

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

In the Matter of the Petition of)	
Missouri-American Water Company for)	
Approval to Establish an Infrastructure)	Case No. WO-2018-0059
System Replacement Surcharge (ISRS))	

**PUBLIC COUNSEL’S RESPONSE TO STAFF’S
RECOMMENDATION AND REQUEST FOR HEARING**

COMES NOW the Office of the Public Counsel (“OPC” or “Public Counsel”), and in response to Staff’s Recommendation regarding Missouri-American Water Company’s (“MAWC”) petition to establish an Infrastructure System Replacement Surcharge (“ISRS”) states:

Overview

1. In its petition, MAWC seeks to base its ISRS rates on a revenue level of \$8,127,145. The Staff’s recommendation makes certain adjustments before arriving at its rates designed to recover ISRS revenues of \$7,105,389. Public Counsel disputes three aspects of the Staff’s recommendation. First, the Commission should reject the Staff’s recommendation that incorrectly and unlawfully includes \$2,484,500 associated with MAWC’s defunct ISRS. Second, OPC recommends the Commission remove income taxes from the ISRS calculation because the company will pay no income taxes due to its Net Operating Losses (“NOLs”). Public Counsel’s adjustment results in a decrease to Staff’s revenue requirement of \$435,088. Third, Staff’s recommendation is in error because it includes costs associated with earnings-based and equity-based incentive compensation that are not recovered in general rates, and so, should not be included in the ISRS. The ISRS revenue requirement impact of this adjustment is a \$4,347 reduction. Applying these adjustments to Staff’s recommendation, the appropriate ISRS revenue requirement is \$4,181,454. The differences between the Staff’s recommendation and Public Counsel’s adjustments are detailed below:

	Staff Total	OPC	Difference
ISRS Plant Additions	\$48,094,172	\$48,094,172	\$0
CIAC	(\$869,167)	(\$869,167)	\$0
Accumulated Deferred Income Taxes	(\$9,125,799)	\$0	\$9,125,799
Depreciation Reserve	(\$616,623)	(\$616,623)	\$0
Incentive Comp-earnings	\$0	(\$51,290)	(\$51,290)
Incentive Comp-equity	\$0	(\$7,536)	(\$7,536)
Reserved	\$0	\$0	\$0
Total	\$37,482,583	\$46,549,557	\$9,066,974
ROR (Staff with and OPC without taxes)	10.35%	7.39%	
Return on ISRS Rate Base	3,879,447	3,440,012	(\$439,435)
Depreciation Expense	627,750	627,750	\$0
Property Taxes	113,692	113,692	\$0
Subtotal	4,620,889	4,181,454	(\$439,435)
Amount from Previous ISRS	2,484,500	0	(\$2,484,500)
Total ISRS Revenue Requirement	7,105,389	4,181,454	(2,923,935)

Adjustment 1	(\$2,484,500)	Exclude costs from previous ISRS
Adjustment 2	(\$435,088)	Remove ADIT and Income Tax Expense
Adjustment 3	(\$4,347)	Incentive Comp.
Total Staff/OPC Difference	(\$2,923,935)	

Improper to Include Past Reconciliation Amount

2. The Staff recommendation includes a “carry-over” or “reconciliation” amount of \$2,484,500 from MAWC’s prior ISRS. Within its recommendation Staff asserts that Commission Rule 4 CSR 240-3.650(17) “requires if an over or under recovery of ISRS revenues exists after the ISRS has been reset to zero, the amount of over or under recovery should be included in the water utility’s next ISRS filing” (Doc. No. 5, Staff Recommendation, Memorandum p. 5). The Staff’s analysis is incorrect for three reasons.

3. First, Staff fails to address the underlying legality of the accumulated balance. The Commission’s *Order Granting Motion to Dismiss* in Case No. WO-2017-0297 addressed the issue, stating:

[a]s the Court of Appeals found, the Commission finds that the county in which MAWC operates does not have more than one million inhabitants based upon the 2010 census, as required by the currently effective Section 393.1003.1. Therefore, **MAWC does not qualify for an ISRS** under the express terms of Section 393.1003, and its petition must be dismissed.

(Case No. WO-2017-0297, Doc. No. 15, p. 5). The Commission's decision granting OPC's motion to dismiss the company's ISRS petition in WO-2017-0297 recognized the company did not meet the statutory requirements prior to the effective date of H.C.S. H.B. 451. As such, the prior ISRS was also unauthorized. When the statutory authority for an ISRS ceased so did any authority that may have once existed to collect any over- or under-recovered balance. Staff's Recommendation fails to consider that no statutory authority existed for the prior ISRS and so there is no accumulated balance to be reconciled. Including this amount without specific statutory authority is prohibited retroactive and single-issue ratemaking.

