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August 2, 2000

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FILED[2]
AUG 0 2 2000
Missouri Public
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RE: WR-2000-281, et al.

Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and eight (8) conformed copies of a **REPLY BRIEF OF STAFF.**

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,

Keith R. Krueger
Deputy General Counsel
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KK/jb
Enclosure
cc: Counsel of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Tariff Sheets Designed to Implement General Rate Increases for Water and Sewer Service provided to Customers in the Missouri Service Area of the Company.	))))))	Case No. WR-2000-281, et al. (Consolidated)

REPLY BRIEF OF STAFF

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REPLY BRIEF OF STAFF

COMES NOW the Staff of the Missouri Public Service Commission ("Staff") and for its Reply Brief states to the Missouri Public Service Commission ("Commission") as follows:

ARGUMENT

ISSUE NO. 1: ACCOUNTING AUTHORITY ORDER

Should MAWC be allowed to include in the cost of service, through rate base and expense adjustments, amounts related to post-in-service AFUDC and deferred depreciation expense for the period from the in-service date of the new St. Joseph water treatment plant to the operation of law date in this case?

The Company contends that it should be allowed to continue to capitalize AFUDC throughout the post-in-service period (i.e., from April 30, 2000 until the effective date of the Commission's order in this case), and that it should be allowed to defer the depreciation of the newly constructed SJTP until the effective date of the order (approximately September 15, 2000). The Company claims that this is necessary, because the construction of the SJTP was extraordinary and if this relief is not granted, the Company will suffer financial hardship. Neither argument is persuasive.

The burden of proof that the construction of the SJTP was an extraordinary event falls upon the Company, which has simply failed to sustain this burden. Construction of capital improvements is a normal part of doing business for a water company. In fact, the Company states that it plans to spend about $17 million per year for the next four years on the construction of improvements to its existing facilities.

The only thing unusual about the construction of the SJTP is that it was a very large project. However the events that precipitated the construction – low water in 1989 and a flood in 1993 – occurred long ago, and the Company has had ample time to plan and build this facility, and it has in fact been planning the construction since at least 1991. The construction of the SJTP was not extraordinary.

Nor will the Company suffer financial hardship, contrary to the arguments advanced at pages 103-104 of the Company's Initial Brief. The Company will experience returns on equity of at least 9.14% for every 12-month period that ends on the last days of April 2000 through September 2000, and most of these are projected to be above 10%. (Rackers Rebuttal, Ex. 53, p. 6, lines 6-9). Although the returns may not be everything the Company would hope for, they hardly constitute financial hardship.

Furthermore, the Company's earnings are not in danger of falling below the minimum level of 1.5 times interest that is required by its indenture. Even Company witness Salser testified that the interest coverage would be 1.81 times for the 12 months ending April 30, 2000 through September 30, 2000. (Salser Surrebuttal, Ex. 8, p. 5).

The AFUDC and depreciation are merely the normal consequences of regulatory lag. Sometimes, when a company's costs are declining, the company benefits from regulatory lag. At other times, when its costs are increasing, the company suffers from regulatory lag. In either situation, the presence of regulatory lag provides a strong incentive for the company to be more efficient.

To allow the Company to capitalize AFUDC and to defer depreciation would be improper, because it would allow the company to effectively increase its rates for the four and one-half month period between the SJTP's in-service date and the effective date of the new rates without a consideration of all relevant factors. The Company's requests should be denied.

ISSUE NO. 2: PREMATURE RETIREMENT

Shall the net plant investment associated with the existing St. Joseph water treatment plant facilities that are no longer providing service to St. Joseph customers be included in MAWC's rate base and amortized to expense?

As the Staff explained at pages 9-10 of its Initial Brief in this case, the Staff believes the Company should be allowed to amortize the costs associated with the premature retirement of the old plant, consisting of the undepreciated account balance of the old plant plus the costs of removal and demolition that the Company incurs in abandoning it. However, the costs of removal and demolition were not known at the time of the evidentiary hearing, and the appropriateness of increasing the current depreciation/amortization expense accrual could not be determined because a depreciation study was based upon data that is not flawed has not been performed. Therefore, the amount to be amortized is not yet ascertainable.

The Staff therefore recommends that the Company perform a depreciation study prior to filing its next rate case. After the results of that study and the costs of removal and demolition are known, the Commission can consider the proper amounts to include in amortization of the old plant. Until this occurs, both the plant account and the depreciation reserve should be reduced by the original cost of the old treatment plant as of the date the old plant was taken out of service. The Company has agreed with this proposal (see Company's Initial Brief, p. 99), but the OPC opposes it (see OPC's Initial Brief, pp. 44-48).

When plant is in service, a utility company is entitled to a return on its investment, through inclusion in rate base, and a return of the investment, through depreciation. When plant is prematurely retired, the company receives a return of the investment, through amortization of the prematurely retired plant, but it does not receive a return on the investment. This is the rationale for the Commission's decision in *GTE North, Inc.*, Case No. TR-89-182, which OPC cited in its Initial Brief at pp. 45-46.

In the instant case, however, it would be improper to amortize the prematurely retired plant at this time, because of the uncertainty over the amount that should be amortized, which is discussed above. The Company should have an opportunity to receive a return on its of investment, pending the determination of the amount to be amortized.

In the present case, where the Company would not receive a return of its investment until after the depreciation study is complete, it is appropriate to allow the Company to receive a return on its investment, through inclusion in rate base, until the depreciation study is complete. When the depreciation study is complete, it should have the opportunity to receive a return of its investment through amortization of the properly determined balance of the plant account, the reserve for depreciation and the costs of removal and demolition.

ISSUE NO. 3: AFUDC CAPITALIZATION RATE

Should MAWC's rate base be adjusted to reflect a different capitalization rate for AFUDC?

The Company contends that the AFUDC on the SJTP (for the pre-in-service period) that ought to be included in the Company's rate base should be a fictitious amount that is determined by applying the rate of return from the Company's last previous rate case to the outstanding balances of the CWIP. The Staff, on the other hand, contends that the AFUDC should be determined, to the extent possible, by determining the actual carrying charges that the Company incurred in constructing the SJTP. These actual carrying charges would reflect the fact that the Company uses short-term debt as the principal means of financing its construction projects.

As of December 31, 1999, the Company had approximately $35 million of short-term debt outstanding. This is not an insignificant sum of money. In fact, it is nearly half of the construction cost of this project that the Company has, in its argument on the AAO issue, described as "extraordinary."

The interest rates on the Company's short-term debt are not included anywhere in the Company's determination of its required rate of return. The only sources of financing that are included there are long-term debt, preferred stock and common equity. The same is true for the Staff's and OPC's determination of the Company's required rate of return.

The Company insists that the interest rates on its short-term debt must not be included in the determination of the carrying charges on the CWIP, either. In fact, the Company does not think these short-term interest rates (which are lower than the interest rate on the long-term debt) should be considered in any way in this rate case. That is, the interest rates actually associated with loans of up to $35 million should just be ignored. Instead, the Commission should assume that the CWIP was financed with only common and preferred equity and long-term debt. This is a fiction, it is contrary to the facts, and it should not be sanctioned.

The Company argues that it is "inappropriate" for the Commission to "penalize" the Company by applying the interest rates on the loans that were actually used to finance the CWIP in the determination of AFUDC. But doing so would not "penalize" the Company at all. It is no more appropriate for the Commission to use fictitious carrying charges on the CWIP (based on the rates from an old case) than it would be for the Commission to use a fictitious construction cost (based on the rates that existed at another time).

If the actual cost of a construction project is $70 million, it is not appropriate to include $71 million in rate base, merely because the Company assumed that this would be done. For the same reason, if the actual carrying charges on CWIP are those that relate to short-term debt, it is not appropriate to use the carrying charges that relate to the Company's other sources of financing, merely because the Company assumed that this would be done.

The Company may have believed that AFUDC would be based on the rate of return from the last previous rate case, but it did not incur these costs, to finance its construction projects.

