STATE OF MISSOURI
PUBLIC SERVICE COMMISSION
JEFFERSON CITY
May 3, 2001

CASE NO: WR-2000-844

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Enclosed find certified copy of a REPORT AND ORDER in the above-numbered case(s).

Sincerely,

Dale Hardy Roberts

Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of St. Louis County Water Company for Authority to File Tariffs Reflecting Increased Rates for Water Service	))))	**Case No. WR-2000-844** Tariff File No. 200001199

REPORT AND ORDER

Issue Date: May 3, 2001

Effective Date: May 13, 2001

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of St. Louis County Water Company for Authority to File Tariffs Reflecting Increased Rates for Water Service	))))	**Case No. WR-2000-844** Tariff File No. 200001199

Deputy Chief Regulatory Law Judge Lewis Mills

REPORT AND ORDER

Findings of Fact

St. Louis County Water Company d/b/a Missouri-American Water Company (the Company), on June 23, 2000, filed revised tariff sheets to implement a general rate increase. By order of the Commission, those tariff sheets have been suspended until May 20, 2001. The Company is a public utility engaged in the provision of water service to the general public in the state of Missouri and, as such, is subject to the general jurisdiction of the Missouri Public Service Commission pursuant to Chapters 386 and 393, RSMo 2000.

The parties prefiled testimony pursuant to a Commission order, local public hearings were held in the St. Louis area on January 17, 2001, and on January 18, 2001, the parties filed a list of contested issues. An evidentiary hearing was held February 5-9, 2001. In the remainder of this section of this Report and Order, the Commission will make findings of fact on each disputed issue. The following section will contain the Commission's conclusions of law on each issue.

The Missouri Public Service Commission makes its findings of fact having considered all of the competent and substantial evidence upon the whole record. The positions and arguments of all of the parties have been considered by the Commission in making this decision. Failure to specifically address a piece of evidence, position or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision. The numbering on each of the contested issues follows that used by the parties in their list of issues.[1]

1.B.(1) What is the appropriate manner in which to treat net salvage?

Depreciation, in the context of this rate case, is the loss in service value primarily due to age and use of capital assets used to provide water service to the Company's customers. Depreciation accounting is the system that spreads the cost of these assets over their useful lives. In the whole life method of accounting, net salvage is accounted for in depreciation rates, and in straight line whole life depreciation, the original cost of an asset less net salvage is allocated in equal amounts to each year of an asset's service life. Net salvage is the difference between the value of retired plant and the cost of removing that plant. If it costs more to remove a piece of plant than that piece's value, net salvage is negative. Conversely, if at retirement a piece of plant has value in excess of the cost of removal, net salvage is positive.

1 Because some issues were resolved after the numbering scheme was developed, the numbers are not consecutive.

The disagreement on this issue is whether the Commission should use the whole life method of calculating depreciation rates, or calculate depreciation rates without taking net salvage into account, and address net salvage in a different manner. The Company proposes the use of the whole life method, and Staff proposes to treat net salvage as an expense, separate from the calculation of depreciation rates.

Company's approach will collect from current customers a portion of the net salvage related to current plant in service. Staff's approach will collect from current customers net salvage related to plant that is being retired from service. Company's position is that a portion of the net salvage cost of a piece of plant should be recovered each year from the customers using that plant, in the same way that a portion of the original cost is recovered.

Company witness Stout's net salvage estimates, calculated as a ratio of cost of removal to original cost, average 33 percent for all depreciable plant in service on December 31, 1999. Staff witness Adam asserts that the Company's calculations of net salvage are as high as 200 or 300 percent. But the Company's actual calculations show that net salvage was higher than 100 percent for only two accounts (126 percent for Account 343.20 and 141 percent for Account 343.24). Although Mr. Stout's net salvage figures are estimates, as Staff points out, the Commission finds them to be reasonable estimates and finds Staff's assertions that they are 200 or 300 percent to be incorrect.

1.B.(2) Should the existing service lives of certain depreciable plant be adjusted?

The service life of a particular group of assets (sometimes grouped for the purposes of depreciation accounting as a plant account) is the time over which the cost of those assets will be recovered. Both Staff and the Company propose changing the service lives of many plant accounts. Staff's proposed lives are attached to Staff witness Adam's direct testimony as a two-page list. In the body of Mr. Adam's testimony, he recommends that the Commission order the Company to use these lives. There was no evidence adduced that shows how any of these proposed lives were determined.

The Company's primary depreciation witness, Mr. Stout, determined his proposed service lives after analysis of available historical service life data, review of the Company's management's current plans and operating policies, and his general knowledge of service lives experienced and estimated in the water industry. He used Iowa type survivor curves to depict the estimated survivor curves for the plant account property groups. For major structures he used the life span technique, in which he estimated the date of final retirement for each building, and truncated the estimated survivor curves applied to each vintage at ages coinciding with this date.

The service lives proposed by the Company were based on historical data from the property records of the Company compiled through 1999. This data included plant additions, retirements, transfers and other activity. Mr. Stout used retirement data for the years 1939 to 1999 in the actuarial tables that are the primary statistical support for his service life estimates. Mr. Stout discussed with operating and management personnel the reasons for past retirements and the expected future causes of retirements, and incorporated information regarding future plans in his interpretation and extrapolation of the statistical analyses.

1.B.(3) Should the existing amortization of the depreciation reserve deficiency be adjusted?