4. Second, assuming *arguendo*, statutory authority existed for MAWC to recover the prior ISRS charge, this putative reconciliation amount must be excluded. As the Commission is aware, Public Counsel challenged the Company's ISRS in its previous rate case (WR-2015-0301). However, this issue was not litigated during the evidentiary hearing. As a part of a revenue requirement stipulation and agreement, the ISRS issue was resolved (Non-Unanimous Revenue Requirement Stipulation and Agreement, Case No. WR-2015-0301, Doc. No. 227, p. 2). The parties agreed to "resolve the ...issues as described in the List of Issues, List and Order of Witnesses, Order of Opening Statements, and Order of Cross-Examination, filed with the Commission on March 10, 2016" (*Id*). The issue presented the question: "[h]ow should the Commission address the Western District Court of Appeal's opinion in WD78792?" (List of

Issues, Case No. WR-2015-0301, Doc. No. 196, p. 14). The Commission is aware the Western District Court found in favor of Public Counsel that MAWC did not meet the statutory requirements for the ISRS.¹ From OPC's perspective, the stipulation resolved the issue by eliminating the company's ISRS, including all "reconciliation" amounts, but included the value of the infrastructure in-service in the company's rates consistent with traditional ratemaking standards. This stipulation and agreement was approved by the Commission on April 6, 2016 – effectively ending the company's then existing ISRS (*Order Approving Non-unanimous Stipulation and Agreement*, Case No. WR-2015-0301, Doc. No. 371). Since July 2016 MAWC has not had an ISRS. Including this amount in the present application is both a violation of the stipulation and agreement and collateral attack on the Commission's order approving the stipulation and agreement (*See* Section 386.550 RSMo).

5. Third, the Supreme Court order dismissing Public Counsel's prior appeal as moot supports the proposition that all ISRS issues were resolved. *Mo. Pub. Serv. Comm'n v. Office of the Pub. Counsel*, 516 S.W.3d 823 (Mo. 2017). The Supreme Court stated "[b]ecause the costs that formed the basis of the disputed surcharge have been incorporated into MAWC's base rate, the base rate supersedes the surcharge. The surcharge has been reset to zero, and superseded tariffs cannot be corrected retroactively." *Id.* Therefore, even assuming statutory authority existed for the prior ISRS charges, this reconciliation amount from MAWC's defunct ISRS was resolved by stipulation and agreement in the Company's prior rate case, and should have been excluded by the Staff during its audit. Moreover, this faux "reconciliation" amount should be excluded by the Commission in this case.

¹ As noted above, in its order granting OPC's motion to dismiss in WO-2017-0297 the Commission has now endorsed the Western District Court's reasoning.

Income Tax Adjustment

6. OPC's second adjustment is related to Staff's inclusion of accumulated deferred income taxes in MAWC's ISRS rate base. Section 393.1000(1) RSMo provides that appropriate pretax revenues are the revenues necessary to produce net operating income equal to 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 ("ADIT"). Therefore, an ISRS rate base is required to be reduced by the ADIT associated with the deferred income taxes related to book-tax timing differences associated with the ISRS plant investments. While OPC supports, in theory, Staff's inclusion of ADIT in its ISRS rate base, there are potential problems with reflecting ADIT in this ISRS case that cause OPC to recommend different treatment.

7. OPC, understands that MAWC may believe including ADIT in the ISRS rate base in this case would be inconsistent with the Internal Revenue Service's ("IRS") Normalization requirements as reflected in the federal tax code. As an initial matter, OPC has doubts whether the conclusion reached by MAWC about a potential Normalization violation is accurate. If there was not a better option to reflect MAWC's current income tax condition in this ISRS revenue requirement OPC would support Staff's position on ADIT. However, OPC believes there is a better option that does not have any risk related to an IRS Normalization violation and preemptively addresses any concerns that MAWC may raise.

8. MAWC has proposed that no ADIT be included as a reduction to its ISRS rate base because the company is in a net operating loss condition. This means that MAWC is not able to reduce taxable income through its accelerated tax depreciation because it has no taxable income to reduce. Any taxable income produced by MAWC both for ISRS and non-ISRS revenues will be offset by

NOL carry-forwards. As a result of not having any taxable income due to the use of NOLs, MAWC has no income tax expense related to the revenues generated by this ISRS.

