

**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)

In the Matter of Missouri-American)
Water Company's Request for)
Authority to Implement General Rate) Case No. SR-2020-0345
Increase for Water and Sewer Service)
Provided in Missouri Service Areas)

**RESPONSE TO MISSOURI AMERICAN WATER COMPANY
MOTION TO ESTABLISH FUTURE TEST YEAR**

COME NOW the Midwest Energy Consumers Group (“MECG”); the Staff of the Missouri Public Service Commission (“Staff”); the Office of the Public Counsel (“OPC”); the Consumers Council of Missouri (“CCM”); the Missouri Industrial Energy Consumers (“MIEC”); the City of St. Joseph; the City of Riverside; and the Municipal League of Metro St. Louis (collectively referred to as the “Signatories”), and for their Response to Missouri American Water Company’s (“MAWC”) Motion to Establish Future Test Year (“Motion”) respectfully state as follows:

1. On June 30, 2020, MAWC filed tariffs to increase water revenues by 21.1% over and above those revenues currently produced by base rates and the ISRS surcharge. Simultaneously MAWC filed its Motion To Establish Future Test Year (“Motion”). In its Motion, MAWC claims that the Court of Appeals has endorsed the use of future test years. Furthermore, MAWC mischaracterizes the Commission’s finding in the last MAWC case

claiming that the Commission “specifically rejected the notion that it was not authorized to [implement a future test year].”

2. In its Motion, MAWC provides two reasons for the drastic movement to a future test year. First, MAWC asserts that revenues and usage are declining.¹ Second, MAWC asserts that rate base will increase beyond that reflected in the test year.² Ultimately, MAWC states that the combination of these factors undermines the “fundamental rate making matching principle.”³ Through this response, the Signatories address the legal issues associated with the use of a future test year. Furthermore, the Signatories address the detriments underlying the use of a future test year methodology. Based upon legal and policy problems inherent in MAWC’s future test year proposal, the Signatories ask that the Commission expressly reject MAWC’s future test year proposal in favor of a historical test year. In the alternative, the Signatories suggest that the Commission, as it did in Case No. WR-2017-0285, order the use of a historical test year period while considering future test year adjustments beyond those associated with the historical test year in the context of the evidentiary hearing.

**I. MISSOURI STATUTES CONTAIN A PREFERENCE
FOR HISTORICAL TEST YEARS**

3. As support for its future test year request, MAWC simply asserts that the Western District Court of Appeals has “affirmed the Commission’s authority to use forecasts to address the effects of inflation on selling [sic] rates based on historical information.”⁴ Noticeably, however, despite the Court of Appeals demand for the showing of express statutory authority,⁵

¹ Motion at page 5.

² *Id.*

³ *Id.* at page 6.

⁴ See, Motion to Establish Future Test Year, filed June 30, 2017, at page 2 (citing to *State ex rel. Kansas City Power & Light Company v. Missouri Public Service Commission*, 509 S.W.3d 757, 771-772 (Mo.App. W.D. 2016).

⁵ “Since it is purely a creature of statute, the Public Service Commission's powers are limited to those conferred by the above statutes, either expressly, or by clear implication as necessary to carry out the powers specifically granted.” *State ex rel. Utility Consumers Council of Missouri v. Public Service Commission*, 585 S.W.2d 41, 49

MAWC fails to provide any legal analysis. MAWC simply concludes, based upon the dicta in a recent KCPL case, that the Commission has the authority to utilize a future test year.

4. Despite its assertions, however, MAWC’s conclusion that Missouri statutes authorize the Commission to use a future test year is not as clear as MAWC maintains. ***First***, the KCPL decision referenced by MAWC is not on point. The Court of Appeals decision does not address the authority for the use of future test years. Moreover, the decision does not address the use of forecasts with regards to plant and usage. As such, any discussion in that opinion as to the statutory authority for the use of future test years is simply dicta.⁶

5. ***Second***, regarding MAWC’s assertion that a future test year is needed to address future growth in rate base, Missouri statutes appear to require the use of a historical test year.⁷ Section 393.270.4 provides that in setting rates, the Commission shall consider all relevant factors including “a reasonable average return upon capital ***actually expended***.”⁸ In its future test year approach, MAWC asks that it be permitted to earn a return on capital applied to a 13-month average of forecasted plant in service through May 31, 2022. As such, MAWC does not seek to earn a return on capital “actually expended” as provided by Section 393.270.4. Instead, MAWC seeks to earn a return on capital that ***may*** be expended, at some indefinite point in the future.

