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JUL 24 2000
Missouri Public Service Commission

Mr. Dale Hardy Roberts
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Missouri-American Water Company - Consolidated Case Nos. WR-2000-281 and SR-2000-282

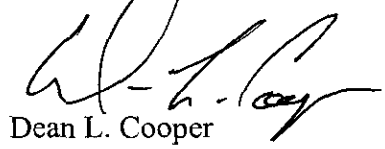
Dear Mr. Roberts:

Enclosed for filing in the above-referenced proceeding please find an original and eight copies of MAWC's Initial Brief. Please stamp the enclosed extra copy "filed" and return same to me.

Thank you very much for your attention to this matter.

Sincerely,

BRYDON, SWEARENGEN & ENGLAND P.C.

By: 
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Mr. Stu Conrad
Mr. Louis Leonatti
Mr. Jim Fischer
Mr. Jeremiah Finnegan

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BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Tariff Sheets Designed to Implement General Rate Increases for Water and Sewer Service provided to Customers in the Missouri Service Area of the Company.	))))))	Case No. WR-2000-281 Case No. SR-2000-282

MISSOURI-AMERICAN WATER COMPANY'S

INITIAL BRIEF

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2016

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

INITIAL BRIEF

TABLE OF CONTENTS

I. INTRODUCTION

COMES NOW Missouri-American Water Company ("MAWC" or "Company") and, as its initial brief in this matter, states the following to the Missouri Public Service Commission ("Commission"):

On October 15, 1999, MAWC filed revised tariff sheets in Case No. WR-2000-281 for the purpose of implementing a general rate increase for water service provided by the Company. On the same date, the Company filed revised tariff sheets in Case No. SR-2000-282 for the purpose of implementing a general rate increase for sewer service provided by the Company.

On October 28, 1999, the Commission issued its Suspension Order and Notice and Order Consolidating Cases, in which it ordered that Cases Nos. WR-2000-281 and SR-2000-282 were to be consolidated for all purposes.

In addition to MAWC, the Commission Staff ("Staff"), and the Office of the Public Counsel ("OPC" or "Public Counsel"), the list of parties to this case includes the following intervenors: Ag Processing Inc, a cooperative, Friskies Petcare, a division of Nestle USA, and Wire Rope Corporation of America Inc. (collectively, "St. Joseph Industrial Water Users"); The Boeing Company, Ford Motor Company and Hussmann Refrigeration (collectively, "MIEC"); Public Water Supply District Nos. 1 and 2 of Andrew County, Public Water Supply District No. 1 of DeKalb County, and Public Water Supply District No. 1 of Buchanan County (collectively, "St. Joseph Area Water Districts"); City of Warrensburg, City of Joplin, City of St. Peters, City of O'Fallon, City of Weldon Spring, St. Charles County, Central Missouri State University, Hawker Energy Products, Inc., Stahl Specialty Company, and Swisher Mower and Machine Company (collectively, "Municipal & Industrial Intervenors"); St. Joseph Building and Construction Trades Council ("Trades Council"); Public Water Supply District No. 2 of St. Charles County ("St. Charles Water

District"); City of St. Joseph ("St. Joseph"); City of Joplin ("Joplin"); and City of Mexico ("Mexico").

On May 25, 2000, the parties filed the Proposed List of Issues, Order of Witnesses and Order of Cross-Examination. By this document the parties unanimously identified a list of contested issues as well as an order of witnesses and order of cross-examination.

MAWC's Initial Brief in this matter addresses each of the identified contested issues. The table of contents refers to the titles assigned in the List of Issues and at the beginning of each issue section the contested issue/question is repeated for the benefit of the reader.

A few additional matters are also discussed in this Initial Brief. First, MAWC's Motion to Strike Testimony and Motion for Summary Determination was taken with the case by the Commission. Because it is related directly to the St. Joseph treatment plant and related facilities issues, it is addressed within Section II of the brief (St. Joseph Treatment Plant and Related Facilities) under the heading "Estoppel."

Second, certain issues have been deemed to be uncontested by their failure to be identified in the List of Issues and acquiescence of at least some of the parties through testimony and/or stipulation. These issues are addressed in Section VI of the Initial Brief.

Lastly, the true-up part of this process resulted in two issues based upon the testimony of the Staff and MAWC -- chemical expense and property taxes. At the true-up hearing, MAWC agreed to certain portions of the Staff recommendations as to both issues. These true-up issues are addressed in Section VII of the Initial Brief.

II. ST. JOSEPH TREATMENT PLANT AND RELATED FACILITIES ("SJTP")

A. VALUATION. WHAT VALUATION SHOULD BE INCLUDED IN RATE BASE FOR THE WATER TREATMENT PLANT AND RELATED FACILITIES NECESSARY TO PROVIDE WATER FOR THE ST. JOSEPH DISTRICT?

B. CAPACITY. WHAT IS THE APPROPRIATE CAPACITY FOR SJTP THAT SHOULD BE INCLUDED IN RATE BASE?

1. INTRODUCTION

a. Explanation of the Issues

The SJTP valuation issue has two areas of contest. There is an unfortunate overlap due to casual use of terminology, but the areas can be best analyzed by dividing them into Valuation (or prudence) and Capacity.

OPC and the St. Joseph Industrial Water Users challenge the prudence of the Company's decision to construct the new groundwater treatment plant. Each uses different numbers and arguments, but both generally argue that instead of constructing the new plant, the existing surface water treatment plant should have been renovated. They then argue that their respective estimates of the cost of that renovation should be the only amount permitted in rate base. They argue that the actual cost of the new plant in excess of their respective estimates should be disallowed. It is also interesting that these two parties admitted collusion in their testimony preparation. Counsel for St. Joseph Industrial Water Users acknowledged receiving testimony from OPC in advance of its simultaneous filing with their own. (Tr. 1139).

The Staff disagrees with OPC and St. Joseph Industrial Water Users on prudence and

supports the construction of the new ground water plant and related facilities.

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

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

- First, the Commission authorized it to build the new ground water treatment plant subject only to a review of the prudence with which it undertook to complete the described and estimated project (See "Estoppel," addressed later in this brief.);
- Second, that given the comparable costs of constructing the new plant versus renovation of the old plant with its inherent deficiencies, renovation of the old plant would be unjustifiable;
- Third, relative costs do not necessarily dictate the result. A comparison of the respective advantages and disadvantages of the two projects, absent significant cost disparity, could by itself make relocation the only prudent alternative; and,
- Fourth, the capacity of the new plant is both appropriate and used and useful.

The Company acknowledges taste and hardness complaints at the plant startup, but adjustments in treatment together with lower hardness from the wells have sharply reduced public reaction. As MAWC witness John S. Young, Jr. stated, hardness is an "aesthetic" issue unrelated to public health, and the ground water is anticipated to "end up" being only 10% harder than the river

water. (Tr. 1381). When water taste changes for any reason, people typically need time to adjust. After becoming accustomed, acceptability and even preference changes. (Tr. 1390-1391).

b. Undisputed facts about prudence of the SJTP

There are two undisputed facts that will influence, if not control, the outcome of this issue. The parties dispute only significance:

First, the Commission has issued a previous finding that the new SJTP is a reasonable alternative. In Case No. WA-97-46, the Commission found that "based on the extensive evidence presented, the Commission finds that proposed project, consisting of the facilities for a new ground water source of supply and treatment of a remote site, is a reasonable alternative." It is true that the Commission reserved the right to examine the "prudence of the actual costs incurred and the management of construction of the proposed project." (See paragraph 7 of the Company's Motion to Strike Testimony and Motion for Summary Determination heretofore filed in this case). The legal implications of this will be argued later in this brief. However, the point here is that this finding cannot be ignored. The Company received it in good faith, and the Company relied upon it in good faith. It does exist.

Second, there is no evidence in this case that the new SJTP was constructed in an imprudent manner. The contentions are that the undertaking was not prudent because of the availability of alternatives; not that the construction itself was imprudently completed. The evidence before the Commission in Case No. WA-97-46 depended largely on the Company's 1996 Feasibility Study which is in evidence in this case as Schedule TLB-3 to Exhibit 19. That schedule projects the estimated cost of the proposed new ground water treatment plant to be $63.7 million in 1995 dollars, excluding AFUDC. There is no evidence in this case, and no anticipated likelihood of such evidence, that the final cost of the new ground water treatment plant will exceed this number. In fact

to the contrary, OPC witness Biddy stated, "...MAWC may have made a reasonable cost estimate for the proposed new ground water source and treatment plant..." (Biddy Sur., Ex. 20, p. 16). And Staff witness Merciel stated, "...it appeared to me the Company went to great lengths to make sure they got the best – best cost or the best deal , so to speak." (Tr. 1593).

These two facts, (the Commission's finding in its Order in Case No. WA-97-46 and the absence of evidence that the new plant will cost more than estimates presented in Case No. WA-97-46), are critical to the Commission's factual determination of prudence in this case in another evidentiary way from the estoppel and foreclosure arguments in Company's pre-trial Motion: Since the Commission has no reason to renege on its determination that the new plant is a "reasonable alternative," its remaining charge would be to determine whether the actual construction of the "reasonable alternative" was completed prudently. Staff witness Merciel explained the remaining charge of the Commission as follows: "Even though the Commission specifically did not 'pre-approve' the costs associated with the project...[it] ...specifically reserved any review of the prudence of actual expenses associated with the project for the future..." (Merciel Dir., Ex. 48, p. 5).

In other words, by offering no evidence of imprudent construction, OPC and St. Joseph Industrial Water Users have "bet the farm" so to speak, on arguments that the old plant could have been renovated for some amount significantly less than the cost of the new plant. There are only OPC, and relatively minor Staff, contentions regarding capacity. Absent the arguments that alternatives to the new plant could have cost less money (each of which will be addressed herein but all of which go only to the weighing of alternatives), there is no evidence whatsoever in this record from which the Commission could find that the construction of the new plant was done imprudently. Findings necessitate "competent and substantial evidence." Section 536.140 RSMo 1994. None was

offered.

c. Why does the Company have so many different numbers addressing renovation of the old plant, and then why are there so many conflicting numbers from Mr. Biddy and Dr. Morris?

Before responding to the allegations about the myriad of cost estimates, preliminary explanation is needed. Beginning with the 1991 estimate, the Company continued to obtain new information, revise the scope of the project and adjust its estimates accordingly through preparation of the final Feasibility Study comparisons in 1996. The objective was to avoid a false picture.

OPC and the St. Joseph Industrial Water Users used confusion as a tactic. The Feasibility Study (Biddy Dir., Ex. 19, Sch. TLB-3; and also evidence for the Commission's Order in WA-97-46) was inherently complex. The Feasibility Study of 1996 sought to estimate the costs of various alternatives for addressing problems with the existing surface water plant. Because of many factors, including the evolution of information prior to the Feasibility Study, the scope of the renovation alternative, the host of other alternatives, the inflation calculations attributable to changes in time, AFUDC effects, and the use of present value calculations of total cost and revenue requirement, the Study was necessarily sophisticated. To those motivated to cause confusion, it could be conveniently misinterpreted.

The confusion seemed to stem from three fundamental (or purposeful) misconceptions about the information in the Feasibility Study. First, there was confusion over which cost estimates represented the actual project alternatives weighed when the decision to build the new ground water treatment plant was made and suggested to the Commission in Case No. WA-97-46. This included confusion about what the individual physical elements of the project would be. Second, there was confusion over what the Company had estimated to be the costs of the various individual elements that would have comprised the project. And third, there was even further confusion provoked by Mr.

Biddy and Dr. Morris with incomprehensible comparisons of estimates consisting of "construction costs" against estimates consisting of "total project costs." The two were treated as being indistinguishable and interchangeable. They are not. Also, Mr. Biddy and Dr. Morris did not recognize non-construction costs necessary to implement projects.

For illustration, the following numbers were used in this case by various parties to argue what the cost might have been to renovate the existing surface water treatment plant:

$15,300,000 1991 Company construction cost estimate for Superpulsators, a Chemical Building, Filters and a transfer pump station. (Young Reb., Ex. 17 p. 12).

$22,600,000 The Company's total project cost estimate for the above 1991 Work including engineering design, omissions, interest, supervision, etc. (Ex. 86; Biddy Dir., Ex. 19, Sch. TLB-6).

$26,630,000 1993 Gannett Fleming construction cost estimate adding to the 1991 estimate a 30 MGD Filter Building, a Transfer/Distribution Pump Station, Clearwell Tank, Electrical, HVAC, Plumbing, Instrumentation and Site Work. (Young Reb., Ex. 17 p. 12).

$36,697,775 OPC Witness Biddy's estimate for renovation and flood proofing described as being his determination of necessary additions to the Company's 1991 estimates. It is unclear whether this purports to be construction cost or total project cost, or whether witness Biddy acknowledges any distinction. (Ex. 86).

$40,300,000 Dr. Morris' initial estimate of renovation costs from his Direct testimony and work papers. (Morris Dir., Ex. 65, Ex. 91).

$38,200,000 Dr. Morris' adjusted estimate of renovation costs described by him as being the 1991 Company project with additions and flood-proofing. This reduced his earlier estimate due to his discovery that his 1991 numbers were actually 1993 numbers. (Ex. 104). It is unclear whether this purports to be construction cost or total project cost, or whether witness Morris acknowledges any distinction.

$44,100,000 Company's total project cost estimate for the 1993 Gannett Fleming construction estimate issued June 4, 1993, pre-flood. (Young Reb., Ex. 17, Sch. Ex 86; JSY-7).

$78,000,000 The Company's estimate from the 1994 Comprehensive Planning Study which was an attachment to the Feasibility Study representing a renovation project at that time contemplated. This project was thereafter completely revised by, among other things, addition of a clearwell, removal of clearwell baffling, removal of residual handling costs, increasing ozone costs due to planned delayed installation and complete revision of all derivative costs associated with the project changes. (Biddy Dir., Ex. 19, Sch. TLB-3, Ex. 86; Biddy Sur., Ex. 20, Sch. TLB-16).

$63,300,000 The actual Company total project cost estimate for the renovation (in 1995 dollars), excluding AFUDC and excluding any flood protection work in the 1996 Feasibility Study. This was the actual number used to evaluate alternatives as shown in the 1996 Feasibility Study and includes both construction items not in the 1993 Gannett Fleming estimate such as intake and low service pumps, a third presedimentation clarifier, ozone facilities, distributive pumps and switchgear for the pumps. It also includes all the related project costs that must be added to construction costs such as design, engineering, construction supervision, omissions, community relations, permits, attorney fees, land acquisition, insurance, etc. (Biddy Dir., Ex. 19, Sch. TLB-3; Young Reb., Ex. 17, p. 16).

$70,500,000 The Company's total project cost estimate from the Feasibility Study representing phased construction Alternative I-C (renovation). OPC witness Biddy took cash flow amounts from this schedule thinking them to be the Company's facility costs. (Biddy Dir., Ex. 19, Sch. TLB-3).

This brings us to the three areas of confusion mentioned above about use of these estimates:

i) What cost numbers represent the actual project scope that would need to have been undertaken had the existing plant been renovated?

The first question about which costs were actually used by the Company to evaluate renovation versus relocation, was apparently provoked by the presence of the multiple different numbers in the 1996 Feasibility Study ("Study") that evolved from changing project scope. The Study included the historic amounts that showed how the evolution of new data changed both the project scope and its associated costs. Both OPC's witness Biddy (Biddy Dir., Ex. 19; Biddy Sur., Ex. 20) and St. Joseph Industrial Water Users' witness Morris (Morris Dir., Ex. 65) seized on the number of $78 million that appears on page 30 of 34 in Appendix A to the Feasibility Study. They

then attacked this number as being too high, re-priced various elements from it, added differing flood-protection amounts and accused the Company of using this number to discourage the proper consideration of the renovation alternative.

But Appendix A is actually Chapter 5 – St. Joseph Production Facilities from the 1994 Comprehensive Planning Study, and the number of $78 million in Appendix A was not used in the final Feasibility Study analysis comparisons. The scope of the proposed project changed after that number was developed. (Tr. 1187-93). The $78 million project was not the project weighed against an alternative to constructing the new ground water plant in the final comparisons. On Page 3 of 8 of the Summary Report comprising Exhibit A to the Feasibility Study, the actual estimated cost of the renovation alternative is stated to be $63,300,000. This is in 1995 dollars and does not include any flood protection costs. This number then tracks into Exhibit B which is the Summary of Project Costs. There, Exhibit B compares the $63.3 million against $63.7 million, which was the estimated cost for the ground water plant construction actually undertaken (again in 1995 dollars without AFUDC).

While the confusion is apparent, it is no less critical to the Intervenors' challenges. Unfortunately, since it was the $63.3 million project that was weighed against the alternative of the new ground water plant, all the contest over the propriety of the $78 million estimate and its components is academic and valueless.

Later, to add complexity to the confusion, OPC attempted to compile a comparison of what purported to be various costs for renovation of the existing plant site. (Ex. 86). The exercise was apparently to show inconsistencies. What best exemplifies the difficulties with the parties' misunderstandings, is that no two of these comparisons are of the same project. They are by definition inconsistent. (Tr. 1208 and 1413). More to the point, the most significant column, the one

representing the $63.3 million used in the Feasibility Study evaluation of the alternatives, is omitted entirely.

ii) Do the Annual Cash Flow Comparisons from the Feasibility Study specify the construction costs of the individual elements comprising the $63,300,000?

The second area of confusion is critically damning to OPC's and the St. Joseph Industrial Water Users' positions. As both Mr. Biddy and Dr. Morris attempted to re-price the renovation alternative, they each claimed inadequate time to obtain independent pricing of certain facilities. They both purported instead to use what they thought were the Company's estimates of various elements of project cost. Nowhere is this more apparent than on Exhibit 91, which is one of Dr. Morris' work papers.

In the section of the Feasibility Study identified at Appendix B, Summary of Project Costs, there are spread sheets for each project alternative being weighed. They include sheets for Alternative I-A being the old plant renovation priced at $63.3 million, and Alternative III-A being the new plant priced at $63.7 million. The spreadsheets are clearly labeled as representing "ANNUAL CASH FLOW" of the alternatives. Apparently, the significance of this label was lost on both Dr. Morris and Mr. Biddy.

As Mr. Young explained on his redirect examination, (Tr. 1414-1418), this document cannot be read in the manner that Biddy and Morris attempt to read it. It does not purport to show a "facility" and the corresponding estimated cost of that facility. Instead, it shows dollars spent in a particular year, and facilities closed into service in that year. The difference is that facilities placed in service in a given year are very likely to have had dollars expended on them in years earlier than the year placed in service. If one reads the document as if all costs for a facility are represented in the dollars coincidentally spent in the year the facility was closed into service, the conclusion would

be dreadfully wrong.

We know that this is indeed what happened. Mr. Biddy arrived at an even $4 million as his estimate for Ozone Facilities and $4.6 million for "New Raw Water Intake and Low Service Pumping." (Biddy Dir., Ex. 19 p. 21). These numbers are not coincidentally the same numbers that appear on the Annual Cash Flow document for Alternative I-C, Surface Water-Phased Construction at Existing Site. They appear nowhere else in cost estimates, and Mr. Biddy ultimately admitted his source. (Tr. 1707-09; 1643).

Furthermore, Mr. Biddy's estimate is less than half the actual estimated cost of ozone facilities. One can reasonably deduce what the estimated cost of ozone facilities would have been by properly reading the Cash Flow document and realizing that $5.5 million from the year 2005 must be added to the $4 million in the year 2006 to determine the Company's actual projected cost. Ozone is the only facility not yet closed into service in 2005, so logically the $5.5 million must be for ozone. He similarly ignores $9.2 million of the intake costs by not realizing that expenditures in 2008 precede and are part of the facility costs for facilities being closed into service in 2009. The only way to avoid the mistake is to be familiar with a Cash Flow statement and how it works. And conversely, the only way to arrive at the numbers Mr. Biddy used is to misread the document.

Dr. Morris's dependence on the misread Annual Cash Flow document is even more apparent. He showed us his calculation on his work papers in Exhibit 91. He simply deletes $10 million from the year 1997 because it is not adjacent to any description of facility closed into service in that year, and then concludes that all facilities closed into service in 1998 and 1999 are represented by the amounts shown expended in those years. If one simply adds back both the mistakenly deleted amounts and the cost of ozone facilities, his estimate would not be significantly different than the Company's Feasibility Study estimate.

Sadly, and considerably beneath Dr. Morris' credentials, after learning from Mr. Young's testimony that the Annual Cash Flow document was not the Company's estimated "total" expenditure for the named items as he described it in his prepared testimony (Morris Dir., Ex. 65, p. 14-15), and admitting his misunderstanding (Tr. 1856), he prepared another work paper mid-trial. (Tr. 1912; Ex. 104). He then embarrassingly presented this as his independent calculations that conveniently matched his previously ill-chosen entries from the Cash Flow spread sheet. He said he arrived at exactly the same numbers by "coincidence" after applying his "engineering judgment" and inflationary factors to 1991 numbers. (Tr. 1855-60).

