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August 2, 2000

FILED[2]

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Missouri Public
Service Commission

Mr. Dale Hardy Roberts
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

**RE: Missouri-American Water Company - Consolidated Case Nos. WR-2000-281 and SR-2000-282**

Dear Mr. Roberts:

Enclosed for filing in the above-referenced proceeding please find an original and eight copies of MAWC's Reply Brief. Please stamp the enclosed extra copy "filed" and return same to me.

Thank you very much for your attention to this matter.

Sincerely,

BRYDON, SWEARENGEN & ENGLAND P.C.

By: Dean L. Cooper

Dean L. Cooper

DLC/rhg
Enclosures
cc: Office of the Public Counsel
Mr. Keith Krueger
Ms. Shannon Cook
Ms. Diana M. Vuylsteke
Mr. Karl Zobrist
Mr. Leland Curtis
Mr. Brent Stewart
Mr. James Duetsch
Mr. Joseph Moreland
Mr. Stu Conrad
Mr. Louis Leonatti
Mr. Jim Fischer
Mr. Jeremiah Finnegan

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

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|---|---|---|
| In the Matter of Missouri-American Water Company's Tariff Sheets Designed to Implement General Rate Increases for Water and Sewer Service provided to Customers in the Missouri Service Area of the Company. | ) ) ) ) ) ) | Case No. WR-2000-281<br>Case No. SR-2000-282 |

# MISSOURI-AMERICAN WATER COMPANY'S

# REPLY BRIEF


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**MISSOURI-AMERICAN WATER COMPANY**
**CASE NO. WR-2000-281**
**CASE NO. SR-2000-282**

# REPLY BRIEF

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## I. INTRODUCTION

**COMES NOW** Missouri-American Water Company ("MAWC" or the "Company") and, in reply to the initial briefs filed in this case, states as follows to the Missouri Public Service Commission ("Commission"):

Initial Briefs were filed in this matter by the Commission Staff ("Staff")[1]; the Office of the Public Counsel ("OPC")[2]; Ag Processing Inc, a cooperative, Friskies Petcare, a division of Nestle USA, and Wire Rope Corporation of America Inc. (collectively, "St. Joseph Industrial Water Users") and the City of Riverside ("Riverside")[3]; Public Water Supply District Nos. 1 and 2 of Andrew County, Public Water Supply District No. 1 of DeKalb County, and Public Water Supply District No. 1 of Buchanan County (collectively, "St. Joseph Area Water Districts")[4]; City of Warrensburg, City of Joplin, City of St. Peters, City of O'Fallon, City of Weldon Spring, St. Charles County, Central Missouri State University, Hawker Energy Products, Inc., Stahl Specialty Company, and Swisher Mower and Machine Company (collectively, "Municipal & Industrial Intervenors") and the City of Joplin ("Joplin")[5]; and the City of St. Joseph ("St. Joseph")[6].

MAWC will respond to each of these initial briefs where it believes it is necessary to clarify and further explain its position. Failure to respond to any individual matter raised by another party should not be taken as acquiescence in such matter. Rather, it indicates that MAWC believes it has

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1 Referred to herein as "Stf. Brf."

2 Referred to herein as "OPC Brf."

3 Referred to herein as "SJ Ind. Brf."

4 Referred to herein as "Wat. Dis. Brf."

5 Referred to herein as "M&I Brf."

6 Referred to herein as "St. Joe Brf."

addressed this matter sufficiently in its Initial Brief, and that further argument would be redundant and unnecessary.

## II. ST. JOSEPH TREATMENT PLANT AND RELATED FACILITIES ("SJTP")

### A. VALUATION. WHAT VALUATION SHOULD BE INCLUDED IN RATE BASE FOR THE WATER TREATMENT PLANT AND RELATED FACILITIES NECESSARY TO PROVIDE WATER FOR THE ST. JOSEPH DISTRICT?

### B. CAPACITY. WHAT IS THE APPROPRIATE CAPACITY FOR SJTP THAT SHOULD BE INCLUDED IN RATE BASE?

The St. Joseph Industrial Water Users, OPC and Staff addressed these issues in their initial briefs. MAWC will first address the assertions made by the parties concerning the legal standard to be applied by the Commission. It will then separately address the St. Joseph Industrial Water Users, OPC and Staff briefs.

**Legal Standard**

There are two aspects of the valuation issue that turn on the legal standards to be applied rather than the facts adduced at hearing. First, the burden of proof regarding prudence is not automatically on the Company as has been alleged; and second, there is related law that indicates the Commission's previous finding that the new plant was a "reasonable alternative" is equivalent to a finding of "prudent choice."

St. Joseph Industrial Water Users state at page 16 of their Brief that, "Prudence, by the way, is MAWC's burden to prove. It is not St. Joseph Industrial [Water Users'] burden to prove that MAWC's choices were imprudent; rather, it is MAWC's burden to prove that they were." It is not be that simple. In fact, a utility's costs are presumed to be prudently incurred until some party raises "serious doubts" about the presumption.

This point (hereinafter quoted) was observed by the Missouri Commission in the Callaway case:

> A utility's costs are presumed to be prudently incurred. However, the presumption does not survive a showing of inefficiency or improvidence... As the Commission has explained, utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent... However, when some other participant in the proceeding raises a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent.

*Re: Union Electric Company (Callaway Nuclear Plant)*, 27 Mo. P.S.C. (N.S.) 166, 193, Case No. EO-85-17, (January 4, 1985).

The arithmetically unsupported accusations of OPC and St. Joseph Industrial Water Users do not rise to the necessary level of casting "serious doubt." The burden of proof has not shifted to the Company in this case.

In the same case the Commission defined prudence using a reasonable care standard which it described as follows:

> The company's conduct should be judged by asking whether the conduct was <u>reasonable</u> at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, <u>our responsibility is to determine how reasonable people would have performed the tasks that confronted the company</u>... The Commission will not rely on hindsight. The Commission will assess management decisions at the time they are made and ask the question, "Given all the surrounding circumstances existing at the time, did management use due diligence to address all relevant factors and information known or available to it when it addressed the situation?"

(*Id.* at p. 194) *(emphasis added).*

MAWC has met any burden of proof that might be legally applied to it regardless of whether it is imposed in the first instance or in response to a shifted burden by the raising of "serious doubt."

The Company has presented a Commission finding of "reasonableness," a Feasibility Study, and two litigated case files of prepared testimony, schedules and transcripts. This is as opposed to presentations by OPC and St. Joseph Industrial Water Users that lack sufficient competent and substantial evidence to support *any* finding of costs, and certainly any possible finding of lower relative costs for the not-selected alternative. Additionally, no evidence was presented that the new plant was managed or constructed imprudently.

But this burden of proof argument is not the legal point that is most persuasive in the determination of prudence in this case. The even more important point is what the courts (and the Commission in the *Union Electric* case cited above) have described to be the significance a "reasonable" action in relation to the issue of "prudence." Justice Brandeis discussed the presumption-of-prudence issue which he saw as a constitutional safeguard that protects a utility's right to be free of confiscatory rates under the due process clause of the Fifth and Fourteenth Amendments to the United States Constitution, but in doing so described the relevance of the word "reasonable":

> The term "prudent investment" is not used in a critical sense. There should not be excluded, from the finding of the base, investments which under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown.

*Southwestern Bell Telephone Company v. Missouri Public Service Commission*, 262 U.S. 276, 290, 43 S. Ct. 544, 547, concurring opinion n. 1 (1923) (emphasis added). See also *West Ohio Gas Company v. Public Utilities Commission*, 284 U.S. 63, 55 S. Ct. 316, 79 L. Ed. 761 (1935).

The building of a facility which the Commission has found to be a "reasonable alternative," and that OPC's expert witness described as "the most reasonable alternative,"[7] must be, using Justice Brandeis' standard, an "investment which under ordinary circumstances would be deemed reasonable."

**St. Joseph Industrial Water Users**

St. Joseph Industrial Water Users suggest that the Company's motive to build the new plant was to make more money. They suggest at page 4 of their brief that the decision to build the new plant was "driven" by the "function of the regulatory environment which creates an incentive for a public utility to invest in utility plant to counter the effects of depreciation on its rate base previously installed."

This is naive and incorrect in at least three respects: First, water companies are massively capital intensive; there is no shortage of places to invest, and in fact the need for capital investment in infrastructure and other plant is insatiable. Second, investment is supported by relative parts of debt and equity investment, both of which must be serviced with interest or return. To argue that any investor makes more money on his or her investment due to new investment, is simply incorrect. The attainable return on equity is effectively set by the Commission in the ratemaking process, and it does not grow due to the amount of investment. In fact, because of attrition/lag in the ratemaking process, an individual investor's equity return shrinks between cases. Third, if this incentive to invest were true, Staff witness Merciel would not state, "Well, there -- there isn't much. The truth is, we don't see much overbuilding in the water industry. We have more problems getting companies to do what they need to do rather than try to hold them back any." (Tr. 1535).

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[7] Public Counsel's own expert witness Gary Lee of Archer Engineering in Kansas City stated in Commission Case No. WA-97-46 that building the new ground water plant was "the most reasonable alternative of the alternatives analyzed by the Company." (Tr. 300, Case No. WA-97-46).

St. Joseph Industrial Water Users base their entire case on cost estimates. They argue that "MAWC never produced any detailed cost estimate...constituting an engineering study that actually compared the cost of one alternative to the other," and "...there is no detail ...that makes or even attempts a comparison or comparative evaluation of solid costs." (SJ Ind. Brf., p.14). This focus on their word "detail" is virtually the entirety of their position.

There are many ways to respond to this focus on the term "detail" as it applies to the cost estimates in this case:

1. Estimates are not perfect by definition. Cost estimates are, by their nature, not exact. Dr. Morris acknowledged the legitimacy of the American Waterworks Association book on Water Treatment Plant Design. It tells us that preliminary estimates vary by up to 45%. (Tr. 1873). The potential variance is highest at the conceptual stage, before design is begun.

2. <u>Pre-design estimates cannot be "detailed."</u> All of the estimates in this case, excepting only the 1993 Gannett Fleming construction cost estimate, are very early, pre-design estimates. The 1993 estimate is more detailed because it was in the early stages of actual design. To the limited extent the 1993 design was not changed, those numbers survived in the feasibility comparisons.

None of the other comparisons ever reached the design stage. It would have been impractical to expend the time and money necessary to actually design all the alternatives that were not proving to be competitive in pre-design. This is, for example, the reason the Company never invested in pricing flood protection at the old plant.