(Mo. banc 1979) (citing to *State ex rel. City of West Plains v. Public Service Commission*, 310 S.W.2d 925, 928 (Mo. banc 1958)).

⁶ MAWC’s assertion that the Commission has clear authority to adopt a future test year is further obfuscated by the fact that legislation concerning future test years has recently been considered and rejected by the General Assembly. For instance, in 2017, the General Assembly considered Senate Bill 190 which would have provided the express statutory authority for future / forecasted test years. Ultimately, that legislation failed to even advance to the Senate floor for consideration. Later in 2017, the Governor called a special session to address certain Commission-related authority. One portion of the Governor’s Proclamation calling for that special session included changes to the Commission’s ratemaking authority. In response, House Bill 1 was offered. As introduced, that legislation again included authorization for the Commission to utilize “partially forecasted test years.” The next day, the future test year provision was removed and the bill was allowed to proceed without such authority.

⁷ It should be pointed out that, at least with regards to electric utilities, the use of future test years and the inclusion of future plant growth have been expressly declared unlawful. See, Section 393.135.

⁸ Emphasis added.

6. **Third**, as it pertains to MAWC’s assertion that a future test year is necessary to address alleged usage reductions, the General Assembly has already specifically provided a mechanism by which declining usage may be addressed; i.e., a Revenue Stabilization Mechanism (“RSM”).⁹ Under such a mechanism, if approved by the Commission, MAWC would be assured that it collects class revenues equal to those established in this rate proceeding.¹⁰ Thus, if an RSM were approved, declining usage would no longer justify the Commission taking the more drastic step of implementing a future test year.¹¹

II. FUTURE TEST YEARS ARE NOT SOUND RATEMAKING POLICY

7. There are also ratemaking policy concerns that the Commission should evaluate when evaluating MAWC’s requested future test year. These concerns include those considered by this Commission when it refused to adopt MAWC’s future test year proposal in Case No. WR-2017-0285.

8. **Immediate Over-Earnings**: In its testimony, MAWC seeks to earn a return on projected investment through May 31, 2022.¹² This creates a situation in which MAWC will immediately over-earn if new rates are based on future rate base investment. Specifically, on May 27, 2021, when rates go into effect, MAWC will be collecting a return on investment that is not projected to be in-service for as much as 12 months in the future. As such, for several months, MAWC will collect rates on investment that it has not yet made, and may not ever make. This collection of rates on “phantom plant” creates a situation of immediate over-earnings.

⁹ See, Section 386.266.4.

¹⁰ Given the early stages of this proceeding, parties have not had an opportunity to conduct the discovery necessary to determine whether declining usage exists or the magnitude of any usage changes.

¹¹ In addition to the future test year, MAWC has also sought the implementation of a Revenue Stabilization Mechanism. See, Direct Testimony of John Watkins. Within this filing, the Signatories are not taking a position on MAWC’s RSM proposal at this time, but may do so in later stages of this proceeding.

¹² See, LaGrand Direct, page 23.

9. This inequitable outcome is compounded by the fact that MAWC has repeatedly made clear that its capital expenditures are never certain. For example, in a prior MAWC rate case, Case No. WR-2015-0301, the Company was ordered to submit a 5-year capital investment plan. The Highly Confidential plan¹³ submitted in EFIS included language on the first page stating “Projects/budgets are subject to change based on changes in circumstances and/or the Company’s periodic review of projects and priorities.”¹⁴

In another case, the Company reiterated the uncertainty surrounding its capital investment by threatening to “re-examine the prioritization of projects” and deploy capital elsewhere if its request is not granted.¹⁵ Clearly, MAWC’s projections of capital expenditures are far from certain. To set rates based on the Company’s assertions would not result in rates “based on capital actually expended” but, instead, would allow the Company to earn a return on speculative “phantom plant”.

10. Informational Asymmetry: In July 2013, the National Regulatory Research Institute (“NRRI”)¹⁶ published a briefing paper entitled Future Test Years: Challenges Posed for State Utility Commissions.¹⁷ In that paper, NRRI found that the use of future test years is inherently problematic for several different reasons. For instance, NRRI pointed out that the use

¹³ MAWC designated the spreadsheet provided Highly Confidential because it “includes market-specific information relating to goods or services purchased or acquired for use in providing services to customers, as well as information relating to future contract negotiations.” No Highly Confidential information is quoted in this pleading.