The significance of these misread and misused spread sheets is that both the resulting estimates of Mr. Biddy and Dr. Morris are now discredited and unsubstantiated. There is now no evidence in the record from which the Commission could decide that either of these witnesses had credible estimates of what a renovation of the existing plant could have cost.

iii) Isn't there a critical difference between construction costs vs. total project costs, and did Morris and Biddy properly account for non-construction costs?

The third area of confusion is in the distinction between "construction costs" and "total project costs." There are significant non-construction costs in the cost of project completion. Mr. Biddy and Dr. Morris did not address whether or to what extent their cost estimates included non-construction costs. Mr. Young explained that non-construction costs are significant and comprise 30-35% of total project costs. (Young Reb., Ex. 17, p. 11-12, 28). This confusion was apparent in testimony from both Mr. Biddy (Tr. 1701;1713) and Dr. Morris (Tr. 1865-66).

OPC offered Exhibit 86. It purported to depict five columns of cost estimates for "Upgrading & Refurbishing Existing Plant." It is not a comparison of identical projects; but to add to the confusion some of the columns represent only construction costs, while others purport to include

total project costs. Mr. Young explains this in testimony. (Tr. 1411-12). For example, the first column purports to be the Company's 1991 estimate of costs to refurbish the plant. That cost is then compared to the next column of Gannett Fleming costs, and the argument is made that the similarity of the two costs gives legitimacy to the 1991 estimate. (Biddy Sur., Ex.20). But Mr. Young explained that the first column on Exhibit 86 represents total project costs, but the Gannett Fleming 1993 estimate is of construction cost only. In fact, were one attempting to make a comparison between the project as estimated in 1991 and as estimated in 1993 by Gannet Fleming, the appropriate comparisons would necessarily have to be between either relative construction costs, or between relative project costs. The comparison would have to be between 1991 construction costs of $15,300,000 (Young Reb., Ex. 17, p. 12) and 1993 construction costs on Exhibit 86 of $26,630,000; or it would be between 1991 total project costs of $22,600,000 and 1993 total project costs of $44,100,000. But to compare 1991 project costs to 1993 construction-only costs reveals nothing and is a classic "apples to oranges" comparison.

iv) Are all of these questions relevant to the issue of prudence?

One of the problems the Company has had with this case, was how to concentrate on what is relevant without leaving accusations unanswered. The various cost estimates are explained and defended not because they represent information used *or that could have been used* to weigh the alternative of renovation versus the alternative of constructing the new ground water plant. They are defended because, and only because of allegations that the Company was either incompetent, careless or driven by ill-motive in its final cost comparisons. (Tr. 1699).

For example, as Mr. Young explained, the highly contested 1993 estimate did not include intake and low service pumps, a third presedimentation clarifier, ozone facilities, any flood protection costs, replacement of the distributive pumps, or the switchgear for the distributive pumps.

(Young Reb., Ex. 17. p. 16). The scope of this project was targeted at addressing water quality deficiencies of the existing facilities such as chemical systems, clarifiers and filters prior to the flood. The non-construction costs such as engineering, design, supervision, contingencies, attorney's fees, permits, and even AFUDC (Ex. 86, column 3) depend on project scope. So, as the construction scope contemplated changes, virtually all the costs changed. In other words, the cost comparisons on Exhibit 86 and all the criticisms of these calculations (Biddy Sur., Ex. 20, Sch. TLB-15 and 16) are not relevant with respect to the issue of what renovation of the existing plant as designed by the Company would have cost. What the Intervenors speculate a renovation project might have cost is irrelevant if the renovation project would not have been acceptable because of absent or inadequate facilities.

2. EVIDENCE AND ARGUMENTS

a. The Company's Evidence

John S. Young is Vice President – Engineering for the American Water Works Service Company, Inc., and has been since 1992. He is a registered Professional Engineer with a B.S. in Civil Engineering and an M.S. in Environmental Engineering. He is responsible for managing the Engineering function for the American Water System that includes facilities in 23 states and was intimately involved in the entire planning process for the SJTP. (Young Dir., Ex. 16, p.1). The extent of his experience is considerable, and far exceeds that of the adversarial engineers who criticize his work. (Young Dir., Ex. 16, pp. 1-4).

The Comprehensive Planning Study of the Company identified capacity, reliability, process control and safety deficiencies at the old St. Joseph surface water facility in 1994. The Feasibility Study was begun in 1995 and presented economic analyses of several alternatives in 1996. The cost of the ground water treatment plant alternative was essentially equivalent to renovating the existing

treatment plant, even without considering the cost of future treatment residual facilities at the existing site. (Biddy Dir., Ex. 19, Sch. TLB-3). The benefits of the new plant not only addressed the capacity, reliability, process control and safety deficiencies at the old facility while escaping the cost and risk of flooding concerns, but the ground water plant will also provide a high capacity source of supply with significantly improved quality due to natural filtration provided by the stream bed and the alluvial sediments. (Young Dir., Ex. 16, p.5-6). The ground water is higher in hardness until a shift in quality occurs after pumping from the wells is begun and infiltration from the river is induced, but concern over the transmission of surface water microbiologic contaminants will be significantly curtailed. (Young Dir., Ex. 16, p. 6). The absence of chlorine resistant pathogens like Cryptosporidium and Giardia in ground water, the elimination of need for two-step clarification, superior and consistent microbiological quality and temperature, the resulting ability to rely more on automation, and a reduced volume and variability of treatment residuals are only some of the advantages of ground water. (Young Reb., Ex. 17, p. 22 – 23). All this was presented to the Commission in Cases Nos. WA-97-46 and WF-97-241. (Young Dir., Ex. 16, p. 5).

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

The capacity of the new plant was designed to be 30 MGD, but with a system delivery capacity of 28.5 MGD. The 1.5 MGD difference accounts for filter wash and in-plant usage. This exceeds the 27.7 MGD maximum day demand projection for 2009. (Young Dir., Ex. 16, p. 8). The Company's demand projections were part of the comprehensive planning process completed in 1994. (See also Young Sur., Ex. 18, Sch. JSY-21). The Company's demand projections were rigorous and

evaluated trends within six customer categories. The average day projection for 1999 proved to be very close to the actual average day experienced in 1999. (Young Sur., Ex. 18, Sch. JSY-21). Mr. Young explained the procedures necessary for responsible capacity planning:

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

(Young Sur., Ex. 18, p. 4 – 5).

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

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

OPC and the St. Joseph Industrial Water Users argue that the Company should have made modifications and improvements to the existing surface water plant instead of building the new ground water treatment plant. Their approach is generally to contend that renovation would have been less expensive, that the Company either did not know this or chose to ignore it, and that rate base associated with the new plant should be reduced accordingly. They draw their renovation cost conclusions by a combination of unsupported and changing estimates and arbitrary redesign. Their design criticisms are best illustrated in data requests posed to the Company, and the answers thereto

that were placed in evidence as Exhibit 85. These exchanges explain how and why the Company would have spent the $63.3 million on the old plant, and illustrate how the Intervenors would dangerously meddle with this design.

In 1991, a report was prepared by the Company to attempt to identify and compare filtration and water quality related improvements for the existing surface water plant. It was submitted to the Staff at that time. (Young Reb., Ex. 17, p.6). It was an "initial vehicle" that had no preliminary design work or detail, and it relied on information from other projects submitted to a local contractor for pricing. (Young Reb., Ex. 17, p. 8 – 9). The scope of the project described in the 1991 report was subsequently redefined. In 1992, an analysis of clarification alternatives was performed by Gannett Fleming and a Design Concept was then prepared from that study. (Young Reb., Ex. 17, Sch. JSY-2 and JSY-3). As evaluation continued, it became evident that "renovation" was not a correct characterization of what would be necessary. "Extensive rebuilding" ... "while keeping the existing treatment and pumping facilities in operation" would be necessary. (Young Reb., Ex. 17, p. 10). In early 1993, the Company hired Gannett Fleming to begin preliminary design of filter and water quality related improvements at the existing water treatment plant. Thereafter, in 1993, a Design Concept evolved followed by preliminary construction cost estimates from Gannett Fleming of $26,630,000. (Young Reb., Ex. 17, p. 11). Additional facilities had been added to the 1991 project. They are named, priced and described in detail on pages 11 through 13 of Exhibit 17. (Young Reb., Ex. 17). It is critical to observe that this Gannett Fleming number is "construction cost" only, and does not include any costs of engineering, AFUDC, project management costs or any other non-construction costs. (Young Reb., Ex. 17, p. 11 - 12). Mr. Young testified that Gannett Fleming said it was reasonable to add 10% for omissions and contingencies related to construction. (Tr. 1224).

Following the 1993 construction cost estimate, a project cost was developed to account for

increased construction costs, phased construction, [1] AFUDC, inflation and other non-construction expenses. (Young Reb., Ex. 17, p. 15; Sch. JSY-7). This cost estimate of $44,100,000 was made public to business leaders and the Company's Board of Directors in July of 1993. It is notable that the Company was accused by OPC witness Biddy of developing this number following the 1993 flood to discourage the rebuilding alternative, but publication of the number actually preceded the flood. (Young Reb., Ex. 17, p. 16).

The $44,100,000 did not include everything ultimately determined to be necessary in a rebuild of the old plant. Mr. Young describes the omissions as, "The June, 1993 cost estimate did not include an intake and low service pumps, a third presedimentation clarifier, ozone facilities, any flood protection costs, replacement of the distributive pumps, or the switchgear for the distributive pumps." (Young Reb., Ex. 17, p. 16). This is critical, because both Intervenors try to seize on the Gannett Fleming construction cost estimate and derive from it costs that are neither complete in physical scope nor complete in total project finance and management costs that evolve from physical scope.

Following the 1993 flood, things were indeed different. The 1994 Comprehensive Planing Study was undertaken, (the production chapter for St. Joseph appears in Biddy Dir., Ex. 19, Sch. TLB-3 where it is part of the 1996 Feasibility Study as Appendix A). This was followed by "a more rigorous economical evaluation of alternatives" in the 1996 Feasibility Study itself. (Young Reb., Ex. 17, p. 18). Revenue requirements on a 20-year present worth basis were compared; and to avoid bias the renovation option did not include treatment residuals processing costs at the surface water

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[1] Phasing was initially believed to be valuable for stepping revenue requirements and to minimize rate shock; but in the final 1996 Feasibility Study it was realized that phasing would actually increase project costs on both a present worth and total revenue requirement basis. (Young Reb., Ex. 17, p. 15).

plant even though they were included in the ground water alternative. Also, flood protection costs were not quantified because renovation became economically nonviable without the necessity to undertake to develop accurate flood protection costs. The new flood protection design criteria caused by the 1993 flood elevation would have significantly affected the proposed facilities at the existing plant. They would have been more costly than anticipated before the flood. Factors such as foundation designs, building placement, chemical delivery routes, and all design criteria had to be reconsidered. The Company had no predisposition to moving; it had successfully renovated ten plants in the last five years. (Young Reb., Ex. 17, p. 18 – 19).

A factor that was considered to be critical to the comparison of alternatives was the differing quality of source water between surface water and ground water. (Young Reb., Ex. 17, p. 21 - 23). These differences were explained in detail when the Feasibility Study was presented in Case No. WA-97-246. These are critical public health and safety concerns as well as operating cost concerns. As earlier explained, the absence of chlorine resistant pathogens like Cryptosporidium and Giardia in ground water, the elimination of need for two-step clarification, superior and consistent microbiological quality and temperature, the resulting ability to rely more on automation, and a reduced volume and variability of treatment residuals are only some of the advantages of ground water. (Young Reb., Ex. 17, p. 22 – 23). These health and safety benefits were determined to outweigh the slightly increased hardness of the ground water supply.

Dr. Morris essentially conceded the differences when he attempted to argue that the ground water supply would be considered "ground water under the direct influence of surface water," and thus have similar detriments of surface water. Dr. Morris had no evidence to this effect other than to state what Mr. Bernabe of the DNR told him. But the evidence is to the contrary: The United States Environmental Protection Agency ("EPA") instructs the state to make this determination, (Ex.

88); the Missouri DNR has done so specifying that, "...wells...will be considered to be not under the direct influence of surface water if:...the well is located at least 200 feet from any surface water," (Ex. 89); and the Company's DNR construction approval permit signed by Mr. Bernabe states "The outer end of each lateral shall not extend closer than 200 feet from the river's edge." (Ex. 102).

Mr. Young summarizes the source of supply part of the decision to move the plant in his response to the intervenors: "Mr. Biddy and Dr. Morris would have chosen to remain at the existing site where the facilities would have remained subject to both high and low river elevations, with a surface water source that is being targeted with regulations to protect customer health, and with a project that would have be much more complex to design, build and operate. In addition, the existing surface water treatment plant would eventually be required to construct and operate residuals handling facilities when Federal and State regulations addressed the direct discharge issue." (Young Reb., Ex. 17, p. 27). And this says nothing about potential flooding.

b. Response to specific OPC contentions

OPC witness Biddy describes himself as being "self-employed as a professional engineer and land surveyor." (Biddy Dir., Ex. 19, p. 1). But he has no experience with planning, design or construction of surface water treatment plants other than with an industrial supply that was not even potable. That construction was in 1969; so long ago that it predated the Enhanced Surface Water Treatment Rule, and even the EPA itself. (Tr. 1643). He said they do not use surface water in Florida, and although he never designed a potable surface water plant, he could do so now because he "learned it in school." (Tr., 1644). He has never testified in a regulatory proceeding outside of Florida. (Tr. 1736). His convictions are transparently "for sale" and he not only agreed to testify that the new plant was imprudent by a letter dated the day after he received OPC's request for proposals ("RFP"), but he then tried to bargain an additional $100,000 out of OPC for more study. (Tr. 1636).

OPC chose not to accept his offer for detailed work, and we are left with what is essentially the product of Mr. Biddy's self described "gut feeling," accentuated with name-calling. (Ex.100; Tr. 1630).

Mr. Biddy used four tactics: He re-priced old Company projections and essentially redesigned the old plant renovation to suit his estimates; he ignored or discounted all the intangible shortcomings of the old plant including potential flooding and ignored the intangible benefits of the new plant including water quality; he undertook a series of accusations of competence and motive to discredit the Company; and finally he even took a shot at capacity claiming the new plant was larger than it needed to be. Partly because of his lack of support for his cost estimate, but mostly because of his critical dependence on numbers thought by him to be Company's numbers which were disclosed instead to be cash flow numbers (see the above discussion), Mr. Biddy's cost estimate is irreparable and unusable for Commission findings. Keeping in mind that much that follows has marginal relevance other than to the issue of the Company's credibility, the following is a look at OPC's contentions:

Mr. Biddy says that "the overriding consideration"...becomes a matter of "cost comparisons." (Biddy Dir., Ex. 19, p. 16). Nothing else matters to him. Although he has never designed a surface water treatment plant for potable water in his life, he says he can design a plant rehabilitation "up to and equal in every way to the New Plant..." (Biddy Sur., Ex. 20, p. 2). He is redesigning the plant in a manner that would be unacceptable and useless to the Company, and without taking any personal responsibility for the consequences of his mistakes. Look, for example, at his flood protection errors due to his ignorance of DNR requirements and complete disregard not only for protection and access, but for operating complications of deliveries and maintenance. (Tr. 1668-72). He even argues with the need for new intake facilities. (Biddy Sur., Ex. 20, p. 15). He

admits he did not perform "independent designs, quantity computations and cost estimates for the many features included in MAWC reported designs of the upgrade at the existing plant or the new groundwater source and treatment plant." (Biddy Dir., Ex. 19, p. 16). He did not check with vendors for prices, (Tr. 1640), and he said he depended on evaluating other people's cost estimates. (Tr. 1641). This is critical both because his numbers are guesses and extrapolations, but also because he evaluated the wrong numbers to begin with.

Mr. Biddy's starting point is the Company's 1991 report described above. He describes it as being "very important," (Biddy Dir., Ex. 19, p. 6), and calls it "the most objective and truthful analysis of upgrades needed.... (Biddy Dir., Ex. 19, p. 18). Curiously, as committed as he was to this 1991 number in his Direct testimony, he abandons it in his Surrebuttal testimony and in trial. (Tr. 1716). There, he seizes on the 1993 Gannett Fleming construction estimate (which is a different project than the one in the 1991 report, and different still than the one ultimately evaluated in the Feasibility Study) and testifies that it is "very detailed and includes all construction necessary to upgrade the existing plant to 30 MGD capacity and state of the art condition." (Biddy Sur., Ex. 20, p. 9). Because the 1991 and 1993 projects are different, his positions are contradictory.

He then undertakes a challenge to nearly every element of the non-construction cost items in the 1993 project cost that was derived from the 1993 Gannett Fleming construction cost, (Biddy Sur., Ex. 20, Sch. TLB-15); but he does not realize that these numbers do not form any part of the 1996 Feasibility Study conclusions, (Tr. 1419), and do not represent a project acceptable to the Company. In the final Feasibility Study comparisons, the elements from TLB-15 were not only very different, but were often spread equally by the Company to all options to avoid unfairness. (Tr. 1419-20).

Mr. Biddy discounts or ignores any intangible aspects of either the old plant or the new

ground water plant. He says the existing plant could have been completely "flood proofed" which he defines as 95% certain. (Tr. 1626). This would mean the plant could be out of service 1 in 20 times it experiences flooding threats. He says, "...obviously if the levees fail you're out of water." (Tr. 1745).

He estimated the cost of making an alternate access road passable without knowing if the road was blocked off, (Tr. 1617), without looking at the creeks for which he priced culverts, (Tr. 1623), and, amazingly, without even viewing the road by walking it. (Tr. 1622).

Although discounting anything other than cost comparisons, he did admit many shortcomings at the existing plant. His "number one" is operating while under construction. (Tr. 1651). Though admitting no operating experience whatsoever, (Tr. 1647), he acknowledged concerns over quantity and quality of surface water. (Tr. 1652-53). He said, "I do know that the quality of the surface water can vary from month to month and season to season in terms of turbidity, in terms of content of insecticides or herbicides, the height of the water at times. You certainly have to be sure that you can handle both high water and low water with still a reliable source of supply." (Tr. 1654). He acknowledged concerns over taste and odor, (Tr. 1655); testing and disinfection concerns over Cryptosporidium and Giardia, (Tr. 1656); manpower requirements for surface water, (Tr. 1657); employee safety due to working on the river, (Tr. 168); cold weather main break problems, (Tr. 1657); and levee and relief well maintenance needs. (Tr. 1652). He even conceded that, "There are evolving in years from now other requirements that maybe EPA, which is a changing agency and has more rules all the time, there's things that you might have to do in the future," (Tr. 1675), and that the surface water treatment rule is "Absolutely...a serious concern." (Tr. 1675). In spite of these admissions, he stuck to his incredulous contention that renovation of the old plant would be "equal in every way" to the new plant. (Tr. 1655).

After offering his estimates and discounting intangibles, Biddy resorted to accusations of competence and motive. Biddy's testimony was unusually caustic. He called Mr. Young's work the "most incompetent I have seen in 37 years of engineering practice," (Biddy Sur., Ex. 20, p. 11) but later in the same testimony was forced to multiply his previously sworn flood protection estimate by a factor of four because he made a "mistake" and did not know Missouri DNR requirements. (Biddy Sur., Ex. 20, p. 21; Tr. 1665-66). He accused Mr. Young of concealing a Gannett Fleming cover letter, until he was forced to acknowledge that it had been placed in evidence by the Company. (Biddy Sur., Ex. 20, p.8; Young Reb., Ex. 17, Sch. JSY 5). He contended that the Company disclosed it only after his allegation forced them to, but his allegation of non-disclosure was in his surrebuttal testimony (Biddy Sur., Ex. 20, p.8) and the disclosure was in Mr. Young's rebuttal testimony (Sch. JSY-5) filed prior to Biddy's surrebuttal. (Young explained that the letter about contingencies had been questioned by the Company, and that the Company had been instructed that an additional contingency was indeed appropriate; (Tr. 1224). This type of accusation and response is lint in the scheme of this case, but this was Biddy's tack- accuse and retreat.

Mr. Biddy also made an accusation that the Company had begun construction on the new plant in 1995 before completion of the 1996 Feasibility Study. (Biddy Sur., Ex. 20, p. 10). Then he was directed to the date on the cost comparison schedules in the Feasibility Study and realized the analysis predates the alleged construction. (Tr. 1420-21). He accused Mr. Young of giving him false and contradictory information because Mr. Young first told him there were no residual handling costs in the 1996 Feasibility Study comparisons, and then later disclosed them as being elements of the $78 million estimate. (Biddy Sur., Ex. 20, p. 12). Mr. Biddy did not understand that Mr. Young's answers had been scrupulously honest because there is a critical difference between the $78 million estimate and the $63.3 million estimate. It was not until trial, that he learned the $78 million

estimate is from the 1994 CPS, (Tr. 1698-99), and is not the 1996 Feasibility Study estimate of $63.3 million used in the final comparative analysis. (Tr. 1695).

