

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

In the Matter of Missouri-American Water )  
Company for Certificates of Convenience )  
and Necessity Authorizing it to Install, Own, )  
Acquire, Construct, Operate, Control, )  
Manage, and Maintain Water and Sewer )  
Systems in and around the City of Lawson, )  
Missouri )

Case No. WA-2018-0222

**RESPONSE TO STAFF RECOMMENDATION AND  
MOTION TO OPEN A WORKSHOP DOCKET**

COMES NOW the Office of the Public Counsel (“OPC”), by and through undersigned counsel, and files this *Response to Staff Recommendation and Motion to Open a Workshop Docket* in response to the *Staff Recommendation* filed by the Missouri Public Service Commission’s Staff (“Staff”). In support thereof, OPC states as follows:

**I. Introduction**

1. On February 5, 2018, Missouri-American Water Company (“MAWC”) entered into an *Asset Purchase Agreement* with the City of Lawson (“the City”) outlining MAWC’s purchase of the City’s water and sewer systems.<sup>1</sup>

2. On February 12, 2018, MAWC filed an *Application and Motion for Waiver* with the Missouri Public Service Commission (“the Commission”) requesting certificates of convenience and necessity to install, own, acquire, construct, operate, control, manage, and maintain water and sewer systems in and around the City.<sup>2</sup>

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<sup>1</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Pg. 2.

<sup>2</sup> *Id.* at 1.

3. MAWC’s application is unique in that it has requested the Commission employ the never-before-used procedural system set forth in Missouri Revised Statute section 393.320 to establish the rate base for ratemaking purposes associated with the acquired systems.

4. Under Section 393.320, a statutorily defined “large water public utility” engaged in the acquisition of a statutorily defined “small water utility” may choose to have the rate base of the small water utility determined, for ratemaking purposes, as the lower of either the purchase price for the acquired systems or the systems’ appraised value, as determined by three independent appraisers, together with any reasonable and prudent closing and transaction costs.<sup>3</sup>

5. On May 29, 2018, Staff filed a recommendation to approve MAWC’s request for certificates of convenience and necessity subject to 19 enumerated recommendations.<sup>4</sup>

6. Having reviewed MAWC’s *Application* and Staff’s *Recommendation*, the OPC has identified a number of issues that it seeks to bring to the attention of the Commission regarding the application of section 393.320.6, the methods used during the appraisal, and Staff’s enumerated recommendations 8, 9, and 10. These issues have been laid out in further detail below.

7. OPC is not requesting an evidentiary hearing in this matter because OPC believes a rulemaking workshop would be the preferred forum to address the concerns raised herein; however, OPC reserves its right to contest the prudence of any transaction, closing, and transition costs incurred by MAWC in future proceedings.

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<sup>3</sup> RSMo. § 393.320.1,5

<sup>4</sup> EFIS, WA-2018-0222, Staff Recommendation.

## **II. Issue Regarding the Application of Section 393.320.6**

8. Staff's enumerated recommendations 2, 3, and 4 would require MAWC to submit new tariff sheets that would effectively apply the existing Lawson inside-city water and sewer rates to a newly established "Lawson service area."<sup>5</sup>

9. OPC does not oppose this recommendation; however, OPC is concerned that Staff's recommendation may possibly be a contravention of the statutory requirements of section 393.320.6, which reads as follows:

Upon the date of the acquisition of a small water utility by a large water public utility, whether or not the procedures for establishing ratemaking rate base provided by this section have been utilized, the small water utility shall, for ratemaking purposes, become part of an existing service area, as defined by the public service commission, of the acquiring large water public utility that is either contiguous to the small water utility, the closest geographically to the small water utility, or best suited due to operational or other factors. This consolidation shall be approved by the public service commission in its order approving the acquisition.<sup>6</sup>

10. OPC therefore requests that the parties identify which of MAWC's existing service areas the City's water and sewer system shall become a part of such that the Commission's order may approve the consolidation as required under the statute.

## **III. Issues Regarding the Methodology of the Appraisal**

11. The appraisal report submitted by MAWC was written by Edward W. Dinan of Dinan Real Estate Advisors, Inc.; Joseph E. Batis of Edward J. Batis & Associates, Inc.; and Chris Stallings of the Butler Burgher Group.

