BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Lake Region Water & Sewer Company's Application to Implement a General Rate Increase in Water and Sewer Service.	)))	**Case No. SR-2013-0459**
In the Matter of Lake Region Water & Sewer Company's Application to Implement a General Rate Increase in Water and Sewer Service.	)))	**Case No. WR-2013-0461**

STAFF'S REPLY BRIEF

COMES NOW the Staff of the Missouri Public Service Commission, by and through counsel, and for its *Reply Brief*, states:

INTRODUCTION

This case is a general rate case, initiated by Lake Region Water and Sewer Company ("Lake Region" or "the Company") on July 16, 2013, by the filing of water and sewer service tariffs seeking an additional $218,762 in annual revenues. Only four issues were litigated: availability fees, capital structure, return on equity, and legal fees.

ARGUMENT

Availability Fees:

Pursuant to an obligation imposed by deed, the owners of undeveloped lots in Lake Region's service area must pay an annual fee securing their eventual right to hook-up to the Company's water and sewer systems.[1] In fact, payment of the fee secures nothing, because the Company is obliged to serve anyone in its service area that requests service, so long as any conditions in the Company's tariff are met.[2]

[1] *See* the discussion of the history of the availability fees at *Company's Brief,* pp. 15-28.

[2] The availability fees are not in the tariff.

Although the deeds require payment of these availability fees to the Company, the present shareholders have since 2004 diverted this revenue stream from the Company and collected it themselves and spend it for their own purposes.[3] The Company sees none of this money. Naturally, the shareholders do not want the Commission to interfere with this lucrative arrangement and they will not willingly divulge even the most basic information concerning it.

In this case, as in the last one, the Company vigorously opposes Staff's goal of returning this revenue stream to it, although Staff's goal is entirely to the benefit of the Company and its ratepayers. And, in this case as in the last, the Company's very able counsel has worked hard to confuse the issue, injecting countless red herrings in order to deflect the Commission's attention from the simple reality that necessarily must drive the solution of this issue. What is that reality? It is the fact that the transfer of the availability fee revenues away from the Company and into the pockets of the shareholders was never approved by this Commission as the law requires and is thus void as a matter of law. The availability fees belong to the Company now and have always belonged to the Company and the shareholders must give an accounting explaining what they have done with these funds that were never theirs.

The first red herring is this Commission's *Report and Order* from Lake Region's last rate case. The Company's counsel carefully describes the length of that order – it is "extensive and exhaustive" -- and the ponderous nature of the proceedings and record that produced it – "an extensive record was built on the subject at great expense" – and invites this Commission to adopt the non-decision that the Commission

[3] *Company's Brief,* pp.17-18. In fact, collection is evidently undertaken by a public water supply district, a political subdivision of the State of Missouri, on behalf of the shareholders, without compensation.

reached in 2010, "before availability fee revenue could be imputed to Lake Region[,] a duly promulgated rule on the matter must be adopted."[4] Staff urges the Commission to reject the Company's invitation to adopt that conclusion.

What is a rule and why might they matter here? According to the *Missouri Administrative Procedures Act* (*"MAPA"*), at Chapter 536, RSMo.,[5] a rule is an "agency statement of general applicability that implements, interprets, or prescribes law or policy, or that describes the organization, procedure, or practice requirements of any agency."[6] The courts have noted that this statutory definition is unhelpful because it encompasses "virtually any statement an agency might make in any context."[7] To clarify, the Missouri Supreme Court pointed out that ""[n]ot every generally applicable statement or 'announcement' of intent by a state agency is a rule."[8] To be a rule, the agency statement "must set a standard of conduct intended to have a general and prospective application."[9]

Duly promulgated administrative rules have the force and effect of law.[10] "Duly promulgated" means promulgated using the procedures set out in Chapter 536.[11] If a rule *was not duly promulgated,* there are consequences for the agency:

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[4] ***In the Matter of Lake Region Water and Sewer Co.,*** 19 Mo.P.S.C.3d 515, 603 (*Report and Order,* iss'd Aug. 18, 2010).

[5] Unless otherwise specified, all statutory references are to the Revised Statutes of Missouri ("RSMo."), revision of 2000, as amended and cumulatively supplemented as of th4e date of this document.

