

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

In the Matter of Missouri-American Water Company)
Request for Authority to Implement a General Rate)
Increase for Water and Sewer Service Provided in)
Missouri Service Areas.)
Case No. WR-2017-0285

RESPONSE TO MOTION TO ESTABLISH FUTURE TEST YEAR

COMES NOW the Staff of the Missouri Public Service Commission (Staff), by and through counsel, and for its *Response to Motion to Establish Future Test Year*, hereby states the following:

1. On June 30, 2017, Missouri-American Water Company (MAWC or Company) filed its *Motion to Establish Future Test Year*.
2. On July 5, 2017, the Public Service Commission issued an *Order Directing Notice, Consolidating Cases, Establishing Deadlines, and Setting a Procedural Conference*. The Commission set a deadline of July 27, 2017, for all interested parties to respond to the Company's *Motion*.

The Motion

3. MAWC's *Motion* seeks an order from the Commission that grants the use of a future test year, ending May 31, 2019.¹
4. MAWC cites the recent Missouri Western District Appellate Court's decision in *Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase for Electric Service v. Missouri Public Service Commission*, 509 S.W.3d 757, 771-72 (Mo. App. W.D. 2016), *reh'g and/or transfer denied* (Nov. 1, 2016), *transfer denied* (Feb. 28, 2017)(*In re KCPL*), as authority that

¹ EFIS Item 18, *Motion to Establish Future Test Year*, p. 1.

answers the question in the affirmative as to whether the Commission can adopt a future test year.²

5. MAWC primarily argues, among other things, that a future test year is necessary because MAWC claims it is experiencing declining revenues, while MAWC anticipates an increase in capital investment and expenses in the near term.³

6. MAWC further makes the policy argument that adopting a future test year will prevent a scenario where declining revenues and increasing investment “undermin[e] the matching principle.”⁴

7. According to the *Motion*, MAWC’s proposed process for establishing a cost of service for a future test year starts with the evaluation of the actual expenses, revenues and rate base during a traditional twelve month test year ending December 31, 2016. The next step would be “consideration of changes to those cost elements through a verifiable link period (January 1, 2017 to May 31, 2018).” And finally, a forecast of the components used to establish rates during the first year that new rates are expected to be in place.⁵

Staff Response

Legal Authority

8. Staff disagrees that *In re KCPL* explicitly authorizes a future test year. In that case, Kansas City Power & Light Company (KCPL) requested that the Commission adopt its use of “specific estimated future costs in the calculation of KCPL’s revenue

² *Motion*, p. 2, ¶ 1.

³ *Id.*, p. 4, ¶ 6, 7.

⁴ *Id.*, p. 4, ¶ 8.

⁵ *Id.*, p. 5.

requirement.”⁶ The Commission denied the request, and the appellate court affirmed, stating that because the Commission’s analysis included consideration of possibilities that could affect KCPL’s estimated future costs, the Commission was justified in ultimately deciding not to include the projected costs.⁷ Notably, the appellate court observed that the Commission refused to include the forecasted costs in part because “KCPL failed to adequately explain how it arrived at its estimates and how the Commission has the legal authority to grant KCPL’s requested relief.”⁸ The Court did not make an affirmative statement that a future test year is authorized. Instead, the appellate court upheld the Commission’s determination *not to use* KCPL’s forecasted projections.

9. Further, the authority cited in *In re KCPL* also does not conclusively support a future test year.⁹ In *State ex rel. Missouri Public Service Company v. Fraas*, 627 S.W.2d 886 (Mo. 1981), Missouri Public Service Company, described in the opinion as a “gas and electric company,”¹⁰ sought, among other things, an “attrition” adjustment to pre-emptively build into rates revenue that would account for future inflation, which was prevalent throughout the late 1970s and early 1980s.¹¹

10. The Commission declined to authorize inclusion in rates for attrition. The *Fraas* Court agreed, making the following observation:

⁶ *In re KCPL*, 509 S.W.3d 757, 771 (Mo.App. W.D. 2016), *reh’g and/or transfer denied* (Nov. 1, 2016), *transfer denied* (Feb. 28, 2017).

⁷ *In re KCPL*, 509 S.W.3d 757, at 771-772.

⁸ *Id.*, at 771.

⁹ *State ex rel. Missouri Public Service Co. v. Fraas*, 627 S.W.2d 882, 886 (Mo. 1981).

¹⁰ *Id.*, at 882.

¹¹ *Id.*, at 885-886.