Then he accused Mr. Young of refusing to acknowledge that "flows have not come up to his Company's projections due to a loss of industrial customers in recent years." (Biddy Sur., Ex. 20, p. 24). But flows for industrial customers actually exceed projections. (Young Sur., Ex. 18, Sch. JSY-21; Tr. 1407). He accused Mr. Young of "artificially inflating" the 1993 project cost estimate because it was after the flood and the Company had "an axe to grind." (Biddy Dir., Ex. 19, p. 18). But the estimate had been distributed to the public in July *before* the flood occurred. (Young Reg., Ex. 17, p. 16). These accusations are essentially what Mr. Biddy offered to the analysis.

It is evident that Mr. Biddy simply never grasped the differing natures of the projects estimated in 1991, 1993, 1994 and 1996, the difference between "project costs" and "construction costs," or the fact that the Company's cash flow numbers were never intended to represent the specific elements of either project or construction costs. His cost estimate total is so corrupted with bad data that it is useless.

Mr. Biddy concluded that it was not prudent to abandon the existing plant and describes it as having been done by the Company "without the benefit of detailed studies of the engineering and economic feasibility of expanding and upgrading the existing plant..." (Biddy Dir., Ex. 19, p. 8). He was confronted with the fact that OPC had offered an expert engineering witness in Case No. WA-96-46 who testified completely the opposite of what Mr. Biddy was saying about the need for and advisability of the new plant. Mr. Lee testified among other things that residuals would be a problem at the old plant, (Young Reb., Ex. 17, Sch. JSY-1, p 6); that he would not recommend staying at the old site as a permanent solution, (Tr. 287, Case No. WA-96-47); and that building the new ground water plant was "the most reasonable alternative of the alternatives analyzed by the

Company." (Tr. 300, Case No. WA-97-47). Mr. Biddy's only response was that Mr. Lee's testimony "must be disregarded" because Mr. Lee did not characterize his testimony as being an evaluation of prudence. (Biddy Sur., Ex. 20, p. 11). OPC has simply pragmatically purchased different testimony in an attempt to gain the benefits of the new plant for less than its cost.

Finally, Mr. Biddy offered an excess capacity recommendation. He very simply takes a ratio of year 2002 projections to those of 2009 used by the Company, and applies that 80.45% to his $36 million cost estimate. There are three things wrong with this: First, as Mr. Young explained, "Well, if we were to build a plant at the 23 MGD capacity that Mr. Merciel proposed, or even the 24 MGD that Mr. Biddy proposed, and we had a maximum day similar to what we had in 1991, we would actually have to operate the plant over its approved capacity." (Tr. 1389). Mr. Biddy agreed that using actual 1999 usage as the design year, and applying OPC witness Lee's maximum-day-to-average-day design factor of 1.6 (which Mr. Biddy accepted), the plant should be sized at 25.68 MGD for 1999. (Tr. 1778). As it was built, there is only 28.5 MGD available for distribution to customers. (Tr. 1778).

Secondly, he admits that his theory of over-capacity would make it impossible for the Company to ever build, for example, a new clarifier that must be built in increments of 8 MGD. He says this should be handled like they do in Florida with tap-on CIAC charges, and not with rate base additions beyond present use requirements. His position is incredibly that anytime a company takes advantage of economies of scale, present customers should not pay for it. (Tr. 1740-41). This is a radical and unworkable suggestion that is completely contrary to Missouri regulation. If you punish a Company for using economies of scale, it will eliminate economies of scale.

Third, Mr. Biddy's straight-line disallowance recommendation makes no sense.[2] He has no basis for the use of a ratio of capacity against rate base other than to say he believes it "more appropriate" than specifically eliminating costs as did Mr. Merciel. (Biddy Sur., Ex. 20, p. 6). Mr. Biddy himself acknowledged the absence of the relationship between cost and capacity. (Tr. 1742). Dr. Morris agrees that the straight-line disallowance is inappropriate. (Tr. 1900). Besides, Missouri has previously rejected this approach calling it "utterly illogical" (Ex. 17, p. 56):

> Furthermore, the application of this theory seems to us to be illogical in view of the fact that the cost per unit of much of the Company's property does not vary in the same ratio as does the capacity. For example, a six-inch main does not cost six-eighths noe [sic.] nine-sixteenths as much as an eight-inch main, and so on through many of the items comprising the Company's property. If the plant were reconstructed to serve a permanently lessened capacity of 4.9% its cost would not be 4.9% less than a plant of 100% capacity. For the foregoing and other reasons, we believe that the application of the principle of a horizontal per cent reduction in the rate base, because of the decline in these times of consumption, is wholly inadmissible and indefensible in the present case.

Laclede Gas Company vs. PSC, 8 F. Supp. 806 (W.D.Mo. 1934).

Mr. Biddy argues that plants should be designed and built every two years. (Biddy Dir., Ex. 19, Sch. TLB-13). Mr. Biddy does not support his use of a two-year planning horizon other than to say that Florida has accepted it on occasion. Florida is unique in this position, and even has a CIAC practice that mandates large tap fees to offset against margin reserves. *Florida PSC v. Florida Waterworks Assn.*, 731 So.2d 836 (Ct. App. 1999).[3] One can only surmise that such a short planning horizon is attributable to weather consistency and predictability added to the relatively small size and

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[2] And, in fact, is directly contrary to OPC witness Hu's discussion of economies of scale. (Hu Dir., Ex. 30, p. 5-6).

[3] It should be noted that Missouri does not have a similar cost recovery mechanism, so absent inclusion of additional capacity costs in future rate cases, MAWC is left with no way to recover its investment in this "excess capacity," even though it is being used to meet present demands. (Tr. 2056-2057).

treatment requirements of systems. Mr. Young observed that Connecticut uses a planning horizon of fifteen years, (Young Reb., Ex. 17, p. 53), and Virginia has cited ten to thirty years. (Young Reb., Ex. 17, p. 53). Mr. Young says that two years is "ridiculously short...especially considering the time frame needed for the budgeting, design, permitting and construction of a substantial project such as a filter plant." (Young Reb., Ex. 17, p. 52). He cited an Indiana Public Utility Commission decision in one of the Company's own cases rejecting a 2 ½ year planning horizon advocated by the Indiana OPUC which called the horizon "providing no margin of safety..." The Indiana Commission stated:

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

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

Mr. Young quotes the Indiana Commission stating that a prudently built plant must be included in rate base, and "not just the portion that will be exhausted by demand during these rates."(Young Reb., Ex. 17, p. 54). With current historic usage exceeding 23 MGD in 1983, 1988 and 1991 all with fewer customers than exist today, the acknowledged potential for weather driven pumpage in excess of 25 MGD at any time, maximum delivery capacity of the new plant being only 28.5 MGD, and the unavoidable incremental size of facilities such as clarifiers, the entirety of the plant is effectively in use today. (Tr. 1576; Tr. 1605).

c. Response to specific St. Joseph Industrial Water Users' contentions

Charles D. Morris, an associate professor at Rolla, testified for The St. Joseph Industrial Water Users. He holds a doctorate and claimed to have designed plants. He could not respond to questions about the particulars of any water treatment plant that he had designed or had substantial

involvement in designing because they had taken place more than ten years ago. (Tr. 1874).

His association with the University at Rolla made it painful for those in the hearing room who heard his testimony. When Dr. Morris realized he had based his calculations on faulty numbers (numbers he thought were Company's costs, but were actually only cash flow calculations, Ex. 91), he chose not to acknowledge his mistake, and instead claimed he arrived at the same numbers by "coincident" independent analyses. (Tr. 1911). He then shamelessly produced a work paper to support the numbers. He admitted preparing it during the trial after Mr. Young's testimony disclosed Dr. Morris' misreading of the Cash Flow document. (Ex. 104).

Like Mr. Biddy, Dr. Morris admitted not performing designs, detailed cost estimates based on designs or other detailed engineering "due to the time and budget constraints." (Morris Dir., Ex. 65, p. 6). Dr. Morris simply criticized the Company's numbers and made his own estimates based on "engineering judgment." (Tr. 1862). He did not base his estimates on design, but rather on what he called experience and judgment. (Tr. 1869).

Like Mr. Biddy again, he mistakenly starts with the 1991 Study numbers to redesign the surface water plant. (Morris Dir., Ex. 65, p. 7). Like Mr. Biddy, he mistakenly thinks the Company's cost of renovating and upgrading the existing plant that was used to weigh its potential was $78 million, (Morris Dir., Ex. 65, p. 10) when it was in fact, $63.3 million (Biddy Dir., Ex. 19, Sch. TLB-3). He acknowledged a difference between total project costs and construction costs, (Tr. 1865), but was under the mistaken belief that the $63.3 million was construction cost alone, and did not realize that it was a total project cost number excluding only AFUDC. (Tr. 1867). He did not understand that all the projects on OPC's Ex. 86 were different in nature. (Tr. 1866). Like Mr. Biddy, he objects to inclusion of residuals handling costs in the renovation estimates, (Morris Dir., Ex. 65, p.11), without realizing that such costs were not included in the $63.3 million estimate used

for the comparison. (Biddy Dir., Ex. 19, Sch. TLB-3).

Dr. Morris testifies that the existing plant could have been renovated and upgraded for $38.2 million. (Morris Dir., Ex. 104, 91). Aside from his own unsupported estimates of certain items such as land acquisition, (Ex. 65, p.15), he makes at least three critical errors that render his calculations valueless. First, as can be seen on both Ex. 91 and his testimony in Ex. 104, $30.1 million of his costs are purportedly the Company's numbers for the cost of "replacement/renovation of existing filters, superpulsators, and the pre-sedimentation clarifier...and renovation of the chemical and operations building, the transfer pump stations, and the clearwell." (Morris Dir., Ex. 65, p. 13-14). Where he found these numbers is disclosed in his work papers. (Ex. 91). He simply marked-up the Annual Cash Flow analysis from the 1996 Feasibility Study, (an unmarked version of Ex. 91 is in Biddy Dir., Ex. 19, Sch. TLB-3). He even breaks down the numbers into the two expenditure numbers from 1998 and 1999 which are $18 million and $12.1 million, respectively. (Morris Dir., Ex. 65, pp. 13-14).

Looking at the Cash Flow Analysis, (Ex. 91), one can easily see that the Company estimated another $10 million to have been spent in 1997 which Dr. Morris simply crosses out and disregards. He is at least $10 million short in this one omission alone. Next, he totally disregards the costs of ozone. He calls the need for ozone "speculation." (Morris Sur., Ex. 66, p.11). Staff witness Merciel testified that this omission fails to give "consideration...to what could reasonably be expected to happen during the years that go well beyond the current rate case." (Merciel Reb., Ex. 49, p. 9)[4]. That's another $10.5 million. (Ex. 91).

Third, he makes an unsupported and unrealistic estimate of $3 million for a new intake. (Ex.

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[4] It's reasonable to look at the "long term" when comparing alternatives.

91). As Mr. Young explained in response to questions from the bench, (Tr. 1386), the Company is building an intake of smaller capacity in Alton for "twice the price" of Dr. Morris' $3 million estimate. (See actual cost of Alton intake in Young Reb., Ex. 17, Sch. JSY-8; corrected at Ex. 84). If you add these three mistakes to Dr. Morris' estimate, it approximates the estimate actually used by the Company in the 1996 Feasibility Study. (Ex. 91).

Dr. Morris then acknowledged the legitimacy of the book Water Treatment Plant Design by the American Waterworks Association and that he even keeps it on his desk. (Tr. 1870). He acknowledged that the book states that "preliminary cost estimates" as he characterized his own work in this case, can be off by 45% between estimates and what costs ultimately prove to be. (Tr.1873).

Unlike Mr. Biddy, who discounts all intangible comparisons except cost in evaluating alternatives, (Biddy Dir., Ex. 19, p. 16), Dr. Morris was candid about offsetting benefits of "ground water" compared to the surface water supply at the old treatment plant. (Tr. 1879-1892). Dr. Morris even indirectly argued the water quality concerns of surface water when he made the attempt to claim the new plant produces not ground water, but rather a "ground water under the direct influence of surface water." (Ex. 88,89). He thought the wells were closer than 200 feet from the river, as required by DNR in order to be automatically qualified as ground water and exempt from surface water treatment rules. If wells are closer than 200 feet, they are subject to other evaluations to determine if they might possibly be "ground water under the direct influence of surface water." If then considered to be under the "direct" influence of surface water, they would be subject to similar treatment requirements as would be required for surface water. (Tr. 1841).

The intimation was discredited because, 1) he never measured the well distances from the river (Tr. 1824); 2) Exhibit 102 was the ground water permit itself specifying a 200 foot from the

river placement requirement; and, 3) Exhibit 103 was the "Interim Approval to Operate" acknowledgment of legal operation under the permit (Tr. 1907). But his argument is an acknowledgment of the differing treatment concerns and risks associated with ground water that make it safer and easier to treat than surface water.

Curiously, at the same time he raises this speculative and inaccurate suggestion, he also suggests that the well field should have been located closer to the existing plant in order to save construction costs. (Morris Sur., Ex. 66, p.9). He had no hydrological studies indicating that this would be possible, (Tr. 1903), and did not suggest any possible locations. The Company evaluated two potential well locations closer to the existing plant with actual test wells, but the formation was found to be unsuitable for municipal capacity wells. (Young Dir., Ex. 16, p. 7).

Interestingly, Dr. Morris' estimates of flood protection costs are five times greater than Mr. Biddy's, exceeding $2 million. (Ex. 91). He rejected Mr. Biddy's estimates as being unrealistic. (Tr. 1863). Finally, Dr. Morris claimed benefits could have been derived from "phasing." (Morris Sur., Ex. 66, p. 8). It was never made clear what he was suggesting; he talks about reduced AFUDC because of "appropriate accounting and ratemaking treatment," (Morris Sur., Ex. 66, p.8), but he apparently does not understand either. AFUDC stops when facilities are placed in service, and rate cases would have to be frequent and somehow abbreviated to deal with phasing of renovation stages that would have been completed by this date under any scenario. He admitted total project costs would not be less because of staging, and in fact could be more because of remobilization. (Tr. 1901-02). However, the project was to have been complete by now (i.e. 2000) so the total costs (not a phase-in) should be reflected.

d. Response to Staff contentions

Staff witness Merciel testified that the Staff supported the construction of the new plant

because it was "in the public interest." (Merciel Dir., Ex. 48, p. 4). He observed that the Commission has "...more problems getting water companies to do what they need to do rather than try to hold them back any." (Tr. 1535). He said his position was a formally adopted Staff position and not simply his own. (Tr. 1592). It was made on both a cost comparison and a comparison of "factors other than just cost." (Merciel Dir., Ex. 48, p. 4). He itemized those other factors as:

> [T]he day-to-day fluctuation of river water quality characteristics; the future of drinking water regulations pertaining to the use of surface water supplies (which include river water supplies); the unresolved issue of lime treatment waste disposal; the continued risk of low river water levels; the risks associated with river flooding that would exist even if flood protection measures were taken; and, the Missouri Department of Natural Resources' policies regarding plant siting in flood plains.

(Ex. 48, p. 4).

He observes that neither Dr. Morris nor Mr. Biddy placed any value whatsoever on these intangible benefits, (Merciel Reb., Ex. 49, p. 9), and he expressed serious concern over the unavoidable potential for flooding. (Tr. 1523). The following was his testimony in this regard:

> ...Here is where I stand on -- for this facility, we -- it's preferable -- we've seen whole towns moved out of flood plains. I don't see anybody constructing new structures, new facilities where you -- where you -- if you can't afford for them to be out of service. You see some warehouses or offices, things that maybe a person or a business could abandon. But something that -- that a whole town depends on every day I don't think it's appropriate to do some construction within the flood plain. And that's what we're talking about here. We're talking about replacing basically this entire plant. Now, if we had, whatever, $20 or $30 or $40 million sitting in the ground, it's not practical to abandon a large investment like that. You would need to construct levies and floodproof it as best you can. But we're talking about replacing this facility, and, in my opinion, the question is, do you replace it there where it's at, or do you replace it somewhere else?

(Tr. 1523-24).

When asked what the reaction would likely be if the Company had chosen to renovate the existing plant and had then later been flooded again, he said the following:

> ...[T]he town would be outraged. Probably every party in this room would be

> outraged if the Company had spent money someplace where it just -- just had a disaster. I think it would be -- it would be difficult to support the Company's decision in a hindsight-type situation where something happened again after it happened once.

(Tr. 1578-79).

In addition to flooding concerns, Mr. Merciel describes in detail the advantages of ground water over surface water. (Merciel Reb., Ex. 49, pp. 10-11).

Mr. Merciel does make a capacity adjustment recommendation worth $2.3 million of rate base. He first argues that the filters are not yet approved by DNR for operation at the rate they were built for, so other construction of components could have been delayed. (Merciel Reb., Ex. 49, p. 18). His observation about DNR approval of the filters is not accurate. The filters are, in fact, being legally operated at the 5.56 gpm/sf today as was always contemplated by both the Company and by the DNR. (Young Sur., Ex. 18, pp. 5-8, 10). Mr. Merciel admitted this during cross examination. (Tr. 1573).

He argues that the plant is designed to have a "firm" capacity of 30 MGD. (Merciel Reb., Ex. 49, p. 16). He at first overlooked the fact that only 28.5 MGD is available for distribution due to in-plant usage, but more importantly he overlooked the fact that the "firm capacity" of the plant with one clarifier out of service would only be 22.8 MGD. (Young Sur., Ex. 18, p. 9). Accordingly, if one of three present clarifiers had not been built as he suggests, the capacity of the plant with one of the remaining two clarifiers out of service would be only 11.4 MGD. (Young Sur., Ex. 18, p. 9). If Mr. Merciel's recommendation had been adopted, and only two clarifiers had been build instead of three, the plant could not meet even average day needs if one clarifier failed or otherwise had to be taken out of service.

Finally though, Mr. Merciel argues that a 23 MGD capacity would be adequate for the present because 23 MGD is less than maximum days actually experienced in the past. (Young Reb.,

Ex. 17, Sch. JSY-16 shows 23 MGD was exceeded in 1983, 1988 and 1991. Mr. Merciel admitted that with the right weather, the Company could at any time be "absolutely" required to pump more than 25 MGD. (Tr. 1576; 1605). His testimony was that 23 MGD capacity would be adequate but, "That's not to say you won't exceed that at sometime... It's – you wouldn't want to exceed it for long periods. For short periods you can do it *and you can get by with it.*" (Tr. 1605, emphasis added). As explained by MAWC witness Young, "...to operate a plant at a higher-than-approved rate, you're basically putting the public at risk for public health." (Tr. 1390).

3. SJTP CONCLUSION

The Company has acted responsibly and in the public interest at every stage of this project. The Company identified and evaluated a number of alternatives in the 1996 Feasibility Study. OPC and AG Processing, Inc., were involved in the decision-making process by virtue of their participation in the original presentations before the Commission in Case No. WA-96-47. They chose not to contest the proposed project. In fact, OPC condoned it.

Faced with the problem of an obsolete, deteriorated plant that was dependent on increasingly regulated surface water, and painfully evident flooding concerns, the Company made the only reasonable choice. The Commission called it a "reasonable alternative" and OPC's expert called it "the most reasonable alternative." Staff's testimony summarizes the Company's choice: "...the Company would also be under harsh criticism if it had made a large capital investment in the flood area." (Merciel Reb., Ex. 49, p. 12). "...[I]t was reasonable and prudent for the Company to take advantage of the situation and construct the New Plant in a location where operation and access during flooding is not an issue." (Merciel Reb., Ex. 49, p.6).

No credible evidence has been produced by OPC or the St. Joseph Industrial Users that would change the conclusions of the Feasibility Study, or show that the ground water treatment plant

and associated facilities is not the most reasonable alternative. Rather than being criticized for its efforts, the Company should be commended for its willingness to responsibly dedicate capital for the health and safety of the public. The entirety of the capital costs of the SJTP should be included in rate base. It was prudently constructed and is used and useful in providing safe and reliable water service to the citizens of St. Joseph.

C. ESTOPPEL.

On June 2, 2000, MAWC filed its Motion to Strike Testimony and Motion for Summary Determination with the Commission. The OPC and the St. Joseph Industrial Water Users presented their responses to the Commission on June 5, 2000. The Commission stated at that time that it would take this issue with the case. The aspects of this motion that concerned striking the testimony of various witnesses is now moot as this testimony is now in evidence in this proceeding. Accordingly, MAWC will limit its discussion in the Initial Brief to those aspects of its motion which were directed to its request for summary determination. These aspects are based on matters of law and potentially impact the Commission's ultimate decision in this matter.

1. Commission has previously decided the reasonableness of construction

In *Re the Application of Missouri American Water Company for a Certificate of Convenience and Necessity to Lease, Operate, Control, Manage and Maintain a New Source of Supply in Andrew County, Missouri*, Case No. WA-97-46 (Issued October 9, 1997), MAWC filed an application with the Commission requesting a certificate of convenience and necessity for property in Andrew County, Missouri, for the purpose of providing additional water supply to the St. Joseph, Missouri service area. MAWC also proposed the construction of a new treatment facility and lines to transport the raw water from the adjacent water field to the new facility. Public notice was issued by the Commission. The OPC was a party to this case and AG Processing, Inc. was granted status

as a participant without intervention. The Commission's Order Regarding the Scope of the Proceeding and Setting Procedural Schedule issued on November 20, 1996 in Case No. WA-97-46 directed that "all parties should fully inform the Commission of their views on whether this project is needed, as well as whether the proposal submitted by MAWC is prudent."

