

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



In the Matter of the Application of Missouri-
American Water Company for a Certificate of
Convenience and Necessity to Lease, Operate,
Control, Manage and Maintain a New Source of
Supply in Andrew County, Missouri.)

) **Case No. WA-97-46**

In the Matter of the Application of Missouri-
American Water Company for Authority (1) to
Enter into and Perform in Accordance with the
Terms of a Facility Lease Agreement for the
Purpose of Financing the Construction and
Operation of a Well Field, a Treatment Facility
and Associated Transmission Water Pipelines in
its St. Joseph, Missouri Service Area, (2) to
Mortgage the Leasehold Property and (3) to
Enter into and Perform in Accordance with
Related Agreements.)

) **Case No. WF-97-241**

REPORT AND ORDER

Issue Date: October 9, 1997

Effective Date: October 21, 1997

OF THE STATE OF MISSOURI

Case No. WA-97-46

Case No. WF-97-241

APPEARANCES

Kathy L. Pape, 1025 Laurel Oak Road, Voorhees, New Jersey 08043, for Missouri-American Water Company.

W.R. England, III and Dean L. Cooper, Brydon, Swearingen & England, P.C.,
312 East Capitol Avenue, P.O. Box 456, Jefferson City, Missouri 65102, for
Missouri-American Water Company.

Leland B. Curtis, Curtis, Oetting, Heinz, Garret & Soule, P.C., 130 South
Bemiston, Suite 200, Clayton, Missouri 63105, for City of Warrensburg,
Missouri.

James M. Fischer, James M. Fischer, P.C., 101 West McCarty Street, Suite 215, Jefferson City, Missouri 65101, for Public Water Supply District No. 1 of Andrew County, Public Water Supply District No. 2 of Andrew County, Public Water Supply District No. 1 of DeKalb County, and Public Water Supply District No. 1 of Buchanan County.

John B. Coffman, Senior Public Counsel, Office of the Public Counsel, Post Office Box 7800, Jefferson City, Missouri 65102, for the Office of the Public Counsel and the public.

R. Blair Hosford, Assistant General Counsel, Missouri Public Service Commission, Post Office Box 360, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

ADMINISTRATIVE

LAW JUDGE: Joseph A. Derque III.

REPORT AND ORDER

History of the Case

On August 2, 1996, Missouri-American Water Company (MAWC) filed an application with the Commission requesting approval to engage in a transaction for the lease of property in Andrew County, Missouri, for the purpose of providing additional water supply to its St. Joseph, Missouri service area. MAWC also proposed construction of a new treatment facility and lines to transport the raw water from the adjacent water field to the new facility. In Case No. WF-97-241, MAWC filed an application with the Commission to provide for the financing of the proposed project through arrangements with Missouri Capital Resources Company which, like MAWC, is wholly-owned by American Water Works Company.

This matter was heard on July 7, 1997. In that hearing five issues were presented to the Commission, several of which were issues of first impression, including the consideration of the prudence of the proposed project to construct the well and treatment facilities.

This matter was heard and, after briefs and reply briefs, finally submitted to the Commission for decision on September 30, 1997.

Rulings on Motions at Hearing

Immediately prior to the hearing of this matter, the Commission made on-the-record rulings on three pending motions. Attorney Kathy Lee Pape, representing American Water Works Company and the applicant, MAWC,

was admitted without objection to practice before the Commission in this case as counsel *pro hac vice*.

A motion tendered by MAWC to strike the cross-surrebuttal testimony of the Office of the Public Counsel (OPC) witness Mark Burdette as being not responsive was denied. In that ruling the Commission found that, while some question existed as to the relevance and probative value of the testimony, the Commission found that the testimony was not strictly outside the scope of proper cross-surrebuttal.

A third pending matter involved a late-filed application for participation without intervention by Ag Processing. No objections to this application were tendered and Ag Processing was granted participation without intervention to the extent that Ag Processing was allowed to present an opening statement and file post-hearing briefs.