Even more and newer devices to meet the inflation problem have been suggested and used. One such new device now being urged is the use of a future or “projected test year” instead of an historical test year. . . . This particular approach would not be available in Missouri because of the adoption by popular vote of Initiative Proposition 1, now Section 393.135.¹²

11. The Missouri Supreme Court agreed, noting that, while “the Commission must make an intelligent forecast with respect to the future period for which it is setting the rate,”¹³ that it was already doing so through “a modified version of the projected year model by utilizing a test year which was adjusted to take into account known and measurable future changes.”¹⁴ The Court described the process that the Commission continues to apply today.

12. In ***State ex rel. SW. Bell Tel. Co. v. Pub. Serv. Comm'n of Missouri***, 645 S.W.2d 44, 53 (Mo. Ct. App. 1982) (***SWBT***), the appellate court reiterated that, while § 393.135 RSMo applied only to electric utilities, the *policy* of the historical test year and of limiting rate base to “used and useful” assets were reasonable for the Commission to apply. In that case, Southwestern Bell Telephone Company asked the Commission for inclusion of short term construction work in progress (CWIP) into rate base.¹⁵ The Commission declined, and the appellate court upheld the decision, stating that the Commission’s decision was consistent with the Commission’s previous CWIP treatment, allowing capitalization of interest expenses while the construction continued.

¹² ***Fraas***, 627 S.W.2d 882, at 887-888. (Mo. 1981); ***but compare***, § 393.135 RSMo; ***State ex rel. Sw. Bell Tel. Co. v. Pub. Serv. Comm'n of Missouri***, 645 S.W.2d 44, 53 (Mo. Ct. App. 1982)(“This approach is dictated by statute in Missouri, but only with respect to electric utilities. Section 393.135 (Initiative Proposition No. 1)”).

¹³ ***Fraas***, at 886.

¹⁴ *Id.*, at 888.

¹⁵ ***State ex rel. SW. Bell Tel. Co. v. Pub. Serv. Comm'n of Missouri***, 645 S.W.2d 44, 52 (Mo. Ct. App. 1982).

The appellate court then upheld the Commission's CWIP treatment, focusing on the Commission's use and purpose of the historical test year:

The accepted way in which to establish future rates is to select a test year upon the basis of which past costs and revenues can be ascertained as a starting point for future projection. * * *

This consideration is well expressed in *New England Tel. & Tel. Co. v. Public Utilities Commission*, 448 A.2d at 294: * * *

"A basic assumption of the test-year concept is that, over all, the test year is representative of the foreseeable future. The elements that go into the test-year computations of income and expense are not scrutinized individually to determine the degree of likelihood that particular items will recur or disappear or change in the relatively near future. To permit such scrutiny would be to make the test-year concept unworkable as a device for prediction of net revenues."¹⁶

13. Helpfully, the **SWBT** appellate court distilled the CWIP controversy down to a single question relevant to the analysis here: whether reason exists to mandate different treatment from an approach widely used and approved that the Commission has adopted and applied.¹⁷

Updated Test Year and the Matching Principle

14. As described above, the Commission uses the "modified historic test year" or "updated test year" adopted by other utility commission jurisdictions and approved by the courts. In the updated test year, the Commission reviews the actual costs, revenues, and rate base valuation for a twelve-month period ending prior to the filing of the rate case. During the course of the rate case, the filing company provides documentation of further *actual or known and measurable* expenses, investments, and revenues to update the information used to calculate the cost of service. Finally, a "true-

¹⁶ **SWBT**, at 52.

¹⁷ *Id.*

up audit,” may occur, further updating the original test year cost of service with more recent data.

15. The “matching principle” is an accounting principle that requires measurement of a utility’s revenues, expenses, rate base and rate of return at a consistent point in time—the test year. In Missouri, these measurements are based upon historical, actual data, adjusted to reflect the most current trends experienced by the utility. If an expense occurs outside of the test year, but is known and measurable (that is, the actual cost is known and is certain to occur), then that expense is included and the historical test year data is thereby updated.

16. From a policy perspective, Staff disagrees with the Company’s argument that a future test year is needed to prevent the undermining of the matching principle. The matching principle is an accounting principle as described above. Its purpose is to measure and compare normalized revenues and expenses occurring within a given period of time. In MAWC’s request, its future test year is a *projection* of normalized costs, created by multiplying normalized test year costs by a factor based upon an *estimated* future inflation rate, and a 13-month average of *planned*—not certain—rate base expenditures. Instead, MAWC’s request itself may undermine the matching principle, by asking the commission to place into rates future amounts outside of the test year that are not “known and measurable.”

Procedural Question – The Historic Test Year and Reconciliation

17. Less than thirty days from the filing of this rate case, Staff is in the early stages of its audit and investigation, and is still in the process of reviewing the relevant documentation and information that MAWC has presented as the basis for the general

rate increase request. At this point in time, Staff has not reviewed any materials that provide a definitive basis for a need for a future test year. As a result, Staff has not reached a conclusion as to whether there is a sufficient factual basis to support the use of a future test year.