12. The report utilized two different methods for determining the value of the water and sewer systems owned by the City.

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<sup>5</sup> EFIS, WA-2018-0222, Staff Recommendation, Pg. 2, recommendations 2, 3, and 4.

<sup>6</sup> RSMo. § 393.320.6

13. The first method, designated the “Cost Approach” method, is based on the cost required to reproduce the existing property.<sup>7</sup> Under this method, the total value of the systems was calculated to be \$3,800,000.00.<sup>8</sup>

14. The second method, designated the “Sales Comparison” method, is based on the sale of comparable water and sewer systems.<sup>9</sup> Under this method, the total value of the systems was calculated to be \$4,000,000.00.<sup>10</sup>

15. OPC has identified a number of issues in the appraisal report submitted by MAWC both generally and individually with regard to these two methods.

16. To begin, OPC is concerned generally with the statement in the appraisal report that “each of the appraisers performed different tasks, and were responsible for different parts of this assignment.”<sup>11</sup>

17. Under section 393.320, the appraisal is to be prepared “jointly” by three separate appraisers: one appointed by the small water utility, one by the large water utility, and the last by the two other appraisers.<sup>12</sup> The statute further contemplates that if the three appraisers are unable to agree as to the appraisal value, then only the signature of two of the appraisers is required to make it a good and valid appraisal.<sup>13</sup>

18. The statute therefore implies that each of the three appraisers should be engaged in appraising the *total* value of the system, as opposed to a situation wherein each appraiser

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<sup>7</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Pg. 52.

<sup>8</sup> *Id.* at 58.

<sup>9</sup> *Id.* at 52.

<sup>10</sup> *Id.* at 71.

<sup>11</sup> *Id.* at 2.

<sup>12</sup> RSMo. § 393.320.3(1), (2)(a).

<sup>13</sup> RSMo. § 393.320.3(3)

determines the value of only part of the overall system after which the three separate parts are added together to provide a total value.

19. If each appraiser were required to value only part of the total system, then there would be no point to dividing the appointment of appraisers between the small and large water utilities or in providing a mechanism to resolve disagreements between the appraisers given that each appraiser would only ever be concerned with their own segment of the total appraisal.

20. While the OPC is aware that the appraisal report states that the three appraisers “consulted throughout the assignment with each other,”<sup>14</sup> it remains unclear whether each of the three appraisers hired by MAWC formed an independent conclusion regarding the entire value of the system or if, as the appraisal report language implies, each appraiser was responsible for determining only part of the total value.

21. OPC is also concerned with the fact that none of the three appraisers hired by MAWC made a personal determination of the value of any of the plant assets owned by the City and also based their appraisal on the assumption that all plant assets were in good working order.

22. On the first page of the appraisal report, the appraisers state as follows:

Throughout the attached appraisal report, any reference to the appraisers' "inspection", "subject property inspection", "inspection of the subject property", "inspection of the subject water and wastewater systems", etc., refers to the appraisers' customary task of viewing the subject property for purposes of observing the condition, layout, design, and utility of the real property (land and building), as is typical in the appraisal profession and in the framework of completing the appraisal process. The reference to the term "inspection" in the context of the appraisers' work should not be interpreted to suggest the appraisers have any expertise and/or qualifications in the assessment of the condition and functionality of any mechanical and non-mechanical components of the subject property water delivery and wastewater systems. The appraisers refer the client and intended users of the attached appraisal report to the engineer's report for an assessment of the water and wastewater systems' infrastructure components. The three professional real estate appraisers co-signing the attached appraisal report are

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<sup>14</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Pg. 2.

not qualified to independently detect and assess the condition and functionality of the water and wastewater systems' infrastructure components. However, the three professional real estate appraisers co-signing the attached appraisal report assume that the water and wastewater delivery systems' components (including the plant, pumps, and all related facilities) are in proper working order and have been maintained adequately to meet all pertinent codes and regulatory requirements.<sup>15</sup>

23. The appraisal report goes on to restate the same when laying out the special assumptions and limiting conditions upon which the appraisal is based.<sup>16</sup>

24. As a result, the only valuation of the plant assets made in the appraisal report is supplied not by any of the three appraisers but rather by a single third-party engineering firm: Flinn Engineering.

