BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of Missouri-American Water Company for authority to file tariffs reflecting increased rates for water service in the Missouri service area of the Company.	)))))	Case No. WR-93-212

APPEARANCES:

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William M. Barvick, Attorney at Law, 240 E. High Street, Suite 202, Jefferson City, Missouri 65101 for AG Processing et. al.

Willard C. Reine, Attorney at Law, 314 East High Street, Jefferson City, Missouri 65101, for Public Water Supply District No. 1-Buchanan, Andrew and DeKalb Counties, Public Water Supply District No. 2-Andrew County.

John Coffman and Randy Bakewell, Assistant Public Counsel, Office of the Public Counsel, P.O. Box 7800, Jefferson City, Missouri 65102 for the Office of Public Counsel and the public.

Penny Baker and David L. Woodsmall, Missouri Public Service Commission Staff, P.O. Box 360, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

HEARING EXAMINER: Dale Hardy Roberts

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I. CASE HISTORY

On December 30, 1992, Missouri-American Water Company (Missouri American or Company) submitted revised water tariffs with the Missouri Public Service Commission designed to increase gross annual water revenues by two million two hundred eighteen thousand seven hundred dollars ($2,218,700) or approximately eighteen (18) percent (%). The communities served by the Company which would be affected by the potential rate increase are the areas of Joplin and St. Joseph, Missouri. On January 26, 1993, the Commission issued an order suspending the proposed tariffs and establishing a procedural schedule. This order established an intervention date of March 1, 1993, established a procedural schedule for the filing of testimony, set out the notice to be issued by the Company, established a date for the evidentiary hearing and addressed other procedural matters. Numerous motions were filed requesting intervention prior to the deadline for such filings and intervention was, therefore, granted to the following parties: AG Processing, Inc. (hereafter referred to as the Industrial Intervenor or AG Processing); the City of St. Joseph, Missouri; Public Water Supply Districts Nos. 1 and 2 of Andrew County, Missouri; Public Water Supply District No. 1 of DeKalb County, Missouri; Public Water Supply District No. 1 of Buchanan County, Missouri (hereafter referred to as Public Water Supply Districts or PWSDs). On July 14, 1993, a motion was filed for leave to intervene out-of-time on behalf of several industrial customers of Missouri American. These parties asked that they be allowed to

join AG Processing, Inc. as joint intervenors and this request was granted. These intervenors were subsequently referred to collectively as the Industrial Intervenors. On July 16, 1993, a motion was filed to dismiss the City of St. Joseph, Missouri, for failure to participate in these proceedings and on August 6, 1993, the Commission issued an order granting the motion to dismiss the City of St. Joseph for failure to participate. Local hearings were held in both the Joplin and St. Joseph communities on July 1, 1993.

On February 26, 1993, in response to the Commission's Suspension Order, Missouri American filed its recommendation concerning the proper test year in which it recommended that the proper test year be the year ending on December 31, 1992, adjusted for known and measurable changes for plant in-service, capital structure, customer base and maintenance expense through March 31, 1993, and requested that it be as adjusted for Company employees' wages and benefits through September 1, 1993. On March 8, 1993, Staff and OPC filed a joint test year recommendation in which they concurred with the test year recommendation of Company except for the Company's request for any adjustment for employees' wages and benefits through September 1, 1993. On May 18, 1993, the Commission issued its Order Establishing Test Year in which it ordered the test year be the twelve (12) months ending December 31, 1992, as updated through March 31, 1993. On May 3, 1993, the Office of Public Counsel (OPC) filed a motion to compel an answer to its data request No. 18 in which it alleged that the Company had failed or refused to answer the specified data request and this

request was granted on May 26, 1993.

On July 23, 1993, Missouri Public Service Commission Staff (Staff) filed a Hearing Memorandum in this case. On July 26, 1993, an Amended Hearing Memorandum was filed. The Amended Hearing Memorandum set out the rate design which was subsequently filed on August 19, 1993, in a Stipulation and Agreement of the parties. The Amended Hearing Memorandum also identified the issue regarding a true-up and stated that pursuant to an agreement of the parties, a true-up audit would no longer be necessary. The Hearing Memorandum went on to set out those issues which remain contested and to identify the positions of various parties as they were known at that time. Depreciation rates had been agreed to by the Company and the Staff and a depreciation schedule was attached to the Amended Hearing Memorandum.

On August 19, 20 and 23, 1993, the evidentiary hearing for this case was conducted. On September 3, 1993, a Notice was issued to the parties indicating that simultaneous briefs should be filed by September 20, 1993, and simultaneous reply briefs should be filed by September 30, 1993. On October 5, 1993, the Industrial Intervenors filed a Motion to strike portions of the Missouri American Reply Brief and on October 12, 1993, Missouri American filed its Response to the Motion to Strike. The post-brief motions will be addressed in this Report and Order under Procedural Issues.

FINDINGS OF FACT

The Missouri Public Service Commission, having considered all

competent and substantial evidence upon the whole record, makes the following findings of fact:

II. RATE CASE EXPENSE

The Rate Case Expense issue concerns the expenses incurred by the Company in the presentation of the rate case itself. The regulated utility is entitled, under traditional ratemaking concepts, to rates that recover all reasonable amounts expended in rendering service. The general rule governing rate case expense provides that those expenses which are known and measurable, reasonable, necessary and prudently incurred in the preparation and presentation of the Company's case may be included in the expenses of the Company.

Rate case expenses are commonly amortized and included in the Company's cost of service at a reasonable level calculated upon historic data. The Commission records and the statements of the parties indicate that Missouri American files a rate case approximately every two (2) years. Missouri American has proposed to include in its cost of service those expenses approved by the Commission within this case and to amortize those rate case expenses over a period of two (2) years. Public Counsel has concurred in that proposal and no party has objected to it.

