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March 26, 2002

Mr. Dale H. Roberts
Secretary/Chief Regulatory Law Judge
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

FILED

MAR 26 2002

**Re: Missouri-American Water Company
Case No. WR-2000-281**

**Missouri Public
Service Commission**

Dear Mr. Roberts:

Enclosed for filing in the above-referenced case please find the original and eight copies of **Suggestions of the Office of the Public Counsel Regarding the Manner of Proceeding on Issues in This Case Which Were Remanded From the Courts**. Please "file" stamp the extra-enclosed copy and return it to this office.

Thank you for your attention to this matter.

Sincerely,

A handwritten signature in cursive script, appearing to read "M. Ruth O'Neill".

M. Ruth O'Neill
Assistant Public Counsel

MRO:jb

cc: Counsel of Record

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

FILED

MAR 26 2002

**Missouri Public
Service Commission**

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

**SUGGESTIONS OF THE OFFICE OF THE PUBLIC COUNSEL REGARDING
THE MANNER OF PROCEEDING ON ISSUES IN THIS CASE WHICH WERE
REMANDED FROM THE COURTS**

COMES NOW, the Office of the Public Counsel (Public Counsel), and respectfully submits the following suggestions regarding the issues remanded to the Missouri Public Service Commission.

Procedural History

The Missouri-American Water Company (Company) filed Case No. WR-2000-281 in order to request a general rate increase its Missouri service territories. At the time of this request, the Company had seven (7) service territories, located in St. Joseph, Parkville, Joplin, Warrensburg, Brunswick, Mexico and St. Charles, Missouri. These service areas are not interconnected. Many of the issues in this rate case centered around the Company's decision to abandon its existing river water treatment plant in St. Joseph, Missouri, and construct a grand new, state-of-the-art ground water treatment plant a few miles away, and the subsequent abandonment of the old plant, which was not fully depreciated. On August 31, 2000, the Missouri Public Service Commission entered its Report and Order in this case. Several parties to the rate case, including the Public

Counsel, filed petitions for review of various aspects of the Commission's decision in the Report and Order.

After significant litigation regarding the appropriate venue for the hearing of these petitions for review, all of the petitions were eventually consolidated into two proceedings before the Cole County Circuit Court. The Court issued decisions on May 25, and October 3, 2001, affirming in part and reversing and remanding in part a number of issues. Specifically, the Circuit Court reversed and remanded this case to the Commission on the following issues:

- (1) the Commission's disallowance of depreciation related to the prematurely retired (abandoned) St. Joseph water treatment plant.

- (2) the Commission's decision not to allow rates to be phased-in over a period of time to avoid "rate shock"

- (3) the level of rates set for the Joplin district and

- (4) the manner in which the Commission should treat larger and smaller distribution mains.

The Circuit Court affirmed the Commission's Order in other respects, including the Commission's prudence determination regarding the new St. Joseph treatment plant, which disallowed a small portion of the plants costs because they were not used or useful. Other than the remand regarding the level of rates set for Joplin, the Circuit Court did not rule that any rates set in the Report and Order were not just and reasonable.

Following dismissal of appeals in this matter by the Western District Court of Appeals, and the refusal of the Missouri Supreme Court to accept transfer of the appeals, the matter is back before the Commission.

On March 7, 2002, the Commission entered an Order directing:

“That each party or group of parties herein shall prepare and file, on or before 4:00 p.m. on [Tuesday], March 26, 2000, a pleading setting out its suggestions as to the course of action that the Commission should follow with respect to the remanded issues. Each such pleading shall be divided into sections corresponding to the issues in question and should indicate, with respect to each such issue, whether or not the existing record is sufficient to support the necessary findings of fact.”

These suggestions are intended to comply with that order.

Suggestions Regarding Remanded Issues

1. The Commission’s decision to disallow depreciation related to the Company’s prematurely retired (abandoned) river water treatment plant was correct and is supported by substantial evidence in the record. This decision was inextricably connected to the Commission’s decision on the prudence of the construction of the new groundwater plant, and should be re-affirmed, because the failure to do so will cause new, even higher rates be set for the St. Joseph service area, and those rates will not be just and reasonable. The Commission will be able to make sufficient findings of fact to support its original conclusion on this issue, and which recognize the connection between its decision on this issue and its decision regarding the prudence of the Company’s decision to build a new water plant and abandon the old plant.

