BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of Capital City Water Company's tariff revisions designed to increase rates for water service provided to customers in the Missouri service area of the company.	)))))	**Case No. WR-94-297**

APPEARANCES

W.R. England, III, Brydon, Swearengen & England, P.C., 312 East Capitol Avenue, Post Office Box 456, Jefferson City, Missouri 65102, for Capital City Water Company.

James M. Fischer, Attorney at Law, 101 West McCarty Street, Suite 215, Jefferson City, Missouri 65101, for the City of Jefferson, Missouri.

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

Eric B. Witte, Assistant General Counsel, Missouri Public Service Commission, Post Office Box 360, Jefferson City, Missouri 65102, for the staff of the Missouri Public Service Commission.

HEARING EXAMINER: **Thomas H. Luckenbill.**

REPORT AND ORDER

On March 25, 1994, Capital City Water Company (Company) submitted tariff sheets to increase rates for water service in its Missouri service area effective April 24, 1994. The effect of the proposed tariff sheets would be to increase annual revenues of the Company by $523,616, or approximately 19.7 percent. On April 1, 1994, the Commission issued a Suspension Order And Notice suspending the tariffs to February 22, 1995.

On April 21, 1994, the City of Jefferson, Missouri (Jefferson City, Missouri) filed an Application To Intervene. On May 6, 1994, the Commission issued an Order Establishing Test Year. The Commission established the year ending December 31, 1993, as updated through June 30, 1994, as the proper test year to be used in this case. On September 12, 1994, a public hearing was held in Jefferson City, Missouri. On September 27, 1994, the Commission convened a prehearing conference in which all parties participated.

On October 21, 1994, a Hearing Memorandum was filed which identified six contested issues to be decided by the Commission. The six contested issues identified in the Hearing Memorandum are: (1) Capital City Water Company/Public Water Supply District No. 2 (District) contract (Company/District contract issue, or contract issue); (2) return on equity; (3) FAS 87 versus ERISA accounting; (4) inflation; (5) payroll; and (6) interruptible water sales.

On October 11, 1994, the Office of the Public Counsel (OPC) filed a Motion To Limit Scope Of Proceedings (OPC's Motion). OPC's Motion requested that the Commission issue an order reasserting that its decision from Commission Case No. WR-90-118 was a final judgment on the merits and to limit the scope of the Company/District contract issue to a determination of the proper amount of adjustment that should be made as a result of the contract.

On November 7, 1994, the evidentiary hearing commenced. On November 7, 1994, the Commission ruled from the bench that OPC's Motion would be taken with the case. The evidentiary hearing adjourned on the afternoon of November 9, 1994.

Findings of Fact

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact.

1. Company/District Contract Issue

In 1977, the Company needed more water storage facilities and reviewed its only two options: building its own tanks or leasing them from the District. Company experts recommended leasing the facilities if the lease agreement contained an annual cap of 182.5 million gallons. In August, 1977, the Company entered a lease agreement for the use of three of District's tanks with a total capacity of 1.3 million gallons and three adjacent wells. In exchange for the use of these facilities, the Company agreed to: (1) pay the District $2,000 a month rent; (2) pay the District a monthly sum equal to the cost of water sold to the District the previous month; (3) pay for the variable costs of the water sold to the District (treatment, electricity, etc.); and (4) pay for the operational and maintenance expenses of District's tanks and wells. The contract is for 20 years (1978 to 1997). Most importantly, the agreement does not contain any cap on the amount of water that the Company must transfer to the District.

In the Company's last rate case (WR-90-118), the Commission found that the Company's agreement to the contract without a cap on annual water transfers to the District, against the recommendation of the Company's own experts, was unreasonable, ***Re: Capital City Water***, 30 Mo. P.S.C. (N.S.) 373, 378, Report And Order. The Commission stated:

> For a fixed amount of storage, the Company agreed to provide unlimited free water <u>and</u> pay a $2000 a month rental fee <u>and</u> pay for the maintenance of the leased facilities. In the Commission's opinion, this is excessive compensation. That Company would agree to such unequal and burdensome terms is not the concern of this Commission if its shareholders bear the costs but when the costs of such items fall upon the ratepayers, it is incumbent upon the Commission to act. The Commission finds it would be totally inappropriate to allow the Company to fully recover the expense associated with the execution of this contract. (***Id.***)

In 1989 the Company's management, concerned about adequate capacity to meet the District's growing needs and Company's rising costs under the contract, approached the District to renegotiate the contract. In March 1990, the District and Company signed an addendum to the contract. This addendum allows Company the use of District's one million gallon Schott Road tank and its .25 million gallon Brazito tank; obligates Company to operational and maintenance expenses on the new tanks; obligates Company to pay for installing a valve control; obligates Company to incur the operational and maintenance expenses of future storage facilities created to meet the District's needs; and extends the original terms and conditions of the contract three more years to December 31, 2000.

