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August 11, 2000

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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 Suggested Findings of Fact, Conclusions of Law and Ordered Paragraphs. 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 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

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 Case No. SR-2000-282

MISSOURI-AMERICAN WATER COMPANY'S

SUGGESTED FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDERED PARAGRAPHS

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

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I. PROCEDURAL HISTORY

On October 15, 1999, Missouri-American Water Company ("MAWC" or "Company") filed with the Missouri Public Service Commission ("Commission") revised tariff sheets in Case No. WR-2000-281 for the purpose of implementing a general rate increase for water service provided by the Company. On the same date, the Company filed revised tariff sheets in Case No. SR-2000-282 for the purpose of implementing a general rate increase for sewer service provided by the Company.

On October 28, 1999, the Commission issued its Suspension Order and Notice and Order Consolidating Cases, in which it ordered that Case No. WR-2000-281 and Case No. SR-2000-282 were to be consolidated for all purposes.

In addition to the Company, the Commission Staff ("Staff"), and the Office of the Public Counsel ("OPC"), the list of parties to this case includes the following intervenors: 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"); The Boeing Company, Ford Motor Company and Hussmann Refrigeration (collectively, "MIEC"); 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"); 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"); St. Joseph Building and Construction Trades Council ("Trades Council"); Public Water Supply District No. 2 of St. Charles County ("St. Charles Water District"); City of St. Joseph ("St. Joseph"); City of Joplin ("Joplin"); City of Mexico ("Mexico"); and City of Riverside ("Riverside").

By their filing of a Proposed List of Issues, Order of Witnesses and Order of Cross-Examination on May 25, 2000, the parties unanimously identified the following list of contested issues:

1. **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?

2. **Premature Retirement.** Shall 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?

3. **AFUDC Capitalization Rate.** Should MAWC's rate base be adjusted to reflect a different capitalization rate for AFUDC?

4. **St. Joseph Treatment Plant and Related Facilities ("SJTP") 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?

5. **SJTP Capacity.** What is the appropriate capacity for SJTP that should be included in rate base?

6. **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?

7. **Return on Equity.** What return on equity is appropriate for MAWC?

8. **Rate Design.**

8a. Single Tariff Pricing, District Specific Pricing or Compromise. Shall MAWC's rates be designed consistent with a "single-tariff" rate design, "district-specific" rate design, or some other methodology?

8b. Allocation of Corporate District Expense. What is the proper allocation of MAWC's corporate district investment and expense?

8c. Allocation of Cost Among Classes. On what basis shall the portion of revenues to be borne by MAWC's various customer rate classes be determined?

8d. 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?

Local public hearings were held in St. Charles, Joplin, Mexico, Joplin and St. Joseph. An evidentiary hearing was held on June 5-9, 14-16, 27, 2000, and a true-up hearing was held on June 26, 2000. Two additional issues – concerning chemical expense and property taxes – arose at the true-up hearing. Initial and reply briefs were filed and the cases are now ripe for decision.

II. PENDING MOTIONS AND EXHIBIT

At the hearing, the Commission requested that MAWC's responses to customer complaints from local public hearings be provided as an exhibit. Exhibit 120 was reserved for this purpose. On July 3, 2000, MAWC filed its responses as late-filed Exhibit 120. Commission Rule 4 CSR 240-2.130(17) provides that any objection to a late-field exhibit be made within ten days of the date the exhibit was tendered. No objections to late-filed Exhibit 20 have been received by the Commission.

On June 2, 2000, MAWC filed its Motion to Strike Testimony and Motion for Summary Determination ("Motion to Strike") with the Commission. The OPC and the St. Joseph Industrial Water Users presented their responses to the Commission on June 5, 2000. The Commission stated during the hearing that it would take this motion with the case.

The aspects of the Motion to Strike that concerned striking the testimony of various witnesses are now moot as this testimony has been received into evidence. The aspects of the Motion to Strike concerning summary determination are also now moot. The legal matters discussed therein, however, remain relevant to the valuation issue and will be considered by the Commission in that context.

On July 7, 2000, the OPC filed its Motion to Open Investigation Regarding Water Quality wherein it requested that "the Commission issue its Order establishing a separate case for the purpose of investigating the quality of water being provided to MAWC's customers in its St. Joseph operating district." MAWC responded to this motion on July 17, 2000, and doing so stated that it "would like the opportunity to directly address in a separate docket the concerns and misconceptions that have developed since the new St. Joseph treatment plant was brought on line." The Staff later filed its response stating that it "would be useful and thus recommends the Commission establish a 'spin-off' case for the purpose of the investigation." Having heard support for, and no opposition to, the establishment of such a case, the Commission will grant the OPC's motion to establish a separate case for the purpose of investigating the quality of water being provided to MAWC's customers in its St. Joseph operating district.

III. JOINT RECOMMENDATION

On July 3, 2000, a Joint Recommendation as to Rates for Sewer Service, Depreciation Study, Provision of Billing Information, Conversion to Monthly Billing, and Pensions and OPEBS was

jointly filed by the Staff, MAWC and OPC. This document identified several aspects of this case in which these parties joined to recommend a particular outcome as to issues which were not deemed to be "contested" in the unanimous list of issues. As there has been no evidence or argument contrary to the joint recommendation, the following will be adopted by the Commission:

Sewer Rates

MAWC will be authorized to file tariff sheets containing rate schedules for sewer service designed to produce an increase in overall Missouri jurisdictional gross annual sewer revenues of Two Thousand Three Hundred Sixty-Three Dollars ($2,363.00), exclusive of any applicable license, occupation, franchise, gross receipts taxes or other similar fees or taxes, upon the effective date of the order in this case. This rate increase is consistent with MAWC's original filing and testimony in this case. (Amman Dir., Ex. 1, p. 2). MAWC's evidence of the basis for this sewer rate increase was not contradicted nor opposed by any evidence to the contrary.

Change to Monthly Billing in the St. Joseph District

The Commission will order the Company to change from quarterly meter reading and billing to monthly meter reading and billing in the St. Joseph District. The Company has asserted, and the Commission agrees, that monthly billing results in smaller individual bills and allows the customers to better plan their personal finances. (Amman Dir., Ex. 1, p. 10). It also provides the customer the opportunity to better monitor usage and detect leaks on a more frequent interval. (*Id.*).

Depreciation Study

MAWC shall perform a depreciation study prior to the filing of its next rate case and shall supply the Staff with the actuarial retirement histories in the Gannett Fleming format and provide cost of removal and gross salvage data for, at a minimum, the most recent 15 years.

Billing Information

The Company and Staff shall accumulate more detailed histories of billing cycle information

than had been provided historically consistent with the Joint Recommendation.

Pension and Other Post-Retirement Employee Benefits

The Company has agreed to make adjustments in the determination of revenue requirement, in future cases, for pension and other post-retirement employee benefits expenses, which amortize unrecognized gains and losses, using the method proposed by the Staff in this case, with the ability to raise concerns where circumstances change.

IV. FINDINGS OF FACT

In reviewing the contested issues, the Commission has considered all of the competent and substantial evidence upon the whole record in order to make the following findings of fact. The Commission has also considered the positions and arguments of all the parties in making these findings. Failure to specifically address a particular item offered into evidence or a position or argument made by a party does not indicate that the Commission has not considered it. Rather, the omitted material was not dispositive of the issues before the Commission.

