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February 9, 2001

FILED[3]

FEB 0 9 2001

Missouri Public
Service Commission

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Case No. EA-2000-308

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and eight (8) conformed copies of **STAFF'S REPLY BRIEF.**

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,

Dennis L. Frey

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Enclosure
cc: Counsel of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

FILED[3]

FEB 0 9 2001

Missouri Public Service Commission

In the Matter of the Application of the City of Rolla, Missouri, for an Order Assigning Exclusive Service Territories and for Determination of Fair and Reasonable Compensation Pursuant to Section 386.800, RSMo 1994.	)	Case No.EA-2000-308

REPLY BRIEF OF STAFF

Submitted by:

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February 9, 2001

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of the City of Rolla, Missouri, for an Order Assigning Exclusive Service Territories and for Determination of Fair and Reasonable Compensation Pursuant to Section 386.800, RSMo 1994.	))))))	Case No. EA-2000-308

STAFF'S REPLY BRIEF

INTRODUCTION

On October 29, 1999, the City of Rolla ("City" or "Rolla"), through Rolla Municipal Utilities ("RMU"), filed with the Missouri Public Service Commission ("Commission"), an Application pursuant to Section 386.800 RSMo 1994[1], seeking an order that both authorizes RMU to acquire the facilities/customers of Intercounty Electric Cooperative Association ("Intercounty" or "Cooperative") within Rolla's newly annexed territory and establishes fair and reasonable compensation to Intercounty for the right to do so. As a result of the Application, the matter is being litigated for the first time before the Commission.

In its initial brief of this case, the Staff of the Missouri Public Service Commission ("Staff") offered its position on the issues raised by the parties, as well as on the legal questions posed for briefing by the Commission. Staff's Reply Brief is considerably more narrow in scope. Only a few of the factual issues will be addressed. In addition, the brief will revisit the

[1] Unless otherwise noted, all subsequent statutory references are to RSMo 2000.

Commission's legal questions in an effort to clarify and elaborate on Staff's position. The emphasis will be on the Commission's question concerning its ability to draw territorial boundaries in the newly annexed area ("Area").

ARGUMENT

<u>LEGAL QUESTIONS</u>

I. Can the Commission assign any part or all of the annexed territory as the exclusive service area of Intercounty for the future, and if so, would Intercounty be able to serve new structures?

In Staff's Initial Brief ("Staff Brief"), the Staff stated its view that Section 386.800 permits the Commission to assign any part or all of the annexed territory as the exclusive service area of Intercounty. Citing subsection 6 language, which in pertinent part states that "...the municipally owned electric utility may apply to the commission for an order assigning exclusive service *territories* within the annexed area...." (emphasis added), Staff argued, therefore, that the Commission is authorized to assign an exclusive service territory to more than one utility within the newly annexed area. The Staff further argued that the statute did not preclude the Commission from assigning all of the recently annexed area to Intercounty. (Staff Brief at 2-4).

At the initial briefing stage, only RMU took a contrary position. Intercounty specifically asserted that the Commission may, for example: a) assign an exclusive service territory to Intercounty and one to RMU, all within the Area, with both electric suppliers having the right to serve new and existing customers within their respective territories; or b) partition the Area such that one electric supplier has an exclusive service territory as to both new and existing structures in one part of the annexed area, while both suppliers share service in another territory. The Cooperative then allowed as how other combinations would also be possible. (Initial Brief of Intercounty ["Intercounty Brief"] at 27-28). In the opinion of the Office of the Public Counsel

("OPC"), the Commission may grant or deny RMU's Application; permit Intercounty to serve the Area, with compensation to RMU for "associated lost revenues" for those structures built after annexation, and the areas within the annexed area that remain undeveloped; or specify some other territorial configuration that it finds to be in the public interest. (Initial Brief of OPC ["OPC Brief"] at 11).

RMU, on the other hand, argues that the Commission lacks the authority to assign all, or even part, of the Area exclusively to Intercounty; stating that Section 386.800 "cannot be considered in a vacuum." RMU cites case law for the proposition that Section 386.800 may not repeal, by implication, any other provisions of law; and that all consistent statutes must be construed together in an effort to harmonize them with the overall legislative scheme. RMU reasons that since only the municipal utility is statutorily permitted to seek Commission involvement in this whole process, it does not make sense that a non-applicant such as Intercounty could end up with an exclusive service territory. Citing subsection 2 of Section 386.800, RMU notes that the municipal utility is permitted, without permission of the Commission, to serve new structures within a lawfully annexed area. (Initial Brief of RMU ["RMU Brief"] at 31-36).