The issue of how to treat the prematurely retired river water treatment plant in St. Joseph, Missouri, arose because the Company decided to build a new ground water treatment plant to replace the existing plant. The Commission discussed this decision in its original Report and Order in this case. The Commission based its decision to disallow the abandoned river water treatment plant from rates, on substantial competent evidence. The Commission’s order not only recognized and applied the “used and useful” and “matching” principles, the Commission obviously considered the impact of including the balance of the old, abandoned plant, which was not used or useful, in determining the appropriate rates in this case. The Commission made a deliberate choice to exclude this

abandoned plant from rate base, on the basis of both the used and useful and matching principles. If the Commission were to seriously consider altering its prior order to include the abandoned plant in rate base, it **must** re-open the prudence issue.

In its original decision on what plant to include and what plant to exclude from rate base, the Commission stated, in its Report and Order:

“MAWC was aware in late 1995, when the decision to build the new St. Joseph plant and related facilities was made, that extensive renovations and improvements were needed in St. Joseph. The nature of the existing plant site made some of these renovations and improvements difficult, or perhaps impossible. The regulatory and environmental outlook was such that the use of a riverine source, and the return of residuals to that source, would necessarily result in ever-increasing costs to the company. There were aesthetic problems with the river water that could not be readily resolved. Finally, the flood of 1993 demonstrated that the reliability of St. Joseph’s public water supply could not be assured in the case of a treatment plant located in the flood plain.

MAWC assessed four options, one being to renovate and improve the existing plant, and another, that ultimately selected, being the construction of a new plant above the flood plain, the development of a ground water source of supply, and a pipeline linking the two. The other options were a new surface water treatment plant above the flood plain and interconnection with the Kansas City system. *The preliminary numbers developed by MAWC suggested that the ground water source/new plant option was about as expensive as any of the other options, and perhaps less expensive than some of them.* This option would include all the benefits associated with a ground water supply source: consistent raw water characteristics; diminished public health concern with organisms and other toxins; easier control of aesthetic factors, among others. Likewise, this option would remove the threat posed by another flood.

On the basis of the record made in this case, the Commission finds and concludes that the management of MAWC did use due diligence to address all relevant factors and information known or available to it when it assessed the situation and reached the decision to build a new treatment plant and develop a new ground water source of supply in St. Joseph.” (Emphasis added.)

Once the Company made the decision to build this grand plant, the question of how to consider the abandoned river water plant remained. The Commission correctly concluded that "in the case of the old St. Joseph treatment plant, the accounting convention yielded an imperfect result and the plant was not yet fully depreciated at the moment of its retirement." The Commission further noted that "MAWC is permitted a reasonable return only on the value of its assets actually devoted to public service. From the moment of its retirement, a moment controlled by MAWC, the old plant was no longer used and useful in public service."

The Commission then correctly concluded that:

"It follows that the treatment proposed by Public Counsel is correct. Utility plant--service will be reduced by the original cost of the old St. Joseph plant, while the depreciation reserve will be reduced only by the amount of depreciation accumulated with respect to the plant. The difference, the plant's net original cost of \$2,832,906, will be written off. Likewise, any amount expended by MAWC to retire the old plant is also not recoverable in rates."

The Public Counsel introduced testimony regarding this issue, from which the Commission clearly could find adequate facts to support its decision. At the evidentiary hearing in this case, Public Counsel introduced into evidence (Tr. p. 2111) the direct (Exhibit 21) rebuttal (Exhibit 22) and surrebuttal (Exhibit 23) testimony of Kimberly Bolin.

In her direct testimony, Ms. Bolin noted that, as of spring 2000,

"the river source water treatment plant in St. Joseph will no longer be used and useful. It will be physically disconnected from the Company's distribution system. The Company is entitled to earn a fair return on prudent investments that are used and useful in rendering utility service. However, the ratepayers should not have to pay for plant that is no longer rendering utility service. In addition,

new customers should not be expected to pay for plant that served past customers, that may no longer be on the system." (Exh. 21, p. 5.)

In her rebuttal testimony, Ms. Bolin discusses the valid reasons for excluding the prematurely retired plant from rate base. Ms. Bolin testified to that the prematurely retired river treatment plant should not be included in rate base. "Plant that is no longer used and useful should not be placed in the rate base." (Ex. 22 at p. 1.) In support of this statement, Ms. Bolin referenced United Telephone Company of Missouri, Commission case No. TR-91-181. (Exh.22, p. 2).

