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Missouri Public Service Commission

Secretary
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Case No. WO-2002-273

Dear Sir:

Enclosed for filing in the above-referenced proceeding please find an original and eight copies of the Initial Reply Brief of Missouri-American Water Company. Please stamp the enclosed extra copy of each "filed" and return same to me.

If you have any questions concerning this matter, then please do not hesitate to contact me. Thank you very much for your attention to this matter.

Sincerely,

BRYDON, SWEARENGEN & ENGLAND P.C.

By: Dean L. Cooper

DLC/tli
Enclosures
cc: Keith Krueger
Ruth O'Neill
Stuart Conrad
James B. Deutsch
Jeremiah Finnegan

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Joint Application of Missouri-American Water Company, St. Louis County Water Company d/b/a Missouri-American Water Company and Jefferson City Water Works Company d/b/a Missouri-American Water Company for an accounting authority order relating to security costs.	)))))))	Case No. WO-2002-273

INITIAL BRIEF

OF

MISSOURI-AMERICAN WATER COMPANY

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MISSOURI-AMERICAN WATER COMPANY

MISSOURI-AMERICAN WATER COMPANY
CASE NO. WO-2002-273

INITIAL BRIEF

TABLE OF CONTENTS

I. OVERVIEW

COMES NOW Missouri-American Water Company ("MAWC" or the "Company")[1] and, as its initial brief in this matter, states the following to the Missouri Public Service Commission ("Commission"):

The opening statement of Staff counsel Keith Krueger provides a good description of the events that led to this application for an accounting authority order:

> On September 11, 2001, there was a devastating attack on the World Trade Center in New York City and the Pentagon in Washington, D.C. It resulted in the deaths of about 3,000 people and the total destruction of two of America's best-known landmarks, and it caused great emotional and physical damage to the citizens of the United States and even the world, and New York City in particular. It is the first attack of this magnitude within the United States since at least the start of World War II, and perhaps the largest attack in the last 200 years . . . .
>
> As a result of this bombing, Americans came to realize that they were vulnerable to attack from abroad. People became fearful. Many studies have been conducted to determine what we must do to protect ourselves. One area of special concern is our utility systems, including water supply systems such as those operated by [MAWC]. . . .

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[1] This case was initially filed by Missouri-American Water Company, St. Louis County Water Company d/b/a Missouri-American Water Company and Jefferson City Water Works Company d/b/a Missouri-American Water Company. Effective December 31, 2001, St. Louis County Water Company and Jefferson City Water Works Company were merged into Missouri-American Water Company. Thus, Missouri-American Water Company is the remaining applicant.

(Tr. 85-86).

In the aftermath of this event, many unprecedented actions were taken by governmental entities in order to both assess and address protection of this country, to include its utility systems. These included the following efforts:

- The federal government created the position of homeland security advisor and is in the process of considering a complete overall of its agencies responsible for security and continues to provide terrorist alerts;
- The State of Missouri became the first state to appoint a special advisor for homeland security and convened the Missouri Security Panel whose purpose was, as rapidly as possible to conduct an intensive statewide security audit, and to propose recommendations for improvements to public safety (Ex. 2, Kartmann Sur., Sch. FLK-1);
- New security measures were implemented at large state office buildings (*Id.*);
- The Missouri Security Panel Utility Committee, the Department of Natural Resources and this Commission specifically recommended to utilities certain "Best Practices" for security (Ex. 2, Kartmann Sur., pp. 3-5);
- The President and the FBI both warned that public water facilities were a specific target that had been studied by terrorists (*Id.* at p. 6; Ex. 1, Kartmann Dir., p. 3). This was followed by information related to counter terrorism and security training in the water industry which cited an FBI agent who indicated that there have been credible threats in EPA Region VII (Ex. 2, Kartmann Sur., p. 8).

Faced with this environment, MAWC initiated a program to analyze the security status of the water plant and systems within each of its operating districts with a sense of

urgency (Ex. 1, Kartmann Dir., p. 4). Thereafter, MAWC took security actions in each of those operating districts. This was a reasonable and prudent response which would seem to be supported by the Staff. Staff witness Fischer stated that she did not "believe [the Staff] would expect any company, and utility company in the state of Missouri to not make some change in their procedure after 9/11/01" (Tr. 437).

The next step, however, is addressing the cost. It is an unavoidable fact that analyzing potential vulnerabilities and strengthening security efforts will have financial consequences. The National Association of Regulatory Utility Commissioners ("NARUC") recognized this fact stating that "[t]he State Commissions are also encouraged to...establish procedures for timely recovery of prudently incurred security related costs" (Ex. 4, Grubb Sur., Sch. EJG-3). NARUC had previously indicated that "to assist with efficient cost-recovery of prudently-incurred security-related expenditures, and to reduce uncertainty regarding the ability to recover prudently-incurred security related costs, Public Utility Commissions may wish to consider...deferral of expenses for accounting purposes only until a more comprehensive rate case expense review can take place at the time of the utility's next base rate case filing" (Ex. 1, Kartmann Dir., p. 6).

The security efforts made by MAWC included both operation and maintenance expenses which, without the opportunity of deferral, have an immediate one for one impact on MAWC's finances, and capital investments which, once the individual projects are placed in service, harm the Company's finances through the impact of depreciation expense and carrying costs.

Accordingly, MAWC has asked the Commission for an accounting authority order allowing MAWC to defer those costs associated with the adoption of new procedures,

updating existing procedures, and the installation of facilities to further safeguard MAWC's water plant that MAWC incurred in response to the events of September 11, 2001. This is one of the approaches identified by NARUC as a means of dealing with security costs.