A. Accounting Authority Order

MAWC has requested that it be allowed to include in its cost of service, through rate base and expense adjustments, amounts related to post-in-service allowance for funds used during construction ("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. This proposal was opposed in testimony by both the Staff and the OPC.

The Uniform System of Accounts ("USOA") contemplated that, unless the Commission ordered otherwise, the capitalization of AFUDC would terminate on the date the St. Joseph treatment plant and related facilities were placed in-service. (Rackers Reb., Ex. 53, p. 3). Thus, as of the "in service" date, the interest being paid by MAWC would no longer be a part of the construction costs and no longer booked in such a way as would allow it to be placed in rate base or recovered in rates. (See *Id.*). Also, as of the "in service" date, the accrual of depreciation expense would commence

which, in the case of a project this large, would create a significant expense item. (See *Id.*).

An Accounting Authority Order ("AAO") is an accounting mechanism recognized by the USOA and utilized in the past by the Commission to defer expenditures from one rate period for recovery in a later period. (Rackers Reb., Ex. 53, p. 3; Salser Reb., Ex. 7, p. 2).

The construction of the St. Joseph treatment plant and related facilities resulted from 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. (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."

The discontinuance of the capitalization of AFUDC and the commencement of depreciation on the St. Joseph Treatment Plant and related facilities would reduce MAWC's earnings approximately $319,000 each month the St. Joseph treatment plant and related facilities are in-service and not included in rates. (*Id.* at p. 4). Over the approximate four and one-half months between the expected in-service date and the operation of law date, this amounts to a loss to the Company of $1.6 million. (*Id.*). This is particularly significant as post-in-service AFUDC and deferred depreciation expenses net of taxes represent over twenty-four percent (24%) of MAWC's pro forma utility operating income at present rates. (*Id.*). 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) results 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).

B. Premature Retirement

The "premature retirement" issue concerns how to address the remaining book value of the old St. Joseph treatment plant in light of the construction of the new treatment plant and related facilities. It is a "depreciation" issue in that depreciation rates have failed to match the actual life of the old plant.

"As applied to utility plants, depreciation means the loss in service value not restored by current maintenance, incurred with the consumption or prospective retirement of utility plants in the course of service from causes which are known to be in the current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action or the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, etc." (Bolin Dir., Ex 21, p. 3).

In this case, the past depreciation analysis has proved incorrect and the depreciation rates have failed to match capital recovery with capital consumption. 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) which is a reasonable length of service. However, the old treatment plant was not fully depreciated before its retirement leaving a net plant investment or net original cost. Thus, a depreciation reserve deficiency of $3,332,906 exists (which includes the net salvage or cost to disable the old treatment plant). (Salser Dir., Ex. 6, p. 12; Bolin Dir., Ex. 21, p. 3).

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).

C. AFUDC Capitalization Rate

Allowance for funds used during construction ("AFUDC") is the carrying cost that a utility is allowed to capitalize as a part of the cost of a construction project. (Rackers Dir., Ex. 52, p. 13). Absent Commission authority, the capitalization of AFUDC ceases upon completion of a construction project. (Rackers Reb., Ex. 53, p. 2). This issue concerns the pre-in-service AFUDC connected with the construction of the St. Joseph treatment plant and related facilities. The parties agree that this AFUDC should be capitalized. However, the question for Commission decision is what rate to utilize in this capitalization.

The Staff proposes that MAWC's AFUDC capitalization rate 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.*).

During the course of the construction of the St. Joseph treatment plant and related facilities, MAWC has recorded AFUDC using the rate of return on rate base authorized in its most recent rate case (Case No. WR-97-237). (Salser Reb., Ex. 7, p. 5). This process began in November of 1997 and continued through the date the St. Joseph Treatment Plant and related facilities were placed in-service. (*Id.* at p. 6).

Utilizing the last authorized rate of return is the approach that the company has taken for approximately the last thirty years. (*Id.* at p. 5). This is also the approach that has been taken by the Commission in past MAWC rate cases. (*Id.* at p. 6).

Because this change is being recommended "after the fact," using the Staff's recommendation would result in a write-off of $1,257,930 in September 2000. (Salser Reb., Ex. 7, p. 6). This write-off would apply to AFUDC which was recorded as far back as November 14, 1997. (*Id.* at p. 7).

D. SJTP Valuation

OPC and the St. Joseph Industrial Water Users challenge the prudence of the Company's decision to construct the new groundwater treatment plant. Each uses different numbers and arguments, but both generally argue that instead of constructing the new plant, the old surface water treatment plant should have been renovated. They then argue that their respective estimates of the cost of that renovation should be the only amount permitted in rate base. They argue that the actual cost of the new plant in excess of their respective estimates should be disallowed.

The Company responds to the prudence and capacity arguments generally as follows:

- First, it argues that the Commission authorized it to build the new ground water treatment plant subject only to a review of the prudence with which it undertook to complete the described and estimated project;
- Second, that given the comparable costs of constructing the new plant versus renovation of the old plant with its inherent deficiencies, renovation of the old plant would be unjustifiable;
- Third, relative costs do not necessarily dictate the result. A comparison of the respective advantages and disadvantages of the two projects, absent significant cost disparity, could by itself make relocation the only prudent alternative.

The Staff disagrees with OPC and St. Joseph Industrial Water Users on prudence and supports the construction of the new ground water plant and related facilities.

In *Re the Application of Missouri American Water Company for a Certificate of Convenience and Necessity to Lease, Operate, Control, Manage and Maintain a New Source of Supply in Andrew County, Missouri*, Case No. WA-97-46 (Issued October 9, 1997), MAWC filed an application with the Commission requesting a certificate of convenience and necessity for property in Andrew County, Missouri, for the purpose of providing additional water supply to the St. Joseph, Missouri service area. MAWC also proposed the construction of a new treatment facility and lines to

transport the raw water from the adjacent water field to the new facility. Public notice was issued by the Commission. The Commission's Order Regarding the Scope of the Proceeding and Setting Procedural Schedule issued on November 20, 1996 in Case No. WA-97-46 directed that "all parties should fully inform the Commission of their views on whether this project is needed, as well as whether the proposal submitted by MAWC is prudent."

In the Hearing Memorandum, several "settled issues" were presented to the Commission by the parties. One of these was stated as follows:

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

After a review of several alternatives in Case No. WA-97-46, the Commission found that *"based on the extensive evidence presented, the Commission finds that the proposed project, consisting of the facilities for a new ground water source of supply and treatment of a remote site, is a reasonable alternative"* (emphasis added). The Commission reserved the right to examine the "prudence of the actual costs incurred and the management of construction of the proposed project." (Case No. WA-97-46).

The Comprehensive Planning Study of the Company identified capacity, reliability, process control and safety deficiencies at the old St. Joseph surface water facility in 1994. The Feasibility Study was begun in 1995 and presented economic analyses of several alternatives in 1996. The cost of the ground water treatment plant alternative was essentially equivalent to renovating the existing treatment plant, even without considering the cost of future treatment residual facilities at the existing site. (Biddy Dir., Ex. 19, Sch. TLB-3). The benefits of the new plant not only addressed the capacity, reliability, process control and safety deficiencies at the old facility while escaping the cost and risk of flooding concerns, but the ground water plant also provided a high capacity source of

supply with significantly improved quality due to natural filtration provided by the stream bed and the alluvial sediments. (Young Dir., Ex. 16, p.5-6).