The AFUDC should be determined by first applying the interest rates associated with short-term debt. To the extent that the CWIP exceeds short-term debt, the rate of return from the Company's last previous rate case should be used. Applying the correct interest rates to the CWIP results in an adjustment of $1,289,674. (Ex. 109, Accounting Sch. 4-3, Adjustment No. P-20.2).

ISSUE NO. 4: ST. JOSEPH TREATMENT PLANT AND RELATED FACILITIES ("SJTP") VALUATION

<u>What valuation should be included in rate base for the water treatment plant and related facilities necessary to provide water for the St. Joseph District?</u>

The St. Joseph Industrial Intervenors, the Municipal and Industrial Intervenors, and the OPC argue that the Commission made no finding on the prudence of the new St. Joseph treatment plant in Case No. WA-97-46. In fact, the St. Joseph Industrial Intervenors even go so far as to say that the Commission "expressly disclaimed" any prudence related decision in connection with the SJTP in Case No. WA-97-46. (St. Joseph Industrial Intervenors Initial Brief, p. 35).

The "disclaimer" language the St. Joseph Industrial Intervenors gleefully quote, from Case No. WA-97-46, and which OPC generally supports, reads as follows: "...the Commission will make no finding regarding the prudence of the actual costs incurred and the management of construction of the project." St. Joseph Industrial Intervenors and OPC choose, however, to either ignore or give only passing mention to the other important language in this case which states, "...based on the extensive evidence presented, the Commission *finds that the proposed project, consisting of the facilities for a new ground water source of supply and treatment at a remote site is a reasonable alternative* (emphasis added)." Placing these two pieces of language together, and carefully reviewing the complete decision in Case No. WA-97-46, reveals that the Commission *approved* the prudence of the Company's decision to construct the new treatment facility in St. Joseph and *reserved* the issue of the management of the construction costs for later determination. The Commission's language mentioned above is entirely consistent with the reality that management of construction costs cannot be scrutinized until they are actually incurred.

Staff agrees that Case No. WA-97-46 was an expansion of the certificated area, or "siting case," and not a rate case, but once again, the St. Joseph Industrial Intervenors and the OPC ignore the fact that the obvious reason MAWC sought expansion of its certificated area was to allow for construction of the SJTP and its related facilities at a location away from the flood plain of the Missouri River. Case No. WA-97-46 did not arise in a vacuum, as the St. Joseph Industrial Intervenors and OPC would have the Commission believe. (See the Report and Order in Case No. WA-97-46, pp. 2 and 7).

Staff takes issue with the assertion of the St. Joseph Industrial Intervenors that Staff Witness Merciel was "seemingly embarrassed" by the investigation and analysis that others had performed in connection with the SJTP (St. Joseph Industrial Intervenors Initial Brief, p. 35). Mr. Merciel's testimony during the hearing was conveyed in the same consistent and honest manner that has characterized his twenty-three of honorable service with the Missouri Public Service Commission. The idea that Mr. Merciel created disallowances related to the SJTP based upon "embarrassment" (St. Joseph Industrial Intervenors Initial Brief, p. 35) is shown to be baseless because Mr. Merciel stated in his Direct Testimony (Ex. 48) at page 9, that "...matters pertaining to the "used and useful status" and the "cost reasonableness" of ...capital projects will be addressed further in rebuttal...or true-up testimony". Obviously, disallowances were contemplated by Mr. Merciel in his pre-filed testimony, long before he took the stand in this case, and prior to any so called "embarrassment".

Staff would also respond to the assertion by the St. Joseph Industrial Intervenors that Staff took the "easy road" in failing to make any prudency review in Case No. WA-97-46 and in this case (St. Joseph Industrial Intervenors Initial Brief, p. 35). This allegation of neglect lacks luster, when exposed to the light of the "settled issues" in Case No. WA-97-46. Specifically, *all* *parties to that case agreed* that "...there is a need to replace and/or improve the existing source of supply and treatment facilities; and/or construct a new source of supply and treatment facilities; and/or secure a new independent source of supply in order to provide safe, adequate and reliable water source." (Report and Order, Case No. WA-97-46, p. 3). Clearly, *everyone* that participated in Case No. WA-97-46 agreed that the St. Joseph District needed serious attention or improvement. Since every party agreed that the St. Joseph District needed serious overhaul, it is hard to accept the proposition that Staff should have conducted an extensive review of the reasonableness of either improving or building a new treatment facility in St. Joseph, especially since the cost difference presented in the certificate case between the two most appropriate alternatives was less than a half million dollars. (Merciel's Rebuttal, Ex, 49, p. 7, lines 4-9).

The St. Joseph Industrial Intervenors and OPC attempted to show that Mr. Merciel was predisposed to allow capital improvements into rate base. However it was undisputed that Mr. Merciel had testified in two cases before the Commission against such inclusion (Ex. 97) and that in his 23 years of experience with the Public Service Commission in the water utility area, Staff had "...more problems getting companies to do what they need to do rather than trying to hold them back..." (Tr. 1535, lines 5-9). In fact, no evidence was offered to rebut or refute Mr. Merciel's opinion that water companies were reluctant to incur capital improvement expenses during his tenure with the Commission.

More importantly, in connection with a Staff prudence review, since the Commission approved the prudence of the Company's decision to build a new, remote facility in Case No. WA-97-46, Staff had no reason to further scrutinize the reasonableness of the decision to build a new facility in this case. In terms of the "easy road" allegation made by the St. Joseph Industrial

Intervenors, it should be noted that the St. Joseph Industrial Intervenors took no active part in previously objecting to the new facility during Case No. WA-97-46. It has waited until the new facility was constructed and then has emerged from the sidelines, to shout "imprudence".

OPC argues that Staff witness Merciel took the position that building the new SJTP was a prudent choice because of a variety of "intangible benefits". Implicit in OPC's characterization of Merciel's position is the suggestion that these intangibles were the *only* basis for Mr. Merciel's opinion concerning the new ground water source water treatment plant in St. Joseph. To the contrary, Mr. Merciel testified that he did review the alternatives submitted by the Company in Case No. WA-97-46. (Tr. 1504, lines 2-11). Mr. Merciel testified that he did not simply accept the estimates laid out in the feasibility study presented by MAWC in Case No. WA-97-46. (Tr. 1504, lines 12-17). In fact, Mr. Merciel stated that he was not sure he would agree with the figures presented in the feasibility study used by the Company. (Tr. 1504. lines 16-17). Mr. Merciel said that, in conducting his review, he envisioned what was being designed/constructed and looked at the estimates presented by MAWC. (Tr. 1504. lines 24-25; Tr. 1505, line 1). Mr. Merciel stated that he relied on his common sense and the appearance of the estimate numbers to make his conclusions regarding the alternatives of upgrading the existing plant and the construction of a new plant. (Tr. 1505, lines 12-17). Mr. Merciel also testified that he did express concerns about the estimates furnished by the Company in several meetings and field visits. (Tr. 1506, lines 14-24). Mr. Merciel indicated that OPC was involved in the meetings and discussions about the estimates presented by the Company. (Tr. 1506, lines 17-24). Ultimately, Mr. Merciel stated that he was satisfied that the estimates in the feasibility study were close enough to establish that either one of the alternatives (either rebuilding the existing surface water supply treatment plant or building a new plant) was economically feasible.

(Tr. 1505, lines 4-8). As mentioned in Staff's Initial Brief, at page 22, the difference in the choice of costs in MAWC's feasibility study between rebuilding the old facility versus building a new remote plant was about $400,000.00.