The contested issue is whether the expenses requested are 1) known and measurable, 2) reasonable, 3) necessary and 4) prudently incurred. No party to this case has suggested that rate case expenses are per se inappropriate. Rather, the controversy touches

the actual amount of expense in this particular case. Company has argued that one hundred sixty thousand eight hundred dollars ($160,800) is a reasonable level of rate case expense, the Staff has argued for an amount of one hundred ten thousand one hundred fifty dollars ($110,150) and Industrial Intervenors submit that there is no evidence to support any award.

Company argues that the magnitude of its rate case expense is due, in great part, to the cost of litigating the FAS 106 question. While this might be true this alone does not necessarily justify the total expense. The Company has argued that to allow it to recover anything less than its prudently incurred rate case expense would "violate Missouri-American's procedural rights." The Commission recognizes this argument but this does not establish which expenses were prudently incurred.

The Company further argues ". . . it is the Company's prerogative to determine the level of legal representation believed to be necessary to present its case." Industrial Intervenors suggest that the Company would not pursue this prerogative as freely if the shareholders were the ones to pay these fees. The parties' arguments seem to concentrate more on the number of witnesses and attorneys than their individual necessity and reasonableness in terms of expense. The threshold question is "are the expenses (witness and attorney fees, etc.) claimed by the Company known and measurable, reasonable, necessary and prudently incurred in the preparation and presentation of the Company's case?" Inasmuch as the witnesses themselves testified that they

did not know what their (total) fees were, the Company cannot expect the Commission to find that these expenses meet the "known and measurable" portion of the test. The Company has essentially asked for approval of an unknown and this the Commission cannot do.

Company cites *Howard Const. v. Teddy Woods Const.*, 817 S.W.2d 556, (Mo.App. 1991) for the proposition that "payment of professional fees constitutes substantial evidence as to reasonableness of the rates charged." Company's authority is not controlling in that the court stated that "The evidence at trial supported the award of attorney fees to the extent of the fees already paid . . ." (Emphasis added.) There is little evidence of fees having been paid herein and, in fact, there was evidence to the contrary. This crucial element is required for a party to rely on that particular case.

Industrial Intervenors point out that there was no actual testimony as to the reasonable nature of the expenses, indeed, in some instances there was no testimony as to the actual amount of the expenses. The Company's own witnesses did not seem to have any idea what they owed their expert witnesses and attorneys. And, Industrial Intervenors has accurately pointed out that the Company representative to whom the case preparation was delegated had little idea as to what the billing rate would be for any one of the expert witnesses. Again, since the expert witnesses themselves often had no firm idea of what their fees would be, the Company certainly could not know until so informed by the witness and yet, the Commission is being asked to accept these as known and

reasonable. One expert witness stated that his fees in this case would be two hundred ninety-five dollars ($295) per hour. He further estimated his total hours at approximately fifteen (15) to twenty-five (25) and opined that his total bill to the Company was fourteen thousand dollars ($14,000). Even assuming the high end of his estimate twenty-five (25) hours at his rate of two hundred ninety-five dollars ($295) per hour, the sum arrived at is seven thousand three hundred seventy-five dollars ($7375), a figure far short of fourteen thousand dollars ($14,000). Staff's brief demonstrated examples where two (2) other expert witnesses' fees reflected additional discrepancies. In one case, a witness had given an estimate of his fee at ten thousand dollars ($10,000) but at hearing his bill was estimated at eighteen thousand dollars ($18,000) and in the other case a witness estimated his fees at eleven thousand dollars ($11,000) but at hearing his bill was estimated at forty thousand dollars ($40,000). These fees are eight thousand dollars ($8,000) and twenty-nine thousand dollars ($29,000) over the original estimates, respectively. These are but specific examples of what appears to be the Company's overall decision to commit to rate case expense which is above and beyond the scope of prudently incurred rate case expense. Industrial Intervenors have suggested that witnesses were retained and then unleashed upon this case carte blanche. The Commission finds no evidence to the contrary.

The Industrial Intervenors' point is well taken in that the Commission has always required rate case expenses to be known. The

Commission will stop short of instituting a "rate case within a rate case" wherein an applicant would offer additional witnesses to prove each element of its expenses. The Commission recognizes that it must allow some degree of latitude on the issue of attorney fees which, unlike expert witness fees, are an ongoing expense. This is an expense which conceivably may continue somewhat beyond the hearing and for that reason this expense may not be known as a final total. But the Commission must continue to look to the record for evidence in support of rate case expense and in this case that evidence is lacking. Disallowing all expense, or perhaps even disallowing any prudently incurred rate case expense could be viewed as violating the Company's procedural rights. The Commission does not want to put itself in the position of discouraging necessary rate cases by discouraging rate case expense. The operative words here, however, are necessary and prudently incurred. The record does not reflect efforts at cost containment and consequently it does not support that these expenses have been prudently incurred.

The Commission finds that the Staff's assessment of rate case expense, as based upon historical data from this company's previous rate case expenses, is the more reasonable position. The Commission finds it is reasonable, as proposed by the Company, that these expenses shall be amortized over a two (2) year period and included in the Company's cost of service. Finally, the Commission finds that the rate case expense which is reasonable, necessary and prudently incurred in the preparation and presentation of the

Company's case shall be adjusted by twenty five thousand four hundred twenty-seven dollars ($25,427) for each year of the two (2) year amortization period.

III. OPEBS

Other Post-Retirement Employee Benefits (or "OPEBs") refers to certain benefits paid to retired employees which are non-pension related and primarily medical benefits. Almost all major utilities incur OPEB expense to some degree. These costs, if prudently incurred, have been generally granted rate recovery in Missouri and other states. Traditionally, such costs have been treated on a pay-as-you-go basis, both for financial reporting and ratemaking purposes.