It is appropriate to observe that one can determine that alternatives will not likely be competitive without detailed design. That is how feasibility study comparisons have to be done. The estimating process was validated when the new plant was actually built, and was completed within the budgeted numbers shown in the 1996 Feasibility Study comparisons.

3. Dr. Morris' and Mr. Biddy did not provide detail of their estimates. Even the estimates of Mr. Biddy and Dr. Morris themselves are nothing other than broad round numbers without any detail whatsoever. This is for the same reasons set forth above. They did not have the time or resources to undertake actual design. Mr. Biddy's and Dr. Morris' estimates are less detailed than the Company's estimates, even though they purport to price individual facilities. Unfortunately, this pricing was valueless because they both used only a combination of "engineering judgment" and copying the wrong numbers from the Company's cash flow statements. Proof of this can be seen in Dr. Morris' workpaper. (Ex. 91). It hardly constitutes "detail."

4. The 1991 estimate preferred by intervenors has **no** detail. Interestingly, both OPC and St. Joseph Industrial Water Users seize on the 1991 estimate and find it to be acceptable, although it has very little detail. It appears to be acceptable to them only because it produced a number that they prefer.

5. The 1993 detail by itself is functionally obsolete. Following the much-touted 1993 Gannett Fleming construction cost estimate, significant changes to the proposed project were deemed necessary. All of these changes are completely discounted as unneeded "extras" by OPC and St. Joseph Industrial Water Users. On the contrary, the following supposed "extras" that were added to the Gannett design are critically necessary and are not conveniences:

- Ozone is necessary for disinfection byproduct control and disinfection of cryptosporidium. (Merciel Reb., Ex. 49, p. 9; Young Reb., Ex. 17, p. 25, 39; Ex. 85, D.R. #4005, Question 7).
- An intake was needed that would be reliable in low water conditions, with ice, and in high water conditions. It would provide reliability with traveling screens to remove logs and debris from river water. (Young Reb., Ex. 17, p. 16).
- Replacement of electrical switchgear was absolutely necessary. The old switchgear was 45 years old with parts that are no longer available. (Ex. 85, D.R. #4005, Question 7).
- A third pre-sedimentation clarifier was necessary to provide reliability in removing sand and silt prior to the Superpulsators. (Ex. 85, D.R. #4005, Question 4; Young Reb., Ex. 17, p. 16).
- And finally, there was an obvious need for an access road during flooding conditions. Remember, no other flood protection was ever priced in the Company's estimates. (Young Reb., Ex. 17, p. 29, 33).

The above items were not proposed in the first stage of improvements but would have been prioritized for subsequent construction to provide for a reliable facility. It is certainly appropriate to include these items when comparing a new water plant alternative.

Arguing that the 1991 estimated project or the 1993 estimated project should have been adequate is simply wrong. The critical difference between the Company's decision-making and the criticisms from Dr. Morris and Mr. Biddy is that these men are not responsible for providing safe and reliable water service.

6. The Feasibility Study did not concentrate on defending individual facility costs. The cash flow schedules in the Feasibility Study do not itemize the per-item facility costs because that is not the reason they were prepared. They form part of an intricate evaluation of the ramifications of the available choices. This evaluation focuses on revenue projections that depend on present value calculations, cash flow requirements and projected operating costs. The Company evaluated four main alternatives with several variations for each. How would anyone guess that the focus of contest, after-the-fact, would be on speculation about detailed design costs for one of the alternatives examined?

7. Why now and not in 1996? If the individual facility costs in a renovation are now the only critical focus of all the study conclusions, they should have been equally critical in 1996, when the parties to Commission Case No. WA-97-46 had the same Feasibility Study before them in a formal proceeding. And, if OPC and the St. Joseph Industrial Water Users believe that the Company has inflated or otherwise improperly attributed costs to these individual elements of the project, why did not OPC and the St. Joseph Industrial Water Users prove that by procuring independent pricing of the facilities? Instead, they simply "made-up" numbers using purported "engineering judgment" and added them to the wrong numbers they "lifted" off of the cash flow statements.

The Company used actual construction costs from other projects for several of the large additional items, such as the estimates for ozone and intakes, which is far more reliable than what Dr. Morris and Mr. Biddy did. The bottom line is that these criticisms were no where to be found in 1996. Nothing has changed since then.

Instead of criticizing the detail in the study, OPC's witness in Commission Case No. WA-97-46 was able to use the same data to make a determination of what the "most reasonable alternative" would be.

8. Health and Safety should be driving this issue. Despite the legitimate comparability of costs for renovation of the old plant compared to building the new ground water plant, public health and safety is the driving issue here. Since 1991, when renovation of the old plant was first contemplated, the country has seen the Great Flood of 1993 and the tragic 1993 Cryptosporidium outbreak in Milwaukee that resulted in deaths caused by surface water supply contaminants. Both events underscored the importance and vulnerability of water treatment plants.

Lack of cryptosporidium in ground water is a significant positive health and safety benefit as compared to surface water treatment. The natural cryptosporidium removal process provided by induced infiltration is much more reliable than operation of a conventional surface water treatment plant.

Since 1991, the United States Environmental Protection Agency ("USEPA") proposed in 1994, and subsequently finalized, the Interim Enhanced Surface Water Treatment Rule in 1994 and the Disinfection/Byproduct Rule. There has been no pause in the continued development of regulations by the USEPA, all focused on short term and long term health consequences of surface water contaminants, and not ground water. From the point of view of health and safety, the Company could be severely criticized if it had continued to treat the highly variable and contaminated Missouri River surface water supply when a ground water supply with acceptable quality and capacity was available.

After spending pages criticizing the Company's estimates for lacking detail, St. Joseph Industrial Water Users present what they call a "simple analogy" about the purchase of a new automobile. They suggest that the Company bought a Cadillac when a Chevrolet would do, and they accuse the Company of justifying the cost of the Cadillac by adding options to the Chevrolet until its price would have been higher than the Cadillac.

The analogy is conveniently inaccurate. First, no one has suggested by other than name calling that the new ground water plant is extravagant. There is no testimony as to what items should have been left out of the SJTP. That is because it is a completely functional facility, without bells and whistles. But more importantly, the more appropriate analogy would be the choice between the purchase of a new car versus the "shade tree" repair shop that attempts to convince you to make repairs to your old car instead of paying the price of a new car. The repair shop tells you that it doesn't matter that the old car has hundreds of thousands of miles on it, that it is obsolete and inadequate in the way it operates, that it produces both waste and product containing environmental concerns, that it doesn't operate in adverse weather, and lest we forget, **that it has been through a flood**. The repair shop tells you literally that they can make it as good as new! But this is the car on which the health and safety of your family depends. Your children depend on it for their very survival. Dr. Morris would tell us, "[t]he fact that a plant is old does not mean that it is worthless."(SJ Ind., p. 9). Mr. Biddy would tell us he could design a rehabilitation "up to and equal in every way to the New Plant..."(Biddy Sur., Ex. 20, p. 2.).

Completing the analogy, once the repair shop talks you into the repairs and cashes the check, the responsibility for that choice is yours. They go on to the next gullible, shortsighted person willing to cut corners, and your children bear the consequences of your decision. And, then, as St. Joseph Industrial Water Users say metaphorically at page 17 of their brief, "...**you really** need a car." (Emphasis theirs).

Finally, St. Joseph Industrial Water Users argue that import should be given to the fact that Dr. Morris and OPC witness Biddy came to similar renovation estimates independently. They state at page 34 of their brief, "Neither Dr. Morris nor Mr. Biddy consulted with each other at any time during this process. Indeed, the first time they met or spoke to one another was at the hearing itself." They even observe, "Given this, it is indeed remarkable that they arrived at virtually the same conclusion with respect to MAWC's work and the quality of its estimates." (SJ Ind., p. 34).

Maybe it is not so remarkable after all. The statement conspicuously says nothing about the exchange of information between the two parties through counsel. When counsel for St. Joseph Industrial Water Users objected to Company's evidence of 1993 numbers claiming that those numbers had not been provided to them, it was brought to their attention that their own witness, Dr. Morris, had, in fact, used the 1993 numbers in his own Direct Testimony (although he mischaracterized it as being a 1991 number). To do so, he obviously had to have had access to the number. Counsel responded as follows:

> Yeah. Well, it was attached to -- as it turns out, the report that he is referring to was attached as an exhibit to Mr. Biddy's – I believe his surrebuttal, which was filed essentially simultaneously, <u>and in advance of that there had been -- we had obtained some material.</u> Dr. Young [sic.] had, I think, been here at the Commission and had tried to obtain a copy of this after we found out that there was something apparently that was being referred to that we had not been provided with.

(Tr. 1139) (emphasis added).

If Dr. Morris had not been provided with the 1993 numbers by the Company, where did he get it? Even though there may have been no conversations between Mr. Biddy and Dr. Morris prior to hearing, that does not mean they did not have access to each others' work product, as the above quote would seem to indicate.

It should not go unnoticed, that despite St. Joseph Industrial Water Users position with respect to valuation which is similar to that of OPC, St. Joseph Industrial Water Users did not take the position that the new ground water treatment plant has any excess capacity.

**OPC**

OPC's brief is essentially a recitation of Mr. Biddy's testimony, but it completely ignores the evidence that was presented in the hearing. Most of Mr. Biddy's testimony was shown to be incorrect. Nevertheless, OPC's brief restates Mr. Biddy's completely discredited allegations (such as his insinuations about the beginning of the new plant construction in 1995 and the 1996 submission date of the Feasibility Study) as if the hearing never took place.

Like the St. Joseph Industrial Water Users, OPC relies on "spin." On the first page of its brief, OPC characterizes the Company's decision to build the new ground water plant as an, "...**abrupt** decision to switch gears toward the construction of an extremely expensive groundwater facility." The flood of 1993 was seven years ago. The Feasibility Study has been on the table for more than four years. In the hearing for Commission Case No. WA-97-46, OPC's contribution was to provide sworn testimony dated May 6, 1997 of Gary M. Lee that concluded with the characterization that building the new ground water plant was "the most reasonable alternative" of those reviewed by the Company. Now OPC would have the Commission believe that the new plant was the result of an "abrupt" change of which OPC was unaware?