[6] § 536.010(6).

[7] ***United Pharmacal Co. of Mo., Inc. v. Mo. Bd. of Pharmacy,*** 159 S.W.3d 361, 365 n. 3 (Mo. banc 2005).

[8] ***Baugus v. Dir. of Revenue,*** 878 S.W.2d 39, 42 (Mo. banc 1994).

[9] ***Mo. Ass'n. of Nurse Anesthetists v. State Bd. of Nursing,*** 2010 WL 3629583, *4 (Mo. App., W.D. 2010).

[10] ***United Pharmacal,*** *supra,* 159 S.W.3d at 365.

[11] § 536.021.7.

> If it is found in a contested case by an administrative or judicial fact finder that a state agency's action was based upon a statement of general applicability which should have been adopted as a rule, as required by sections 536.010 to 536.050, and that agency was put on notice in writing of such deficiency prior to the administrative or judicial hearing on such matter, then the administrative or judicial fact finder shall award the prevailing nonstate agency party its reasonable attorney's fees incurred prior to the award, not to exceed the amount in controversy in the original action.[12]

In summary, a rule is an enforceable standard of conduct set by an administrative agency such as this Commission. If an agency enforces a policy that should have been promulgated as a rule, it may have to foot its opponent's legal fees; it would also incur the wrath of the General Assembly. It is this consideration that led the Commission to say, in 2010, that it would not disturb the existing state of affairs regarding availability fees without first adopting a rule. Staff respectfully suggests that the Commission's 2010 decision on availability fees was wrong and should not be followed now.

The truth is that the Commission doesn't need a rule on availability fees because very few utilities have any availability fees issues and, for those that do, the facts are very different from one company to another. All the Commission needs to do in this case is apply a statute, § 393.190.1, which requires Commission authorization *before* a public utility may transfer any part of its "franchise, works or system, necessary or useful in the performance of its duties to the public." Certainly, the availability fees revenue stream was once part of Lake Region's "franchise, works or system" and that money would be "necessary or useful in the performance of its duties to the public."[13] Because the availability fees revenue was separated from the Company without prior Commission authorization, that purported transfer is void. It's just that simple.

[12] § 536.021.9.

[13] *Id.*

While Lake Region is correct in stating that the Commission ordered Staff to open a workshop on the treatment of availability fees, it is an overstatement to say that it directed Staff to "formulate a rule." In fact, the Commission stated:

> To satisfy the standards of due process and avoid unpredictability with such a significant issue involved with determining a company's operational revenues, the Commission will open a workshop docket to lead to rulemaking. In the rulemaking proceeding, the Commission will delineate the definitive policy for the prospective treatment of availability fees, reservation fees, standby fees, connection fees, or any other similar fees, their proper use as mechanisms of capital recovery and their proper ratemaking treatment.[14]

Contrary to Lake Region's contention that the Staff has ignored the Commission's directive to "formulate a rule," a working docket was ordered and occurred. However, not all working dockets will result in a rule. Ultimately, the working docket that included availability fees closed without producing a rule. Staff does not argue by implication that the Commission vacated its orders in the 2010 *Report and Order,* as Lake Region's counsel suggests.[15] Instead, Staff argues that the workshop docket complied with the directive it was given in the 2010 *Report and Order.* Competing interests and inability to reach a consensus made rulemaking an ineffective avenue for addressing the issues raised in the docket. This inability to establish a rule shows that adjudication of this rate case is exactly the forum for the Commission to answer the question of availability fee treatment in rates for this Company. The reality is that very few utilities charge availability fees and the facts are significantly different

[14] ***Lake Region,*** *supra,* 19 Mo.P.S.C.3d at 605.