Company states that it acted prudently in entering into the contract with the District. Company further states that since the last rate case, significant changes in the District's production and storage capacity as well as the Company's operation of the District's facilities have resulted in the Company being a "net importer" of water from the District. Accordingly, Company contends that it is inappropriate to adjust the Company's test year cost of service in order to allocate any additional costs to the District.

Staff maintains that the costs of the contract did not exceed its benefits and thus proposed no adjustment to the Company's revenue requirement.

OPC states that the Commission ruled, and the Court of Appeals affirmed, that the Company acted imprudently by entering into the contract; therefore, this question is not subject to reconsideration. OPC asserts that the cost of providing water to Public Water Supply District No. 2 exceeds the value of the storage which the Company enjoys.

The City agrees with OPC.

A. Public Counsel's Motion To Limit Scope Of Proceedings

OPC argues that the Commission should adopt the doctrine of collateral estoppel and recognize that its imprudence ruling in Case No. WR-90-118 was a final judgment on the merits of an historical issue, affirmed on appeal, and then move on to the next step--calculating the appropriate amount of subsidization that occurred during the test year in this rate case. In its Response to OPC's Motion, the Company states that the Commission should deny OPC's Motion. Staff and Jefferson City state that the Commission need not rule on OPC's Motion because it is not relevant to the issues in this case.

The Commission is charged with the responsibility of setting just and reasonable rates. To perform its duty in relation to the Company/District contract, the Commission must look at the effect of the agreement during the test year period. The Commission would point out that the contract was considered imprudent by the Commission in the Company's last rate case (WR-90-118) and nothing has occurred since its decision in the Company's last rate case to materially change the Commission's opinion with respect to the overall prudence of the contract. The Commission is of the opinion that changes in the manner in which the Company operates the District facilities and the construction of additional production and storage facilities by the District do not have the effect of making the contract prudent. The district contract is still imprudent due to the uncertain, fluctuating and unrelated benefits and costs associated with the contract during any given period of time. The 1990 amendments to the contract did not cure the imprudence of the contract in that there is still no limit in the agreement on potential deliveries of Company-treated water to the District. (Ex. 51, Sch. RWT-4.1 - 4.12). Additionally, the Commission is of the opinion that the contract cannot be characterized as an arm's length agreement due to the uncertain and widely fluctuating benefits and costs that arise as a result of the contract. Based upon this reasoning, the Commission will grant OPC's Motion.

Even though the Commission is of the opinion that the contract is still imprudent, it must proceed to apply a cost-benefit analysis to the events that transpired during the test year as a result of the existence of the contract to determine what, if any, adjustment should be made to Company's revenue requirement.

B. Contract Adjustment Issue

The fundamental question for the Commission to address in this proceeding is how to analyze the District contract for ratemaking purposes. The Commission is of the opinion that the benefits and costs that occur as a result *of the existence of the contract during the test year must be quantified and* balanced against each other. If the costs to the Company associated with the existence of the contract exceed the benefits that accrue to the Company, the Commission will make an adjustment to the Company's revenue requirement to compensate the Company's ratepayers for the excessive value transferred by the Company to the District. If, on the other hand, the benefits associated with the existence of the contract exceed the costs associated with the contract, the Commission will make no adjustment. The foregoing is the analysis to be applied by the Commission in this case.

In order to measure the benefits and costs associated with the existence of the contract, a value must be assigned to the water that the Company transfers to the District storage facilities and a value must be assigned to the water that the Company receives back from the storage facilities. The value per hundred cubic feet (ccf) of water transferred from the Company to District storage facilities is not the same as the value per ccf of water received by the Company from the storage facilities, because the Company is transferring 100 percent Company-produced water into the District's storage facilities and receiving water which is a mixture of District-treated water from the District's wells (District-produced water) and Company-treated water from the Missouri River (Company-produced water). The cost associated with producing water from the District's wells is less than the cost of producing water from the Company's treatment plant. In addition, there is a value associated with the benefit that inures to the Company by not having to build additional storage. Also, the

Company pays the District $2,000 per month which is a cost associated with the contract.

