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November 10, 2003

Secretary
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Case No. WO-2004-0116

Dear Sir:

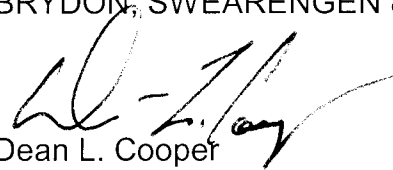
Provided in electronic format for filing in the above-referenced proceeding, please find a Response to Staff Report filed on behalf of Missouri-American Water Company.

If you have any questions concerning this matter, then please do not hesitate to contact me. Thank you very much for your attention to this matter.

Sincerely,

BRYDON, SWEARENGEN & ENGLAND P.C.

By:


Dean L. Cooper

DLC/jar
Enclosure

cc: Ruth O'Neill
Robert Johnson
Diana Vuylsteke
Keith Krueger

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

In the Matter of the Application of Missouri-American)	
Water Company for Approval to Establish an)	Case No. WO-2004-0116
Infrastructure System Replacement Charge (ISRS))	

RESPONSE TO STAFF REPORT

COMES NOW Missouri-American Water Company ("MAWC" or the "Company"), in accordance with the Missouri Public Service Commission's ("Commission") Order Adopting Procedural Schedule, and, states the following in response to the Commission Staff's ("Staff") Recommendation ("Recommendation"):

SUMMARY

MAWC responds to the Staff Recommendation by pointing out inconsistencies with Section 393.1000, et seq., RSMo, as to the Staff's application of accumulated depreciation, property taxes and net salvage. MAWC also agrees with certain other adjustments made by the Staff. Correcting the adjustments that violate Missouri law and making the adjustments with which MAWC agrees produces an annual ISRS revenue requirement of \$3,813,222. MAWC lastly responds to the Staff's inquiry as to whether the percentage add on contained in the ISRS rate schedules will be applied to the customers' entire bill or just the usage portion of the bill by referring the Commission to MAWC's original filing.

BACKGROUND

1. On September 2, 2003, MAWC filed an application with the Missouri Public Service Commission pursuant to Sections 393.1000, 393.1003, and 393.1006, RSMo (HB-208, 2003), requesting that the Commission authorize it to establish an Infrastructure System Replacement Surcharge relating to work performed in St. Louis County, Missouri. MAWC's application

suggested that pursuant to Section 393.1006.2(3) that a ISRS in the amount of \$4,038,923 per year was appropriate based upon the \$29,047,973 of qualifying investment MAWC had made since its last rate case.

2. The Commission's Order Adopting Procedural Schedule, issued on October 16, 2003, directed, among other things, that the Commission Staff file a report, as it is required to do by statute, by October 31, 2003. MAWC was directed to file its response to the report by November 10, 2003.

3. The Staff filed its report on October 31, 2003. The Staff recommended that the Commission issue an order approving MAWC's application to establish an ISRS surcharge in the amount of \$1,887,301 per year.

DISCUSSION

A. Accumulated Depreciation Reserve

4. The Staff's recommendation as to accumulated depreciation reserve is an express and egregious violation of House Bill 208 (Section 393.1000, et seq., RSMo) and, therefore, should be rejected by the Commission.

5. House Bill 208 specifically states that the ISRS revenue should be calculated in such a manner as to take into account "recognition of accumulated deferred income taxes and accumulated depreciation *associated with eligible infrastructure system replacements . . .*." Section 393.1000(1)(a), RSMo (emphasis added). The Staff did not recognize accumulated depreciation based only upon associated eligible infrastructure system replacements. On page 4 of the Case File Memorandum, Staff asserts it "believes" that the amount of the accumulated depreciation reserve, which is used as reduction to the replacement mains and facilities relocation, less reimbursements,

should be based on a ratio of the Company's investment in this plant to the *total change in the amount of MAWC's investment in plant in service, since the last rate case*. Other than this is what the Staff "believes," there is no other explanation as to why this adjustment is appropriate or correct. The reason the Staff provides no other sound or logical explanation for this adjustment is because there is none.

6. The Staff's approach has several other related errors.

A. First, the Staff's proposed adjustment calculates and assigns \$15,550,171 accumulated depreciation to an ISRS eligible investment of \$29,047,973. This calculation implies that these assets, which were placed into service between January 1, 2002 and August 31, 2003, are now depreciated over 53%. This would make the annual depreciation rate for these assets approximately 21%. None of the mains or hydrant accounts has a depreciation rate of 21%. The actual range of depreciation rates for these assets is 1.62% to 2.66%.

B. Second, the Staff has inappropriately assigned accumulated depreciation taken on other non-ISRS eligible investment made after the last rate case and applied it to the ISRS calculation.

C. Third, the Staff has inappropriately assigned accumulated depreciation taken on assets that were included in the Company's rate base in its most recent general rate case.