A depreciation reserve deficiency exists if a calculated theoretical accrued depreciation reserve exceeds the book deprecation reserve. The size of the theoretical accrued depreciation reserve (and any deficiency or surplus) is a direct result of establishing net salvage, service lives, and the attendant depreciation rates. Any adjustment to the amortization of the depreciation reserve deficiency in this case depends on the Commission's resolution of the net-salvage and service-lives issues. If the Commission had adopted Staff's position on these issues, it would eliminate the amortization as Staff proposes. But since the Commission adopts the Company's position on them, it follows that the Company's proposed adjustment to the amortization is appropriate.

1.C.(1) Should the Company recover, in this rate case (return of and return on), transaction and/or transition costs related to the merger/acquisition between American Water Works (AWK) and National Enterprises (NEI)?

The Company proposes to recover costs associated with the acquisition of NEI (its former parent company) by AWK. The Company asserts that the acquisition will result in savings to customers of over $3 million per year, and that the costs incurred to bring about these savings should be recovered in rates. The Company's proposal is to recover the costs over a ten-year period and to include the unamortized balance in rate base.

Staff and the Office of the Public Counsel oppose recovery of these costs on a number of grounds. They consider some of the costs to be imprudent. They also believe that the Company will recover these costs through reduced expenses before the rates set in this case will go into effect, and that the costs are not recurring.

The costs associated with this issue are primarily related to the elimination of employees. As a result of the merger, the Company had the opportunity to reduce its workforce, but in doing so incurred separation and severance costs. These costs are unusual and will not be incurred again. The Commission finds that, for ratemaking purposes, these costs are non-recurring.

1.C.(2) Should the Company recover, in this rate case (return of and return on), transaction and/or transition costs related to the Company's use of the name "Missouri-American Water Company?"

The Company spent $103,861 primarily to communicate to its customers that it is now using the name "Missouri-American Water Company." The Company argues that these expenditures are essential to providing safe and adequate service to its customers, and proposes to recover them over a ten-year period. Staff and the Office of the Public Counsel oppose recovery of these costs on a number of grounds. Public Counsel asserts that these costs are associated with a type of advertising categorized as institutional, and as such serve primarily to enhance a utility's image and are not recoverable. The Company counters that they are general advertisements and provide information that is useful in the provision of service. Although the Company alleges that the advertisements were necessary to allay customer confusion about the name it chose to use, there is no evidence in the record that any customers were confused by the Company's decision to change the name under which it operates. The Commission finds that these costs are a direct result of Company management's decision to operate under a new name. Furthermore, there is no evidence that these costs will be incurred in the future when the rates set in this case are in effect, and the Commission finds them to be non-recurring.

1.D. Should the Company be allowed to recover a portion of any "savings" which resulted from the AWK/NEI merger from Company's customers under its proposed "Shared Savings Plan"?

The Company asserts that, as a direct result of the merger, it will achieve savings of over $3 million in the first year following the merger, and almost $40 million in the ten years following the merger. It proposes to assign half of the demonstrated savings to the Company and the other half to ratepayers.

The Staff claims that the proposed savings plan is a thinly disguised attempt to recover the premium AWK paid to acquire NEI, and asks the Commission to reject it. Staff and Public Counsel both assert that the Company has already retained the benefit of sufficient savings to offset the prudently incurred costs of implementing the merger. They argue that this retention is of sufficient benefit to the Company to obviate the need for any additional relief.

The Commission resolves this issue on policy grounds as discussed in the Conclusions of Law. It need not, and does not, make specific findings as to whether Company's asserted savings have occurred or will occur. Neither will the Commission make a finding as to whether the proposed shared savings plan is tied to recovery of an acquisition premium.

1.E. Should the Company recover property taxes associated with plant that was placed in service during calendar year 2000?

The question presented here is whether rates should include an amount for property taxes that is equivalent to the last tax bill actually paid, or an estimated amount that is intended to be more representative of the amount expected to be paid in the future. Staff proposed to use the last actual tax payment as the most reliable indicator of future payments. The Company proposed to calculate the ratio of plant in service at December 31, 1999, to the property tax paid on that plant, and then apply that ratio to plant in service on December 31, 2000.

The Company's property tax expense has increased each year for the last ten years, but the actual tax rate for 2000 will not be known until sometime in the fall of 2001.

Staff used an expense lag of 182.5 days for property taxes in its calculation of cash working capital. Company witness Grubb testified that, if the Commission adopts Staff's position on property taxes, it should make an adjustment to cash working capital to eliminate any expense lag for property taxes. The Company reasons that:

> . . . Staff is proposing to include in rates a level of property tax expense that was paid in December 2000. Rates in this case will go into effect in May 2001. Therefore, [cash working capital] should reflect the fact that the Company will pay the property taxes in December 2000 and not recover those taxes until starting in May 2000.

1.F. Should deferrals from infrastructure main replacement AAOs be recovered over a 20-year period as addressed by the Commission in WR-96-263, or should they be recovered over a 10-year period as advocated by Staff, or should they be eliminated as advocated by OPC, or should they be afforded some other treatment?

In 1994, in an order approving a stipulation in Case No. WR-94-166, the Commission recognized that the Company needed to begin an infrastructure replacement program.[2] In 1994, the Company spent $2.5 million on main replacements. The Company proposed to increase this expenditure over the next five years until it reached $19.2 million in

2 The parties use the terms "infrastructure plan," "main replacement plan," and various combinations to refer to a systematic analysis of the Company's mains and a plan to increase the rate of their replacement. In the context of this Report and Order, when the Commission uses the term "infrastructure," it is referring to the portion of infrastructure consisting of transmission and distribution mains.