In 1990, the Financial Accounting Standards Board (FASB) issued Financial Accounting Standard No. 106 (FAS 106) concerning the accounting treatment and financial reporting of OPEB costs. FAS 106 states that the accrual method of accounting should be used for OPEB costs for financial reporting purposes for most entities, beginning January 1, 1993. In addition, and in supplementation of FAS 106, the Emerging Issues Task Force (EITF) of the FASB created several standards interpreting FAS 106 and providing for its implementation. These standards set out, inter alia, the appropriate amortization periods and provide that a transitional benefit obligation (TBO) would be incurred in converting from pay-as-you-go accounting to the accrual method. This TBO is comprised of catch-up accrual costs for all current employees which would

occur as a result of the conversion from the pay-as-you-go to the accrual method.

Initiation and use of the accrual method of accounting for OPEBs will cause utilities to estimate and charge to expense OPEBs earned by employees at the time they are "accrued," not at the time they are paid out. The FASB views post-retirement benefits as deferred compensation for current services rendered and believes that the obligation for that compensation is incurred as employees render the necessary service. Moving to the accrual method of accounting for OPEBs will sharply increase the expense charged on the financial statement for most utilities.

Company requests inclusion in rates of four hundred sixty-four thousand nine hundred three dollars ($464,903) as representing the difference between accrued costs of prudently incurred OPEBs (including the TBO) versus the pay-as-you-go costs of those benefits. It is Company's position that all FASB pronouncements are considered part of the generally accepted accounting principles (GAAP) currently in use by both the regulated utilities and the Commission. Company is of the opinion that the Commission is obliged to accept FAS 106 as part and parcel of the GAAP standards. Missouri American proposes, as suggested by the EITF, a twenty (20) year phase-in of prior costs, TBO, and a full recovery of current costs.

Company maintains that the use of GAAP standards are required by the Securities and Exchange Commission in conjunction with the external auditing of investor-owned companies. Company states that

failure to receive an unqualified external audit can negatively reflect upon the Company and may have a negative impact on the Company's financial rating. In addition, Company argues that accrual accounting for OPEBs properly matches the cost of providing service with the revenues received for that service. This is commonly referred to when discussing OPEB issues as inter-generational equity.

The Staff is opposed to any form of accrual accounting for OPEBs. The Staff takes the position that the Commission should maintain pay-as-you-go accounting to establish the expense level for non-pension benefits included in the revenue requirement determination. The Staff offers a number of arguments supporting its position, not the least of which were the uncertainties associated with paragraphs 194 and 195 of FAS 106. Staff cites these in support of its argument that this issue is not as exact or precise as Company suggests. Staff also argues that the Company has no legal obligation to deliver or continue the provision of the OPEBs and specifically notes that the Company is preparing to renegotiate these and other employee benefits in 1995.

Company argues that the Commission is being asked to ignore the FAS Board and EITF rules, recommendations and regulations. Irrespective of whether this is, in fact, the position of the parties who oppose the implementation of FAS 106 the Commission does not ignore these agencies. The Commission has invested considerable time, effort and resources in the evaluation and consideration of this issue and has given the aforementioned

agencies and their rules, recommendations and regulations the weight which they are due in this process. This consideration includes, but is not limited to, paragraphs 194-195 of FAS 106 and the assumptions upon which they rely.

The Commission has addressed the issue of OPEBs in six previous cases, those being: *In re: Union Electric,* Case No. EO-92-179, *In re: Empire District Electric Company,* Case No. EO-93-35, *In re: Western Resources,* Case No. GO-93-201, *In re: Missouri Public Service,* Case No. ER-93-37, *In re: St. Joseph Light and Power Company,* Case No. ER-93-41, and *In re: United Telephone Company,* Case No. TR-93-181. The Public Service Commission has been charged with the responsibility of regulating the various utilities to achieve fairness and balance between the interests of the ratepayers and shareholders and to ensure that safe, economical and efficient utility service is provided to the public. Inherent in that responsibility is the obligation to set rates at levels that reflect the cost of service and duly compensate the shareholders for their investment, but protect the ratepayer from the abuses of the natural monopoly.

The Commission finds that insufficient substantial and competent evidence exists on the record in this case to show that FAS 106 costs are adequately known and measurable. The relevant factors which need to be considered include the number of employees which will remain with the Company until retirement, the number of these employees requiring post-retirement medical care, the length of time this medical care will be required and the cost to be

incurred in the provision of this medical care. The Commission finds insufficient evidence as to consideration of these numerous issues.

Moreover, it was specifically pointed out by Industrial Intervenors that Congress is currently considering a national health care plan and this will doubtless have a profound effect on OPEBs. This potential legislation was discussed by the Commission in *United*, supra. The Commission feels that an expensive and abrupt change in the method of accounting for OPEBs at this time is especially ill-timed and premature considering the current legislative proposals. Adoption of FAS 106 at this time will result in additional ratepayer costs which may, in the near future, be rendered clearly inappropriate depending upon the type of national health care plan enacted. Now is not the time to adopt FAS 106. The industry has been paying OPEBs for many years and maintaining this policy in the face of changes which may well be imminent as well as immense is the sure course to follow. Ratemaking recognition of this accounting procedure could rather easily be adopted in the near future, after the federal government has the opportunity to act on a national health care plan. However, adopting FAS 106 now, only to reverse the rate impact of that adoption in the face of a new federally mandated health care plan would be difficult, if not impossible, for this Commission to do without substantial cost having already been incurred by the ratepayer and without substantial disruption and confusion within the regulated utilities of Missouri.

The Commission acknowledges the difficulty Missouri American may be having with this matter. However, the Commission finds, after an in-depth review of the issues and testimony surrounding the proposed adoption of FAS 106, that it must reaffirm its position. For ratemaking purposes, the Commission finds the pay-as-you-go method is the just and reasonable course to follow and continues to be in the public interest. The Commission finds that the impending federal attempts to provide a national health care plan constitute an issue which must be resolved before the Commission can establish a new policy on this issue. The Commission declines to adopt FAS 106 and the accrual method of accounting for OPEBs, and will approve the four hundred sixty-nine thousand nine hundred eighty-nine dollar ($469,989) adjustment proposed by Staff.