7. As indicated above, Section 393.1000(1)(a), RSMo states that "recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements which are included in a currently effective ISRS." The Company's proposed ISRS has specifically identified the impact on deferred income taxes associated with the eligible infrastructure. The Staff used the same methodology that the Company did in

calculating deferred taxes (Staff Attachment B, page 3 of 4). The Company's proposed ISRS also has specifically identified the impact on accumulated depreciation by using the actual accumulated depreciation for each ISRS eligible infrastructure asset that the Company has placed into service since January 1, 2002. The Staff did not calculate the impact in the accumulated depreciation specific to only the ISRS eligible infrastructure as required by statute and, by expanding the scope of its review beyond matters specified in the statute itself the Staff has violated—and recommended that the Commission violate—section 393.1006.2(2) which provides that: "The staff of the commission may examine information of the water corporation to confirm that the underlying costs are in accordance with the provisions of sections 393.1000 to 393.1006, and to confirm proper calculation of the proposed charge, and may submit a report regarding its examination to the commission not later than sixty days after the petition is filed. **No other revenue requirement or ratemaking issues shall be examined in consideration of the petition or associated proposed rate schedules filed pursuant to the provisions of sections 393.1000 to 393.1006.**" (emphasis supplied). Therefore, the Staff's adjustment to accumulated depreciation should be denied.

B. Other Issues

8. On page 3 of its Recommendation, Staff identified four (4) other adjustments to the Company's proposed ISRS calculation. All four adjustments lower the amount of the proposed ISRS revenues. A discussion of each adjustment along with the Company's comments are shown below:

A. **Facility Relocations.** Staff has adjusted the Company's net investment in ISRS eligible investment by reducing the amount of the investment made by the Company for facility relocations. The amount of the adjustment is \$1,952,000. The Company brought this adjustment to the attention of the Staff during their initial review of the filing and therefore agrees with the

Staff's proposed adjustment for this issue.

B. **Treatment of Net Salvage.** Staff is recommending disallowance of the impact of cost of removal/net of salvage that the Company has included in the ISRS. Staff's adjustment violates the law. Section 393.1006.4, RSMo, states that "in determining the appropriate pretax revenues, the commission shall consider . . ." "(6) *The current depreciation rates* applicable to the eligible infrastructure system replacements." Staff has stated that the Company has been collecting the cost of removal/net of salvage as part of the depreciation expense and accumulating it in the depreciation reserve account. Staff fails to recognize however, that the current water rates for the St. Louis district were set by Order of this Commission in Case No. WR-2000-844. That Order utilized the amounts collected by the Company for cost of removal/net of salvage to lower rates by reducing net rate base. The impact of the Company now making the expenditure for the cost of removal, net of salvage reverses that accrual and adds to the investment of the Company. The Staff approach ignores the accounting treatment for the cost of removal currently on the Company's books. As depreciation and cost of removal is collected in rates, the accumulated depreciation account balance is increased (as this account increases, rate base is reduced and the impact on rates in a general rate case is decreased). When an asset is retired, the cost of the asset is eliminated from utility plant with a corresponding reduction in the depreciation reserve account. If the Company should incur cost of removal expenditures, cash is reduced and the accumulated depreciation account is reduced. The reduction in the depreciation reserve account for the cost of removal is made to reflect the fact that ratepayers have paid this cost of removal in depreciation rates and now the Company is paying out of the reserve account those amounts. The impact on making these payments reduces the depreciation reserve and increases the Company net investment in rate base. The Staff's

proposal to adjust cost of removal/net of salvage fails to comply with the law and should be denied.

C. **Property Taxes.** Staff's recommendation that the Commission disallow property taxes associated with ISRS investments made during 2003 is also contrary to the law. The ISRS legislation states that ISRS costs should include "property taxes that will be due within twelve months of the ISRS filing." Section 393.1000(5), RSMo. Additionally, Section 393.1006.4, RSMo, states that "in determining the appropriate pretax revenues, the commission shall consider . . ." "(5) The current property tax rate or rates applicable to the eligible infrastructure system replacements." Once a liability for an expense item has been recognized then those items have become "due." The Company will realize (incur the cost) the liability for property taxes associated with these investments beginning January 1, 2004. This is just one day after the ISRS is placed into effect and less than twelve months after the filing of the ISRS. Therefore, the Staff's proposed adjustment to property taxes should be denied.

D. **Deferred Income Taxes.** Staff adjusted the level of deferred taxes to reflect an adjustment for state deferred income taxes. Company and Staff have discussed this issue. The Company agrees with the adjustment to deferred income taxes.

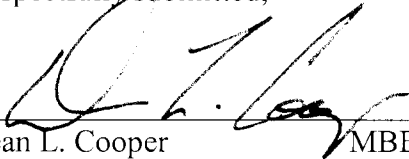
9. **The ISRS Rate Schedules.** The Staff indicates in its Recommendation that it was not clear whether or not the percentage "add-on" to customers' bills will be applied to the customers' entire bill or just the usage portion of the bill. The Staff further states that it had inquired of the Company regarding this matter, but has yet to receive a response. No one at the Company can recall being inquired regarding this issue. If the inquiry was made then the Company apologizes for not responding. There would have been no reason not to respond. However, in the Company's initial ISRS filing that was made on September 2, 2003, the filed tariff "Rate I" identified a provision under

the “Rate Component” section of the tariff that states the following “The appropriate tariff surcharge will be multiplied by the total water charges for a customer’s current billing cycle to calculate the ISRS amount”. The water charges of a customer are the service charge plus any commodity charge.

CONCLUSION

WHEREFORE, MAWC respectfully requests that the Commission issue its order approving MAWC’s application to establish an ISRS surcharge in the amount of \$3,813,222 per year for the reasons stated herein

Respectfully submitted,



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ATTORNEYS FOR
MISSOURI-AMERICAN WATER COMPANY

CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was hand-delivered, or sent by U.S. Mail, postage prepaid, or sent by electronic mail, on November 10, 2003, to the following:

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