The first step is to quantify the costs to the Company arising as a result of the contract. There is a cost associated with Company-produced water delivered into District storage facilities. The Commission will quantify the cost to the Company (and its ratepayers) of the Company-produced water delivered into the storage facilities of the District during the test year. During 1993, 173,610 ccf (129,860,280 gallons) of Company-produced water was delivered into District storage facilities as a result of the contract. One cubic foot of water is equal to 7.48 gallons of water. (Tr. 227, lines 11-14). The acronym "ccf" means one hundred cubic feet. Therefore, to convert 129,860,280 gallons into ccf, one divides the number of gallons by 748 (i.e.: 129,860,280 ÷ 748 = 173,610). (Ex. 49, p. 13).

The Commission finds that the value of the Company-produced water is $1.01 per ccf. The Commission based this finding upon the following calculation: Revised Schedule 10 attached to Staff witness Henderson's surrebuttal testimony shows the derivation of Cost Component E-C which are the costs incurred by the Company if there had been a sale of water from the Company facilities to the District. (Ex. 36, Rev. Sch. 10). Mr. Henderson's analysis shows a TOTAL COMPONENT "E-C" of $0.91 per ccf. However, Mr. Henderson's calculation subtracts $146,170 associated with "Return" in the derivation of the $0.91 per ccf. The Court of Appeals for the Western District of Missouri said that the rates applied in this matter should not include return on investment and depreciation with regard to water coming from *District* facilities because the Company does not own the District facilities. However, the Commission is of the opinion that the Court of Appeals did not intend to preclude the inclusion of return on investment and depreciation in connection with Company-produced water. Therefore, the Commission added back the $146,170 associated with return shown on Revised

Schedule 10 of Mr. Henderson's surrebuttal (Ex. 36) which produces a cost of $1.01 per ccf. (Ex. 36, Rev. Sch. 10). By multiplying $1.01 by 173,610 ccf, a product of $175,346 is derived. Therefore, the Commission finds that the value of the Company-produced water transferred to District storage during the test year is $175,346. In addition to transferring $175,346 worth of Company-produced water to the District's storage facilities during the test year period, the Company also paid the District $24,000 under the terms of the contract. Thus, the total costs associated with the contract during 1993 are $199,346.10.

The next step is to quantify the benefits received by the Company as a result of the contract. The Commission will establish a value for the water received by the Company as a result of the existence of the contract during the test year period. The Company received 229,590 ccf (171,733,320 gallons) back from the District's storage facilities in 1993. (Ex. 49, p. 13). The record in this case demonstrates that when the Company transferred Company-trated water to the District's storage facilities, it was "mixed" with well-produced water before water was returned to the Company for use by its customers. (Tr. 229, Ex. 38, p. 4). During 1993, 173,610 ccf (129,860,280 gallons) of the Company-produced water was mixed with the well production of the District wells at the District's storage facilities. During 1993, the District wells produced 495,369 ccf (370,536,000 gallons). Assuming perfect mixing, 74.05 percent of the water received by Company from the storage facilities came from District wells while 25.95 percent came from Company production (i.e., the Missouri River). The amount of water received from each source by the Company as a result of the contract is calculated by applying the above percentages to the total amount of water received from the District storage facilities by the Company. The amount of water received by the Company from its own production facilities equals the product of 25.95 percent and 229,590 ccf (171,733,320 gallons). Therefore, the Company received 59,579 ccf of Company-produced water as a result of the contract during the test year (.2595 x 229,590 = 59,579). Likewise, the amount of District-produced water received by the Company as a result of the contract during the test year is 170,011 ccf (.7405 x 229,590 = 170,011).

The value of the water which originated at the District wells is $0.34 per ccf. The unit cost of water originating at the District's wells is derived by taking the fully-allocated cost of the Company to operate and maintain the District's facilities and dividing by the production of the District facilities (i.e.: $167,512 ÷ 495,369 = $0.34 per ccf). (Ex. 36, p. 3, Rev. Sch. 10). Therefore, the benefit to the Company associated with water received as a result of the contract is $117,979. This figure is the number of ccfs of District-produced water times the cost per ccf of District-produced water *plus* the number of ccfs of Company-produced water times the cost per ccf of District-produced water (i.e.: (170,011 x $0.34) + (59,579 x $1.01) = $117,979).

In addition to receiving $117,979 worth of mixed water, the Company did not have to build additional storage to meet the needs of its growing customer base. Therefore, another benefit to the Company is foregone storage expense. OPC offered evidence indicating that the cost to Capital City if it had built its own storage tank would be $119,189. (Ex. 49, App. B). The Commission determines that $119,189 is a reasonable estimate of the benefit to the Company during 1993 of not having to build storage. By adding the value of the water received by the Company to the savings in storage costs (or foregone storage expense), the Commission finds that the total benefit to the Company as a result of the contract during the test year is $237,168 ($117,979 + $119,189).

