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December 4, 2003

FILED

DEC 04 2003

Missouri Public
Service Commission

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

Re: Case No. WO-2004-0116

Dear Mr. Roberts:

Enclosed for filing in above-referenced matter, please find an original and eight copies of the Brief of Missouri-American Water Company.

Please bring this filing to the attention of the appropriate Commission personnel. A copy of this filing will be provided to parties of record. If there are any questions, please direct them to me at the above number. I thank you in advance for your cooperation in this matter.

Sincerely,

W.R. England, III

WRE/da
Enclosures
cc: Parties of Record
RLJ Woodruff
Mr. Ed Grubb
Mr. Dave Abernathy

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Missouri-American	)	
Water Company for Approval to Establish an	)	Case No. WO-2004-0116
Infrastructure System Replacement Surcharge (ISRS)	)	Tariff No. YW-2004-0274

BRIEF OF MISSOURI-AMERICAN WATER COMPANY

Introduction

On September 2, 2003, Missouri-American Water Company (MAWC or the Company) filed its verified Application and Petition for Establishment of an Infrastructure Replacement Surcharge (Application) pursuant to Sections 393.1000, 393.1003 and 393.1006 RSMo 2003. (Exh. 5) In addition, MAWC filed a revised tariff sheet setting forth the rates, terms and conditions for its proposed ISRS. By its Application and revised tariff, MAWC seeks an adjustment to its rates and charges through the implementation of an Infrastructure System Replacement Surcharge (ISRS) rate schedule to provide for the recovery of costs for infrastructure system replacements and relocations eligible for ISRS recognition (hereinafter referred to as ISRS eligible plant). The total annual revenues which MAWC sought to recover through implementation of its initial ISRS were $4,038,915.

Subsequently, the Missouri Energy Group (MIEG)[1] and the Missouri Industrial Energy Consumers (MIEC)[2] sought and were granted Intervenor status.

On October 31, 2003, the Staff of the Commission (Staff) filed its Memorandum and Recommendation regarding MAWC's Application for Establishment of Infrastructure Replacement Surcharge. (Exh. 1) Essentially, the Staff followed the Company's method for calculating ISRS revenues but made adjustments in approximately five areas, to wit:

[1] Members of which are Barnes-Jewish Hospital, Emerson Electric Company, SSM Health Care and St. John's Mercy Health Care.

accumulated depreciation, accumulated depreciation – net cost of removal, reimbursements for relocations, deferred income taxes, and property taxes. As a result, Staff recommended that the proposed ISRS only recover annual revenues of $1,887,301. (Exh. 1, Attachment B, p. 1 of 4).

On November 10, 2003, Company filed its Response to Staff's Memorandum indicating agreement with Staff's adjustments regarding deferred income taxes and reimbursements for relocations, but disagreed with Staff's adjustments to accumulated depreciation, accumulated depreciation – net cost of removal, and property taxes. Accordingly, Company's revised ISRS revenue requirement is $3,813,222. (Exh. 6)

On November 19, 2003, the Parties participated at a Prehearing Conference to further discuss the issues that continued to exist between them. As a result of that Prehearing Conference, Staff filed on November 20, 2003, an Amended List of Issues, Jointly Proposed by All Parties.

On November 21, 2003, the Parties participated in a Hearing before the Commission, at which time witnesses for the Company, Staff, MIEC, and MEG presented testimony on behalf of their respective positions.

<u>The Issues to be Determined</u>

As a result of the November 19, 2003, Prehearing Conference and as reflected in the Amended List of Issues, Jointly Proposed by All Parties, there remain three (3) issues that the Commission must resolve in order to determine the appropriate revenues to be recovered by the Company's proposed ISRS filing. Those three (3) issues are: (1) the appropriate amount of accumulated depreciation to be used as an offset to the total original cost of ISRS eligible plant; (2) whether the accumulated depreciation amount should be further adjusted to reflect the net

[2] Members of which are the Boeing Company, DaimlerChrysler, Ford Motor Company, Hussmann Refrigeration, Monsanto Company, and Pfizer.