1999. In Case No. WR-95-145, the Commission determined that Company's proposed infrastructure replacement expenditure for the five years ending in 1999, as described in the 1994 Plan, would constitute "a significant and unusual increase in County Water's business-as-usual construction expenditures, and is extraordinary in nature." The Commission adopted Staff's proposal to allow the Company to defer these expenses, and granted the Company accounting authority; this authorization is referred to as the first AAO.

In the Company's next rate case, Case No. WR-96-263, the Commission established a 20-year period for the amortization of the amounts deferred pursuant to the first AAO. The Commission authorized a second AAO for main replacement capital expenditures "[b]ecause the infrastructure replacement costs appear to be of such an extraordinary, infrequent and unusual nature when the rate of their increases is considered[.]" The Commission did not explicitly establish an amortization period for the second AAO.

The unamortized balance from the first AAO is over $100,000, and from the second is $207,000. The Company proposed to amortize and recover these balances over 20 years, with the unamortized portion being afforded rate base treatment. This is the method the Commission adopted for the first AAO in Case No. WR-96-263. Staff proposed that the balances should be amortized over ten years, with no rate base treatment for the unamortized balance. This is the method the Commission adopted in a 1998 Missouri Gas Energy rate case, Case No. GR-98-140.

1.G. Should amounts deferred and accumulated by the Company pursuant to the AAO requested by the Company, which is presently under consideration in Case No. WO-98-223, be afforded the treatment determined to be appropriate in (F) above?

The Company's 1997 rate case, Case No. WR-97-382, was settled by the unanimous agreement of the parties. One of the items that the parties agreed upon was that the issues concerning a third AAO should be docketed as a new case. That case was assigned Case No. WO-98-233. In the Report and Order issued February 13, 2001, in that case, the Commission decided not to grant the Company a third AAO. The Company, during the pendency of Case No. WO-98-233, deferred and accumulated amounts attributable to main replacements. At the time of the hearing in this case, the Company estimated that it had deferred approximately $2.8 million.

The Company has not yet begun to implement an infrastructure replacement plan. It has consistently stated that it has never committed to begin such a plan, and consistently stated that it will not begin such a plan until it receives favorable regulatory treatment. There is evidence that the Company's spending on main replacements had increased from approximately $2.5 million annually in 1995 to approximately $7 million annually at the time of the hearing, but it is clear that this spending is not part of a systematic main replacement program.

2.A. How should the Commission treat the unamortized amounts from the two accounting authority orders (AAOs) related to infrastructure costs, which were previously addressed by the Commission?

This issue is simply another facet (the rate base treatment) of Issue 1.F., and the Commission's discussion of this issue is found under that heading.

2.B. Should amounts deferred and accumulated by the Company pursuant to the AAO requested by the Company, which is presently under consideration in Case No. WO-98-223, be afforded the treatment determined to be appropriate in (A) above?

This issue is simply another facet (the rate base treatment) of Issue 1.G., and the Commission's discussion of this issue is found under that heading.

3. What return on equity (ROE) should the Commission authorize?

The parties have resolved all issues related to the Company's cost of capital with the exception of the rate of return on equity.

Staff witness McKiddy used the continuous growth Discounted Cash Flow (DCF) model, a market-oriented approach, to determine AWK's cost of common equity. The Commission agrees with Ms. McKiddy's synopsis of the DCF model:

> This model relies upon the fact that a company's common stock price is dependent upon the expected cash dividends and upon cash flows received through capital gains or losses that result from stock price changes. The rate which discounts the sum of the future expected cash flows to the current market price of the common stock is the calculated cost of equity.

Because the Company's stock is not publicly traded (it is held by its parent, AWK[3]), the DCF model cannot be used to directly analyze its cost of equity. AWK's stock is publicly traded, and Ms. McKiddy determined its cost of equity and applied it to the Company. She calculated a growth rate range of 6.75 percent to 7.75 percent using historic and projected data from a number of sources. She calculated a dividend yield using AWK's monthly high/low average stock price from June 1 through September 1, 2000, and Value Line's estimate[4] of AWK's average dividend for 1999 and 2000. This calculation resulted in an average dividend yield of 3.50 percent, and this is the figure Ms. McKiddy used in her DCF cost of equity estimate. Adding the dividend

3 Technically, the Company is a second tier subsidiary of AWK.
4 The Value Line Investment Survey: Ratings and Reports, August 4, 2000.

yield to the growth rate results in Staff's recommended cost of equity of 10.25 to 11.25 percent.

Ms. McKiddy also performed both a risk premium analysis and a capital asset pricing model (CAPM) analysis on AWK to check the reasonableness of her DCF analysis. Both of these analyses yielded results that confirmed the accuracy of the DCF calculation. In addition, she performed DCF, risk premium, and CAPM analyses on a group of five water utilities she considers comparable to AWK. All of these analyses, she concludes, support her recommended cost of equity of 10.25 to 11.25 percent. In conclusion, Ms. McKiddy notes that Value Line predicts that the water utility industry will earn 11.00 percent on equity in 2000 and 2001. The Commission finds that Ms. McKiddy's application of the DCF model is the most appropriate of the three in this case for determining the cost of equity.