IV. PLANT HELD FOR FUTURE USE

Plant which is held for future use generally includes property acquired for future utility service. The most common occurrence of plant held for future use, as is the case here, is the acquisition of land which is acquired in advance and subsequently held for future use for various utility facilities. In Missouri, plant held for future use generally is not allowed in the rate base if the use is to occur outside the test year. The Commission infers that plant which is not in use and which is held for use at a non-specific time is exposed to the potential for continuing nonuse. This nonuse could allow a subsequent transfer to non-utility

accounts and the sale of such plant would then result in profits for which the utility would need to account.

The plant held for future use herein is a parcel of land located in Joplin. Company hopes to use this location for the construction of a tank facility. The Commission takes particular notice of the fact that this is the same land which Missouri American acquired in 1990 and which Company had imminent plans for in its last rate case. See *In the matter of Missouri American Company*, Case No. WR-91-211 (Report & Order issued August 1, 1991). Missouri American states that it has undertaken engineering studies of this land, that it has now become aware that this land is not suited for a vertical tank and that its alternate plans are to construct a tank which will not interfere with the flight path into and out of the local airport. However well fixed these plans may be, they fail to elevate this property to the category of used and useful. The plans referred to in this case have been changed in the past and may well change again. The Commission's general policy is not to allow rate base consideration for that property which does not now contribute to the service(s) offered to the customers.

The Commission finds that the property in question is not being used at this time for the production of water services for the customers of Missouri American, nor is there competent and substantial evidence to prove that it shall be so used in the foreseeable future. The Commission further finds that it would not be in the public interest to include this property in the rate base

which is neither used nor useful in the provision of utility services to the customers of the Company. The Commission finds for Staff and the record will reflect an adjustment of nine thousand two hundred ninety-three dollars ($9,293).

V. SHERWOOD MEDICAL PLANT LOST REVENUE

As this case came to hearing, the state of Missouri was enduring an historic flood of both the Missouri and the Mississippi rivers. The St. Joseph area was flooded by the Missouri River and Missouri American has argued that some results of this flood must be considered within this case. Any loss resulting from this flood are certainly outside the test year as requested by the Company and ordered by the Commission. The value of a test year comes from the fact that the parties may compare data from the same specific period of time. The test year allows a specific beginning and an exact end to the period of time over which revenue and expenses may be measured. There does exist the potential limitation on the use of the test year if it were allowed to artificially prevent the Commission from considering evidence which is known, measurable and relevant to the issues under consideration.

Missouri American has offered for the record competent and substantial evidence as to the net loss of approximately thirty three thousand dollars ($33,000) in its annual revenue due to the closing of a local manufacturer known as Sherwood Medical. This evidence was offered over the objections of one or more of the parties and was, therefore, taken with the record. This evidence,

including the testimony offered by Witness Holsapple beginning at line 1 of page 602 of the transcript and continuing to line 21 of page 610, and exhibits 50 and 51 will be admitted to the record herein. Exhibit 50 is a copy of a newspaper article reporting the facts concerning this plant closure and exhibit 51 is a report of revenue and expense associated with this particular customer of the Company. The Commission finds it is reasonable to allow Company to submit this evidence of an occurrence which took place outside the test year and the Commission further finds the issue in favor of the Company.

The Commission finds that it would not be in the public interest to include revenue and expenses in the rate calculations for this case which the Commission believes will no longer actually exist. The very purpose of the test year is to enhance the accuracy of the data to be used in a rate case, not to prohibit the introduction of data which is known and measurable with specificity upon a date which is relevant to this case. The Commission finds the closing of the Sherwood Medical plant is but one example of the unsure economic conditions which exist for the Company in the communities which it serves. The record will reflect the adjustment of the thirty-three thousand two hundred forty-three dollars ($33,243).

VI. INTEREST SYNCHRONIZATION

Interest synchronization provides a tax deduction which is consistent with the amount of interest included in rates through a

rate of return times rate base calculation. Any other method would result in an inequity to the ratepayer as has been noted in previous cases by this Commission.

This issue concerns the amount of Missouri American's tax deductible interest expense. The interest expense is calculated by multiplying the rate base by the weighted cost of debt included in the capital structure. This method assures that the amount of interest expense used in the calculation of income tax expense, for ratemaking purposes, equals the interest expense the ratepayer is required to provide the Company in rates. Since the revenue requirement is based on a rate of return computation, the interest synchronization method allows an interest deduction consistent with the rate of return computation which is applied to rate base. This method is frequently utilized to match or "synchronize" the interest rate charged to the ratepayers with the interest used in the income tax calculation.

The Staff's capital structure computation in the interest synchronization process includes the debt of Missouri American Water Company's parent corporation, American Water Works Company (AWWC), which supports the equity of Missouri American. Staff has argued that the recognition of the income tax deduction associated with the interest on the debt of AWWC is required to prevent the Company from earning a higher rate of return than recommended by Staff through Company's use of double-leveraging. The Staff asserts that this process retains for the ratepayers the support which they have paid through the interest expense provided within

rates to the Company. Therefore, the failure to include the interest associated with the debt of American Water Works Company as calculated through the double-leverage calculation would deprive the ratepayer of the full interest deduction associated with the interest expense provided in rates.

This process has been followed by the Commission in the past and recently, with regard to the Iowa-American Water Company, was followed by the Iowa Utility Board. Although the Orders of that agency have no binding authority in this jurisdiction, the clarity of this issue as stated in that case bears repeating:

> There is no dispute that American Water Works Company is allowed, for income tax purposes, to deduct the interest expense associated with the debt that it holds at the parent level. Use of the double-leverage methodology mathematically incorporates part of the parent's interest expense in the cost of service via the rate of return. The issue here is whether the ratepayers or the shareholders should receive the tax benefit associated with this interest expense. Fairness compels that if the expense item is included in the cost of service via double-leverage, then the associated tax benefit should also be included. Similarly, if an expense item is included from the cost of service so should the associated tax benefits be excluded. . . . Since the expense item will be included in the cost of service, the ratepayers should receive the associated tax benefit. PUR slip copy, 1991 WL 517019, *24 (Iowa U.B.).

