

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

Exhibit No. 2
Case No(s). WO-2004-0116
Date 11-21-03 Rptr TUT

In the Matter of the Application of)
Missouri-American Water Company for)
Approval to Establish an Infrastructure)
System Replacement Charge (ISRS).)

Case No. WO-2004-0116

STAFF'S REPLY TO MISSOURI-AMERICAN'S RESPONSE

COMES NOW the Staff of the Missouri Public Service Commission and, for its Reply to Missouri-American's Response, states to the Missouri Public Service Commission as follows:

I. INTRODUCTION

On September 2, 2003, Missouri-American Water Company (MAWC) filed its Application seeking an infrastructure system replacement surcharge (ISRS) pursuant to §§ 393.1000 to 393.1006.¹ The Application seeks authorization from the Commission to impose a surcharge on customer bills to recover the costs of certain infrastructure replacements permitted by HB 208. Section 393.1006.2(2) provides that the Staff of the Commission may examine information of the water corporation to confirm that the underlying costs are in accordance with the provisions of HB 208, and to confirm proper calculation of the proposed charge. Staff may submit a report regarding its examination to the Commission not later than sixty (60) days after the petition is filed. No other revenue requirement or ratemaking issues shall be examined in consideration of the petition or associated proposed rate schedules. On October 31, 2003, the Staff filed its report regarding the examination of the Company's ISRS

¹ Senate Substitute for Senate Committee Substitute for House Bill No. 208 Ninety Second General Assembly. Hereafter referred to by Section number, or collectively as HB 208.

filing, which identified several issues. On November 10, 2003, the Company filed a response to the Staff's report accepting some of the Staff's issues but opposing the Staff's elimination of cost of removal and Staff's calculation of accumulated depreciation and property taxes.

A. Purpose of the Legislation

The purpose of HB 208 is to provide rate recovery of certain infrastructure costs earlier than would otherwise be provided by the Commission's accounting authority order process. HB 208 provides legislative sanction for a single issue rate case to provide appropriate revenues to reflect the growth in a Company's rate base caused by a water utility's eligible plant investment and related expenses since its last general rate case.

An Accounting Authority Order (AAO) allows a utility to defer unusual or extraordinary costs for future consideration, and possible recovery in a general rate case. The utility does this by recording them to a miscellaneous account. *State ex rel. Office of the Public Counsel v. Public Serv. Comm'n*, 858 S.W.2d 806, 808, 810 (Mo. App. 1993); See, *Missouri Gas Energy v. Public Serv. Comm'n*, 978 S.W.2d 434, 435 to 437 (Mo. App. 1998). The Commission has granted AAOs to utilities that incur costs for such extraordinary things as floods, ice storms, main or service line safety programs, and electric plant rehabilitation. AAOs typically permit utilities to defer, for possible later recovery, carrying costs for the new plant investment, depreciation expense for the new investment, and property taxes that were attributable to the new plant. Recovery of cost deferred pursuant to an AAO is considered in the utility's next-following rate case. In the context of the rate case, the Commission decides the appropriate amounts for recovery, as well as the timeframe or amortization period over which the costs would be recovered. Recording expenses pursuant to an AAO, however, is not a guarantee of recovery. See, *Missouri Gas Energy*, above.

B. HB 208 Provisions

HB 208 clearly establishes a new ratemaking procedure. Section 393.1003.1 provides in pertinent part "...a water corporation...may file a petition and proposed rate schedules with the Commission to establish or change ISRS rate schedules that will allow for the adjustment of the water corporation's rates and charges to provide for the recovery of costs for eligible infrastructure system replacements...." It is equally clear that the General Assembly intends a single-issue ratemaking. Section 393.1002.(2) provides in pertinent part "...no other revenue requirement or ratemaking issue shall be examined in consideration of the petition or associated proposed rate schedules filed pursuant to the provisions of §§ 393.1000 to 393.1006."

The single issue for consideration by the Commission is the utility's recovery of appropriate pretax revenues that consist of an appropriate return on the utility's net original cost of eligible infrastructure system replacement, § 393.1000(1)(a); the tax effects of this additional revenue, § 393.1000(1)(b); depreciation expense (return of eligible infrastructure system replacements), § 393.1000(1)(c) and § 393.1000(5); and certain property taxes on the eligible infrastructure system replacements that are due within one year of the filing, § 393.1000(5). It is these ratemaking issues, and only these ratemaking issues, that the Commission can consider in the ISRS ratemaking process.

While the Commission's determination of the "appropriate pretax revenues" requirement is a final agency action, the Commission's setting of the rates is not. ISRS rates are interim, subject to refund, at the end of each twelve-month calendar period that the rates are in effect, based on a reconciliation of collected revenues to the Commission's appropriate pretax revenues. § 393.1006.5(2). Thus, the ISRS process has an element of the Actual Cost Adjustment that the Commission uses for the recovery of gas costs by local distribution companies.