Ms. Bolin testified that the "used and useful" principle is an appropriate criterion for determining whether customers should pay for the amortization of plant. She stated:

"The ratepayer should not required to pay a return on or a return of the cost of plant that is not being used in the provision of service to current ratepayers. The ratepayer is not receiving any benefit of service from this (retired) water treatment plant. In fact, the ratepayers are being served by another water treatment plant whose cost will be built into the cost of service. To require the ratepayers to pay for two water treatment plants when only one is needed to provide service violates the standard of used and useful in determining if an asset should be included in rate base." (Exh. 22, p3.)

Ms. Bolin defined rate base as representing " the investor-supplied plant and other investments required to supply utility service to customers." (ID.)

Ms. Bolin also testified regarding the matching principle, which she described as

"a regulatory concept, which for a specified period of time compares the level of revenue received from the sale of goods or services which the expenses incurred and investment (i.e. rate base) necessary in order to provide that level of goods or services. This concept is reflected in the revenue requirement formula (revenue require = expenses + return on rate base.)" (ID.)

She further testified that including the old river water plant in rate base would distort the matching of rate base, revenue, and expenses for the test period. (Exh. 22, p. 4.)

In her surrebuttal testimony, Ms. Bolin testified further regarding Public Counsel's opposition to the Company's proposal to treat the premature retirement like a normal plant retirement, that is, removing the original cost of the plant from both "plant in service" and "depreciation reserve." She testified that this proposal would result in increasing the company's rate base by \$2,832,906. Ms. Bolin testified that this proposal would allow the Company "to earn a return on plant that is no longer used and useful in rendering utility service." (Exh. 23, p. 2.) She recommended that the Company "remove the original cost of the plant from plant in service and remove only the recorded amount of depreciation from the accumulated depreciation reserve. The difference between the original cost of the plant and the recorded depreciation should be written off." (ID.)

Ms. Bolin further testified that allowing the Company to remove the entire original cost of the abandoned plant, as it had proposed, would "decrease the depreciation reserve by \$2,832,906 more than what the Company has recorded in the reserve for the retired river source treatment plant. By decreasing the depreciation reserve the Company will be increasing the net plant in service and the rate base." (Exh. 23, p. 4.) She explained how the Company's proposal would increase rate base, by testifying that the Company's proposal would increase the rate base by "decreasing the depreciation reserve." (ID.) "The accumulated depreciation reserve is subtracted from plant in service to arrive at net plant in service.... In mathematical terms, subtraction of a negative (the accumulated depreciation reserve), results in an addition (in this case to rate base.)" (Exh.

23, 4-5.) She testified that, as a result of such machinations, the Company's rates would be unjustly increased.

"By decreasing the accumulated depreciation reserve by the original cost of the river...plant the Company has added the undepreciated amount of the retired plant to rate base. Thus, the Company would be earning a return on plant that is no longer providing utility service to the ratepayers." (Exh. 23 p. 6).

Ms. Bolin's testimony, as well as the testimony of other witnesses in this case, provide ample testimony from which the Commission can make findings of fact to support the conclusion that the prematurely retired plant should have been excluded from rate base in this case.

The undepreciated river plant was not included in the cost comparisons for the various methods of addressing the problems the Company faced with its St. Joseph plant. However, the Commission was obliged to consider and did consider all relevant factors in determining what were the just and reasonable rates. In doing so, the Commission obviously considered the impact of including the balance of the old, abandoned plant, which was not used or useful, in determining the appropriate rates in this case. The Commission made a deliberate choice to exclude this abandoned plant from rate base, on the basis of both the used and useful and matching principles, as set forth in the Report and Order.

If the Commission seriously considers including the abandoned plant in rate base, it **must** re-open the prudence issue. To do otherwise will result in unjust and unreasonable rates.

2. The Commission's decision to reject a phase-in of rates was incorrect, and there is substantial evidence in the record on this issue, from which the Commission could make findings of fact and conclusions of law supporting a phase-in, in order to alleviate "rate shock".

The Commission received evidence from witnesses sponsored by the Commission Staff and Public Counsel on the issue of phase-in. Based on this evidence the Commission could have easily made findings of fact and conclusions of law on which to order a phase in of rates. On remand, Public Counsel believes it would be appropriate for the Commission to reconsider its decision regarding phase-in, especially if the Commission's Order following remand results in an increase in customer rates in one or more districts, above the levels ordered in the original report and order in this case.