The Company has indicated that its interest synchronization calculation is simply total rate base times the weighted cost of debt from Missouri American's capital structure. This calculation, however, will not equal the actual expenses reflected on the books of Missouri American and therefore the Company's proposed interest deduction is not the actual annual interest shown on the Company's books.

The Company alleges that the net result of Staff's calculation reduces the Company cost of service by artificially imputing to Missouri American a portion of its parent's debt expense.

The Commission finds that where an item is included as an expense within the cost of service then an associated tax benefit should be accounted for in attributing costs and benefits to the ratepayers. The Commission further finds that the use of the double leverage methodology mathematically incorporates part of the parent corporation's interest expense in the cost of service via the rate of return. The Commission also finds that any method other than interest synchronization would result in an inequity to the ratepayer due to the tax benefit accorded the Company that results from the amount of interest included in rates. The Commission finds for the Staff and the record will reflect an adjustment of one hundred nineteen thousand six hundred seventy-six dollars ($119,676).

VII. DEFERRED MAINTENANCE COSTS

Deferred maintenance costs reflect the category of expenses incurred in the overall maintenance of the facilities of the utility, generally the real property. These costs are often for service rendered in one accounting period that will not be reflected until a subsequent period.

The Company proposes to include one hundred sixty-nine thousand four hundred eighty-two dollars ($169,482) of deferred maintenance in its rate base for tank painting expense. Staff

proposes allowance of one hundred ten thousand one hundred fifty dollars ($110,150) and OPC proposes ninety-nine thousand one hundred eighty-three dollars ($99,183). It appears that the Company has arrived at its request on this issue by determining the tank painting expense, amortizing it over the life of the project and then multiplying that number by an inflation index number which Company offers from the *Handy-Whitman Index*. Staff's brief indicates this index has been designed to project current value of rate base items in those states which employ the fair value method of valuation. The practical effect of such a multiplier is to treat deferred maintenance, which is an expense item, as if it were a capital cost.

The Commission finds that storage tank painting is a maintenance function which, while preserving the tank as a capital asset, does not itself rise to the level of an addition to rate base. The Commission finds that the Company's unamortized and deferred tank painting maintenance expense, accrued over time, is not a part of Company's rate base but simply an element of Company's cost of service. To find otherwise would invite similar treatment of other deferred expenses which might eventually increase the difficulty with which one finds the logical and fair separation for ratemaking purposes between rate base and cost of service. This finding represents the traditional view of the Commission. See *In the Matter of Missouri-American Water Company*, 30 Mo. P.S.C. (N.S.) 251, 258-259, (May, 11, 1990).

The Commission finds that this request represents a simple

maintenance function for which inclusion in the Company's rate base would not be appropriate. The Commission finds that its decision In the Matter of Missouri-American Water Company, 30 Mo. P.S.C. (N.S.) 251 (May 11, 1990) continues to represent a policy which best protects the public interest. The Commission finds for Staff and the record will reflect an adjustment of sixty-seven thousand four hundred eighteen dollars ($67,418).

VII. DEPRECIATION

The Company has requested one million one hundred fifty-nine thousand seven hundred thirty-eight dollars ($1,159,738). Staff agrees with the Company's request. Public Counsel recommends a figure of one million twenty-nine thousand seven hundred thirty-eight dollars ($1,029,738) for a difference of one hundred thirty thousand dollars ($130,000). The depreciation rates which are applicable to this issue were attached to the amended Hearing Memorandum and are attached hereto and incorporated herein. The Hearing Memorandum stated that Company and Staff both agreed to those depreciation rates.

OPC indicated that it reserved the right to pursue the position on depreciation set forth in prefiled direct testimony of Staff witnesses Jungmeyer and Merciel which was neither offered nor received into the record. This method was the whole life method. This issue is the one for which Public Counsel attempted to argue the position which Staff had abandoned after reaching an agreement with the Company and was the subject of considerable discussion at

the end of the last day of the hearing. This matter begins at Page 614 in Volume 6 of the Transcripts.

The issue is that OPC wishes to follow the whole life method of depreciation whereas Company and Staff both agree that the remaining life method of calculating depreciation was more appropriate in this case. OPC did not file any testimony on this issue nor did it present any witness on this issue. OPC cannot adopt the testimony of another party if that party has chosen not to offer the testimony in the first place. It should be clear that no party can force another party to offer testimony which the originating party no longer feels is beneficial or appropriate for its own case. Therefore, the only testimony and the only evidence on this issue is that which was offered by Staff and Company, both of whom agree on the resolution of depreciation.

The Commission finds it is reasonable to accept the agreement as to depreciation and the specific depreciation rates proposed by Staff and Company.

IX. RATE OF RETURN

Compensation to the Company and its shareholders is expressed in terms of a percentage rate of return. A fair rate of return must strike a balance such that it does not produce either inadequate earnings or excessive earnings. In order for a utility to provide proper service and to maintain its financial integrity its return must be adequate to service existing debt requirements and to attract the new capital needed for plant replacement and

expansion. It is not entirely possible to establish the precise rate of return, or dollar revenue requirement, which will give the customer maximum protection. Rather, a just and reasonable rate of return can be developed only by weighing all circumstances impartially. This process requires the estimation of the Company's cost of common equity and combination of that number with its costs for debt and preferred stock as well as the relative proportion of these elements comprising capital structure. These two issues, Capital Structure and Return on Equity are discussed at length infra.