[15] *Company's Brief,* p. 13.

from case-to-case. A rule of general applicability is inappropriate; instead due process requires contested case adjudication.[16]

Even though the Staff did dutifully comply with the Commission's order to pursue a rulemaking workshop, in no way is a promulgated rule indispensable to the exercise of jurisdiction. In fact, based on the specific circumstances of Lake Region, a promulgated rule cannot be a prerequisite to Commission jurisdiction over availability fees. Here, the availability fees have been unlawfully transferred from the utility to its shareholders. In a case involving the transfer of utility property without Commission approval as required by statute, the Supreme Court of Missouri reasoned:

> We find no law, nor are we cited to any, whereby the Public Service Commission is given power to validate a deed of trust which is void under the statute. **The statute declares that an incumbrance made other than in accordance with the statute is void, and, being void, the commission is not authorized to make it valid**. Under the foregoing authorities the validity of a void transfer of public utility property is subject to collateral attack (emphasis added).[17]

Similarly, the transfer of availability fees away from Lake Region constitutes the transfer of a utility asset without commission approval. "Section 393.190, governs the transfer of franchise or property of water and sewer corporations. Under this section a regulated utility proposing a sale of its assets must secure an order authorizing the sale from the Commission."[18] Where, as here, the transfer is unauthorized, it is void as a

[16] § 536.010(4): "'Contested case' means a proceeding before an agency in which legal rights, duties or privileges of specific parties are required by law to be determined after hearing."

[17] ***Webster v. Joplin Water Works Co.,*** 352 Mo. 327, 339, 177 S.W.2d 447, 452 (1944) (citing ***Cooper County Bank v. Bank of Bunceton***, 221 Mo.App. 814, 822, 288 S.W. 95, 99).

[18] ***Environmental Utilities, LLC v. Public Service Com'n***, 219 S.W.3d 256, 264 (Mo. App., W.D. 2007).

matter of law.[19] The revenue stream from availability fees remains Lake Region's property.

The fact the Commission, ordered a workshop docket, does not make the transfer valid. As articulated in Lake Regions brief: "It is so elementary an axiom that it requires no citation of authority that the Commission is a creature of the legislation that enables it and it has no powers beyond what are granted by statute."[20] Lake Region argues in error that to accept Staff's position requires it to completely reclassify revenue. In fact, the Availability fees belong to Lake Region now and always have. The Commission must evaluate all relevant factors in setting just and reasonable rates[21] and should consider this revenue in the calculation of rates for Lake Region.

The Company's counsel also mentions due process. The phrase "due process," of course, refers to constitutional limitations on the power of the state to deprive persons of life, liberty or property: "Procedural due process imposes constraints on governmental decisions which deprive individuals of 'liberty' or 'property' interests within the meaning of the Due Process Clause of the Fifth or Fourteenth Amendment."[22] "Due process contemplates the opportunity to be heard at a meaningful time in a meaningful manner."[23] Due process requires notice and "an opportunity for a hearing appropriate to the nature of the case."[24]

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[19] § 393.190.1.

[20] *Company's Brief*, p. 28.

[21] ***State ex rel. Utility Consumers' Council v. Public Service Commission,*** 585 S.W.2d 41, 48 (Mo. banc 1979) (***"UCCM"***).

[22] ***Mathews v. Eldridge,*** 424 U.S. 319, 332, 96 S.Ct. 893, ___, 47 L.Ed.2d 18, ___ (1976).

[23] ***Moore v. Bd. of Education,*** 836 S,.W.2d 943, 948 (Mo. banc 1992).

[24] ***Dabin v. Director of Revenue,*** 9 S.W.3d 610, 615 (Mo. banc 2000).

First, the present proceeding, convened on ample notice, constitutes the *Company's* opportunity to be heard. The shareholders are not themselves parties to this case and the Commission cannot take the availability fees revenue from them in any case. What the Commission *can* do is impute the availability fees revenue to the Company, thereby practically requiring the shareholders to either contribute funds to the Company's operations or seek belated approval for the transfer of the revenue away from the Company.[25] Second, the property in question – the availability fees revenue stream --- is in the shareholders' possession unlawfully, consequently, they have no interests in it that due process will protect. There is absolutely no due process obstacle to the Commission's resolution of the availability fee issue by applying § 393.190.1 to the facts of record.

Next, coming full circle, the Company's counsel claims the "protection" of the Commission's 2010 *Report and Order.* "Lake Region is entitled to rely on the Commission's order(s)."[26] Just what is it in that order that the Company's counsel wants to rely on? This statement: "The Commission asserting jurisdiction over revenue derived from availability fees. . . cannot simply be based on an adjudication on a specific set of accrued facts."[27] Why.not? Administrative tribunals resolve contested cases every day by applying existing law to the facts of record.