There was evidence proffered in this proceeding about the benefit to the Company of having operational control over the District's facilities and there was evidence offered about the costs to the Company associated with operating and maintaining District facilities. The Commission finds that the costs and benefits arising as a result of the Company's operational control of much of the District's plant are each part and parcel of the same concept (i.e., a transfer of operational control to the Company from the District). The Commission believes that the costs of operating and maintaining District facilities are properly considered exclusively in the calculation of cost per ccf of District-produced water, based on the record before it.

Table Showing Benefits And Costs Of Company/District Contract As Applied To Capital City Water Company During Calendar Year 1993

Benefits		Costs	
Water Received	$117,979	Water Tendered	$175,346
Foregone Storage Expense	119,189	Fixed Lease Payment	24,000
TOTAL BENEFITS	$237,168	TOTAL COSTS	$199,346

An important reason that the Commission found the contract imprudent in WR-90-118 was the lack of a cap in the contract on the amount of water to be transferred from the Company to the District. In the WR-90-118 case, 338,731,000 gallons were transferred from the Company to the District during the test year, and the Commission made an adjustment. During 1993, 129,860,280 gallons were transferred from the Company and the Commission has found that no adjustment is appropriate. Although the facts have changed since the test year applicable to WR-90-118, the above comparison demonstrates the consistency between the two Commission decisions in relation to the 182,500,000 recommended limit of annual water transfers from Company to District.

In summary, the Commission finds that the benefits associated with the contract during the test year period applicable to this rate case exceed the costs associated with the contract during the same period. Therefore, no adjustment is warranted in this case. The Commission will emphasize that it contemplates applying the identical framework of analysis to the Company/District contract in future rate cases of Capital City Water Company.

The Commission's approach to analyzing the costs and benefits associated with the contract is similar to the approach presented by the City of Jefferson in its initial brief and entitled "Alternative Compromise Approach". The "Alternative Compromise Approach" presented by the City of Jefferson results in an adjustment to Company's revenue requirement of $66,015 while the Commission approach results in a $0 adjustment. The primary reason for the different results is that the "Alternative Compromise Approach" presented by the City of Jefferson failed to take into account the benefit to the Company associated with receiving 229,590 ccf (171,733,320 gallons) of mixed water. The value of the mixed water received by the Company during 1993 is $97,647 as calculated by the City of Jefferson and $117,673 as calculatd by the Commission.

The Commission finds that OPC's analysis and result are not correct and the policy effect of the analysis is inappropriate. OPC's analysis double-counts several expenses incurred by the Company as a result of its relationship with the District. For example, OPC's analysis shows a direct assignment of $64,703 in purchased power expense. (Ex. 52). This is the cost of electricity which the Company incurs to pump water from the District's wells into the District's system or tanks. In addition, however, OPC allocates 22.27 percent of the remaining purchased power expense incurred by the Company in operating the Company's treatment plant and distribution system. This results in an allocation of approximately 44 percent of the Company's total electric costs to the District, even though total well production is only 22 percent of total well and treatment plant production.

Another shortcoming of OPC's analysis is that it is built upon an assumption that the Company "will continue to operate the wells at a production capacity that will result in either a net export from the PWD#2 system or at least a balanced amount." (Ex. 49, p. 9). The Commission prefers a framework of analysis which produces a logical result in varying circumstances, including the circumstances which existed during 1989 when the Company was a net exporter of water to the District, which circumstances gave rise to the Commission determination that the contract is imprudent. OPC's cost allocation method creates a questionable policy incentive in that the magnitude of OPC's adjustment is positively correlated with the amount of District water production in that its indirect cost allocator is calculated by dividing District well production by District well plus treatment plant production. (Ex. 49, p. 10; Ex. 55). This gives the Company an incentive to increase Company production and decrease District production, which appears a poor allocation of resources in that water produced from the District wells is a lower cost source.

2. Return on Equity

A. Company's Motion to Strike a Portion of Public Counsel's Rebuttal

On November 8, 1994, during the hearings, the Company stated its objection to a portion of the surrebuttal testimony of OPC witness Tuck. Specifically, the company objected to page 6, line 2, continuing through page 15, line 18 of Tuck's surrebuttal (Ex. 22). The basis of the Company's objection is that the testimony objected to responds to the Company's risk premium and comparable earnings analyses, both of which were proffered in Company witness McGuire's direct testimony.

OPC's response to Company's objection was that the portion of Tuck's surrebuttal objected to is responsive to Company witness McGuire's rebuttal testimony. (Tr. 158).

The Commission is of the opinion that the testimony objected to is, in fact, responding to the Company's analysis of risk premium and comparable earnings analyses and that OPC should have had such testimony in its rebuttal testimony to afford the Company an opportunity to respond. Thus, the Commission will sustain the Company's objection and strike the page 6, line 2, continuing through page 15, line 18 of Exhibit 22 from the record of this proceeding.