IX.a. CAPITAL STRUCTURE

Capital Structure is the relationship between a Company's debt and equity and generally influences the overall cost of capital. It may be said that there is an optimum balance in this structure which will produce the minimum cost. A utility must meet its obligations and maintain a balanced but flexible capital structure so that it can raise capital whenever necessary, ideally, at a reasonable cost. The two primary components of capital structure are debt and equity and the contested issue in this case is entirely related to the debt component. The debt figures which may be used in a given rate case are actual if the figures are known and measurable or the figures may consist of a hypothetical structure, or proforma alterations where the debt is somehow either unknown, unmeasurable or inappropriate. The parties disagree as to the appropriate treatment of the short-term low interest debt of

Missouri American. Company has requested that proforma changes be made and Staff believes that the requested changes are too vague to be used for ratemaking purposes.

As of March 31, 1993, Missouri American's capital structure included an unusual and extraordinary amount of short-term debt due to the Company's decision to prematurely retire a substantial amount of long-term debt. The amount listed for the short-term obligations was six million seven hundred thousand dollars ($6,700,000). The Company indicated its intention to replace this debt in the last quarter of 1993 at an expected rate of 7.25%. The short-term debt is now carried at approximately 3.68%. The Company argued that it cannot continue to carry this amount of short-term debt nor would it be able to re-finance this amount at such a low interest. Therefore, the Company proposed that this short-term debt be reflected in its capital structure as long-term debt at a projected cost of 7.25%.

The singular salient fact, here, is that Company seeks to utilize a capital structure which did not exist, which does not now exist and which might not ever exist and seeks to postulate a cost for that hypothetical long term debt. Company's testimony that it intends to re-finance at the higher interest rate does not eliminate the potential for market and other intervening forces beyond the control of Company's witness and which may prevent this re-financing from taking place.

The decisions which brought this issue about are entirely under the control of the Company. It is the Company which decided

that this was the appropriate time to recall these mortgage bonds which were not yet mature, it is the Company which decided that this was the appropriate time to file this rate case, and it is the Company which exercised its voice in the choice of an appropriate test year. It is noteworthy that in its test year recommendation filed February 26, 1993, Missouri American requested a test year ending December 31, 1992, updated through March 31, 1993, for known and measurable changes to, among other things, capital structure. This is the test year which the Commission has adopted and ordered. The Company now argues these are extraordinary circumstances which require extraordinary ratemaking treatment as these circumstances are beyond the control of the Company. The Commission cannot find competent and substantial evidence in the record to support this position.

The Company prematurely called four (4) general mortgage bonds between November of 1992 and March 1, 1993. Missouri American has argued that its proforma adjustment to its capital structure reflecting short-term debt as long-term debt at a cost of 7.25% is a reasonable adjustment reflecting the true experience to be expected by the Company. And, in response to Staff, Missouri American has argued "whether the treatment of the Company's short-term debt as long-term debt is hypothetical or a proper proforma adjustment is academic inasmuch as the treatment proposed by Company more accurately reflects the true capital debt structure of Missouri-American Water Company." Company alleges that this debt structure will permit Company to recover its **true** cost of debt

through its rate structure and will permit its ratepayers to pay the minimum reasonable cost for such debt service. (Emphasis Added.)

It would appear, however, that this is not the "true" cost of debt. The cost which would be "true" would be that cost which is "conformable to fact; correct; exact; actual; genuine; and honest." *Black's Law Dictionary*, Sixth Ed., 1990. The cost of debt requested by the Company is nearly double the amount of the "true" cost at this time. Perhaps the proposed amount of 7.25% will be the cost of debt when the Company does actually replace the debt with long-term notes. This has not yet occurred; indeed, the Commission notes the conspicuous absence of any evidence in the record that any such request for authority to do so has occurred. It is not inconceivable that the Company may not ever make such a conversion. Absent other considerations Missouri American may well consider it to be advantageous to maintain retention of short-term debt versus the potential 7.25% and there would not appear to be any Commission regulation or order which would prevent maintaining the debt at a lower interest rate.

The primary consideration in this evaluation returns the Commission to the concept of known and measurable. The Company seeks to utilize a capital structure which, in fact, does not exist. Traditional ratemaking concepts reject using projected numbers. The Commission has long recognized a preference for those matters which are known and measurable versus those which are projected to exist at some future time.

For the facts and reasons stated above that the Commission finds that the most accurate measure of capital structure is that measure which reflects the facts as they may now be known and actually measured. The current capital structure with the current short-term debt is the only structure which complies with the test year as ordered by the Commission.

The Commission also finds that due to the status of Missouri American as a wholly owned subsidiary of the American Water Works Corporation the use of a double leveraging methodology is necessary if the Commission is going to make the most accurate capital structure calculation(s) possible. The Commission finds for staff and the record will reflect an adjustment of five hundred sixteen thousand eighty-nine dollars ($516,089).

IX.b. RETURN ON EQUITY

Common equity is difficult to measure definitively and for that reason various measurement methods are utilized. These techniques include the discounted-cash-flow method which has been utilized within the state of Missouri.

The discounted-cash-flow (DCF) method generally proposes a rate of return equal to current annual dividends divided by current market price plus the anticipated annual rate of growth. The current dividend and market prices are easily determined. Generally, one or a combination of three indices (dividends per share, earnings per share, and book value per share) are used to determine the growth factor. Each of these indicators requires the

use of historical data to predict future expectations.