OPC examined Mr. Merciel's concerns about flooding at the old facility and agreed that "the potential of flooding at the river treatment plant is an important issue…" (OPC Initial Brief, p. 35). However, OPC argues that Mr. Biddy's flood prevention measures had "more than adequately" addressed the "intangible benefit" connected with the elimination of flooding concerns. (OPC Brief at p. 36). Staff finds this conclusion less than convincing, especially in light of Mr. Biddy's refusal to confirm that his flood prevention measures would "flood-proof" the old St. Joseph facility. (Tr. 1627, lines 3-18). Clearly, Mr. Biddy would not testify that it was "absolutely certain" the old plant would be flood-proofed by his levee improvements. Mr. Biddy did state, however, that "…as good as man can design, it would be flood proof". (Tr. 1627, lines 15-18). Staff is reminded that the SS Titanic was dubbed "unsinkable" by the engineers of its era, and it was "as good as man could design" in its time, to use Mr. Biddy's terminology. Obviously, the Titanic failed to live up to its billing when it met the compelling forces of nature. Staff submits that when a treatment facility is located yards away from one of the country's largest rivers, its "flood proof" capabilities could be put severely to the test at any time.

While examining the issues of flood protection, it should be noted that OPC and Ag Processing are both silent on the portions of Mr. Merciel's testimony that says, in effect, if MAWC had rebuilt the old facility in the flood plain, and it was damaged again by another flood, everyone would then consider this to be an outrageous situation. (Tr. 1578, lines 14-24). Clearly, if this scenario occurred, the outcry and argument would be that it was obviously "imprudent" to have rebuilt the old treatment facility in a proven flood plain.

Lastly, OPC states that Mr. Merciel was advocating that MAWC "take advantage" of the great flood of 1993 to the detriment of the ratepayers. (OPC Brief, p. 36). Staff vigorously disputes this assertion. Mr. Merciel's testimony during the hearing established that the great flood of 1993 convinced him that the SJTP should not be constructed at a location that is prone to damage by flood. (Tr. 1524, lines 4-6). In addition, Mr. Merciel stated that the depreciated value of the rate base at the old facility was only $2.8 million dollars. (Tr. 1524, lines 17-23). Obviously, after placing Mr. Merciel's testimony in the proper context, it was evident that Mr. Merciel concluded that the Company should take advantage of a flooding disaster by moving its facility out of harms way *while investment in the old plant was at a low level.* To suggest, as OPC has, that Mr. Merciel thought the Company should take advantage of the ratepayers is disingenuous, misleading and totally unwarranted. Mr. Merciel's rationale was merely a recommendation to make the best of a bad situation, rather than any desire whatsoever to harm the ratepayers of Missouri.

ISSUE NO. 5: SJTP CAPACITY

<u>What is the appropriate capacity for SJTP that should be included in rate base?</u>

Staff has recommended an excess capacity disallowance from rate base inclusion in connection with the SJTP of $2,271,756.00. (Merciel Rebuttal, Ex. 49, pp, 16-18). MAWC argues initially that Mr. Merciel's view of the Missouri Department of Natural Resources ("MDNR") approval status of the filters at the new facility in St. Joseph is inaccurate. (MAWC Initial Brief p. 36). However, during cross-examination of John Young, Mr. Young admitted that the filter rate approved at the new facility "...until we completed a demonstration study to show that the filters effective operate at...5.56 (gallons per minute per square foot or gpm)" (Tr.

1158, lines 13-15). Mr. Young tacitly admitted that the filters at the new plant are operating on a "demonstration" basis and unless MAWC can show that the filters at the new facility can operate properly at the 5.56 gpm rate, MDNR would impose a different rate. (Tr. 1158, lines 16-23). Mr. Young also admitted that the normal standard for dual media filters is four gallons per minute in connection with surface water plants, although he emphasized that the new SJTP is a ground water facility. (Tr. 1159, lines 4-9). Staff has no quarrel with the fact that MAWC is currently operating its new St. Joseph facility at 5.56 gpm, but the evidence establishes that this filter rate has not received MDNR's final stamp of approval as to its permanency. In addition, the evidence is that 4 gpm is the current MDNR filter rate standard, at least for surface water supply sources. Thus, since the filter rate at the new facility is not yet approved, it cannot be assumed per se, that the plant will be able to use this rate on a permanent, going forward basis.

Basically, in its brief at page 36, the Company argues that Staff wishes to reduce capacity at the SJTP on what Staff alleges is an unapproved filter capacity. However, the filter capacity is only one of two components that comprise the basis of Mr. Merciel's excess capacity adjustment. The other component involves actual customer demand. Mr. Merciel demonstrated what the actual water demand totaled, on several peak days, on Schedule 2-1 (Merciel Rebuttal, Ex. 49), which is shown as "Historical usage from plant records" under a column entitled "Pumped to system". This column shows the amount of water leaving the plant and going to the distribution system.

MAWC also argues that Mr. Merciel did not take in-plant use of water into account in his excess capacity conclusions. (MAWC Brief, p. 36). This is inaccurate because on Schedule 2-1 (Ex. 49) Mr. Merciel indicates in addition to "Pumped to system," another column representing "Total Production", which represents the total amount of water that was treated at the plant on peak days. The larger amounts of water in the "Total Production" column does allow for in-plant water usage. (Some of the numbers in the "Total Production" column were estimated by Mr. Merciel.) Thus, Schedule 2-1 is utilized by Mr. Merciel to establish that his capacity recommendation of 23 mgd is based on total production, including in-plant water usage for all water demand days in the history of the St. Joseph district, with the exception of a one-day peak demand occurring in 1991.

MAWC contends that the higher capacity capability at the new facility in St. Joseph of 30 million gallons a day (mgd) is necessary if the new facility were to experience a hot and very dry weather pattern at some time in the future. (Tr. 1160, lines 7-12). Again, however, that pattern has not yet arrived, as Mr. Young admits, in terms of the actual water demands. (Tr. 1160, lines 21-25 , Tr. 1161, lines 1-8 and Tr. 1163, lines 20-25). It is undisputed that the SJTP has never experienced a demand of more than 25.6 mgd in its history. (Tr. 1160, lines 21-25 and Tr. 1161, lines 1-9). It is also undisputed that the SJTP did not exceed 23 mgd in 1994, 1995, and 1999. MAWC answers with evidence that 23 mgd was exceeded in 1983, 1988, and 1991. Clearly, in *more recent years* the SJTP has not exceeded the 23 mgd that Staff witness Merciel recommends.

The Company argues at page 35 of its Initial Brief that when Mr. Merciel includes only two clarifiers in rate base instead of the three clarifiers that were built at the new facility that the capacity is actually 22.8 mgd, rather than 23 mgd. Staff concurs with this conclusion, but Mr. Merciel's Schedule 2-1 (Merciel Rebuttal, Ex. 49) indicates that 22.8mgd (200,000 gallons per day less than 23 mgd), still *exceeds* the historical total production (except for one day in July of 1991) of the SJTP in recent years.

Mr. Merciel testified that it was permissible that a plant designed for 23 mgd could be run for short periods of time at a higher capacity. (Tr. 1605, lines 9-10)) MAWC counters this statement by Mr. Merciel with Mr. Young's warning that to "...operate a plant at a higher-than-approved rate, you're basically putting the public at risk for public health." (Tr. 1390, lines 4-6). However, during cross-examination Mr. Young admitted that if the plant is being run at a higher capacity than its design features for a short period of time, it would probably have no impact on water quality, so long as no adverse water conditions exist at the time. (Tr. 1400, lines 22-25; Tr. 1401, lines 1-5). Basically, Mr. Merciel's position concerning exceeding capacity was that plant "capacity" is more of a prescribed limit, rather than an absolute physical limit. Support for this rationale lies in the fact that the Company's all-time peak production amount of 25,328,000 gallons per day was satisfactorily met in 1991 with the old plant. The old St. Joseph plant was rated at a 21 mgd capacity. (Tr. 1605, lines 4-6).

ISSUE NO. 6: DEFERRED TAXES

Should MAWC's rate base be adjusted to reflect the amount of deferred taxes existing on the books of Missouri Cities Water Company prior to its acquisition by MAWC? If so, what is the appropriate adjustment?

In its Initial Brief, the Company cited the testimony of Staff witness Roy M. Boltz, Jr. and OPC witness Ted Robertson in Cases Nos. WR-95-205 and SR-95-206, *In the Matter of Missouri-American Water Company's Tariff Revisions*. The Company contends that in those cases the Commission based its decision to deny the Company recovery of an acquisition adjustment, at least in part, on the testimony of Mr. Boltz and Mr. Robertson. The Commission reasoned that the ratepayer will already suffer one negative impact of the sale because of the loss of the deferred taxes.