25. However, an examination of the calculations made in the "Cost Approach" method of the appraisal report indicates that the plant assets owned by the utility account for more than 70% of its total value.<sup>17</sup>

26. Thus, the vast majority of the value determined in the appraisal report submitted by MAWC was not the work product of any of the three appraisers but rather arose from the effort of a single outside engineering firm.

27. This use of a single third-party engineering firm would appear to contradict the requirements of section 393.320, in that it subverts the requirement that three separate appraisers perform the appraisal. It also raises a host of other issues specific to the appraisal report submitted by MAWC.

28. For example, the report prepared by Flinn Engineering states that the firm was engaged to provide only a "high level review" of the condition of the City's water and sewer

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<sup>15</sup> *Id.*, Pg. 1 n. 1.

<sup>16</sup> *Id.*, Pg. 11.

<sup>17</sup> *Id.*, Pg. 58.

systems and that no individual from the firm performed any onsite inspection of the plant assets being valued.<sup>18</sup>

29. Instead, Flinn Engineering made its determinations as to the quality of the plant assets based entirely off photographs supplied by unknown third parties.<sup>19</sup>

30. Therefore, no one involved in the production of the appraisal report submitted by MAWC performed an onsite evaluation of the quality of the plant assets being appraised despite these plant assets accounting for more than 70% of the determined value of the systems.

31. The OPC is also concerned about the fact that the use of the engineering report resulted in the double counting of some assets.

32. The “Cost Approach” method of the appraisal report calculates the value of the systems by adding together the value of the real-estate that makes up the water and sewer systems (as determined by the three appointed appraisers) and the value of the plant assets (as determined by the Flinn Engineering report).<sup>20</sup>

33. However, an examination the Flinn Engineering report shows that their valuation included an asset of real property ambiguously described as “land” as well as an asset of real property labeled “lagoon.”<sup>21</sup>

34. Therefore, the Flinn Engineering Report already included assets that were also independently being valued by the three appraisers.

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<sup>18</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Flinn Engineering report, Pg. 1.

<sup>19</sup> *Id.*

<sup>20</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Pg. 58.

<sup>21</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Flinn Engineering report, City of Lawson, Mo Depreciation Schedules Pg. 2, group #9, line items 1, 2.

35. The failure of the appraisers to address this fact during their calculations in the “Cost Approach” method resulted in these assets being counted twice.

36. In addition, the three appraisers included in their “Cost Approach” method calculation an “adjustment” equal to 20% of the value of the plant assets determined by Flinn Engineering (rounded up to \$550,000.00) which they claimed was necessary because the Flinn report “does not indicate whether all construction and instillation costs are included.”<sup>22</sup>

37. However, the Flinn report clearly states that the book values for the items included in its report are “assumed to include the material and labor required to place the assets in service.”<sup>23</sup>

38. Thus, the Flinn report does indicate that the construction and instillation costs were included in its assessment, which directly contradicts the basis for the appraisal report’s inclusion of the 20% adjustment.

39. Further, the 20% adjustment included in the report (which is meant to adjust the original cost of the plant assets to include expenses relating to construction/installation) is calculated using the fully depreciated value of the plant assets inflated to present book value and not the original book cost of the items being built/installed.

40. After adjusting the amount calculated under the “Cost Approach” method to exclude the 20% adjustment and the assets improperly double counted, the difference between the values determined using the “Cost Approach” method and the “Sales Comparison” method increases from \$200,000.00 to nearly \$800,000.00. This disparity heightens the concerns OPC has regarding the calculations at work in the “Sales Comparison” method.

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<sup>22</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Pg. 58.

<sup>23</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Flinn Engineering report, Pg. 3.

41. OPC is concerned, for example, with the fact that of the eight water and sewer system sales that were used in the “Sales Comparison” approach, six constituted purchases by either MAWC or its sister subsidiary Illinois-American Water Company while the remaining two consisted of municipalities acquiring privately owned systems in transactions the Staff recommended the Commission deny due to the existence of large acquisition premiums.<sup>24</sup>

42. Further, one of these MAWC sales was an undisclosed transaction in which the final price was still under negotiation.<sup>25</sup>

43. Despite this fact, the appraisers nevertheless placed significant value upon this transaction and, in essence, used it as the primary transaction for determining the value of the Lawson City sewer system.<sup>26</sup>

44. This means that, for the most part, the “Sales Comparison” approach employed by the appraisers was attempting to determine the value of the Lawson City sewer system by comparing it to the price that MAWC might *possibly* pay at some unknown future point for an undisclosed system.