The Company first proposed to amortize the deferred costs beginning with the effective date of an order in the Company's next rate case. However, on June 21, 2002, MAWC filed its Supplemental Statement of Position. Therein, MAWC suggested to the Commission that a grant of an AAO in this case should call for amortization of the deferred amounts, over a twenty year basis, to begin with the effective date of a Report and Order in this case. Additionally, MAWC took the position that it would not oppose a Commission order granting an AAO which contains language clarifying that nothing in the Commission's order would foreclose normal rate case issues related to possible recovery of the costs. MAWC believes that these provisions will make its proposal more consistent with the positions the other parties have taken in the case the accounting authority order is granted.

In connection with this request, the Commission Staff ("Staff") has asked the Commission to determine what standard should be applied in assessing applications for accounting authority orders. At its most basic level, an accounting authority order is an order related to accounting procedures and is authorized by Section 393.140, RSMo 2000. Because no "express standard" is contained in the statute, "the Commission may exercise this authority for good cause shown" (Order Regarding Motion to Dismiss, Protective Order and Discovery, Case No. WO-2002-273 (March 12, 2002)).

The "traditional criteria" that have been examined in reviewing a deferral request is whether the event is "extraordinary, unusual, unique and nonrecurring" as determined on a case-by-case basis. The Commission derived this criteria by interpreting the uniform

system of accounts.[2] MAWC will further explain herein why its request satisfied the "traditional criteria."

The Staff has sought in this case to "expand the traditional criteria" by proposing four new criteria. MAWC will discuss further herein why adoption of these new criteria would be inappropriate, and possibly unlawful. It will also explain why MAWC satisfies those four new criteria, should the Commission choose to apply them.

MAWC's opponents made two primary points over and over at the hearing of this matter that MAWC would like to address up front - - 1) there was no government "mandate" to take action, thus MAWC had a "choice"; and, 2) there was no direct damage to MAWC from the terrorist attacks.

The first distinction, mandate or no, is without import. In this situation, conditions were such that there was no choice. As Staff witness Fischer agreed, doing *nothing* was not an option (Tr. 438-439). This is similar to the situation where a utility's customers are without service due to an ice storm. There is no "mandate" to return those customers to service. However, everyone understands that leaving those customers without service for an extended period of time is understood to not be an option. MAWC similarly had a social mandate to act by events beyond its control.

The second insinuation, that MAWC need not act until it has suffered damage to its customers or plant, is a surprising issue. While waiting for actual damage from a terrorist action would have certainly put MAWC in a better position for its accounting authority order application, MAWC does not believe this would have been the prudent or appropriate thing

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[2] *In the Matter of the Application of Missouri Public Service,* 1 M.P.S.C. (N.S.) 200, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991).

to do (Ex. 4, Grubb Sur., p. 22). Moreover, the idea that there must be direct damage from an extraordinary event in order to obtain an accounting authority order would be something new for the Commission.

An example of this is found in the recent Commission approval of an accounting authority order to address expenses incurred to comply with Year 2000 computer concerns.[3] The underlying costs in that situation did not result from a Commission or other governmental mandate. No damage to Missouri Gas Energy was experienced prior to the costs being incurred.

The *Missouri Gas Energy* case also addressed similar concerns to those voiced in this case regarding whether the subject expenses are "non-recurring." The Public Counsel had argued in *Missouri Gas Energy* that the Y2K expenditures were "similar to routine computer hardware and software upgrades, and similar to 'activities that MGE has taken to correct other problems it has had with its computer systems and operating processes.'"

The Commission did not agree with the Public Counsel's focus on the underlying nature of the expenses. The Commission found:

> . . . that MGE's expenditures to ensure its systems are Y2K compliant are *not recurring*. Although businesses regularly upgrade computer systems to ensure that they do not become obsolete, the comprehensive scope of MGE's Y2K project, and the fact that it was a response to a non-recurring event, supports MGE's arguments that these costs are non-recurring.

The Commission in the *Missouri Gas Energy* case further relied upon the

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[3] *In the Matter of the Application of Missouri Gas Energy*, Case No. GO-99-258 (March 2, 2000).

comprehensive nature of the Y2K project and the short time it was accomplished in finding that the expenditures were extraordinary.

MAWC was faced with a similar, albeit much more serious, scenario in this case. MAWC incurred significant costs to assess and ensure that appropriate security measures were in place to address the threat as it was known after September 11, 2001. MAWC now asks the Commission help MAWC address the financial impacts of these efforts by granting MAWC an accounting authority order.

For the Commission's benefit, MAWC will specifically address the substantive issues identified in the Proposed List of Issues, Schedule of Proceedings and Order of Cross-Examination in the order they were raised in that document.

II. STAFF'S FOUR AAO CRITERIA -- THE COMMISSION SHOULD NOT ADOPT THE FOUR CRITERIA PROPOSED BY THE STAFF FOR THIS ACCOUNTING AUTHORITY ORDER APPLICATION.

The four criteria would not be beneficial to the Commission's performance of its duties. This Commission has utilized the "traditional test" – extraordinary, unusual, unique and nonrecurring – for accounting authority order applications since approximately December 20, 1991, the date of its decision in the "Sibley Case."[4]

In doing so, the Commission has seemingly had little trouble in applying this flexible test. The Commission has both granted and denied accounting authority order requests -- presumably in just those cases where it wanted to grant or deny. It is not good policy for the Commission to eliminate its flexibility in exchange for a rule where 5.00% qualifies for

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[4] *In the Matter of the Application of Missouri Public Service*, 1 M.P.S.C. (N.S.) 200, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991).

an AAO, but 4.9999% does not (Ex. 4, Grubb Sur., p. 11-12).

