

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

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| In the Matter of Missouri-American Water     | ) |                       |
| Company's Request for Authority to Implement | ) | Case No. WR-2017-0285 |
| General Rate Increase for Water and Sewer    | ) | Case No. SR-2017-0286 |
| Service Provided in Missouri Service Areas.  | ) |                       |

**MAWC REPLY TO RESPONSES CONCERNING  
MOTION TO ESTABLISH FUTURE TEST YEAR**

COMES NOW Missouri-American Water Company (MAWC, Missouri-American, or Company), and, states as follows to the Missouri Public Service Commission (Commission):

1. On June 30, 2017, MAWC filed its *Motion to Establish Future Test Year*. The Staff of the Commission filed its *Response to Motion to Establish Future Test Year* (Staff Response) on July 27, 2017. The Signatories<sup>1</sup> also filed their *Response to Motion to Establish Future Test Year and Test Year Recommendation* (Signatories Response) on July 27, 2017. The Commission’s Order Setting Deadline for Filing, issued on July 28, 2017, directed that MAWC file a reply to the responses by August 2, 2017.

**SUMMARY**

2. MAWC agrees with Staff’s assertion that the Commission’s decision in regard to this issue “is a fact question within the discretion of the Commission.” Given the importance of this issue, and MAWC’s understanding that the Commission will want to consider all the facts available, and to be made available, in this case before making a decision in regard to the future test year, MAWC supports Staff’s recommended approach as further discussed below.

3. MAWC also responds below to the Signatories Response and, in doing so,

identifies its disagreement with the Signatories' position as to the Commission's authority, provides the "rest of the story" in regard to the National Regulatory Research Institute (NRRI) Report provided in the Signatories Response, and addresses the other arguments raised by the Signatories.

### **COMMISSION AUTHORITY**

4. Perhaps the most significant point made in the responses is found in the Staff Response where it states that "[the] determination of what test year to use, and how to adjust it, is a fact question within the discretion of the Commission. *State ex rel. GTE North, Inc. v. Missouri Public Service Com'n*, 835 S.W.2d 356, 370. (Mo. App., W.D. 1992). Moreover, for all of the matters addressed by the responses, neither response identifies any express authority stating that the Commission is prohibited from utilizing a future test year. The future test year question is a matter within the Commission's discretion. The Commission should utilize that discretion to ultimately order the use of a future test year in this case.

### **STAFF RESPONSE**

5. MAWC agrees with Staff's recommendation that the Commission issue its order: 1) Setting a test year of the 12-months ended December 2016 as a starting point for rate change analysis in this case; 2) an update period of the six months ended June 2017, and a true-up period of the six months ending December 2017, with all parties utilizing actual historic Company financial data to present their cases based upon these time frames; and, 3) articulating that by ordering such dates, no party is precluded from presenting further adjustments for Commission

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<sup>1</sup> The Midwest Energy Consumers' Group ("MECG"); the Missouri Industrial Energy Consumers ("MIEC"); the Office of the Public Counsel ("OPC"); the City of Joplin; the City of Jefferson City; the City of Warrensburg; the City of St. Joseph; the City of Riverside; and the Consumers Council of Missouri.

consideration base upon projected or forecasted data past December 2017 to determine MAWC's revenue requirement in this proceeding, or that any party is precluded from opposing such adjustments. Staff Response, p. 9-10, para. (A) and (B).

6. MAWC recognizes that the adoption of a future test year would represent a departure from past practice for this Commission. As explained in MAWC's *Motion to Establish Future Test Year*, it is a departure that is called for by current circumstances. MAWC's rate base and expenses are increasing while revenues are declining as it moves forward in time. Therefore, the relationship between revenues, expenses and rate base that may exist in an historical test year will not exist in the first year rates will be in effect. It is MAWC's burden to provide evidence and to persuade the Commission as to these facts. If the Commission issues its order consistent with the Staff's recommendation, MAWC will seek to do just that through the course of this case.

### **SIGNATORIES RESPONSE**

7. The Signatories Response addresses many subjects. MAWC will address those subjects in the order they are represented in the Signatories Response.

#### **Missouri Statutes Contain No Test Year Preference**

8. In spite of the Signatories' representation of there being a statutory preference for an historic test year, the only statute applicable to water corporations cited in the Signatories Response<sup>2</sup> is Section 393.270.4, RSMo, which states as follows:

In determining the price to be charged for gas, electricity, or water the commission may consider all facts which in its judgment have any bearing upon a proper determination of the question although not set forth in the complaint and not

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<sup>2</sup> The Signatories Response mentions in a footnote Section 393.135, RSMo. However, that statute refers exclusively to electric corporations.

within the allegations contained therein, with due regard, among other things, to a reasonable average return upon capital actually expended and to the necessity of making reservations out of income for surplus and contingencies.

9. This statute is much less restrictive than represented. First, it is permissive in nature – “. . . the Commission *may* consider all facts which in its judgment have any bearing upon a proper determination of the question. . . .” (emphasis added) Second, while rates should be based on capital actually expended, there is no requirement that this capital be expended by a certain date. Certainly, it does not require that capital be expended five months prior to the date rates will be effective, such as would be common place in Missouri rate cases utilizing a true-up period. All that is required is that rates be based on “capital expended.” Consistent with Section 393.270.4, RSMo., MAWC’s future test year proposal is designed to base rates on capital that will be expended through the first year in which new rates set in this case will be in effect.

10. The Signatories next attempt to rely on legislation *not adopted* by the General Assembly in support of their position. Initially, it must be pointed out that the non-adopted legislation relied on by the Signatories (both Senate Bill 190 and House Bill 1) concerned *electric corporations* – an industry with at least one different statutory parameter, as pointed out by the Signatories. See Signatories Response, FN 6, page 3.

11. Additionally, even where legislation has been adopted, legislative history has been found rarely persuasive in Missouri. It is necessarily incomplete as “the Missouri legislature does not record debates on any bill, nor does it publish committee reports. A legislative history . . ., therefore, is lacking.” *Roosevelt Federal Savings and Loan Association v. Crider*, 722 S.W.2d 325, 328, FN 3 (Mo.App. S.D. 1986). For this reason and others, the courts have commented that “our supreme court has cautioned that the use of the history of a Missouri bill’s

enactment is not highly persuasive.” *Page, et al. v. Scavuzzo, et al.*, 412 S.W. 3d 263, 268 (Mo.App.W.D. 2013), *citing Butler v. Mitchell-Hugeback, Inc.*, 895 S.W.2d 15, 19 (Mo.banc 1995). If the legislative history of bills actually adopted by the General Assembly is of very little value for statutory construction, history related to the failure to adopt legislation is of no value at all.

### **NRRI Concludes that the Use of Future Test Years has been Successfully Implemented in Many States**

12. The Signatories’ Response references a July 2013 Report by the National Regulatory Research Institute (NRRI) finding that the use of future test years is inherently problematic for several years.<sup>3</sup> Signatories Response, p. 5. Signatories then go on to present an entire argument that relies on this single source for its conclusions. However, the Signatories neglect to inform this Commission that the same author of the July 2013 NRRI Report issued a follow-up Report in October of 2013 (a copy of which is attached as **Appendix A**). Of particular significance is the follow-up Report’s general finding that:

. . . most Commissions using an FTY have had an overall positive experience, with no thought to discard an FTY in subsequent rate cases. Although in some instances Commissions endured initial difficulties, they were able eventually to overcome them.

(NRRI Report, October 2013, p. iv)

13. This follow-up Report, unlike its predecessor, is based upon empirical evidence -- actual responses by State Commissions who have implemented Future Test Years --- rather than the speculations of its author, which constitute the earlier draft. The October 2013 NRRI Report

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<sup>3</sup> In July of 2013, presumably after review of the July 2013 NRRI Report, NARUC reiterated the use of its 2003 resolutions which described the use of “prospectively relevant test years” as a “Best Practice.” See MAWC Motion, p. 5-6.

specifically addresses the concerns raised by the author in the earlier draft and either dismisses or diminishes those concerns as further explained throughout the remainder of this reply.

### **Rate Cases with Future Test Years Are Not More Time Intensive**

14. The Signatories Response, referencing the July 2013 NRRI Report, claim that the complexities of future test year cases necessarily involve more time. Again, the October 2013 NRRI Report dispels this notion, concluding that:

**Most Commissions made minimal adjustments in their internal operations when initially using an FTY.**

Some Commissions reported that they had to acquire new Staff expertise. Almost all Commission replied that an FTY took little, if any, time away from addressing other rate case topics. Only one respondent mentioned that, given the limited time for rate cases and the complexity of evaluating forecasts, parties may have insufficient time to assess a utility's forecast.

(October 2013 NRRI Report, p. 11) MAWC submits that the use of a future test year is, in fact, simpler than the current system, which uses a hybrid test year with numerous updates for known and measurable changes or true-ups for large plant additions.<sup>4</sup>

15. The Signatories further argue that MAWC is asking the Commission to cast aside the historical test year, updated for known and measurable changes, without an adequate opportunity for parties to conduct discovery to contest to the factual basis for the Company's request or an opportunity for parties to submit testimony contesting the Company's conclusions. Signatories Response, p. 7. MAWC is not asking to cast aside the historical test year. As MAWC has indicated, it has presented historical information, and its future test year is built on historical test year information. However, a Commission order consistent with the Staff

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<sup>4</sup> Several states that currently use future test years to set rates initially experimented with hybrid test periods (i.e., historical test periods with true up periods), but abandoned the approach as unnecessarily complicated and

Response, as supported by MAWC above, should address head on the Signatories concern about their ability to present evidence concerning the proposed future test year adjustments.

### **The Incentive to Minimize Costs is Similar to that with an Historic Test Year**

16. The Signatories Response argues that a Future Test Year will reduce MAWC's incentive to minimize costs that they believe is a function of regulatory lag. Signatories Response, p. 7. However, the same incentives to control costs remain with a future test year because regulatory lag will still provide incentives for the utility to minimize costs and operate efficiently. A utility is still allowed to retain profits that result from lower costs or improved efficiency in between rate cases. So, whether a historic or future test year is utilized, a utility still has an incentive to minimize its costs.

17. The Signatories' further argue that utilizing a future test year will automatically result in the utility earning above its authorized return on the first day that new rates go into effect based upon a future test period. Signatories Response, p. 4. Again, this assertion is misleading and inaccurate. The October 2013 NRRI Report explains why this is not the case:

Both utilities and commissions would more likely favor an FTY when average cost increases. This condition occurs when the combined growth input prices and levels exceeds the growth in sales. For example, with moderate to high inflation, large investments in new facilities, and slow sales growth, average cost would likely rise. Failure to account for the higher average cost in setting rates would likely lead to more frequent rate cases and revenue deficiencies.

(2013 NRRI Report, p. 5, footnote 18)

18. MAWC is in a situation where it is experiencing moderate inflation, investing large amounts of capital in new facilities and experiencing slow to declining sales growth. Therefore, its average cost is rising and utilizing a future test year to establish its revenue

deficiency under those circumstances will not result in overearning. In fact, by not using a future test year and setting rates on historic costs, the utility will earn below its authorized return from the very first day those rates become effective.

19. The Signatories erroneously argue that utilities will have “little incentive to minimize costs where a higher level of that cost has already been included in rates under the future test year process” and, thus, “rates are destined to increase in a future test year rate case.” Signatories Response, p. 9. In fact, the same incentives to control costs remain with a future test year because regulatory lag will still provide incentives for the utility to minimize costs and operate efficiently. So, whether a historic or future test year is utilized, a utility still has an incentive to minimize its costs. Rates continue to be set prospectively and a utility is still allowed to retain profits, if any, that result from lower costs or improving efficiency between rate cases. So, whether a historic or future test year is utilized, a utility still has an incentive to minimize its costs.

20. Moreover, the Signatories’ analogy that a future test year is similar to a parent giving a child \$50 to go out on Friday night, with the caveat the child must return any change, is pure sophistry, unless that child has an obligation to provide safe and adequate water and sewer service to over 475,000 customers in the state of Missouri, along with the substantial capital demands associated with that service.

### **Forecasting Costs**

21. The Signatories Response next alleges that utilities are unable to accurately forecast costs based upon a comparison of rate increase requests and authorized increases from four electric corporations, one gas corporation, and one water corporation case (MAWC’s last



rate case). This is a meaningless comparison in regard to the future test year question and says nothing about a utility's ability to forecast its costs.

22. First, those cases were based on historical test years and true-up periods, which have the deficiencies outlined in MAWC's Motion. Second, the increase requests include a number of things other than a "forecast of costs," that may be proposed by a utility. Lastly, as noted above, four of the cases cited concern electric corporations, whose revenue requirements can swing greatly based on base fuel numbers, and are mitigated by the fact that they have a fuel adjustment clause to provide recovery of a great amount of those costs later, if the base fuel number turns out to be low.

23. The Signatories also allege as an example of weakness in forecasting costs the Mueller meter issues that arose in the last rate case. Again, this issue really has nothing to do with the future test year issue.<sup>5</sup> MAWC provided analysis in the subsequent investigation that shows that any problem associated with these meters "amounted to a change in the Company's "filed" residential declining use rate of 0.04% annually, or approximately \$93,000 of water sales revenue during the test year."<sup>6</sup> Revenues are examined in historic test years and in future test year reviews. Ultimately, revenues are a rate case issue and this information will be relevant with, or without, the use of a future test year.

### **Bond Rating Agencies and MAWC's Actions**

24. The Signatories cite findings from the *Report Regarding Policies to Improve Electric Utility Regulation*, Case No. EW-2016-0313 (December 6, 2016), as an indication that

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<sup>5</sup> The Signatories allegation about the referenced employee was also reviewed by the Commission and its Staff in the last rate case.

<sup>6</sup> MAWC's Response to Report of Staff's Findings Into Faulty Meters and Negative Reserve Balances, File No. WO-

no changes to the historic test year process are necessary. Signatories Response, p. 11-12. Of course, the water industry was not a subject of that proceeding and MAWC was not a participant. The process proposed by the Staff, and agreed to by MAWC, would allow MAWC to present evidence and attempt to persuade the Commission that its approach should be different in this case.

25. The Signatories attempt to attack the necessity of the future test year by calculating a rough “return on equity” for MAWC based on an Annual Report, as compared to certain recommendations from the last MAWC rate case. Signatories Response, p. 12. However, the Direct Testimony of MAWC witness Bulkley explains that ROE recommendations must take into account that many of the comparable operating companies already use a forward looking test year:

For purposes of evaluating whether these factors affect the authorized ROE of MAWC, the relevant question is whether other companies in the proxy group are allowed to use a forecast test year or have similar mechanisms that reduce volumetric risk. As shown in Schedule 1 AEB-9, approximately 57 percent of the operating companies held by the proxy group have forward test periods, which serve to mitigate risk related to regulatory lag. In addition, another 19 percent of the operating companies have protection against volumetric risk (i.e., revenue stabilization mechanisms, revenue decoupling, etc.). The evidence demonstrates that the proxy companies have implemented some form of alternative ratemaking mechanism to increase the companies’ ability to achieve the revenue requirement that was authorized by the regulatory commission.

26. The Signatories also allege that a future test year is not needed because of MAWC’s continued investments in Missouri. Signatories Response, p. 13. They then proceed to identify seven small water and/or sewer systems that have been the subject of either acquisition or certificate cases over the past 19 months as proof of the stability of the regulatory system in

Missouri. The Signatories further suggest that American Water Works Company, Inc. redirect its capital investments to jurisdictions that provide a higher return. It is certainly possible that the Signatories wishes will come true. As the Commission is aware, small water and sewer operations are a great challenge from an investment and rates standpoint. If MAWC's ownership of such systems is not something that the Commission believes is beneficial, it can be halted. Similarly, as discussed in the Direct Testimony of Cheryl Norton (p. 7), the investment of discretionary capital is very much an issue with which MAWC must contend.

### **Impact of Adopting a Future Test Year on Rates**

27. The Signatories further allege that the use of a future test year will mean that customers will pay more for safe and adequate service. Signatories Response, p. 14. Under MAWC's proposal, customers will pay for the plant that is in place and providing safe and adequate service as of the time new rates are effective, not the plant that was in place five months prior to the time rates became effective.

### **The Used and Useful and Known and Measurable Standards Need Not be Abandoned**

28. The Signatories, referencing the July 2013 NRRI Report, argue that Future Test Years are incompatible with the "used and useful" standard. Signatories Response, p. 6. The Signatories also suggest that the use of a future test year requires "abandonment" of the used and useful and known and measurable standards. Signatories Response, p. 15. This is not the case. The October 2013 NRRI Report noted above finds that most future test year states subject to a "used and useful" standard include future, major capital projects as part of the revenue requirement as long as: (a) the commission found the costs prudent; and, (b) a project is scheduled for in-service during the test year. Such charges represent "capital actually expended"

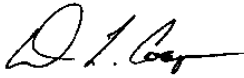
and are “used and useful” in the utility business. Further, the Commission need not merely trust the Company’s statements that capital will be invested. Investment is something that can be reviewed, compared, and adjusted in the future, if investment does not meet levels used to establish rates.

29. The Signatories Response also accuses MAWC of asking the Commission to turn its back on the well-established “known and measurable” standard. Signatories Response, p. 15. That is not the case. Ratemaking is not simply accounting. The courts have stated that “the Commission must make an intelligent forecast with respect to the future period for which it is setting the rate; rate making is by necessity a predictive science.” *State ex rel. Missouri Public Service Commission v. Fraas*, 627 S.W.2d 882, 886 (Mo.App. W.D. 1981). The Signatories seek to ignore this aspect of the Commission’s job with strict adherence to historical data – something that ignores the revenues, expenses, and investment that will be experienced by the Company during the time rates will be in effect. If the Company’s request for a future test year is denied and the forecast revenues, expenses and investments are not taken into account in the setting of MAWC’s rates, the Company will be denied an opportunity to earn the authorized rate of return which the Commission determines is appropriate in this proceeding.

30. Finally, MAWC notes that the test year established by the Commission for the purpose of establishing rates on a going forward bases is not comparable to the Financial Accounting Standards Board (“FASB”) or the generally accepted accounting principles (“GAAP”) referenced by the Signatories. This is not simple accounting. While there is necessarily some interaction, FASB and GAAP are not established or followed for the same purposes.

**WHEREFORE**, MAWC respectfully requests the Commission to issue its order adopting a future test period covering the first year that new rates are expected to be in effect (the 12 months ending May 31, 2019).

Respectfully submitted,



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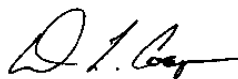
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**ATTORNEYS FOR MISSOURI-AMERICAN WATER COMPANY**

## CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was sent by electronic mail or by U.S. Mail, postage prepaid, on August 2, 2017, to the following:

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