45. Another major problem with the “Sales Comparison” approach is the fact that for both water and sewer systems the “unit value per customer” ultimately determined by the

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<sup>24</sup> EFIS, WA-2018-0222, Application and Motion for Waiver, Appendix E - Appraisal City of Lawson Water and Wastewater Systems, Pg. 69. In the “scope of work” section of the appraisal report, the appraisers explained that because market data for utility acquisitions was very limited in the state of Missouri (due to MAWC being the primary purchaser), they decided to expand their search for comparable market data by looking across the border into Illinois. *Id.* at 9. However, the OPC notes that the market data the appraisers utilized from the state of Illinois consisted solely of acquisitions by Illinois-American Water Company, which is a subsidiary of the same parent company who owns MAWC, thus defeating the purpose of the appraiser’s decision to look to Illinois.

<sup>25</sup> *Id.* at 68.

<sup>26</sup> *Id.* at 71. (“Giving most consideration to the undisclosed transaction with a slight adjustment based upon the influence of the allocated prices of Wardsville and Sundale results in a unit value conclusion of \$1,500 per sewer customer for the subject property sewer system.”).

appraisers was generated by comparison to only three other sales, all of which fell within relatively extreme ranges.

46. For example, in the case of water systems the three cases used as representative comparisons ran the gamut from \$1,714 per customer to \$3,528 per customer.<sup>27</sup>

47. In the case of sewer systems, the range grew even larger running from \$356 per customer to \$4,802 per customer.<sup>28</sup>

48. Given the combination of extremely small sample sizes and extremely large ranges between samples, it is hard to consider the “average” value per customer ultimately determined by the appraisers as anything more than purely arbitrary.<sup>29</sup> The addition of even a single other sample sale has the power to significantly change the appraiser’s results.

49. The OPC also questions the appraisal report’s decision to place greater weight on the “Sales Comparison” method as opposed to the “Cost Approach” method. While the OPC acknowledges that in the course of a general real-estate appraisal the decision as to which method requires greater emphasis would be a determination best left to the expert appraisers, the OPC argues that the same does not hold true with regard to an appraisal for purposes of section 393.320.

50. The purpose of the appraisal for use in section 393.320 is to establish the rate base, generally understood as the capital utilities have invested in order to supply service. As such, the “Cost Approach” method of appraisal is a far better method as it comes the closest to ascertaining the value of the investments that have been *actually made* by the small utility company in question.

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<sup>27</sup> *Id.* at 70.

<sup>28</sup> *Id.* at 71.

<sup>29</sup> The OPC also notes that the actual value per customer designated by the appraisers does not directly correlate to either the arithmetic average or the median number for each of the sample sets and instead falls somewhere in between these values with no explanation given as to why.

51. By contrast, the “Sales Comparison” method requires comparing the small utility to other utilities that, while serving the same approximate number of customers, have made significantly different types of investments in order to provide the same level of service.

52. For example, several of the water systems used for the comparison in the MAWC appraisal had invested in wells and were thus capable of producing water (unlike the City of Lawson) while several of the sewage systems utilized different methods of sewage treatment that ranged from a full-fledged treatment plant to pumping the sewage to a different city for further treatment.<sup>30</sup>

53. Therefore, greater weight should have been laid upon the “Cost Approach” method as opposed to the “Sales Comparison” method in determining the value of the City’s systems for purposes of 393.320.

#### **IV. Issues Regarding Staff’s Enumerated Recommendations 8, 9, and 10**

54. Both the North Highway 69 Sewage Lift Station and Vibbard Water Pump Station components of the City’s water and sewer system were included in MAWC’s appraisal yet Staff concedes and OPC agrees that neither would ordinarily be included in the rate base.<sup>31</sup>

55. Nevertheless, Staff’s enumerated recommendations 9 and 10 seek to provide a mechanism for including both these assets in the rate base.

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<sup>30</sup> *Id.* at 61,63,64,66. This would explain the wide range between the “value per customer” determinations previously discussed.