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

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

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

The Commission made these findings in 1997, prior to the start of construction. The Commission previously has stated that it will not rely on hindsight and that it "will assess management decisions at the time they are made and ask the question, 'Given all the surrounding circumstances existing at the time, did management use due diligence to address all relevant factors and information known or available to it when it assessed the situation?'" *Re: Union Electric Company (Callaway Nuclear Plant)*, 27 Mo.P.S.C. (N.S.) 183, 194 (1985).

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

"reasonable alternative." Additionally, the St. Joseph Treatment Plant and related facilities has been the subject of two financing cases since the completion of Case No. WA-97-46. *See In re Missouri-American Water Company*, WF-99-69 (November 12, 1998) (the Commission approved financing for "the construction of the new St. Joseph treatment plant, well field, and associated lines, and to allow it to retire existing short-term debt."); *See also In re Missouri-American Water Company*, WF-2000-383 (February 17, 2000).

2. Commission is estopped from relitigating this issue

The general rule is that the doctrine of equitable estoppel is not applicable against a governmental entity, such as the Commission itself. *See State ex re. Capital City Water Co. v. Missouri Public Service Commission*, 850 S.W.2d 903, 910 (Mo. Ct. App. W.D. 1993). However, an exception applies when the circumstances are exceptional–where justice or the prevention of a manifest injustice requires its application. *Id.* Such is the situation in this case.

The Commission in Case No. WA-97-46 specifically stated:

> However, based on the extensive evidence presented, the Commission finds that the proposed project, consisting of the facilities for a new groundwater source of supply and treatment at a remote site, is a reasonable alternative . . . The Commission finds that issuance of that certificate to be in the best interest of the public.

See Report and Order, Case No. WA-97-46. As such, the Commission granted a certificate of convenience and necessity to MAWC for the construction of the new facilities.

The elements necessary to warrant application of the equitable estoppel doctrine are: (1) an admission or statement inconsistent with a later claim; (2) reliance by a third party; and (3) injury to the third party if the first party is allowed to repudiate such statement. *See Lick Creek Sewer Systems, Inc. v. Bank of Bourbon*, 747 S.W.2d 317, 324 (Mo. Ct. App. S.D. 1988). All of those elements exist in the present situation. The Commission in Case No. WA-97-46 found that the

project was a reasonable alternative and that the issuance of a certificate of convenience and necessity to build the new system was in the best interest of the public.

In reliance on these findings by the Commission, MAWC constructed the St. Joseph Treatment Plant and related facilities and has expended approximately $70 million in this effort. The Company's reliance on the Commission's findings was certainly reasonable. All parties agreed that improvements to MAWC's water supply system in the St. Joseph, Missouri area were necessary. The Commission found that the alternative chosen was reasonable and in the best interest of the public. *See* Report and Order, Case No. WA-97-46. For the Commission to potentially hold that MAWC's actions were imprudent and/or unnecessary, and that MAWC will not be able to include the cost of the new facilities in rate base, constitutes manifest injustice. As such, the Commission should make a finding that the full cost of the St. Joseph Treatment Plant and related facilities should be placed in rates.

3. Parties may not make collateral attack on prior commission order

Section 386.550 RSMo states that "In all collateral actions or proceedings the orders and decisions of the commission which have become final shall be conclusive." In *State ex rel., Ozark Border v. Public Service Commission, et al.*, 924 S.W.2d 597 (Mo. Ct. App. 1996), the Missouri Court of Appeals for the Western District described the effect of this provision as follows:

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

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

> In *State ex rel. State Highway Com'n v. Conrad*, 310 S.W.2d 871, 876[4] (Mo. 1958), the court stated that it had so frequently been held that orders of the PSC are not

> subject to collateral attack that the court was not required to elaborate on the effect and meaning of § 386.550. In that case the court refused to entertain a collateral attack on an order of the Commission which had apportioned the costs of constructing a railroad crossing. The court held that § 386.510 provides the sole method of obtaining review of any final order of the commission. If a statutory review of an order of the Commission is not successful, the order becomes final and cannot be attacked in a collateral proceeding.

Commission Case No. WA-97-46 was fully litigated in 1997 and the Commission's decision became a final order of the Commission. Any attack in this case on the Commission's finding that construction of a "new groundwater source of supply and treatment at a remote site is a reasonable alternative" constitutes an improper collateral attack and is violative of Section 386.550 RSMo. The Commission should therefore uphold its previous decision and find in favor of MAWC as to the prudence of MAWC's decision to construct the St. Joseph Treatment Plant and related facilities.

This having been said, while the Commission has determined the reasonableness, or prudence, of MAWC's decision to construct the St. Joseph Treatment Plant and related facilities, it has clearly left for itself the question of the prudence of the actual costs incurred and the management of construction of the proposed project. It is these subjects which are properly relevant to this rate case.

Thus, the Commission should determine that MAWC's decision to construct the St. Joseph Treatment Plant and related facilities is prudent based on its earlier decision and that what remains is the question of the prudence of the actual costs incurred and the management of construction of the project.

III. RATE DESIGN

A. SINGLE TARIFF, DISTRICT SPECIFIC OR COMPROMISE. SHALL MAWC'S RATES BE DESIGNED CONSISTENT WITH A "SINGLE-TARIFF" RATE DESIGN, "DISTRICT-SPECIFIC" RATE DESIGN, OR SOME OTHER METHODOLOGY?

1. INTRODUCTION

Once the Commission has determined the appropriate revenue requirement for MAWC it must then determine how existing rates are to be adjusted in order for the Company to achieve that revenue requirement (this exercise has commonly been called the "rate design" part of the case). In this case, the Commission is once again confronted by what is becoming a time-honored debate between supporters of single tariff pricing (STP) and district specific pricing (DSP). Although Public Counsel would have this Commission believe that it is supporting a "compromise" rate design, Public Counsel's position is more accurately characterized as a move away from STP and a move toward DSP (Busch Reb., Ex. 28, p. 10).

It is MAWC's position that the Commission should maintain the single tariff pricing structure that currently exists today. The reasons for using STP in a multi-district operation (such as MAWC's) include the long term rate stability which results from a single tariff, the operating characteristics of the districts, the equivalent services offered, both the allocated cost of service and the cost of service on a stand alone basis, and the principle of gradualism.. (Stout Dir., Ex. 9, p. 14) If, however, the Commission is reluctant to adopt full STP, in light of the revenue requirement impact of the St. Joseph Treatment Plant and related facilities ("SJTP"), then MAWC has proposed a "Capital Addition Surcharge" that would mitigate the impact of the SJTP on the rates in other districts while preserving many of the benefits of STP. This rate proposal maintains uniform rates

for customer charges and consumption rates for all districts but applies a surcharge to the total bill of the St. Joseph customers. (Stout Reb., Ex. 10)

2. HISTORY OF THE ISSUE

A brief history of the past rate cases involving MAWC (and its predecessor company, Missouri Cities Water Company or Missouri Cities) is helpful in understanding the development of this issue. MAWC currently provides water service to the public in seven districts in the state of Missouri. Missouri Cities was MAWC's predecessor in five of those districts. (i.e. Brunswick, Mexico, Platte County, St. Charles County and Warrensburg).

The primary rate design methodologies that have been discussed before the Commission are single tariff pricing and district-specific pricing. Single tariff pricing is the use of a unified rate structure for multiple water (or other) utility systems that are owned and operated by a single utility, but that may or may not be contiguous systems or physically interconnected. In other words, all customers within the same customer classification pay the same unit price for water service irrespective of geographic location. District-specific pricing would instead attempt to assign all costs (direct as well as common and joint) to individual districts and, thus, set separate prices/rates by district to recover those costs.

A review of the single tariff pricing proposals as they relate to MAWC must begin with Missouri Cities. In approximately 1989, in Commission Case No. WR-89-178, et al., *In the matter of the application of Missouri Cities Water Company of St. Charles, Missouri, for authority to file tariffs designed to increase rates for water service to customers in the Missouri service area of the Company.* (October 4, 1989). (Unreported), Missouri Cities proposed a system of uniform rates that set uniform service charges for all districts, along with a differential volumetric rate for softened water versus unsoftened water, and separate, higher volumetric rates for Brunswick. The parties to

the case reached a stipulation on the rate design issue. Although the stipulation made no significant progress toward a uniform rate, Missouri Cities and Public Counsel ("OPC") supported uniform rates to one degree or another and recognized some of the benefits as a basis for recommending approval of uniform rates (albeit only a partial approval in the case of Public Counsel) Report & Order, p. 2, 3.

In approximately 1990, in Case No. WR-90-236, Missouri Cities again proposed uniform rates, but then tempered the proposal by developing an "equalization" rate, which, when added to the uniform rate, effectively resulted in the same district-specific rates as were approved in the previous case. *In the matter of Missouri Cities Water Company,* 30 Mo. P.S.C. (NS) 363 (October 12, 1990). This case was revenue neutral, that is, the newly proposed rate design was not intended to increase or decrease overall Company revenues, but merely to implement the uniform rate with an "equalization" rate adjustment. The Commission approved the uniform rate tariff with an equalization rate adjustment in this case stating as follows:

> The Commission has reviewed the evidence in this matter and finds that the proposal to establish a system-wide rate for water service is reasonable. These tariffs would not make everyone's water bill the same. This proposal would only make future rate increases the same. That is, current differences in rates among the districts would remain the same but the increases would be spread equally among all customers. The Commission finds also that the proposal to establish equalization rates to maintain the current differentials between Company districts is also reasonable. The Commission agrees with Public Counsel that the proposal will allow Company to spread future increases in rates on a system-wide basis while maintaining the current rate differential which will reduce rate shock in future cases and limit cross-subsidization. Spreading the costs to all Company customers will also allow Company greater flexibility in timing plant additions.
>
> The Commission agrees with Public Counsel that the equalization rates should stay in effect until some future date. Even though an equalization rate might change because of changed billing determinants, the Commission finds that the current rate differential should be maintained. This matter can be reviewed in some future rate case.

30 Mo. P.S.C. (NS) at 365.

The next Missouri Cities rate case was in approximately 1991 (Case No. WR-91-172). *In the matter of Missouri Cities Water Company,* 1 Mo. P.S.C. 3d 119 (September 20, 1991). Missouri Cities made no specific rate design proposals in its initial filing. The Report and Order in the case summarized the position of the parties on rate design as follows:

> Company, Public Counsel, Warrensburg and the City of St. Peters urge the Commission to stay with Company's "uniform" rate design, a design which this Commission approved in Company's revenue neutral rate design case, No. WR-90-236. Platte County Intervenors would have the Commission adopt "full" uniform rates.

1 Mo. P.S.C. 3d at 144. The Commission further observed "The aim of the parties in the rate design case, including OPC, was to formulate a design which would eventually lead to uniform Company-wide rates, and according to OPC, 'single tariff' filings." *Id.* at 144. The Commission's statement of policy at that time was as follows:

> The Commission continues to support the concept of system-wide rates for Company, and in this respect is of the opinion that Staff's proposal to establish a system-wide flat rate for Company's minimum monthly charge and private fire charge is a step in the right direction.

Id. at 147.

In approximately 1992 (Case No. WR-92-207), Missouri Cities again proposed to spread an increase to all districts under the uniform rate, but to maintain the equalization rate component. *In the matter of Missouri Cities Water Company,* 2 Mo. P.S.C. 3d 60 (1993). The Commission decision in that case maintained the equalization rate component since ". . . MAWC has not completed its first 'building cycle' since the implementing of uniform rates barely a year ago in Case No. WR-91-172. 2 Mo. P.S.C. 3d at 71. Again, the Commission expressed a desire, at some future date, to implement uniform rates. After completion of this case, Missouri Cities was acquired by

MAWC, See *In the Matter of the Application of Missouri-American Water Company for approval of its acquisition of the common stock of Missouri Cities Water Company*, 2 Mo. P.S.C. 3d 305 (1993).

The first consolidated case for MAWC was in 1995 (Case No. WR-95-205), *In the matter of Missouri American Water Company,* 4 Mo. P.S.C. 3d 205 (November 21, 1995), in which the Company proposed a "stepped" implementation of single tariff pricing for the seven districts of the merged Company. This implementation plan included three volumetric rate zones initially merging together rates for St. Charles and St. Joseph into one tariff, Mexico and Parkville into one tariff and Joplin and Warrensburg into one tariff. Brunswick would remain on a separate tariff, but Brunswick rates would not be increased 4 Mo. P.S.C. 3d at 224. The Company proposal would have equalized all monthly service charges for all of the Missouri Cities' districts. *Id.* at 224. Three parties to the case, Company, Staff and OPC joined in a stipulation in an effort to resolve the single tariff pricing issue by implementing a three step implementation plan. After hearing testimony on the issue, the Commission concluded:

> The Commission finds the proposed move toward single tariff pricing for Missouri-American and all of its districts, as jointly agreed to by the Staff, Missouri-American and OPC and as, to some degree, supported by all Intervenors, is therefore in the public interest

Id. at 226.

As a result of the Stipulation and Agreement in Case No. WR-95-205, the Company began a three step process toward full implementation of single tariff pricing. In the first step, the Company implemented uniform rates in its St. Joseph, Joplin, Platte County and St. Charles Districts immediately upon the conclusion of the case. Rates in the Mexico and Brunswick Districts were lowered, but they were still above the uniform level established for the other four districts. Rates

in Warrensburg were increased but they were still below the level of the uniform rates. In the second step, which occurred one year after implementation of the rates set in Case No. WR-95-205, (approximately December 5, 1996), rates in the Warrensburg District were again increased, and the rates in Mexico and Brunswick were reduced so that the overall impact on the Company was revenue neutral.

In the third step (and consistent with the Stipulation), the Company proposed implementation of uniform rates for all of its districts in its 1997 rate filing (Case No. WR-97-237 et al.), *In the matter of Missouri American Water Company*, 6 Mo. P.S.C. 3d 549 (November 6, 1997). In its Report and Order, the Commission approved a rate design based upon single tariff pricing given the record in that case. However, the Commission also expressed a desire to make a more detailed comparison of the methodologies before making a final commitment to single tariff pricing. The Commission stated as follows:

> The difficulty for the Commission is that, without a district specific cost study there is no way to compare the resulting rates under STP with the resulting rates under more traditional ratemaking. The Commission is left with unsupported allegations from both sides of the controversy as to which method is theoretically superior.

6 Mo. P.S.C. 3d at 556.

> The Commission agrees with OPC that the distinction between costs which are directly assignable to specific customer groups, and costs which are joint and common costs cannot be made without a detailed cost of service study. The Commission also agrees with OPC that it can only properly evaluate the advantages and disadvantages of a uniform rate design if it has the necessary information for a clear understanding of the design's financial impact.

Id at 557.

Subsequently, on November 20, 1997, the Commission issued its Order Establishing Class Cost of Service Study and Rate Design Case and Proceeding Notice establishing Case No. WO-98-204. As a result of the proceedings in that case, the Commission found as follows:

> Although the Commission's decision in Case No. WR-97-237 adopted a rate design that used STP, the Commission declined to announce what approach it would use during MAWC's next rate case. The record indicates that it is anticipated that the St. Joseph water treatment plant currently under construction may be added to the rate base in MAWC's next rate proceeding. This, in itself, is sufficient reason for the Commission to defer its decision on this issue.

Report and Order issued November 2, 1999, in Case No. WO-98-204 at p. 7.

> Given the significant uncertainties associated with the exact amount of rate base that will be included in rates in the next rate case, and the effects, if any, of the proposed merger of MAWC's parent with the parent of St. Louis County Water Company, the Commission will not attempt to decide the rate design issue until the next rate case.

Id at p. 8.

This history of the issue clearly reveals that: 1) the debate over STP and DSP has continued for well over a decade; 2) some parties have taken different "sides" on the issue in different cases; 3) "pure" district specific pricing has not existed in five of the seven districts for over ten years; 4) the Commission has, over the past ten years, clearly indicated a policy of "moving toward" STP; and 5) despite its unwillingness to announce a firm policy in support of STP, the Commission, in MAWC's last case, nevertheless authorized the Company to take the final step and implement uniform rates for all of its districts.

3. THE RATIONALE FOR SINGLE TARIFF PRICING

The reasons for using single tariff pricing in a multi-district operation such as MAWC's include the long-term rate stability which results from a single tariff, the operating characteristics of the districts, the equivalent services offered, both the allocated cost of service and the cost of service on a stand-alone basis, and the principle of gradualism. (Stout Dir., Ex. 9, p. 14)

Single tariff pricing will provide long-term rate stability for the various districts served by MAWC. Utility customer rates are dependent on the total expenses and rate base of the utility and the amount of the commodity which the utility sells. Increases in rate base, particularly as the result

of the Safe Drinking Water Act, and changes in the quantity sold have a significant potential for adversely impacting the rates of small or medium size utilities or rate districts within a utility.

For example, if Joplin were required to replace significant elements of its present treatment plant, the capital cost could be significant. The ability to absorb the cost of such projects over a larger customer base is a compelling argument in support of STP. Capital programs will never be uniform in the several districts, even over periods of 5 to 10 years. The variances in unit costs that result from major additions are temporal and only tend to cause price instability if reflected in district specific pricing. The cost of district specific programs should be shared by all customers rather than burdening those of the affected districts. Rate increases will be more stable and major increases in specific districts will be avoided. (Stout Dir., Ex. 9, pp. 14-15)

The operating characteristics of the several districts support STP. There are many similarities in the manner in which the several districts are operated. All of the district systems pump their treated water through transmission lines to distribution areas that include mains, booster pump stations and storage facilities. All of the districts provide water to individual customers through a service line and meter. All of the districts rely on a centralized work force for billing, accounting, engineering, administration, and regulatory matters. All of the districts rely on a common source of funds for financing working capital and plant construction. The only significant differences in operating characteristics are the sources of supply and treatment processes. The increasing pressure from regulators and customers related to the level of treatment will ultimately eliminate this operating characteristic difference. Thus, over the long term, the commonality of the operating characteristics support the use of STP. (Stout Dir., Ex. 9, pp. 15-16)

The use of STP in a utility with noncontiguous service areas is supported by the equivalent service rendered in each area. Although there would be considerable debate with respect to the

equivalency of the service rendered to different customer classifications, there can be little argument that the service rendered to a residence in one district is the same as the service rendered to a residence in another district. Residential customers are relatively consistent in their uses of water: e.g., cooking, bathing, cleaning and other sanitary purposes, and lawn sprinkling. If customers use water for the same purposes, the service offering is the same and should be priced accordingly. Thus, from this perspective, there is no basis for charging different prices to customers in different districts.

The electric industry reflects such concepts when it serves customers in geographically dispersed areas. A kilowatt-hour delivered in one area has the same price as a kilowatt-hour delivered in another area despite the fact that cost of service studies could be performed to identify differences in the cost of providing service to customer classes in different regions. The same is true of the gas and telephone industries. (Stout Dir., Ex. 9, p. 16)

There are other cost of service considerations that support STP. The Company has centralized and consolidated a significant portion of its operations. Common costs which have been assigned or allocated to each district include management fees, corporate headquarter costs, customer service costs, depreciation expense developed on the basis of Company-wide depreciation rates and return and income taxes based on total Company financing and tax provisions. The allocations of common costs, while reasonable, are subject to judgment and do not result in the development of district specific revenue requirements which reflect precisely the cost of serving each district, particularly if stand-alone costs are considered. (Stout Dir., Ex. 9, p. 17)

The results of assigning and allocating costs to the districts of MAWC indicate that the differences in costs between districts and, therefore, the difference between costs and STP revenues are due to three primary factors: (1) the average age of plant; (2) the level of treatment required; and,

(3) the size of the district. The first two factors are either temporal or subject to elimination resulting from customer and regulatory pressures. A policy of district specific pricing should not be based on such factors, as it would lead to price instability. (Stout Dir., Ex. 9, p. 17).

The third factor, the size of the district, will continue to produce variances in the unit cost of serving a district. District specific pricing that recognizes the economies of scale in providing service in a larger district would yield higher rates for small districts and lower rates for large districts. It is a reasonable public policy to ignore this cost variance in establishing customer rates. In this manner, the small districts enjoy the cost benefits of being part of a large system. Further, the impact of the rates for the larger districts, when compared to district-specific pricing of such districts, is not significant. (Stout Dir., Ex. 19, pp. 17-18).