The Commission's decision in those cases was based on the evidence that was presented in those cases. The evidence that was presented was based on the reporting requirement for financial accounting purposes. As the Commission is well aware, the accounting methods that are used for the purpose of preparing financial statements and the accounting methods that are used for regulatory accounting purposes are not always identical. The Commission was not presented with the option of "restoring" the deferred taxes for ratemaking purposes in those cases. However, that situation can now be rectified.

The critical issue in this case is not the relationship between the Company and its predecessor, or between the Company and the U.S. Internal Revenue Service, but rather the relationship between the Company and its ratepayers. As evidenced by the testimony of Staff witness Gibbs (Tr. 1967-1968), the ratepayers who provided those deferred taxes to the Company are still providing the Company with a return of depreciation, as well as a return on the related plant that generated those deferred taxes. The ratepayers provided to the Company's predecessor the funds needed to pay the future tax obligation. The equitable thing to do in this case is to provide the ratepayers a return on their "investment of funds" to cover the deferred taxes by including the deferred taxes in the determination of rate base.

As identified by Staff witness Gibbs (Tr. 1968), at least three other merger cases approved by the Commission, each similar to the Company's acquisition of Missouri Cities and each accounted for as a purchase, have all included the provision to reduce rate base to compensate for the loss of deferred taxes that had been written off.

ISSSUE NO. 7: RETURN ON EQUITY

What return on equity is appropriate for MAWC?

As the Staff noted in its Initial Brief, for at least the past 20 years, the Commission has relied upon the Discounted Cash Flow Method ("DCF") as its principal tool for determining the appropriate return on equity ("ROE") for a regulated utility. The Company insists, however, that no single method of determining ROE is perfectly suitable, and that it is better to make use of several different models. The Company utilized three different models in this case, including the Capital Asset Pricing Model ("CAPM") and the Risk Premium Model as well as DCF, and it gave approximately equal weight to each of the three models.

In its Initial Brief, the Company criticized the accuracy and usefulness of the DCF Model. It claimed the stock prices of the "comparable group of water companies" analyzed by its witness, Harold Walker, III have been driven unusually high by a short-term acquisition frenzy and worldwide market sentiment. As a result, these companies currently have market-to-book ratios of 231%, and their dividend yield is therefore very low. The DCF therefore "only provides a reasonable estimate" of the cost of equity, the Company said. Furthermore, the DCF will understate the cost of equity when market-to-book ratios exceed 100%, according to the Company.

But according to Mr. Walker's own testimony, it is very common for market-to-book ratios to exceed 100%. In fact, for the 52 years from 1947 to 1998, the *average* market-to-book ratio for the S&P Industrial Companies was 213%. The high ratio during this period was 692.2%, and the low ratio was 100.2%. (Walker Direct, Ex. 12, Sch. 16, p. 1 of 4). Thus, for the

S&P Industrials, at least, it would appear that, in Mr. Walker's view, the DCF Method would *always* understate the appropriate ROE.

If Mr. Walker believes that the DCF Method always understates ROE, he surely could not believe that it is a reliable tool. Yet, it is the tool that the Commission has placed its primary reliance on for the last 20 years or more. In effect, his testimony says that the Commission has been wrong all this time.

The Staff submits that it is Mr. Walker's view that is in error. If the price of the stock of his comparable group of water companies is high because of an "acquisition frenzy," it seems inescapable that it is, at present, very easy to induce investors to provide equity to these comparable companies. When it is easy to attract equity, the cost of equity is low.

The DCF Method remains the most reliable and accurate method of determining the appropriate cost of equity.

The Company notes that a plan to phase in the rate increases in this case, such as Staff has proposed, would prevent MAWC from earning its authorized return on equity in the early years of the phase-in. It is true that the Company would temporarily have a lower return on its equity during the early years of a phase-in, but the Staff believes that the objective of the phase-in plan – preventing rate shock to MAWC's ratepayers – far outweighs this temporary effect on earnings. Furthermore, as the Company has acknowledged, the Company would earn more than its authorized return on equity during the last years of the phase-in. In both instances, the return would reflect financial statement/book earnings. From a regulatory earnings perspective, as Company witness Jenkins recognizes, earnings in the form of deferrals are being recognized and accumulated. These deferrals, although not reflected currently in the financial statements, are earnings which will be booked in the future and will be reflected in future rates.

The Company contends that the revenue deferral associated with a phase-in "would increase MAWC's risk profile," cause investors to "significantly discount revenue deferrals," and increase the cost of equity, because of the risk that the Commission will not allow the Company to ever recover these revenue deferrals. There is "no guarantee that future regulators will tolerate this apparent 'overearnings'" that would occur in the later years of the phase-in, the Company says.

The Staff contends that Mr. Walker's, and the Company's, cynical view that investors will not trust the Company to recover its deferred revenues is unfounded, and should be disregarded. There is no reason for investors to doubt that the Commission would allow the Company to eventually recover its deferred revenues, and the Company has done so in similar cases in the past. In addition, the Company is again confusing regulatory and financial statement earnings. Rates are not set based on financial statement/book earnings. Rates are established based on a rate of return times rate base calculation that also reflects significant adjustments to test year net income.

Finally, if the return on equity is adjusted to account for the "risk" associated with the phase-in, the whole purpose of having a phase-in is defeated. An increase in the ROE would increase the amount that has to be phased in and accumulate more deferred earnings. The benefits of gradualism would diminish, while the rate shock to MAWC's customers would not.

The Company also argues that Staff's recommended ROE is too low, because it fails to account for the risks associated with the claims of other parties that the Commission should disallow a major part of the Company's investment in the SJTP.

The St. Joseph Industrial Intervenors and the OPC both propose disallowances ranging from \$30 to \$40 million of plant investment. If those disallowances were granted, it would certainly have a major effect on the Company's earnings.

It is important to note, however, that although the Staff has recommended a capacity disallowance in this case, it is small when compared to the disallowances that the St. Joseph Industrial Intervenors and the OPC propose. Staff urges the Commission to accept the Staff's disallowance, reject the other large disallowances, and adopt the Staff's recommended ROE.

The fact that *other parties* want large disallowances should have no effect on *Staff's* ROE.

Furthermore, it would not be proper to increase the ROE as some sort of compensation for the fact that an investment has been disallowed for inclusion in rate base. This principle applies whether the disallowance is large or small. To hold otherwise would be to allow the Company to, in effect, earn a return on plant that has been found to be excessive or imprudent.

Disallowing an investment because it is imprudent, but then allowing a larger-than-normal return on the prudent portion of the investment would tend to compensate the Company for the fact that the Commission – properly – allows no return on the imprudent portion of the investment.

ISSUE NO. 8a: SINGLE TARIFF PRICING, DISTRICT SPECIFIC PRICING OR COMPROMISE

Shall MAWC's rates be designed consistent with a "single tariff" rate design, "district-specific" rate design, or some other methodology?

The Staff of the Public Service Commission ("Staff") recommends District Specific Pricing ("DSP") for all districts, but with a five-year phase-in period for the rate increases in the Mexico, Parkville, Brunswick and St. Joseph districts, as well as the specific plan for Brunswick detailed in Staff's Initial Brief. (Staff's Initial Brief, pp. 46, 52). Staff continues to support this position and will respond to the arguments raised by the other parties in their briefs.