Settled Issues

In the Hearing Memorandum, filed at the evidentiary hearing as Exhibit No. 1, the parties set out various issues that have been settled. As contained in the Hearing Memorandum, those settled issues are:

1. That MAWC is financially and technically qualified to provide the proposed services.

2. That there is a need to replace and/or improve the existing source of supply and treatment facilities; and/or construct a new source of supply and treatment facilities; and/or secure a new independent source of supply in order to provide safe, adequate and reliable water service.

3. That Missouri Capital Resources Company (MCRC) is not a water corporation as defined by Section 386.020(51), RSMo, or a public utility as defined by Section 386.020(32), RSMo, and thus is not subject to regulation by the Commission.

4. That the company agrees to make available to the Commission, at reasonable times and places, all books and records and employees and officers of MCRC as provided under applicable law and Commission rules, provided that MCRC shall have the right to object to such production of records or personnel on any basis under applicable law and Commission rules.

5. That the percentage rent true-up provision of the facility lease agreement should be revised such that any adjustment in the percentage rent component of the lease payment will be forward-looking only and will not involve any adjustment for past over or under earnings experienced by MCRC.

6. That MAWC should be authorized to record on its books the facility lease agreement as an operating lease obligation of MAWC for accounting and ratemaking purposes. In that regard, MAWC should be authorized to book monthly rental payments required by the facility lease agreement to Account No. 604, Source of Supply - Rents, as an operating expense.

7. That the Commission should not make any finding in this case regarding ratemaking treatment of any costs or expenses associated with the proposed project or project financing. The Commission should reserve the right to consider the ratemaking treatment to be afforded these transactions and the resulting cost of capital in any future ratemaking proceeding.

The Commission finds the settled issues to be reasonable and will adopt those matters as they apply to the remainder of the Commission's decision in this case.

Findings of Fact

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact. The positions and arguments of all of the parties have been considered by the Commission in making this decision. Failure to reflect a piece of evidence, position or argument of any party in no way indicates that the Commission has failed to consider relevant evidence, but indicates only that the omitted matter was not considered relevant to the decision or outcome.

MAWC is a public utility regulated by the Commission, organized and existing under the laws of the State of Missouri, and engaged in the business of providing water service to the general public in various certified areas in the State of Missouri. The certified area in question in this matter is the MAWC service area in and around the City of St. Joseph, Missouri. That area does not include the proposed site of the MAWC water field and wells, nor does it include some of the right-of-way for the transportation pipeline proposed to be constructed and used to transport the raw water from the well fields to a treatment facility located within the current MAWC service area.

MAWC requests a certificate of convenience and necessity to lease property, construct and operate the well field and construct and operate a portion of the transmission pipeline from the well field to its proposed treatment plant. In the certificate case (WA-97-46) MAWC also asked for Commission pre-approval of the treatment plant project.

In addition, in Case No. WF-97-241, which is a request for approval of the financing for the project proposed in Case No. WA-97-46, MAWC requests approval of a financing arrangement with Missouri Capital Resources Company (MCRC), also a wholly-owned subsidiary of American Water

Works Company. It is proposed that the entire project will be financed with debt and equity issued by MCRC. MCRC will be the owner and lessor of the entire project, including the treatment facility. MAWC will construct the project through MCRC.

MCRC will purchase from MAWC the necessary real estate for the project and contract for the construction of the well field, raw and finished water lines and treatment facility. MCRC will then lease the project to MAWC under the terms of a facility lease agreement. MAWC will have complete responsibility for the operation and maintenance of the project. The facility lease agreement will be for an initial term of forty (40) years and will contain renewal and purchase options. Currently, the rental payments, among other things, are structured to generate the revenue required to amortize the project debt financing and to provide a return on the project investment over the term of the lease.

In regard to the proposed financing, MAWC seeks approval of the financing arrangements, which is referred to as "project financing," and approval of the current facility lease agreement, which provides for a 15 percent return on equity for MCRC.