Accounting authority orders can be a useful regulatory tool. They provide a means of stabilizing a utility's financial picture after it has been upset by an extraordinary, unique and non-recurring event (Ex. 4, Grubb Sur., p. 17). Generally, this is done without the time and resources that can be consumed in a rate case (*Id.*). The Commission would not be well served by making any decision that would limit its ability to use this tool.

Staff witness Fischer alleges that "continuation of the Commission's current policy, which requires only that expenses be extraordinary for an AAO to be approved, may subject the Commission to AAO requests that do not reasonably merit consideration" (Ex. 6, Fischer Reb., p. 9-10).

The ability of these criteria to reduce the Commission's work load is suspect because of the way the application of the proposed criteria is described. Staff witness Fischer described the criteria "general guidelines" and confirmed that any of the four criteria might be accepted or rejected by the Commission on a case by case basis (Tr. 416-417). Even the 5% test turns out to be the 5% "ballpark" test, as Ms. Fischer indicated the Staff might go below 5% in different situations (Tr. 428-429).

If a utility will only know whether or not the criteria will apply after the Staff, and in turn the Commission, looks at the facts and circumstances on a case-by-case basis and determines whether or not the criteria will apply, the proposed criteria will not protect the Commission from accounting authority order requests. Additionally, there will always be arguments as to whether or not the utility complies with the criteria. In this case for example, establishment of the criteria would still lead to a hearing of the matter as MAWC and other parties differ as to whether or not MAWC satisfies the proposed criteria. The

only way to find out whether or not the criteria will apply and, more importantly, whether a request satisfies the criteria, is to file an application and try the case, a process that does nothing for the Staff's workload.

Ms. Fischer further indicated, during questioning from OPC counsel that the Staff was trying to discourage the filing of "frivolous" applications for accounting authority orders (Tr. 460-461). However, Staff witness Fischer also later stated that she did not believe that this application fit the category of "frivolous." Therefore, it appears there is no purpose to be served by adoption of the proposed criteria in this case, other than an announcement of change in state wide policy.

There are enough factors which fall within the realm of the "extraordinary, unusual, unique and nonrecurring" test previously articulated and applied by the Commission to allow the Commission to do its job. The proposed criteria are unnecessary and bad policy. The Commission should reject the four criteria proposed by the Staff.

A. Unlawful Change in Statewide Policy -- Staff's proposed criteria constitute an unlawful change in statewide policy because such change should be made through a rule making proceeding.

Adoption of the Staff's proposed criteria in this case for general application would constitute an unlawful change in state wide Commission policy. Section 536.010(4), RSMo defines "rule" as an "agency statement of general applicability that implements, interprets, or prescribes law or policy, or that describes the organization, procedure or practice requirements of any agency." The Missouri Supreme Court has stated that "[f]ailure to follow rule making procedures renders void purported changes in statewide policy." *NME Hospitals, Inc. v. Department of Social Services*, 850 S.W.2d 71, 74 (Mo. banc 1993). The

Commission Staff has announced a *change* in statewide policy and statement of general applicability in asserting that it plans to apply its four criteria to future accounting authority order applications (Tr. 90). In the following discussion, MAWC will point out in identified sections: 1) that the criteria proposed by Staff are not a mere "restatement" of the Commission's prior positions; 2) that the proposed criteria come from different origins from the traditional standard for accounting authority orders; 3) that the proposed Criteria One would be new to this Commission; 4) that unlike the electric and natural gas uniform systems of accounts, there is no five percent test of any sort in the *water* uniform system of accounts; and, 5) that like Criteria One, Criteria Two, Three and Four would also be new to this Commission.

Not a "Restatement"

One of the intervenors suggested that the proposed criteria are no more than a "restatement" of Commission principle established in numerous cases, that the proposed criteria were "simply restating the law that was out there, collected it, gathered it and organized it" (Tr. 76-77). The Commission must recognize that the proposed criteria are anything but a mere restatement of prior Commission decisions. Staff witness Fischer confirmed that the Commission had not adopted any of the four proposed criteria, either as a group or individually.[5] She also stated, "I don't believe from what I understand that the Commission has applied these four criteria in the past or accepted them in their evaluation" (Tr. 425).

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[5] "I don't believe there's an AAO order out there where – in which the Staff presented a criteria, one of these four, that the Commission included in their Report and Order" (Tr. 48).

Different Origins

These criteria are also very different in origin from the Commission's decision in the Sibley Case where it first articulated the "extraordinary, unusual, unique and nonrecurring" test. The "traditional criteria" resulted from an interpretation of the uniform system of accounts for electric corporations. Everything in the traditional test in one way or another is derived from the language of the uniform system of accounts. The Commission described the basis for its authority related to accounting authority orders as follows:

> The Commission by authority pursuant to Section 393.140(4) promulgated rule 4 CSR 240-20.030, which prescribes the use of the USOA adopted by the Federal Power Commission, now the Federal Energy Regulatory Commission (FERC), for use by electric utilities subject to its jurisdiction. As stated in the Commission rule, the USOA contains definitions, general instructions, electric plant instructions, operating expense instructions and accounts that comprise the balance sheet, electric plant, income, operating revenues, and operation and maintenance expenses. Costs incurred by the utility during a period are off set against revenues from that same period in determining a company's profitability.
>
> The USOA provides for the treatment of extraordinary items in Account 186. The account was created to include "all debits not elsewhere provided for, such as miscellaneous work in progress, and *unusual or extraordinary expenses*, not included in other accounts, which are in the process of amortization and items the proper final disposition of which is

uncertain."[6]

The Commission went on to quote the uniform system of accounts definition of "extraordinary items"[7] which includes a description of extraordinary expenses as "not typical or customary business activities" which "would not be expected to recur frequently."