Ms. McKiddy stated that, in her opinion, it is appropriate to apply AWK's cost of equity to the Company with no adjustments because they are in the same general line of business and have comparable capital structures.

Public Counsel witness Burdette also primarily used a DCF approach. He analyzed AWK and three other publicly traded water utilities. His analysis of AWK resulted in a cost of equity range of 8.34 percent to 13.75 percent, and his analysis of the other three companies resulted in a cost of equity range of 6.20 percent to 11.54 percent. The midpoint of Mr. Burdette's DCF cost of equity for AWK is 11.05 percent. Mr. Burdette's recommended cost of equity relies more on the calculations from his comparable group than from AWK, and the results of the initial calculations performed on his data were significantly adjusted based on his judgment.

Company witness Walker did not, as did Staff and Public Counsel, use the DCF as the primary analysis to be checked with other analyses. Rather he "used several models to help" him formulate a cost of equity recommendation. Notably, the DCF model yields the lowest return on equity percent of his three approaches. Mr. Walker also relied on analyses of electric utilities to estimate the Company's return on equity, despite significant differences between the water industry and the electric industry.

4.A. Should the Commission add projected costs associated with implementing the Company's infrastructure replacement plan to the test year expenses used to determine cost of service?

The Company proposes to increase rates by $4.8 million (the average of the first three years' revenue requirements) to account for the increased spending it proposes to incur on main replacements. In essence, the Company's proposal is to include in rate base plant that has not yet been installed. The Company states, and the Commission finds, that it is experiencing an exponential increase in main breaks and resulting main repair costs because a portion of the Company's older mains are wearing out and need replacing. The Company also states, and the Commission also finds, that it needs to implement a main replacement program.

The Company provided evidence that it "is investing every dime of its depreciation expense recoveries right back into plant." In fact, the Company has, since 1990, invested more money in plant than it has recovered in annual depreciation expense.

The Company has in recent cases insisted that it will not begin to substantially increase spending on main replacements until it receives what it believes to be favorable regulatory treatment of its expected costs.

The Company's proposal in this case is more detailed than its past proposals. The Company proposes to increase infrastructure spending over the next three years, with an annual revenue requirement increase from this spending of approximately $2 million in 2001, $4.5 million in 2002, and $7.9 million in 2003. The average over the three years is approximately $4.8 million. The annual budget for infrastructure replacement for these years is $9 million in 2001, $15 million in 2002, and $20 million in 2003.

The Company submitted the "Weston Report" which outlines a relatively comprehensive economic analysis of the planned main replacements. In Exhibit 80, admitted at the hearing over the objections of Staff and Public Counsel, the Company added more details to its proposal. The Company offered to commit to replacing certain mains within certain time periods and to make refunds to customers if those commitments were not met. Alternatively, the Company offered to use its best judgment in deciding whether the proposed main replacements should be modified and to allow that judgment to be subject to prudence reviews.

4.B. Should the Company be required to maintain a cost allocation manual and certain other information and reports concerning expenses charged to the Company by the American Water Works Service Company?

AWK, in addition to owning utilities that provide water service to customers, owns a service company that provides service to its water utilities. Public Counsel witness Dittmer proposes that the Company be required to prepare and maintain a cost allocation manual (CAM) that describes the methods American Waterworks Service Company (AWWSC) uses to accumulate or categorize costs and describes how these costs are allocated to AWK subsidiaries. Mr. Dittmer proposes that the CAM include the following information:

1. Listing of accounts including account numbers and descriptive titles, as well as a description of charges to be recorded within each account.

2. A copy of all contracts or service agreements between any and all AWWC affiliates and subsidiaries - including the Service Company. If many of the agreements are identical in nature, one sample copy would suffice. Also, if the various contracts and agreements are voluminous, a description of their availability and locations should, at a minimum, be included within the CAM.

3. Listing of cost pools employed, a description of the physical location(s) wherein pool functions/activities take place, a description of the various types of activities and functions taking place within each given cost pool, and an up-to-date table showing which subsidiaries benefit from each given pool as well as which subsidiaries are exempt from being allocated charges from any given cost pool (i.e., the table should also show a listing of subsidiaries which do not benefit from the pool).

4. For each subsidiary that is exempt from being allocated costs from a given pool, a definitive statement that such subsidiary does not benefit from functions being provided by the cost center in question should be included within the CAM. Furthermore, the CAM should include a brief explanation as to how each subsidiary which is exempt from a given pool's cost allocation accomplishes the functions which are provided by the pool.

5. A listing of each non-AWWC-owned company, municipality or entity included within the CAM which receives goods or services from the Service Company or any other AWWC-owned subsidiary or affiliate as well as a description of the goods and services provided. Additionally, the CAM should include a description and detailed example, as applicable, of the method of determining how goods or services provided are priced or charged. Finally, a copy of any contract or service agreement with each such independent entity should be included in the CAM - or in the alternative simply listed and referenced as to location and availability.

6. For any good or service that is charged to an operating company based upon a routinely-applied allocation factor, such allocation scheme should be supported as to reasonableness, applicability and equity. In many instances, such explanations would be brief and nearly self-evident as to reasonableness. For instance, a brief statement that customer billing costs are allocated based upon number of customers because such costs are understood to be driven primarily by

customer counts would be all that would need to be documented in the CAM. Obviously, other allocation applications could be more detailed and complicated in nature, thus requiring greater explanation and support.