The decision to build the new plant was painstakingly laid out before the Commission and OPC in Commission Case No. WA-97-46. OPC said nothing about the Company's cost elements being inadequate, or about its now-avowed preference that the old plant should have been rehabilitated. The new plant was hardly the result of "abrupt" anything. However, this is not the only instance of OPC mischaracterization. For example, consider the following:

1. The Commission's charge in this case is not accurately stated by OPC. It is not true as OPC says on page 7 of its brief that "The Commission is called upon in the instant rate case to make a...comparison between the cost of an alternative that Company management chose (building an expensive groundwater treatment facility) and the cost of a cheaper alternative for which Company management was aware when it made the decision (rehabilitating and upgrading an existing river treatment facility)." There is no evidence in this record from which the Commission could conclude that rehabilitation of the existing facility could be "cheaper." Because Mr. Biddy and Dr. Morris both based their rehabilitation estimates on numbers alleged to be the Company's *but which were only cash flow numbers and not facility cost numbers,* their conclusions are not supported. They do not rise to the level required by statute for Commission findings. They do not constitute competent and substantial evidence.

2. It is true as OPC says in page 9 of its brief that "The 1991 Report represented Company's best judgment at the time it decided to address the improvement of its water treatment in St. Joseph, Missouri." But it is not true, as OPC says in page 10 of its brief, that "This 1991 Report shows the most objective and reliable analysis of the upgrades that were actually needed in order to upgrade the existing river plant." The 1991 proposal was changed, even as early as 1993 (pre-flood), with increased building sizes driven by redefinition of chemical system improvements, the addition of an above ground clear well in lieu of the 1991 below-grade facility that proved to be not feasible due to a high groundwater table, changes to electrical work and instrumentation, and much better definition of yard piping, utilities, and other site

work than was available for the 1991 report. (Young Reb., Ex. 17, p. 12-13).

OPC witness Biddy himself abandoned the 1991 estimate by switching to the 1993 Gannett Fleming estimate. He said later that the 1993 estimate was, "...very detailed and included all construction necessary to upgrade the existing plant to 30 MGD capacity and state of the art condition." (Biddy Sur., Ex. 20, p. 9). Both the 1991 and 1993 estimates were pre-flood, and further changes were indicated by the time the Feasibility Study was prepared in 1995-96. It is absurd to argue at this point that either the 1991 or the 1993 project plans would have sufficed.

3. It is not true, as OPC states on page 12 of its brief, that "...a close reading of both letters and Missouri Department of Natural Resources ("DNR") Rule 10 CSR 60-10 reveals that the relocation of an existing plant is to be done only if such relocation outside the flood plain is practical and economical." OPC implies that DNR would require staying in the flood plain unless a move could meet the qualifications of being practical and economical. The rule works the opposite way. DNR mandates leaving the flood plain unless it is not practicable to move. The rule states as follows: "To the extent practicable, all new or expanded water systems must not be located on a site which—is subject to a significant risk from...floods... which could cause a breakdown of the public water system or a portion of the system." (Feasibility Study, Biddy Dir., Ex. 19, Sch. TLB-3). The Company is certain that it was both practicable and economic to move the plant; but it is inappropriate and misleading for OPC to misstate DNR preferences and mandates.

4. It is not true, as OPC states on page 16 of its brief with respect to the 1993 estimates that, "Gannett Fleming's total cost estimate for this project was

$26,630,000 ...." This statement exemplifies OPC's inability to grasp the difference between construction costs and total project costs. The Gannett Fleming numbers were for construction costs only, and did not include any other project costs such as design, engineering, construction supervision, omissions, community relations, permits, attorney fees, land acquisition, insurance, etc. (Young Reb., Ex. 17, p. 11-12, 28).

5. It is true, as OPC states in its brief at page 17, that "After adjustment for the time difference of costs, the Gannett Fleming estimate would be very close to the original 1991 Report total estimate of $22,600,000 for all upgrade facilities proposed at the existing plant." But the similarity of these numbers is coincidence, and nothing more. Not only are the two projects different in scope, but the 1991 amount was a project cost, and the 1993 Gannett Fleming number was a construction cost only number. There is no significance whatsoever to the similarity of the two numbers. And, one must not forget that neither number included all of the components ultimately determined to be necessary in the Feasibility Study comparisons. The 1993 cost estimate did not include an intake and low service pumps, a third presedimentation clarifier, ozone facilities, any flood protection costs, replacement of the distributive pumps, or the switchgear for the distributive pumps. (Young Reb., Ex. 17, p. 16).

6. It is not true, as OPC states on pages 18 and 19 of its brief, that the Company estimated $1.6 million for "temporary power and wasted water usage" in its renovation estimates. This is another transparent attempt to discredit the Company by seizing on an unused, obsolete number, and applying to it an absurd

characterization. First, no one ever testified that the $1.6 million was for temporary power and "wasted" water usage. Water Company expenses involve many aspects of project administration and construction. But more importantly, all of the costs OPC references on pages 18-19 of its brief are from the 1994 Comprehensive Planning Study ("CPS") numbers, and they did not flow through to final estimates. The Water Company expenses that were ultimately used in the Feasibility Study were spread equally to all alternatives including the new ground water plant in order to avoid unfairness. (Tr. 1419-20). MAWC witness Young explained that the same amounts of these costs are applied to the new ground water plant and the other alternatives that were applied to the renovation alternative. OPC is being specious with this characterization

7. Despite evidence produced at the hearing, OPC continues to intimate on page 19 of its brief that construction on the new plant began before completion of the 1996 Feasibility Study, and that this "casts serious doubt on Company's purported effort to make a meaningful comparison between the alternatives." OPC knows full well (because it was explained to OPC in the hearing) that the cost comparison part of the Feasibility Study was completed in 1995 and even bears on its face the date to that effect. The conclusions were known to the Company (and even discussed with its Board of Directors) before the final clerical date was affixed to the 1996 study. (Tr. 1420-21). OPC misstates the facts again.

8. It is true, as OPC states at page 25 of its brief, that the Commission found that the construction of the new ground water facility was a reasonable alternative, and did not find in Commission Case No. WA-97-46 that it was the "most reasonable

alternative" discussed. But Public Counsel's own expert witness Lee in that case said that building the new ground water plant was "the most reasonable alternative of the alternatives analyzed by the Company." He said *exactly* those words. (Tr. 300, Case No. WA-97-46).

9. OPC alleges that Company's estimates lack detail and then summarizes Mr. Biddy's estimates on pages 29 and 30 of its brief as though they are more detailed. Those numbers, however, are the total extent of Mr. Biddy's detail. Not only are several numbers incorrectly lifted from the Company's cash flow analyses (See Company's Initial Brief), but nowhere do we see what Mr. Biddy would price such things as design, engineering, construction supervision, omissions, community relations, permits, attorney fees, land acquisition, insurance, etc. OPC is guilty itself of that which it criticizes.

10. It is not true, as OPC states at page 32 of its brief, with respect to the new wells that, "It is not unreasonable to expect that several of these vertical wells may be out of service in every flood event. Floating limbs would be a constant hazard as they could easily reach the vertical well pumps and electrical switchgear and wreak havoc with these facilities." The flood risks of the old plant and the new wells are not comparable. As Mr. Biddy accurately said with respect to the old plant, "...obviously if the levees fail you're out of water." (Tr. 1745). The wells, on the other hand, were intentionally located on the river side of the levee and were not only designed by Black & Veach to have inherent structural defenses to debris vulnerability, but they are also aligned and independently connected so that if one should be damaged, the system can still operate to provide water for the health and

safety of the public. Remember, the wells produce source water only; the new treatment plant itself is out of the flood plain. All this is described in detail at pages 1280-83 of the transcript.

11. OPC further states that the Court in *State ex rel Capital City Water v. PSC*, 850 S.W.2d 903 (Mo. App. W.D. 1993) upheld the Commission's finding that the water company in that case had entered into an imprudent contract based upon a cost/benefit comparison of the terms of the contract to the cost of an alternative. (OPC Brf., p. 6). This is only half of the story. While the Court found that there was competent and substantial evidence to support a Commission finding that the contract was imprudent, the Court nevertheless <u>reversed</u> the Commission's decision because its quantification of the "costs" resulting from the imprudent contract contained two implicit assumptions which the Court found to be "flawed." As a result, the Court concluded that the Commission's quantification of the costs of the contract "simply does not make sense." (*Id* at p. 914). Interestingly, the flawed cost/benefit analysis adopted by the Commission in that case, was the one developed by OPC. The Commission should therefore take extra care as it considers OPC's proposal in this case. As with its analysis in the *Capital City* case, OPC's analysis in this case is based on flawed assumptions and simply does not make sense when examined in light of the record evidence.

12. And finally on the issue of valuation, OPC states on page 5 of its brief that the prevailing case on prudence in Missouri is the Union Electric Company Callaway Nuclear Plant case. OPC observes that in that case the Commission ordered a significant disallowance of new plant based upon imprudent management decisions.

But the analysis there was of costs incurred in the construction of a nuclear plant. No one argued in that case that the costs of the nuclear plant should be judged by what the cost of a coal-fired plant might have been. If the Company here is held to the same standard used in the Callaway case, the cost incurred in construction are clearly prudent as the new plant was, in fact, completed under-budget.

The issue of capacity should not be so controversial. The treatment plant has been designed to have a plant effluent capacity of 28.5 MGD. This key design criterion was set in late 1995 when design of the treatment plant was begun. It should be remembered that the maximum day demand of 25.62 MGD was experienced only four years earlier in 1991. Only three years before that, in 1988, the maximum day demand reached 24.39 MGD. (Young Reb., Ex. 17, Sch. JSY-16).

The Company's methodical and rigorous statistical evaluation of demands in the 1994 Comprehensive Planning Study showed a significant probability that maximum day demand of 25.81 MGD would be reached in a single near-term year (dependent on weather variables) and 27.7 MGD was likely at some year in the longer term. (Feasibility Study, Biddy Dir., Ex. 19, Sch. TLB-3). These demand projections were confirmed by OPC's expert witness Gary Lee in the Certificate Case in 1996. In that case, Mr. Lee recommended that the Company put in wells with 30 MGD capacity immediately, and that the entirety of that capacity be useable within thirty months. Thirty months would have expired before the date of the instant proceedings. (Tr.283-289, WA-97-46 (July 8, 1997)).

Maximum day demands have been depressed in the late 1990's due to unusual weather patterns. Hot and dry weather patterns will recur, and it is important that the new plant have adequate capacity to meet customer demands without putting customers at risk. Planning for major capital investment projects like water treatment plants requires more analysis than a casual review of recent maximum day demands. The Company's analysis looks at the relationship of maximum day demand to average day demand over a 15-year period. This type of statistical analysis results in facilities that better match customer demands through varying weather patterns than would a cursory review of only four or five years of recent data.