The above section of the Sibley Case points out that the Commission has already adopted a rule which addresses deferral of extraordinary expenses, and accounting authority orders in accordance with Section 393.140(4), RSMo 2000.[8] For water corporations, the Commission has similarly adopted the uniform system of accounts issued by the National Association of Regulatory Utility Commissioners in 1973, as revised July 1976 (4 CSR 240-50.030).

Based upon an interpretation of the uniform system of accounts adopted by the Commission, the Commission determined in the Sibley Case that the limited basis allowing for deferral of expenses is "when events occur during a period which are extraordinary, unusual, unique and not recurring."[9] Again, in the Sibley Case, the Commission was interpreting an existing Commission rule in order to ascertain the standard to be applied.

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[6] *In the Matter of the Application of Missouri Public Service*, 1 M.P.S.C. (N.S.) 200, 202-203, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991) (emphasis added).

[7] USOA, General Instruction 7.

[8] "The Commission shall – (4) Have power, in its discretion, to prescribe uniform methods of keeping accounts, records and books, to be observed by gas corporations . . . . Notice of the alterations by the commission in the required method or form of keeping a system of accounts shall be given to such persons or corporations by the commission at least six months before the same shall take effect."

[9] *In the Matter of the Application of Missouri Public Service*, 1 M.P.S.C. (N.S.) 200, 205, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991).

The Staff's proposal in this case is much different. The criteria proposed by the Staff are new criteria. These four criteria HAVE NEVER been applied by the Commission in previous accounting authority order application cases. They ARE NOT a mere interpretation of existing rules. They are NEW CRITERIA.

Proposed Criteria One is New

For example, the Commission expressly rejected a materiality test, proposed by the Office of the Public Counsel, as recently as March 2, 2000. This Commission found that "materiality is an issue that may be considered when determining whether to allow deferral of expenses. However, a finding of materiality is not necessary to allow deferral. Inasmuch *as the Commission finds that both the event causing the expenditures and the expenditures themselves are extraordinary, the Commission need not find that the expenditures are material to allow deferral.*"[10] Staff witness Fischer confirmed that the concept of a strict five percent materiality requirement has been rejected by the Commission in past cases (Tr. 425).

Water USOA Has No 5% Provisions

Additionally, even the thin connection to the uniform system of accounts that Staff has pointed to as a basis for the five percent rule is completely inapplicable to water corporations. Staff witness Fischer stated that the basis for her proposed Criteria One was found in General Instruction 7 of the *Federal Energy Regulatory Commission* ("FERC") uniform system of accounts (Tr. 428). This is a provision that applies to *natural gas and electric* corporations (Tr. 430). That part of General Instruction 7 for natural gas and

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[10] *In the Matter of Missouri Gas Energy*, Case No. GO-99-258 (March 2, 2000) (emphasis added).

electric corporations states, in part:

> To be considered as extraordinary under the above guidelines, an item should be more than approximately 5 percent of income, computed before extraordinary items. Commission approval must be obtained to treat an item of less than 5 percent, as extraordinary.

(Tr. 427-428).

As to FERC General Instruction 7 for natural gas and electric corporations, there is a presumption that costs exceeding 5 percent are extraordinary. Failure to exceed 5 percent is not fatal to an application for deferral under the rule adopted by the Commission. The Commission previously recognized that "[t]his five percent standard is thus relevant to materiality and whether the event is extraordinary but *is not case dispositive*."[11] Thus, even the FERC standard does not support a strict five percent test.

However, even if it did support such a finding, the governing regulations are different for water corporations. A review of the NARUC uniform system of accounts (adopted by rule by this Commission for water corporations) reveals that there is no five percent test whatsoever for water corporations (Tr. 433). The only test found in the NARUC uniform system of accounts for water corporations is that "Commission approval must be obtained to treat an item as extraordinary" (Ex. 17).

Therefore, a decision by the Commission to adopt the Staff's proposed Criteria One and require that in order to be deferred, the expenses "must represent at least 5%" is

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[11] *In the Matter of the Application of Missouri Public Service*, 1 M.P.S.C. (N.S.) 200, 206, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991)(emphasis added).

clearly not a "restatement" of existing rules. It would be a change of well established state wide policy and directly contrary to a rule previously adopted by the Commission.