B. Return on Equity Issue

All parties in this proceeding used a discounted cash flow (DCF) method for estimating the cost of common equity. The DCF model is a market-oriented approach that uses three variables to determine the cost of equity of a company. These variables are the expected dividend, the current stock price and the growth factor. Normally, a difference occurs in the DCF calculations due to differences in factors used to develop the growth rate.

The Company recommends that it be allowed to earn a 12.5 percent return on equity. This recommendation is based on: (1) a discounted cash flow analysis which produced a return on equity of 11.7 percent; (2) a risk premium analysis which produced returns on equity in the range of 11.5 percent to 11.7 percent; and (3) a comparable earnings analysis which produced a return on equity of 14.4 percent. Company states that a 12.5 percent return on equity will produce a pretax interest coverage ratio of 3.0, which falls within the range of interest coverage required by Standard & Poors for an "A" rating. (Ex. 12, pp. 1-18; Ex. 13, pp. 1-8).

Staff's position is that the Company should earn 11.28 percent - 11.75 percent return on equity. The Staff's DCF analysis produced an ROE range of 10.80 percent to 11.75 percent, with a midrange of 11.28 percent. (Ex. 17, p. 33). However, Staff makes an upward adjustment to its required ROE range due to risks that the Company faces in connection with its pretax interest coverage ratios for the periods ending 1991 through 1993 and low return on equity in 1993. (Ex. 17, pp. 35-36). Staff implements the upward adjustment by recommending adoption of an ROE within the upper half of the required ROE range of

10.80 percent to 11.75 percent (midpoint of range is 11.28 percent). Thus, the Staff's recommended ROE, after inclusion of an upward adjustment for the Company's low interest coverage ratios and ROE during 1991 through 1993, is 11.28 percent to 11.75 percent. (*Id.*). Staff states that OPC's recommendation is too low because it does not reflect the risk that Company shareholders bear due to a history of low earnings and coverage ratios--for both the Company and its parent company--relative to the water industry generally. (Ex. 17, pp. 33-36; Ex. 18, p. 4). Staff further states that the Company's third method--comparable earnings analysis--is flawed because the "comparable companies" chosen by the Company for its analysis do not match the low risk characteristics of the water utility industry. (Ex. 18, pp. 11-13).

OPC states that the Company should earn a 10.5 percent return on equity. OPC states that this rate is based primarily upon a market-driven DCF analysis. OPC states that the Company's DCF analysis is improperly implemented. OPC states that Staff's DCF recommendation is not properly based upon investor expectations but rather, the Staff chooses the type of growth variable, for each comparable company, that generates the highest possible growth rate. OPC states that the predominant reason for Company's recent history of low earnings was the Commission's adjustment in WR-90-118 regarding the District contract. To artificially inflate a market-based return on equity would unduly reward the Company for decisions found imprudent by the Commission. (Ex. 20, pp. 2-42; Ex. 21, pp. 1-25).

Jefferson City states that the Company should be authorized to earn a return on equity of 10.5 percent - 11.28 percent.

The Commission finds that the high end of Staff's return on equity range, 11.75 percent, is a reasonable authorized return on equity for Capital City Water Company. Upon consideration of the evidence, the Commission determines that the Staff's DCF analysis is reasonable. However, the Commission does not agree with the Staff's reasoning that an upward adjustment for low earnings and interest coverage ratios is necessary. The Commission is of the opinion that the Company's earnings and coverage ratios have been held down in recent years, at least in part, as a result of the ratemaking impact of the Company's imprudent contract with Public Water Supply District No. 2. As explained in section 1 of this Report And Order, the Commission has found that no adjustment for the imprudent contract is warranted in this case. Thus, Company's earnings will not be subject to the downward effect of the contract adjustment for WR-90-118. Furthermore, the Commission is of the opinion that an upward adjustment to the Company's authorized return on equity for the reasons stated by Staff would, in effect, compensate the Company for the regulatory result of having entered into an imprudent contract. Nevertheless, the Commission finds that the high end of Staff's range is reasonable due to the upward trend in interest rates from February, 1994, through August, 1994. (Ex. 17, Sch. 3-1).