cost of salvage associated with plant taken out of service and replaced by ISRS eligible plant; and (3) the appropriate amount of property taxes associated with the ISRS eligible plant. (Amended List of Issues, p. 2-3, paragraphs A, B & C) There is no longer any issue among the Parties regarding the way in which the ISRS should be calculated and applied to the various customer classes. All Parties now agree and jointly recommend that the proposed ISRS rate schedule include a volumetric rate for each affected customer class, with the ISRS rate to be determined through the use of the customer class billing determinants from the most recent St. Louis County Water Company rate case (i.e., Case No. WR-2000-844) and the ISRS revenues allocated to each affected customer class based on the class-cost-of-service allocations from Case No. WR-2000-844. (Amended List of Issues, p. 3, paragraph D)

Argument

In calculating the appropriate revenues to be recovered through the ISRS, the Company attempted to take a "snapshot view" of the revenue requirement associated with the ISRS eligible plant, without taking into consideration any other revenue requirement or ratemaking issues. The Company first identified the actual investment it made in ISRS eligible plant placed into service since its last rate case (i.e., since January 1, 2001). Next, the Company identified the actual accumulated depreciation on those investments since they were placed into service, as well as the actual deferred taxes on those investments, and deducted those amounts (along with any contributions in aid of construction (CIAC) and reimbursements received for facility relocations) to arrive at a net original cost or "ISRS Rate Base." (Exh. 5 and 6, Tr. 68) The Company then applied the rate of return authorized in its last rate case to this ISRS Rate Base. The Company also identified the annual expenses attributable to depreciation, property tax and state and federal income tax to arrive at the "Total ISRS Revenues" of $3,813,222 to be recovered by its proposed ISRS. (Exh. 5 and 6, Tr. 68-69) The Company believes its calculation of the ISRS revenue requirement is consistent with both the letter and the spirit of the ISRS Legislation (i.e., § 393.1000 et seq. RSMo 2003). By contrast, the Staff has ignored the plain language of the statutes and manufactured an ISRS revenue requirement that is less than one-half of the true revenue requirement associated with approximately $29,000,000 of ISRS eligible plant. By far, the biggest factor in Staff's effort to minimize ISRS revenue requirement is an amount for accumulated depreciation that is nearly 53% of the total investment in ISRS eligible plant (i.e., $15,500,000 of accumulated depreciation versus $29,000,000 of ISRS eligible plant). (Tr. 144) Staff readily concedes its accumulated depreciation amount includes depreciation on non-ISRS eligible plant (Tr. 147, 148, 153); which, on its face, is a clear violation of the prohibition in the ISRS Legislation that "(n)o other revenue requirement or ratemaking issues shall be examined in consideration of the petition or associated proposed rate schedules filed pursuant to the provisions of §§393.1000 to 393.1006." (§393.1006(2) RSMo 2003) The Staff also follows an overly strict (and unreasonable) construction of the ISRS Legislation to deny recovery of the full costs associated with the property taxes and the net cost of removal associated with the ISRS eligible plant. The shortcomings of Staff's approach are more thoroughly discussed below.

1. Accumulated Depreciation

The ISRS Legislation states in relevant part as follows:

> "If the Commission finds that a petition complies with the requirements of Sections 393.1000 to 393.1006, the Commission shall enter an order authorizing the water corporation to impose an ISRS that is sufficient to recover appropriate pretax revenues, as determined by the Commission pursuant to the provisions of Sections 393.1000 to 393.1006." §393.1006.2(4) RSMo 2003. (Emphasis added)

"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 and accumulated depreciation associated with eligible infrastructure system replacements which are included in a currently effected ISRS . . . " §393.1000(1)(a) RSMo 2003. (Emphasis added)

In calculating the "accumulated depreciation associated with eligible infrastructure system replacements", the Company calculated an amount based on the actual accumulated depreciation recorded on the books of the Company for each item of ISRS eligible plant. This detailed calculation is contained in the two schedules comprising Appendix A of the Company's Application. (Exh. 5) No party disputes the accuracy of the Company's calculation. In fact, Staff candidly admits that the Company has accurately calculated the actual accumulated depreciation that is associated with eligible infrastructure system replacements. (Tr. 144-145)