The Commission will restate the issues presented to it as a result of the above proposals and determine the issues in this order:

1. Is it appropriate for the Commission to determine the prudence of the proposed project?
2. If so, is the project selected by MAWC reasonable and prudent?
3. Should the Commission approve the proposed financing arrangement?
4. Should the Commission approve a specific provision of the financing arrangement allowing a non-regulated affiliate of MAWC a 15 percent return on equity?

5. Should the Commission make a finding regarding rate design or single tariff pricing in this case?

Issues 1. and 2. Is it appropriate for the Commission to determine the prudence of this project and, if so, is the MAWC proposed project a prudent alternative?

In its testimony MAWC explains that it has determined that its existing production facilities in the St. Joseph service area are antiquated, difficult to maintain, unreliable and, therefore, in need of replacement. After study of various proposals, including the purchase of water from Kansas City, Missouri, and alternatives involving the rehabilitation and continued use of its existing facilities, MAWC chose what has been referred to as "the project." The project consists of the construction of a new groundwater site above the flood plain in Andrew County, Missouri. This site is also referred to as the well field. In addition, MAWC proposes to construct a new treatment facility above the flood plain of the Missouri River inside its service area in St. Joseph.

Finally, to connect the two facilities, MAWC proposes the construction of approximately 3 1/2 miles of transportation pipeline. Both the well field and most of the pipeline are outside the service area of MAWC, necessitating a certificate of convenience from this Commission. The parties agree that no certificate or other permission from the Commission is necessary to construct the treatment plant in MAWC's own service area.

However, the application for a certificate of convenience and necessity in Case No. WA-97-46 seeks a certificate of convenience and necessity for the entire project. Included in the application is a request that the Commission make a finding that there is a need for the proposed project and that the alternative selected by MAWC is the most appropriate and cost effective method of addressing this need. This type of finding

by a regulatory commission is generally referred to as a finding of prudence or project pre-approval.

MAWC argues that it is appropriate for the Commission to make such a finding. MAWC is of the opinion that such a finding is necessarily a part of a Commission determination that a project will promote the public interest. MAWC argues that all pertinent information is currently before the Commission and, therefore, the Commission may make an informed decision regarding the prudence of the alternative selected by MAWC and its projected cost.

The Staff is in agreement with MAWC in that the Staff supports both the position that it is appropriate at this time to review the prudence of the chosen alternative and that the chosen alternative is, in fact, a prudent alternative. In its argument the Staff recognizes the fact that the Commission has not, up to this time, predetermined the prudence of a proposed project, choosing instead to review both the management decisions and costs associated with such a project during the course of a subsequent general rate case or other appropriate proceeding. The Staff argues, however, that the most appropriate time to assess the prudence of management decisions is contemporaneous with the making of those decisions. The Staff states that an added advantage to contemporaneous review is that the information at hand has not been ". . . influenced or skewed by hindsight based on intervening factors" The Staff supports what may be referred to as a limited decision of prudence in that the Staff urges the Commission to approve only the project alternative selected and not the actual costs incurred or management of the construction of the project.

The OPC maintains that pre-approval, or prudence review, of the proposed project is neither in the public interest nor legally authorized. The OPC points out that the bifurcation of prudency review is not a viable

alternative as, from a practical standpoint, the cost-effectiveness of a project would be, of necessity, an integral part of any finding regarding the prudence of the project. The OPC adds that review of the technical management decisions of a utility would amount to the Commission taking on a management and planning role. The OPC maintains that it is not the responsibility of the Commission to control management decisions of the utilities it regulates. The OPC prefers the Commission retain the traditional method of examining utility practices, management decisions, and expenditures after the project has been placed in service and as a part of a general rate proceeding.

The remainder of the parties have no comments on the first two issues.