<sup>31</sup> EFIS, WA-2018-0222, Staff Recommendation, Official Case File Memorandum, Pg. 3-4. Specifically, Staff concedes and OPC agrees that the North Highway 69 Sewage Lift Station is not yet in service, as there are no customers currently connected to it, meaning that it should therefore be classified as “plant held for future use” (which would ordinarily not be included in rate base) and that the Vibbard Water Pump Station has not been used for a number of years, and it is unknown whether or not a contract for service with the involved water supplier has expired, meaning that the facility is “out of service” and not “used and useful” at present (and thus would ordinarily not be included in rate base).

56. Specifically, Staff suggests that the North Highway 69 Sewage Lift Station be included in the rate base because the city has represented that new customers are expected to connect “soon” and recommends in enumerated recommendation 9 that MAWC book the estimated original cost of the lift station along with an accompanying CIAC offset equal to the estimated original cost.<sup>32</sup>

57. However, the OPC is concerned with the fact that there is no indication in Staff’s Official Case File Memorandum what the term “soon” means.

58. In addition, the OPC notes that recommendation 9 provides no mechanism to ensure that the lift station is actually put into use in a timely manner.

59. Finally, the recommendation also fails to make clear which party is responsible for estimating the lift station’s original cost and whether that estimation must be made by an independent third party appraiser (as the overall appraisal was) or if it may be made by one of the parties themselves.

60. In addition, Staff would allow the Vibbard Water Pump Station be included in the rate base by requiring in enumerated recommendation 10 that MAWC immediately put the pumping station into service by entering into a wholesale contract or a water service agreement with the neighboring water district “within 60 days of closing on the assets, or as soon as possible thereafter.”<sup>33</sup>

61. OPC is concerned with this recommendation, as it requires MAWC to enter into a contract with a specifically designated third party without regard to the contract’s economic

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<sup>32</sup> EFIS, WA-2018-0222, Staff Recommendation, Pg. 3.

<sup>33</sup> *Id.*

feasibility. In other words, OPC believes that this recommendation has the potential to encourage imprudent decision making in order to comply with Commission requirements.

62. OPC also notes that this recommendation constitutes the Staff inappropriately making management decisions on behalf of the utility.

63. OPC recommends that the issues it has identified regarding recommendations 9 and 10 and the inclusion of the North Highway 69 Sewage Lift Station and the Vibbard Water Pump Station be resolved by requiring Staff to determine what portions of the respective water and sewer appraisals correspond to these two assets and then subtracting those portions from the respective water and sewer appraisals, thereby permitting the Commission to disregard recommendations 9 and 10.

64. OPC also disagrees with Staff's enumerated recommendation 8 in as far as it designates MAWC as the party responsible for developing a plan for booking all of the Lawson plant assets.

65. Instead, OPC requests that the recommendation be modified to require Staff to independently perform the necessary task of determining how the Lawson Plant assets should be booked.

66. In the alternative, should the Commission permit MAWC to develop its own plan to book all of the Lawson plant assets, OPC requests that Staff's recommendation be modified to require that MAWC develop a plan to book all of the Lawson plant assets with the concurrence of both Staff and OPC.

## **V. Request to Open a Workshop Docket**

67. In light of the concerns raised herein regarding the proper application of section 393.320, the OPC respectfully requests that the Commission open a workshop docket to discuss,

among other things, the adoption of rules governing the appraisal of small water utilities pursuant to section 393.320.

**WHEREFORE**, the Office of the Public Counsel respectfully submits the forgoing for consideration by the Commission and requests the Commission order: (1) the parties identify which of MAWC's existing service areas the City's water and sewer system shall become a part of, (2) a workshop docket to be created to discuss, among other things, the adoption of rules governing the appraisal of small water utilities pursuant to section 393.320, (3) a scheduling conference in the proposed workshop docket, and (4) any other relief it deems just and reasonable.

Respectfully submitted,  
OFFICE OF THE PUBLIC COUNSEL

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**CERTIFICATE OF SERVICE**

I hereby certify that a true and correct copy of the foregoing motion was submitted to all relevant parties by depositing this motion into the Commission's Electronic Filing Information System ("EFIS") on this 25<sup>th</sup> day of June 2018.

  /s/ John Clizer