RMU further argues that Section 386.800 fails to make an express grant of authority to the Commission to assign an exclusive service territory to Intercounty. (RMU Brief at 34). Notwithstanding RMU's other arguments, it is difficult to reconcile this contention with the Section 386.800.6 language stating that "the municipally owned utility may apply to the commission for an order assigning exclusive service territories within the annexed area...." If only RMU may be granted an exclusive service territory within the Area, how is it that the statute authorizes the assignment by the Commission of more than one such territory? Indeed, why did not the statute simply provide that, upon application (such as in the instant case) by a municipal utility for the establishment of a lawfully annexed area as its exclusive electric service territory, the Commission shall: a) decide whether or not to grant such application and, if it decides in the affirmative, b) establish fair and reasonable compensation to be paid over to the affected electric supplier(s)? Staff asserts that, contrary to the opinion of RMU, in the special circumstances triggering Section 386.800.6, the statute clearly permits the Commission to assign exclusive service territories to electric utilities other than the municipal utility.

Staff reads Section 386.800 as both internally consistent and consistent with other law. As suggested by OPC, the statute contemplates that a municipal utility seeking to serve an annexed territory with a pre-existing electric supplier will reach a territorial agreement with said supplier and present the same to the Commission for approval under Section 394.312. (OPC Brief at 8). Moreover, absent the voluntary invocation by Rolla of 386.800.6, RMU would clearly be authorized to provide electric service to all new structures within any lawfully annexed territory. However, inasmuch as RMU has invited the Commission's involvement in this matter, pursuant to Section 386.800.6, the Commission is required to act in accordance with its findings as to "what best serves the public interest...." In other words, by exercising its right to bring the matter before the Commission, RMU has triggered the Commission's supervening power to specify exclusive service territories within the Area.

In summary, upon application by the municipal utility, the clear language of the statute permits the Commission to assign exclusive service territories as it sees fit. Essentially the only requirement is that the Commission find, pursuant to subsection 6 of the governing statute, that its decision best serves the public interest. As noted by OPC, this is a higher standard than the "not detrimental to the public interest" standard applicable to territorial agreements, and legitimately so, given that the parties involved will be required to comply with the arrangement regardless of whether they agree with it. (OPC Brief at 4-5).

The Staff would also point out the following:

a. In its initial brief, the Staff, in discussing the term "exclusive service territories" in the context of a territorial agreement, indicated that it is a future-oriented term; *i.e.*, one that was designed to help the parties to the agreement manage their future growth. In other words, exclusive service territories are primarily concerned with <u>new</u> customers, and the utility designated to serve such a territory may or may not, depending on the agreement, be permitted also to serve existing customers. (Staff Brief at 3-4). Accordingly, Staff would envision that any assignment by the Commission of an exclusive service territory to Intercounty within the Area would exempt any structures that RMU has already commenced serving. Further, by allowing RMU to continue serving its existing customers under such a scenario, the Commission would effectively neutralize any claim by RMU that the statute does not expressly provide guidelines as to how RMU might be compensated for the loss of existing customers and facilities.

b. Should the Commission desire to specify an exclusive service territory for Intercounty within the Area, the Commission faces a significant practical limitation at the present time; *i.e.*, as was noted by Intercounty, the Commission currently has before it, little if any evidence upon which to base such a decision. (Intercounty Brief at 28). Accordingly, if the Commission wishes to entertain such a scenario, the Staff would recommend that the Commission order the parties to submit additional testimony.

II. If the Commission rules in favor of the proposed transfer of facilities and customers and accordingly, establishes fair and reasonable compensation to Intercounty, does the City of Rolla retain the right to determine whether or not it will go through with the transaction?

In its initial brief, the Staff offered two possible interpretations of the Section 386.800.6 language bearing on this question. (Staff Brief at 4-6). Under both interpretations, Rolla is not automatically entitled to back out of its proposed transaction if the Commission approves the transaction and sets what Rolla regards as an unreasonable amount of compensation. At this juncture, the Staff would only note RMU's statement that, should the Commission grant its Application, Rolla "will not withhold payment" in the event that it is not happy with the Commission's determination of fair and reasonable compensation. (RMU Brief at 60-61). The Staff assumes that the phrase "will not withhold payment" means that the City will not attempt to back out of the transaction on the basis of the amount of fair and reasonable compensation set by the Commission.

OTHER ISSUES

III. What method of calculating depreciation should be employed?

The statute requires a determination of the amount of depreciation on the assets subject to transfer. This figure is then subtracted from the present-day reproduction cost, new ("PDRCN"), in order to arrive at fair and reasonable compensation for said facilities. (Ketter Rebuttal, Ex. 13, p. 8, lines 19-20). Each of the three primary parties filing testimony, Intercounty, RMU and the Staff, all developed different methodologies for estimating the appropriate dollar value to be assigned to depreciation. All three methods have shortcomings, but Staff believes that its methodology is the most appropriate.