All parties agree that the Commission need only issue a certificate of convenience and necessity for that portion of the proposed project to be located outside the current MAWC service area. Authority exists supporting the position that the Commission may not legally take any further action regarding the pre-approval of the proposed project. In State ex rel. Capital City Water Co. v. Public Service Commission, 850 S.W.2d 903 (Mo.App. W.D. 1993) the Court stated:

"The Commission's principal interest is to serve and protect ratepayers, State ex rel. Crown Coach Co. v. Pub. Serv. Comm'n, 238 Mo.App. 287, 179 S.W.2d 123, 126 (1944), and as a result, the Commission cannot commit itself to a position that, because of varying conditions and occurrences over time, may require adjustment to protect the ratepayers, State ex rel. Chicago, Rock Island & Pacific Railroad Co., 312 S.W.2d at 796."

and in re Union Electric Company (Callaway Nuclear Plant), 27 Mo. PSC (N.S.) 183, the Commission states:

". . .the appropriate time for the Commission to inquire regarding the prudence of a capital improvement project is a rate case in which a utility attempts to recover the associated costs of such a project . . ."

In the regulation of monopoly providers, one of the basic functions of this Commission is to stand in the stead of competition. The Commission performs this function principally in the context of a rate proceeding, authorizing recovery through rates of only those costs which were prudently incurred, that is to say spent as if the utility were operating in a competitive environment. This places a proper amount of risk on the regulated utility to manage its decisions and funds as if it were in a competitive environment. The Commission finds that pre-approval of the actual costs incurred and the management of construction of the proposed project would upset this balance.

The Commission is reluctant to assume the role of utility management in the decision-making process. This is true for large projects such as this one and for decisions made on a day-to-day basis. The Commission stated in order of rulemaking, December 4, 1992, Case No. EX-92-299, as follows:

In reviewing this matter, the Commission has considered numerous factors and arguments, both in favor and against initiation of plan pre-approval, and has substantial concerns regarding several key issues. First, serious statutory and precedential issues exist as to the Commission's authority to engage in what may be termed single-issue ratemaking, the preallocation of costs, and the granting of a presumption of prudent action by utility management. Secondly, the Commission is wary of assuming, either directly or in a de facto fashion, the management prerogatives and responsibilities associated with strategic decision making, preferring to allow utility management the flexibility to make both overall strategic planning decisions and more routine management decisions in a relatively unencumbered framework.

Therefore, the Commission will make no finding regarding the prudence of the actual costs incurred and the management of construction of the proposed project. However, based on the extensive evidence presented, the Commission finds that the proposed project, consisting of

the facilities for a new groundwater source of supply and treatment at a remote site, is a reasonable alternative,

The Commission will limit its issuance of a certificate of convenience and necessity to that portion of the proposed project located outside the certificated area of MAWC. The Commission finds that issuance of that certificate to be in the best interest of the public.

Issues 3. and 4. Should the Commission approve the use of project financing and/or the facility lease agreement which provides for a 15 percent return on equity for MCRC?

In consolidated Case No. WR-97-241, MAWC has asked the Commission to authorize MAWC to engage in what the parties refer to as "project financing." This proposal employs a non-regulated affiliate, MCRC, as a special purpose corporation to form and own the project facilities, including the well field and treatment plant. MAWC proposes to lease the project facilities from MCRC under a facility lease agreement for a minimum term of 40 years. MAWC will have responsibility for the operation and maintenance of the facilities after the lease is executed. The facility lease includes a provision for a 15 percent guaranteed return to MCRC over the life of the lease.

MAWC explains that this type of financing permits the greater use of leverage in the capital structure of the company, producing a substantially greater amount of debt and less equity. This reduces the overall cost of capital from that which would be typical in a utility financing. Testimony shows that the resulting debt/equity ratios would be 60%/40% for traditional financing and 80%/20% for project financing, respectively. This produces an overall rate of return on capital of 8.20 percent for traditional financing and 7.80 percent for project financing. MAWC explains that it has chosen this method of financing to mitigate the rate impact for its customers from the project.

MAWC has requested the Commission approve the use of project financing and, in addition, specifically approve the provision for a 15 percent return in the lease agreement.