Mr. Biddy's recommendation for a 2 year planning horizon simply does not realistically recognize the time requirements for budgeting, design, permitting, and construction of major treatment and pumping improvements. It also does not recognize the economy of scale in the larger process units such as clarifiers. As cited in the Company's Initial Brief, Indiana recently rejected a 2-1/2 year planning horizon because it does not provide an adequate margin of safety. (MAWC Brf., p. 30). Missouri should not now buy into this type of short term planning horizon.

**Staff**

With respect to Staff's position on excess capacity, the exchange between Judge Thompson and Mr. Merciel is an excellent summary and synthesis of the problems of that position. Mr. Merciel said, "...I believe the Company could have provided service of 23 million gallons <u>with some peaks that exceed that...on rare occasions</u>." (Tr. 1595) (emphasis added). He is candidly recommending that a plant should have had a design capacity less than usage expectations.

When asked by Judge Thompson if he was "certain" that the additional capacity "will not be required in the very near future," Mr. Merciel responded that he was, but then said, "<u>It could change in a few years,</u> but today that's...that's the answer." (Tr. 1595) (emphasis added). Mr. Merciel is candidly suggesting that the Commission should find that it is appropriate to design a plant that will most certainly be required to operate beyond its capacity; and second, that the design planning horizon should apparently be less than "a few years."

We cannot overlook that the Company has been required to pump in excess of 23 MGD in 1983, 1988 and 1991. (Young Reb., Ex. 17, Sch. JSY-16). Nor can we overlook the unavoidable truth of Mr. Young's observation, "...[T]o operate a plant at a higher-than-approved rate, you're basically putting the public at risk for public health." (Tr. 1390).

**Conclusion**

If we learn anything from this experience, it should be that this is why prudence should be examined at the time decisions are being made rather than being sniped-at after-the-fact. What more could the Company have done to have avoided this attack?

The Commission should also be mindful of the message that this proceeding will send to other utilities. In a time of deteriorating infrastructure and growing environmental and health concerns, does Missouri really want to send a message that construction projects will be reviewed in the fashion suggested by the OPC and the St. Joseph Industrial Water Users? Here you have a Company that did everything it possibly could have to explain to the Commission and everyone else what it believed was necessary for the health and safety of the public, and even *asked for permission* to go forward. Many of the same parties objecting now were present then, and found no fault with a Feasibility Study that they now claim, four years later, has somehow become defective.

The unfortunate truth of the matter is that there are many disincentives for regulated utilities to invest. With a combination of conservative allowed returns and attrition due to regulatory lag, investment is frankly not as attractive as OPC and the Intervenors would have us believe. We should remember what Staff witness Merciel said: "Well, there -- there isn't much. The truth is, we don't see much overbuilding in the water industry. We have more problems getting companies to do what they need to do rather than try to hold them back any." (Tr. 1535).

This Company should not be punished for stepping up and doing the right thing to address the issues which existed in St. Joseph.

## III. RATE DESIGN

### A. SINGLE TARIFF, DISTRICT SPECIFIC OR COMPROMISE. SHALL MAWC'S RATES BE DESIGNED CONSISTENT WITH A "SINGLE-TARIFF" RATE DESIGN, "DISTRICT-SPECIFIC" RATE DESIGN, OR SOME OTHER METHODOLOGY?

#### 1. The Lawfulness of Single Tariff Pricing.

The Company believes that its Initial Brief (at pp. 57-61) clearly establishes the Commission's legal authority to implement uniform rates or single tariff pricing ("STP"). Indeed, it is significant to note that at least two of the opponents of STP (i.e. Staff and Public Counsel) also recognize the Commission's legal authority to adopt such a pricing mechanism. (*See* OPC Brf., p. 64; Stf. Brf., pp. 47-49). The St. Joseph Industrial Water Users and Riverside (sometimes collectively the "Indicated Intervenors") and Joplin and The Municipal and Industrial Intervenors (sometimes collectively the "Municipal Intervenors") nevertheless embark on a tortured interpretation of the law in an effort to convince this Commission that it has no legal authority to adopt single tariff pricing. It is those briefs, and the mischaracterizations contained therein, to which a reply is required.

The Municipal Intervenors begin their many mischaracterizations by saying that "the issue has not heretofore been presented to the Commission whether such single tariff pricing is authorized in Missouri..." (M&I Brf., p. 2). On the contrary, the legality of STP was raised in the Company's last rate case, Commission Case No. WR-97-237 and in the Company's Cost of Service case, Commission Case No. WO-98-204[8]. While the Commission may not have drawn any legal conclusions in either of those cases regarding its authority to implement single tariff pricing, the issue was clearly "presented" to the Commission. Moreover, the fact that the Commission implemented uniform rates in the Company's last rate case tends to indicate that the Commission believes it has the authority to implement STP for this Company.

The Municipal Intervenors also erroneously state that "there are no reported Missouri cases specifically authorizing STP or uniform rates. (M&I Brf., p. 6) (emphasis added). Again, the Municipal Intervenors have failed to read the plain language of two of the cases they cite in their own brief. In *State ex rel. City of West Plains, Missouri v. Public Service Commission*, 310 S.W.2d 925 (Mo. Banc 1958) the Missouri Supreme Court specifically stated "we are able to discern no legitimate reason or basis for the view that a utility must operate exclusively either under a system wide rate structure or a local unit rate structure..." (310 S.W.2d at 933). In *State ex rel. Cape Girardeau, Missouri v. Public Service Commission* 567 S.W.2d 450 (1978), the Missouri Court of Appeals Eastern District stated as follows:

> However, what the City has seemingly chosen to ignore throughout these proceedings is that Section 393.130(3) forbids discrimination against persons as well as locations. The Commission's Order and Report make it clear that it was aware of this dual obligation and in this case chose to emphasis equity to the individual user by maintaining a rate system designed on the basis of cost to a class of customer than to area. For this reason we view the issue as a question of reasonableness, and will treat it with more detail infra. We cannot hold as a matter of law that the City was entitled to the relief it sought merely by showing a lower cost of service to the City area as a whole.

(Emphasis added). 567 S.W.2d at 453

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[8] See the Initial Briefs of Platte County Intervenors (including Riverside), AG Processing, Inc. and the City of Warrensburg filed in Case No. WR-97-237; and the Initial Brief of AG Processing, Inc.; Platte County Intervenors; and, City of Warrensburg filed in Case No. WO-98-204.

These reported cases expressly permit the Commission to engage in uniform rates or single tariff pricing. The Municipal Intervenors' assertions to the contrary do not accurately represent the case law of this state.

Both the Municipal Intervenors and the Indicated Intervenors spend a great deal of time pursuing a tortured analysis of the statutes and case law that is simply not on point.[9] The Municipal and Indicated Intervenors relegate to afterthought the three most relevant cases regarding "undue discrimination" as prohibited by Section 393.130, RSMo. These cases are: 1) *State ex rel. Laundry, Inc. v. Public Service Commission* 34 S.W.2d 37 (Mo. Banc 1931); 2) *The City of West Plains Case, supra*; and, 3) *The Cape Girardeau Case, supra.* The Municipal and Indicated Intervenors do not even acknowledge these cases exist until the end of their discussion. When they do confront these cases, they resort to mischaracterizations of not only the facts, but also the holdings, in those cases. Rather than belabor this Reply Brief with redundant quotes, MAWC would simply request that the Commission review the actual language of the Court (as excerpted in MAWC's Initial Brief at pp. 57-61) and not be mislead by the erroneous mischaracterizations of the Municipal and Indicated Intervenors.

In light of the foregoing, the Commission should not rely upon the flawed legal analysis of the Municipal and Indicated Intervenors. Instead, the Commission should acknowledge that it has

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[9] Indeed, the Municipal and Indicated Intervenors' citations to cases from other jurisdictions is of no value, since each state Public Utility Commission has its own enabling legislation which can and does differ between states. Ironically, one case which the Municipal Intervenors cite from Pennsylvania City of Pittsburgh v. Pennsylvania Public Utility Commission, 560 A.2d 889 (Pa. Cmwlth. 1989) actually approves the Pennsylvania Commission's implementation of STP. "Given the history of the gradual and continuing consolidation of the water company, we hold that the commission is not obliged to repeatedly explain and justify its approval of the goal of single tariff pricing which the commission has been allowing the water company to implement gradually since the late 1950's." (citations omitted) 560 A.2d at 89.

broad authority when it comes to the area of rate design and, more specifically, that uniform rates or single tariff pricing are not prohibited as a matter of law.

**2. The Debate Between STP and District Specific Pricing.**

The debate between STP and district specific pricing is not new and many of the criticisms leveled against STP by the parties who advocate district specific pricing ("DSP") were already addressed in MAWC's Initial Brief. Nevertheless, the Municipal and Indicated Intervenors have turned up the rhetoric and engaged in a number of misstatements or mischaracterizations which can not be ignored.

Municipal Intervenors begin their hyperbole by stating that STP is "[a]t best, ... an unproven, experimental method which has been used only in circumstances and systems quite different than MAWC's." (M&I Brf., p.3). Apparently, the Municipal Intervenors failed to read the testimony of Dr. Janice Beecher who concluded, after extensive review, that in the thirty (30) states with multi-system water utilities, twenty-five (25) have approved STP for one or more of the companies. In the other five (5) states, the issue has never been raised. (Beecher Dir., Ex. 58, pp. 12-13, Sch. JB-2, pp. 53-54). The Municipal Intervenors also forget that this Commission began its move toward STP over ten (10) years ago (for the former properties of the Missouri Cities Water Company) and implemented STP for all seven (7) of the Company's districts in its 1997 rate case. STP is far from unproven or experimental, either in this state or across the country.

The Municipal Intervenors continue the hyperbole when they speculate that an investment of the magnitude of $56 million in the Joplin district "... is not just unlikely, but impossible under even the most optimistic assumptions of growth of demand in the Joplin area." (Brief p. 2) (emphasis added). How quickly these Intervenors forget that the Company was required to spend $70 million in its St. Joseph district - a district not that much larger than Joplin. Moreover, growth is not the only factor driving investment in plant. The need to replace aging infrastructure and comply with ever increasing environmental requirements also have a significant impact on the capital expenditure requirements of the water industry generally and this Company, specifically. To say that it is impossible for future investments in the Joplin District to reach $56 million is simply false.