An estimate of the amount of depreciation requires the determination of the following elements: (1) the PDRCN of the subject facilities; (2) the number of years over which they are scheduled to be depreciated on a straight-line basis, to establish the depreciation rate; (3) a measure of the age of the facilities; and (4) a date as of which that age is measured. The parties agree only that the subject equipment should be depreciated at a rate of 2.8% per year. For the PDRCN, Staff and RMU used the average replacement cost in the Rolla area, including overhead loading, while Intercounty ultimately relied on numbers generated from the experience of its consultant with construction work at the Lake of the Ozarks. The Staff continues to believe that the cost estimates generated on the basis of Intercounty's own experience in the Rolla area are superior. The statute does not specify the particular date that should be used as a cut-off date for depreciation of the assets. Staff used the known effective date of the annexation, which is June 8, 1998, while RMU used an estimated future date of the transfer of facilities (*i.e.*, March 2001).[2]

The absence of definitive data made problematic the determination of the actual age of the facilities subject to transfer. Staff developed an average age of the facilities based on the installation dates of the transformers in the annexed area. The transformers were the only items whose age could be precisely determined from Intercounty's records. The result was an average age of the transformers of 19.74 years, which, then, was considered to be the average age of all facilities in question. Multiplying the average age by the yearly depreciation rate of 2.8% yields an overall depreciation of 55.27% (19.74 years x 2.8/100). Applying that percentage to $742,131 (the replacement cost, new, of the assets at issue), yields a total depreciation of $410,176 and a remaining replacement value, new, of $331,955 ($742,131 minus $410,176).

RMU employed a methodology that involved estimating the age of the facilities based upon the dates that houses in the area were added to the tax roles. Using this information, RMU

[2] Intercounty used June 30, 1998 to calculate depreciation on its district office building. Its calculation for the subject electrical facilities, however, was based on a balance sheet for the year ending 1999.

witness Bourne estimated that 70% of the houses were old enough to fully depreciate the distribution facilities serving these houses, and that the remaining 30% were more than 25 years old. Mr. Bourne used these approximations to develop a remaining life of the facilities, which yielded a remaining replacement value, new, of $66,792. (Bourne Surrebuttal, Ex. 4, Sch. RB-5).

RMU's methodology does not account for any capital improvements/replacements of the subject facilities in subsequent years. RMU argues in its initial brief that there is no need to take these occurrences into account because, by mandating the use of PDRCN, as opposed to original cost, the statute automatically takes care of this concern. (RMU Brief at 42-43). This reasoning is flawed, however, because the method fails to address the other half of the story; namely, the question of the age of the assets. In order that the PDRCN value can be properly reduced as a result of depreciation, it is necessary to determine not only the appropriate value for the statutorily mandated PDRCN, but also the average age of the equipment.

By way of illustration, consider what would have happened had RMU determined, using its methodology, that <u>all</u> (rather than a mere 70%) of the <u>original</u> facilities in the Area were old enough to be fully (100%) depreciated. In that event, RMU, while properly valuing the PDRCN of the facilities, would nevertheless have concluded that the fair and reasonable value of the facilities was zero. (PDRCN minus [PDRCN x 100% depreciated]). (RMU Brief at 48). Yet in actuality, a number of capital replacements and upgrades will have taken place, thereby rendering the plant less than fully depreciated. As a result, Intercounty would be denied fair and reasonable compensation for its facilities. Clearly then, RMU's method of determining depreciation is seriously flawed, and the Commission should therefore reject it.

Intercounty's method of computing depreciation is likewise seriously flawed. The cooperative used a system-wide depreciation figure to calculate the percentage of plant that has not yet been depreciated. This percentage was then applied to Intercounty's adjusted valuation of the subject facilities, new, and a remaining value of said facilities of $749,960 was calculated. (Ledbetter Rebuttal, Ex. 9, Sch. JEL-1). This amount reflects the valuation of the electric distribution facilities.

In its initial brief, the Cooperative states its belief that Staff witness "Ketter's approach is correct in theory," but that it simply disagrees with the average age used by Mr. Ketter. (Intercounty Brief at 36). Why, then, does Intercounty employ such a dramatically different method in the course of developing fair and reasonable compensation for its facilities?

First of all, Intercounty's method uses too broad a pool of assets in the calculation, including such assets as vehicles, offices and office equipment, as well as system-wide utility equipment. Thus, Intercounty's calculation is reflective of the Cooperative as a whole, rather than the particular equipment whose transfer is at issue.