¹⁴ Case No. WR-2015-0301, EFIS Document No. 467.

¹⁵ See MAWC response to Staff DR0010 in Case No. WU-2017-0296.

¹⁶ As reflected on its webpage, NRRI serves as a research arm to NARUC and its members, the utility regulatory commissions of the fifty states and the District of Columbia in the United States. NRRI’s primary mission is to produce and disseminate relevant and applicable research related to the utility sector - natural gas, electricity, water and telecommunications

¹⁷ The NRRI briefing paper is attached as Exhibit 1. (“NRRI Report”)

of a future / forecasted test year places the utility at an informational advantage to other rate case parties.¹⁸

The core problem with FTYs [future test years] for commissions is information asymmetry. Commissions are at a distinct disadvantage relative to the utility in interpreting and evaluating the utility's performance. Commissions generally lack the knowledge, for example, to detect when the utility is efficient or inefficient, and the opportunities for utilities to minimize costs. As part of their duties, they need to evaluate whether the utility's projected costs reflect competent utility management, or imprudent management.¹⁹

11. Abandonment of Used and Useful Standard: Next, the NRRI paper noted that, unlike the historical test year, the future test year precludes application of the "used and useful" standard for determination of rate base. The "used and useful" standard has been the bedrock of Missouri ratemaking for decades.²⁰ The future test year proposed by MAWC abandons this basic principle and customers end up paying for facilities that may never become operational.

12. Abandonment of Known and Measureable Standard: In addition to the abandonment of the "used and useful" standard, the rejection of a historical test year in favor of the flawed future test year also necessarily results in the elimination of the "known and measureable" standard. This standard is based on fundamental accounting principles that require that rates be based on known and measurable costs. Most assets, liabilities, gains and losses and revenues and expenses of U.S. business entities are recorded at historical cost. The Financial Accounting Standards Board ("FASB") and the Accounting profession has determined that

¹⁸ The notion of "information asymmetry" is not simply theoretical. In a recent rate case, Case No. WR-2015-0301, MAWC failed to disclose problems with usage data resulting from faulty meters. Only after testimony was filed was this problem disclosed. Then, the MAWC individual responsible for disclosing this information was suddenly discharged by MAWC. Clearly then, the notion of "information asymmetry" is very real as it applies to MAWC.

¹⁹ NRRI Report at page 19.

²⁰ The "used and useful" standard has been viewed favorably by Missouri Courts. "The property upon which a rate of return can be earned must be utilized to provide service to its customers. That is, it must be used and useful. This used and useful concept provides a well-defined standard for determining what properties of a utility can be included in rate base." (See, *State ex rel. Union Electric v. Public Service Commission*, 765 S.W.2d 618 (Mo.App. 1988)). Through its request to utilize a future test year, MAWC asks that the Commission abandon this well-defined "used and useful" standard.

historical-cost accounting is more reliable than other forms of accounting, such as fair value accounting, or what MAWC proposes as “estimated future costs.” The FASB has retained historical cost accounting as the basis of U.S. generally accepted accounting principles (“GAAP”). GAAP are the Accounting standards that all U.S. companies, including MAWC, must comply with in the preparation of financial records. As a result, significantly all accounting for business operations, both regulated and nonregulated, are based on historical costs. Like the “used and useful” standard, the “known and measureable” standard has been viewed favorably by Missouri Courts.²¹

13. Impact On The Matching Principle: In its Motion, MAWC contends that a future test year may be necessary to prevent the undermining of the matching principle. From a policy perspective, however, the Signatories disagree with the Company’s contention. The matching principle is an accounting principle that requires measurement of a utility’s revenues, expenses, rate base and rate of return at a consistent point in time. MAWC’s request for a future test year would utilize a *projection* of normalized costs (created by multiplying normalized test year costs by a factor based upon an *estimated* future inflation rate) and a 13-month average of *planned*—not certain—rate base expenditures. Therefore, adoption of a future test year would result in the abandonment of the “known and measureable” standard. While the use of a future test year is theoretically consistent with the matching principle, successful application of the principle is entirely dependent upon the utility’s ability to accurately forecast its revenues, expenses, and capital costs without significant bias, and with attention to the inter-relationship between these forecasts. Under an historic test year approach, the matching principle operates through the use

²¹ See, *KCPL’s Request v. Public Service Commission*, 509 S.W.3d 757 (Mo.App. 2016). See also, *State ex rel. Missouri Public Service Co. v. Fraas*, 627 S.W.2d 882, 888 (Mo.App. 1981).

of *verifiable known and measurable* financial data. Thus, it seems more likely that the use of a future test year may *cause* the undermining of the matching principle rather than prevent it.