The Municipal and Indicated Intervenors state that the primary purpose of a rate design structure is to recover costs from those who cause the costs to be incurred and that district specific pricing is more equitably suited to minimizing subsidization and having the cost causer be the ratepayer. The Municipal and Indicated Intervenors exalt cost over any other consideration in the setting of rates. This narrow minded view, of course, ignores other legitimate rate setting considerations which even Public Counsel acknowledges are appropriate (e.g. affordability and gradualism). (OPC Brf., p. 64).

Even if one focuses solely on cost, district specific pricing is no better at matching costs with cost causers than STP. The Municipal and Indicated Intervenors refuse to acknowledge that cost differentials of serving customers within a district can be as great or greater than the cost differentials between districts. (Tr. 1002). It is simply not true to say that there is less chance for undue subsidization on a district specific basis instead of a Company-wide basis. There are numerous subsidies that remain when customers are grouped within classes within a district. Many of these subsidies may be as great as the apparent subsidies that exist on an average basis between districts. For example, it is possible that a long time residential customer in the St. Joseph district with moderate demands and located near the treatment plant would have a lower cost of service than a new residential customer in the Joplin district with very high peak demands and served by the new Third-Second Street well, booster station and tank. However, the Municipal and Indicated

Intervenors choose to ignore the differences of distance; cost of specific facilities between the plant and the customer; pumping and storage; and individual demand characteristics and place their sole focus on the average cost differences between districts. This is a relatively arbitrary grouping of costs given all of the other variables that affect cost. (Stout Sur., Ex. 11, pp. 9-10)

Public utility ratemaking has traditionally differentiated customers based on the nature of the customer's end-use (i.e., whether the customer is residential, commercial, industrial, etc.). (Stout Sur., Ex. 11, pp. 9-10). The case law of this state also focuses on the differences in the use of the service, not on the differences in the cost of the delivery of the service. In *Laundry*, the Supreme Court emphasized that the law required "...the same charge for doing a like and contemporaneous service (e.g. supplying water)...." (34 S.W.2d at 44). In *Cape Girardeau*, the Court affirmed the Commission's "decision to ... emphasize equity to the individual user by maintaining a rate system designed on the basis of costs to a class of customers than to area." (567 S.W.2d at 453). STP appropriately recovers the costs which are caused by each customer class. While the Municipal and Indicated Intervenors attempt to minimize the similarity of water service to each customer class, it nevertheless exists. For example, residential customers are relatively consistent in their uses of water, i.e., cooking, bathing, cleaning and other sanitary purposes, and lawn sprinkling. If customers use water for the same purposes, the service offering is the same and should be priced similarly. (Stout Dir., Ex. 9, p. 16).

Finally, the Municipal Intervenors impugn the City of St. Joseph's and the St. Joseph Area Water Districts' support for STP as opportunistic, (i.e. their opposition to DSP and support for STP is only based on "the economic consequences to them of district specific rates in the present case"). (M&I Brf., p. 34). This is truly rich! The Municipal Intervenors are no less opportunistic, as they are clearly economically advantaged in this case under district specific pricing. History has shown that most Intervenors have tended to be opportunistic and have taken different positions on this issue presumably based on the economic consequences to them at the particular time.

For example, the City of Riverside states at page 37 of its joint brief that "both the St. Joseph Industrials and Riverside consistently continue to oppose the continuation of STP because it is both unlawful and unreasonable...." While the St. Joseph Industrials may have opposed single tariff pricing in prior rate cases, the City of Riverside is not so consistent. In Case No. WR-91-172 (*In Re the Matter of Missouri Cities Water Company*), the Commission noted that the "Platte County Intervenors' [of which Riverside was a member] would have the Commission adopt 'full' uniform rates." (1 Mo. P.S.C. 3rd at 114). Members of the Municipal Intervenors also have an inconsistent history. The Municipal Intervenors make much of the fact that the "small" systems (i.e. Brunswick and Mexico) alleged to most benefit from (and therefore presumed to endorse) STP have neither appeared nor indicated such preference for STP. (M&I Brf., p. 34). In that regard, it is significant to note that neither Joplin nor St. Charles County have previously appeared or indicated their opposition to STP. Given the Municipal Intervenors reasoning, one can only assume that heretofore Joplin and St. Charles County were supportive of STP, or, at the very least, not opposed to it. Even the City of Warrensburg appears to have been a supporter of STP at one time, given the following finding by the Commission in Case No. WR-91-172 (*In the Matter of Missouri Cities Water Company*). "Company, Public Counsel, <u>Warrensburg</u> and the City of St. Peters urge the Commission to stay with Company's "uniform" rate design, a design which this Commission approved in Company's revenue neutral rate design Case No. WR-90-236...." (1 Mo. P.S.C. 3rd at 144) (emphasis added).

While it is understandable that each of the Intervenors wants the best deal for its constituency, their position in the various cases appears to be the ratemaking equivalent of the "not in my back yard" syndrome encountered in the environmental area. In a rather candid display of parochialism, it appears that the Municipal Intervenors' solution to fixing the "problem" of serving higher than average costs districts is for the Company to sell them. (M&I Brf., p. 26-27).

The task of this Commission is to balance all of the interests of all of the Districts. The "public interest" is much larger than the interests of Joplin, Warrensburg or Brunswick. And the factors to be considered are more than just the allocated costs to serve each District. The Commission must determine what pricing policy, in the long run, best serves the interests of all the Company's customers and best promotes safe, reliable drinking water at reasonable rates. When considered in this light, it remains the Company's belief that STP continues to be the best pricing policy for this Company.

**3. The Company's Representations Regarding Single Tariff Pricing.**

Several parties have suggested that the Company mislead its St. Joseph customers by advising them that future rate increases involving the recovery of costs associated with the new St. Joseph Treatment Plant would be recovered through single tariff pricing. For example, the Municipal Intervenors state "If it is true that MAWC made representations and suggestions to the St. Joseph ratepayers that the new treatment plant would be recovered from the other districts under single tariff pricing, such constitutes serious misrepresentation and bad faith on the part of MAWC". (M&I Brf., p. 37-38) The Indicated Intervenors state that "MAWC also seized on this Commission's decisions in WR-97-237 and WO-98-204 to argue that STP had been finally adopted. Thus, the ratepayers in St. Joseph were decoyed with promises of 35% increases". (SJ Ind. Brf., p. 28).

What the Municipal and Indicated Intervenors fail to accept is the fact that the rates for this Company (and particularly for those districts which were previously served by the Missouri Cities Water Company) have not been set on district specific costs and have been moving toward single tariff pricing for a period of at least ten (10) years. In fact, the Commission specifically authorized the move to single tariff pricing five years ago in its Report and Order in Case No. WR-95-205. In the 1997 rate case, while indicating that it was making no final policy decision regarding single tariff pricing, the Commission nevertheless adopted uniform rates for this Company. Thus, by telling its St. Joseph customers that it anticipated future rates to be set on single tariff pricing, the Company was accurately stating what this Commission had specifically approved. What else would the Municipal and Indicated Intervenors have the Company say to its customers? The fact of the matter is that the Company, over the previous five years, made a commitment to move toward single tariff pricing. That commitment was first contained in a stipulation which the Commission adopted in the 1995 rate case and it was fully implemented in the 1997 rate case. Indeed, if the Company had represented that future rate increases would be recovered under anything other than single tariff pricing, that would have been a serious misrepresentation and bad faith.

## B. PHASE-IN. SHOULD MAWC'S RATE INCREASE BE PHASED-IN OVER A NUMBER OF YEARS? IF SO, WHAT IS THE APPROPRIATE "PHASE-IN" AMOUNT AND WHAT IS THE APPROPRIATE PHASE-IN PERIOD?

As indicated in its Initial Brief, the Company is not able to agree to a phase-in because of the financial impact such a phase-in will have on its financial statements and its ability to raise capital on reasonable terms. This is particularly true in light of Public Counsel's and Staff's phase-in plans which would require the deferral of significant amounts of revenue for periods up to 5 and 6 years. It is significant to note that the St. Joseph Area Water Districts in their Initial Brief are also concerned with the impact that phase-in proposals will have on them as customers, given the additional carrying costs associated with the deferred revenues.[10] Obviously, the larger the amount of the deferral coupled with the longer the length of time over which the deferral is recovered, will result in larger carrying costs that will have a significant impact on the ultimate rates to be borne by the customers. This concept is very similar to credit card debt which, if not substantially paid down in the initial billing periods, can result in significant costs to the consumer in later billing periods. Accordingly, the Company would recommend that the Commission first attempt to mitigate the impact of any rate increase through the adoption of single tariff pricing (or single tariff pricing with the Capital Addition Surcharge as proposed by Company). The Commission should also decline to adopt any revenue requirement shifts between classes as indicated by the class cost of service studies filed in this case as that will only add to and exacerbate the "rate shock" on certain customer classes.

The Staff and Public Counsel cite Commission rate decisions involving Union Electric Company and Kansas City Power & Light as precedent for the implementation of rate phase-in plans. While it appears that those rate phase-in plans were designed to allow the Companies to recover the entire deferral over the phase-in period, an important distinction must be kept in mind. Both of those cases occurred prior to the adoption of Financial Accounting Standards Statement No. 92, which now clearly prohibits the booking of any deferred revenues associated with a rate phase-in plan. Accordingly, both Union Electric and KCPL were able to book deferred revenues during the rate phase-in period with no adverse impact on their respective financial statements. That will not be the case with MAWC. Any deferred revenues created as a result of a phase-in in this case will not be included in the Company's current financial statements. Additionally, net income and

[10] "...the Water Districts are also concerned that the rate phase-in proposals may add significant carrying costs to the final rate increase approved over time." (Wat. Dis. Brf., p. 25).

earnings will be less than they would otherwise be if those deferred revenues were included in the financial statements. While those deferred revenues may be able to be reflected in a footnote to the financial statements as recommended by Staff, investors will still discount the quality of the Company's current earnings and, at the very least, demand a higher return for their equity investment in order to account for the additional risks associated with the ultimate recovery of the deferred revenues. (Walker Reb., Ex. 13, pp. 23-24) Despite Staff's best intentions, a footnote on the Company's financial statement will not eliminate the problem that a phase-in will create.

## IV. RETURN ON EQUITY. WHAT RETURN ON EQUITY IS APPROPRIATE FOR MAWC?

### 1. Return on Equity.

Both Staff and Public Counsel continue to advocate use of a DCF calculated return on equity for MAWC's parent, American Water Works ("AWC"), and apply the results of same to MAWC without any adjustment to reflect the additional business and financial risks to which MAWC is exposed. This hide-bound adherence to the DCF analysis, coupled with a continued refusal to acknowledge the additional business and financial risk associated with an investment in MAWC, will inexorably result in an inadequate return on equity for the Company.