Guidance on this point can be found in the Missouri Supreme Court's decision in ***Utility Consumers' Council.***[28] In that case, the Court was called upon to determine

[25] Other steps may be available to require the shareholders to turn these funds over to the Company.

[26] *Company Brief,* p. 13. The unconscious irony of this statement is excruciating, given that Staff is attempting to recover the availability fees revenue for the Company from its shareholders.

[27] *Id.,* quoting ***Lake Region,*** *supra,* 19 Mo.P.S.C.3d at 603.

[28] ***UCCM,*** *supra.*.

the lawfulness of the fuel adjustment clause ("FAC") mechanism for electric utilities that had been in use for many years.[29] The Court determined that the statutes did not authorize the Commission to allow electric utilities to use an FAC, stating "[i]t is for the legislature, not the PSC, to set the extent of the latter's jurisdiction. The mere fact that the commission has approved similar clauses in the past, or that other states permit them, is irrelevant if they are not permitted under our statute[.]"[30]

Although Lake Region is correct in pointing out that the Commission did not impute the revenue derived from availability fees in the 2010 rate case, the Commission is not bound by its previous decisions.[31] As discussed above, Lake Region is also correct that the Commission unequivocally ordered a workshop docket.[32] However, the Commission's stance on jurisdiction over availability fees is not as clear. In fact, Lake Region itself, "acknowledges that in other parts of the 2010 Report and Order, the Commission declared that it "should assert jurisdiction" over availability fees (p.103), but not without engaging in ancillary due process."[33] The relevant portion of the Commission's 2010 *Report and Order* to which Lake Region refers is below:

> There is another factor at play when determining its jurisdiction over the availability fees. In past cases where availability fees, standby fees, reservation fees or connection fees were collected, and where the

[29] To be more precise, the FAC had been used for many years in the tariffs applicable to industrial and large commercial customers; before the ***UCCM*** Court was the question of applying the FAC to residential and small commercial customers.

[30] ***UCCM,*** at 54.

[31] "…the PSC is not bound by stare decisis based on prior administrative decisions, so long as its current decision is not otherwise unreasonable or unlawful." See, e.g., ***State ex rel. AG Processing, Inc. v. Pub. Serv. Comm'n***, 120 S.W.3d 732, 736 (Mo. banc 2003) ("an administrative agency is not bound by stare decisis"); ***State ex rel. Mo. Gas Energy v. Pub. Serv. Comm'n***, 186 S.W.3d 376, 390 (Mo. App. W.D. 2005). ***State ex rel. Aquila, Inc. v. Pub. Serv. Comm'n of State***, 326 S.W.3d 20, 32 (Mo. App. 2010).

[32] As stated previously, Staff complied with this order.

[33] *Company's Brief*, p. 5, note 15.

> Commission determined it lacked jurisdiction over those fees, the fees were always kept completely separate from the entity providing utility service. The fees were never part of the regulated public utility. Even if the ownership of the corporate entity collecting the fees was identical to the ownership of the utility, the revenue was never comingled with, or directly available to, the utility.
>
> **The record in this case demonstrates the utility had possession of the fees at their inception. The fees were paid to directly to the utility between 1974 and 1998.** After that, the availability fee revenue stream was sold to Roy and Cindy Slates. Availability fee revenue was combined with the utility during of the sale of the stock and fees to Waldo Morris, but only long enough to split it off for Mr. Morris as a separate revenue stream. This was repeated when the stock and fees were sold to the current owners of Lake Region. **Because the utility had, at different intervals, direct use of or access to this revenue stream, and because the fees can be defined as a commodity falling under the definition of utility service, the Commission concludes that it should assert jurisdiction over availability fees.** And when the prior owners eliminated Lake Region's access to these fees, these acts had the potential to become a detriment to the ratepayers; albeit, these actions were done with Public Service Commission acquiescence or approval in many cases over many years. (emphasis added).[34]

The preceding reasoning by the Commission certainly appears to support Staff's argument that availability fees rightly belong to Lake Region. Under the heading *Departure from Past Decisions*, Lake Region refers to the discussion regarding past Commission treatment of availability fees and cites the 2010 *Report and Order i*n part:[35]

> To make this determination [that availability fees are a "commodity"] in this matter would be a substantial departure from past Commission decisions, policy and practice. And, although the Commission is not bound by stare decisis the rulings, interpretations, and decisions of a neutral, independent administrative agency, "while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which **courts and litigants** may properly resort for guidance."(emphasis added). It has been established that Lake Region has indeed relied upon this Commission's past decisions and the directions it received from the Commission's Staff for guidance with how availability fee revenue was not regulated revenue and would not receive

[34] ***Lake Region,*** *supra,* 19 Mo.P.S.C.3d at 602.