In conclusion, STP is appropriate for MAWC. Such pricing is supported by considerations of the benefits of sharing the impact of capital programs on a Company-wide basis; the significant costs that are common to all districts; the equivalent service rendered; and the gas, telephone and electric industries' precedent. Most importantly, STP is necessary so that all customers benefit from the economies of scale by being a part of a large system. The small systems will realize the benefits of the lower unit costs of the large systems without significantly impacting the unit costs of the total system. The best interests of all customers are served through gradualism by continuing single tariff pricing. (Stout Dir., Ex. 9, pp. 17-18)

4. RESPONSE TO CRITICISMS OF STP

Opponents of STP (and thus proponents of district specific pricing) generally criticize STP on the grounds that rates developed pursuant to STP 1) are not "cost based"; 2) do not create sufficient accountability or incentives (i.e. they do not promote economic for the utility to control capital spending; do not produce rate stability or efficiency affordability; and finally, 3) are unlawful.

MAWC will address each of these criticisms and demonstrate that they are simply not valid.

a. Cost Based Rates

Parties opposing STP have tried to couch the Commission's choices between district specific pricing methodology which is "cost based" and that which they believe to be a non-cost based methodology STP. The truth is that in the overall picture, both methodologies are cost based. In both, the Company's revenues are based on its cost to provide service. Likewise, neither methodology tries to place the burden of payment directly upon the cost cause.

The difference between the two is merely that they allocate the costs over different groups of customers. In STP, rates are designed for each traditional class of customers (residential, commercial, etc.) across the entire Company and, in district specific pricing, rates are designed for each class of customers within a district. Or, as Staff witness Hubbs explains:

> STP draws its rate design circle around the entire company for allocation of costs to the specific classes. DSP draws its rate design circle around each operating district.

(Hubbs Reb., Ex. 42, p. 3).

Neither methodology tries to place the burden of payment directly on the cost causer. The effort to determine the cost of serving individual customers would be enormous. Factors that would affect the cost of serving an individual customer would include demand characteristics, the actual original cost of the service line and meter serving the customer, the amount of time to read meters in the vicinity of the customer, the customer's payment record, the distance from the treatment plant that water would have to travel to reach the customer, the extent to which that water would require pumping and storage, the cost of the facilities between the customer and the source of supply and the extent to which the customer used those facilities, etc. These factors would result in cost of service for customers in different parts of the system that would be dramatically different. (Stout

Sur., Ex. 11, pp. 8-9)

Opponents of STP argue that there is less chance for undue subsidization on a district specific basis instead of a Company-wide basis. This is simply not true. There are numerous subsidies that remain when customers are grouped within classes within a district. Many of these subsidies may be as great as the apparent subsidies that exist on an average basis between districts. For example, it is possible that a long time residential customer in the St. Joseph district with moderate demands and located near the treatment plant would have a lower cost of service than a new residential customer in the Joplin district with very high peak demands and served by the Thirty-Second Street well, booster station and tank. However, DSP proponents choose to ignore the differences of distance; cost of specific facilities between the plant and the customer; pumping and storage; and individual demand characteristics and place their sole focus on the average cost differences between districts. This is a relatively arbitrary grouping of costs given all of the other variables that affect cost. Public utility ratemaking has traditionally differentiated customers based on the nature of the customer's end-use (i.e., whether the customer is residential, commercial, industrial, etc.). This is the only differentiation or circle drawing that should continue to be used for this Company consistent with other Missouri utilities in the electric, gas and telephone industries. (Stout Sur., Ex. 11, pp. 9-10)

Finally, those parties advocating DSP have elevated cost considerations above and to the exclusion of other factors that are equally appropriate in designing rates. Such other factors include gradualism, value of service, understandability and ease of application, social and community concerns and others. For Example, Staff's proposed rate design, which focuses on costs to the exclusion of other rate design factors, results in increases as high as 490% to the sales for resale customers in the Brunswick district with numerous classes receiving increases in excess of 100%

and decreases as high as 24% to the private fire customers in St. Joseph and 19% to the commercial customers in Joplin. Such rate changes are beyond the bounds of gradualism, do not recognize the value of service principle and are confusing in that there would now be over 30 rate schedules for MAWC. (Stout Reb., Ex. 10, p. 8)

b. Accountability/Incentives/Efficiency

Opponents of STP criticize it for not creating sufficient accountability or incentives in that it will result in investments in extravagant, unnecessary facilities, and will not permit customers a say in the investments that are to be made in their respective districts. These parties further seem to believe that the Company controls rate volatility in that it alone determines when and how much is going to be spent in any given district. These arguments ignore the impact on capital requirements of the regulations of federal and state agencies as well as the impacts of nature and customer demands. MAWC alone does not control rate volatility or how much is going to be spent. Environmental and economic agencies of the federal and state governments also have a very significant say in how much is going to be spent and, therefore, they also have control over rate volatility. Opponents of STP also ignore the impacts of nature (e.g. flooding) and customer demands on the need for capital improvements. The Missouri River is known for finding a way out of its banks and for its periodic high levels of turbidity. Dealing with such issues while maintaining reliable, quality service that meets the demands of customers is not an inexpensive proposition. The level of control that the Company has is the selection of a least cost alterative, not necessarily a low cost or no cost alternative. Furthermore, the selection of a least cost solution based on long term revenue requirements cannot overcome the inherent front-end loading of rate of return/rate base regulation using original costs. The suggestion that these requirements and constraints will miraculously disappear with the introduction of DSP is unrealistic. MAWC's capital spending

requirements will not change with DSP, only the manner in which the related revenue requirements are recovered will change. (Stout Reb., Ex. 10, p. 10).

Cost based rates that use embedded cost can only promote economic efficiency to a point. Opponents of STP seem to suggest that if customers are charged their specific embedded costs of water service, they would in some way respond to this price signal in order to promote economic efficiency. However, most water usage is relatively inelastic and not responsive to price signals. Some parties' concept of economic efficiency seems to suggest that the Company should take a vote of its customers on whether to build a new plant and, if so, how much should be spent to build it. This is not practical. First, public utilities have an obligation to serve and are subject to regulations as to the manner in which this service is provided. These constraints, as well as the constraints of geography and natural resources, limit the extent to which the utility can respond to its customer's desire for a low cost product. Second, a public utility plant is long lived and for the most part, has a fixed location. The ability to modify the production inputs in response to the reaction of customers to the resultant price is either very limited or not possible. Building small increments of capacity as demand grows also is not practical. (Stout Sur., Ex. 11, p. 7) .

c. Rate Stability

The parties have also criticized STP in this case for not achieving its intended goal of rate stability because the proposed increase in rates approximates 50%. Their solution however is to recommend DSP rates that will result in increases to districts that range from a negative 10% to a positive 232%. The increases to customer classes within districts under some parties' proposals create even greater disparity. It is only those parties' phase-in proposals that produce a false sense of stability, not their proposal to use district specific pricing. The fact of the matter is that STP provides more rate stability than DSP. Under STP, new investment in a district will raise rates, but,

all other things being equal, not as much as rates would have been increased under DSP. As new investments are made in other districts, rates in this district would rise even higher, and eventually approach the level that would have resulted from the investment in its area under district specific pricing. That is, the increases in rates would be smooth and more regular under STP, rather than drastic and irregular under DSP. (Stout Sur., Ex. 11, pp. 5-6).

Finally, district specific pricing will result in more rate activity for the Company than STP. Although each district may see fewer but larger increases under district specific pricing, the total number of rate cases will increase dramatically. As plant is added to the various districts or as expenses increase, revenues will be inadequate to provide a fair return and a rate case will be required for each district. Under STP, the impact of the plant addition on the return for the entire Company will be much less and will be able to be absorbed for a period of time until the total expenditures throughout the state warrants a rate proceeding for the total Company. (Stout Sur., Ex. 11, p. 6)

d. Lawfulness of STP

Several opponents of STP have suggested or intimated that rates based on STP run afoul of the mandates of Section 393.130 RSMo (1994) which requires "just and reasonable" rates (Subsection 1) and prohibits any "undue or unreasonable preference or advantage" (Subsection 3). However, a thorough analysis of Missouri case law clearly reveals that this Commission does have the authority to average costs and adopt system-wide, "uniform rates."

In *State ex rel. Laundry, Inc. v. Public Service Commission*, 34 S.W.2d 37 (Mo. banc. 1931), the Missouri Supreme Court discussed the concepts of undue discrimination and undue preference. The following excerpts from the Court's decision reveal that the concept of single tariff pricing is certainly appropriate.

> . . . laws designed to enforce equality of service and charges and prevent unjust discrimination, such as the Missouri act, *require the same charge for doing a like and contemporaneous service (e.g., supplying water)* under the same or substantially similar circumstances or conditions.

Id. at 44.

* * * * *

> The common law today forbids all discrimination between two applicants who ask the same service . . . Thus the principle of equality designed to be enforced by legislation and judicial decision forbids any difference in charge which is not based upon differences of service. . . .

Id. at 44.

* * * * *

> . . . that principle of equality does forbid any difference in charge which is not based upon difference in service, and, even when based upon difference of service, must have some reasonable relation to the amount of difference, and cannot be so great as to produce an unjust discrimination.

Id. at 45.

As indicated by MAWC witness Stout, there is a sameness or equivalence of the service rendered to a residence in one district as compared to the service rendered to a residence in another district. Residential customers are relatively consistent in their uses of water: cooking, bathing, cleaning and other sanitary purposes; and, lawn sprinkling. If customers use water for the same purposes, the service offering is the same and should be priced accordingly. (Stout Dir., Ex. 9, p. 16). Where services provided to customers are identical as a matter of principle, they should be priced the same.

More express support for single tariff pricing can be found in later cases reviewing Commission rate decisions. In 1958, the Supreme Court of Missouri was asked to review a Commission decision authorizing a telephone company to file tariffs allowing it to add to its basic

rates in each community it serves the pro rata amount of the occupational tax levied in said community. A telephone industry case is extremely relevant to this question as its statute regarding charges, section 392.200, RSMo (1999 Supp.), contains the same key language as the statute regarding water service, section 393.130, RSMo (1994), that is, "just and reasonable," "undue or unreasonable preference or advantage," and "undue or unreasonable prejudice or disadvantage."

In *State ex rel. City of West Plains, Missouri v. Public Service Commission*, 310 S.W.2d 925 (Mo. banc. 1958), the Court discussed the "theory of ratemaking" as follows:

> It is true that the theory of ratemaking on a system wide basis assumes that inequities of a sort will exist within the system and that a rough balance of such inequities will usually result, so that the discrimination remaining is not unjust discrimination. For example, as noted, the evidence in this case indicates that certain of Western's exchanges made money and others did not, and that the ones that made money may have carried the ones that did not, and that the increase in the rates was made without regard to whether a particular class of service had theretofore more than paid its way. Consequently, it is undoubtedly true that, compared to a rate for each exchange based upon the exact cost of and the amount of services rendered at each of Western's exchanges or a rate based upon the exact cost of and the amount of services furnished in each of Western's local service areas (even though each such area might encompass more than one exchange), Western's system wide rates would not as nearly reflect the exact costs involved in rendering service at a particular exchange as would an exchange or local service area rate. Thus, to some indefinite and variable extent (depending upon the circumstances and the locations of the service units of the particular utility) inequities in system wide rates exist and a subscriber at exchange A may pay proportionately more for the service he receives than a subscriber in exchange B. (emphasis added)

Id. at 930.

After a review of the law and the facts, the Court then concluded as follows:

> ...we may amplify our views insofar as concerns system wide ratemaking. We are able to discern no legitimate reason or basis for the view that a utility must operate exclusively either under a system wide rate structure or a local unit rate structure, or the view that an expense item under a system wide rate structure must of necessity be spread over the entire system regardless of the nature of the item involved. (emphasis added).

Id. at 933.

The *West Plains* case clearly establishes the broad discretion of the Commission to establish rates either on a "system wide basis" or on a "district specific basis." Although that case involved the establishment of rates for a telephone company, the requirement for just and reasonable rates, and the prohibition against undue or unreasonable preference or advantage, is similar in the Commission's enabling legislation. (See §392.200.1 and .3, RSMo (1999 Supp.)).[5]

The issue of the Commission's ability to average costs and develop uniform rates were again addressed and reaffirmed in 1978 by the Missouri Court of Appeals (St. Louis Division) in *State ex rel. Cape Girardeau, Missouri vs. Public Service Commission*, 567 S.W.2d 450 (Mo. App. E.D. 1978). In that case, the City of Cape Girardeau appealed a Commission decision establishing electric rates for the Missouri Utilities Company's Southeast Missouri Division and argued that the Commission, in establishing system-wide rates, failed to take into consideration that the cost of providing electricity within the city limits is lower than it is to provide service in the rest of the division. The City's witness contended that "the city, with approximately four times as many customers as any other division community, [was] in fact subsidizing the company's operations in the division's more diffused areas . . . ." *Id.* at 452.

Thus, Cape Girardeau contended that the only relevant factor in determining a fair utility rate is the cost of service to the user. 567 S.W.2d at 452. The Court squarely addressed the lawfulness of the Commission's decision as follows:

> However, what the City has seemingly chosen to ignore throughout these proceedings is that Section 393.130(3) forbids discrimination against persons as well as locations. The Commission's order and report make it clear that it was aware of this dual obligation and in this case chose to emphasize equity to the individual user by maintaining a rate system designed on the basis of costs to a class of customer

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

than to area. For this reason we view the issue as a question of reasonableness, and will treat it with more detail infra. We cannot hold as a matter of law that the City was entitled to the relief it sought merely by showing a lower cost of service to the City area as a whole. (emphasis added).

Id. at 453.

These cases clearly establish that (1) the Commission has broad discretion in the establishing of just and reasonable rates and, more specifically, and (2) the Commission possesses the legal authority to establish system-wide or uniform rates for a utility serving more than one geographic area.

5. THE CAPITAL ADDITION SURCHARGE

a. Introduction

In the event that the merits of STP, as set forth above, do not persuade the Commission to retain STP for MAWC, then MAWC has proposed a modified form of STP for the Commission's consideration. This proposal, known as the "capital addition surcharge," was developed to respond to the objection of parties to the impact that the St. Joseph Treatment Plant has on the rates in other districts under STP. Although new plant in two other districts will also require assistance from other customers under STP, (i.e. Mexico and Platte County), it is the St. Joseph Treatment Plant that appears to be the focus of the other parties' debate. Thus, the Company has developed two surcharge proposals that mitigate the impact of the St. Joseph Treatment Plant on the rates in the other districts while preserving many of the benefits of STP. MAWC developed the alternative rate proposals by limiting the impact that the St. Joseph Treatment Plant has on the rates of other districts and determining a surcharge to be applied to bills in the St. Joseph district in order to recover the remaining revenue requirements. This remains a STP proposal as the customer charges and consumption rates will remain the same for all districts. The only difference will be the application

of the surcharge to the total bills of the St. Joseph customers.

b. The calculation of the surcharge.

In order to develop the surcharge, it is first necessary to calculate the capital related revenue requirements of the St. Joseph Treatment Plant. Next, the capital related revenue requirement of the St. Joseph Treatment Plant is compared to the total present revenues of the Company. Finally, a determination must be made as to how much of the capital related revenue requirements will be absorbed by the total body of ratepayers. In this case, the Company has proposed two limits, i.e. 15% and 20% of present revenues. An example of the way in which the surcharge would work is contained in the rebuttal testimony of Company witness Stout. First, Mr. Stout calculated a capital related revenue requirement of $10,718,400.00 associated with the St. Joseph Treatment Plant. This represents approximately 35% of total Company revenues under present rates. With a 15% limit on the plant's impact, the proposed STP revenues (incorporating a portion of the St. Joseph Treatment Plant as well as the additional revenue requirements of the other districts) represent an increase of approximately 28% for all other districts. Under this 15% limitation, the St. Joseph surcharge would be 48.356% resulting in an overall increase in St. Joseph revenues of 89.63%. With a 20% limitation on the plant's impact, the increase to the other districts is approximately 33%, the St. Joseph surcharge is 34.882% and the overall increase in St. Joseph revenues is 79.35% (Stout Reb., Ex. 10, pp. 18 -19).

The advantage of the surcharge proposed is that it addresses the concerns of those who believe that the impact of the St. Joseph Treatment Plant on the total company revenues is inordinate and not likely to occur in other districts. However, to the extent other districts experience capital additions which have an impact on total company revenues that exceed the 15% or 20% limitation, then those districts would also be susceptible to a capital addition surcharge. Thus, the surcharge can

be objectively and uniformly applied and there is no discrimination. The capital addition surcharge also allows for the maintenance of unified rates for all of the districts and thus avoids the multitude of allocations, rate designs and rate filings that the district specific pricing proposals will foster. The capital addition surcharge proposal simply segregates a portion of the cost of the St. Joseph Treatment Plant to be recovered through the surcharge, but continues to treat all other costs in the traditional manner by allocating them to customer classes on a total company basis and designing rates applicable to all districts to recover such costs. (Stout Sur., Ex. 11, p. 11).

c. Legality of the Surcharge.

At the hearing, the Commission asked the parties to address the legality of a surcharge. (Tr. 301). In this case, it is significant to note that the capital addition surcharge, as proposed by the Company, is 1) developed in the context of a "full-blown" rate case where "all relevant factors" will be considered and 2) operates prospectively to recover part of the costs associated with the new St. Joseph Treatment Plant and related facilities. Accordingly, the proposed surcharge does not run afoul of the prohibition against single issue ratemaking or retroactive ratemaking which have been the main legal impediments to surcharges in the past.

Generally speaking, utilities may not implement a surcharge if it us developed without regard to all revenues, expenses and investments. In other words, the Courts have required the Commission to look at all relevant factors in order to determine the proper rates for utilities. *State ex rel. Missouri Water Company v. Public Service Commission*, 308 S.W.2d 708, 719 (Mo. 1957). Also, surcharges that allow a company to collect monies not collectible under the rate in place at the time the charges were incurred are also impermissible as they constitute retroactive ratemaking. *State ex rel. Utility Consumers Counsel of Missouri v. Public Service Commission*, 585 S.W.2d 41, 59 (Mo banc. 1979). In *UCCM*, the Commission authorized the utility company to use an automatic fuel adjustment

clause which contained a surcharge to recover past costs the electric utilities had incurred but were unable to recover under the prior fuel adjustment clause. In that case the Court found that the surcharge was illegal stating:

> "the utilities have no vested right to or legitimate expectation in monies collected in this manner. To permit them to keep these monies would be a windfall to them and would leave their customers without a remedy for recovery of this unlawfully collected surcharge." *Id.* at 59.

The Commission may look at past excess recovery or loss to help determine future rates. However, the monies from the rates may not be used to recover prior losses or refund past excesses. *Id.* at 58. As noted, in the instant case, the proposed surcharge will operate prospectively to recover current and future costs associated with the St. Joseph Treatment Plant and related facilities. Moreover, this surcharge has been developed in the context of a full-blown rate case where all relevant factors have been considered so that it does not constitute single issues ratemaking. Given the nature of the capital addition surcharge and the manner in which it would be implemented (i.e. in the context of a rate case) it is clear that it passes legal muster.

B. THE ALLOCATION OF CORPORATE DISTRICT EXPENSE. WHAT IS THE PROPER ALLOCATION OF MAWC'S CORPORATE DISTRICT INVESTMENT AND EXPENSE?

Both MAWC and Staff prepared cost allocation studies, the purpose of which was to allocate the common corporate costs of the Company to each of its operating districts. Adding the allocation of common corporate costs to the known district specific costs, results in a reasonable identification of the cost to serve a particular district. Although it is somewhat difficult to compare the results of the Company's and Staff's cost allocation studies, given the significant difference in revenue requirements and rate base used by the two parties, the basis for Company's and Staff's allocations

are very similar. In fact, it is the Company's expectation that the use of Staff's allocation factors with a comparable revenue requirement and rate base would produce results very close to those that the Company developed.

Nevertheless, there is one conceptional difference between the two cost studies which remains at issue and that is the manner in which utility plant in service and related depreciation of the corporate district is allocated to the various operating districts. Staff has allocated the utility plant and service and related depreciation of the corporate district based on the sum of the assigned district and allocated corporate labor.[6] However, since the plant being allocated is used by those persons whose labor is included in the corporate district, the Company believes it is more appropriate to use only the allocated corporate labor as the basis for allocating corporate district plant items. (Stout Reb., p. 2).

C. THE ALLOCATION OF COSTS AMONG CLASSES. BY WHAT METHOD SHALL COSTS BE ALLOCATED TO MAWC'S VARIOUS CUSTOMER RATE CLASSES?

1. INTRODUCTION.

If the Commission adopts STP in this case, then it is MAWC's position that the allocation of costs to customer classes is most appropriately accomplished through the use of Base-Extra Capacity Method as described in the 1991 (and prior) Water Rate Manuals published by the American Water Works Association (AWWA). This is a recognized and widely accepted method for allocating the cost to providing water service to customer classifications in proportion to each classifications use of the commodity, facilities and services. The Company's cost allocation study

[6]Since Public Counsel has accepted Staff's allocation of costs between districts then, presumably, this issue exists between the Company and Public Counsel as well. (Tr. 661-662).

used this method in its allocation to customer classes on a system-wide basis, consistent with its STP proposal. If the Commission decides to adopt district specific pricing in this case, then it is MAWC's position that Staff witness Hubbs' allocation of district specific costs to the various customer classes is based upon appropriate methods and factors and results in indication of costs by class that are reasonable. Mr. Hubbs also utilizes the Base-Extra Capacity Method in allocating cost to the various customer classifications within the districts. However, given the fact that any movement from single tariff pricing to district specific pricing will result in dramatic shifts in revenue requirements between districts, further shifts between customer classes within districts would not seem to be warranted at this time and Company would recommend, if the Commission adopts district specific pricing, that rates within districts simply be increased by the uniform percent necessary to achieve the revenues allocated to each district.