Before beginning a discussion of the inadequacies of Public Counsel's and Staff's return on equity recommendations, the Company is compelled to respond to several arguments contained in the Staff brief for which there is no record support. Staff offers a number of criticisms of the various analyses performed by Company witness Harold Walker, but those criticisms are initially suspect because there is no record citation to support them. The reason there is no citation is because the facts supporting these arguments are nowhere to be found in the record. For example, Staff criticizes

Company witness Walker for adding "a factor for dividend growth (in his DCF analysis) that is not included in the generally recognized DCF equation that is reproduced above." (Stf. Brf., p. 38). Staff offers no citation either to the record or to "generally recognized" authority to support this statement.

Staff criticizes Company witness Walker's conclusion that the DCF will always understate ROE when market-to-book ratios are greater than 100% by stating "this ignores the function of the stock market, whose purpose it (sic) to establish an appropriate current market price for the stock. If the current price of the stock is high, it is because investors value their shares highly, regardless of the relatively low yield that the high stock price produces. They are therefore willing to pay more for the stock, and it should be easy for MAWC, or AWK to raise capital in such a market." (Stf. Brf., p. 40). Again, there is no citation for these statements and, in fact, there can be none because the record does not contain it.

Staff also criticizes Company witness Walker's CAPM analysis because "Mr. Walker's tinkering with the established method of calculating ROE's using the CAPM method is not necessary, justified, or supported by the literature on the subject." (Stf. Brf., p. 41). Again, Staff offers no citation for this statement. Not only is there no evidence to suggest that Mr. Walker's risk adjustment to the CAPM analysis is not supported by literature on the subject, it is directly contrary to Mr. Walker's testimony, which indicates that such an adjustment is specifically called for in the Ibbotson Yearbook. (Tr. 2180-2181). Clearly, these arguments cannot be supported by the record and should be disregarded by the Commission.

More importantly, Staff's slavish adherence to the DCF analysis fails to take into consideration the fact that investors use more than one analysis in calculating the equity cost rate for a particular investment. There is no single method which is perfectly suitable. While one investor may rely solely upon one model in evaluating investment opportunities, other investors rely on different models. Most investors who use an equity valuation model rely on many models in evaluating their common equity investment alternatives. Therefore, the average price of an equity security reflects the results of the application of many equity models used by investors in determining their investment decisions. (Walker Dir., Ex. 12, p. 22). Accordingly, Mr. Walker's reliance on several models in developing his recommended return on equity is entirely appropriate and Staff's blind rejection of any other models (other than the DCF) is another indication of the short-coming in Staff's ultimate recommendation.

The validity of the various models notwithstanding, the fact remains that neither Staff's nor Public Counsel's recommended return on equity ("ROE") passes the test of common sense. It is undisputed that A-rated public utility debt is currently yielding 8.42%. (Tr. 2211). Staff's recommended return on equity provides only a 108 to 233 basis point premium over A-rated public utility debt. (i.e. 9.5% minus 8.42% and 10.75 minus 8.42%). Public Counsel's recommended ROE provides only a 150 basis point premium over A-rated public utility debt (9.92% minus 8.42%). Clearly, Staff and Public Counsel have provided an insufficient spread, or premium, over A-rated public utility debt to attract equity investors to the more risky investment. MAWC is riskier because it is smaller, it has more leverage, it has lower interest coverage, it generates less cash flow, and it has a large construction program in comparison to its parent, AWC, or to other publicly traded water companies. (Walker Sur., Ex. 14, p. 13) Given MAWC's additional risk, why would an investor in MAWC be willing to accept an ROE (which is not guaranteed) of 9.5% to 10.75% when he/she can get a guaranteed return of 8.42% on A-rated public utility bonds? Staff's and Public Counsel's recommended ROEs simply make no sense in today's market. This can be further demonstrated by the fact that both Staff and Public Counsel recommended higher returns on equity for this Company in its last rate case when A-rated public utility debt was actually yielding less than today. For example, in MAWC's last rate case (i.e. WR-97-237), Staff witness Broadwater recommended a common equity cost range of 10.10% to 11.10% at a time when A-rated public utility bonds were yielding 60 basis points less than they are today. In that same case, OPC witness Burdette recommended a common equity cost rate of 10.62%, when A-rated public utility bonds were yielding 60 basis points less than they are today. Staff and Public Counsel can tout the virtues of their DCF analyses all they want to, but the fact of the matter is that their end results are not reasonable given current market conditions.

**2. The Additional Risks Associated with Phase-In and Plant Disallowance-Financial Integrity.**

Not only are Public Counsel and Staff unwilling to adjust their DCF derived returns on equity for AWK to reflect the additional business and financial risks to which MAWC is exposed, they are also unwilling to recognize the additional risks (and more severe consequences) associated with the adoption of a phase-in plan and/or plant disallowances that have been recommended in this case. Although Public Counsel would have this Commission believe that generally accepted accounting principals will not require the Company to "write-off" deferred revenues associated with any rate phase-in plan, the only credible evidence of record suggests otherwise.

On the other hand, there is no dispute that a plant disallowance, such as those recommended by Public Counsel and the St. Joseph Industrial Water Users, will, if accepted, result in substantial write-offs to current and retained earnings. In fact, a plant disallowance of approximately $40 million will result in an approximate 50% reduction in MAWC's common equity. (Walker Reb., Ex. 13, p. 25). It is also undisputed that the water industry generally has not experienced the type of plant disallowances that are being recommended in this case. (Walker Reb. Ex. 13, p. 25).

Amazingly, however, neither Staff nor Public Counsel believe that investors will react negatively to a proposed phase-in or a plant disallowance. This belief is not only unsupported by the record but defies common sense. What common equity investor in his/her right mind would be willing to continue to make equity investments in this Company after 50% of his/her investment has been wiped out by a plant disallowance of $40 million? At the very lease, no one under those circumstances would settle for an ROE of 9.5% to 10.75% (which is only 108 to 233 basis points above what they could earn on A-rated public utility debt)

What are Staff's and Public Counsel's responses to the obvious risks associated with the phase-in plans and the rate base disallowances that have been proposed in this case? Staff witness McKiddy candidly stated that she was unconcerned with the other adjustments being proposed in this case. "I don't look at those things because, like I said, I don't do my analysis based on that type of situation. I do it based on the components of the DCF calculation, and that's the way we've always done it in our department." (Tr. 2229).

Public Counsel witness Burdette offered a last minute interest coverage calculation in an effort to demonstrate that the Company can continue to finance despite Public Counsel's recommended phase-in and rate base disallowance. The credibility of Mr. Burdette's eleventh hour interest coverage calculation has already been discussed in Company's Initial Brief. However, what Public Counsel continues to ignore, and fails to recognize, is the fact that interest coverages are only one part of the test for the Company to be able to issue additional long term debt. The Company's indenture also requires the Company to maintain a debt to total capitalization ratio of no more than 65%. If the Company is required to write-off thirty to forty million dollars of investment in plant, and thereby write down its retained earnings, it will result in debt to total capitalization ratios of more than 65% for at least the next three years which will prohibit the Company from issuing any long term debt. (Walker Reb. Ex. 13 p. 29; Walker Sur., Ex. 14, Schedule HW-6.3, p. 2 of 2). Public Counsel fails to address this part of the indenture requirement and, as a result, Public Counsel's statement at page 37 of its Brief that its "analysis has proven that Company will, in fact, not be in default of its indenture of mortgage interest coverage requirement if the Commission adopts Public Counsel's proposed prudence disallowance, cost of service and rate of return" is, at best, incomplete and, at worst, misleading. This statement conveniently overlooks the debt to total capitalization requirements of the Company's indenture which exist in addition to its interest coverage requirements. The simple fact of the matter is that Public Counsel's proposed plant disallowance, coupled with its plant phase-in and other cost of service adjustments in this case, will, if adopted, preclude this Company from issuing long term debt under its indenture of mortgage. Clearly, if such a situation is allowed to occur, the Company's financial integrity will be impaired and the additional costs resulting therefrom will ultimately be borne by the Company's customers.

## V. ACCOUNTING ISSUES.

### A. DEFERRED TAXES. SHOULD MAWC'S RATE BASE BE ADJUSTED TO REFLECT THE AMOUNT OF DEFERRED TAXES EXISTING ON THE BOOKS OF MISSOURI CITIES WATER COMPANY PRIOR TO ITS ACQUISITION BY MAWC? IF SO, WHAT IS THE APPROPRIATE ADJUSTMENT?

Only the Staff addresses this issue in the initial briefs. (Stf. Brf., p. 28-32). Staff continues to assert that the deferred taxes that existed on the books of Missouri Cities Water Company ("MCWC") at the time MAWC purchased MCWC from Avatar in 1993 should be deducted from MAWC's rate base.

It appears that the Staff has taken the position that because amounts were paid prior to 1993 for the purpose of deferred income taxes, the benefits associated with the deferred taxes should continue to accrue indefinitely. Staff states that "the ratepayers of [MCWC] provided to [MCWC] funds for the purpose of paying a future obligation, which *went away* when MAWC acquired [MCWC]." (Stf. Brf., p. 30) (emphasis added). This statement fails to recognize the purpose for which the deferred taxes were being paid. These funds were not contributed as a permanent savings account. They were contributed in order to pay income taxes when they became due.

Additionally, stating that the funds "went away" is a great oversimplification. The funds remained with Avatar, MCWC's parent, after the sale. (Gibbs, Tr. 1951). This is because Avatar incurred the obligation to pay the taxes resulting from the transaction. (*Id.* at 1952). The Staff has no reason to believe these taxes have gone unpaid. (*Id.*). Therefore, what transpired in 1993 was that ratepayers' contribution of funds for a specific purpose – the payment of taxes – were ultimately expended for that purpose – the payment of taxes.

In spite of this, Staff indicates that the deferred taxes – paid by ratepayers prior to 1993, retained by MCWC's parent, Avatar, and used by Avatar to pay income taxes – should act as an off-set to rate base. According to Staff, this is because the "funds were available to the Company" and thus "the Company should not earn a return on these funds." (Stf. Brf., p. 30). For the reasons stated above, this rationale is inapplicable to the situation at hand. The funds ARE NOT available to MAWC. They were retained by Avatar as a part of the transaction because Avatar had the obligation to pay the resulting taxes. Likewise, because MAWC has no access to the funds, there is no reason to reduce its actual plant investment for monies that do not benefit MAWC. This is especially true in this case as the Commission made a specific finding related to the impact of the deferred taxes in a past case and, in fact, used this finding against MAWC.