Perhaps more important is the fact that the method is sensitive to inflation; that is, recent capital expenditures, because they were made with inflated dollars relative to those made much earlier, will suggest a younger overall plant than is really the case. (Ketter Cross-Surrebuttal, Ex. 14, p. 530, line 8). To illustrate, suppose that Intercounty's entire asset base consists of two poles, and that the depreciation life of a pole is 10 years at the straight-line rate of 10% per year. One asset, Pole A, was purchased and installed at the beginning of year one for $100. The other asset, Pole B, was purchased and installed eight years later (*i.e.*, at the beginning of year nine) for $500. The <u>actual</u> average age of the total plant at the end of year nine is five years (*i.e.*, nine years for Pole A plus one year for Pole B divided by two). However, the average age resulting from the use of Intercounty's method is only about 2.3 years because the total cost of the two poles is approximately 23% depreciated. ($100 minus [nine years of depreciation x $100] + $500 minus [one year of depreciation x $500]) divided by ($100 + $500) = approximately 77% undepreciated; thus, only 23% depreciation, or 2.3 years). Intercounty's assertion that its method of calculating depreciation "is best representative of the average age and physical state of the facilities which RMU seeks to have transferred" (Intercounty Brief at 36) is therefore plainly false because of the dollar-weighting effect of the method chosen by the Cooperative.

Staff believes that its methodology yields the best overall estimate of the average age of the facilities subject to transfer, using the statutorily mandated straight-line depreciation. Unlike RMU's method, Staff's approach approximates the actual age of these facilities. Moreover in contrast to Intercounty's approach, Staff's method is not distorted by the inclusion of non-electric assets or by the effects of inflation. The Commission should reject the approach of both RMU and Intercounty in favor of the Staff's method, which yields a depreciation value of $410,176 for the facilities subject to transfer.[3]

IV. 400% of Gross Revenues

RMU argues that the appropriate value for this component of fair and reasonable compensation is $1,166,814. This represents an adjustment from an earlier figure of $1,481,853.80, to reflect Intercounty witness Strickland's claim that the rates of the two utilities are roughly comparable because of discounts and refunds received by Cooperative members. In its initial brief, the Staff argued that this adjustment was inconsistent with the statutory requirement that *gross* revenues be considered. (Staff Brief at 17-18). It should also be noted that RMU heralds, as one of the big reasons its proposed transaction is in the public interest, a sizeable resultant rate reduction for the Intercounty members to be transferred. (RMU Brief at 17). Thus, in making this adjustment in revenues to reflect comparable rates, RMU is attempting to "have its cake and eat it too." The Commission should reject RMU's estimate and adopt Staff's value of $1,534,146.

V. Should the equity owed to the Intercounty members in the annexed area be considered in the calculation of fair and reasonable compensation?

Staff is opposed to Intercounty's inclusion in fair and reasonable compensation of any amounts that Intercounty owes as a patronage obligation (a.k.a. "capital credits") to the 286 members subject to transfer to RMU. These are monies to which the affected members are, at some point, entitled. Intercounty states in its brief that the Commission's ordering of the customer transfer would present the Cooperative with "another obligation it otherwise would not need to immediately incur." (Intercounty Brief at 46). As noted in Staff's initial brief, the payout is at the discretion of the Cooperative's board of directors. Accordingly, it is not at all clear why Intercounty should incur such obligation earlier than it would absent the transfer, unless it so decides. In fact, on cross-examination, Intercounty witness Strickland testified that if the Cooperative were to receive this windfall, it did not intend to make the funds available to the 286 members subject to transfer; rather, Mr. Strickland indicated that the funds would be distributed in due course to "the general membership." (Tr. 501, lines 14-17).

The Staff sees no reason whatsoever why RMU should be required to fund this fundamental obligation of Intercounty to its members. The Commission should reject

[3] In reaching its decision, the Commission should be mindful of the fact that it need not adopt the methodology of a particular party in its entirety. For example, the Commission may elect to adopt Staff's general methodology, but to order a change in the above-discussed cut-off date for depreciation.

Intercounty's request that $402,649.39 in capital credits be included in the amount of fair and reasonable compensation to Intercounty.

CONCLUSION

In Staff's view, the transaction proposed by RMU best serves the public interest. The Staff therefore recommends that the Commission: a) order the transfer to RMU of Intercounty's facilities and customers in the City of Rolla's newly annexed area; b) establish the newly annexed area as the exclusive service territory of RMU; and c) order a compensating payment by RMU to Intercounty in the amount of $1,890,101 PLUS the reasonable costs of activities associated with detaching facilities and reintegrating Intercounty's system.

Respectfully submitted,

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 9th day of February 2001.

Dennis L. Frey

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