The Commission must also determine what is a just and reasonable return on equity for the Company. In doing so the Commission ultimately relies on *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602, 64 S. Ct. 281, 287, 88 L. Ed. 333 (1945), wherein the U.S. Supreme Court said: "It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." The Commission in its determination also relies upon *State ex rel. Mo. Public Service v. Pierce,* 604 S.W.2d 623 (Mo.App. 1980) wherein the Missouri Court of Appeals, Western District stated: "The considerations toward a fair rate structure and rate of return are too variable to be concluded by any single historical event or any single formula." The Court further stated, "The contention that the data of actual cost of capital must always weigh decisively against an hypothetical 'ideal' return on equity to insure the integrity of the administrative determination, is a notion also dispelled." The court in *Pierce* made specific reference to the findings of the Commission in that case that provide support for the Commission's determination herein: "The earnings stability -- and hence a diminished investment risk -- augured by the improvement was stated as the basis for the 14.0% rate of return determination."

The Staff calculated the range of equity returns from 10.03%

to 10.72% with the final recommendation, after some adjustments by Staff, at 10.37% to 10.72%. It is not clear from the record that the Staff took into consideration various risk and liability factors which exist for water companies in general and for Missouri American specifically. These issues will be addressed infra.

The Company's cost of equity estimates ranged from 10.04% to 14.66% with a midpoint range 12.59%. Based upon this the Company's witness suggested a cost of equity rate of 12.60% for Missouri American. Granted, this recommendation relied upon the DCF analysis but recognized, or imputed, the risk premium and capital asset pricing model (CAPM) estimates as well as Missouri American's relatively small size in terms of capitalization relative to proxy groups. The Commission does not accept the Company's method but does find that the Company's calculation offers a range for the return on equity which is more reflective of the risks and demands which exist for a utility of this type.

The Commission finds that the use of the DCF model is appropriate, but the Commission is not convinced that the Staff has properly analyzed the risk factors arising from the enhanced environmental regulations which must be included in the calculation of a reasonable return on equity for this Company. The Commission also notes the overall economic condition of the Company's service territory.

The Commission finds that the closing of the Sherwood Medical plant is an example of the uncertain economic conditions which exist in the communities which it serves. The Commission finds

that the return on equity which the Commission will order above the Staff's recommendation reflects those environmental regulatory demands which are increasingly being placed upon water companies and the economic conditions which exist in these service areas. The Commission finds that it is in the public interest to allow a return on equity which will allow the Company to anticipate and comply with the Safe Drinking Water Act and other similar environmental regulations. Therefore, the Commission finds that the fair and reasonable return on equity for Missouri American is 12% which falls within the range supported by the Company.

X. PROCEDURAL ISSUES

On October 5, 1993, after the submission of the reply briefs, the Industrial Intervenors filed a MOTION TO STRIKE PORTIONS OF THE MISSOURI-AMERICAN COMPANY'S REPLY BRIEF. Although the hearing has been completed it now appears that the parties continue to respond to each other and not to the issues. As both the trier of fact and of law the Commissioners are charged with the responsibility to disregard information which does not constitute competent and substantial evidence. This applies to information which is admitted into the record just as forcefully as it applies to matters inadmissible. The fact that the Commission will discharge this duty without the necessity for prompting from the various parties does not remove the propriety and permissibility of objections under appropriate circumstances. Motions to strike briefs are not appropriate. Both the Federal Rules of Civil

Procedure (12f) and the Missouri Rules of Civil Procedure (55.27) provide that a motion to strike may be directed at a pleading or at evidence before the jury, reply briefs are not included as pleadings or evidence to which a motion to strike may be directed. See *Hanraty v. Ostertag*, 470 F.2d 1096, 1097 (10th Cir. 1972) and *O'Connor v. State of Nevada*, 507 F. Supp. 546, 548 (D.Nev. 1981). The Industrial Intervenors' Motion To Strike shall be denied as a motion for which no relief may be granted. As with any evidence or argument offered, the Commission gives the material in question no more weight than it is due.

The Commission notes for the record that Company has a request for an Accounting Authority Order pending before the Commission. See In the matter of the Application of Missouri-American Company for an Accounting Authority Order relating to FAS 106, Case No. WO-93-155. While the decision in this case may be dispositive of the request in WO-93-155 the final and official disposition of that case shall be made within that docket and not herein.

CONCLUSIONS OF LAW

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

Company is a public utility subject to the jurisdiction of the Commission pursuant to Chapters 386 and 393, RSMo 1986, as amended. Company's tariffs herein were suspended pursuant to authority vested in the Commission by Section 393.150, RSMo 1986, which places upon Company the burden of proof to show that the proposed

increase in rates is just and reasonable.

Pursuant to Section 536.060, RSMo 1986, the Commission may approve a stipulation and agreement concluded between parties as to any issues in a contested case. The Commission has determined that the agreements among the parties as to the issues of depreciation and rate design are reasonable, and, therefore, the Commission concludes that these agreements should be approved. These documents are attached hereto as attachments A and B respectively and incorporated herein.

The Commission must also determine what is a just and reasonable return on equity for the Company. In so doing the Commission ultimately relies on *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 602, 64 S. Ct. 281, 287, 88 L. Ed. 333 (1945). The Commission in its determination also relies upon *State ex rel. Mo. Public Service v. Pierce*, 604 S.W.2d 623 (Mo.App. 1980). Based upon its findings herein and the conclusions of law as herein set forth, the Commission finds and concludes that the return on equity as herein set out is just and reasonable.

The Commission concludes that *State ex rel. Associated Natural Gas Company v. Public Service Commission of Missouri*, 706 S.W.2d 870 (1986) authorizes, the use of the double leverage method.

Based upon the Commission's findings in this case, the Commission concludes that just and reasonable revised tariffs should be filed by Company designed to increase its total revenues by two hundred nineteen thousand four hundred fifty-two dollars ($219,452).

IT IS THEREFORE ORDERED:

1. That the tariffs submitted on December 30, 1992, are hereby rejected and Missouri-American Water Company is hereby authorized and required to file tariffs consistent with this order for service on and after November 29, 1993.

2. All objections and offers of proof not specifically ruled upon are hereby overruled or denied.

3. The Commission approves the Stipulation(s) and Agreement(s) regarding rate design and depreciation rates as attached hereto and incorporated herein.