The regulatory history of the MAWC/MCWC transaction started with the Commission's review of the agreement between the parties in Commission Case No. WM-93-255. *In the matter of the application of Missouri-American Water Company for approval of its acquisition of the common stock of Missouri Cities Water Company*, 2 Mo.P.S.C.3d 305 (July 30, 1993). An evidentiary hearing was held, the Staff and OPC filed testimony, other intervenors "presented substantial testimony," and the case was briefed before the Commission issued a decision[11]. (*Id.*).

As stated in MAWC's Initial Brief, the Commission later specifically addressed this issue in *In the Matter of Missouri-American Water Company's Tariff Revisions*, 4 Mo.P.S.C.3d 205 (1995). The Commission ruled against MAWC's request for an acquisition adjustment and, in doing so, stated:

> The Commission finds in this case that the Company has failed to justify an allowance for the acquisition adjustment. The Commission finds that as argued by OPC, the ratepayers will already suffer one negative effect from the sale of MCWC stock. Because the transaction is considered a "sale of assets" for federal tax purposes, the deferred taxes that have accumulated throughout the life of the property will be lost.

(*Id.*).

There is no question that even if the Commission did not address the deferred taxes in its proceeding authorizing the acquisition, it was fully aware of the impact of the deferred taxes in the following rate case. Further, not only was the Commission aware of this impact, it also based its decision to deny MAWC an acquisition adjustment on the loss of the deferred taxes.

The Commission should not agree to implement the fiction proposed by the Staff. The deferred taxes are not available to MAWC and have been used for their intended purpose, payment

[11] Contrary to the Staff's assertion that the acquisition case "was not litigated." (Stf. Brf., p. 30).

taxes. To direct that some imputed amount of deferred taxes should now be used to benefit ratepayers, has no basis in theory or fact.

Additionally, the Commission has addressed this issue previously and found that the deferred taxes would be lost. A change in the Commission's approach to these deferred taxes five years later is potentially an improper collateral attack on a prior commission order in violation of Section 386.550, RSMo (1994). If it does not violate Section 386.550, it would then certainly provide justification for MAWC to relitigate its request for an acquisition adjustment as the critical factor upon which the Commission based its decision, loss of the deferred taxes, will have changed.

### B. PREMATURE RETIREMENT. SHOULD THE NET PLANT INVESTMENT ASSOCIATED WITH THE EXISTING ST. JOSEPH WATER TREATMENT PLANT FACILITIES THAT ARE NO LONGER PROVIDING SERVICE TO ST. JOSEPH CUSTOMERS BE INCLUDED IN MAWC'S RATE BASE AND AMORTIZED TO EXPENSE?

The Staff, OPC and MAWC addressed this issue their initial briefs. All three parties indicated that there is a net plant investment remaining in the amount of $2,832,906 that has not been recovered by MAWC through depreciation and that there are also cost of removal expenses (estimated by the Company to be $500,000) associated with the old St. Joseph treatment plant. The disagreement between the parties concerns how these amounts should be treated.

The Staff recommends as follows:

> . . . that both the plant account and the depreciation reserve be reduced by the original cost of the old treatment plant as of the date when the old treatment plant was taken out of service. These corresponding adjustments will preserve the estimated unrecovered investment of $2,832,906 until the depreciation study is performed. (Mathis Direct, Ex. 44, p. 4, lines 10-13)

> The Company should also be permitted to reduce the depreciation reserve associated with the old treatment plant by cost actually incurred for removal and demolition when those costs are actually incurred. (Mathis Dir., Ex. 44, p. 4, lines 14-15).

(Stf. Brf., p. 10).

MAWC originally proposed in this case to recover the net original cost, including the estimated cost of removal, through an amortization over twenty (20) years. (Gutowski Dir., Ex. 2, Sch. LJG-2.27). After reviewing the Staff's direct testimony, MAWC adopted a position consistent with that of the Staff. That is, reducing the plant account and the depreciation reserve by the original cost of the old treatment plant as of the date when the old treatment plant was taken out of service, just as any other retirement would be recorded. (Salser Reb., Ex. 7, p. 10). This position was taken because it seemed to be a reasonable balancing of the interests involved.

The OPC has not agreed to this compromise position and, instead, has recommended that no recovery of any of the net original cost or removal be included in rates, in any fashion. This is not an appropriate, reasonable or lawful approach.

A utility is allowed to earn a return on its prudent investment in plant. It is recognized that plant depreciates in value and, thus, depreciation expense is included in a utility's cost of service. Depreciation rates for ratemaking purposes are set by the Commission, not the utility, in an attempt to match capital recovery with capital consumption. *See Re: Depreciation*, 25 Mo.P.S.C. (N.S.) 331, 334, (1982). This process necessarily involves an analysis of expected future events such as useful life, salvage value and cost of removal. *See In the Matter of St. Louis County Water Company's tariff revisions designed to increase rates*, 4 Mo.P.S.C.3d 94, 102-103 (1995).

Because of the estimates and unknowns involved with this analysis, it is not unheard of for the depreciation rates to miss their goal to some extent. The question is what to do with this failure to match recovery with consumption. Commonly, a piece of property is fully depreciated before the end of its life. In that situation, depreciation stops. The utility does not get to over-depreciate. Here, the OPC recommends that MAWC should be forced to under-depreciate and lose any right to recover this amount because 1) the old plant is no longer "used and useful" and 2) OPC alleges that any recovery would allow the Company to recover for two water plants.

The amount being addressed is associated with a plant that was used and useful for over one hundred years. It is merely depreciation that would have been taken previously, if recovery had matched consumption. (Salser Sur., Ex. 8, p. 4).

The most straight forward way to address the net original cost is to expense the entire amount immediately. However, this is recognized as a harsh result. Both the original Company proposal (20 amortization) and the Staff proposal (address the amounts in conjunction with other accounts), attempt to mitigate this potential result.

The Commission itself has recognized that whether or not these amounts are placed in rate base, recovery is appropriate. The OPC cites as authority for its used and useful argument *In the matter of United Telephone of Missouri*, 2 Mo. P.S.C. 3d 403, Case No. TR-93-181 (1993). In the quoted portion of the *United Telephone* case, the Commission determined that the net original cost associated with abandoned equipment should not be placed in rate base. However, it is important to understand that in that case United Telephone requested both a three year amortization of the net original cost at issue and rate base treatment of the depreciation reserve. (*Id.* at 407). While the Commission did not include the proposed amount in rate base, it did find that it was "appropriate" to amortize the amount over a three year period. (*Id.* at 408)

This is similar to the result reached in the second case cited by the OPC in support of its position, *In the matter of GTE North Incorporated*, 30 Mo. P.S.C. (N.S.) 88 (1990).[12] In *GTE North*, GTE sought recovery of an undepreciated amount of $2,597,000 related to the early retirement of an EAX switch. It proposed to recover this amount by amortization over a five-year period amounting to $519,000 annually. (*Id.* at 92). GTE also proposed that the unamortized investment remain in rate base until recovered. (*Id.*).

The OPC argued in *GTE North*, as it has in this case, that if GTE was allowed to recover the undepreciated amount, it would result in "double recovery for Company since recovery of the current switch is also reflected in the depreciation rates being set." (*Id.*). While the Commission did find, as OPC alleges, that the unamortized investment should not remain in rate base, it also directed that the reserve deficiency be recovered through an amortization over a five year period. (*Id.* at 94).

The Commission stated as follows in finding that recovery of the reserve deficiency was appropriate:

> The Commission accepts the reasons and arguments advanced by the Company on this issue and believes that the loss the Company experienced as a result of the early retirement should be amortized as Company requests. The Commission is committed to the modernization of telephone plant and does not believe that Company should be penalized or its efforts to provide its ratepayers with the latest technology reasonably affordable. The EAX switch was used for 11 years before being retired. This length of service is within a reasonable range.

(*Id.* at p. 93-94).

The similarity between the cases cited by the OPC and the case cited by the Company in its Initial Brief is that there was recovery of the reserve deficiency. In the *GTE North* case, the

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[12] The Commission later issued a decision on remand from the Court of Appeals which is recorded at 3 Mo.P.S.C.3d 144. However, the decision on remand did not address the issue for which the case is cited in this brief.

Commission appeared to take the extra step of determining whether the length of service for the retired item was within a "reasonable range" before finding that eleven years for the EAX switch was reasonable. However, it did not take the position that no improvements should be made to utility plant until existing plant is fully depreciated as suggested by the OPC. (OPC Brf., p. 47 ("The Company made a management decision to construct a new plant knowing full well that part of its investment in the river water treatment plant was not fully depreciated and was yet to recovered.")). Even if the Commission determines that it should look to the length of service in this case, recovery is warranted. The old St. Joseph treatment plant consisted of structures that predate 1900 and filters that predate World War I. (Young Reb., Ex. 17, p. 20). This length of service is within a reasonable range.

Thus, the question for the Commission is not whether the reserve deficiency should be recovered, as suggested by the OPC, but rather how it should be recovered. In *In the Matter of St. Louis County Water Company's tariff revisions designed to increase rates*, 4 Mo.P.S.C.3d 94, 102-103 (1995), while not an early retirement situation, the Commission granted recovery of the depreciation reserve deficiency through a ten year amortization. In *GTE North*, the Commission utilized a five year amortization and, in *United Telephone*, a three year amortization was used. In light of these Commission decisions, MAWC's original proposal to amortize the amount over twenty years is quite reasonable.

In the continued attempt to be reasonable, MAWC later supported the Staff's approach to the situation – preserving the status quo until a depreciation study can be completed and the reserve deficiency related to the old St. Joseph treatment plant addressed along with other accounts. However, the OPC has opposed the Staff's proposal as well as the Company's proposal. If the Commission believes that the OPC is correct and the Staff's proposal to preserve this for a future case is inappropriate, the necessary outcome is not a complete loss of the investment, but rather amortization of the amount. This would be similar to the Commission's approach in the *St. Louis County Water Company*, *GTE North* and *United Telephone* cases cited above. An appropriate amortization would be to amortize the reserve deficiency over twenty years, resulting in an adjustment of $166,645, consistent with MAWC's original proposal. (Gutowski Dir., Ex. 2, Sch. LJG-2.27).