Concern over the transmission of surface water microbiologic contaminants will be significantly curtailed with the use of ground water. (Young Dir., Ex. 16, p. 6). The absence of chlorine resistant pathogens like Cryptosporidium and Giardia in ground water, the elimination of need for two-step clarification, superior and consistent microbiological quality and temperature, the resulting ability to rely more on automation, and a reduced volume and variability of treatment residuals are only some of the advantages of ground water. (Young Reb., Ex. 17, p. 22 – 23). All this was presented to the Commission in Cases Nos. WA-97-46 and WF-97-241. (Young Dir., Ex. 16, p. 5).

MAWC witness Young explained how the new well field sites were determined by hydrogeologists. Borings and other tests led to the chosen site. (Young Dir., Ex. 16, p. 7). How the new plant operates was described in detail. (Young Dir., Ex. 16, p. 8 – 24). The capital cost (which includes AFUDC) for the project was estimated to be $74,684,000. (Young dir., Ex. 16, p.15). However, final costs were less than that.

E. SJTP Capacity

OPC and the Staff challenge the capacity of the new plant, but on different grounds and with different approaches. Both generally argue that the 28.5 million gallons per day ("MGD") capacity of the new plant is unneeded at this time and, therefore, contend that part of the plant should not qualify as being "used and useful." OPC recommends an adjustment to rate base (in addition to their prudence recommendation) based on a "straight-line" ratio of recommended capacity to total cost of the new plant. Staff recommends a $2.3 million reduction in the cost of the new plant based on the actual cost of certain named facilities that Staff suggests are not yet needed.

The Company argues that the capacity of the new plant is both appropriate and used and useful. The capacity of the new plant was designed to be 30 MGD, but with a system delivery capacity of 28.5 MGD. The 1.5 MGD difference accounts for filter wash and in-plant usage. This exceeds the 27.7 MGD maximum day demand projection for 2009. (Young Dir., Ex. 16, p. 8).

The Company's demand projections were part of the comprehensive planning process completed in 1994. (See also Young Sur., Ex. 18, Sch. JSY-21). The Company's demand projections were rigorous and evaluated trends within six customer categories. The average day projection for 1999 proved to be very close to the actual average day experienced in 1999. (Young Sur., Ex. 18, Sch. JSY-21). MAWC witness Young explained the procedures necessary for responsible capacity planning:

> The American Water System employs a methodology based on accepted water utility industry practice. First, average day demands are projected based on a number of factors including historical trends, population projections, input from large users, and local and regional trends. Then, a statistical analysis of historic peak day to average day demands is performed over a 20-year period. A maximum to average day ratio is selected using a 95% confidence level. Said another way, the selected maximum to average day ratio allows for a 5% chance of actually exceeding the projected demand in any one year. The selected maximum to average day demand ratio is then multiplied by the average day demands to produce a "design" peak day demand.
>
> In this way, the water system will be prepared to meet system demands during most hot, dry summers, which can occur in any year. The maximum day projection using this methodology must not be thought of as the prediction of maximum day demand in a given year. Rather, it represents the demand for which there is a 5% chance that it will be exceeded in that year. Therefore, a direct comparison of maximum day projections to actual maximum day demands in any year has little significance. This is a crucial concept because the Company's facilities must be adequate to meet customer's needs not only in the average year, but also in a hot, dry summer...
>
> A maximum day to average day ratio of 1.60 was determined for St. Joseph in the 1994 CPS. This value is further validated by subsequent analysis of data through 1998 which produces a 95% confidence level peak to average day value of 1.57. These values agree within two percent...

(Young Sur., Ex. 18, p. 4 – 5).

Gary Lee, a registered Professional Engineer in the State of Missouri, testifying for OPC in Case No. WA-97-46 (Young Reb., Ex. 17, Sch. JSY-1) agreed that, "...the use of a 1.6 maximum to average day demand ratio when applied to future projections appears reasonable and prudent." (Young Reb., Ex. 17, Sch. JSY-1, p. 3). He also projected a maximum day demand of 27.74 MGD for 2009 (Young Reb., Ex. 17, Sch. JSY-1, p. 4) which matches the Company's projections from the 1994 CPS. (Young Reb., Ex. 17, Sch. JSY-16).

Critical to the capacity arguments are the facts that the Company pumped 25.62 MGD in 1991 when the Company had 2777 fewer customers than in 1999. (Young Reb., Ex. 17, Sch. JSY-16). This was no doubt attributable to hot and dry weather (Tr. 1406), but hot and dry weather can and will recur. The Company pumped 24.39 MGD in 1988 and 23.8 MGD back in 1983. (Young Reb., Ex. 17, Sch. JSY-16). Even under OPC's two-year planning horizon, demand projected for 2002 using OPC approved factors is 27.56 MGD. (Young Reb., Ex. 17, Sch. JSY-17). Add to this, 1) the reality that Commercial and Industrial use is actually exceeding projections, (Young Sur., Ex. 18, Sch. JSY-21); 2) the 1.6 factor applied to 1999's actual average day use of 16.047 produces 25.675 MGD as against 28.5 MGD available and this 1.6 has to be applied not against 1999 but against the average day projection in the "design year" of 2009; 3) the filters are legally being operated today at a rate that will permit the plant to operate at full capacity, (Young Sur., Ex. 18. p. 6 – 7); and 4) it is reasonable to build a plant with a delivery capacity than the 28.5 MGD that was built. The Department of Natural Resources, who is responsible for design criteria to protect public health, requires that plant capacity be designed for the maximum day demand of the design year.

OPC witness Biddy argues that plants should be designed and built every two years. (Biddy Dir., Ex. 19, Sch. TLB-13). MAWC witness Young observed that Connecticut uses a planning

horizon of fifteen years, (Young Reb., Ex. 17, p. 53), and Virginia has cited ten to thirty years. (Young Reb., Ex. 17, p. 53). Two years is extremely short especially considering the time frame needed for the budgeting, design, permitting and construction of a substantial project such as a filter plant. (Young Reb., Ex. 17, p. 52). The Indiana Public Utility Commission rejected a 2 ½ year planning horizon advocated by the Indiana OPUC because the horizon "providing no margin of safety..." The Indiana Commission stated:

> The OUCC's approach would not assure adequate planning for the provision of safe and reliable utility service. By using only a 2-1/2 year planning horizon (the year 2000), by providing no margin of safety, and by only planning for Indiana-American's projected maximum day demand under a "most likely" scenario, the OUCC's proposal would place customers at risk of demand exceeding capacity.

(Young Reb., Ex. 17, p. 54; *Indiana American Water Company*, Indiana PUC Case No. 40703, Dec. 11, 1997).

With current historic usage exceeding 23 MGD in 1983, 1988 and 1991, all with fewer customers than exist today, the acknowledged potential for weather driven pumpage in excess of 25 MGD at any time, maximum delivery capacity of the new plant being only 28.5 MGD, and the unavoidable incremental size of facilities such as clarifiers, the entirety of the plant is effectively in use today. (Tr. 1576; Tr. 1605).