The Staff, on the other hand, calculated an amount of accumulated depreciation that is based upon a ratio of ISRS eligible plant to total plant additions since the Company's last rate case. This ratio is then applied to the total change in the Company's depreciation reserve since its last case (i.e., $53,573,609). (Exh. 4, Tr. 115-116, 145) As a result, Staff calculates an amount of accumulated depreciation that is approximately $15.5 million which it then offsets against total infrastructure eligible plant of approximately $29 million. (Exh. 1, Attachment B, p. 1 of 4, Tr. 143-144) Staff's approach is flawed and runs afoul of the statutory dictates in two respects. First, Staff does not calculate accumulated depreciation that is "associated with eligible infrastructure replacements." (§393.1000(1)(a) RSMo 2003) Second, Staff's accumulated depreciation includes depreciation on non-ISRS eligible plant, which is in direct violation of the statutory prohibition that "no other revenue requirement or ratemaking issues shall be examined in consideration of the petition or associated proposed rate schedules. . ." (§393.1006.2(2) RSMo 2003)

Staff readily concedes that its $15.5 million of accumulated depreciation includes depreciation that has accrued not only on ISRS eligible plant but also on non-ISRS eligible plant. For example, in Staff's $15.5 million, there is accrued depreciation on plant placed in service prior to January 1, 2001 and non-ISRS plant placed in service after January 1, 2001. (Tr. 147) Clearly, both the letter and spirit of the ISRS Legislation were to offset the original cost of ISRS eligible plant with only the accumulated depreciation accrued on that specific plant. By taking into account accumulated depreciation on non-ISRS eligible plant, the Staff is grossly overstating the amount of accumulated depreciation associated with the ISRS eligible plant. (Tr. 69) Although Staff does not agree, the fact of the matter is that by using a depreciation reserve of approximately $15.5 million, Staff's calculation of net original cost assumes that the ISRS plant, which has only been in service for two and one-half years, is approximately 53% depreciated (i.e., $15,500,000 of reserve divided by $29,000,000 of plant). This also assumes an annual depreciation rate of over 20%, when the actual Commission authorized rate of depreciation for ISRS eligible plant is approximately 2%. (Tr. 70) Not only is Staff's calculation of accumulated depreciation contrary to law, it simply defies common sense.

Staff nevertheless attempts to justify its position by claiming that accumulated depreciation represents funds that have been contributed by the ratepayer and available to the Company for investment in infrastructure replacements. (Tr. 148) However, Staff's argument misses the point entirely. The ISRS Legislation does not seek to identify or "ear mark" the source of investment dollars (an exercise which Staff agrees is not possible). (Tr. 149-150) The plain language of the Legislation and its intent is abundantly clear. The Commission is to determine the revenue requirement associated with the ISRS eligible plant and allow the Company to recover those revenues through the implementation of an ISRS. The Commission is not to consider other revenue requirement or ratemaking issues. Even Staff acknowledges this point when it characterizes the Legislation as "single issue ratemaking."

> "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. <u>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</u>." (Staff's Reply to Missouri-American's Response, p. 2, Exh. 2) (Emphasis added)

By taking into account accumulated depreciation that has accrued on plant other than ISRS eligible plant, the Staff has violated both the letter and the spirit of the legislation and gone beyond an examination of the single issue (i.e., the revenue requirement associated with ISRS eligible plant).[3]

Staff's concern with the ISRS Legislation is that it would allow a utility that is overearning to implement a surcharge that would exacerbate those overearnings.(Tr. 121-122) Staff's Exhibit 8 creates a hypothetical situation where a company in its last rate case had a $20 a year revenue requirement. Subsequent to its last rate case the utility seeks to implement an ISRS of $5 a year, even though its "current" revenue requirement is only $18 a year. Staff worries that under Company's proposal, the utility would not only continue to receive the $20 a year that was found reasonable in its last rate case, but also receive a $5 surcharge bringing its total revenues to $25 a year. Staff's proposal is to find (without benefit of an earnings investigation) that the utility is overearning and only needs $18 a year in revenue requirement and adjust the surcharge downward so that the utility only recovers $23 on an annual basis.

> "Q. . . . Under the Staff's proposal and the Staff's methodology, what would the customer's rates be?
> A. [Staff witness Rackers] Twenty-three [dollars].
> Q. And how do you determine that amount?