7. Tables detailing allocation factors derived from latest-calendar-year-ending statistics which would include, but not necessarily be limited to:

a. Direct payroll charged by each AWWC-owned operating company;

b. Revenues received by each AWWC-owned operating company;

c. Net investment in utility plant;

d. Investment in net utility plant and investment in non-utility properties;

e. Direct operation and maintenance expense charged to each AWWC-owned operating company.

The benefits and necessity of requiring that such allocation factors be filed within the CAM are discussed within the following section of testimony.

8. A listing and sample copy of all routinely-prepared reports as well as a narrative description of all data included on each such report.

9. Description of AWWC's or AWWSC's capabilities and availability to generate unique or customized reports from existing data bases.

10. A compendium of accounting guidelines currently in place.

The Company is allocated millions of dollars annually from AWWSC. Mr. Dittmer states that the CAM will allow the Commission to evaluate whether these allocated costs are appropriate. All of the data the CAM would encompass currently exists.

The Company asserts that Mr. Dittmer's proposal takes a different approach than does the Commission's rules on affiliated transactions. It also claims that it will be costly and time-consuming to prepare a CAM like the one Mr. Dittmer proposes. However, it did not produce any evidence to quantify either the time or cost involved.

Conclusions of Law

1.B.(1) What is the appropriate manner in which to treat net salvage?

While Staff criticizes Mr. Stout's estimates of net salvage costs in general, it does not note any specific problem with any specific estimate. Rather, the criticisms are based on the fact that the costs are estimates.

The Commission's decision on this issue is guided by policy. There is ample factual support to allow the Commission to choose either Staff's approach or the Company's. Under the circumstances faced by the Company, including its need for cash flow to address its infrastructure issues, the Commission concludes that using the whole life method and including estimated net salvage is in the public interest. The whole life method collects net salvage cost ratably over the life of plant by customers served by the plant. This approach is equitable based on the circumstances of this case.[5]

The Commission's conclusion about the use of the whole life method should not be taken as a final endorsement of it, nor as a condemnation of Staff's approach. Both have merit, and the Commission will use the one that fits the particular circumstances under investigation. The Commission explicitly distinguishes its holding on the net salvage issue here from its holding in Laclede Gas Company's recent rate case, Case No. GR-99-315. The Commission's holding that the Company's use of the whole life method of determining depreciation rates is based on the record in this case, and on the circumstances in which the Company finds itself. The whole life method is not appropriate for all types of property, for all utilities, and in all situations. In a situation in which a utility has a type of asset that is at or very near the end of its service life, that is not likely to be replaced, and for which the cost of removal is high and likely to move higher, another approach may be appropriate.

5 The concept of intergenerational equity is that one "generation" of utility customers should pay the current costs of providing service to them. It is inequitable for customers to pay for the cost of providing service in the past or in the future.

1.B.(2) Should the existing service lives of certain depreciable plant be adjusted?

No party proposed using the service lives and resulting depreciation rates currently authorized for the Company, and there is no evidence upon which the Commission could make a finding that the current service lives are still reasonable. The Commission thus must choose between Staff's proposed service lives and the Company's. Staff, in its reply brief, discusses at length the process by which it communicated to the Company the support for Mr. Adam's conclusions about proper service lives, and that the Company never challenged the sufficiency of that support. Staff warns the Commission not to make a decision that will require parties to file their entire workpapers as evidence. There is, however, a middle ground between putting in all of a witness' workpapers and putting in no evidence to support the witness' conclusions. In this case, there is no evidence in the record to support Staff witness Adam's conclusions about what the proper service lives should be. In the future, Staff should not automatically seek to have all witnesses' workpapers admitted into the record, but it must provide adequate support for the witnesses' conclusions. The Commission is bound to make its findings and conclusions based on the evidence of record, and the support for Mr. Adam's proposed service lives was never made a part of the record. The Commission concludes that the Company's proposed service lives should be adopted.

1.B.(3) Should the existing amortization of the depreciation reserve deficiency be adjusted?

A depreciation reserve deficiency exists if a calculated theoretical accrued depreciation reserve exceeds the book deprecation reserve. The size of the theoretical accrued depreciation reserve (and any deficiency or surplus) is a direct result of establishing net salvage, service lives, and the attendant depreciation rates. Any adjustment to the amortization of the depreciation reserve deficiency in this case depends on the Commission's resolution of the net-salvage and service-lives issues. If the Commission had adopted Staff's position on these issues, it would eliminate the amortization as Staff proposes. But since the Commission adopts the Company's position on them, it follows that the Company's proposed adjustment to the amortization is appropriate.

1.C.(1) Should the Company recover, in this rate case (return of and return on), transaction and/or transition costs related to the merger/acquisition between American Water Works (AWK) and National Enterprises (NEI)?

A test year allows the Commission to examine the relationship of actual costs, revenues, and rate base for a historical period, and to use that relationship to set rates for future periods. Unusual events that affect the relationship during the test year in a way that is unlikely to happen again are removed. The costs associated with the acquisition are one-time, non-recurring costs. Although they were expenses that occurred during the test year, similar expenses will not occur in the period in which rates set in this case are in effect. The Commission concludes that these costs are non-recurring and inappropriate for inclusion in rates, and therefore the question of what level of savings (if any) Company has achieved by paying these costs is immaterial.

1.D. Should the Company be allowed to recover a portion of any "savings" which resulted from the AWK/NEI merger from Company's customers under its proposed "Shared Savings Plan"?