18. The determination of what test year to use, and how to adjust it, is a fact question within the discretion of the Commission. ***State ex rel. GTE North, Inc. v. Missouri Public Service Com'n***, 835 S.W.2d 356, 370. (Mo. App., W.D. 1992). While MAWC has alleged facts for its argument, Staff recommends that the parties be provided more time to further evaluate the factual basis for a change to a future test year and projected numbers, so that the Commission has an amply supported record for the basis of a decision.

19. MAWC's request that the Commission adopt a future test year at this early stage of this proceeding relies on the argument that failure to address the future test year now will significantly adversely affect the procedure and reconciliation of this case. Staff agrees that if the parties are forced to argue competing historical test year / future test year time periods with different starting dates, the case will be "irreconcilable." This means that the different positions and revenue requirements proposed by the Company, Staff, and any other party may be impossible to clearly articulate, creating an inability to comply with § 386.420.4 RSMo.

20. Nevertheless, Staff estimates that the parties may be able to conduct a more detailed analysis of the factual and policy bases for a future test year during the pendency of the case, so long as the Commission establishes by order two certain conditions: (1) agreement on a test year "starting point" consisting of 12 months of

actual historic data ending December 2016; and (2) agreement by the parties to utilize actual historic data available through the end of calendar year 2017 to develop their recommended revenue requirements.

21. First, the Commission should order that all of the parties use as the case starting point the twelve months of actual data incurred in calendar year 2016. This is essentially the proposal made by MAWC,¹⁸ and is consistent with what MAWC and other large utilities have recommended in the past general rate proceedings in Missouri. Staff agrees with use of a 2016 calendar test year as a starting point for rate change analysis in this case.

22. Second, rather than adopting MAWC's proposal to use projected amounts and "inflation" factors to quantify the revenue requirement changes occurring in 2017, Staff strongly recommends that the Commission order MAWC update its case-in-chief at a later point to incorporate *actual* revenue and expense through June 2017, with a true-up period ending December 2017, to replace the projections and escalations. To the extent there are actual revenue and expense results available for 2017, there are no factual or policy arguments that persuade Staff to discount those actual numbers in favor of estimates or projections. Moreover, consistent use of historic data by all parties to the end of 2017 greatly simplifies the presentation and reconciliation of the parties' cases to the Commission for decision. Under this scenario, proposals by any party to consider changes beyond the end of the true-up period (i.e., future test year projections) for inclusion in rates could be accomplished through discrete revenue, expense, and

¹⁸ *Motion*, p.4, ¶ 8.

rate base adjustments that can be reconciled in terms of their revenue requirement impact.

Conclusion

23. Use of projected data on a comprehensive basis to set utility rates would be a major departure from past practice, with many policy implications. For that reason, Staff does not recommend that the Commission order adoption of such a ratemaking policy, *at this stage of the proceeding*, based upon filed motions, and instead should reserve consideration of such questions only after a complete evidentiary record is available to the Commission in this rate case filing or other proceedings.

24. Therefore, Staff's recommendation is that the Commission is not required to, and should not, affirm or deny the Company's proposed use of projected data to set rates in the context of its test year orders.

25. Finally, if the Commission believes that it must make an upfront determination on the issue of projected data at this time, Staff recommends that it deny the Company's motion and affirm the modified test year approach described earlier that has been used for many years in Missouri.

WHEREFORE, Staff respectfully requests the Commission accept this filing as Staff's Response to the *Motion to Establish Future Test Year*, and requests that when ruling on the *Motion*, the Commission:

(A) Sets a test year of the 12-months ending December 2016, with an update period of the six months ending June 2017, and a true-up period of the six months ending December 2017, with all parties utilizing actual historic Company financial data to present their cases based upon these time frames; and

(B) Articulate that by ordering such dates no party is precluded from presenting further adjustments for Commission consideration based upon projected or forecasted data past December 2017 to determine MAWC's revenue requirement in this proceeding, or that any party is precluded from opposing such adjustments; and

(C) Provide any further relief that the Commission deems just and reasonable under the circumstances.

Respectfully submitted,

/s/ Jacob T. Westen

Jacob T. Westen
Deputy Counsel
Missouri Bar No. 65265
Attorney for the Staff of the
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102
573-751-5472 (Voice)
573-751-9285 (Fax)
jacob.westen@psc.mo.gov

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile, or electronically mailed to all parties and or counsel of record on this 27th day of July, 2017.

/s/ Jacob T. Westen