Proposed Criteria Two, Three and Four Are Also New

Similarly, proposed Criteria Two, Three and Four are also beyond the bounds of rule interpretation and existing state wide policy. Criteria Two's focus on rate issues was rejected by the Commission in the Sibley Case wherein it stated that "Staff's emphasis on whether the utility was earning above its authorized rate of return at the time of deferral, whether the expenditures are reasonable and prudently incurred, and whether to include carrying costs in the recovery, are rate case issues and best left for rate case review."[12]

Criteria Three's attempt to more rigidly define what is and isn't an extraordinary event has also been resisted by the Commission. Staff witness Fischer indicated that this criteria is "probably not" broad enough to capture the accounting authority orders that the Commission has granted in the past (Tr. 434). Also, in the Sibley Case, the Public Counsel proposed to have the Commission impose a similarly strict standard for determining what is, and is not, an extraordinary event. The Public Counsel proposed that deferral of costs only be allowed when associated with acts of God or when integrity of service to customers is threatened. The Commission resisted this attempt stating that:

> . . . to limit extraordinary events to these situations is too restrictive. There may be instances which occur that are neither acts of God nor threaten the provision of service but that are nonetheless unusual, unique and

[12] *In the Matter of the Application of Missouri Public Service*, 1 M.P.S.C. (N.S.) 200, 206, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991).

nonrecurring, where deferral would be justified and reasonable.[13]

The Staff testimony does not allege that its proposal is based upon an interpretation of existing Commission rules. These are new criteria which are in fact contrary to existing rules and prior Commission decisions. This is a situation in which a rulemaking is required. The General Assembly has even indicated a specific desire for rulemaking in the case of accounting decisions stating that "[n]otice of alterations by the commission in the required method or form of keeping a system of accounts shall be given . . . at least six months before same shall take effect."[14]

The Commission Staff has announced a change in statewide policy and statement of general applicability in recommending that the Commission "expand its traditional criteria for the approval of deferred cost recognition under an AAO." The statutorily established rule making procedures have not been followed. The criteria are thus void.

B. If the Commission Adopts the Staff's Proposed AAO Criteria:

(1) Staff's Proposed AAO Criteria One -- If the Commission adopts the Staff's Proposed Criteria One, then the costs incurred and which are sought to be deferred in this proceeding represent at least 5% of MAWC's regulated Missouri income, computed before extraordinary items.

Use of current security data reveals that the costs to be incurred exceed 5% of MAWC's regulated Missouri income. MAWC witness Grubb provided a comparison of the

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[13] *In the Matter of the Application of Missouri Public Service*, 1 M.P.S.C. (N.S.) 200, 207-208, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991).

[14] Section 393.140(4), RSMo (2000).

proposed deferral to regulated net income for 2001 (Ex. 4, Grubb Sur., Sch. EJG-6). This comparison revealed that the proposed deferral represents a materiality impact that is well above the five percent level the Staff is recommending.

Staff witness Fischer generally confirmed this with her revised Schedule JEF-3 (Ex. 14). This schedule utilized substantially the same figures as were found in the materiality computation presented by Mr. Grubb in his Surrebuttal Testimony (Tr. 412). No other computation of the materiality of the proposed deferral is found in the record.

Any remaining disagreement as to this issue comes from the fact that the Staff has indicated that it will change the test to ensure that a utility cannot achieve the required threshold. Staff witness Fischer surprisingly admitted during direct examination that had she known the Company would meet the materiality test the way she calculated it the first time, she would have changed the method (Tr. 412-413). This is not a sufficient basis to find that the proposed deferral fails the proposed materiality test.

Additionally, any disagreement over computation and methods of calculation should further illustrate the fact that the Staff's proposed Criteria One will in fact complicate, rather than simplify, the accounting authority order process. A strict five percent test will result in numerous arguments as to whether a proposal represents 4.9% or 5.05%, how the number should be computed and what numbers should be used. However, if this test is to be applied in this case, the record evidence shows that the proposed deferral exceeds five percent of MAWC's regulated net income, even under the method first used by the Staff.

(2) Staff's Proposed AAO Criteria Two -- If the Commission adopts the Staff's proposed Criteria Two, then MAWC's existing rates are not

sufficient to cover the extraordinary cost and still provide MAWC with a reasonable expectation of earning its authorized rate of return.

There are two significant factors associated with this criteria proposed by Staff which must be examined. First, the entity proposing these criteria has stated that it "is not disputing whether the Company has satisfied the second of these four proposed requirements" (Tr. 90). Thus, Staff does not allege that MAWC fails to comply with this criteria. Second, the actual wording of this proposed criteria shows that there is not sufficient evidence to rule against MAWC. Staff witness Fischer states as follows in describing proposed Criteria Two:

> If the Commission can determine, by examining surveillance reports and other information provided by the utility, *that existing rates appear sufficient* to cover the extraordinary cost and still provide the utility with a reasonable expectation of earning its authorized rate of return, *then the AAO request should be rejected.*

(Ex. 6, Fischer Reb., p. 11) (emphasis added).

Thus, the applicant is not required to come forward with evidence that rates are *insufficient* so that the application may be *approved*, but rather it is for those opposing the application to come forward with evidence that rates are *sufficient* so that the application may be *rejected*.

This has not been done. The Staff indicated that it had not performed a detailed analysis of MAWC's current rate of return (Ex. 4, Grubb Sur., Sch. EJG-7) and volunteered that it did not allege that MAWC was over earning (*Id.*). No other party offered evidence suggesting that MAWC's rates were "sufficient." There is therefore no evidence in this

case that rates are sufficient to provide MAWC with a "reasonable expectation of earning its authorized rate of return."

(3) Staff's Proposed AAO Criteria Three – If the Commission adopts the Staff's proposed Criteria Three, then:

The expenses result from either:

(a) an extraordinary capital addition that is required to insure the continuation of safe and adequate service in which unique conditions preclude recovery of these costs through a rate case filing; and/or,

(b) an extraordinary event that is beyond the control of the utility's management?

The Staff's proposed Criteria Three states, in part, that "[t]he extraordinary expenses that the utility is seeking to defer must result either from a. an extraordinary capital addition . . . required to insure the continuation of safe and adequate service . . . , or b. an extraordinary event that is beyond the control of the utility's management."