II. MAWC's RESPONSE

A. Accumulated Depreciation Reserve

In paragraph 5, at page 2, the Company's quotation only includes a portion of § 393.1000(1)(a). The following is the entire subsection:

As used in sections 393.1000 to 393.1006, the following terms mean:

(1) "Appropriate pretax revenues", the revenues necessary to produce net operating income equal to:

(a) The water corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements which are included in a currently effective ISRS.

This section clearly illustrates that inclusion of accumulated deferred income taxes and accumulated depreciation *associated with eligible infrastructure system replacements* deals with replacements, *which are included in a currently effective ISRS*. MAWC has no currently effective ISRS. Therefore, the words *associated with eligible infrastructure system replacements* quoted by the Company do not apply to this ISRS filing and have been misinterpreted by MAWC.

However, § 393.1000(1)(a) uses the words *net original cost of eligible infrastructure system replacement*. This term is not defined, but it does indicate that some amount is required to be netted against the eligible infrastructure system replacements. The Staff has interpreted this netting to be a ratable share of the change in the accumulated deferred income taxes and the accumulated depreciation since the last rate case. The Staff believes this interpretation is reasonable based on the purpose of the legislation as stated in § 393.1003.1:

[T]o establish or change ISRS rate schedules that will allow for the adjustment of the water corporation's rates and charges to provide for the recovery of costs for eligible infrastructure system replacements made in such county...

The change in accumulated deferred income taxes and accumulated depreciation provided a source of cash that was available to fund all construction projects, including eligible infrastructure system replacements. Therefore, netting a ratable portion of the change in deferred income taxes and accumulated depreciation recognizes this funding source for construction. The remaining amount of eligible infrastructure system replacements that requires additional investment is included in the ISRS to provide for the recovery of these costs. The Staff was not able to calculate a reasonable amount for the change in the deferred income taxes, since the last case specifically related to the St. Louis District, because it was part of the purchase by MAWC of St. Louis County Water Company. Therefore, the Staff calculated the amount of deferred income taxes to net against the eligible infrastructure system replacements. These same techniques were used to determine the amount of the accumulated deferred income taxes and accumulated depreciation to net against the facilities relocation projects.

In paragraph 6, at page 3, the Company lists what it believes to be three "errors" in the Staff's calculation. In item 6.A the Company points out that the actual depreciation rates for mains and hydrants range from 1.62% to 2.66% rather than Staff's implied rate of 21%. The Staff has not implied any depreciation rates and did not specifically calculate depreciation expense as part of its determination of MAWC's accumulated depreciation, nor do the statutes specify such a calculation. The Staff's determination of accumulated depreciation is discussed above. There is a component of accumulated depreciation, the reserve deficiency amortization, that is not dependant on rates. The reserve deficiency amortization provides approximately \$5 million per year that is available to finance all construction projects, including eligible

infrastructure system replacements. The Company's calculation gives no consideration to these funds. The Staff's calculation, on the other hand, recognizes a ratable share of these funds.

In paragraphs 6.B and 6.C the Company states that the Staff has inappropriately assigned to the ISRS calculation accumulated depreciation taken on other non-ISRS eligible investment made after the last rate case and accumulated depreciation taken on assets that were included in the rate base in last rate case. The Staff's approach and its appropriateness are discussed above.

In paragraph 7, at page 3, the Company states that the Staff has violated Missouri statute by not calculating only the impact of accumulated depreciation taken on ISRS eligible infrastructure. As previously stated, the Staff has calculated the appropriate net original cost of eligible infrastructure system replacements. The Company accuses the Staff of violating, and recommending Commission violation, of § 393.1006.2(2) by asserting that no other revenue requirement or ratemaking issue shall be examined in consideration of the petition or associated rate schedules filed pursuant to the provision of §§ 393.1000 to 393.1006. The Staff is not recommending that the Commission violate a statute by considering ratemaking issues. The Staff's calculation is not, and has not been, an issue in any prior rate case. The ISRS calculation, as proposed by either the Staff or MAWC is unique and is not used to calculate revenue requirement in general rate cases. The Staff has not recommended and would not recommend that the Commission violate Missouri statute by considering general rate case issues. To the contrary, the Staff's calculation, like the Company's, uses amounts that are the result of the Commission's findings in the last general rate case to address the issues in this ratemaking.

B. Other Issues

1. Treatment of Net Salvage

At page 5, in paragraph 8.B, the Company accuses the Staff of violating § 393.1006.4, which requires the use of current depreciation rates. The Staff has used the current depreciation rates in its calculation of depreciation expense as defined by §§ 393.1000(1)(c) and 393.1000(4). Neither of these sections or the section cited by the Company mentions cost of removal/net of salvage. Staff's point that the Company has been receiving cost of removal/net of salvage through its depreciation rates and accumulating these funds to pay for the cost when it is incurred, gives full recognition to the depreciation rates currently in effect. The Company appears to agree with the Staff's point of view at the bottom of page 5, where it states "the reduction in the depreciation reserve account for the cost of removal [/net of salvage] is made to reflect the fact that ratepayers have paid this cost of removal in depreciation rates and now the Company is paying out of the reserve account those amounts." If the ratepayer has previously paid and continues to pay cost of removal/net of salvage, why should the ratepayer have to pay these costs again by including them as an addition to the ISRS revenues? The Staff's calculation of accumulated depreciation recognizes both the payment of cost of removal/net of salvage by the ratepayers in depreciation rates and the Company's payment of cost of removal/net of salvage at the date of retirement.