2. Public Counsel's Class Cost of Service Study.

Under no circumstances should the Commission adopt the class cost of service study proposed by Public Counsel in this proceeding. Public Counsel readily admits that it has not used the traditional Base-Extra Capacity Method in developing factors for its allocation to customer classes. Rather, Public Counsel's method reflects a "major modification" to the AWWA Base-Extra Capacity Method. (Hu Sur., Ex. 32, p. 3).

Public Counsel has attempted to introduce the concept of "economies of scale" into the basis for its allocation factors. This concept is not a part of the traditional Base-Extra Capacity Method as described in the AWWA manual and is not typical of water company cost of service studies. Public Counsel witness Hu readily concedes her method has not been accepted by any regulatory Commission anywhere. (Tr. 618, 671 & 673). It is simply not reasonable to incorporate Public Counsel's economies of scale concept in an allocation of cost to customer classes. Public Counsel's

premise is that extra capacity costs represent only the incremental cost of adding such capacity to the system. Public Counsel has, in fact, introduced marginal or incremental cost concepts into the allocation of embedded costs to customer classes, the results of which are used as the basis for designing rates that are also based on embedded costs. Since the Commission is using embedded cost, it is more appropriate to consider the extent to which facilities are used in meeting base and extra capacity requirements. If, instead of using embedded cost for rate setting, the Commission was to adopt marginal cost pricing in which the extra capacity requirements were priced at today's marginal cost of adding such capacity, Public Counsel's concept would at least be consistent. However, the AWWA manual uses the ratio of capacities, not the ratio of marginal costs to total costs, for allocating costs between the base and extra capacity functions. Public Counsel's concept is not described or suggested in any text that sets forth methods for allocation of costs for water, gas or electric utilities.

Public Counsel's proposal is also inconsistent in not extending its logic to the remainder of the pipes' cost. If extra capacity costs are to be determined based only the incremental cost of adding such capacity by using a larger size pipe (e.g. the additional cost to install an 8" main rather than a 6" main), then the base costs should also be determined using only the incremental costs of adding the average capacity. For example, the incremental cost of adding the average or base capacity is the cost to install a 6" main rather than a main of minimal size or a 0" main. The cost of a minimally sized main would largely represent the cost of mobilization, trenching, backfilling, and paving. However, these costs are a significant part of the cost of installing a 6" or 8" main and would significantly reduce the portion of the main allocated to the base cost function. The portion not allocated to the base or extra capacity functions, (i.e. the cost of the 0" main), would be considered a customer cost. This cost would be considered a customer cost because the cost was not incurred

to meet usage requirements, but was incurred simply to reach the customer. Such costs are proportional to the number of customers and allocable to classes based on the number of customers in each class. While the concept of minimal size or 0" main has been discussed in the allocation of costs for gas and electric utilities, it has not been applied to date in the water industry. Such an approach, as with Public Counsel's method, would not be consistent with the AWWA manual and would not represent a traditional functionalization of costs for a water system. (Stout Reb., Ex. 10, pp. 4-7).

Given the potential for dramatic shifts in revenue requirements among districts if the Commission elects to move toward district specific pricing, it is clearly not appropriate to adopt a class cost of service study such as that proposed by Public Counsel which would only exacerbate the shift in revenue requirements among classes within districts. Now is not the time to embark on an untested, untried and inconsistent class cost of service method.

D. 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?

1. INTRODUCTION.

Several parties have suggested that rates established as a result of this case will represent a significant increase to various districts and/or customer classes and that such rates should be "phased- in" over a period of years. Those parties proposing phase-ins have tended to focus on the percent of increase and not the absolute dollar increase in rates. In addition, none of the parties agree on what particular percent constitutes "rate shock" (the OPC proposes a 15% threshold or ceiling and the Municipal and Industrial Intervenors propose a 35% ceiling). All parties proposing a phase-in agree that any portion of the rate increase that is to be deferred to later years should earn a

carrying cost on those deferred revenues so that, in "present value" terms, the Company receives the full amount of the rate increase determined to be appropriate in this case. All parties also seem to agree that the Commission should take care in establishing a phase-in period so that it is not so long that carrying costs, when added to the deferred revenues, will create an unreasonable burden on the customers. (Tr. 1984-1985, 2042). Finally, Staff and Public Counsel recommend that if a phase-in is adopted that the Commission establish a set of rates which will automatically take effect on the operation of law date and each anniversary thereafter. (Rackers Dir., Ex. 52, pp. 12-13; Tr. 2047). Public Counsel has further proposed automatic rate reductions at the end of the phase-in in order to eliminate the carrying costs previously collected on the deferred amounts. (Trippensee Rebuttal Ex. 34, pp. 8-9).

The Company is constrained in its ability to book any revenues deferred as the result of a phase-in plan. 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 (Tr. 520) will result in a weakened financial position in the early years of the phase-in period. For example, Staff's five (5) year phase-in plan would result in equity returns that begin at approximately 3.7% in year 2000 and grow to approximately 13.5% in year 2004. Such a plan would immediately have a negative impact on reported revenues, earnings and cash flow. Reported equity returns as low as 3% are simply unacceptable and not fair to the Company's investors. Moreover, despite the parties best efforts to ensure that the Company will receive all of the deferred revenues under a rate phase-in plan, there is simply no guarantee that this will happen particularly when the Company is reporting equity returns of 13.5% in the final years of a phase-in plan. (Jenkins Reb., Ex. 4, pp. 5-6).

2. FAS 71 and 92 Prohibit MAWC from Recognizing Deferred Revenues on its Financial Statements.

MAWC is subject to the accounting requirements of Statement of Financial Accounting Standards Number 71 (FAS 71) - "Accounting for the effects of certain types of regulation." Accordingly, the effect of regulation must be recorded and reported in the financial statements of MAWC. (Hamilton Sur., Ex. 3, pp. 5-6). The effects of any regulatory order received by MAWC must be evaluated in terms of the related effect on its financial statements. These financial statements are used by the Commission, as well as by independent security holders of MAWC, and therefore, must accurately reflect the effects of regulation in accordance with FAS 71. (Hamilton Sur., Ex. 3, p. 6).

The Securities and Exchange Commission ("SEC") is responsible for the protection of investor interests through its administration and enforcement of federal security laws. Subsequent to the issuance of FAS 71, the SEC became concerned with the significant deferrals arising from phase-in plans as well as the fact that regulatory Commissions were disallowing costs of newly completed plants, yet the financial statements of those companies were not reflecting those write-offs. In concept, the SEC was (and remains today) concerned that if current costs could not be collected currently, deferring these costs to the future raises significant questions as to the ultimate collectability of these costs. As a result, the SEC requested that the Financial Accounting Standards Board (FASB), which is primarily responsible for the development of accounting principles in the United States, amend FAS to address these deficiencies. As a result of this request, the FASB issued FAS 92. The overall effect of FAS 92 was to 1) severely restrict the ability to record phase-in plans for plants for which substantial physical construction had been performed prior to January 1, 1988; and 2) eliminate phase-in accounting altogether for plants where substantial physical construction

had not been performed prior to January 1, 1988.

A phase-in plan is defined as any regulatory method that defers the rates intended to recover allowable costs of a newly completed plant beyond the period in which those costs would be charged to expense under generally acceptable accounting principles. In this case, a phase-in plan would defer a portion of the costs of the St. Joseph plant, proposed to be collected in this rate case, to a future period for collection. The accounting for phase-in plans described in FAS 92 is not available to MAWC, because such accounting was available only to plants which had substantial physical construction performed prior to January 1, 1988. Construction on the St. Joseph plant did not commence until well after January 1, 1988. Thus, if a phase-in plan were ordered, any difference between the costs allowed for recovery under a phase-in plan and the costs expensed under generally accepted accounting principles would be expensed for accounting and reporting purposes. In other words, MAWC would not be permitted to recognize for accounting and reporting purposes the deferral of costs ordered by the Commission for recovery in future periods. (Hamilton Sur., Ex. 3, pp. 8-9).

Public Counsel takes exception to the Company's interpretation of the requirements of FAS 71 and 92. In fact, Public Counsel takes the position that since FAS 92 was enacted with the electric utility industry in mind (i.e. as a result of the large rate base additions due to nuclear plants in the late '70's and early '80's) and does not specifically mention water utilities, it is not applicable to the water utility industry. (Trippensee Sur., Ex. 35, pp. 7-8). Public Counsel's opinion, however, ignores the fact that plain language of FAS 92, which applies to rate regulated enterprises, contains no exclusions. Moreover, it is significant to note that even the Staff accounting witness does not share Public Counsel's opinion on this matter. Staff acknowledges that to the extent a phase-in is tied to a rate increase due to plant additions, it would agree with the Company that FAS 92 precludes

recognition of the deferred revenues on the Company's financial statements. (Rackers Sur., Ex. 54, p. 4; Tr. 1986). Also, with all due regard to Public Counsel's accounting witness, he has never had to issue an opinion for a rate regulated enterprise and certify compliance with Financial Accounting Standards. (Tr. 2058-2059). MAWC's accounting witness, on the other hand, has and will have to render such an opinion if the Commission adopts a phase-in plan for this Company. It is the Company's accounting witness whose license is on the line and he has testified, under oath, that FAS 71 and 92 prohibits the Company from recording any deferred revenues on its financial statements. Accordingly, the Commission should disregard the opinion of Public Counsel on this issue.

3. Rate Shock.

All of the parties proposing phase-ins have done so in an effort to mitigate what they perceive to be the potential for rate shock as a result of the rate increase in this case. All of the parties focus on the percentage increases that districts and/or customer classes will experience and ignore the absolute dollar increase. It should be noted that with the Company's originally proposed revenue deficiency of $16.85 million dollars, its proposal to maintain single tariff pricing results in an average increase in revenues of approximately 54%. (Watkins Dir., Ex. 15, Sch. JMW-1, p. 1 of 6). It is only as a result of the other parties' proposals to move to (or toward) district specific pricing and implement changes due to class cost of service studies, that the percentage increases in customer classes become outrageously high (Tr. 2092-2093). For example, under the Staff proposal to move to district specific pricing coupled with changes in customer class responsibility pursuant to its class

cost of service study, certain customer classes will receive increases as follows:

Customer Class	District	% Increase
Residential	Brunswick	212.48%
Sales for Resale	Brunswick	478.39%
Industrial	Mexico	135.69%
Sales for Resale	Mexico	197.09%
Commercial	Parkville	71.58%
Sales for Resale	Parkville	173.98%
Private Fire	St. Charles	46.09%
Commercial	St. Joseph	79.43%
Industrial	St. Joseph	199.55%
Sales for Resale	St. Joseph	268.61%
Sales for Resale	Warrensburg	148.02%

(Hubbs Reb., Ex. 42, Sch. WRH 2.1). It is not possible to give examples of the ultimate increases by class as proposed by Public Counsel (which will also include significant shifts due to Public Counsel's class cost of service study) because, for whatever reason, Public Counsel has not provided that information.

If, by way of comparison, Staff were to propose an across the board increase in rates (i.e. single tariff pricing) based on its revenue deficiency of approximately $10,700,000.00, it would result in an increase in rates for all customer classes of approximately 33%. (Tr. 1980). Similarly, if Public Counsel were to propose an across the board increase in existing rates based on its revenue deficiency in this case of $6,000,000.00, there would be an overall increase in rates for all customer classes of approximately 20%. (Tr. 2034). As can be seen from this comparison, a lot of the "rate shock" cited by Staff and Public Counsel is of their own creation based on the rate design proposals that they have put forward.

Also, none of the parties have focused on the absolute dollar increase that may come about as a result of the decision in this case. While the Company does not seek to minimize the substantial nature of a 54% increase associated with its proposal, it nevertheless believes that percentages

should be put into context with the associated dollar increase. For example, the average residential monthly bill using STP rates will increase from a range of $13.70 to $22.56, averaging $18.84, under present rates to a range of $18.94 to $33.61, averaging $27.68, under proposed rates. The monthly bill increase for the system-wide, average use residential customer of $8.84 (i.e. $27.68 - $18.84) represents 29¢ per day, less than the price of a cup of coffee, a can of soda or a lottery ticket. Such an increase is affordable given the far greater value of this commodity. While many people will readily pay 99¢ for a 2-liter bottle of soda, 99¢ will buy a customer nearly 1,000 liters of water. Similarly, the cost of the shampoo for washing one's hair is far greater than the water required to work with it. The cost of seeding and fertilizing a lawn is far greater than the cost of the water required to nourish it. Also, consider the amount most customers pay per month for cable service. The average monthly cable bill in 1999 was $28.92, somewhat greater than the proposed monthly bill to MAWC's average residential customer.

Despite what is admittedly a substantial percent increase, water remains a bargain. MAWC's proposed STP rates compare favorably to many utilities in the same geographic region. Company witness Stout presented a table summarizing the monthly bill for use of 7,500 gallons of water at 15 utilities in Missouri, Kansas, Iowa and Illinois. Several of these utilities bill are as much as $35.00 to $40.00 for such use. MAWC's proposed STP rates result in a monthly bill of $30.49 for 7,500 gallons, a usage level somewhat greater than the average user on the MAWC system. Although MAWC's bills will be above average, as would be expected for a utility with this amount of newly constructed facilities, many of the utilities presented in the table to Mr. Stout's testimony are charging rates that are in the $25.00 per month range for this level of use which is only $5.00 per month less than that proposed by MAWC. (Stout Reb., Ex. 10, pp. 16-17, Table 3-D, Table 3-E).

4. The Problem with Phase-Ins.

In addition to the fact that the Company's financial statements will be adversely impacted by a phase-in plan, there are other problems associated with a phase-in. For example, all parties recognize that any amounts deferred as a result of a phase-in plan must receive a carrying cost in order to ensure that the Company receives in present dollars, the full value of its rate increase over the phase-in period. All parties seem to recognize that at some point the length of a phase-in period becomes counterproductive in that the carrying costs become more than the actual revenues to be deferred and create a substantial burden that may outstrip the revenues to be deferred. Despite Public Counsel's and Staff's belief that the Company will receive all of the revenues due under a phase-in plan, Public Counsel and Staff readily concede that decisions of this Commission cannot necessarily bind future Commissions. (Tr. 1994-1995; 2053). Similarly, neither Public Counsel's nor Staff's phase-in proposal would preclude them (or any other party) from instituting an earnings investigation regarding the reasonableness of the Company's rates at any time during the phase-in period. (Tr. 1994; 2047; 2048).

Finally, both Public Counsel's and Staff's phase-in calculations fail to include one-half of the first year's net phase-in deferred balance. (Salser Reb., Ex. 7, p. 7; Salser Sur., Ex. 8, p. 2). In other words, Staff's and Public Counsel's phase-in calculations require MAWC to carry the deferred revenues for the first year and only begin earning a return beginning in year two of the phase-in. The rough equivalent of this is an individual who started making a deposit each month to a savings account beginning September 15, 2000, but did not begin earning interest on his/her first deposit until September 15, 2001 (one full year later). Both Public Counsel's and Staff's phase-in calculations ignore the "interest" or return that should be earned during year one of the phase-in proposal. (Salser Reb., Ex. 7, pp. 7-8; Salser Sur., Ex. 8, p. 2).

5. The Authority of the Commission to Order a Phase-In

There is no question that the Company is experiencing a revenue deficiency and therefore is entitled to a rate increase. The only question is how much. Public Counsel has calculated that, based upon existing circumstances, the Company is experiencing a revenue deficiency of approximately $6 million (Tr. 2032-2033). Staff has calculated revenue deficiency (after true-up) of approximately $10.4 million (based on Staff's mid-point recommended rate of return) (Ex. 109, revised). Accordingly, the Company is entitled to rate relief now. If this Commission authorizes a rate increase which in the first year is less than that which it has determined is the full amount necessary to allow it to earn a reasonable return on its investment, this would amount to a confiscation of property in violation of the federal and state constitutions. The only express authority which allows the Commission to authorize a rate increase which is less than the full amount of a utility's revenue deficiency is §393.155 RSMo (1994) which states in pertinent part as follows:

> If, after hearing, the commission determines that any electrical corporation should be allowed a total increase in revenue that is primarily due to an unusually large increase in the corporation's rate base, the commission, in its discretion, need not allow the full amount of such increase to take effect at one time, but may instead phase-in such increase over a reasonable number of years. Any such phase-in shall allow the electrical corporation to recover the revenue which would have been allowed in the absence of a phase-in and shall make a just and reasonable adjustment thereto to reflect the fact that recovery of a part of such revenue is deferred to future years. In order the implement the phase-in, the commission may, in its discretion, approve tariff schedules which will take effect from time to time after the phase-in is initially approved.

As the Commission is well aware, it is a creature of statute and possesses only those powers and duties specified in its enabling legislation "and also all powers necessary or proper to enable it to carry out fully and effectually all the purposes of (the) chapter." Section 386.040 RSMo (1994); see also *State ex rel. Kansas City Transit Inc. v. Public Service Commission*, 406 S.W.2d 5 (Mo.

banc 1966). The Commission does not have the power to extend the meaning of a statute beyond what is implied within the statutory interpretation. Section 393.155.1, RSMo (1994) applies to *electrical* corporations only and does not refer to any other type of utility. Courts have said that when a statute mentions something specifically, it in turn implies the exclusion of something else. *Harrison v. MFA Mutual Insurance Corporation*, 607 S.W.2d 137, 146 (Mo. banc 1980); see also *Bridges v. Van Enterprises*, 992 S.W.2d 322, 325 (Mo. App. SD. 1999) (Citing *Brown v. Morris*, 290 S.W.2d 160 (Mo Banc 1956)). Because Section 393.155 RSMo (1994) explicitly mentions electric utilities, it would therefore imply the exclusion of all other utilities. *Greenbrier Hills Country Club v. Director of Revenue* held that when a "statute enumerates the subject or things on which it is to operate, or the persons affected, or forbids certain things, it is to be construed as excluding from its effect all those not expressly mentioned." 935 S.W.2d 36, 38 (Mo. banc 1996) (Citing *Giloti v. Hamm-Singer Corp.*, 396 S.W.2d 711, 713 (Mo 1965)).

Since Section 393.155.1 RSMo (1994) does not mention water, gas or sewer utilities, it would not apply to these other utilities and they should necessarily be excluded from the meaning of the statute. Accordingly, it does not appear that the Commission has the specific authority (as it does in the case of electric utilities) to require a phase-in of rates due to an unusually large increase in a water company's rate base.

6. Conclusion.

Because MAWC is precluded from recognizing any deferred revenue associated with a rate phase-in plan on its financial statements, and the phase-in plans as proposed result in unacceptably low returns, the Company cannot agree to a phase-in plan. The impact on its earnings and financial statements is simply too great to ignore. If the Commission determines that it must do something to mitigate the rate increase to be authorized in this case, then the Company would recommend that the

Commission first mitigate impacts on customer classes by declining to adopt any of the shifts in customer class responsibility resulting from the class cost of service studies performed by Staff and Public Counsel. Similarly, the Commission can further mitigate the impact of any increase on districts by continuing to maintain single tariff pricing for MAWC. Finally, if the Commission believes, contrary to the argument above, that it has the legal authority to implement a phase-in plan, then at the very least it should keep the phase-in period as short as possible. In the recent United Water Missouri, Inc. rate case, a stepped increase was approved over an eleven month period of time with the first increase taking place on January 1, 2000 and the second, and final, increase to take effect on December 1, 2000. *In re United Water Missouri, Inc.* (Sept. 2, 1999) Commission Case No. WR-99-326. In the *United Water* case, both increases will occur within the same calendar and accounting year so the impact on the first year's revenues and earnings will be minimal. In addition, the Commission should make it clear that 1) the deferral of revenues associated with such a phase-in plan recognizes all of the carrying cost associated with the deferrals; 2) there will be automatic annual increases in rates in accordance with the tariff filing proposal of Staff; and 3) that although the return on equity for the Company in the final years of the phase-in plan may be higher than that authorized by the Commission it is nevertheless acceptable because of the low equity returns experienced in the first years of the phase-in plan.

IV. RETURN ON EQUITY. WHAT RETURN ON EQUITY IS APPROPRIATE FOR MAWC?

A. INTRODUCTION

MAWC's staff and OPC have agreed to the following capital structure and embedded cost rates for long term debt and preferred stock:

Capital Component	Percentage Of Capital	Embedded Cost
Common Stock Equity	42.27%	----
Preferred Stock	1.69%	9.09%
Long-Term Debt	56.05%	6.77%
Short-Term Debt	0.00%	0.00%
	100.00%	

(McKiddy True-Up Dir., Sch. 5).