The Commission finds that the capacity as constructed was appropriate. The proposed adjustment is denied.

F. Deferred Taxes

Staff proposes 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. The deferred income taxes represent cash contributed by the ratepayers to MCWC for the purpose of paying federal income taxes. (Gibbs Dir., Ex. 36, p. 17;

Gibbs, Tr. 1951). Because the liability for these taxes was not acquired by MAWC, they were "written off" by the Company when the purchase was recorded. (Gibbs Dir., Ex. 36, p. 16-17). It is the Staff's position that while this was appropriate from a "financial reporting perspective," there should be different treatment in the regulatory arena. (*Id.* at 17).

MAWC's acquisition of MCWC was authorized by the Commission in 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). Thereafter, on August 31, 1993, MAWC acquired all of the outstanding common stock of MCWC. *In the Matter of Missouri-American Water Company's Tariff Revisions*, 4 Mo.P.S.C.3d 205, 214 (1995). The transaction was accounted for as a sale of assets for federal income tax purposes. (Gibbs, Tr. 1951). The accounting entries for this transaction would have been recorded shortly after the acquisition in 1993. (Gibbs, Tr. 1951).

The funds at issue remained with Avatar, MCWC's parent, after the sale (Gibbs, Tr. 1951) as 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, the funds contributed by ratepayers for a specific purpose – the payment of taxes – were ultimately expended for that purpose – the payment of taxes. The funds are not available to MAWC.

Additionally, the Commission made a specific finding related to the impact of the deferred taxes in a past case and, in fact, used this finding to the detriment of MAWC. This specific issue of the impact of the deferred taxes was previously raised by both the Staff and the OPC in Commission Cases Nos. WR-95-205 and SR-95-206 (the "1995 rate case"). *In the Matter of Missouri-American Water Company's Tariff Revisions*, 4 Mo. P.S.C. 3d 205 (1995). As a result, the Commission's Report and Order in the same cases specifically addressed this issue. 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.*). Clearly, 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.

There is no reason to reduce MAWC's actual plant investment by the amount of the deferred taxes on the books at the time MCWC was acquired by MAWC. The deferred taxes are not available to MAWC and have been used for their intended purpose, payment taxes. It would be inappropriate to now direct that some imputed amount of deferred taxes be used to benefit ratepayers.

Additionally, the Commission has addressed this issue previously and found that the deferred taxes would be lost. The finality of the Commission's earlier treatment of this issue will be honored by the Commission. The proposal to adjust MAWC's rate base to reflect the amount of deferred taxes existing on the books of MCWC prior to its acquisition by MAWC is denied.

G. Return on Equity

The Commission finds that in developing an appropriate return on equity there is no single method (model) 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, while the Commission has heretofore expressed a preference for the

discounted cash flow or DCF model, it is also appropriate to review the results of other models such as the capital asset pricing model or CAPM and the risk premium or (RP) model. Moreover, the accuracy of the DCF model is questionable when, as now, the ratios of market to book prices for water companies are well above 1.0. (Walker Dir., Ex. 12, p. 34)

The Commission finds that since MAWC's common stock is not publicly traded, it is appropriate to utilize a comparable group of water companies with publicly traded stock to determine a market determined cost rate of common equity capital. Since there are no perfectly comparable companies to MAWC, it is reasonable to determine the market required cost rate for a comparable group of water companies and adjust, to the extent necessary, for the investment risks differences between MAWC and the comparable group. In that regard, the Commission finds that the Value Line Water Group utilized by MAWC witness Harold Walker is an appropriate group of comparable companies from which to determine a return on equity for MAWC. (Walker Dir., Ex. 12, pp. 7-8)

The Commission finds that, as a general matter, MAWC is riskier than the Value Line Group of comparable water companies because MAWC's capital structure is more highly leveraged (i.e. has more debt to total capital); MAWC's construction program, as a percentage of capital and or revenue, is greater or more "intense" than that of the Value Line Water Group; MAWC's fixed charges and various cash flow coverages are lower than the comparable group of companies; and MAWC is many times smaller than the comparable group of water companies. (Walker Dir., Ex. 12, pp. 9-15)

The Commission also finds that MAWC is riskier than its parent, American Water Works (AWK), because of its smaller size, less diverse geographic operation, less regulatory diversification and less diverse customer base. (Walker Dir., Ex. 12, p. 16)

The Commission finds that utilizing the DCF, CAPM and RP analyses, the comparable group

of water companies' common equity cost rate is the range of 10.5% to 12.4%. (Walker Dir., Ex. 12, p. 42) However, the Commission further finds that this is not an appropriate range of cost rates for MAWC because these rates must be adjusted to reflect the risk differences of MAWC versus the comparable group. Since MAWC is exposed to greater risk than that of the comparable group of water companies, the Commission finds that an adjustment to the common equity cost rate for the comparable group of water company's of thirty (30) basis points is appropriate in order to reflect the additional business and financial risk to which MAWC is exposed. Accordingly, the Commission finds that the appropriate range of common equity cost for MAWC is 10.8% to 12.7%. (Walker Dir., Ex. 12, pp. 43-46) The Commission further finds that the recommended return on equity of Company witness Walker of 11.654% is appropriately within this range and is hereby adopted for purposes of this case.

The Commission finds that both recommended returns on equity of Staff (9.5% to 10.75%) and OPC (9.92%) are insufficient because they fail a comparison test of alternative investment opportunities when compared to current bond yields and forecasted returns on equity. (Walker Reb., Ex. 13, pp. 1-2) For example, Staff's recommended return on equity of 9.5% to 10.75% only provides a spread or "premium" over the current cost of A-rated public utility debt of 108 to 233 basis points. (Walker Reb., Ex. 13, p. 3) Similarly, Public Counsel's recommended return on equity of 9.92% only provides a spread of 150 basis points over A-rated utility debt. (Walker Reb., Ex. 13, p. 17) These spreads or "premiums" are simply not sufficient to attract equity investors to an investment in MAWC. In addition, Staff and Public Counsel's recommended returns on equity are well below the average projected returns on equity for the Value Line Water Group of 12% for the period of time 2002 to 2004. (Walker Reb. Ex. 13, p. 3)

Since the Commission has declined to implement a rate phase-in plan or accept the

substantial disallowances of plant investment recommended by several parties, the Commission finds that it is unnecessary to further adjust its authorized return on equity of 11.654% to reflect the additional risks investors would perceive are associated with such phase-in and/or plant disallowance.

H. Single Tariff, District Specific or Compromise

The Commission finds that in determining what rate design pricing method to use, it must decide how far it should go in ascertaining the cost to serve a customer or a group of customers as a basis for the development of rates. Both single tariff pricing and district specific pricing methodologies are cost based in that the Company's revenues are based on its cost to provide service. Both methods involve the use of average costs to provide service. Neither method attempts to place the burden of payment directly on the causers of each specific cost. The two methodologies merely allocate the cost to different subsets of customers. (Hubbs Reb., Ex. 42, p. 3)

The Commission finds that single tariff pricing is the appropriate pricing methodology for MAWC for several reasons, including the Commission's focus on what is in the best interests of MAWC's ratepayers over the long term. (Stout Reb., Ex. 10, p. 12) While the district cost of service studies submitted in this case have greatly assisted the Commission's decision-making process, these studies by their very nature are merely a snapshot of costs and rates at a specific point in time. Imbalances between costs and rates may result from any number of factors in addition to single tariff pricing. The imbalance is just a matter of degree. The fairness and equity of single tariff pricing comes from benefits that accrue over time. Thus, policies must be based on long term goals and benefits, not on temporal variances.