4. The Commission accepts the Scenario and the responses thereto and hereby admits same as Exhibit No. 58.

5. This order shall become effective on November 29, 1993.

BY THE COMMISSION

David L Rauch

David L. Rauch
Executive Secretary

(S E A L)

Mueller, Chm., McClure, Perkins,
and Kincheloe, CC., Concur.
Crumpton, C., Dissents with
Opinion to follow.

Dated at Jefferson City, Missouri,
on this 18th day of November, 1993.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of Missouri-American Water Company's tariffs to increase rates for water service in the Joplin and St. Joseph, Missouri, areas of the Company.	))))))	Case No. WR-93-212

STIPULATION AND AGREEMENT

REGARDING RATE DESIGN

On December 30, 1992, Missouri-American Water Company (MoAm or Company) filed revised water tariffs with the Missouri Public Service Commission (Commission) designed to increase gross annual water revenues by $2,218,700, or 18%, exclusive of applicable and occupational taxes.

In their suspension order dated January 26, 1993, the Commission ordered a prehearing conference to take place on July 12, 1993. As a result of negotiations that took place during that prehearing conference, the undersigned parties have reached the following Stipulation and Agreement:

1) The parties agree that any increase or decrease found to be just and reasonable by the Commission shall be distributed among the company's customers by the same methodology as that which was used by the Staff in the Company's last rate case, WR-91-211.

2) More particularly describing that methodology, it is understood and agreed that it will consist of the following components:

a) The method to be used to allocate the revenue requirement for the Joplin and the St. Joseph Districts resulting

either from negotiations among the parties to this case or from a determination by the Commission shall be the Base-Extra Capacity Method, as generally described in Water Rates, Manual M-1, Fourth Edition, published by the American Water Works Association.

b) The revenue requirement shall be classified to the following five (5) elements:

1. Unity load factor;
2. Load factor;
3. Peak hour;
4. Service charge; and
5. Fire hydrant charge.

The definition of each of these elements is that contained in the Direct Testimony of Staff Witness Wess A. Henderson filed in this proceeding (Exhibit No. ___).

c) The Base-Extra Capacity Method described above, as used in this case, shall contain the following modifications:

1. The factors used to classify plant in-service, capital costs and operating costs to the load factor element shall be based on plant production capacity stated in million gallons per day in the Joplin District and the St. Joseph District, respectively.

2. The portion of purchased power expense related to the operation of booster pumps in the Joplin and the St. Joseph Districts shall be classified to the base-maximum hour element, to reflect the use of booster pumps to meet peak hour demand.

3. Costs classified to the unity load factor shall be divided by total sales in the Joplin and St. Joseph Districts,

respectively, to determine a unit rate to be applied to water sales in the second rate block.

4. Costs classified to the load factor and peak hour elements shall be divided by unit sales in the first block to determine a unit rate for these elements. The unity load unit cost, as specified in Paragraph 3, will be added to this unit rate to determine the total rate to be charged for water sales in the first rate block.

3) The rate design calculations shall be performed by Staff witness Henderson. However, each party shall have the opportunity to review those calculations before they become the basis for new rates. Each party shall also have the right to comment on the accuracy with which Mr. Henderson has performed the rate design allocations contemplated by this agreement.

4) This agreement is submitted as a complete resolution of the rate design issue. The agreement of the parties is premised on the condition that the Commission will adopt the stipulation and agreement without modification. If, for any reason, it is not adopted by the Commission in full, each party reserves the right to withdraw its consent.

Respectfully submitted,

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PLANT ACCOUNT NUMBER	PLANT ACCOUNT DESCRIPTION	DEPRECIATION RATE
311	Source of Supply Structures	2.00%
312	Collecting & Impounding Reserv.	1.85%
313.1	Lake, River & Other Intakes	3.67%
313.2	Lake, River & Other Intakes	1.45%
314	Wells & Springs	2.22%
316	Transmission/Supply Mains	1.47%
TOTAL	SOURCE OF SUPPLY PLANT	2.44%
321	Pumping Structures	2.13%
322	Boiler Plant Equipment	0.00%
323.2	Other Power Production Equip.	2.08%
324	Steam Pumping Equipment	0.00%
325	Electric Pumping Equipment	2.19%
326	Diesel Pumping Equipment	2.28%
328.3	Other Pumping Equipment	2.08%
TOTAL	PUMPING PLANT	2.18%
331	Water Treatment Structures	2.27%
332	Water Treatment Equipment	2.48%
TOTAL	WATER TREATMENT PLANT	2.45%
342	T & D Reservoirs & Standpipes	2.76%
343.1	T & D Mains (4" & less)	4.75%
343.2	T & D Mains (6' - 10")	1.24%
343.3	T & D Mains (12" & more)	1.67%
345	Services	1.94%
346.1	Meters - Bronze Case	2.11%
346.2	Meters - Plastic Case	8.88%
347	Meter Installations	1.76%
348	Hydrants	3.96%
TOTAL	T & D PLANT	1.97%
390.1	Office Structures	2.80%
390.2	Stores, Shops, & Garage Str.	2.08%
390.3	Miscellaneous Structures	2.08%
391.1	Office Furniture	2.82%
391.21	Computers & Peripheral Equip.	13.25%
391.22	Other Office Equipment	4.97%
391.23	Computer Software	20.00%
392.11	Light Trucks	11.21%
392.12	Heavy Trucks	6.78%
392.2	Automobiles	14.39%
392.3	Transportation Other	10.00%
393	Stores Equipment	0.00%
394	Tools, Shop & Garage Equipment	5.41%
395	Laboratory Equipment	2.86%
396	Power Operated Equipment	5.10%
397	Communication Equipment	7.69%
398	Miscellaneous Equipment	4.64%
TOTAL	GENERAL PLANT	7.36%
TOTAL - ALL DEPRECIABLE PLANT		2.48%