Thus, the only issue that remains among the parties is the appropriate return on equity to be authorized as a result of this case.

It is MAWC's position that an appropriate cost of common equity which reflects MAWC's unique characteristics is 11.654%. This recommendation was developed by MAWC witness Harold Walker, after a thorough analysis of a comparable group of publicly traded water companies and applying three widely accepted models, i.e. the Discounted Cash Flow (DCF) model, the Capital Asset Pricing Model (CAPM), and the Risk Premium (RP) model.

Staff recommends a return on equity in the range of 9.5% to 10.75% and Public Counsel recommends a return on equity of 9.92%. Neither of these recommended returns, in Company's opinion, are adequate to provide MAWC with an adequate rate of return given its unique risk characteristics.

B. THE COMPANY'S POSITION

Because MAWC's common stock is not actively traded, MAWC witness Walker utilized a comparable group of water companies with actively traded stock to determine a market-required cost rate of common equity capital. Since there are no perfectly comparable companies to MAWC, it is reasonable to determine the market-required cost rate for a comparable group of water companies and adjust, to the extent necessary, for the investment risk differences between MAWC and the comparable group. Mr. Walker used the Value Line Water Group, based upon the criteria to include

all water utilities who were covered by Value Line Investment survey. (Walker Dir., Ex. 12, pp. 7-8).

Before beginning his analysis of an appropriate return on equity for his comparable group of water companies, Mr. Walker performed a comprehensive comparison of MAWC with his comparable group of water companies. For example, Mr. Walker examined the capital structure of MAWC and the comparable group of water companies and found that the Company's capital structure is more highly leveraged (i.e. has more debt to total capital) than the capital structure ratios currently employed by the comparable group of water companies. (Walker Dir., Ex. 12, pp. 9-10). Next, Mr. Walker examined the capital expenditures of MAWC and the comparable group of water companies and determined, that over the last five (5) years, MAWC's capital base has grown faster than the comparable group. The 1998 construction and capital intensity figures shown in Mr. Walker's direct testimony (Walker Dir., Ex. 12, Table 2, p. 13), demonstrate that MAWC's construction program, as a percentage of capital and/or revenue, is greater, or more "intense," than that of the comparable group of water companies. Capital intensity is an indicator of MAWC's greater risk. Comparing the coverage of fixed charges and various cash flow coverages between MAWC and the comparable group of water companies also show that MAWC's coverages are lower than those of the comparable group of companies. Taken together these comparisons clearly establish that MAWC is exposed to similar, but more, risk compared with the comparable group of water companies. (Walker Dir., Ex. 12, p. 14).

Company size is also an indicator of business risk and, in that regard, Mr. Walker's analysis reveals that MAWC is many times smaller than the comparable group of water companies. (Walker Dir., Ex. 12, Table 3, p. 15). The size of a company can be likened to ships on the ocean since a large ship has a much better chance of weathering a storm than a small ship. The loss of a large customer impacts a small company much more than a large company because a large customer of a small

company usually accounts for a larger percentage of the small company's sales. Moreover, a larger company has a more diverse geographic operation than a smaller company, which enables it to sustain earnings fluctuations caused by abnormal levels of rainfall in one portion of its service territory. A larger company operating in more than one regulatory jurisdiction enjoys "regulatory diversification" which makes it less susceptible to adverse regulatory developments in any single jurisdiction. Further, a larger company with a more diverse customer base is less susceptible to down turns associated with regional economic conditions than a small company. For example, the operations of American Water Works Company ("AWK") provide water service in 22 states to approximately 1,942,000 customers. The population of the communities served by AWK is more than 7,000,000 people. These wide ranging operations provide AWK shareholders substantial geographic, economic, regulatory, weather and customer diversification. MAWC on the other hand provides water service to a population of about 260,000 people and to 94,000 customers located in one state. (Walker Dir., Ex. 12, p. 16).

The National Association of Regulatory Utility Commissioners ("NARUC") recognizes that size affects relative business risks. Its discussion paper states as follows:

> ...Size affects the business risk of water companies because small companies generally have a narrow customer base and a limited geographic market. As a result, smaller companies have less diversity in their markets and may be more severely affected by economic or demographic changes in their service areas. Also because of their relative size, small companies cannot take advantage of certain economies of scale available to larger companies . . . Finally, small companies have less access to capital markets. This is due in part to their perceived riskiness and in part because the transaction costs associated with most financial instruments make raising small amounts of capital relatively expensive.

(Walker Dir., Ex. 12, p. 18).

The foregoing discussion reveals that MAWC experiences greater financial and business risk than the comparable group of water companies, as well as MAWC's parent AWK. This fact cannot

be ignored when one attempts to calculate the cost of equity for MAWC utilizing a comparable group of water companies, or its parent company.

In developing an appropriate return on equity, there is no single method (model) which is perfectly suitable. While one investor may rely solely upon one model in evaluating investment opportunities, other investors rely on different models. Most investors who use an equity valuation model rely on many models in evaluating their common equity investment alternatives. Therefore, the average price of an equity security reflects the results of the application of many equity models used by investors in determining their investment decisions. (Walker Dir., Ex. 12, p. 22). Accordingly, Mr. Walker did not rely on one model in developing his recommended return on equity. Instead, he used three methods including the Discounted Cash Flow or DCF model, the Capital Asset Pricing model or CAPM, and the Risk Premium or RP model.

In calculating an appropriate DCF return on equity for MAWC, Mr. Walker used an average dividend yield of 3.6% for his comparable group of water companies. After an extensive review of historical and projected growth rates, he derived an expected 6.8% growth rate for the comparable group of water companies. (Walker Dir., Ex. 12, pp. 24-29). Thus, his DCF cost rate for the comparable group of water companies is 10.5%. However, Mr. Walker cautions that less weight should be given the results of the DCF model due to the market's current market-to-book ratios and the impact that the market-to-book ratio has on the DCF results. The comparable group of water companies' current market-to-book ratios of 231% and low dividend yield are being affected by a short term acquisition frenzy and worldwide market sentient and not the DCF fundamentals. (Walker Dir., Ex. 12, p. 29). In short, the DCF only provides a reasonable estimate of the comparable group of water companies' common equity cost rate when their market price and book value are the same (i.e. M/B = 100%). A DCF will overstate a common equity cost rate when M/Bs are below 100%

and understate when M/B's are above 100%. Since the comparable group of water companies' current M/Bs are 231%, the DCF understates their common equity cost rate and should therefore be given less weight in any analysis. (Walker Dir., Ex. 12, p. 34).

Mr. Walker also utilized the Capital Asset Pricing Model to determine an appropriate return on equity for his comparable group of water companies. The CAPM is based on the assumption that investors hold diversified portfolios and that the market only recognizes or rewards nondiversifiable (or systematic) risk when determining the price of a security because a company-specific risk (or non-systematic) is removed through diversification. Further, investors are assumed to be risk averse and, therefore, they require additional or higher returns for assuming additional or higher risks. This assumption is captured by using a Beta that provides an incremental cost of additional risk above the base risk-free rate available to investors. The Beta of a particular security reflects the market risk or systematic risk of the security relative to the market. The Beta for the market is always equal to 1.00 and, therefore, a company whose stock has a Beta greater than 1.00 is considered riskier than the market and a company with a Beta less than 1.00 is considered less risky than the market. The base risk-free rate is assumed to be a U.S. Government Treasury Security because they are free of default risk. (Walker Dir., Ex. 12, pp. 34-35). Mr. Walker determined a risk-free rate of 6.0% based upon recent and forward looking long term treasury yields and an average Beta of 0.52 for the comparable group of water companies. Next, Mr. Walker determined an average projected market premium of 9.0%. Finally, Mr. Walker applied a CAPM size premium which is necessary because the Beta (systematic risk) does not capture or reflect the comparable group of water companies' small size. (Walker Dir., Ex. 12, pp. 36-37). The comparable group of water companies' CAPM, based on projected market returns, shows a 12.3% cost rate and the CAPM, based on historical market returns, shows an 11.3%, with an average of 11.8%. (Walker Dir., Ex. 12, p. 37).

Finally, Mr. Walker performed a Risk Premium analysis to develop an appropriate return on equity for his comparable group of water companies. A Risk Premium is the common equity investors' required premium over the long term debt cost rate for the same company, in recognition of the added risk to which the common stockholder is exposed versus long term debt holders. Long term debt holders have a stated contract concerning the receipt of dividend and principal repayment whereas common stock investors do not. Further, long term debt holders have first claim on assets in case of bankruptcy. A Risk Premium, therefore, recognizes the higher risk to which a common stock investor is exposed. The Risk Premium derived cost rate for common equity is the simplest form of deriving the cost rate for common equity because it is nothing more than a premium above the prospective level of long term corporate debt. (Walker Dir., Ex. 12, p. 38). To do this, Mr. Walker first determined the appropriate estimated future long term borrowing rate for the comparable group of water companies of 7.9% based upon a credit profile that supports an A bond rating. (Walker Dir., Ex. 12, p. 38). Mr. Walker then added to that a risk premium of 4.5% to arrive at a derived cost rate for common equity of 12.4% for his comparable group of companies. (Walker Dir., Ex. 12, p. 42).

Based upon the results of the three models employed, the comparable group of water companies' common equity cost rate is in the range of 10.5% to 12.4%. However, this is not an appropriate range of cost rates for MAWC because they must be adjusted to reflect the risk differences of MAWC versus the comparable group. As detailed earlier, based upon the analysis of financial and business risks, it is obvious that MAWC is exposed to greater investment risks than that of the comparable group of water companies. (Walker Dir., Ex. 12, pp. 42, 43). Accordingly, Mr. Walker recommends an adjustment to the common equity cost rate for the comparable group of water companies of 30 basis points in order to reflect the additional business and financial risks

to which MAWC is exposed. Adding the 0.3% risk adjustment to the various results of the three models employed shows a current range of common equity cost for MAWC of 10.8% (DCF) to 12.7% (RP), with the CAPM equity cost of 12.1% falling in-between. (Walker Dir., Ex. 12, p. 44). Mr. Walker's recommended "point" return on equity is 11.654%, which is very reasonable when compared to the average projected return on average book common equity for the comparable group of water companies for the period 2002 to 2004. This average projected return on average book common equity ranges from 11.8% to 12.2%. Therefore, an opportunity for MAWC to earn 11.654% on the portion of its rate base finance with common equity capital is conservative. (Walker Dir., Ex. 12, p. 45).

C. RETURNS ON EQUITY RECOMMENDED BY STAFF AND OPC ARE INADEQUATE.

Staff has recommended a return on equity in the range of 9.5% to 10.75%. OPC, on the other hand, recommends a return on equity of 9.92%. Both of these recommendations are insufficient because they fail a comparison test of alternative investment opportunities when compared to bond yields, forecasted returns on equity and authorized returns for other water utilities. In addition, both Staff and OPC recommendations have "financial prejudices" against MAWC. Finally, neither recommendation reflects the additional risks associated with rate phase-in plans and large rate base disallowances that have been proposed in this case.

Staff's recommended return on equity of 9.5% to 10.75% provides an inadequate spread over the prospective cost of A rated public utility debt. A rated public utility debt is yielding 8.42% as of the date of hearing. (Tr. 2211). Accordingly, Staff's recommendation provides only a 108 to 233 basis point premium over A rated public utility debt. Mr. Walker's analysis shows that the current premium of equity rates over A rated public utility debt is at least 450 basis points. (Walker Dir.,

Ex. 12, p. 24; Schedule 19, p. 1 of 4). Moreover, an update of Staff witness McKiddy's risk premium analysis for AWK, reflecting today's interest rate level, now supports an 11.0% to 11.2% cost for AWK. (Walker Reb., Ex. 13, p. 9). Finally, Value Line's projected returns on common equity for water utilities for the period 2002 to 2004 is 12%. (Walker Reb., Ex. 13, p. 3).

NAWC's 1998 Financial and Operating Data for Investor Owned Water Utilities shows that, on average, the 47 water utilities analyzed were authorized a return of 10.9% when A rated public utility bonds yielded 7.20%, or over 120 basis points lower than the current yield of 8.42%. Simply adjusting for bond yield changes (i.e. from 7.2% to 8.42%) results in an averaged authorized return of 12.08% for the 47 water utilities. Thus, a comparable opportunity return of 12.1% for similar risk enterprises demonstrates the insufficiency of Staff's recommendation of 9.5% to 10.75% for MAWC. (Walker Reb., Ex. 13, p. 3).

Staff's primary tool in determining the Company's return on equity was the DCF analysis which it applied to MAWC's parent company, American Water Works Company ("AWK"). Directly applying the DCF cost rate determined for AWK to MAWC, without reflecting any risk differences, results in "financial prejudices" to MAWC. As previously noted, MAWC is many times smaller than AWK. (Walker Sur., Ex. 14, Table 1, p. 2). AWK has a more diverse geographic operation than MAWC. AWK operates in more than one regulatory jurisdiction and thus, enjoys "regulatory diversification." AWK has a more diverse customer base and is less susceptible to downturns associated with regional economic conditions than MAWC. Finally, AWK's dividend payout ratio is only 52%, whereas MAWC's payout is 70 to 75% of earnings. (Walker Reb., Ex. 13, p. 5). All of these facts reveal that an investment in MAWC is more risky than an investment in AWK. Investors who invest in a risky asset expose themselves to investment risks peculiar to that investment. The greater the risk associated with the risky asset the higher the required return. This

is a basic tenet of corporate finance concerning risk and return. The investment risk of an asset does not change regardless of who owns the asset. Staff's recommendation results in financial prejudice to MAWC because it applies a calculated equity cost of AWK to MAWC without reflecting the measurable risk differences. (Walker Reb., Ex. 13, pp. 5-6).

Staff's recommendation also fails to account for the fact that A rated public utility money cost rates are about 74 basis points higher today than they have been since 1993, and that the current prime rate has not been this high since 1993. (Walker Reb., Ex. 13, p. 8). Consider also that in MAWC's last rate case (i.e. WR-97-237) Staff witness Broadwater recommended a common equity cost range of 10.10% to 11.10% at a time when A rated public utility bonds were yielding 60 basis points less than they are today. Clearly, Staff's recommended cost of common equity in the present case should be higher than it was in the last case, yet it is lower. This, by itself, brings into question the reasonableness of Staff's recommendation. (Walker Reb., Ex. 13, p. 17).

Public Counsel's recommended return on equity of 9.92% suffers many of the same inadequacies as Staff's recommended return. As noted previously, a 9.92% return on common equity provides an inadequate spread over A rated public utility debt capital. (Walker Reb., Ex. 13, p. 17). Public Counsel, like Staff, relied primarily on a DCF analysis of MAWC's parent, AWK. However, Public Counsel's DCF analysis, like Staff's, fails to take into account the additional business and financial risk attendant with an investment in MAWC versus an investment in AWK. Finally, it should be noted that in MAWC's last rate case (i.e. WR-97-237) OPC witness Burdette filed testimony and recommended a common equity cost rate range of 10.62% at a time when A rated public utility bonds were yielding 60 basis points less than they are today. This alone should demonstrate that OPC's recommended cost of common equity in the present case should be higher than it was in the last case, yet it is lower. As a result, this also brings into question the

reasonableness of OPC's recommendation in this case. (Walker Reb., Ex. 13, p. 22).

D. ADDITIONAL RISK ASSOCIATED WITH RATE PHASE-INS AND PLANT DISALLOWANCES - FINANCIAL INTEGRITY

1. INTRODUCTION

Something that was not contemplated at the time Company filed its direct testimony and made its recommendation regarding an appropriate return on equity was the proposed rate phase-in plans advanced by some parties and the proposal by some parties to disallow large portions of investment in the plant. These proposals, if accepted, will have a significant impact on the Company's financial performance and its ability to raise capital on reasonable terms.

2. PHASE-IN

As previously noted, if a rate phase-in plan is adopted, MAWC's financial results would be negatively affected for some period of time. Specifically, earnings each year would be reduced by the net tax amount of the revenue deferral. This would produce lower financial benchmark statistics and would increase MAWC's risk profile. A phase-in plan would prevent MAWC from earning its authorized return on equity in the early years of the phase-in. The lower than authorized returns on equity would jeopardize MAWC's ability to attract new common equity capital, to maintain its dividend and to maintain its credit. A phase-in plan would cause MAWC to under earn its allowed authorized return on equity in the early years of the deferral and cause it to over earn its authorized return on equity when higher revenues were permitted in the later years of the phase-in. However, there is no guarantee that future regulators will tolerate this apparent "over earnings" for the required time period. Therefore, investors are likely to significantly discount revenue deferrals, especially since they would not be capitalized from the financial statements and the uncertainty of their full recoverability over the entire phase-in period. (Walker Reb., Ex. 3, p. 23-24).

Given MAWC's current financial position, a phase-in plan will severely jeopardize its credit rating. Particularly troublesome is the fact that Staff, in developing its recommended return on equity, consciously ignored other adjustments which its Accounting and Rates Department were making in the case which would significantly and adversely affect the Company's ability to achieve its authorized return. (Tr. 2226-2227). At the very least, Staff's recommended return does not take into account the added risk associated with the rate phase-in plan. Moreover, Staff has made no determination whether its recommended return coupled with its recommended phase-in plan will provide the Company with adequate cash flow and interest coverages to allow it to attract capital upon reasonable terms. (Tr. 2228-2229).

3. PLANT DISALLOWANCE

Of more concern is the impact that Public Counsel's and the St. Joseph Industrial Water Users' proposed plant disallowances will have on the financial integrity of the Company. While MAWC does not mean to suggest that the Commission cannot (and should not) disallow imprudently incurred investments or expenses, parties making such recommendations should at the very least consider the affect those recommendations will have upon a utility's ability to continue to provide safe and reliable service. While it may be easy for Public Counsel and the St. Joseph Industrial Water Users to throw around accusations of imprudence and propose disallowances ranging from $30 to $40 million of plant investment, the Commission has the much more difficult task of weighing the validity of those accusations against the reality of financial disaster.

There is no question that a disallowance of the Company's investment in the St. Joseph treatment plant, such as that proposed by Public Counsel and the St. Joseph Industrial Water Users, will severely damage the financial integrity of the Company. No one disputes the fact that the Statement of Financial Accounting Standards No. 90 (FAS 90) requires an immediate write-off of

any portion of the cost related to the St. Joseph treatment plant not included in rate base. (Tr. 1989-1990; 2055; 2251-2253). A plant disallowance and write off of approximately $30 to $40 million dollars, coupled with a rate phase-in plan, will wipe out the current year's income and retained earnings and result in negative retained earnings for the Company. The impact of such a disallowance would drive MAWC's retained earnings balance negative, result in negative interest coverage ratios and increase debt leverage ratios to unacceptable levels beyond 65%. MAWC would be immediately prohibited from a) issuing any long term debt, and b) paying dividends on its capital stock. (Jenkins Reb., Ex. 4, p. 4). At the very least, neither Staff nor Public Counsel has addressed the effect a plant disallowance, such as those proposed, will have on investors' perceptions of the risk attendant with an investment in this Company in the future. Moreover, while both Staff and Public Counsel are supposed to be recommending a return that will allow the Company to finance on reasonable terms, neither party has demonstrated that their recommendations, coupled with a plant disallowance on the order of $30 to $40 million, will allow the Company to engage in any reasonable permanent financing, including the issuance of long term debt at reasonable terms. (Tr. 2232; 2280-2281).

From an investor's stand point, a rate base disallowance is a form of confiscation of capital unless the higher risk associated with the disallowance is included in the rate of return established by the Commission. In the late 1980's and early 1990's, some electric utilities experienced rate base disallowances. However, those disallowances occurred at the end of their construction cycle and therefore, the electric companies did not have to continually attract new capital. MAWC is not at the end of its construction cycle. It is necessary that the Company be allowed to have access to needed capital on reasonable terms and conditions in order to attract the required capital for its planned future capital expenditures. (Walker Reb., Ex. 13, p. 26). For example, the Company will

need to finance $64.790 million over the next four years, averaging about $16.198 annually. (Walker Dir., Ex. 13, pp. 10-11).

MAWC's ability to access capital is strictly based on its assets, earnings and cash flow, and not the resources of its parent, AWK. (Walker Reb., Ex. 13, p. 26). To date, AWK has advanced common equity funds solely at its discretion based, in part, on its expectation that MAWC will receive a full and fair return on its investment enabling it to support its traditional dividend policy. As the sole shareholder of a number of water utilities, AWK has the discretion to ration its common equity capital infusions to its subsidiary based upon a risk/return profile. If an operating water subsidiary's risk does not provide sufficient returns, common equity capital will not be provided. The disallowance of the plant from rate base further subverts MAWC's capital integrity because its common equity will be reduced by the net of tax disallowance. (Walker Reb., Ex. 28). In this case, Public Counsel's proposed plant disallowance of approximately $40 million is equal to about 50% of MAWC's common equity. (Walker Reb., Ex. 13, p. 25). As stated earlier, based upon the combined rate base disallowance recommendations of OPC and the rate of return recommendation of Staff, MAWC will experience negative retained earnings and will not be able to pay any dividends. Further, the increased debt leverage resulting from the write-off will preclude MAWC from issuing additional bonds under its indenture because pro forma debt issuance would result in more than 65% debt. In short, the only access to capital will be to extremely high cost, short term debt due to MAWC's poor credit quality. (Walker Sur., Ex. 14, p. 11)

Adopting the rate base disallowance recommendations of OPC and the Staff's return on equity results in interest coverage ratios of a -1.14 in 2000, 1.73 in 2001 and 2.13 in 2002. (Walker Sur., Ex. 14, Sch., HW-6.3, p. 2 of 2). More importantly, MAWC's debt to total capital ratio will be 70.4% in 2000, 69.3% in 2001 and 66.7% in 2002. (Walker Sur., Ex. 14, Sch. HW-6.3, p. 2 of 2).