[35] *Company's Brief*, pp. 5-6.

> ratemaking treatment. And, Missouri Courts have applied the doctrine of quasi-estoppel to prevent agencies from taking positions contrary to, or inconsistent with, positions they have previously taken[36]

The context of the sentences immediately preceding that text in the 2010 *Report and Order* are vital to explain how the Commission viewed the past treatment of availability fees.

> However, the ability to hook up to a water and sewer system is property right that can be transferred; it can be bought and sold. While the Commission has not done so in the past, availability fees could be construed to be a "commodity" and thus fall under the definition of a "service," despite its expert Staff's testimony to the contrary.[37]

Certainly, this argument does play a part in the determination of Commission jurisdiction. However, the past treatment referred to does not reflect the Commission's past treatment of availability fees in general, but the more narrow view that the Commission had not exercised jurisdiction over availability fees as a "commodity." In fact, treating the availability fees as Company revenue is consistent with the Commission's treatment of availability fees with respect to other regulated utilities.[38] Specific to Lake Region, the availability fee revenue was in the past treated as utility revenue for the company's predecessors in interest. JRS Exhibit 1, attached to Lake Region's *Post Hearing Brief*, is a table that contains the heading "Availability fees owned by Company" and lists the predecessor companies of Lake Region, with three of them listed as "yes" to owning the revenue. The Commission has done this without any rulemaking.[39]

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[36] ***Lake Region,*** *supra,* 19 Mo.P.S.C.3d at 600-601.

[37] *Id*. at 600.

[38] *Merciel Surrebuttal*, p. 5, lines 8-9.

[39] *Merciel Surrebuttal*, p. 8, lines 18-20.

The record in this case shows the Commission has exercised jurisdiction over availability fees, and continues to do so with other utilities. That the Commission did not exercise its jurisdiction over availability fee revenue in the last case, and seemed to abdicate that jurisdiction is an aberration - not the controlling Commission practice.

Next, following a lengthy review of the history of the availability fees, the Company's counsel asserts that "[t]he Commission is without subject matter jurisdiction over the billing and collection of availability fees."[40] This conclusion is based upon the argument that "[h]aving water or sewer system facilities available to an undeveloped subdivision lot does not constitute a "service" as defined in Section 386.020."[41] This argument constitutes still more misdirection. The record shows that the availability fees revenue stream belonged to the Company and was thus an asset of the Company; it was alienated without the authorization of the Commission and that transfer is void as a matter of law.[42] The issue of what is or what is not a utility service is irrelevant. Also irrelevant is the Commission's resolution in 2007 or 2008 of a case involving Central Jefferson Utilities because, in that case, the comparable revenue stream *never belonged to the utility.*[43]

There are clear differences between the facts and circumstances of the Central Jefferson case and those presented by this case. The first and foremost distinction being the difference in the creation of availability fees in Lake Region and the connection fees in Central Jefferson. In the Central Jefferson case, Raintree Plantation

[40] *Company's Brief,* p. 29.

[41] *Id.*

[42] § 393.190.1.

[43] *See* discussion, *Company's Brief,* pp. 30-31.

subdivision was developed by Raintree Plantation, Inc. ("Raintree"), which separately created the connection fees to recover its costs of installing the water and sewer mains. Raintree required the buyers of each lot to pay a connection fee for connecting to the water and sewer mains. Raintree's connection fee was collected pursuant to an "Intrastate Exemption Statement" executed by the developer and the purchaser of the lot. The "Intrastate Exemption Statement" stated:

> Water and sewer service in pipes laid in easements or in the streets will be furnished by Central Jefferson County Utility Company and a connection fee of $700.00 for the sewer and $300.00 for the water must be paid to RAINTREE PLANTATION, INC. prior to commencing construction for any home.[44]

The money was clearly owed to the developer as explicitly articulated in the document that created the connection fee. The revenue stream never belonged to the public utility. Not so in Lake Region.