The Commission finds that rate stability is provided by single tariff pricing. Rather than having very large rate increases in each of the seven separate districts, there is the potential for

smaller increases over seven districts, representing a much larger pool of customers. (Stout Sur., Ex. 11, p. 6) Utility customer rates are dependent on the total revenues, expenses and rate base of the utility. Increases in rate base, particularly as a result of the Safe Drinking Water Act, and decreases in the quantities sold have a significant potential for adversely impacting the rates of smaller and medium sized utilities or rate districts within a utility. (Stout Dir., Ex. 9, pp. 14-15)

The Commission finds the ability to absorb the cost of major projects over a larger customer base is a compelling argument in support of single tariff pricing. Capital programs will never be uniform in the various districts, even over periods of five to ten years. The variances in unit costs that result from major additions are temporal and only tend to cause price instability if reflected in district specific pricing. The cost of district specific programs should be shared by all customers rather than burdening those of the affected districts. Rate increases will be more stable and major increases in specific districts will be avoided. (Stout Dir., Ex. 9, p. 15)

The Commission finds that the unit cost of providing service in the several districts varies primarily based on three factors:

1) The average age of the plant in service;

2) The level of treatment; and

3) The variation in district size.

Two of these factors are temporal and one is permanent. The addition of new plant decreases the average age of plant and initially increases the unit cost of service. As the added plant is depreciated, the unit cost decreases over time. This process decreases the rate stability of all districts under district specific pricing. Single tariff pricing reduces the peaks and valleys of these variances and therefore provides a more gradual approach to rate changes. The second variance, i.e., the level of treatment, also is temporal. Increasing regulatory requirements are moving all districts to

significant levels of treatment that will mitigate, if not eliminate, any unit cost variance that currently exists based on treatment differences. Single tariff pricing recognizes that this variance will be significantly lessened or eliminated in the future and would not differentiate district rates for this reason. Lastly, the deviation among the district sizes is not temporal and is not likely to be lessened or eliminated over time. Because of the economies of scale, the unit cost of providing service in a small district will be greater than the unit cost of providing service in a large district. Single tariff pricing allows the smaller systems to enjoy the benefits of the lower unit costs of the large system without having a significant impact on the average unit cost of service for the combined system. (Stout Dir., Ex. 9, pp. 17-18)

The Commission finds that there are many costs which are similar and common to all of the several districts. All of the district systems pump their treated water through transmission lines to distribution areas that includes mains, booster pump stations and storage facilities. All of the districts provide water to individual customers through a service line and meter. All of the districts rely on a centralized workforce for billing, accounting, engineering, administration and regulatory matters. All of the districts rely on a common source of funds for financing working capital and plant construction. (Stout Dir., Ex. 9, pp. 15-17)

The Commission finds that the use of single tariff pricing in a utility with non-contiguous service area is supported by the equivalent service rendered in each area. Although there could be considerable debate with respect to the equivalency of the service rendered to different customer classifications, there can be little argument that the service rendered to a residence in one district is the same as the service rendered to a residence in another district. Residential customers are relatively consistent in uses of water: 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 accordingly. Thus, from this perspective, there is no basis for charging different prices to customers in different districts. (Stout Dir., Ex. 9, p. 16)

The Commission finds that the gas, electric and telephone industries have used single tariff pricing for many years. (Stout Dir., Ex. 9, p. 16; Tr. 190, 990) Some of the Intervenors have argued that such precedent is not compelling and that the numerous service areas of these utilities are interconnected, while the service areas of MAWC and other water utilities are not interconnected. This interconnection argument may be applicable to the commodity or generation portion of the service rendered by the gas and electric industries or the long distance service rendered by the telephone industry. However, the argument has no applicability to the transportation, transmission or delivery portions of the service provided by these utilities and yet these other utilities use single tariffs for the recovery of these costs as well. Single tariff pricing was adopted in other utility industries for the same reasons advocated by MAWC in this proceeding – it is an equitable means of sharing the cost of capital programs over a larger base, recognizing that many costs are common to all areas and charging the same rate for the same service.

(Alternative) Notwithstanding, the foregoing findings regarding the preferability of single tariff pricing, the Commission, nevertheless finds that the revenue requirement impact of the St. Joseph Treatment Plant and related facilities, is so substantial that it is not appropriate to recover the total revenue requirement from all of the Company's customers. Accordingly, the Commission finds that a Capital Addition Surcharge is appropriate in order to mitigate the impact of the St. Joseph Treatment Plant on the rates in other districts while still preserving many of the benefits of single tariff pricing. In this case the Commission finds that to the extent the capital related revenue requirements of the St. Joseph Treatment Plant exceed (15% or 20%) of the total present revenues of the company, then that portion above (15% or 20%) will be recovered through a surcharge on the

rates to be charged in the St. Joseph district. Implementation of the Capital Addition Surcharge will result in all ratepayers of the Company recovering a portion of the revenue requirement associated with the St. Joseph Treatment Plant to the extent such revenue requirement does not exceed (15% or 20%) of total Company revenues. The actual manner in which the surcharge shall be calculated shall follow the method as contained in the prepared testimony of Company witness William Stout. (Stout Reb., Ex. 10, pp. 17-19)

I. Allocation of Corporate District Expenses

The Commission finds that the only difference between the cost allocation studies prepared by MAWC and Staff is the manner in which the two allocate utility plant in service and related depreciation of the corporate district to the various operating districts. The Commission finds that the Company's allocation procedure, which utilizes corporate labor as the basis for allocating corporate district plant, is more appropriate since the plant being allocated is used by those persons whose labor is included in the corporate district. (Stout Reb., Ex. 10, p. 2)

J. Allocation of Cost/Revenue Among Classes

The Commission finds that the Company, Staff and Public Counsel each performed class cost of service studies which allocate costs to the various customer classes. The Company developed its class cost of service study at a total company level which is consistent with its single tariff pricing approach. The Staff and Public Counsel, on the other hand, performed their class cost of service studies at the district level which is consistent with their proposal to move to (or toward) district specific pricing.