MAWC satisfies both prongs of this criteria. As to the first prong, the security expenses are "extraordinary capital additions" "required to insure the continuation of safe and adequate service." The unique condition is that rather than a large individual project, the project is actually a series of projects that are impossible to time with a rate case filing. As to the second prong, the events and the resulting consequences of September 11, 2001, which drove these projects, are certainly "beyond the control of the utility's management" (Ex. 4, Grubb Sur., p. 16).

(4) Staff's Proposed AAO Criteria Four – If the Commission adopts

the Staff's proposed Criteria Four, then there is a sufficient reason why MAWC cannot recover the costs resulting from these expenditures through the normal rate case process; or, MAWC will amortize the deferred amounts beginning with the effective date of an order in this case.

Staff proposed Criteria Four states:

There must be a sufficient reason why the utility could not file a rate case to recover the costs resulting from the extraordinary event. *Alternatively*, the utility must file a rate case within 90 days of the AAO approval to allow for prompt rate treatment of the deferred costs. *If the utility intends* to seek rate recovery and *defer amortization of the AAO balance until the effective date of rates for a future rate case*, the utility should be required to file a rate case soon after approval of the AAO.

(Ex. 6, Fischer Reb., p. 11) (emphasis added).

MAWC initially applied for an accounting authority order which would call for amortization to begin with the effective date of new rates in its next general rate case. However, on June 21, 2002, MAWC filed its Supplemental Statement of Position. In that document, MAWC suggested to the Commission that if the Commission grants an AAO, amortization of the deferred amounts, on a twenty year basis, should begin with the effective date of a Report and Order in this case

According to the Staff's position prior to the hearing of this matter, this change in position should have resulted in a change to proposed Criteria Four. Staff witness Fischer had previously indicated that the proposed criteria would "apply only to AAOs for which any

amortization of deferred amounts is to be delayed until the effective date of rates for a future rate case" (Ex. 6, Fischer Reb., p. 12). By data request, MAWC sought to determine what criteria would apply if an amortization were instead started with the grant of an accounting authority order. The Staff indicated in answer to this data request (MAWC Data Request No. 5) (Ex. 16) that its response could be found in a separate data request (MAWC Data Request No. 2)(Ex. 15).

> In answer to MAWC Data Request No. 2, the Staff stated in part as follows:
>
> The staff would change requirement 4 (pages 11-12 [of Ms. Fischer's Rebuttal Testimony]) in the case of any AAO request that includes a prescribed amortization period. The staff would propose that the prescribed amortization begin (a) immediately upon either the completion of the extraordinary event or project associated with the deferred costs or (b) the Commission's effective date of the order granting the AAO.
>
> The attached pages from the rebuttal testimony of Staff witness V. William Harris in Case No. EO-2000-843 contained an explanation of the Staff's recommended criteria for Commission AAO issuances under both scenarios of when amortization of deferred costs is requested to begin on the effective date of new rates in the applicant's next rate proceeding, and when an amortization is requested to begin immediately after the AAO is granted.

(Ex. 15).

The attached testimony of V. William Harris stated in part:

> For an AAO request with a prescribed amortization period commencing upon the conclusion of the specified event or the Commission's

approval date for the AAO request.

Requirements (1), (2) and (3) as discussed above, and

(4) The event or project is one that is traditionally amortized over several years in rate cases or there are benefits in future periods that will be better matched through the deferral of these costs. A five-year amortization of major flood and ice storm costs are two examples. The prescribed amortization will begin immediately upon either:

(A) completion of the event or project associated with the deferred costs, or

(B) the effective date of the order granting the AAO.

(Ex. 15).

The Staff had clearly taken the position prior to the hearing of this matter that its proposed Criteria Four was completely changed in the situation where an accounting authority order was to be amortized with the effective date of the accounting authority order. At the hearing, Staff witness Fischer indicated that this was not completely true. Staff witness Fischer indicated that the earlier amortization period caused the 90 day requirement to "fall away," but that the portion related to having a sufficient reason why a rate case cannot be filed would still apply (Tr. 422-423).

This position does not make sense. First, the 90 day requirement was always described by the Staff as an "alternative" to the requirement that there be a sufficient reason why a rate case could not be filed. Second, the Commission's interest in an immediate rate case would seem to be lessened by the earlier amortization.

When an amortization starts with the order in the accounting authority order case,

the deferred amount is reduced, without a change in rates, until the effective date of an order in the next general rate case. Thus, the longer a company puts off a rate case filing, the smaller the deferral that will be available for Commission consideration at the time of the rate case.

In the alternative, the Company has provided the reasons it cannot recover these expenditures though the normal rate case process. First, the "normal rate case process" does not provide for the recovery of past expenditures. The purpose of the rate setting process is to use the past to set rates for the future. Whether the expenses are found in a test year or not, none of the amounts that MAWC seeks to defer will be recovered in a future rate case.

Second, filing a rate case for MAWC is not something that can be done quickly. The preparation of a rate case for a company the size of MAWC requires the coordination of both personnel and financial resources. This is especially true for MAWC as it has ten separate rate schedules for its operating districts (Ex. 4, Grubb Sur., p. 18). The ninety day period suggested by the Staff as an alternative is unreasonable. A more appropriate time period for filing a rate case after the approval of an accounting authority order would be the one to three year periods used by the Commission in the accounting authority orders it has issued since 1991 (*Id.*).