Public Counsel's witness in regard to phase-in was Russell Trippensee. Mr. Trippensee testified at the evidentiary hearing about a number of issues. In addition, he filed direct (Exhibit 33); Rebuttal (Exhibit 34) and Surrebuttal (Exhibit 35) testimony which was admitted into evidence in this case. Although there was evidence against phase-in presented by Company witness Hamilton (Exh. 3), there are several reasons why this witness's conclusions are incorrect. First, the rates of regulated water utilities are set by the Commission, not by Financial Accounting Boards, and the Commission is not bound to follow Financial Accounting Standards when setting rates. Second, FAS 92 would not apply to the phase-ins which Public Counsel proposed in this case. (Exh. 35, pp. 5-7). Mr. Trippensee also testified that the concerns that led to the adoption of FAS 92 referred to developments in the electric industry and that these concerns are not applicable to the regulation of the water industry. (ID. p. 7.) He also testified that Financial Accounting Standard 71 allows the Company to change its accounting methods to allow the implementation of regulatory decisions. (ID., pp. 3-6). Mr. Trippensee explained that Public Counsel's recommendation to phase in rates meets the three requirements of FAS 71 with regard to accounting treatments ordered by regulatory

agencies when they diverge from otherwise generally accepted accounting principles. (ID, pp. 3-4.)

Public Counsel's evidence regarding phase-in was designed to address rate shock concerns caused by both the large revenue requirement increase and the shifts in revenue requirement responsibility between districts and customer classes with districts. Public Counsel witness Trippensee testified that a phase-in would address these rate shock and equity concerns. (Exh. 34, p.13.)

Mr. Trippensee testified that, by implementing the proposed phase-ins, the Commission could provide the Company with full recovery of its authorized revenue requirement along with the carrying costs incurred during the phase-in period. (Exh. 34, Schedules RWT-2 -RWT-4, RWT-6; Exh. 35, Schedule RWT-35, Revised.) The Commission Staff also recommended phase-ins in a somewhat similar manner. (Exh. 52, pp. 11-12; Exh. 53, p. 7; Exh. 54, pp. 3-4.)

The Commission has previously adopted phase-ins in regard to electric rate increases; the Commission has adopted rate phase-ins in other water cases, notable, United Water Missouri, Inc. Case NO. WR-99-326 (Report and Order, Sept. 2, 1999). The Commission practice of implementing phase-ins where rate shock would otherwise be great is consistent with the broad statutory discretion granted the Commission in setting just and reasonable rates. See, Office of the Public Counsel v. PSC, 938 S.W. 2d 393 (Mo. App. W.D. 1997). It is not the theory or methodology, but the impact of the rate order which counts. Id., at 344. The Commission has broad ratemaking authority pursuant to Chapters 386 and 393 RSMo., relating to water corporations, and has all of

the powers necessary and proper to enable it to fulfill its obligation to set just and reasonable rates.

The phase-in proposal made by the Commission's own Staff and Public Counsel was legally sound, and the Commission should take this opportunity on remand to make findings of fact and conclusions of law supporting a new order, phasing in rates.

3. The Commission's decision regarding the manner in which rates were set in the Joplin district is supported by substantial evidence, and is consistent with the Commission's decision to move toward district specific pricing, which was affirmed by the Circuit Court on review.

As the Commission acknowledged in the Report and Order in this case, "Perhaps the most difficult issue presented by this case is the issue of rate design." This issue was made more difficult by the need to set rates that are just and reasonable, and, as the Commission stated,

"One factor for consideration in determining just and reasonable rates is public perception. The testimony adduced at the Local Public Hearings held in this matter was strongly in favor of DSP. MAWC, therefore, must set its rates separately for each service area in order to recover the appropriate revenue requirement for each service area.... In moving toward DSP, however, the Commission will adhere to the principle that no district will receive a rate decrease."

A "just and reasonable" rate is one that is fair to the ratepayer and fair to the utility. It is one which covers the cost of service and a reasonable return on assets dedicated to public use, and no more. See State ex rel. Washington University, supra, 308 Mo. at 344-45, 272 S.W. at 973. "[I]t is not methodology or theory but the impact of the rate order which counts in determining whether rates are just, reasonable, lawful, and non-discriminating." State ex rel. Associated Natural Gas Co. v. Public Service Commission of Missouri, 706 S.W.2d 870, 879 (Mo. App., W.D. 1985).

Public Counsel presented evidence regarding rate design which moved the rates the Company charges its customers toward district-specific pricing. The decision to move toward district-specific pricing was affirmed by the Circuit Court. Within the rate design that moves in the court-approved direction of district-specific pricing were the Joplin rates.