The Commission finds that in performing a class cost of service study, it is appropriate to use the Base-Extra Capacity Method as described in the 1991 (and prior) water rate manuals published by the American Water Works Association (AWWA). This is a recognized and widely accepted

method for allocating the cost of providing water service to customer classification's in proportion to each classifications use of the commodity, facilities and services. (Stout Dir., Ex. 9, p. 19) Since both Company and Staff have utilized the Base-Extra Capacity Method for purposes of performing their class cost of service studies, the Commission finds that their class cost of service study are based on appropriate methods and factors and result in a reasonable indication of cost by class whether at a total company or district level. (Stout Dir., Ex. 9, pp. 18-19; Sch. WMS-2; Stout Reb., Ex. 10, p. 3)

The Commission finds that the Public Counsel's class cost of service study is unacceptable in that it makes a major modification to the Base-Extra Capacity Method by attempting to incorporate a "economies of scale" adjustment into the basis for its allocation factors. The Commission finds that the "economies of scale" concept as proposed by Public Counsel is not a part of the traditional Base-Extra Capacity Method as described in the AWWA manual and is not typical of water company cost of service studies. (Stout Reb., Ex. 10, p. 4; Tr. 618, 671 and 673) The Commission further finds that Public Counsel's study is flawed because it introduces marginal or incremental cost concepts into the allocation of embedded costs to customer classes, the results of which are used as the basis for designing rates that are also based on embedded costs. Since the Commission is using embedded costs, it is more appropriate to consider the extent to which facilities are used in meeting base and extra capacity requirements. (Stout Reb., ex. 10, pp. 4-7) The Commission therefore, rejects Public Counsel's class cost of service study as it is unprecedented and inappropriately introduces incremental cost concepts into the allocation of embedded cost to customer classes.

Although both Company's and Staff's class cost of service studies are based upon appropriate methods and factors and result in a reasonable indication of cost by class, the Commission finds that

it is not appropriate to design rates based upon the results of those class cost of service studies as they would produce significant shifts in revenue requirement among classes which, under the circumstances, are not appropriate at this time. Therefore, the Commission finds that for purposes of this case, it is more appropriate that all customer charges be increased by 20% and consumption charges be increased uniformly by a percent that produces total revenues equivalent to total revenue requirements.

K. Phase-In

The Commission finds that, by adopting single tariff pricing and declining to shift revenue requirements among classes as a result of the various class cost of service studies, this will to a large extent mitigate the impact of the rate increase awarded herein to customer classes and that a further mitigation through a phase-in of the rate increase is unnecessary at this time. While the amount of the increase may appear to be substantial in terms of percentages, it is not unreasonable when viewed in terms of total dollars. The Commission finds that the rates resulting from this case amount to approximately $_____ per month for an average residential customer. The Commission finds that the monthly bill for an average residential customer of $_____ is in line with that charged by many other water utilities as indicated in the testimony of company witness William Stout. (Stout Reb., Ex. 10, pp. 16-17; Sch. WMS-3, Table 3-D)

The Commission also finds that FAS 71 and 90 preclude the Company from including any deferred revenues resulting from a rate phase-in plan in its financial statements. (Hamilton Sur., Ex. 3, pp. 8-9) This will preclude the Company from having a reasonable opportunity to earn the return on equity authorized herein and thus adversely affect its ability to raise capital on reasonable terms. (Jenkins Reb., Ex. 4, pp. 5-6) The Commission also finds that the deferral of revenues associated with any rate phase-in plan will include carrying costs that also must be recovered from customers.

Such carrying costs, depending upon the amount of the deferral and the length of the phase-in can have a substantial, negative impact upon the ultimate rates to be paid by the customers. (Tr. 1984-1985; 2042) For these reasons the Commission does not believe it necessary or appropriate to implement a phase-in of rates as authorized in this case.

L. True-Up

Only the Staff and MAWC filed true-up testimony in this case. That testimony revealed two issues which were unique to the true-up process. Those issues concerned certain chemical expenses and property taxes in the St. Joseph district. (Gibbs True-Up Reb., Ex. 112, p. 1).

In the true-up rebuttal testimony of Staff witness Gibbs, the Staff recommended that chemicals being used to address the hardness of the water in the St. Joseph district be capitalized for a period of one year following the in-service date of the SJTP. (*Id.* at 2-3). At the true-up hearing, MAWC indicated that it accepted the Staff's recommendation as to chemical expenses. (Tr. 2130-2131). The Commission finds that the chemicals being used to address the hardness of the water in the St. Joseph district shall be capitalized for a period of one year following the in-service date of the SJTP

Staff witness Gibbs also addressed the property tax expense related to the SJTP in his true-up rebuttal testimony. (Gibbs True-Up Reb., Ex. 112, p. 3). Staff took the position that the first property tax payment was too far removed from the true-up cut-off to be reflected in the cost of service. (*Id.*). However, if the Commission were to find that some level of property tax related to the SJTP should be included in the cost of service, Staff, in the alternative, recommended that recovery be accomplished by the application of a surcharge that would take effect when actual payment is required. (*Id.* at p. 6-7). The amount recovered would be examined in the next rate case and any over recovery would be refunded to the rate payers. (*Id.* at p. 7).

The Commission finds that there is no dispute in this case that the SJTP is on-line and that property tax will have to be paid. Property taxes apply to utility property and are a normal cost of providing service. Further, property tax is a common true-up item in rate cases as it is a known expense. In this case, the information regarding the property tax is known. The Buchanan County Assessor has sent correspondence indicating an increased assessment based on the SJTP. (*Id.* at p. 4). While there is an appeal pending and some unknowns, it does not change the fact that there will be a substantial amount of property tax paid by MAWC associated with the SJTP. Thus, it should be included in the cost of service.

The Commission finds that the true-up property taxes should be included in rates and orders that the refundable surcharge alternative offered by the Staff be used to collect such property taxes. Accordingly, the alternative offered by the Staff – a refundable surcharge – is accepted by the Commission. (Tr. 2130-2131). This approach will bring a match between both the timing and measurability of the property tax expense and thereby satisfy the interests of both the ratepayers and the Company.

V. CONCLUSIONS OF LAW

The Missouri Public Service Commission has arrived at the following Conclusions of Law:

Missouri-American Water Company is an investor-owned public utility engaged in the provision of water service in the State of Missouri and, therefore, is a "water corporation" as defined under section 386.020(58), RSMo Supp. 1999, subject to the jurisdiction of the Missouri Public Service Commission under Chapters 386 and 393, RSMo.

Orders of the Commission must be based upon competent and substantial evidence on the record. Section 536.140, RSMo (1994).

All relevant factors must be considered in establishing rates for a public utility. *State ex rel. Missouri Water Co. v. Public Service Commission*, 308 S.W.2d 704, 718-719.

Based upon its findings of fact and the following conclusions of law, the Commission concludes that in order to set just and reasonable rates, MAWC is authorized and required to file tariff sheets consistent with this order to increase total revenue by the amount of $14,167,114. For the same reason, the Commission concludes that the tariffs as submitted by MAWC on October 15, 1999, are not supported by competent and substantial evidence and shall be rejected.

A. Accounting Authority Order

The practice of granting AAO's has been reviewed by the Court of Appeals and found to be appropriate in certain circumstances. *Missouri Gas Energy v. PSC*, 978 S.W.2d 434, 436 (Mo. Ct. App. 1998).

MAWC filed a Motion for Accounting Authority Order with the Commission on November 19, 1999. On February 1, 2000, after considering MAWC's motion, as well as other pleadings concerning the requested AAO, the Commission issued its Order Concerning Test Year, True Up, Accounting Authority Order, and Local Public Hearings. The Commission, among other things, ordered:

> That the Commission will defer decision on Missouri-American Water Company's Motion for an Accounting Authority Order until it issues its Report and Order in this case. The parties will thoroughly advise the Commission on this issue in testimony and briefing. Any party that wishes to supplement its already-filed testimony to include this issue may do so.