The Commission will not utlize the Company's comparable earnings approach because the Commission is of the opinion that the DCF is a more reliable approach to cost of common equity estimation. In the 1989 Southwestern Bell Telephone Company complaint case, the Commission stated the following regarding the DCF model:

> As recognized by the parties, the Commission has, in recent years, almost exclusively utilized the constant growth DCF method for determining the ROE (return on equity) for the public utilities under its jurisdiction. Even though characterized as simplistic or naive, the Commission has found that the DCF method takes into account investor expectations, including the risk of a particular common stock. The constant growth DCF model, with adjustments for particular circumstances, has been used to set rates for small water companies as well as electric utilities with nuclear construction. The returns developed using this method and approved by the Commission have been reasonable and have maintained the financial integrity of each utility. ***Southwestern Bell Telephone***, 29 Mo. P.S.C. (N.S.) 607, 650-51 (1989).

In addition, the Commission is of the opinion that the "comparable companies" used by Company witness McGuire do not match the low risk characteristics of the water industry.

The Commission is not adopting the Company's DCF approach because the Company included a quarterly compunding adjustment and flotation cost adjustment. The Commission is of the opinion that these upward adjustments to the return on equity using the DCF approach are not appropriate.

3. FAS 87 v. ERISA Accounting

The Employee Retirement Income Security Act of 1974 (ERISA), which was enacted to ensure the adequate funding of pension obligations, requires that a company must, in most instances, fund its pension obligation in advance by setting up an external trust fund into which periodic contributions are made. ERISA also sets standards by which actuarial calculations are made to determine both the minimum annual contribution necessary to adequately fund a company's pension obligation, as well as the maximum allowable contribution. A company will not be allowed a current tax deduction for amounts in excess of the maximum ERISA amount. Prior to 1987 most companies accounted for pension expenses by charging to expense on their income statement the amount of the cash contribution made to their pension fund.

In 1987 the Financial Accounting Standards Board (FASB) issued FAS 87, which established accrual accounting of pension expense for financial reporting purposes. The FAS 87 expense levels, like the ERISA contributions, are based on actuarial calculations, but the actuarial methodologies used in some respects differ between the two; consequently, the FAS 87 amount may vary significantly from the ERISA amount.

The Company proposes that its test year pension expense be based upon its minimum ERISA funding requirements. (Ex. 23, pp. 5-6; Ex. 24, pp. 8-12).

The Office of the Public Counsel proposes that all postretirement benefits should be consistently treated pursuant to the accrual accounting of FASB. OPC argues that FAS 87 accrual accounting for ratemaking is appropriate just as FAS 106 accrual accounting has been determined to be appropriate regulatory accounting.

The Staff states that as a result of the enactment of Section 386.315, R.S.Mo. 1994, which requires adoption of FAS 106 treatment of OPEB costs by the Commission for ratemaking purposes, the Staff has determined that similar ratemaking treatment should be afforded pension costs by using FAS 87 to set rates, due to the similarities between FAS 106 and FAS 87. However, Staff's position in this case is that Capital City Water Company should be allowed to recover minimum ERISA funding requirements because the Company has not adopted FAS 106 for ratemaking purposes. (Ex. 27, p. 2). The record in this case shows that the Company does not use FAS 106 accounting for OPEBs because the adoption of FAS 106 would not have a material effect on the Company's financial statements. Although the Commission agrees with the Staff that the Company should be allowed to recover the minimum funding amount required under ERISA and Internal Revenue Service (IRS) laws and regulations, the Commission does not find the Company's auditor's opinion that the Company need not adopt FAS 106 treatment for OPEB expenses to be issue-dispositive.

The Commission determines that Capital City Water Company shall be allowed to recover the expenditures made by it for pension expense as calculated by the Company to meet minimum ERISA and IRS regulations and laws because this represents a level of cost that must be paid into the pension fund. The Commission is not persuaded that it is appropriate to exclusively apply FAS 87 expense recognition as a result of the enactment of Section 386.315, R.S.Mo. 1994.

The Commission is of the opinion that there are at least two significant distinctions between FAS 106 and FAS 87 for regulatory purposes. First, the Missouri legislature has enacted legislation mandating that the Commission not disallow or refuse to recognize FAS 106 expenses so long as such expenses have been reviewed and approved by the Commission and such review and approval is based on sound actuarial principles. Section 386.315, R.S.Mo. 1994. There is no analogous Missouri legislation for FAS 87 expenses. Secondly, ERISA and its implementing regulations specify minimum pension funding requirements. There is no analogous federal law or regulation pertaining to minimum OPEB funding requirements.

4. Inflation

The Company proposes adjustment of certain test year expenses to account for the effects of inflation from December 31, 1993, to December 31, 1994. (Ex. 23, pp. 5-6; Ex. 24, pp. 8-12). The Staff's position is that test year expenses are a better indicator of future expenses. Staff further states that there is insufficient evidence of future inflation levels to permit the Commission to make an adjustment. (Ex. 27, pp. 3-4). OPC and Jefferson City each support Staff.

