

6 A. Staff contends that by adopting the approach of allocating indirect
7 Belleville Lab charges based on the number of actual test analyses, AWW can improve upon
8 its current allocation process by making it more reflective of the work that is performed at the
9 lab. Using the method proposed by Mr. Williams results in a system-wide inconsistency
10 between the work being performed at the Belleville Lab and the amounts being charged to
11 individual operating companies.

12 Q. How does Staff respond to Mr. Williams’ contention in his Rebuttal
13 Testimony, page 10, lines 21-26, that consistency from state to state is important?

14 A. Mr. Williams claims that by using number of tests as its allocation
15 methodology, AWW will be unable to recover all of its Belleville Lab costs. However,
16 Mr. Williams fails to point out the same problem can exist with the current customer
17 allocation methodology. Customer growth and the purchase or sale of water systems at other
18 operating companies in between various rate cases can create the same situation Mr. Williams
19 uses to rebut Staff’s proposal. Furthermore, Mr. Williams’ claim ignores the fact that
20 customer counts have no correlation to testing and sampling expense. Mr. Williams’ position
21 would force MAWC customers to pay for costs that were not incurred to serve them, but are
22 incurred to serve customers in other states. Therefore, using customer counts consistently
23 results in an inaccurate cost assignment and a subsidy between the various operating

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1 companies in each state. In contrast, the Staff's proposed allocation methodology tracks
2 actual test analyses, which represents the majority of the resources and work that is performed
3 at Belleville Lab. If a test analyses-based allocation was to be used consistently by AWW for
4 all of its water divisions, this approach would allow AWW an opportunity for full cost
5 recovery based upon a fair and cost-driven allocation basis. Staff asserts MAWC's current
6 allocation methodology is creating a situation where MAWC is being forced to pay more than
7 twice as much for testing costs, as compared to its actual cost using the Staff's test analyses
8 allocation process. In addition, this result would suggest the Company's allocation
9 methodology creates inter-company subsidies and is inappropriate. Staff recommends the
10 Commission adopt the test analyses allocation methodology to determine the indirect
11 Belleville Lab costs included in MAWC's cost of service.

12 **CHEMICALS**

13 Q. In Mr. Thakadiyil's Rebuttal Testimony, page 3, lines 26-29, he suggests that,
14 in computing its Chemical Expense adjustment, Staff should have used the chemical prices
15 from the purchase orders of chemicals provided on Staff's on-site visit of MAWC on
16 September 28, 2011. Do you agree with this suggestion?

17 A. No I do not.

18 Q. Please explain.

19 A. The new chemical prices provided to Staff became effective on January 1, 2012,
20 far outside of the test year period ending December 31, 2010, to be considered in this rate
21 case. Staff included the prices provided by the Company that were in effect for 2011.

1 Q. Is there any other reason why the new chemical rates should not be included in
2 Staff's Chemical Expense adjustment?

3 A. Yes. In the Commission's Order Regarding True-Up Period filed on
4 August 24, 2011, which established the December 31, 2011 true-up date, item 2 of the
5 Commission order states, in part, "True-up shall be limited to the following items:"
6 "Chemical Expense (will reflect true-up volumes of water sold, *pricing will remain the same*
7 [emphasis added]." Therefore, the Company, which was involved in creating the list of true-
8 up items, was aware that prices affecting chemical expense would not be adjusted.

9 **FUEL AND POWER EXPENSE**

10 Q. Page 10, lines 4 and 5 of Ms. Tierney's Rebuttal Testimony states "Staff has
11 erroneously excluded the reclassification of heating expenses posted to fuel and power
12 expense account during the test year." What is your response to this statement?

13 A. Staff overlooked this adjustment and will revise our figures to include the
14 Company's \$31,533 adjustment for reclassification of heating expense.

15 Q. Does this conclude your Surrebuttal Testimony?

16 A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

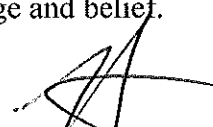
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water)
Company's Request for Authority to) Case No. WR-2011-0337
Implement A General Rate Increase for Water)
and Sewer Service Provided in Missouri)
Service Areas)

AFFIDAVIT OF KEITH D. FOSTER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

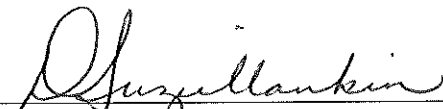
Keith D. Foster, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 14 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that 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.



Keith D. Foster

Subscribed and sworn to before me this 2nd day of February, 2012.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071



Notary Public