C. Extraordinary, Unusual, Unique and Non-Recurring -- If the Commission does not adopt Staff's four criteria as requirements to granting an AAO, an accounting authority should be granted because the costs incurred by MAWC to increase security measures subsequent to the events of September 11, 2001, "extraordinary, unusual, unique and non-

recurring."

The events of September 11, 2001 and the resulting expenditures made by MAWC to assess risks and to protect against terrorist attacks are certainly extraordinary, unusual, unique and nonrecurring.[15] The September 11, 2001, terrorist attack on the United States and the threat resulting therefrom, had a profound impact on the security environment across the entire country, as well as in the State of Missouri. Most of the parties agree that this was an extraordinary event.

The results of this event in terms of public reaction were also unique and unusual. While there have been previous terrorist attacks against United States interests, none of those events led to the federal, state and public response experienced after September 11, 2001. On the federal level, these events led to the appointment of a Homeland Security Advisor and the consideration of a complete overhaul of those agencies responsible for the nation's security. The event was equally unusual and unique for this Commission. Prior to September 11, 2001, Staff witness Fischer was aware of no Commission dockets concerning security issues (Tr. 435). On October 23, 2001, the Commission Staff requested, and the Commission later opened, a docket (Case No. OO-2002-202) for the purpose of receiving information from Missouri utilities concerning their preparedness for disaster and emergency situations, to include "procedures for dealing with terrorist threats or with actual attacks on employees or facilities" (Ex. 2, Kartmann Sur., p. 4).

Certain parties have argued that the tragedy in New York does not make the events of September 11, 2001, an extraordinary event for MAWC. However, it is undeniable that

[15]"Nonrecurring" is derived from the uniform system of accounts' statement that the event should be "infrequently recurring." Thus, it does not require a one-time event.

the events of September 11, 2001, had very real ramifications in Missouri.

The State of Missouri itself made many security enhancements at its buildings and at other critical facilities. For the first time, the Governor of Missouri appointed a Special Advisor for Homeland Security and instituted the Missouri Security Panel, whose Utility Committee specifically addressed utility security issues (Ex. 2, Kartmann Sur., p. 2-3). The Missouri Security Panel issued a "Best Practices" list for improving security and, in doing so, stated that "All Missouri utilities should be encouraged to review the Best Practices list and, where applicable, adopt those items they are not currently performing." (*Id.* at p. 3). This Commission directed that the "Best Practices for Improving Security" be published on the Commission's web site and sent by mail to all utility companies and municipal and cooperative organizations operating utility systems (Id. at p. 4-5).

MAWC also received regular warnings that water utilities were identified targets of known terrorist networks (*Id.* at p. 5). These warnings were consistent with the experience of Captain Robert Young, Commander of the Office of Emergency Management for St. Louis County, Missouri (Ex. 5, Young Sur., p. 1). In October of 2001, his office received an alert from the Federal Bureau of Investigation ("FBI") indicating that the FBI had information suggesting that the nation's drinking water was at risk (Tr. 234). Captain Young's office was asked to do whatever they could to protect the community's drinking water supply (*Id.*). In response, Captain Young contacted all the utilities in his area of operation and scheduled a meeting on October 15, 2001 to discuss security issues (Id. at p. 4-5). The utilities were asked to reexamine their security efforts in light of the alerts and events of the time and asked to take any and all additional steps possible in order to minimize the risk of a terrorist attack (*Id.* at p. 6; Tr. 236-237).

Later, the President of the United States further indicated that there was a danger to water utilities. On January 29, 2002, in the State of the Union Address, President Bush stated that "we have found diagrams of American nuclear power plants and *public water facilities* . . . What we have found in Afghanistan confirms that, far from ending there, our war against terror is only beginning" (Ex. 1, Kartmann Dir., p. 3) (emphasis added).

MAWC had no choice but to increase its security measures immediately in light of the actions of the federal government, the state government, the Public Service Commission and emergency management agencies, and the security warnings it received. MAWC does not believe that it would have been prudent to wait until a terrorist attack directly damaged MAWC facilities prior to securing against such attacks (Tr. 331).

MAWC believes that the event and the resulting expenses are nonrecurring. This is not to say that a terrorist attack will not occur again in the future. However, MAWC believes that as a result of the post September 11, 2001 focus on security, it has taken the steps that are within its ability to protect the MAWC plant, facilities and customers (Ex. 1, Kartmann Dir., p. 3). In other words, while terrorist attacks may happen again, the comprehensive review of security conducted by MAWC and the substantial implementation and investment MAWC made in security measures over a short period of time should not be necessary in the foreseeable future.

Also, the operation and maintenance expenses incurred by MAWC in these efforts, without the opportunity for deferral, will have an immediate and detrimental impact on MAWC's finances. The capital investments, once the individual projects are placed into service, impact the Company's finances through depreciation and carrying costs. In both cases, MAWC will never have the opportunity to recover those dollars unless an

accounting authority order is granted. Even if expenses are found in a test year, a utility is not allowed to go back and recover those prior year's expenses (Tr. 400, 466). The test year is utilized to assess and set rates for future periods (*Id.*).

Similarly, some allegation was made that because depreciation costs associated with the capital investments would be present in future rate periods costs associated with capital investments could not be non-recurring. However, the Staff's proposed criteria does not support such an approach. Proposed Criteria Three specifically provides for "extraordinary capital additions" as a type of investment that is appropriate for an accounting authority order (Ex. 6, Fischer Reb., p. 11). Thus, the mere fact that a proposed deferral is associated with a capital addition does not alone disqualify it for an accounting authority order.