The Staff notes that this type of proposed financing creates a reliable cash flow to finance the construction of the project. The Staff agrees that this proposal will likely mitigate the resulting rate impact. The Staff supports Commission approval limited to the form of the financing and the general form of the lease agreement. The OPC agrees with the Staff and adds that this is all that is legally required of the Commission. The OPC thinks it inappropriate to guarantee a return to an affiliate which is substantially higher than the OPC and Staff witnesses think is reasonable. Staff and OPC urge the Commission to approve only that which is legally required and to avoid a finding that the proposed project financing is prudent and that the 15 percent return in the lease is an appropriate return for MCRC.

The Commission finds that the proposed financial transaction complies with the pertinent statutory and regulatory requirements and, in particular, the provisions of Section 393.200, RSMo 1994. The Commission determines that it is necessary only to find that the proposed financial transaction, including the form of the lease arrangement, is reasonably necessary to accomplish the construction and operation of the proposed project. Nothing more is authorized by statute. In addition, the Commission is of the opinion that the 15 percent return provision in the lease agreement, if it is appropriate at all, should properly be taken up in the context of a general rate case. This would enable the parties and the Commission to gain access to sufficient information to make a determination as to what a fair and just return might be. Regardless, the Commission would make it clear that any return paid by MAWC to MCRC will

be subject to review by the Staff, OPC and any other interested party in the context of any future rate proceeding.

The Commission finds the proposed financial transaction to be reasonable and not detrimental to the public interest. The Commission will approve the financial transaction and form of the lease agreement but defer to a future rate proceeding any finding regarding the prudence of the transaction, its costs and the specific contents of the lease agreement.

Issue 5. Should the Commission approve single tariff pricing for the MAWC service area?

This issue was raised by the City of Warrensburg (City) and the water districts (water districts) intervenors. The City believes that the Commission should be made aware of the potential rate impact on all ratepayers in the MAWC Missouri service area that are projected to result from the cost of the proposed project.

In providing for the cost of the project in rates, two rate theories have been suggested, those being "single tariff pricing" in which the cost of the project is borne equally by all ratepayers in the entire Missouri service area of the company, and "stand alone pricing" in which the cost of the project is borne only by the ratepayers in the St. Joseph service area.

It is pointed out by the intervenors that only the St. Joseph area ratepayers are causing the costs associated with the project and gaining the resultant benefit from the project. The City wishes the Commission to make clear at the outset of this project that the costs will be assessed only to the St. Joseph area ratepayers.

Both MAWC and the water districts also believe it is reasonable to consider the potential rate impact of the project at this juncture. MAWC and, to a lesser extent, the water districts support the position that the rate impact of the project should be spread over the entire MAWC rate

base through single tariff pricing. It is the concern of the water districts that the customers of MAWC, and particularly those in the St. Joseph area, have not been fully and properly informed of the anticipated rate impact of the project. The water districts are of the opinion that, while an anticipated 34 percent increase in rates through single tariff pricing is substantial, it would certainly be more palatable to the customers in the St. Joseph area than an anticipated 105 percent increase through stand alone pricing.

The Commission has considered the various positions of the parties on this issue and understands the various concerns regarding who might bear the ultimate cost of the proposed project and how much of it they should rightfully bear. Ultimately, however, the Commission finds that this issue is one involving rate design and should be considered in the context of a rate proceeding in which all factors which influence rates and rate design may be considered as a whole. Therefore, the Commission will make no finding in this case regarding this issue.

Conclusions of Law

The Missouri Public Service Commission has arrived at the following conclusions of law:

That Missouri American Water Company is a public utility engaged in the provision of water service in the State of Missouri and therefore subject, generally, to the jurisdiction of the Missouri Public Service Commission pursuant to Chapters 386 and 393, RSMo 1994.

The Commission has authority under Section 393.170, RSMo 1994, to grant permission and approval to construct and operate the instant pipeline and water field as part of the Missouri American Water Company's franchised service territory if, after hearing, the Commission finds that the franchise is necessary or convenient for the public service.