Legality of STP

It is clear that since Case No. WR-97-237 that full STP has been utilized by MAWC. (Case No. WR-97-237, Report and Order, p. 13-14; Stout Direct, Ex. 9, p. 14, lines 8-10). Single Tariff Pricing has been expressly approved by this Commission (see Case No. WR-97-237, Report and Order, p. 14; see also Case No. WO-98-204, p. 7). In Case No. WR-97-237, the Commission reviewed a nonunanimous stipulation **for MAWC** in which parties proposed a single tariff rate design (Case No. WR-97-237, Report and Order dated November 6, 1997, pp. 13-14). The Commission noted that it must protect the public interest, ensure that MAWC's rates are just and reasonable, and ensure that MAWC provides safe and adequate service to the public in compliance with Sections 393.130 and 393.140 RSMo (Case No. WR-97-237, Report and Order, p. 15). The Commission determined that the STP rate design advocated by MAWC was just and reasonable (Case No. WR-97-237, p. 15).

While Staff submits that STP is not the appropriate rate design in the present case, it is clear that STP is legal in Missouri. There is no statute in Missouri that expressly prohibits STP, but case law clearly supports the legality of STP in Missouri. Accordingly, STP is legal in Missouri and could be utilized in this case if the Commission determines that it is the most suitable rate design for MAWC.

Some parties allege that STP is not lawful, at least in the context of a multi-district public water utility such as the present case (St. Joseph Industrial Intervenors Initial Brief, pages 37-49; Municipal and Industrial Intervenors Initial Brief pages 1-13). OPC apparently does not share the belief of the St. Joseph Industrial Intervenors and the Municipal and Industrial Intervenors because the OPC recognizes that there are attractive aspects to each of the "extremes" (presumably a reference to STP and DSP) (OPC Initial Brief at 58).

The St. Joseph Industrial Intervenors and the Municipal and Industrial Intervenors have written pages of argument suggesting that STP is unlawful because it is unjust, unreasonable, unlawful, discriminatory and/or any combination of one or more of these terms (Municipal and Industrial Intervenors Initial Brief, pages 1-35; St. Joseph Industrial Intervenors Initial Brief, pages 37-49). However, this argument misses the applicable law on the subject. It is not the methodology or theory but the impact of a rate order that counts in determining whether rates, are just, reasonable, lawful and nondiscriminating. *State ex rel. Associated Natural Gas Company v. Public Service Commission,* 706 S.W.2d 870, 879 (Mo. App. W.D. 1985). The courts will review the impact of the entire ratemaking order instead of the particular methodology or theory. The Commission could very well adopt an order utilizing STP that is just, reasonable, lawful and nondiscriminatory.

Both the St. Joseph Industrial Intervenors[1] and the Municipal and Industrial Intervenors[2] cite, and are therefore aware of the existence of, the leading case regarding the legality of STP in

[1] St. Joseph Industrial Intervenors Initial Brief, p. 41.
[2] Municipal and Industrial Intervenors Initial Brief, p. 9.

Missouri. However, neither of these parties acknowledge its significance nor do they try to explain why the case of *State ex. rel. City of West Plains v. Public Service Commission, 310* S.W.2d 925 (Mo. banc 1958) does not support the use of STP in Missouri.

This is quite understandable because the case clearly supports and establishes a legal basis for STP in Missouri. The Missouri Supreme Court indicated its approval of the concept of systemwide ratemaking in the case of *State ex rel. City of West Plains v. Public Service Commission*, 310 S.W.2d 925, 933 (Mo. Banc 1958), stating:

> We are able to discern no legitimate reason or basis for the view that a utility must operate exclusively either under a systemwide rate structure or a local unit rate structure, or the view that an expense item under a systemwide rate structure must of necessity be spread over the entire system regardless of the nature of the item involved. Experts in utility rates may well conclude that a "hybrid system" or a "modified system" of ratemaking, wherein certain expense items are passed on to others on a systemwide basis, is the system that will produce the most equitable rates. And it would appear to be the province and duty of the Commission, in determining the questions of reasonable rates, to allocate and treat costs (including taxes) in the way in which, in the Commission's judgment, the most just and sound result is reached.

This is consistent with the principle that the Commission has considerable discretion in ratemaking.

The Commission has primary authority to regulate utility rates. *State ex rel. Capital City Water v Public Service Commission,* 850 S.W.2d 903, 911 (Mo. App., W.D. 1993). The Courts have clearly recognized that the Commission requires flexibility in the exercising of its ratemaking function in order to deal with changing and unforeseen circumstances. *Id.* at 911. See also *State ex. rel. West Plains v. Public Service Commission,* supra at 933. The ability in this case to choose an appropriate rate design, whether it is STP, DSP, or something in between, is clearly within the sound discretion of the Commission. Staff submits that while DSP with the changes previously discussed by

Staff is the best rate design in this case, it is clear that STP is also a legal option. For the same reasons, MAWC's alternate plan to utilize STP with a surcharge in St. Joseph is also legal.

Appropriateness of DSP

While Staff has previously advocated STP in MAWC's cases, Staff has determined, and urges this Commission to agree, that DSP is the appropriate rate design in this case, because of the particular facts surrounding this case, most notably the substantial impact of the SJTP on the cost of service for MAWC (Tr. 974, lines 1-12; Tr. 1002, lines 8-18). This is a very substantial change since the previous MAWC rate case (Tr. 974, lines 1-12; Tr. 1002, lines 8-18). Staff endorses DSP with a five-year phase-in for those districts receiving significant rate increase. (Rackers Surrebuttal, Ex. 54, p.6, lines 3-11; Ex. 105). Staff has made one important modification to its position of advocating DSP in this case (Hubbs Surrebuttal, Ex. 43, p. 4, lines 16-18).

Staff proposes that the commodity rates for the Brunswick District would be set equal to the highest commodity rates of the other districts; to the extent that the DSP-allocated costs are not recovered from the Brunswick District by the application of this rate, they should be applied to the Joplin District classes. (Hubbs Rebuttal, Ex. 42, p.4, lines 16-18). The differential herein is approximately $175,000; responsibility for this shortfall would be shifted from the Brunswick District to the Joplin District. However, ever after absorbing this amount, the Joplin District would still receive an overall decrease in water rates under DSP. (Hubbs Rebuttal, Ex. 42, Sch. Joplin WRH 1- 4). This provision, together with the five-year phase-in period, keeps the effect of the

Company's overall move to DSP within the bounds of gradualism, and should be supported. (Hubbs Surrebuttal, Ex. 43, p. 4, line 19 – p. 5, line 6).

OPC offers an alternative proposal which, it alleges, balances the benefits of cost-based rates with the benefits of tempering rate shock. (OPC Initial Brief, p. 58). OPC acknowledges "some level of sharing is necessary to ensure the reasonableness of rates in this case. (OPC Initial Brief, p. 58). OPC then sets out in substantial detail what districts would pay for the other districts. (OPC Initial Brief, p. 58). OPC also touts its proposal of limiting the individual increases to no more than 50% (OPC Initial Brief at 59).

It is interesting to note that OPC considers STP and DSP to be "extreme" positions. (OPC Initial Brief, p. 58). However, OPC sees "attractive aspects" in each of the "extremes," and even supports movement toward the "extreme" of DSP, but cannot seem to opt for one or the other. If OPC's plan were to be adopted, then the issue of DSP or STP would live to be fought still another day. It would next be seen when MAWC comes to the Commission again for a rate increase, and the same evidence and arguments would be presented again. OPC's plan would create subsidization that would not even have the supposed benefits of STP to those communities paying substantially above their cost of service. For this reason also, OPC's plan must be rejected.

OPC's plan is a disingenuous plan that ultimately mirrors some of the same discriminatory aspects of STP that, ironically, other parties are using to justify STP. This was clearly recognized by another party in the case, who characterizes OPC's plan as "STP with compassion" (Municipal and Industrial Intervenors Initial Brief, p. 35). The principal problem with OPC's plan is that it violates one of the principal goals of ratemaking, which is to design rates that recover the allocated cost of service from those causing the costs to be incurred. (Hubbs Rebuttal, Ex. 42, p.3, lines 1-3). A subsidization plan such as that proposed by OPC. (OPC Initial Brief, p. 59: Busch Direct, Ex. 27, p.4, lines 4-7), no matter how well-intentioned violates another important and proper goal of ratemaking which is to minimize subsidization (Hubbs Rebuttal, Ex. 42, p. 3, lines 7-11).