14. More Time Intensive: A general rate case utilizing a historic test year already involves an intense review process by all parties involved, and under normal circumstances, can be an extremely time-intensive process. However, as the NRRI paper points out, given the complexities of future test year rate cases, these those cases must necessarily involve even *more* time.²²

Utilities have a distinct “resource” advantage over other parties that they can better exploit under an FTY rate filing. Given the limited time for rate cases and the complexity of evaluating forecasts, parties may have insufficient time to thoroughly assess a utility’s forecasts.²³

15. Operational Inefficiency: Finally, future test years reduce or eliminate a utility’s incentive to minimize costs and operate efficiently. The NRRI paper notes that “FTYs can have a negative effect on cost efficiency.” For instance, NRRI notes that a utility would have a “weaker incentive” to control a cost where that cost has already been imputed into rates through a future test year. As such, NRRI concludes that “an FTY would seem to score poorly in achieving cost efficiency.”²⁴

16. Based upon the multitude of problems detailed by NRRI, the paper concludes that “an environment of rising average cost does not constitute a sufficient condition for the use of an FTY.”²⁵ Given the numerous flaws inherent in the use of future test years, the Signatories agree that future test year ratemaking represents poor regulatory policy.

²² The Signatories would note, in addition to the clear policy concerns outlined in this pleading, this proceeding will not take place under “normal circumstances.” The COVID-19 pandemic currently gripping this country has forced parties before this Commission to utilize alternative working arrangements not necessarily conducive to the litigation of a major rate case. Drastic changes to the rate making process would serve to further complicate this proceeding.

²³ *Id.* at page 23.

²⁴ *Id.* at page 26.

²⁵ *Id.* at page iv.

17. For this Commission to switch from its foundational principle of rate-of-return regulation, which is the use of historical cost data, it should have an overwhelming reason to do so. MAWC has not provided anything approaching what the Commission should require prior to moving from the foundational principle of historical cost accounting and ratemaking.

IV. TEST YEAR RECOMMENDATION

18. Given the multitude of legal and policy problems associated with future test years, the Signatories recommend that the Commission reject MAWC's future test year proposal. Instead, the Signatories recommend that the Commission adopt a historical test year in this proceeding. The Signatories will provide their specific test year, update period and, if applicable, true-up period recommendations to the Commission following the prehearing conference scheduled for August 3, 2020.

19. As an alternative, the Commission may also follow the path that it took in MAWC's last rate case. Specifically, the Commission refused to reject the future test year, as recommended by numerous parties and, instead, ordered a historical test year while still allowing parties to present adjustments consistent with a future test year, as follows:

THE COMMISSION ORDERS THAT:

1. The parties shall use a test year of the 12 months ending December 2016, with an update period of the six months ending June 2017, and a true-up period of the six months ending December 2017.
2. All parties shall use actual historic financial data for Missouri-American Water Company to present their positions based upon the periods set in Ordered Paragraph 1.

3. Parties may present further adjustments for the Commission’s consideration based upon projected or forecasted data past December 2017. No party shall be precluded from opposing such adjustments.²⁶

20. In the event that the Commission proceeds in this alternative manner, as it did in Case No. WR-2017-0285, it is critical that it orders all parties to present historical revenue requirement calculations as of consistent points in time. That is, in addition to its future test year proposal, MAWC must be required to submit a historical test year revenue requirement, updated with historical results in accordance with the requirements of the Commission’s test year orders in this case, so that the parties can accurately quantify the value of the issues once they have been decided by the Commission.

WHEREFORE, the Signatories respectfully request that the Commission reject MAWC’s future test year proposal and, instead, adopt a test year consistent with this pleading.

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²⁶ See, *Order Regarding Test Year*, Case No. WR-2017-0285, issued August 9, 2017 (pages 2-3).

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that the foregoing pleading has been served by electronic means on all parties of record as reflected in the records maintained by the Secretary of the Commission through the EFIS system.

/s/ David Woodsmall
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Dated: July 27, 2020