MAWC later filed its Motion for Reconsideration. After considering several additional pleadings, the Commission issued its Order Concerning Non-Unanimous Stipulation and Agreement, Denying Motion to Modify Procedural Schedule, Granting Reconsideration as to Accounting Order and Denying Motion to Compel on March 23, 2000. This order, among other things, stated as

follows:

> That the Motion for Reconsideration filed by Missouri-American Water Company on February 10, 2000 is granted. Missouri-American Water Company may capitalize post-in-service AFUDC and defer depreciation with respect to its new water treatment plant in St. Joseph, Missouri, pending the final determination by this Commission.

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.*).

While it has already found the costs to be extraordinary by implication, the Commission also expressly finds that the subject costs were extraordinary. 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.

The above findings of facts lead to the conclusion of the St. Joseph treatment plant and related facilities are extraordinary in nature. The question remaining for the Commission is whether these items should be recovered by the Company as a part of its cost of service after consideration of other items of expenses and revenue.

The Commission concludes that the costs should be included in rates when considered with other items of expense and revenue. Placing a utility in the financial condition indicated by the evidence by not placing post-in-service AFUDC and deferred depreciation in rates would be a huge disincentive for investment in water systems, as well as other utility systems in the State of Missouri. (*Id.*). The interest of MAWC's customers is served by the improvements to the utility systems from which they receive service and a utility's sound financial base. (*Id.*). These interests will be served by an order which allows MAWC to continue to book the post-in-service AFUDC to the appropriate plant accounts and amortizes the amounts over twenty years and which allows deferral of the subject depreciation to Account 186 – Miscellaneous Deferred Debits and an amortization over the estimated service life of the St. Joseph Treatment Plant and related facilities.

B. Premature Retirement

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, depreciation rates can, and do, miss their goal. 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. Because a utility does not get to benefit from excess depreciation, it should not be penalized by under depreciation.

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.

The Commission concludes that the Staff recommendation is a reasonable approach in order to preserve 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. Therefore, the both the plant account and the depreciation reserve shall 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. (Mathis Direct, Ex. 44, p. 4, lines 10-13). The Company is also 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).

Additionally, as stated above in the Joint Recommendation, MAWC shall perform a depreciation study prior to the filing of its next rate case and shall supply the Staff with the actuarial

retirement histories in the Gannett Fleming format and provide cost of removal and gross salvage data for, at a minimum, the most recent 15 years.

C. AFUDC Capitalization Rate

The Commission concludes that it is inappropriate to reach back to 1997 to adjust a capitalization rate that was recorded in accordance with past Commission practice. The Staff's proposed adjustment is denied.

D. SJTP Valuation

The Commission has stated previously the following as to the burden in a prudence inquiry:

> 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).

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 reasonable 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, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company... 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).*

Therefore, the courts (and the Commission in the *Union Electric* case cited above) have

described a "reasonable" action to be significant 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 and 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 Commission found in Case No. WA-97-46 that MAWC's proposed construction of the SJTP was a reasonable alternative. This finding was made in 1997 at the time MAWC made its decision to move ahead with the project. The Commission will not rely on hindsight and it "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 assessed the situation?'" *Re: Union Electric Company (Callaway Nuclear Plant)*, 27 Mo.P.S.C. (N.S.) 183, 194 (1985).

Thus, Case No. WA-97-46 was the appropriate time to address MAWC's decision and at that time the Commission found that the St. Joseph Treatment Plant and related facilities was a "reasonable alternative."

Section 386.550 RSMo states that "In all collateral actions or proceedings the orders and

decisions of the commission which have become final shall be conclusive." In *State ex rel., Ozark Border v. Public Service Commission, et al.*, 924 S.W.2d 597 (Mo. Ct. App. 1996), the Missouri Court of Appeals for the Western District described the effect of this provision as follows:

> This statute is indicative of the law's desire that judgments be final. *State ex rel. Harline, v. Pub. Serv. Comm'n*, 343 S.W.2d 177, 184 (Mo. App. 1960). A judgment of a court having jurisdiction cannot be impeached collaterally. *Id.* This statutory provision makes a decision of the Commission immune to collateral attack.

The provision was similarly treated in *State ex rel. Licata, Inc. v. Public Service Commission, et al.*, 829 S.W.2d 515 (Mo. Ct. App. 1992):

> In *State ex rel. State Highway Com'n v. Conrad*, 310 S.W.2d 871, 876[4] (Mo. 1958), the court stated that it had so frequently been held that orders of the PSC are not subject to collateral attack that the court was not required to elaborate on the effect and meaning of § 386.550. In that case the court refused to entertain a collateral attack on an order of the Commission which had apportioned the costs of constructing a railroad crossing. The court held that § 386.510 provides the sole method of obtaining review of any final order of the commission. If a statutory review of an order of the Commission is not successful, the order becomes final and cannot be attacked in a collateral proceeding.

Commission Case No. WA-97-46 was fully litigated in 1997 and the Commission's decision became a final order of the Commission. Any attack in this case on the Commission's finding that construction of a "new groundwater source of supply and treatment at a remote site is a reasonable alternative" constitutes an improper collateral attack and is violative of Section 386.550 RSMo.

Additionally, no evidence has been produced that would change the conclusions of the Feasibility Study, or show that the ground water treatment plant and associated facilities is not a reasonable alternative, as found previously by the Commission. The entirety of the capital costs of the SJTP should be included in rate base. It was prudently constructed and is used and useful in providing safe and reliable water service to the citizens of St. Joseph.

E. Return on Equity

In determining an appropriate return on equity, the Commission is guided by the decision of the United States Supreme Court in two cases. First, the Court stated in *Bluefield Water Works and Improvements Company v. Public Service Commission of West Virginia* 262 US 679, 692-3 (1923):

> 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 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 anticipated in highly profitable or speculative ventures. A 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 its credit and enable it to raise the money necessary for the proper discharge of its public duties. (Emphasis supplied).

This decision was augmented by a second case, *Hope Natural Gas Company v. Federal Power Commission* 320 U.S. 591, 603 (1943):

> The return to the equity owner should be commensurate with returns on investments in *other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.* (Emphasis supplied).

The Commission concludes that a return on equity of 11.654% is the minimum necessary to assure confidence in the financial integrity of the Company and permit it to maintain its credit and attract capital reasonable terms.

F. Single Tariff, District Specific or Compromise

The Commission concludes that it has the legal authority under Missouri Law to authorize single tariff pricing for MAWC. Several Intervenors have challenged the Commission's authority to authorize single tariff pricing based on Section 393.130, RSMo. (1994), which requires, "just and reasonable" rates (Subsection 1) and prohibits any "undue or unreasonable preference or advantage" (Subsection 3). Missouri case law, however, reveals that the language cited by the Intervenors does

not prohibit single tariff pricing and that this Commission does have the authority to adopt system-wide or "uniform rates." *State ex rel. Laundry v. Public Service Commission*, 34 S.W.2d 37 (Mo. 1931), provides ample support for the Commission's authority to approve single tariff pricing. The court in *Laundry* stated the following principles:

> . . . laws designed to enforce equality of service and charges and prevent unjust discrimination, such as the Missouri act, require the same charge for doing a like and contemporaneous service (e.g., supplying water) under the same or substantially similar circumstances or conditions.
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> * * *
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> The common law today forbids all discrimination between two applicants who ask the same service . . . . Thus the principle of equality designed to be enforced by legislation and judicial decision forbids any difference in charge which is not based upon differences of services . . . .