Regulation is intended to be a substitute for competition. In a competitive market, a company that achieves gains in efficiencies only gets to keep the benefit of those gains until its competitors implement similar efficiencies, and the company is forced to lower its prices to remain competitive. A regulated company does not get to keep the benefit of its efficiency gains indefinitely either. If the gains are large enough and not offset by increased costs elsewhere in its operations, a utility will get to keep the gains only until a complaint is brought and resolved. If the gains are offset by increased costs, the utility will only get to keep them until a rate increase case is filed and resolved. Gains in efficiency are "captured" in a rate case, and forward-looking rates are set taking the gains into account.

This last situation is the one in which the Company finds itself: it claims it has achieved gains in efficiency from the merger of NEI and AWK, but nonetheless has found it necessary to request an increase in rates. The Company asks to be allowed to share (i.e., keep 50 percent) of the savings it asserts it has achieved from the AWK/NEI merger. The Commission, in keeping with regulation's role of simulating competition, will not approve the shared savings plan.

The Company argues that adopting a policy of allowing utilities to retain some of the savings they achieve will encourage them to pursue mergers and acquisitions. The Commission rejects this argument for two reasons. First, the utility industry, including water utilities, seems to be pursuing mergers and acquisitions quite willingly without this Commission approving shared savings plans. In fact, the Commission has never approved a savings sharing plan. Second, the Commission does not need to allow utilities to keep these benefits to create an incentive to achieve efficiencies (either through successful mergers and acquisitions or otherwise); the lag inherent in the regulatory process provides sufficient incentive.

1.E. Should the Company recover property taxes associated with plant that was placed in service during calendar year 2000?

The Commission traditionally, and properly, allows recovery of cost increases that are projected to occur after the end of the test year (including any adjustment periods) only if those costs are known and measurable. A cost increase is "known" if it is certain to occur, and it is "measurable" if the Commission is able to determine the amount of the increase with reasonable precision. The Company's projected property tax increases are neither known nor measurable. While it is probable that the Company will experience an increase in property tax expense at the end of the year, it is by no means certain. Even more damaging to the Company's proposal is the fact that its best estimate of the amount of any increase is based on an assumption that finds no support in the record. Company's proposed property tax calculation assumes that the tax rates for 2000 will be the same as the tax rates for 1999. Because any increase in the Company's property tax expense is not known and measurable, the Commission will not adopt the Company's proposal. Staff's proposal to use a known amount (the last amount actually paid), while probably not a perfectly accurate representation of the property taxes that will be paid in the future, at least avoids the speculation inherent in Company's proposal.

The Commission also rejects the Company's proposal to adjust the expense lag for property taxes to zero. Rates are set for the future based on an examination of the test year. Cash working capital is not a reconciliation of actual income received during the test year to actual expenses paid in the future, it is an estimate of the amount of time the Company is likely to have between when it receives cash and when it must pay expenses. In setting rates, the Commission uses a going-forward level of property taxes; it is not reconciling the payment of the actual taxes paid in December 2000 to when the cash was collected for that expense. The Commission adopts Staff's position on property taxes as the best estimate of the level of property taxes during the period when rates set in this case will be in effect. The revenues collected through those rates, including an amount calculated to cover property taxes, will be collected throughout each calendar year, and property taxes will be paid at the end of each calendar year. The fact that the going-forward rates include an amount for property taxes that is identical to the amount paid in December 2000 is (from the standpoint of making adjustments to cash working capital) merely a coincidence. Staff's calculation of 182.5 days' lag for property taxes recognizes this collection period and this payment date. Mr. Grubbs' proposed adjustment to cash working capital is inappropriate and is rejected.

1.F. Should deferrals from infrastructure main replacement AAOs be recovered over a 20-year period as addressed by the Commission in WR-96-263, or should they be recovered over a 10-year period as advocated by Staff, or should they be eliminated as advocated by OPC, or should they be afforded some other treatment?

In Case No GR-98-140, a Missouri Gas Energy (MGE) rate case, the Commission adopted a position advocated by Public Counsel that "guaranteeing the Company a 'return of' and 'return on' the . . . deferred balance [of an ongoing construction project] is not a fair allocation of regulatory lag. . . ." The Commission concluded that, for ratepayers and shareholders to share in the effect of regulatory lag, MGE should be allowed to earn a return of the deferred balance, but not a return on the deferred balance. This is the approach advocated by Staff in this case. The Company urges the Commission to continue to allow both a return of and a return on the deferred balance as it determined appropriate in Case No. WR-96-263.

Nothing binds the Commission to a particular ratemaking treatment of deferrals made pursuant to an AAO:

> In the Public Counsel case [State ex rel. Office of Public Counsel v. Public Service Com'n of Missouri, 858 S.W.2d 806, Mo.App. W.D. 1993)], the court made it clear that AAOs are not the same as ratemaking decisions, and that AAOs create no expectation that deferral terms within them will be incorporated or followed in rate application proceedings.[6]

The Commission, based on the same reasoning it used in Case No. GR-98-140, will allow the Company to recover the deferred balances over ten years, but will not allow a return on the unamortized balance.

1.G. Should amounts deferred and accumulated by the Company pursuant to the AAO requested by the Company, which is presently under consideration in Case No. WO-98-223, be afforded the treatment determined to be appropriate in (F) above?