OPC's plan has another fundamental weakness. OPC acknowledges that its plan of a 50% cap on rate increases is conditioned upon the Commission adopting OPC's revenue requirement. (OPC Initial Brief, p. 59). This is anything but certain, given the extensive and strong evidence in the record regarding the revenue requirements advocated by Staff and MAWC. In the event that the revenue requirement proposals of the Staff or MAWC are adopted, then OPC must modify its proposal to prevent other districts from providing a very substantial subsidy to St. Joseph. (OPC Initial brief, pages 59-60). In other words, OPC's rate design proposal lacks the ability to adapt to changing circumstances. The Staff's DSP plan can adapt to whatever revenue requirement is ultimately approved by the Commission. For this reason also, the OPC's proposal must be rejected.

OPC also mistakenly believes that Staff's recommended rate design shows "...substantial movement toward Public Counsel's position..." (OPC Initial brief at 62). While it is true that Staff has modified its proposal slightly to allow phase-ins in those districts wherein substantial rate increases will occur in order to mitigate rate shock – (a concern shared by OPC (OPC Initial Brief, p. 62), it is equally true that Staff is recommending DSP, which will be reached at the end of the phase-in, with the possible exception of Brunswick. This is totally different from OPC's position which will still be somewhere between DSP and STP at the end of the five year phase-in. The only clear common ground herein between OPC and Staff is that both parties want phase-ins to mitigate rate shock.

However, OPC clearly recognizes the reasons for, and the validity of the Staff's support for the DSP position. In its Initial Brief, OPC states:

> Given the disparity in capital improvements and other cost characteristics exhibited between MAWC's seven districts, revenue recovery should better reflect district specific class cost and should not be based on simplistic company-wide cost of service studies. In this case, it is the only way to ensure that the rates are just and reasonable for each MAWC district. (Ex. 27, pp. 3-7). Public Counsel and Staff are the only parties that performed specific class cost of service studies for each district.[3]

While it is true that OPC is in the difficult position of balancing the different interests of customers of seven districts and molding them into one position that balances all of the divergent interests, it is also true that its rate design is not the best alternative. Staff has already stated the best alternative rate design in this case. That is DSP with the phase-in and modification as discussed herein.

Staff has already explained in its Initial Brief the reasons why STP is not appropriate in this case (Staff's Initial Brief, pp. 49-53). STP violates one of the principal goals of ratemaking, which is to design rates that recover the allocated cost of service from those causing the costs to be incurred. (Hubbs Rebuttal, Ex. 42, p.3, lines 1-3). The customers in the six districts other than St. Joseph did not cause the new SJTP to be built, nor will the customers in those other six districts reap any benefits from the new SJTP. Each of the seven districts should move toward actual cost of service under DSP as advocated by Staff.

DSP, unlike STP, satisfies one of the other important goals of ratemaking, which is to minimize subsidization. (Hubbs Rebuttal, Ex. 42, p. 4, lines 5-15). It is clear that when the actual costs of providing water service to one district are recovered from the water users within

[3] OPC Initial Brief, p. 65.

that district, it has the effect of more equitably recovering the cost of serving a class of customers from those customers. (Hubbs Rebuttal, Ex. 42, p. 4, lines 5-15). Under this guiding principle, the costs for the SJTP must be recovered from ratepayers in the St. Joseph District. As the evidence clearly showed, when large cost differentials exist between districts, as exist in this case, DSP should be used to recover the costs of the cost-causing district from the customers of the cost-causing district (Hubbs Rebuttal, Ex. 42, p.5, lines 6-7).

In view of the foregoing Staff respectfully submits that the Commission should adopt DSP with a five-year phase-in, and with the modification of the rates for the Brunswick District, as previously discussed.

ISSUE NO. 8b: ALLOCATION OF CORPORATE DISTRICT EXPENSE

What is the proper allocation of MAWC's corporate district investment and expense?

MAWC continues to prefer its own cost allocation study for allocating the common corporate costs of the Company to each of its operating districts, over the Staff's cost allocation study. (MAWC Initial Brief, p. 64). MAWC, however, has confined its position on the allocation of corporate district costs to the plant investment and related depreciation and "believes it is more appropriate to use only the allocated corporate labor as the basis for allocation corporate district plant items." (MAWC Initial Brief, p. 68). This could be somewhat confusing considering that the Staff allocated the items of corporate plant and depreciation on the basis of allocated corporate payroll. (Gibbs Surrebuttal, Ex. 37, p. 6, lines 9-10).

Additionally, MAWC acknowledges that if the cost allocation studies of Staff and MAWC regarding Corporate District Expense used a similar revenue requirement and rate base, then the use of Staff's allocation would yield very similar results to the MAWC cost allocation study. (MAWC Initial Brief, p. 65; Stout Rebuttal, Ex. 10, p. 2, lines 4-6).

In view of the foregoing, Staff and MAWC do not appear to have any significant difference in corporate cost allocations. This is further buttressed by the true-up testimony that MAWC filed in this case. It does not contain any adjustment for the corporate allocations that are advocated in MAWC's true-up testimony. (Salser True-Up Direct, Ex. 107, Sch. JES-2-1; Salser True-Up Rebuttal, Ex. 108, Sch. JES-5, p. 1 of 8). The absence of any such adjustment suggests that MAWC agrees with Staff's corporate allocations.

In view of the foregoing, it is clear that MAWC's corporate district expense and investment should be allocated utilizing the composite payroll allocation as advocated by the Staff.

ISSUE NO. 8c: ALLOCATION OF COST/REVENUE AMONG CLASSES

<u>On what basis shall the portion of revenues to be borne by MAWC's various customer rate classes be determined?</u>

Staff urges the Commission to adopt DSP, with the modification discussed previously, with the district-specific costs then being allocated to the various customer classes in each district, as advocated by Staff Witness Hubbs. (Staff Statement of Positions, p. 4). Staff's support for DSP has already been discussed herein, under Issue No. 8a.

Staff allocated the cost of service to MAWC's various rate classes and also developed the customer rates necessary to recover the costs allocated to each customer classification. (Hubbs Direct, Ex. 40, p. 2, lines 21-23). The results of these allocations provide the relative cost levels that should be recovered from each customer class within each district. (Hubbs, Direct , Ex. 40, p. 2, line 17 – p.3, line 2). Rates are then designed to recover the allocated cost from each customer class utilizing district-specific cost of service computations (Hubbs, Ex 40 p. 3, lines 1-2).

If the Commission were to adopt DSP, MAWC does not want to have the necessary interclass shifts to each class of customers under DSP. However, MAWC states that if DSP is adopted, then Mr. Hubbs's allocation of district-specific costs to the various customer classes is reasonable. (MAWC Initial Brief, p. 66). MAWC also noted that Mr. Hubbs utilized the Base-Extra Capacity Method in allocating costs to the various customer classifications within the districts. (MAWC Initial Brief at 66). However, MAWC recommends that if the Commission adopts DSP, then no interclass shifts should be done, but instead a uniform percentage increase should be applied. (MAWC Initial Brief, p. 66). If rates are not set by class pursuant to Mr. Hubbs's proposal, then dramatic interclass subsidization within customer classes in each district would occur.

The Industrial Intervenors who support DSP also do not want to have the necessary interclass shifts performed. (Municipal and Industrial Intervenors Initial Brief, p. 53). The St. Joseph Industrial Intervenors note that Mr. Harwig suggested that class rates be adjusted based on an equal percentage or an "across the board" approach, due to the significant impact that the proposed increase would have "even with the large disallowance" for SJTP that the St. Joseph Industrial Intervenors advocate. (St. Joseph Industrial Intervenors Initial Brief, p. 53). This proposal, just like the MAWC proposal if the Commission utilizing Mr. Hubbs' study adopts DSP, essentially recommends doing a class cost of service study and then ignoring the results of it.