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[3] When questioned by RLJ Woodruff, "Is there anything in the statute that says Staff should be looking at non-ISRS investments?" Staff witness Rackers readily conceded, "No." (Tr. 185)

> A. Well, the cost of service associated with those assets from the last case has been reduced by 2 [dollars] and that cost of service should be considered in the determination of the ISRS. So it should reduce the surcharge by $2." (Tr. 197) (Emphasis added)

This Exhibit and Staff's testimony clearly indicate that Staff is taking into consideration "other revenue requirement or ratemaking issues" in adjusting the surcharge and thus violating the express prohibition of the ISRS Legislation. See also the following testimony of Staff witness Rackers:

> "I think that it's important to take into consideration what's in rates today before you establish an additional surcharge, which we're establishing an additional rate in this proceeding. And I think you have to consider what's in rates today, what's the company recovering today before you just blindly establish a new surcharge on top of that." (Tr. 150) (Emphasis added)

"What's in rates today" (or what rates would be today if the Commission was setting rates in a rate case) is exactly the cumbersome and contentious inquiry the Legislation sought to avoid.

Of course, to fully appreciate the unfairness of Staff's approach, one need only ask what would happen if a utility was under-earning since its last rate case and experiencing a revenue requirement of $22 a year? Would Staff acknowledge the under-earnings and allow the Company to implement a larger-than-necessary surcharge of $7 in order to recover $27 (i.e., $22 + $5) on an annual basis? Absolutely not! According to Staff, it is up to the Company to file for a rate increase if it believes that it is under-earning. (Tr. 154)

Staff's approach in this case is nothing more than a conscious effort to subvert the plain reading and application of legislation with which it does not agree. Unlike the MIEC who actively opposed the Legislation but nevertheless acknowledged its clear mandate, Staff refuses to accept the plain reading of the statute. (Tr. 224, 229-230) The fact that even Public Counsel remained silent on this issue speaks volumes about the credibility of Staff's position.

2. Accumulated Depreciation – Net Cost of Removal

In developing the appropriate amount of accumulated depreciation to be offset against the original cost of the ISRS eligible plant, the Company further adjusted its total accumulated depreciation to reflect the cost of removal (net of salvage) that it actually incurred when replacing plant. As with its calculation of accumulated depreciation, the Company identified each specific item of ISRS eligible plant and the net cost of removal associated therewith. This is detailed on the thirty-nine page schedule which is part of Appendix B attached to the Company's Application (Exh. 5).

When an item of plant is retired from service, the Company will typically incur a cost to remove it from service. If the plant has any salvage value, the salvage value is deducted from (or netted against) the cost of removal. Generally speaking, however, the cost of removing a piece of plant from service exceeds its salvage value and a "net cost of removal" is incurred. In this case, the Company determined the net cost of removal for the specific plant that was retired and replaced by ISRS eligible plant. In total, the Company incurred a net cost of removal of $1,036,533.75 associated with the ISRS eligible plant. (Exh. 5, Appendix 3, p. 39 of 39) This amount was then deducted from the accumulated reserve which, in turn, increased the net original cost of the ISRS eligible plant. (Exh. 6, Tr. 65-66)

Staff, on the other hand, made no adjustment for the net cost of removal arguing that there is no specific mention of this item in the ISRS Legislation and, alternatively, arguing that by calculating accumulated depreciation using its "ratio" method, Staff has indirectly captured any net cost of removal. (Tr. 126, 158, 171)

While Staff is technically correct – there is no mention of the term "net cost of removal" in the ISRS Legislation, it is nevertheless a commonly recognized element of calculating a utility's accumulated depreciation. Proper accounting requires that when a piece of property is retired from plant-in-service and a net cost of removal is incurred, there is an adjustment to the plant for the original cost of the plant and an adjustment to the reserve for an equal amount. In addition, there is a further adjustment to the reserve, which has the effect of increasing the net original cost of plant. (Tr. 155) Therefore, to the extent the ISRS Legislation acknowledges that accumulated depreciation is an offset to the original cost of ISRS eligible plant, it implicitly recognizes that there may be a net cost of removal that is associated with that accumulated depreciation calculation. Staff's overly strict interpretation of the ISRS Legislation is suspect when compared to its reason for deducting accumulated depreciation from the original cost of the ISRS eligible plant. When asked what was the basis for deducting accumulated depreciation from original cost, Staff refused to agree that it was specifically addressed in §393.1000(1)(a) and simply relied on the fact that accumulated depreciation was "contemplated" in the determination of net original costs. (Tr. 191-192) Therefore, it is irreconcilable for Staff to argue, on the one hand, that a reduction from original cost for accumulated depreciation is "contemplated" in the Legislature's use of the term "net original cost," but, on the other hand, that further adjusting accumulated depreciation for net cost of removal is not contemplated because it is not specifically mentioned in the Legislation.