34 S.W.2d at 44.

There is a sameness or equivalence of the service rendered to a residence in one MAWC district as compared to the service rendered to a residence in another MAWC district. Residential customers are relatively consistent in their uses of water: i.e., cooking, bathing, cleaning and other sanitary purposes; and, lawn sprinkling. Where services provided to customers are equivalent, as a matter of principle, the Commission has the authority to order that they be priced the same.

Other cases provide support for the proposition that the Commission has authority to approve single tariff pricing. In *State ex rel. City of West Plains, Missouri v. Public Service Commission*, 310 S.W.2d 925 (Mo. 1958), the Missouri Supreme Court discussed the "theory of ratemaking" as follows:

> It is true that the theory of ratemaking on a systemwide basis assumes that inequities of a sort will exist within the system and that a rough balance of such inequities will usually result, so that the discrimination remaining is not unjust discrimination. For example, as noted, the evidence in this case indicates that certain of Western's exchange made money and others did not, and that the ones that made money may have carried the ones that did not, and that the increase in the rates was made without regard to whether a particular class of service had theretofore more than paid its way.

> Consequently, it is undoubtedly true that, compared to a rate for each exchange based upon the exact cost of and the amount of services rendered at each of Western's exchanges or a rate based upon the exact cost of and the amount of services furnished in each of Western's local service areas (even though each such area might encompass more than one exchange), Western's systemwide rates would not as nearly reflect the exact costs involved in rendering service at a particular exchange as would an exchange or local service area rate. Thus, to some indefinite and variable extent (depending upon the circumstances and the locations of the service units of the particular utility) inequities in systemwide rates exist and a subscriber at exchange A may pay proportionately more for the service he receives than a subscriber at exchange B.

310 S.W.2d at 930 (emphasis added).

After a review of the law and the facts, the Court in *West Plains* concluded as follows:

> ...we may amplify our views insofar as concerns system wide ratemaking. 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, or the view that an expense item under a system wide rate structure must of necessity be spread over the entire system regardless of the nature of the item involved.

310 S.W.2d at 933 (emphasis added).

The *West Plains* case establishes the broad discretion of the Commission to establish rates either on a "system wide basis" or on a "district-specific basis." Although that case involved the establishment of rates for a telephone company, the requirement for just and reasonable rates, and the prohibition against undue or unreasonable preference or advantage, is similar in the Commission's enabling legislation. (See §392.200.1 and .3, RSMo. Supp. 1999)[1]

The issue of the Commission's ability to average costs and develop uniform rates was again addressed and reaffirmed in 1978 by the Missouri Court of Appeals (St. Louis Division) in *State ex rel. Cape Girardeau, Missouri vs. Public Service Commission*, 567 S.W.2d 450 (Mo. App. 1978). In that case, the City of Cape Girardeau appealed a Commission decision establishing electric rates

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[1] The same phrases were included in the Missouri statute in effect at the time of the *West Plains* case. (§392.200.1 and 3 RSMo. 1949).

for the Missouri Utilities Company's Southeast Missouri Division and argued that the Commission, in establishing system wide rates, failed to take into consideration that the cost of providing electricity within the city limits is lower than it is to provide service in the rest of the division. The City's witness contended that "the city, with approximately four times as many customers as any other division community, [was] in fact subsidizing the company's operations in the division's more diffused areas . . . ." Id. at 452.

Cape Girardeau contended that the only relevant factor in determining a fair utility rate is the cost of service to the user. 567 S.W.2d at 452. The Court addressed the lawfulness of the Commission's decision 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 emphasize equity to the individual user by maintaining a rate system designed on the basis of costs 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.

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

The Commission, therefore concludes that it has broad discretion in the establishment of rates and, more specifically, possesses the legal authority to establish system-wide or uniform rates for a utility serving more than one geographic area.

(Addition) The Commission further concludes that the Capital Addition Surcharge, as adopted herein, is 1) developed in the context of a "full blown" rate case where "all relevant factors" have been considered; and 2) operates prospectively to recover a portion of the costs associated with the new St. Joseph Treatment Plant and related facilities. Accordingly, the Commission concludes that the proposed surcharge does not violate the prohibition against single issue ratemaking (see e.g.

State ex rel. Missouri Water Company v. Public Service Commission, 308 S.W.2d 708 Mo. (1957)), nor does it constitute prohibited retroactive ratemaking (see e.g., *State ex rel. Utility Consumer Council of Missouri v. Public Service Commission* 585 S.W.2d 41 (Mo. Banc 1979)).

G. Phase-In

The Commission concludes that there is real question whether it has the ability to implement a rate phase-in plan for a utility, other than electric utility, where that utility does not agree to such a phase-in plan. The Commission notes that it is a creature of statute and possesses only those powers and duties specified in its enabling legislation "and also all powers necessary or proper to enable it to carry out fully and effectually all the purposes of (the) chapter" Section 386.040, RSMo (1994); *See also State ex rel. Kansas City Transit Inc. v. Public Service Commission*, 406 S.W.2d 5 (Mo. Banc 1966). In that regard, the Commission notes that Section 393.155, RSMo 1994 specifically permits it to implement a phase-in of rates for an electrical corporation where the increase is "primarily due to an unusually large increase in the corporation's rate base..." The express authorization for phase-in of rates for electrical corporations implies the exclusion of such authority for other utilities. See *Harrison v. MFA Mutual Insurance Corporation* 607 S.W.2d 137 (Mo. Banc 1980). See also *Bridges v. Van Enterprises*, 992 S.W.2d 322 (Mo. App. SD 1999). Thus, the Commission is without the specific authority to require a phase-in of rates due to an unusually large increase in a water company's rate base.

IT IS THEREFORE ORDERED:

1. That Exhibit 120 related to MAWC's responses to customer complaints at the local public hearings is admitted.
2. That MAWC's Motion to Strike Testimony and for Summary Determination is denied as moot.

3. That OPC's Motion to Open Investigation Regarding Water Quality is granted.

4. That Tariff No. 200000366 submitted on October 15, 1999, concerning water service is rejected.

5. That MAWC is hereby directed to file revised tariff sheets to be effective September 15, 2000, consistent with the findings in this Report and Order, which increase total revenue by the amount of $14,167,114. should include the increase to its revenue requirement of $14,167,114 and all other changes consistent with this order.

6. That Tariff No. 200000367 submitted on October 15, 1999, concerning sewer service is approved.

7. That the Company shall change from quarterly meter reading and billing to monthly meter reading and billing in the St. Joseph District.

8. That MAWC shall perform a depreciation study prior to the filing of its next rate case and shall supply the Staff with the actuarial retirement histories in the Gannett Fleming format and provide cost of removal and gross salvage data for, at a minimum, the most recent 15 years.

9. That the above ordered increase in revenue requirement will be applied as specified in this Report and Order.

10. That any objection not ruled on is overruled, any motion not ruled on is denied, and any exhibit not admitted is excluded.

11. That this Report and Order shall become effective on August 29, 2000.

WHEREFORE, MAWC prays the Commission adopt these Suggested Findings of Fact and Conclusions of Law and issue such other orders as are reasonable in the circumstances.

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 11th day of August, 2000, to the following:

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