OPC Cost of Service

OPC claims that its class-cost-of-service methodology is the most appropriate method. They claim it properly allocates costs to the small users who have a high peak-to-average usage ratio, while the Base-Extra Capacity Method overallocates to this group of customers. (OPC Initial Brief, p. 65). OPC further contends that the primary flaw of the Base-Extra Capacity Method is that it skews the allocation of cost toward consumers that have volatile demand. (OPC Initial Brief, p. 65). OPC identifies these individuals as the residential and small commercial users (OPC Initial Brief at 65).

The Base-Extra Capacity Method is a recognized method for allocating the cost of providing water service to customer classifications in proportion to each class's use of the commodity, the facilities, and the services. (Stout Direct, Ex. 9, p. 19, lines 13-19; Hubbs Direct, Ex. 40, p. 3, lines 5-6). It is the most widely accepted costing methodology in the water industry. (Harwig Rebuttal, Ex. 61, p. 3 at lines 10-12) and was accepted for use in MAWC's most recent rate case (Stout Direct, Ex. 9, p. 19, lines 13-19).

In order to correct this perceived "problem" in the widely used and generally accepted Base-Extra Capacity Method, OPC introduces its concept of "economies of scale" (OPC Initial Brief at 65). The "economies of scale" referred to by OPC are not a part of the traditional Base-Extra Capacity Method as described in the AWWA manual, however, and this approach is not typical of the many water company cost of service studies that Mr. Stout has prepared or reviewed. (Stout Rebuttal, Ex. 10, p. 4, lines 4-7). The serious conceptual and analytical problems with OPC's concept of "economies of scale," as well as the lack of support in scholarly journals, are discussed in Staff's Initial Brief at pages 59-67, and need not be repeated here.

Despite OPC's arguments to the contrary, the base-extra capacity method properly reflects the cost causation responsibility associated with the different usage patterns of the classes. The base-extra capacity method allocates costs based on average use, and on capacity use over average use. (Hubbs Surrebuttal, Ex. 43, p. 9, lines 5-6). Base capacity is allocated based on class average use, whereas extra capacity (that use which exceeds average use) is allocated based on peak use, on both an hourly basis and a daily basis. (Hubbs Surrebuttal, Ex. 43, p. 9, lines 7-9).

In addition, the base-extra capacity method also appropriately allocates costs based on the peak use of the system. (Hubbs Surrebuttal, Ex. 43, p. 7, lines 18-19). The peaking requirements for each class of service represent that portion of the costs that are needed to provide service for peak usage. (Hubbs Surrebuttal, Ex. 43, p. 7, lines 19-21). The base-extra capacity method allocates these costs based on their capacity needs, and thereby allocates the costs of system facilities between the classes based upon the capacity usage of the separate classes. (Hubbs Surrebuttal, Ex. 43, p. 7, line 21 - p. 8, line 3). Low-load-factor customers require more capacity to be served and therefore use a greater proportion of the capacity-related facilities than do high-load-factor customers, and accordingly should pay the costs associated with the capacity facilities that they use. (Hubbs Surrebuttal, Ex. 43, p. 8, lines 3-6). Allocation of capacity-related facilities based on a method that does not assign capacity-related costs on a capacity or peaking basis is inappropriate (Hubbs Surrebuttal, Ex. 43, p. 8, lines 10-12), and accordingly OPC's cost of service study is not appropriate.

ISSUE NO. 8d: PHASE-IN

Should MAWC's rate increase be phased in over a number of years? If so, what is the appropriate "phase-in" amount, and what is the appropriate "phase-in" period?

As previously discussed, supra, Staff advocates a District Specific Rate Design in this case. However, Staff is cognizant of the significant increases in rates that would occur in several of the districts if DSP is implemented. For this reason Staff advocates a five-year phase-in of rates, and recommends allowing the Company to earn a carrying charge equal to the rate of return authorized by the Commission on any amounts deferred. (Rackers Surrebuttal, Ex. 54, p. 5, lines 18-20).

The only party that clearly objects to a phase-in is MAWC (MAWC Initial Brief at 68-78). While MAWC raises several arguments against a phase-in (MAWC Initial Brief at 68-78), its primary concern appears to be the alleged negative impact on MAWC's financial statements. In its brief, MAWC states the following: "...While the Company would like nothing better than to be able to agree to a phase-in plan, the financial impact of not being permitted to recognize for accounting and reporting purposes any phase-in revenue deferrals will result in a weakened financial position in the early years of the phase-in period..." (MAWC Initial Brief, p. 69). While MAWC purports to be willing to accept a phase-in, it takes the position that there would be a negative impact on its financial statements and accordingly it cannot accept phase-ins. This apparently would include phase-ins with a carrying cost to the Company. (MAWC Initial Brief, p. 75).

However, unlike MAWC, this Commission has a much broader mission. It cannot merely consider an alleged short-term negative impact on the financial statements of MAWC and automatically grant MAWC its every wish. "Because ratemaking is not an exact science, the utilization of different formulas is sometimes necessary." *State e. rel. Associated Natural Gas Company v. Public Service Commission of Missouri,* 706 S.W.2d 870, 880 (Mo. App., W.D. 1985). The Commission can select its methodology in determining rates and then make the pragmatic adjustments that are called for by particular circumstances. *Id.* at 880. Clearly the Commission has considerable discretion in ratemaking. Staff urges the Commission to determine that not only is a phase-in necessary but that it is appropriate in this case.

Staff submits that while the alleged impact on MAWC's financial statements is one concern for the Commission, it is by no means the only concern and it certainly is not the most important. In testimony, Mr. Hamilton admitted that his only consideration was the Company's books. (Tr. 370). Of course, this Commission is not so narrowly focused. It must consider all parties and all positions in reaching a decision. Staff has considered this impact in its phase-in proposal. Even though the Company's reported earnings may be initially reduced, the Staff's proposal accumulates deferrals that will be reflected in the Company's rates and in its reported financial statement earnings in the future. (Rackers Surrebuttal, Ex. 54, p. 5, lines 1-5). Staff advocates a carrying cost equal to the rate of return ultimately_approved by the Commission until the entire approved rate increase is actually fully reflected in rates. (Rackers Surrebuttal, Ex. 54, p. 5, lines 4-5). This carrying cost compensates the Company for the time value of money during the deferral period. (Rackers Surrebuttal, Ex. 54, p. 5, lines 4-5).

Financial Accounting Standards ("FAS")

MAWC next alleges that it is subject to the accounting requirements of Statement of Financial Accounting Standards 71 ("FAS 71") about regulatory accounting and Financial

Accounting Standard 92 (FAS 92) which MAWC alleges severely restricts the ability to record phase-in plans for plants commenced after January 1, 1988 (MAWC Initial Brief at 70-72).

MAWC insinuates, but not overtly state, that since it is supposedly bound by these accounting standards, and because these standards don't allow MAWC to record rate phase-ins on their accounting statements, the Commission cannot order a phase-in in this case. This position is without any authority whatsoever, and MAWC does not even seriously suggest that there is any such authority. On the contrary, such a position would significantly impair the authority of the Commission to do its job. It should be summarily rejected.

MAWC also suggests that FASB 92 prohibits the recognition of phase-ins until the actual dollars are received (MAWC Initial Brief at 70-71). MAWC is justifiably concerned about the validity of its position as evidenced by its attack on Mr. Trippensee's testimony. OPC Witness Trippensee correctly points out that there is absolutely no reference to the water industry in FAS 92. (Trippensee Surrebuttal, Ex. 35, p. 7, line 4 – p.8, line 2). Mr. Trippensee explains that FAS 92, by its very terms, applies only to the electric industry. (Trippensee Surrebuttal, Ex. 35, p. 7, line 4 – p. 8, line 2).

However, any arguments regarding FAS 92 or its impact are largely moot because the individual who has the final say on this matter, Mr. Hamilton, has already made his determined on behalf of MAWC that FAS 92 does apply to their situation if a phase-in is ordered. (Tr. 372, lines 11`-16; Hamilton, Surrebuttal, Ex. 3, p. 8, lines 15-22).