In certain limited instances, the Commission has found it appropriate to deviate from a strict application of historical test year principles. For example, in United Telephone Company of Missouri's (UTM's) most recent rate case, the Commission approved a seven-year modernization plan proposed by UTM to comply with 4 CSR 240-32.100 (Case Nos. TR-93-181 and TO-93-309, consolidated). The Commission approved a two-year (Phase I) incremental revenue requirement over the costs incurred in UTM's then-current method of operation. The UTM case reflects a slight deviation from historical test year principles, but the State had an important interest in the effective implementation of UTM's modernization plan.

In contrast with the facts of the UTM case, the Company in this proceeding has presented no compelling reason to deviate from historical test year principles. The test year is twelve months ending December 31, 1993. The test year as updated is the twelve months ending June 30, 1994. In addition to a proposed test year or a proposed test year as updated, a party may request isolated changes, such as those imposed by governmental bodies, as part of its case and the Commission will consider whether these isolated changes are known and measurable and whether they should be included in the Company's revenue requirement.

In the situation presented in this proceeding, the Company's proposed use of the Gross Domestic Product (GDP) deflator to selected operation and maintenance (O&M) expenses does not even rise to the level of a *prima facie* showing and the Company certainly has not shown that the projected increases in O&M are known and measurable by a preponderance of the evidence.

The Commission determines that no adjustments for inflation are appropriate because the proposed inflation adjustments are not known, nor are they measurable. In addition, the Commission is of the opinion that the proposed adjustments for inflation are speculative in nature.

5. Payroll

The Company and the Staff agree to use a five-year average of overtime expenses as an indicator of future overtime expense. OPC's position is that future overtime expense will not reach the test year level, and certainly not the five-year average level, due to the Company's declining number of permanent employees and various job position changes.

The overtime figures over the past five years show a downward trend. However, the years 1992 through 1994 show overtime hours leveling out around 1,100. The record is not entirely clear with regard to whether the nonexempt position of Plant Operator/Assistant Production Manager has yet been or at what specific point in time it will be filled. It is clear from the record that Mr. Riedenhour was promoted from the position of Plant Operator/Assistant

Production Supervisor (a nonexempt position) to Production Supervisor (an exempt position) and that in his prior position, Mr. Riedenhour earned 110.5 hours of overtime pay during 1993. It appears that the Company intends to put a person named Shelton in the position of Plant Operator/Assistant Production Supervisor at some point in time.

The Commission is of the opinion that the most reasonable way to estimate annual payroll expense, given the record presented, is to use actual overtime hours from January 1, 1994, to September 30, 1994, and add to that the five-year average of overtime incurred in October, November and December. This results in 1,101 hours of overtime. This method recognizes the downward trend in overtime expense experienced by the Company (after normalization for the flood).

6. Interruptible Water Sales

The Company maintains that future sales to the Missouri State Penitentiary will be lower than the average of the past ten years' sales because, in the future, the Missouri State Penitentiary will obtain water from its own supply and not from the Company. Thus, the Company states, the Commission should set rates based on a lower level of sales. (Ex. 29, pp. 5-6; Ex. 24, pp. 15-20). The Staff's position is that the average of the past ten years' sales is the best predictor of future sales. Staff continues that there is insufficient reason to believe that the Missouri State Penitentiary will not continue to take water from the Company system as it has in the past. (Ex. 31, pp. 3-4); Ex. 32, pp. 1-2). OPC and Jefferson City support Staff's position.

The Commission finds that the average of the past ten years' sales is the most reasonable method to predict future sales, considering the methods presented herein. The Commission is of the opinion that the Company did not establish by a preponderance of evidence that the usage of Company water by the

Missouri State Penitentiary will dramatically decline. In fact, a letter dated March 23, 1994, from the Missouri Department of Corrections to Capital City Water Company states, in pertinent part,

> "At the present time, the Department of Corrections does not have any plans for changing its method of operating procedure in the utilization of the Capital City Water Company backup supply." (Ex. 32, Sch. 2).

7. Revenue Requirement

The Commission finds that the Company is entitled to an increased revenue requirement in the amount of $334,799, as shown by the Revenue Requirement Scenario filed in this proceeding (Exhibit No. 56).

Conclusions of Law

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

The Company is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 393, R.S.Mo. 1994.

The Company's tariffs herein were suspended pursuant to authority vested in this Commission by Section 393.150, R.S.Mo. 1994, which places upon Company the burden of proof to show that the proposed increase in rates is just and reasonable.