Public Counsel submitted the direct testimony of James Busch in support of its proposal to move toward district-specific pricing. In his direct testimony (Exh. 27) Mr. Busch states that,

“Public Counsel is recommending that the Commission approve a rate design that moves away from [single tariff pricing] STP. Public Counsel’s rate design is a compromise between STP and [district specific pricing] DSP. Considering the magnitude of the investment in the St. Joseph district, Public Counsel feels that it is in the best interest of all ratepayers to avoid utilizing either district specific rates or system wide uniform rates in this particular case.” (Exh. 27 p.4.)

Mr. Busch provided evidence about the advantages of utilizing district specific pricing in setting rates for this Company because, while some areas of operation are centralized, most of the treatment, transmission and distribution of water on the Company’s systems is specific to a certain district. In addition, he provided testimony regarding the problems which would be incurred if the Commission ordered a jump to absolute district specific pricing in this case, including the expense of the new St. Joseph treatment plant and other recent plant improvements in some other districts. (Exh. 27 pp5-7.) He further testified that Public Counsel’s proposal would allow the commission to set rates which more closely reflected the cost of service by district, but which would “mitigate the rate shock that will result from the addition of the new plant in St. Joseph.”

In addition, Public Counsel witness Hong Hu testified that the results of her cost of service study supported a move toward district specific pricing. (Exh. 30 p. 10-11.)

As the Commission stated in its "Order of Clarification" issued September 12, 2001, "Joplin will contribute approximately \$880,000 toward the total water system increased revenue requirement.

In its clarification, the Commission correctly noted that

"this surplus will be used to ameliorate the rate increase impact on the other six districts. A portion of the surplus, approximately \$225,000, will be allocated as Staff suggests to the Brunswick district so that rates there will not exceed the highest rates established in any other of the company's districts. The remaining \$655,000, will be allocated among the other five water districts, St. Joseph, Warrensburg, Parkville, Mexico, and St. Charles, to ameliorate the increased revenue requirement in each of these districts. The allocation to each of these districts will be in proportion to the increase of the revenue requirement for each district over the amount of revenue previously generated by that district."

The Commission correctly noted that, based upon all relevant factors, the most just and most reasonable rates which would meet the Company's increased revenue requirement were those which moved toward district specific pricing. Had the Commission determined that it would impose single tariff pricing, Joplin's rates would have increased, and perhaps would have increased to a greater extent than is the case here. The Commission had before it adequate evidence from which to make findings of fact.

4. The Commission can make findings of fact and conclusions of law on which to base a decision regarding the treatment of various sizes of distribution mains based upon the evidence presented at the hearings in this case.

As noted above, the most difficult issues for the Commission in this case involved issues related to rate design. The parties' rate design proposals are based, in part, on the results of various class cost of service studies. Public Counsel witness Hong Hu presented Direct (Exh.30), Rebuttal (Exh. 31) and Surrebuttal (Exh. 32) testimony regarding the class cost of service study which she performed. Her class cost of service study revealed that "for most districts, and for all districts combined, most customer classes are paying significantly above or below the proportion of the total costs that are incurred to serve that class. The residential class in all districts is paying a disproportionately large share of the total company cost of service." (Exh. 30 p.10.)

Ms. Hu provided evidence for treating larger and smaller distribution mains differently. (Exh. 30 p. 5.)

Staff witness Hubbs (Exhs. 40, 41 and 42) also provided testimony concerning his class cost of service study, which the Commission relied on in making its findings in this case.

The Commission has sufficient evidence before it from which to make adequate findings of fact on this issue.

Conclusion

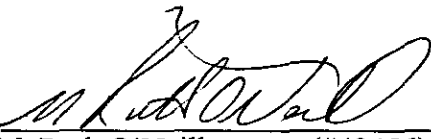
The Commission has sufficient evidence before it, in the transcripts and the pre-filed written testimony, to make findings of fact and conclusions of law on the issues remanded in this case. In particular, substantial evidence exists to support the Commission re-affirming its initial decision to exclude the Company's abandoned river water treatment plant in St. Joseph from rate base, and to support a conclusion that the

Commission's decision in this regard was a relevant factor in its determination of the prudence of the Company's decision to build the new groundwater plant, and in determining an overall revenue requirement which would result in just and reasonable rates.

WHEREFORE, it is respectfully recommended that the Commission utilize the existing record in order to make findings of fact and conclusions of law consistent with the forgoing information.

Respectfully submitted,

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I hereby certify that copies of the foregoing have been mailed or hand-delivered to the following this 26th day of March 2002:

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