9. Importantly, Section 393.1000 RSMo also provides that ISRS pretax revenues will be set to recover state, federal, and local income or excise taxes applicable to such income. Therefore, OPC believes that if MAWC's proposed treatment is followed, due to MAWC's NOL tax condition, MAWC's ratepayers do not get the benefit of the ADIT rate base reduction. MAWC's ratepayers should not pay in an ISRS for an income tax expense that MAWC will not incur as a result of this ISRS income. OPC's adjustment removes the ADIT included by Staff in MAWC's ISRS rate base, but also removes any income tax expense from the ISRS calculation. As indicated above, Public Counsel's adjustment results in a decrease to the Staff's revenue requirement of \$435,088.

Earnings-based and Equity-based Incentive Compensation Adjustments

10. Included in MAWC's proposed ISRS plant are dollars related to MAWC's income-based incentive compensation and equity-based incentive compensation. The Staff's recommendation does not make any adjustment to remove those items. Removing dollars related to income-based incentive compensation and equity-based incentive compensation would be consistent with the Commission's longstanding practice that these types of expense provide no ratepayer benefit and therefore should not be included in a utility's cost of service.

11. In its Report and Order in Case No. GR-96-285, a Missouri Gas Energy ("MGE") case, the Commission explained its policy that compensation not significantly driven by the interests of ratepayers should not be included in a utility's revenue requirement:

The Commission finds that the costs of MGE's incentive compensation program should not be included in MGE's revenue requirement because the incentive

compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers.

Approximately eight years later, the Commission reiterated and emphasized yet clarified its position on rate recovery of utility incentive compensation in its Report and Order in Case No. GR-2004-0209.

The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.

If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the cost of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.

12. In a 2006 Empire rate case, the Commission again restated its position on earnings-based incentive compensation. In its Report and Order Upon Reconsideration in Case No. ER-2006-0315, the Commission stated:

The Commission finds that the Staff reasonably applied objective criteria for the exclusion of certain incentive compensation. The Staff disallowed compensation related to charitable activities and activities related to the provision of services other than retail electric service...We conclude that incentive compensation for meeting earnings goals, charitable activities, activities unrelated to the provision of retail electric service, discretionary awards, and stock options should not be recoverable in rates.

The Commission has also applied and reiterated its position on earnings-based incentive compensation in its Report and Orders in Case Nos. ER-2006-0314 and ER-2007-0291 - both KCPL rate cases.

13. To ensure that the Commission's policy is applied in this ISRS case, the capital costs associated with \$51,290 of earnings-based incentive compensation and \$7,536 of equity-based incentive compensation should be removed. These are the dollar amounts attested to by MAWC in response to OPC data request 1001 that are included in the proposed ISRS additions in this case. The ISRS revenue requirement impact of this adjustment is a reduction of \$4,347. The revenue requirement impact associated with property taxes, depreciation expense and depreciation reserve from this adjustment is determined to be immaterial and has not been calculated as an additional adjustment.

Request for Hearing

14. In total, Staff's recommendation should be adjusted because (1) it unlawfully includes \$2,484,500 in the ISRS revenue requirement to account for "under-collected ISRS revenue" from a defunct ISRS, (2) does not appropriately treat income taxes, and (3) includes dollars related to MAWC's income-based incentive compensation and equity-based incentive compensation.

15. The Commission may hold a hearing on an ISRS petition and shall issue an order to become effective no later than one hundred twenty days after the petition is filed. Section 393.1006.2(3). Here, Public Counsel requests the Commission schedule a hearing to examine the deficiencies with the Staff's recommendation described herein.

WHEREFORE Public Counsel submits this *Response to Staff's Recommendation* and requests the Commission set this case for hearing.

Respectfully,

OFFICE OF THE PUBLIC COUNSEL

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to all counsel of record this 9th day of November 2017:

/s/ Tim Opitz

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

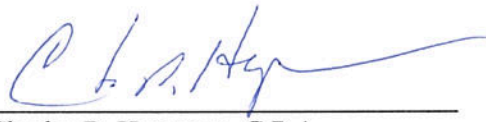
AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI)
) SS.

COUNTY OF COLE)

COMES NOW CHARLES R. HYNEMAN and on his oath declares that he is of sound mind and lawful age; that he has read the foregoing Public Counsel's Response to Staff's Recommendation; that he contributed to the statements and information set forth in the Response; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.




Charles R. Hyneman, C.P.A.
Chief Public Utility Accountant

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 9th day November, 2017.



JERENE A. BUCKMAN
My Commission Expires
August 23, 2021
Cole County
Commission #13754037



Jerene A. Buckman
Notary Public

My Commission expires August 23, 2021.