Rate Shock

MAWC next addresses the issue of rate shock. It attacks other parties for allegedly being insensitive to rate shock. (MAWC Initial Brief, pp. 72-74). On the contrary, Staff is well aware of the causes and effects of the rate increases in this case and took these matters into account in developing its rate design including a phase-in to mitigate rate shock.

The Staff's phase-in methodology defers a portion of the rate increases that result from the revenue requirement associated with the SJTP as well as the extremely significant increase from the aforementioned factors. These deferrals would earn a return equal to the rate of return ultimately approved by the Commission in this case. The accumulated deferrals would be recovered in the future through additional rate increases in years two through five. By the end of year five, all necessary rate increases associated with the plant additions recognized in this case and other factors will be fully reflected in rates, and all prior phase-in deferrals will be recovered. The Staff recommends that the Commission approve all four of the subsequent rate increases as part of its order in this case. Each of these rate increases will take effect automatically on the annual anniversary of the effective date of the rates from this case. (Rackers Direct, Ex. 52, p. 12, line 14 – p. 13, line 10; Rackers Rebuttal, Ex. 53, p. 7, lines 2-12; Rackers Surrebuttal, Ex. 54, p. 3, line 11 – p. 7, line 17).

Exhibit 105 sets out the phase-in for the affected districts and shows that the phase-in does successfully mitigate rate shock, contrary to the assertion of MAWC.

Legality of Phase-ins

MAWC next challenges the legality of phase-ins. (MAWC Initial Brief, pp. 76-77). MAWC does not cite any specific authority that prohibits phase-ins. Instead it points to § 393.155, RSMo, which expressly allows for phase-ins in electric rate cases. (MAWC Initial Brief, p. 76). MAWC suggests that since only the electric industry is mentioned, the Commission must not have the authority to order phase-ins in other regulated utility rate cases.

By this same logic, since water corporations are not mentioned in FAS 92, then FAS 92 does not apply to MAWC.

MAWC's argument presupposes that the only possible reason that a statute regarding rate phase-ins would be enacted is that the Commission had no such power prior to the enactment of the statute. This is incorrect. Statutes can also be enacted to clarify, rather than to change, existing law. *State ex re. Laclede Gas Co. v. Public Service Commission of Missouri,* 535 S.W.2d 561, 567 (Mo. App., K.C.D. 1976). MAWC does not offer any authority for the proposition that the Commission had no authority to utilize phase-ins in rate cases prior to the enactment of §393.155.

The Commission did and does, in fact and in law, have the power to utilize phase-ins. One recent water case with a rate phase-in is *In re United Water Missouri, Inc.*, Case No. WR-99-326 (order issued September 2, 1999). The Public Service Commission is an administrative agency of limited jurisdiction. *State ex rel. Gulf Transport Company v. Public Service Commission of Missouri,* 658 S.W.2d 448, 452 (Mo. App., W.D. 1983). It only such powers as are expressly conferred by statutes and reasonably incidental thereto. *State ex rel. Kansas City Transit, Inc. v. Public Service Commission*, 406 S.W.2d 5, 8 (Mo. Banc 1966); section 386.040. Section 386.040 provides that the Commission has all powers and duties specified in Chapter 386 as well as all powers necessary or proper to enable it to carry out fully and effectually all the purposes of Chapter 386.

The Commission has considerable discretion in rate setting due to the inherent complexities involved in the rate setting process. *State ex. rel. Office of the Public Counsel v. Public Service Commission of Missouri,* 938 S.W.2d 339, 344 (Mo. App., W.D. 1997). It is not the theory or methodology, but the impact of the rate order that counts. *Id.* at 344. It is not the methodology or theory but the impact of a rate order which counts in determining whether rates, are just, reasonable, lawful and nondiscriminating. *State ex rel. Associated Natural Gas Company v. Public Service Commission,* 706 S.W.2d 870, 879 (Mo. App. W.D. 1985). Commission determinations about ratemaking are favored by a presumption of validity. *Id.* at 344. Judicial inquiry ends if the total effect of the rate order cannot be said to be unjust and unreasonable. *Id.* at 344.

The Commission, as stated above, has considerable discretion in setting rates. The Commission also requires flexibility in exercising its ratemaking function to deal with changing and unforeseen circumstances. *State ex. rel. Capital City Water v. Public Service Commission,* 850 S.W.2d 903, 911 (Mo. App., W.D. 1993).

In the present case, the Commission must exercise its discretion. If the Commission allows the Company to recover the full amount of its prudently incurred costs in a single rate increase, it will result in "rate shock" to the customers of Missouri-American Water Company. The Company's interest is protected under the Staff's proposal, because it provides for a carrying cost on the phase-ins. The Commission should therefore order that the rate increase should be phased in over a period of five years as advocated by Staff, subject to all of the other conditions advocated by Staff.

Other Phase-In Issues

MAWC complains that OPC's and Staff's phase-in calculations fail to include one-half of the first year's net phase-in deferred balance. (MAWC Initial Brief at 75). MAWC opines that Staff's and OPC's phase-in calculations require MAWC to carry the deferred revenues for the first year and to only begin earning a return commencing in the second year of the phase-in

(MAWC Initial Brief at 75). This is incorrect as Mr. Salser admitted on cross-examination (Tr. 570-572). As Mr. Salser admits on cross-examination, all of the Staff's deferrals and revenue requirements already include a full year's worth of return. (Tr. 570-572). Apparently the Company wants 18 months of return. It would be inappropriate to include more than a full year's rate of return in determining revenue requirements for phase-in.

MAWC further alleges that the OPC's and the Staff's phase-in proposal fail to include one-half of the first year's net phase-in deferred balance. (MAWC Initial Brief, p. 75). MAWC fails to state specifically what part of the first year's net phase-in deferred revenue should be included. (MAWC Initial Brief, p. 75). MAWC does not specify in what half of the first year's net phase-in should be included within. (MAWC Initial Brief, p. 75). However, by looking at the testimony of Mr. Salser, as cited by MAWC, it would appear that MAWC wants to inflate rate base by adding half of the first year revenue phase-in to rate base. (MAWC Initial Brief, p. 75; Salser Rebuttal, Ex. 7, p. 7; Salser Surrebuttal, Ex. 8, p. 2). To inflate rate base in this matter is inappropriate and should be rejected. (Rackers Surrebuttal, Ex. 54, p. 4).

There is no basis for any argument that the Company may not receive the full rate increase ordered by the Commission. In the previous two phase-ins ordered by the Commission, which involved Union Electric Company and Kansas City Power and Light Company, all amounts deferred were fully reflected in the cost of service and rates. (Rackers Surrebuttal, Ex. 54, p. 5, lines 6-14). Utilizing the old adage that past actions are the best predictor of future behavior, there is no credible reason to believe that the Commission or its Staff would not propose to reflect amounts previously deferred, under an ordered phase-in plan for MAWC, in the cost of service.

The Company also suggests that it could be forced to continue deferrals or to forgo recovery of deferrals due to future rate increases required by future plant additions. (Rackers Surrebuttal, Ex. 54, p. 5, lines 8-14). This contention is also without merit. There is nothing in the Staff's phase-in proposal that prevents the Company from filing for a rate increase to address future plant additions or other changes in the cost of service. (Rackers Surrebuttal, Ex. 5, p. 5, lines 18-20). As a matter of course, any future rate case filing during the phase-in period would require an examination of the total cost of service, but clearly would not prevent recovery of amounts previously deferred. (Rackers Surrebuttal, Ex. 54, p. 5, lines 18-23). The past actions of the Commission and Staff provide no basis for MAWC's suggestion that deferred amounts under an ordered phase-in for MAWC would not be reflected in the cost of service.

In view of the foregoing, Staff submits that there is a legal basis for phase-ins, that a phase-in of five years is appropriate herein to reduce rate shock, and that MAWC should be compensated for the deferrals by means of a carrying cost equal to the rate of return authorized by the Commission in this case.

CONCLUSION

The Staff respectively request that the Commission issue its Order granting such relief as is consistent with the foregoing.

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 2nd day of August 2000

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