These interest coverage ratios indicate that the Company would not be able to issue any long term debt under its indenture until year 2001. However, with the debt to total capital limitation of 65% in its indenture, the Company will not be able to issue any long term debt for at least 3 years because, even in 2002, its debt to total capital will be 66.7%, which is more than 65%.

While Public Counsel attempted to perform an interest coverage calculation showing that the Company would meet its indenture requirements in the first year after rates are set in this proceeding, that interest coverage calculation is of questionable validity. First, it was not performed until at or about the time surrebuttal testimony was filed in this case, when little time was left for discovery and no time was available for the Company to file written testimony in response thereto. (Tr. 2238). Secondly, Public Counsel witness Burdette was not willing to certify that his calculation of interest coverage comports with the requirements of the Company's indenture. (Tr. 2256). Third, it was not adequately explained how Public Counsel can calculate an interest coverage of 2.39 times based on a total revenue increase of $6,000,000 effective September 15, 2000, and, only several months earlier, calculate a 1.51 interest coverage ratio assuming a $12,700,000 increase in revenues effective August 1, 2000. However, the issue of interest coverages is of secondary concern because of the indenture requirements which limit debt to total capital of no more than 65%. The simple fact of the matter is that the financial ratios resulting from the proposed plant disallowances and recommended returns on equity (of either Staff or Public Counsel) place MAWC in a junk bond credit quality position of BB when compared to Standard and Poor's published benchmark ratios. Large plant disallowances will result in MAWC having a business position of "below average" thus requiring the most stringent benchmark ratios. MAWC will not be able to attract the required capital if it maintains financial ratios that result from the rate base disallowances and low returns recommended by OPC. In the future, it will be necessary for MAWC to achieve higher returns on equity, decrease

leverage and increase cash flow just to have access to capital markets. (Walker Sur., Ex. 14, pp. 18-19). Clearly the rate of return recommendations of both Staff and OPC are woefully inadequate when considered in light of the impact the proposed rate phase-in plans and plant disallowances will have on the investors' perceptions of risk for any future investment in this Company.

V. ACCOUNTING ISSUES

A. 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?

This Staff adjustment reflects the deferred income tax liability that was recorded on the books of Missouri Cities Water Company ("MCWC") at the time it was purchased by MAWC. (Gibbs Dir., Ex. 36, p. 16). The deferred income taxes represent cash contributed by the ratepayers to MCWC for the purpose of paying federal income taxes. (Gibbs Dir., Ex. 36, p. 17; Gibbs, Tr. 1951).

MAWC did not acquire these deferred taxes as a part of the MCWC acquisition. (Salser Reb., Ex. 7, p. 8). As a part of the agreement between the parties, the deferred taxes were kept by MCWC's parent, Avatar. (Gibbs, Tr. 1951). Avatar would have used the deferred taxes to pay deferred taxes due related to the gain on the assets. (Gibbs, Tr. 1952). Staff witness Gibbs has no reason to believe that these taxes were not paid. (*Id.*).

Because the liability for these taxes was not acquired by MAWC, they were "written off" by the Company when the purchase was recorded. (Gibbs Dir., Ex. 36, p. 16-17). It is the Staff's

position that while this was appropriate from a "financial reporting perspective,"[7] there should be different treatment in the regulatory arena. (*Id.* at 17).

MAWC's acquisition of MCWC was authorized by the Commission in Case No. WM-93-255. *In the matter of the application of Missouri-American Water Company for approval of its acquisition of the common stock of Missouri Cities Water Company*, 2 Mo. P.S.C.3d 305 (July 30, 1993). Thereafter, on August 31, 1993, MAWC acquired all of the outstanding common stock of MCWC. *In the Matter of Missouri-American Water Company's Tariff Revisions*, 4 Mo.P.S.C.3d 205, 214 (1995). The transaction was accounted for as a sale of assets for federal income tax purposes. (Gibbs, Tr. 1951). The accounting entries for this transaction would have been recorded shortly after the acquisition in 1987. (Gibbs, Tr. 1951).

This is the third rate case that MAWC has participated in since the recording of these entries. In his rebuttal testimony, MAWC witness Salser asserted that because so much time and so many cases have passed since the acquisition, the actions of the Commission have indicated that the deferred taxes are no longer at issue. (Salser Reb., Ex. 7, p. 8). In response, Staff witness Gibbs stated that had this issue been litigated and a decision handed down by the Commission, Mr. Salser's argument might be justified. (Gibbs Sur., Ex. 37, p. 3). However, Mr. Gibbs went on to state that "[t]he Commission has not made a decision concerning the Company on this issue because it has not been litigated before them." (*Id.*) This was based on Mr. Gibbs' belief that the issue of deferred taxes related to the MAWC acquisition of MCWC had not been raised by the Staff previously. (Gibbs, Tr. 1953).

This specific issue, however, had been raised by both the Staff and the OPC in Commission

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[7] It is also consistent with the Internal Revenue Code and a letter ruling issued by the Internal Revenue Service. (Salser Reb., Ex. 7, p. 9).

Cases Nos. WR-95-205 and SR-95-206 (the "1995 rate case"). *In the Matter of Missouri-American Water Company's Tariff Revisions*, 4 Mo. P.S.C. 3d 205 (1995). In the 1995 rate case, MAWC had asked to recover its acquisition adjustment related to the MCWC acquisition. In support of this proposal, MAWC presented evidence of actual cost savings and of savings increases over time. 4 Mo.P.S.C.3d at 215. In the rebuttal testimony of Staff witness Roy M. Bolt, Jr., Staff criticized MAWC's evidence stating that the Company's analysis did not take into account the revenue requirement associated with the impact of the acquisition on deferred taxes. (Gibbs, Tr. 1955). Mr. Boltz explained this impact with the following question and answer:

> Q. What is the impact of this acquisition on the area of deferred income taxes?
>
> A. Since this transaction is considered a "sale of assets" by Missouri Cities Water Company (MCWC) as the seller to MAWC, the buyer, the deferred taxes funded by MCWC ratepayers that have accumulated throughout the life of the Missouri property will be lost to MAWC. This deferred tax reserve is normally used as an offset to rate base in setting rates and because of the sale, the rate base associated with MCWC property will be higher due to the loss of this deduction. The end result is that Missouri customers will lose rate recognition of the "flow-back" of deferred taxes as a result of the acquisition.

(Gibbs, Tr. 1955-1956).

The OPC also highlighted the loss of the deferred income taxes in the 1995 rate case. OPC witness Ted Robertson criticized the Company's savings projections in his 1995 rate case rebuttal testimony because of the impact on the deferred income taxes. He explained this as follows:

> Additionally, since the transaction is considered a "sale of assets" for federal income tax purposes, the deferred taxes that have accumulated throughout the life of the Missouri property will be lost. Therefore, the rate base and related return on rate base associated with the Missouri property will be higher after the sale than it was immediately prior to the sale.

(Gibbs, Tr. 1957).

The Commission made a finding concerning the impact of the MCWC deferred taxes in

declining to allow MAWC recovery of the associated acquisition adjustment. The Commission first noted Staff witness Boltz' testimony on this issue. 4 Mo.P.S.C.3d at 216. It then made the following finding:

> The Commission finds in this case that the Company has failed to justify an allowance for the acquisition adjustment. The Commission finds that as argued by OPC, the ratepayers will already suffer one negative effect from the sale of MCWC stock. Because the transaction is considered a "sale of assets" for federal tax purposes, the deferred taxes that have accumulated throughout the life of the property will be lost.

4 Mo.P.S.C.3d at 217; Gibbs, Tr. 1958-1959.

As Staff witness Gibbs admitted during this hearing, it is clear from both the testimony in the 1995 rate case and the Commission's Report and Order in that case that the Commission understood the impact of the MCWC deferred taxes on MAWC's rate base. (Gibbs, Tr. 1959). In fact, the Commission made a finding to that effect and cited this impact as a significant reason to deny recovery of the acquisition adjustment proposed by MAWC. (Gibbs, Tr. 1959).

The finality of the Commission's earlier treatment of this issue should be honored by the Commission. MAWC's rate base should not be adjusted to reflect the amount of deferred taxes existing on the books of MCWC prior to its acquisition by MAWC.

B. PREMATURE RETIREMENT. SHOULD 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?

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

The Commission has previously described depreciation accounting as follows:

> Depreciation accounting is a system of accounting which generally aims to distribute costs or other basic values of tangible capital assets less salvage, over the estimated useful life of the unit or group of assets in a systematic manner. It is a process of allocation, not of valuation. Depreciation is an attempt to match capital recovery with capital consumption. The emphasis is upon a systematic and rational allocation of the expense of capital consumption. The accounting does not purport to follow the actual rate of consumption of property during individual accounting periods. It is an equitable and sound accounting method to spread the depreciation expense to equal annual charges over the useful life of the property, but the actual rate of consumption may be different.

Re: Depreciation, 25 Mo.P.S.C.(N.S.) 331.

> Any attempt to allocate such costs over a period of time requires an analysis of expected future events such as useful life, salvage value, and cost of removal. To the extent such analyses prove incorrect, depreciation rates will fail to match capital recovery with capital consumption resulting in depreciation reserve deficiency.

In the Matter of St. Louis County Water Company's tariff revisions designed to increase rates, 4 Mo.P.S.C.3d 94, 102-103 (1995).

OPC witness Bolin has stated that "[a]s applied to utility plants, depreciation means the loss in service value not restored by current maintenance, incurred with the consumption or prospective

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

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

The question is what to do with this depreciation reserve deficiency. The Commission has taken different approaches in the past. In the *St. Louis County Water* case cited above, the Commission granted recovery of the depreciation reserve deficiency through a ten year amortization in order to avoid rate spikes that would otherwise occur. 4 Mo.P.S.C.3d at 102-104. The Staff proposed a similar approach in MAWC's last rate case. *In the Matter of Missouri-American Water Company's Tariff Designed to Increase Rates for Water Service*, Case No. WR-97-237 (1997). In that case, the Staff had prepared a depreciation study which reflected the then St. Joseph treatment plant being retired within the next three to four years. (Salser Sur., Ex. 8, p. 3). As an alternative, the Staff proposed to recover the projected depreciation reserve deficiency through a ten year amortization. (*Id.*). Otherwise, the old treatment plant would not have been fully depreciated until 2028. Case No. WR-97-237. At the urging of the OPC and other intervenors, the Commission chose to not address the deficiency in Case No. WR-97-237. We are now faced with the actual retirement.

Staff witness Mathis has recommended that instead of an amortization starting with this case, the Commission take the following steps:

1. Reduce the plant account and depreciation reserve account by the original cost of the "old" St. Joseph plant in order to preserve the estimated unrecovered investment until a depreciation study is performed;

2. Reduce the depreciation reserve account by the amount of the cost to remove when those costs are actually incurred;

3. Initiate a depreciation study.

(Mathis Dir., Ex. 44, p. 4). Staff has proposed this approach so that the accuracy of the majority of the reserve and depreciation rates for the major accounts of MAWC can be evaluated before an amortization is initiated for a single account. (*Id.*).

MAWC has adopted a position consistent with the Staff's recommendation. MAWC has suggested that the accounting treatment proposed by the Staff be followed (in order to preserve the issue for future decision) and a depreciation study be completed with MAWC's next rate case. (Salser Reb., Ex. 7, p. 10; Salser Sur., Ex. 8, p. 4).[8] This approach will allow the retirement issue to be addressed in a comprehensive manner in conjunction with other depreciation issues.

C. AFUDC CAPITALIZATION RATE. SHOULD MAWC'S RATE BASE BE ADJUSTED TO REFLECT A DIFFERENT CAPITALIZATION RATE FOR AFUDC?

Allowance for funds used during construction ("AFUDC") is the carrying cost that a utility is allowed to capitalize as a part of the cost of a construction project. (Rackers Dir., Ex. 52, p. 13).

[8] The agreement to perform a depreciation study with MAWC's next rate case is contained in the Joint Recommendation as to Rates for Sewer Service, Depreciation Study, Provision of Billing Information, Conversion to Monthly Billing, and Pensions and OPEBS filed by the Staff, MAWC and OPC on July 3, 2000.

Absent Commission authority, the capitalization of AFUDC ceases upon completion of a construction project. (Rackers Reb., Ex. 53, p. 2). This issue concerns the pre-in-service AFUDC connected with the construction of the St. Joseph Treatment Plant and related facilities. The parties agree that this AFUDC should be capitalized. However, the question for Commission decision is what rate to utilize in this capitalization.

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

Utilizing the last authorized rate of return is the approach that the company has taken for approximately the last thirty years. (*Id.* at p. 5). This is also the approach that has been taken by the Commission in past MAWC rate cases. (*Id.* at p. 6). In this case, the Staff has recommended a new approach to the AFUDC rate. It recommends that the rate first reflect all of the outstanding short-term debt available to the Company. (Rackers Dir., Ex. 52, 14). Any construction in excess of outstanding short-term debt would be subject to a rate calculated based on the composite of other sources of financing available to the Company. (*Id.*).

Because this change is being recommended "after the fact," using the Staff's recommendation would result in a write-off of $1,257,930 in September 2000. (Salser Reb., Ex. 7, p. 6). This write-off would apply to AFUDC which was recorded as far back as November 14, 1997. (*Id.* at p. 7). It is inappropriate for the Commission to reach back this far and penalize MAWC for actions which were in accordance with past Commission practice. If the Commission determines that the calculation of the AFUDC rate should change, it should make this change on a going

forward basis only so that MAWC has this information available at the time the AFUDC entries are made. (*Id.*).

D. 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?

In conformity with the Uniform System of Accounts ("USOA") prescribed by this Commission, MAWC capitalized AFUDC during the period of construction of the St. Joseph Treatment Plant and related facilities. AFUDC, as stated above, represents construction carrying charges, or interest on the funds borrowed for the construction. This interest is capitalized during the "construction period." The "construction period" comes to a conclusion at the point the project is placed "in service."

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

MAWC attempted to address these effects through a request for an Accounting Authority Order ("AAO"). An AAO is an accounting mechanism recognized by the USOA and utilized in the past by the Commission to defer expenditures from one rate period for recovery in a later period. (Rackers Reb., Ex. 53, p. 3; Salser Reb., Ex. 7, p. 2). The practice of granting AAO's has been reviewed by the Court of Appeals and found to be appropriate in certain circumstances. *Missouri Gas Energy v. PSC*, 978 S.W.2d 434, 436 (Mo. Ct. App. 1998).

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

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

In response, MAWC filed its Motion for Reconsideration on February 10, 2000. After considering several additional pleadings, the Commission issued its Order Concerning Non-Unanimous Stipulation and Agreement, Denying Motion to Modify Procedural Schedule, Granting Reconsideration as to Accounting Order and Denying Motion to Compel on March 23, 2000. This order, among other things, stated as follows:

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

Thus, MAWC has previously been granted the ability to defer the subject items. The

question remaining for the Commission is whether these items should be recovered by the Company as a part of its cost of service.

MAWC is not asking the Commission to change the general approach to post-in-service AFUDC and depreciation as a matter of general policy. In fact, in this case MAWC has asked for this treatment only for the St. Joseph Treatment Plant and related facilities and not for its other capital projects. (Salser Reb., Ex. 7, p. 3-4). MAWC has limited its request to the St. Joseph Treatment Plant and related facilities because this project has a very serious financial impact and MAWC believes the circumstances warrant the proposed accounting treatment. (*Id.* at p. 4).

The discontinuance of the capitalization of AFUDC and the commencement of depreciation on the St. Joseph Treatment Plant and related facilities reduces MAWC's earnings approximately $319,000 each month the St. Joseph Treatment Plant and related facilities are in-service and not included in rates. (*Id.* at p. 4). Over the approximate four and one-half months between the expected in-service date and the operation of law date, this amounts to a loss to the Company of $1.6 million. (*Id.*). This is particularly significant as post-in-service AFUDC and deferred depreciation expenses net of taxes represent over twenty-four percent (24%) of MAWC's pro forma utility operating income at present rates. (*Id.*). Eliminating post-in-service AFUDC and deferred depreciation and using actual (May 1, 1999 through April 30, 2000) cash dollars and budgeted cash dollars (May 1, 2000 through April 30, 2000) results in interest coverage of 1.81 times for the twelve months ended April 30, 2000 through September 30, 2000. (Salser Sur., Ex. 8, p. 5).

Placing a utility in this financial condition by not placing post-in-service AFUDC and deferred depreciation in rates would be a huge disincentive for investment in water systems, as well as other utility systems in the State of Missouri. (*Id.*). The interest of MAWC's customers is served by the improvements to the utility systems from which they receive service and a utility's sound

financial base. (*Id.*). These interests will be served by an order which allows MAWC to continue to book the post-in-service AFUDC to the appropriate plant accounts and amortizes the amounts over twenty years and which allows deferral of the subject depreciation to Account 186 – Miscellaneous Deferred Debits and an amortization over the estimated service life of the St. Joseph Treatment Plant and related facilities.

VI. UNCONTESTED ISSUES

A. CAPITAL STRUCTURE

The Staff, OPC and MAWC have agreed to use the capital structure and embedded cost of preferred stock and long-term debt as of April 30, 2000. (Salser Sur., Ex. 8, p. 5-6). This capital structure is attached as Schedules 1-4 to Staff witness McKiddy's True-Up Direct Testimony. (McKiddy True-Up Dir., Ex. 110, p. 2). MAWC has taken the position that Ms. McKiddy accurately describes the capital structure of Missouri-American Water Company as of April 30, 2000. (Salser True-Up Reb., Ex. 107, p. 4).

B. JOINT RECOMMENDATION

On July 3, 2000, a Joint Recommendation as to Rates for Sewer Service, Depreciation Study, Provision of Billing Information, Conversion to Monthly Billing, and Pensions and OPEBS was jointly filed by the Staff, MAWC and OPC. This document identified several aspects of this case in which these parties joined to recommend a particular outcome. The following subjects were addressed:

Sewer Rates

Company and Staff[9] agreed to recommend that MAWC be authorized to file tariff sheets containing rate schedules for sewer service designed to produce an increase in overall Missouri jurisdictional gross annual sewer revenues of Two Thousand Three Hundred Sixty-Three Dollars ($2,363.00), exclusive of any applicable license, occupation, franchise, gross receipts taxes or other similar fees or taxes, upon the effective date of the order in this case. This rate increase is consistent with MAWC's original filing and testimony in this case. MAWC's evidence of the basis for this sewer rate increase was not contradicted nor opposed by any evidence to the contrary.

Change to Monthly Billing in the St. Joseph District

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

Depreciation Study

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

Billing Information

In consideration of the settlement of the weather normalization issue and the dollar amounts connected with weather normalization in this case, the Company and Staff agreed to accumulate more detailed histories of billing cycle information than had been provided historically.

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[9] OPC did not join in this recommendation, but did not oppose it.

Pension and Other Post-Retirement Employee Benefits

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

VII. TRUE-UP ISSUES

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

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

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

There is no dispute in this case that the SJTP is on-line and that property tax will have to be paid. Property taxes apply to utility property and are a normal cost of providing service. Further,

property tax is a common true-up item in rate cases as it is a known expense. In this case, the information regarding the property tax is known. The Buchanan County Assessor has sent correspondence indicating an increased assessment based on the SJTP. (*Id.* at p. 4). While there is an appeal pending and some unknowns, it does not change the fact that there will be a substantial amount of property tax paid by MAWC associated with the SJTP. Thus, it should be included in the cost of service.

MAWC does, however, understand the Staff's concerns. MAWC has no desire to create an over recovery relating to this item and is willing take steps to ensure that it will not. Accordingly, the alternative offered by the Staff – a refundable surcharge – is acceptable to MAWC. (Tr. 2130-2131). This approach would bring a match between both the timing and measurability of the property tax expense and thereby satisfy the interests of both the ratepayers and the Company.

Accordingly, MAWC requests that the Commission find that the true-up property taxes be included in rates and order that the refundable surcharge alternative offered by the Staff be used to collect such property taxes.

WHEREFORE, MAWC respectfully requests the Commission to issue its order granting such relief as is consistent with the foregoing.

Respectfully submitted,

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Certificate of Service

I hereby certify that a true and correct copy of the above and foregoing document was sent by U.S. Mail, postage prepaid, or hand-delivered on this 24th day of July, 2000, to the following:

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