2. Property Taxes

At page 6, in paragraph 8.C, the Company claims, "Once a liability for an expense item has been recognized then those items have become due." This statement is incorrect and inappropriate, especially with regard to property taxes. Liabilities are generally established in anticipation of possible future payments. Any amount that is booked as a liability is subject to

change before final payment is made. For example, an accounts payable liability may be established when an invoice is received. The invoice will likely display a "due date" when payment is required. However, the actual amount finally paid may be less as a result of invoice miscalculation or zero as a result of a return for damaged items. Simply establishing a liability does not mean that the amount will eventually become due and require payment.

The only property taxes due within one year of MAWC's September 2, 2003 filing are the taxes that are due before January 1, 2004 for property assessed as of January 1, 2003.

Property is assessed for taxation as of January first of each year. § 137.075. The assessor in first class counties, such as St. Louis County, must deliver the assessment rolls to the county clerk by May 15 of each year. § 137.375. The county commission must provide the clerk with the rates of levy not later than August 15 of each year. § 137.390. The county clerk extends the tax rates for the county and the various political subdivisions in the tax book, and delivers the tax book to the county collector not later than October 31 of each year. §§ 137.290, 137.392. Taxes not paid before January first next ensuing, are delinquent. §§ 139.100, 140.010, 140.730. Therefore, property taxes are not due until December 31 of each tax year, after which they become delinquent.

The only taxes due between September 2, 2003, and September 2, 2004, are the taxes for the year 2003. These taxes are assessed on MAWC's property as of January 1, 2003, and are due not later than December 31, 2003. The taxes for 2003, include no property put into service after January 1, 2003.

The taxes for 2004 will be assessed as of January 1, 2004, and will include property put into service during 2003. However, 2004 taxes will not be due until December 31, 2004, more than one year after MAWC's filing of this petition for an ISRS. Such property taxes are not

eligible for recovery pursuant to § 393.1006.4. When MAWC accrues the liability for property taxes has no bearing upon when those taxes are due.

3. The ISRS Rate Schedules

In paragraph 9, on pages 6 and 7, of its response, the Company responds to the Staff's comments regarding the application of the proposed ISRS rates. In its response, the Company notes that the proposed tariff states that "the appropriate tariff surcharge will be multiplied by the total water charges for a customers current billing cycle" and further clarifies that the phrase "total water charges" is intended to include both the applicable customer charge and the charges related to water usage (the commodity charge). The Staff appreciates this clarification.

As noted in the Staff's report, the Staff anticipated that the Company would propose a commodity-based surcharge. The Staff believes that the proposed percentage "add" can essentially accomplish the same result, but only if it is applied only to the commodity portion of the affected customers' bills. Additionally, the Staff believes that this method of recovery is more appropriate considering that the costs being recovered through the ISRS are not in any fashion related to customer charge related costs. As a result, the Staff believes the Commission should order the Company to calculate its surcharge rate to recover the allowable costs only through the commodity portion of the affected customers' bills, whether that is through a separate commodity charge or through a percentage "add."

Additionally, the Staff has now noted some minor language changes in the subject proposed tariff sheet that it believes are appropriate, but will address those directly with the Company in the hope of resolving those without the necessity of taking them before the Commission.

4. Rate Of Return

The Staff believes it is appropriate to bring the following item to the Commission's attention for consideration. Section 393.1006.4.(2) states: "In determining the appropriate pretax revenues, the commission shall consider only the water corporation's actual regulatory capital structure as determined during the most recent general rate proceeding of the water corporation." The Staff and the Company both used the actual regulatory capital structure as determined during the most recent general rate proceeding for St. Louis County Water Company since the ISRS only addresses the residents of St. Louis County. However, St. Louis County Water Company no longer exists. It was purchased by American Water Works and merged with MAWC. MAWC is the "water corporation" that filed this ISRS and the statutes appear to require the use of MAWC's actual regulatory capital structure as determined during the most recent general rate proceeding. In MAWC's most recent general rate case the Commission determined that the actual regulatory capital structure shown below was appropriate.

Capital Component	Percent	Cost	Weighted Cost
Equity	42.27%	10.00%	4.23%
Preferred Stock	1.69%	9.09%	0.15%
Long Term Debt	56.05%	6.77%	3.80%
Short Term Debt	0.00%	0.00%	0.00%
Total	100.00%		8.18%

WHEREFORE, having fully replied to Missouri-American's Response to Staff Report, the Staff recommends that the Commission issue an order in this case approving Missouri-American's application to establish an ISRS surcharge, and approving the Staff's determination that the proper amount of the surcharge is \$1,887,301 per year.

Respectfully submitted,

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or emailed to all counsel of record this 14th day of November, 2003.

/s/ Keith R. Krueger