Authority exists supporting the position that the Commission may not legally take any further action regarding the pre-approval of the proposed project. In State ex rel. Capital City Water Co. v. Public Service Commission, 850 S.W.2d 903 (Mo.App. W.D. 1993) the Court stated:

"The Commission's principal interest is to serve and protect ratepayers, *State ex rel. Crown Coach Co. v. Pub. Serv. Comm'n*, 238 Mo.App. 287, 179 S.W.2d 123, 126 (1944), and as a result, the Commission cannot commit itself to a position that, because of varying conditions and occurrences over time, may require adjustment to protect the ratepayers, *State ex rel. Chicago, Rock Island & Pacific Railroad Co.*, 312 S.W.2d at 796."

and in re Union Electric Company (Callaway Nuclear Plant), 27 Mo. PSC (N.S.) 183, the Commission states:

". . .the appropriate time for the Commission to inquire regarding the prudence of a capital improvement project is a rate case in which a utility attempts to recover the associated costs of such a project . . ."

Orders of the Commission must be based on substantial and competent evidence, taken on the record as a whole, and must be reasonable, and not arbitrary, capricious or contrary to law. In this regard, the Commission has considered all relevant substantial and competent evidence in this matter and determines that the granting of a certificate of convenience and necessity to Missouri American Water Company, as modified by the Commission in this Report and Order, is in the public interest and necessary and convenient for the public service.

That Section 393.200, RSMo 1994, provides that the Commission may approve a financial transaction upon a finding by the Commission that the purpose of the proposed indebtedness is reasonably required for the purposes as set out in this Report and Order. In addition, to grant approval, the Commission must find that the proposed transaction has no detrimental impact on the ratepayers.

The Commission finds that the proposed transaction is reasonably required for the purposes as described in this Report and Order and that the proposed transaction is not detrimental to the ratepayers. The Commission will approve the proposed financial transaction, referred to as "project financing" and the associated lease agreement with an affiliate company. In doing so, the Commission makes no finding as to the prudence of either the financial transaction or lease agreement and further makes no finding as to the value for ratemaking purposes or the ratemaking treatment to be afforded this financial transaction and lease in any later proceeding.

IT IS THEREFORE ORDERED:

1. That Missouri American Water Company is hereby granted a certificate of convenience and necessity for the purpose of constructing and operating a well field and transportation pipeline outside its current service area, as described in this Report and Order.

2. That Missouri American Water Company is hereby authorized to enter into, execute and perform a financial transaction as set out in this Report and Order and in its application in Case No. WF-97-241, and to do any and all other things as may be necessary in performance of acts in furtherance of the above financial transaction.

3. That MAWC is ordered to file tariffs reflecting its new St. Joseph service area, together with a map and metes and bounds description within 30 days of the effective date of this order.

4. That MAWC is ordered to file a copy of all documents relating to the financial transaction and lease upon completion of the financial transaction and lease.

5. That nothing in this Report and Order shall be considered a finding by the Commission of the prudence of either the proposed construction project or financial transaction, or the value of this

transaction for ratemaking purposes, and the Commission reserves the right to consider the ratemaking treatment to be afforded the proposed construction project and financial transaction and their results in cost of capital in any future proceeding.

6. That this order shall become effective on October 21, 1997.

BY THE COMMISSION

A handwritten signature in black ink, appearing to read "Cecil I. Wright", with a stylized flourish at the end.

**Cecil I. Wright
Executive Secretary**

(S E A L)

Lumpe, Ch., Crumpton, Murray,
and Drainer, CC., concur.

Dated at Jefferson City, Missouri,
on this 9th day of October, 1997.

ALJ/Sec'y: Dergue/Boyce
9-29 WA-97-46
Date Circulated WF-97-241
CASE NO.

Zobrist, Chairman

Crumpton, Commissioner

cm, 23, 5, 8, 9, 10, 13
Murray, Commissioner

Lumpe, Commissioner

Drainer, Vice-Chair

10/7
Agenda Date

Action taken: 4-0 A A

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 9th day of October, 1997.

Cecil I. Wright
Cecil I. Wright
Executive Secretary