This makes sense when one examines past accounting authority orders adopted by the Commission. Over the last ten years the Commission has issued accounting authority orders for gas safety costs (Cases No. GO-92-67, GO-92-185, GO-94-133, GO-97-301, and GO-94-234) and FAS 106/OPEBs (EO-92-179, EO-93-35, GO-93-201, TO-95-175). In each of those circumstances, certain costs would continue into the future. What was extraordinary in those cases was the cause of the costs and the condensed period in which the costs were required to be incurred.

As stated in the introduction, the Commission has recently addressed very similar issues in a Missouri Gas Energy case[16] concerning Year 2000 computer costs. In that case, the Public Counsel argued that the Year 2000 expenditures were "similar to routine

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[16] *In the Matter of the Application of Missouri Gas Energy*, Case No. GO-99-258 (March 2, 2000).

computer hardware and software upgrades, and similar to 'activities that MGE has taken to correct other problems it has had with its computer systems and operating processes.'" Over this objection, the Commission found that Missouri Gas Energy's "expenditures to ensure its systems are Y2K compliant are not recurring. Although businesses regularly upgrade computer systems to ensure that they do not become obsolete, the comprehensive scope of MGE's Y2K project, and the fact that it was a response to a non-recurring event, supports MGE's arguments that these costs are non-recurring." The costs incurred by MAWC which are discussed in this case are also non-recurring.

As a result of the events of September 11, 2001, MAWC, and others, believed it was necessary to adopt new procedures, update existing procedures and install facilities to further safeguard its water plant and systems with a sense of urgency and in an extremely short period of time (Ex. 1, Kartmann Dir., p. 4). Assessing the security status of the ten MAWC operating districts, which provide service to over 400,000 customers, in a relatively short period of time and then making prudent improvements again, in a relatively short period of time, was an extraordinary, unusual, unique and non-recurring undertaking.

III. GRANT AN AAO -- IN LIGHT OF THE ABOVE, THE COMMISSION SHOULD GRANT TO MAWC AN ACCOUNTING AUTHORITY ORDER TO DEFER RECOGNITION OF THE COSTS IT INCURRED AND ATTRIBUTED TO INCREASED SECURITY NEEDS AFTER THE TERRORIST ATTACKS OF SEPTEMBER 11, 2001 IN NEW YORK CITY AND WASHINGTON, D.C..

Based upon the above, the Commission should grant MAWC an accounting authority order in this case.

IV. ACCOUNTING AUTHORITY ORDER GRANTED -- IF THE COMMISSION

GRANTS MAWC AN ACCOUNTING AUTHORITY ORDER:

A. Conditions -- What conditions, if any, should be reflected in the Commission's order?

An order granting an accounting authority order in this case should direct that MAWC begin to amortize the deferred amounts, on a twenty year basis, beginning with the effective date of a Report and Order in this case. This position is found in MAWC's Supplemental Statement of Position.

The twenty year amortization period is based upon a recommendation made by the Office of the Public Counsel ("OPC") witness. OPC witness Bolin recommended that if the Commission granted an accounting authority order that "the time period for recovery of the deferred balances should be at least twenty years" (Ex. 7, Bolin Reb., p. 4). OPC witness Bolin also suggested in the case of a grant of the requested accounting authority order application, that amortization should begin as soon as the Report and Order takes effect" (*Id.*).

B. Future Rate Making Treatment -- The Commission should make the indication regarding future rate making treatment of the deferred expenditures in the Commission's order as recommended in MAWC's Supplemental Position Statement.

MAWC took the position in its Supplemental Statement of Position, filed on June 21, 2002, that an order granting an accounting authority order in this case should contain the following provision:

> That nothing in the Order shall be considered a finding by the Commission of the value for rate making purposes of the deferred expenditures.

This provision deferring issues to a rate case is substantially the same as that used by this Commission in granting an accounting authority order to Missouri Gas Energy in March of 2000.[17] MAWC seeks to merely acknowledge that, as this Commission has stated previously:

> By seeking a Commission decision the utility would be removing the issue of whether the item is extraordinary from the next rate case. All other issues would still remain, including, but not limited to, the prudency of any expenditures, the amount of recovery, if any, whether carrying costs should be recovered, and if there are any offsets to recovery.[18]

MAWC witness Grubb confirmed during cross-examination that if the Commission so desired, the Company would not object to including the phrase "or the prudence thereof" in the proposed condition to further clarify its intent (Tr. 271).

WHEREFORE, MAWC respectfully requests the Commission issue its order granting MAWC an accounting authority order authorizing it to maintain on its books in Account 186 a regulatory asset which represents the operation and maintenance expenses, carrying costs, and depreciation expenses associated with the adoption of new procedures, updating existing procedures, and the installation of facilities to further safeguard MAWC's water plant after the events of September 11, 2001, subject to the following conditions:

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[17] *In the Matter of the Application of Missouri Gas Energy*, Case No. GO-99-258 (March 2, 2000).

[18] *In the Matter of the Application of Missouri Public Service*, 1 M.P.S.C. (N.S.) 200, 203-204, Case Nos. EO-91-358 and EO-91-360 (December 20, 1991).

A. MAWC shall amortize the amount deferred over a twenty-year period beginning with the effective date of this order; and,

B. That nothing in the Order shall be considered a finding by the Commission of the value for rate making purposes of the deferred expenditures.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the above and foregoing document was sent by U.S. Mail, postage prepaid, or hand delivered, on this 15th day of August, 2002, to the following:

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