## C. AFUDC CAPITALIZATION RATE. SHOULD MAWC'S RATE BASE BE ADJUSTED TO REFLECT A DIFFERENT CAPITALIZATION RATE FOR AFUDC?

The Staff was the only party to address the AFUDC capitalization rate in its Initial Brief. It continues to suggest that the AFUDC capitalization rate should be equal to the carrying charges associated with the Company's short-term debt. (Stf. Brf., p. 11). To the extent the construction work in progress ("WIP") exceeds short-term debt, the composite rate of the outstanding amounts of other sources of financing available to the Company (long-term debt, equity and preferred stock) would be used. (*Id.*).

The Company has instead recorded AFUDC consistent with its past practice and that of the Commission in MAWC's rate cases by utilizing the rate of return from MAWC's most recent rate case. In this instance, the rate used was the rate of return established in Commission Case No. WR-97-237.

The Staff criticizes MAWC's approach by stating that as a result of the Company's proposal its rate base "would be determined on the basis of a fiction that the carrying charges on construction work in progress ("CWIP") are related to the rate of return from the prior case, which reflected no short-term debt." (Stf. Brf., p. 12). First, the rate of return in this case initially contained no short term debt because "the 12-month average balance for [CWIP] exceeds the 12-month average outstanding balance for short-term debt." (McKiddy Dir., Ex. 45, p. 20).

Second, the use of a "fiction" is not without precedent in the rate of return world. For example, a rate of return will be established in this case which is based upon market conditions in the year 2000. No matter how those market conditions change, the rates incorporating this rate of return will remain unchanged until the effective date of a new report and order in a general rate proceeding. MAWC will not be allowed to immediately adjust its rates to give it the opportunity to earn a higher rate of return, even if market conditions would indicate this is appropriate (and likewise its rates will not be immediately reduced where it would otherwise be appropriate). This is the nature of the rate of return process.

Against this backdrop, the Staff now wants to adopt an AFUDC capitalization rate process which will immediately incorporate market changes. This is not consistent with the overall rate of return process. The Commission should not order MAWC to write off the proposed $1,289,674 associated with the AFUDC capitalization rate issue as the amounts originally recorded are consistent with past practice and the Commission's general approach to rate of return.

## D. ACCOUNTING AUTHORITY ORDER. SHOULD MAWC BE ALLOWED TO INCLUDE IN THE COST OF SERVICE, THROUGH RATE BASE AND EXPENSE ADJUSTMENTS, AMOUNTS RELATED TO POST-IN-SERVICE AFUDC AND DEFERRED DEPRECIATION EXPENSE FOR THE PERIOD FROM THE IN-SERVICE DATE OF THE NEW ST. JOSEPH WATER TREATMENT PLANT TO THE OPERATION OF LAW DATE IN THIS

**CASE?**

Both the Staff and the OPC argue that the post-in-service AFUDC and deferred depreciation are not extraordinary. While MAWC believes that the question of whether or not these costs should be included in MAWC's cost of service is at issue, past Commission decisions concerning accounting authority orders ("AAO") indicate that the extraordinary nature of the items has already been decided. Otherwise, it would not be appropriate for these amounts to have been deferred.

An application for an AAO contains a single factual issue -- whether the costs which are asked to be deferred are extraordinary in nature. *In the matter of the application of Missouri Public Service*, 1 Mo.P.S.C.3d 200, 203-204 (1991). "By seeking a Commission decision [regarding he issuance of an AAO] the utility would be removing the issue of whether the item is extraordinary from the next rate case. All other issues would still remain, including, but not limited to, the prudency of any expenditures, the amount of recovery, if any, whether carrying costs should be recovered, and if there are any offsets to recovery." (*Id.*).

The effect of an AAO has been discussed by the Missouri Court of Appeals. The Court of Appeals has stated that an AAO preserves the expenses for a rate case where they can be addressed by the Commission. In *State ex rel. Office of the Public Counsel v. Public Service Commission*, 858 S.W.2d 806, 812 (Mo.App. 1993), the Court of Appeals took note of the fact that an AAO only authorizes an accounting entry on the books of the utility. The deferred expenditures, along with all other items of revenue and expense, are considered together in a subsequent rate case.

In *Missouri Gas Energy v. Public Service Commission*, 978 S.W.2d 434 (Mo.App. 1998), the Court stated as follows:

> The whole idea of AAOs is to defer a final decision on current extraordinary costs until a rate case is in order. At the rate case, the utility is allowed to make a case that the deferred costs should be included . . . .

(*Id.* at 438). The question for the Commission at this point in time is not then whether the costs are extraordinary, but whether the costs should be included in rates when considered with other items of expense and revenue.

MAWC believes, however, that even if the Commission examines the nature of the post-in-service AFUDC and deferred depreciation as suggested by the Staff and OPC, it will find that these items result from extraordinary events as those have been defined by the Commission.

The Commission has previously stated that in order to issue "an Accounting Authority Order to permit the deferral of such costs, the costs incurred by the utility must result from an event or circumstance that is extraordinary, unusual and unique, and not recurring. *See In re The Application of Missouri Public Service for the Issuance of an Accounting Authority Order*, 1 Mo. P.S.C. 3d 200, 205 (1991). Extraordinary costs would include costs associated with Acts of God such as storm damage, fire or flood. However, extraordinary might also include costs resulting from man-made decisions that result in significantly changed business conditions." *In the Matter of the Application of United Water Missouri Inc.*, Case No. WA-98-187 (April 20, 1999). Alternatively stated, the ". . . issuance of AAO's have historically been tied to the occurrence of extraordinary items, events impacting a utility that are unusual in nature and infrequent in occurrence." *In Re St. Louis County Water Company*, 4 Mo.P.S.C. 3d 94, 98 (September 19, 1995). An AAO is not required to have resulted from an "emergency" and that MAWC be required to take "immediate action" as suggested by the Staff. (Stf. Brf., p. 6).

For example, in the *St. Louis County* case, the Commission granted an AAO for an infrastructure replacement program designed to address "deterioration of County Water's distribution system" and the resulting "escalating expenses." The Commission found that "the infrastructure program represents a significant and unusual increase in County Water's business-as-usual construction expenditures, and is extraordinary in nature." *St. Louis County* at 98.

As was discussed in detail in Commission Case No. WA-97-46, the St. Joseph treatment plant and related facilities result from several of the factors that have been described by the Commission. It was revealed that there were capacity, reliability, process control and safety deficiencies with the old St. Joseph treatment plant (which was over 100 years old) that made it necessary to take the dramatic steps of changing the source of supply and construction of a treatment plant at a new location. Both extreme low water on the river and extreme high water had left the City of St. Joseph without water twice within the last decade (Acts of God). While improvements had been made to temporarily address this problem, the only real solution was to move the treatment plant out of the flood plain and eliminate the river as a source of supply. Additionally, increased regulatory requirements enacted by Congress and implemented by the Environmental Protection Agency and the Missouri Department of Natural Resources relating to the treatment of the water drove this construction. These regulations represent man-made decisions that are resulting in extraordinarily changed conditions for water utilities, and are similar in effect to the gas safety rules which have lead to AAOs in the natural gas industry. (Salser Reb., Ex. 7, p. 3). The construction of this plant can also be said to represent a "significant and unusual increase" in MAWC's "business-as-usual construction expenditures."

Both Staff and OPC implied that somehow because the AAO is an attempt to protect shareholders from regulatory lag, that it is unworthy. (Stf. Br., p. 7-8; OPC Brf., p. 48 ("Company's Motion . . . is nothing more than an attempt to insulate its shareholders from 'regulatory lag.'"). This is not a weakness, it is the nature of an AAO. Financial Accounting Standard No. 71, "Accounting for Regulated Industries," which was issued by the Financial Accounting Standards Board in 1982, contemplates the AAOs and allows deferral of costs by a utility on its financial statements under certain conditions. As a result of this recognition of the AAO process, this Commission has addressed AAOs many times. The granting of an AAO in certain circumstances to address regulatory lag is consistent with generally accepted accounting principles.

The Staff further alleges that regulatory lag in this case is acceptable because "the Company exercised total control over the planning and construction of this project" and "total control over the timing and manner in which it sought to have the cost of the plant in the rates it charges to its customers." (Stf. Brf., p. 7). The implication is that MAWC had the opportunity to time the in-service date of the treatment plant and related facilities to coincide with the operation of law date. This is inaccurate. It completely ignores the fact that the test year and any true-up periods are set, not by MAWC, but by the Commission.

In this case, for example, MAWC's proposed true-up period, which would include the St. Joseph treatment plant and related facilities, was met with opposition from more than one party based on the allegation an insufficient time had been provided between the close of the true-up period and the operation of law date. This is in spite of the fact that MAWC's proposal provided for a period of 137 days from true-up to operation of law date. As a result of these objections, MAWC was only certain that the St. Joseph treatment plant and related facilities would be included in this rate case with the issuance of the Commission's Order Concerning Test Year, True-Up, Accounting Authority Order, and Local Public Hearings on February 1, 2000. Up until that time (3 ½ months into this rate case and only three months from the completion of the St. Joseph treatment plant and related facilities), MAWC was forced to address and consider the possibility that it would be required to file a later rate case to capture this construction. MAWC does not have "total control over the timing and manner" and to indicate that it does is not an accurate description of the ratemaking process.

As pointed out in MAWC's Initial Brief, this treatment is necessary because of the financial impacts that will result over the approximate four and one-half months between the expected "in service" date and the operation of law date – a loss to the Company of $1.6 million. (Salser Reb., Ex. 7, p. 4). The OPC and Staff indicate that the Company's numbers are not significant because they do not reflect twelve month periods. (Stf. Brf., 8; OPC Brf., p. 52). However, MAWC did perform an interest coverage calculation for a twelve month period. Eliminating post-in-service AFUDC and deferred depreciation and using actual (May 1, 1999 through April 30, 2000) cash dollars and budgeted cash dollars (May 1, 2000 through April 30, 2000) resulted in interest coverage of 1.81 times for the twelve months ended April 30, 2000 through September 30, 2000. (Salser Sur., Ex. 8, p. 5). This impact on MAWC's finances justifies inclusion of the post-in-service AFUDC and deferred depreciation in rates.

**WHEREFORE,** MAWC respectfully requests the Commission to issue its order granting such relief as is consistent with the foregoing and MAWC's Initial Brief.

Respectfully submitted,


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Certificate of Service

I hereby certify that a true and correct copy of the above and foregoing document was sent by U.S. Mail, postage prepaid, or hand-delivered on this 2nd day of August, 2000, to the following:

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