Staff's alternative argument that the net cost of removal is indirectly included in its "ratio" method of calculating accumulated depreciation also must fail because, as demonstrated previously, Staff's ratio method of calculating accumulated depreciation is clearly improper and contrary to the statute.

3. **Property Taxes**

In calculating the property tax associated with ISRS eligible plant, the Company took the original cost of all ISRS plant (less retirements) and multiplied it times the current tax rate. (Exh. 5, Appendix B, p. 2 of 4; Tr. 66) Staff, on the other hand, took the original cost of ISRS plant placed in service in years 2001 and 2002 (less retirements) and multiplied it by the current tax rate. (Exh. 1, Attachment B, p. 4 of 4) Staff has therefore excluded ISRS eligible plant placed in service in calendar year 2003 from its calculation of property taxes arguing that property tax on this 2003 plant is not "due" until December of 2004, which is more than twelve months after the filing of the Company's application. (Tr. 128, 131-132)

The ISRS Legislation as it relates to property taxes contains the following references: First, "ISRS costs" are defined as "depreciation expenses, and property taxes that will be due within twelve months of the ISRS filing." §393.1000(5) RSMo 2003. And "(i)n determining the appropriate pretax revenues, the commission shall consider only the following factors: . . . the current property tax rate or rates applicable to the eligible infrastructure replacements." §393.1006.4(5) RSMo 2003. There is no dispute between the Company and Staff regarding the appropriate property tax rate to be applied to the ISRS eligible plant, the only issue is whether or not ISRS eligible plant placed in service in calendar year 2003 should be included in the calculation. (Tr. 131-132) There is also no question that the Company will owe property taxes on all of its ISRS eligible plant, the only question is when will that tax be due. (Tr. 133)

Company believes that 2003 ISRS eligible plant is appropriately included in the calculation because property taxes on that plant will become a liability on the Company's books as of January 1, 2004. On January 1, 2004, the Company will begin accruing, each month, a liability for the property taxes on this plant, which it will pay in approximately December of

2004. (Tr. 71-72, 80-81) Company therefore believes that these taxes are due January 1, 2004, even though they may not be required to remit them to the taxing authority until December, 2004. As long as the Company is accruing these taxes on its books and recognizing them as a debt, they are clearly due.

As a final matter, it should be noted that under Staff's analysis, property taxes on ISRS eligible plant placed in service in the same year that the ISRS application is filed will never be recovered, unless the application is filed in December of a calendar year. (Tr. 132) Surely the Legislature did not intend for utilities to continually underrecover their full property tax expense on ISRS eligible plant. Staff's reading of the statute is unreasonably strict and should be rejected.

Conclusion

A plain reading and reasonable interpretation of the ISRS Legislation clearly supports the Company's calculation of the ISRS revenues to be recovered from its proposed surcharge. The Staff's attempt to inject other revenue requirement and ratemaking considerations into its calculation of accumulated depreciation, and thereby manufacture an offset of nearly $15.5 million, or 53% of the original cost of the ISRS eligible plant, is patently unreasonable and contrary to the law. Further, Staff's attempted strict construction of the ISRS Legislation to deny the Company recovery of its actual net cost of removal and property taxes associated with the ISRS plant is likewise unreasonable and contrary to the law. The Commission should recognize and reject the Staff's position in this case as nothing more than a conscious effort to deny the Company the ability to recover the true and correct level of ISRS revenues in accordance with the letter and spirit of the ISRS Legislation.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing document was served by U.S. Mail or hand-delivered this 4th day of December, 2003, to the following:

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