The covenants which created the availability fees at issue in this case stated in part: "…the owner of each lot agrees to pay to the owner or owners of the sewage disposal system and water works system to be constructed with the Development a minimum monthly availability charge for water, water service…"[45] And further on, the covenants defined that the owner would be a regulated utility: "The said owner or owners of said water works system and sewage disposal system will be a privately owned public utility authorized by a Certificate of Public Convenience and Necessity issued by the State of Missouri Public Service Commission."[46] In Lake Region,

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[44] *In the Matter of the Application of Central Jefferson County Utilities, Inc. for an Order Authorizing the Transfer and Assignment of Certain Water and Sewer Assets to Jefferson County Public Sewer District and in Connection therewith, Certain other Related Transactions, Staff Ex.* 12.

[45] *Company's Brief,* p. 18; Four Seasons Lakesites POA, Ex. 1, pages 22-24.

[46] *Company's Brief,* p. 19; Four Seasons Lakesites POA Ex. 1, pages 22-24.

the covenants specifically stated the availability fee was to be paid to the regulated utility and originally were so paid. Thus, the availability revenues belonged to the utility, which is distinct from the Central Jefferson facts and situation. In the Central Jefferson case, the connection fee was created to favor the named unregulated developer and later assigned to another unregulated entity. The sewer district there appeared to be merely a collection agent. In Lake Region, the availability fee was a utility asset and was unlawfully transferred to the detriment of ratepayers and Lake Region's viability.

For the above reasons, Central Jefferson is inapplicable to the facts and situation presented by Lake Region. However, the Commission's feelings about the transactions involved in Central Jefferson can be accurately applied to the Lake Region availability fees transaction: "Simply put, this transaction does not pass the 'smell test.'"[47]

Whether or not the Commission has jurisdiction depends on the facts of the case at hand. Developers may structure their affairs however they like, but where, as here, they structure them so that availability fees belong to and are paid to the regulated public utility, then the Commission necessarily has jurisdiction over them. It does not matter that the reason the developer created the fees was to recoup the developer's investment in the utility infrastructure; what matters is how the matter was arranged.

In conclusion, Staff states again that the immediate resolution of this matter is simple. The availability fees revenue stream belonged to the Company *ab initio* until the present shareholders separated the Company and the revenue, retaining the latter for themselves. They never sought or obtained authorization from the Commission, as the law requires, for this alienation of the Company's valuable asset and the transfer thus is

[47] *Company's Brief,* p. 31.

void. The shareholders do not own that revenue, nor the right to receive it. Their unlawful possession of it, however long it persists, cannot create in them any right or title to it. The resolution of this issue, therefore, is simple. The Commission need only apply settled law to the facts of record. The revenue must be imputed to the Company, its lawful owner.

Capital Structure and Return on Equity ("ROE"):

Staff favors use of a hypothetical capital structure for ratemaking purposes, while the Company and the Public Counsel ("OPC") prefer the actual capital structure. Staff and the Company favor a high ROE while OPC argues for a low ROE. This pair of issues are not as complicated as they might appear to be at first glance.

Unlike OPC and the Company, Staff considers the shareholders' acquisition loan to be debt of the Company because it is secured by the shares, that is, the ownership of the company, its cash flow and its assets. On that view, the Company's financing is 100% debt. However, in cases of small water and sewer companies that are overburdened by debt, Staff's policy is to employ a hypothetical capital structure consisting of 75% debt and 25% equity. Staff believes this hypothetical capital structure results in a more just and reasonable ratemaking than the use of an actual capital structure containing more than 75% debt.

The Company asserts that "Staff's conclusion and support for its development of Lake Region's actual capital structure is based on erroneous conclusions and unsupported conjecture, and should be disregarded."[48] The Company's assertion is belied by the facts. The record shows that the Company is in debt to Alterra Bank and

[48] *Company's Brief,* at 45.

that the debt is secured by the Company's assets and cash flow. The shareholders are also indebted to Alterra Bank and that loan is secured by their shares. The two loans aggregate to a figure greater than the value of the Company's rate base. The interest rate on both loans is the same. A default at either level will result in Alterra Bank owning the Company.