In the Report and Order in Case No. WO-98-233, the Commission held that "The record makes it abundantly clear that the Commission should not grant the requested third AAO for infrastructure replacement because the circumstances are recurring, not nonrecurring." The Commission stated that the Company, to the extent it had deferred costs without Commission approval, could seek to recover them in this case. The costs that the Company deferred during the pendency of GO-98-233 are not extraordinary. They represent the level of main replacement expense that the Company has incurred in recent years and will continue to incur until it implements a systematic main replacement program. That program has not yet begun (or at least has not yet achieved a level that could in any sense be

6 Missouri Gas Energy v. Public Service Com'n, State of Mo., 978 S.W.2d 434, (Mo.App. W.D. 1998), at 438.

considered extraordinary). Because these costs are not extraordinary, they should not be afforded extraordinary treatment.

2.A. How should the Commission treat the unamortized amounts from the two accounting authority orders (AAOs) related to infrastructure costs, which were previously addressed by the Commission?

This issue is simply another facet (the rate base treatment) of Issue 1.F., and the Commission's discussion of this issue is found under that heading.

2.B. Should amounts deferred and accumulated by the Company pursuant to the AAO requested by the Company, which is presently under consideration in Case No. WO-98-223, be afforded the treatment determined to be appropriate in (A) above?

This issue is simply another facet (the rate base treatment) of Issue 1.G., and the Commission's discussion of this issue is found under that heading.

3. What return on equity (ROE) should the Commission authorize?

Staff recommends that the Commission establish a ROE between 10.25 percent to 11.25 percent, and prefers the midpoint of that range, 10.75 percent. The Company proposes a value of 12 percent and Public Counsel proposes 10 percent. The Commission has for many years judged the DCF method to be the most reliable for calculating a utility's cost of equity:

> The Commission has consistently found Discounted Cash Flow (DCF) analyses to be appropriate for determining a rate of return on equity. . . . This is because it is relatively simple to apply and measures investor expectations for a specific company. . . . [T]he DCF analysis is considerably more systematic and allows this Commission to treat all utilities it regulates in a consistent manner.[7]

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7 In the Matter of the Joint Application of Missouri Cities Water Company, 26 Mo.P.S.C. (N.S.) 1, 26-27 (1983).

The Commission concludes that the evidence in this case shows the DCF model to be the best approach. The Commission also concludes that, of the applications of the DCF model in this case, Staff's DCF analysis of AWK is the most pertinent to the determination of the Company's cost of capital. Staff's approach is the best because it uses the most directly comparable substitute and because it is the "purest" application of the DCF model in the sense that it relies primarily on publicly reported data with little adjustment by the analyst. It is also the most appropriate because it uses the best proxy for the Company: the Company's parent. Staff simply applied the DCF method to the publicly-traded common stock of the Company's parent, AWK, and imputed that result to the Company. This is appropriate because the Company and AWK are in the same general line of business and have similar capital structures. Whenever possible, actual market data should be used to determine the cost of equity. Investors in AWK are investing in all of the companies that make up AWK, including the Company, and no risk adjustment is justified. The analyses performed by Public Counsel witness Burdette and Company witness Walker do not as accurately reflect the cost of equity for the Company because their proxy groups do not as closely approximate the Company as does AWK. In addition, they both made significant adjustments to the results of their DCF analyses. Mr. Walker's use of electric utilities to determine the Company's ROE is a significant flaw.

After considering all of the evidence and the arguments of the parties, the Commission determines that the appropriate return on equity for the Company is 10.75 percent. 10.75 percent is close to the average return Value Line predicts that the water utility industry will earn in 2000 and 2001. It is also very close to the midpoint of the range calculated by Public Counsel witness Burdette's DCF analysis of AWK (11.05 percent). It is near the midpoint between Public Counsel's recommended ROE of 10 percent and the Company's recommended ROE of 12 percent. Finally, it is the midpoint of Staff's range, and is the recommendation of Staff witness McKiddy.

4.A. Should the Commission add projected costs associated with implementing the Company's infrastructure replacement plan to the test year expenses used to determine cost of service?

The Commission will not get bogged down in the arguments over whether the Company has in the past made commitments to ramp up its replacement, or whether the Commission made an invitation for the Company to request inclusion in rate base of future plant or a suggestion that the Commission would approve such a request. The evidence in this case indicates that, while the situation may not yet be a crisis, now is the time for the Company to begin its infrastructure replacement program. The Company has recognized that such a program is necessary, and the Commission has found it to be so.

The Company's future plant proposal, however, runs afoul of several core regulatory principles and the Commission will not adopt it. It violates the used and useful standard, with the attendant harm to intergenerational equity. In other words, it would require current customers to pay for plant that is proposed to be built in the future, and possibly not used to provide service until after some of them are no longer customers. It violates the matching principle, that is, it builds into current rates an increase in one area of expenses, but does not take into account any possible savings in other areas or possible increased revenues. While the Company's proposal may eliminate the problem of refunds for money built into rates but not actually (or not prudently) spent, it does not eliminate the used and useful and matching problems. Because of these problems, the Commission cannot approve the inclusion of future plant in rates.

Even conceding the Company's argument that AAOs are a failed device, the fact remains that the Company received a significant increase in depreciation rates in its 1995 rate case and receives another increase in this case. In addition, the Company was allowed an amortization of the depreciation reserve deficiency in the 1995 case, and an additional amortization here. Just because the AAOs did not operate as Company hoped does not mean that it has not received favorable regulatory treatment that could have allowed it to begin to ramp up its infrastructure replacement program.