Pursuant to Section 393.270(4), R.S.Mo. 1994, the Commission may consider all facts which in its judgment have any bearing upon a proper determination of the price to be charged for water service with due regard, among other things, to a reasonable average return upon capital actually expended.

In ***State ex rel. Capital City Water v. PSC***, 850 S.W.2d 903, 915, the Appellate Court for the Western District of Missouri stated:

> Included in the calculation of Rate E is wear and tear on the facility utilized, i.e., depreciation. By applying

> Rate E to the water supplied from the District's own facilities, the Commission would be reducing the revenue requirement for costs assessed to the imprudent contract when the Company is not actually incurring such costs. Although there is a legitimate basis for assessing depreciation on the Company facilities as a cost of the water supplied from such facilities, there is no legitimate basis to assess a cost of depreciation for the water supplied from the District's own facilities.
>
> . . . . .
>
> The Commission utilized Rate E because it found it was without other evidence to establish a reasonable rate for water service to the District. The Commission had evidence sufficient to adjust Rate E for application to the present case. Depreciation costs and return on investment were incorporated into Rate E. Evidence of the computation of the existing tariff Rate E and the Company's proposed increase contained a breakdown of the costs of depreciation and specified the rate of return. The Commission's intention in establishing the appropriate revenue requirement for setting rates was that the Company's shareholders not be permitted to recover from ratepayers the expenses associated with the imprudent contract. It is reasonable to exclude only those expenses actually incurred. Although Rate E is a valid basis for computing the cost of supplying water generally, it was unreasonable for the Commission to utilize Rate E when valuing the water supplied to the District without adjusting the rate to exclude depreciation applicable to the water supplied from the District's own facilities and to exclude a return on investment on all water supplied.

Fortunately, the record before the Commission in this case shows costs associated with providing water originating from District wells distinguished from costs associated with water originating from the Missouri River (Company-treated). Given the record in this case, it is incumbent upon the Commission to follow fundamental principles of utility regulation and include return on investment dollars when calculating the cost associated with Company-produced water.

A landmark case in public utility regulation is the ***Bluefield*** case of 1923. In ***Bluefield***, the Court argued:

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the

> property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculatory ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time, and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.

Bluefield Water Works & Imp. Co. v. Pub. Service Commn. of West Virginia, 262 U.S. 679, 692-93 (1923), ***Missouri ex rel. Southwestern Bell Teleph. Co. v. Missouri Pub. Service Commn.***, 262 U.S. 276 (1923)

Following the reasoning in the ***Bluefield*** case, the Commission determines that Capital City Water Company is entitled to a return on its reasonable investments and, thus, Rate E-C must include such costs.

Based on its findings that the Company is entitled to an increased revenue requirement in the amount of $334,799, the Commission shall order the Company to file tariffs reflecting such increase in revenue requirement. On January 23, 1995, the Commission issued a Revenue Requirement Scenario in this case to the parties. On January 27, 1995, the parties filed the completed Revenue Requirement Scenario, which the Commission will receive as Exhibit No. 56. In addition, on January 27, 1995, the parties filed late-filed Exhibit 2, which is the updated case reconciliation.

IT IS THEREFORE ORDERED:

1. That pursuant to the findings of fact and conclusions of law in this Report And Order, the proposed tariff sheets filed by Capital City Water Company on March 25, 1994, are hereby rejected.

2. That Capital City Water Company be hereby authorized to file, in lieu of the rejected tariffs, for approval of the Commission, tariffs designed to increase gross revenues, exclusive of any applicable license, occupation, franchise, gross receipts taxes, or other similar fees or taxes, by the amount of $334,799 for water service rendered in its Missouri service area on an annual basis over the current revenues.

3. That the tariff sheets to be filed pursuant to this Report And Order shall become effective for water service rendered on and after February 22, 1995.

4. That the Motion of the Office of the Public Counsel to limit scope of proceedings is granted as discussed above.

5. That Capital City Water Company's objection to page 6, line 2, continuing through page 15, line 18 of Exhibit No. 22 is sustained.

6. That late-filed Exhibit No. 2 shall be and is hereby received into the record.

7. That the completed Revenue Requirement Scenario filed on January 27, 1995, shall be and is hereby received into the record as Exhibit No. 56.

8. That those Motions and Objections not specifically ruled on in this Order are hereby denied or overruled.

9. That this Report And Order shall become effective on the 22nd day of February, 1995.

BY THE COMMISSION

David L Rauch

David L. Rauch
Executive Secretary

(S E A L)

Mueller, Chm., McClure, Perkins, Kincheloe and Crumpton, CC., concur and certify compliance with the provisions of Section 536.080, R.S.Mo. 1994.

Dated at Jefferson City, Missouri, on this 8th day of February, 1995.