Although the shareholders and the Company are legally distinct, Staff cannot agree that they are financially distinct. The shareholders purported equity share of 60% of Lake Region's rate base is dwarfed by the debt they owe to Alterra Bank, secured by their very ownership interest. To consider the shareholders' interest as equity under those circumstances would be to engage in a sham. All of the Company's capital comes from, and is owed to, Alterra Bank. For this reason, Lake Region's financing is 100% debt and Staff's proposed hypothetical capital structure of 75% debt and 25% equity is the most reasonable result.

Staff proposes a ROE of 13.89%, if applied to Staff's hypothetical common equity ratio of 25%, or 11.93%. if the Commission accepts the capital structure proposed by Lake Region.[49] The lower alternative ROE is proposed because, using Lake Region's proposed capital structure, its Financial Risk Profile no longer justifies the higher ROE.[50] Less debt in the capital structure means less financial risk for the utility investors; therefore, a higher return on equity is not necessary to allow the company to attract capital and investors.

[49] *Cost of Service Report,* p. 4, lines 13-17 (Staff recommends an overall Rate of Return of 7.22 %)

[50] *Atkinson Surrebuttal,* p. 7.

Legal Fees:

Staff's position is that the legal fees incurred by the Company in an unsuccessful contract dispute should be recovered in rates because the Company was not imprudent to pursue the litigation. Staff recommends that these fees be amortized to rates over five years.

OPC opposes recovery of these fees, but OPC can prevail only if the expenditure was imprudent. The utility bears the burden of proof in a rate case.[51] Nonetheless, a presumption of prudence is accorded to its expenditures and the utility will not be required to prove up the prudence of an expenditure unless a challenging party raises a "serious doubt" as to its propriety.[52]

If the threshold requirement is met and the Commission proceeds to a prudence determination, it employs a standard of reasonable care requiring due diligence as the standard for evaluating the prudence of a utility's conduct.[53] The Commission has described this standard as follows:

> 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 assessed the situation?"[54]

In making this analysis, the Commission is mindful that "[t]he company has a lawful right to manage its own affairs and conduct its business in any way it may choose, provided

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[51] § 393.150.2.

[52] ***In the Matter of Union Electric Company***, 27 Mo.P.S.C. (N.S.) 183, 193 (1985) (*quoting* ***Anaheim, Riverside, etc. v. Federal Energy Regulatory Commission***, 669 F.2d 779, (D.C. Cir. 1981)) (*citations omitted*).

[53] *Id.,* at 194.

[54] *Id.*

that in so doing it does not injuriously affect the public."[55]

The unsuccessful litigation imposed costs on the ratepayers that they otherwise would not have borne. However, the litigation was undertaken to *reduce* rates and, had it been successful, the ratepayers would have benefitted. The litigation was not so speculative as to be an unreasonable risk to undertake and, indeed, Lake Region prevailed in the trial court. Staff considers these fees to be the result of a reasonable management decision and urges the Commission to allow their recovery.

Conclusion

WHEREFORE, based on the foregoing, Staff requests the Commission resolve each issue in this case as recommended by Staff.

Respectfully submitted,

/s/ Kevin A. Thompson
Kevin A. Thompson
Chief Staff Counsel
Missouri Bar Number 36288

/s/ Tim Opitz
Tim Opitz
Assistant Staff Counsel
Missouri Bar Number 65082

Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 751-6514 (Voice)
(573) 526-6969 (Fax)
Kevin.thompson@psc.mo.gov

Attorneys for the Staff of the
Missouri Public Service Commission

[55] ***State ex rel. City of St. Joseph v. Public Service Commission***, 325 Mo. 209, 223, 30 S.W.2d 8, 14 (banc 1930).

CERTIFICATE OF SERVICE

I hereby certify that the foregoing has served, by hand-delivery, electronic transmission, or First Class United States Mail, postage prepaid, upon all parties of record as shown on the Service List maintained by the Data Center of the Missouri Public Service Commission, this **7th day of April, 2014.**

/s/ Kevin A. Thompson