The Commission has authority to prescribe depreciation rates pursuant to Section 393.240.2, RSMo 2000. The Commission also has authority pursuant to that section to require a utility to place the moneys generated from depreciation rates into a separate fund and to prescribe the purposes for which they may be used. The Commission's favorable treatment of the Company's depreciation proposals will generate funds that can be used to begin to address infrastructure issues. The Company provided evidence that there is little need to restrict the use of funds received through depreciation rates since it "is investing every dime of its depreciation expense recoveries right back into plant." In fact, the Company has, since 1990, invested more money in plant than it has recovered in annual depreciation expense. Nonetheless, to ensure that these depreciation expense recoveries are used for main replacements, and to ensure that main replacements occur at the rate the Company believes is appropriate, the Commission will order the Company to set a certain level aside in a depreciation fund and to expend them only for main replacements. The Commission will require the Company to segregate depreciation expense recoveries in a depreciation fund sufficient to fund main replacements at the average level proposed by Company witness Salser in Schedule JES-1 to Exhibit 47.

4.B. Should the Company be required to maintain a cost allocation manual and certain other information and reports concerning expenses charged to the Company by the American Water Works Service Company?

The Commission agrees with Public Counsel that there should be information available for interested entities and the Commission to evaluate the costs the Company is allocated from AWWSC. The CAM described by Mr. Dittmer will be a very effective tool in this evaluation, and the Commission will order the Company to prepare and maintain such a CAM.

The Company points out that the Commission considered establishing affiliate transaction rules for the water industry, but decided against it. It argues that the Commission's decision not to implement these rules means that it should not require the Company to maintain a cost allocation manual. This argument has little merit. Simply because the Commission found no need to impose affiliate transaction rules on the water industry as a whole does not mean that there is no reason to be concerned about the Company's transactions with its affiliates. The Company's argument that the approach taken in Public Counsel's proposed CAM is different than the approach taken in the Commission's affiliate transaction rules is similarly misplaced. The focus of the CAM ordered here is much narrower than the rules; it is designed to provide information about the allocation of costs from a service-company affiliate. Finally, the Commission is unpersuaded by the Company's claims that the CAM will be costly and time-consuming to produce since the Company did not quantify either the time or the cost.

Pending Matters

On November 17, 2000, Public Counsel filed a motion for leave to late-file the direct testimony of its witness Dittmer. No party opposed that motion and it will be granted.

On January 16, 2001, the Staff filed a motion for leave to late-file the proposed list of issues. No party opposed that motion and it will be granted.

On January 29, 2001, the parties filed a Stipulation and Agreement as to Rate Design. Although the agreement was not unanimous, no party opposed it and the Commission will treat it as unanimous pursuant to 4 CSR 240-115. The Commission finds the agreement to be reasonable and will approve it.

On April 5, 2001, Staff filed a motion for leave to late-file its brief. No party opposed that motion and it will be granted.

IT IS THEREFORE ORDERED:

1. That the tariff sheets filed by St. Louis County Water Company d/b/a Missouri-American Water Company on June 23, 2000, and assigned tariff number 200001199, are rejected.

2. That St. Louis County Water Company d/b/a Missouri-American Water Company is hereby authorized to file proposed tariff sheets in compliance with this Report and Order.

3. That St. Louis County Water Company d/b/a Missouri-American Water Company shall establish a depreciation fund as described herein.

4. That St. Louis County Water Company d/b/a Missouri-American Water Company shall establish depreciation rates in compliance with this Report and Order.

5. That the motion for leave to late file the direct testimony of its witness Dittmer filed by the Office of the Public Counsel on November 17, 2000, is granted.

6. That the motion for leave to late file the proposed list of issues filed by the Staff of the Commission on January 16, 2001, is granted.

7. That the Stipulation and Agreement as to Rate Design filed on January 29, 2001, is approved.

8. That the motion for leave to late file its reply brief filed by the Staff of the Commission on April 5, 2001, is granted.

9. That all motions not previously ruled upon by the Commission in this case are hereby denied, all objections not previously ruled upon are hereby overruled, and all evidence the admission of which was not specifically denied is admitted.

10. That this order shall become effective on May 13, 2001.

BY THE COMMISSION

Dale Hardy Roberts

Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge

(S E A L)

Lumpe, Ch., Simmons and Gaw, CC., concur;
Drainer and Murray, CC., dissent, with attached
dissenting opinion of Murray; certify compliance
with the provisions of Section 536.080, RSMo 2000.

Dated at Jefferson City, Missouri,
on this 3rd day of May, 2001.

ALJ/Secretary: Mills/Boyce

5-1
Date Circulated

WR-2000-844
CASE NO.

p57, 13?, 14?, 30, 24, 27? (15+R)
Lumpe, Chair

2
Drainer, Vice Chair

NO Dissent to attached
Murray, Commissioner

KS p13
Simmons, Commissioner

Gaw, Commissioner

5-3
Agenda Date

Action taken: 3-2 AA

Must Vote Not Later Than

STATE OF MISSOURI

OFFICE OF THE PUBLIC SERVICE COMMISSION

I have compared the preceding copy with the original on file in this office and I do hereby certify the same to be a true copy therefrom and the whole thereof.

WITNESS my hand and seal of the Public Service Commission, at Jefferson City, Missouri, this 3rd day of May 2001.

Dale Hardy Roberts

Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge