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July 24, 2000

Mr. Dale H. Roberts
Secretary/Chief Regulatory Law Judge
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Missouri-American Water Company
Case No. WR-2000-281, et al.

Dear Mr. Roberts:

Enclosed for filing in the above-referenced case please find the original and eight copies of **Initial Brief of the Office of the Public Counsel.** Please "file" stamp the extra enclosed copy and return it to this office.

Thank you for your attention to this matter.

Sincerely,

John B. Coffman
Deputy Public Counsel

JBC:jb

cc: Counsel of Record

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Tariff Sheets Designed to Implement General Rate Increases for Water and Sewer Service Provided to Customers in the Missouri Service Area of the Company.	)))))	**Case No. WR-2000-281, et al.**

INITIAL BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

July 24, 2000

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I. INTRODUCTION

If Missouri-American Water Company ("Company" or "MAWC") were not the monopolistic provider of water service in St. Joseph, Missouri, it would not be able to pass along to its customers the cost of an expensive capital improvement when a reliable and more cost effective alternative was available to it. The Missouri Public Service Commission ("Commission") has the ability in this case to protect consumers by setting the rate base of this water company at a level that is prudent and reasonable by determining the value for the most cost effective and financially responsible manner in which Company should have upgraded its water treatment in St. Joseph.

The most important consumer safeguard inherent to the regulation of utilities is the power invested in public utility commissions to make rate base adjustments to monopoly utility investments. This rate case presents the Commission with an opportunity to make such an adjustment and to fulfill its responsibility to protect the public from utility rates that would otherwise be unjust and unreasonable by ensuring that rates are set at a level no higher than would be expected from a water company subjected to the forces of competition.

This initial brief outlines the legal and regulatory doctrine of prudence, explains how it is properly applied when determining the value of a capital improvement, and explains why such a determination must ultimately be made in the course of a rate case. The Office of Public Counsel (Public Counsel) summarizes the competent and substantial evidence that has been accepted into the record in this case, which makes a compelling case for a prudence disallowance of well over $30 million dollars. Public Counsel's case is built upon documents and cost estimates available and known to Company at the time it was making its abrupt decision to

switch gears toward the construction of an extremely expensive groundwater facility. It is based primarily upon reports and costs actually developed by Company in prior years.

The record in this case tells the incredible story of how Company's own estimates for upgrading its water service in St. Joseph grew and grew from 1991-1996 until its inflated estimates nearly matched the expensive cost of the groundwater treatment facility that was most desired by this profit-driven utility. The Commission has been presented in this case with the results of two completely independent prudence reviews that recommend a rate base valuation for this project of between $35 - $40 million, and would reflect the cost that would have been incurred to flood-proof the St. Joseph river treatment facilities and to upgrade water service to a level comparable to the service now being provided by the new groundwater facility.

After the Commission has made a determination regarding the valuation for providing water service to St. Joseph, the Commission should also recognize in rate base only 80.45% of that total valuation in order to ensure that Company's rate base only reflects the value of plant-in-service for that portion of facilities currently necessary to provide service to current customers. This "used and useful" capacity adjustment is appropriate because customers do not currently demand (and are not expected to demand in the near future) the 30 MGD capacity that the new groundwater facility is designed to produce.

This brief will also present Public Counsel's arguments on the other revenue requirement issues in this case, many of which also relate to Company's imprudent and ill-advised decision to abandon its river treatment plant and take advantage of the tragic 1993 Flood to justify an unreasonable excessive addition to its rate base. For instance, the Commission should not include in its determination of Company's cost of service any rate base or expense related to the Accounting Authority Order (AAO) issued in this case on March 23, 2000. None of the deferred

costs requested by the Company in its AAO Motion are appropriate in this case because the "triggering event" (the planned construction of a water plant) does not meet the regulatory requirements established by Commission precedent, and it is not appropriate to shield stockholders from the short regulatory lag involved with this request. In fact, Company's earnings were adequate during the deferral period. In addition, the accounting authority request is not structured in conformance with the Uniform System of Accounts (USOA) as it relates to water companies.

Finally, Public Counsel's initial brief will explain why the various components of Public Counsel's rate design proposal are the most just and reasonable for Company's water customers:

1) With regard to determining the appropriate revenue responsibility vis-à-vis Company's seven diverse and distinct districts, Public Counsel proposes a compromise between the extremes of "single tariff pricing" (STP) and "district specific pricing" (DSP). Given the disparity in the capital improvements and other cost characteristics Exibited by the seven districts, revenue recovery should more closely reflect district specific class costs and should not be based on a simplistic Company-wide "single tariff pricing" cost of service study. Public Counsel's district specific class cost of service study should guide the Commission to adopt rates that more closely reflect district specific class cost of service. However, the Commission should temper the more dramatic rate shifts by reflecting the consideration of all relevant factors in this case, including equity and the mitigation of rate shock. Public Counsel's study supports some limited sharing between the larger Joplin and St. Charles districts and the smaller districts of Brunswick, Parkville and Mexico.

2) With regard to appropriately assigning revenue responsibility among the various customer classes, Public Counsel's class cost allocation methodology is the most appropriate.

This methodology properly allocates costs to small users with a high peak to average usage ratio, while the method employed by Company and the Staff of the Commission (Staff) over-allocates costs to this group. To accommodate a reasonable level of inter-class movement toward cost, Public Counsel's recommendation adjusts the district increases to account for inter-class shifts.

3) Regardless of the revenue requirement approved and regardless of which rate design is approved by the Commission in this case, the corresponding rate increase should be phased-in over a number of years. Public Counsel's rate design methodology provides for a phase-in of a 15% increase in revenue from any given district per year under a reasonable revenue requirement recommendation. This phase-in proposal is designed to provide Company with full recovery of its Commission-determined revenue requirement (through approval of a series of tariffs) along with all carrying costs associated with the deferral of any revenue requirement recovery during the phase-in period.

II. ST. JOSEPH TREATMENT PLANT VALUATION

A. Legal Standard for a Prudence Review

The prevailing Public Service Commission case in Missouri regarding the standard for prudence reviews is the Union Electric Callaway Nuclear Plant rate case "Callaway Nuclear Plant case," in which the Commission ordered a significant disallowance of new plant based upon imprudent management decisions. Re: Union Electric Company (Callaway Nuclear Plant Case), 27 Mo.PSC (N.S.) 183 (1985). In this case, the Commission expounded upon the legal responsibility that the Commission bears in such inquiries:

> Under the Public Service Commission law, the Commission has the duty to set just and reasonable rates. A public utility must furnish and provide such service instrumentalities and facilities as shall be safe and adequate and in all repect [sic] just and reasonable. Every unjust or unreasonable charge is prohibited. Section 393.130(1), RSMo 1978.
>
> At any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the public utility. Section 393.150(2), RSMo 1978.
>
> The Commission has the power to ascertain the value of the property of a public utility and every fact which in its judgment may or does have any bearing upon such value. 393.230(1), RSMo 1978.
>
> . . .
>
> The United States Supreme Court established as far back as 1898 that a utility is entitled to ask a fair return on its prudent investment in property devoted to public service. This principle has been developed from early United States Supreme Court cases, including *Smyth, Hope,* and *State ex rel. Southwestern Bell Telephone Company v. Missouri Public Service Commission,* 252. U.S. 276 (1923).
>
> . . .
>
> The Commission determines that the appropriate standard to be used in this case was enunciated by the New York Public

> Service Commission in Re: *Consolidated Edison Company of New York, Inc.,* 45 P.U.R., 4th, 1982. In that case at page 331, the New York Commission rejected an earlier "rational basis" standard in favor of a reasonable care standard.
>
> . . .
>
> In reviewing UE's management of the Callaway project, the Commission will not rely on hindsight. The Commission will assess management decisions at the time they are made and ask the question, "Given all the surrounding circumstances existing at the time, did management use due diligence to address all relevant factors and information known or available to it when it assessed the situation?"
>
> Public utility regulation is based on the theory that a public utility is a natural monopoly since only one firm can efficiently serve a given market. To avoid monopoly pricing the state regulates the public utility to ensure reasonable rates. Thus, regulation is intended to serve as a surrogate for competition. The public utility is given a franchise to serve within a given area as a state-sanctioned monopoly and in return accepts the duty to serve all customers.
>
> Because of the grave financial consequences, which could accrue to captive monopoly ratepayers if a utility's investments were to prove uneconomic, the Commission determines that a standard of reasonable care requiring due diligence is appropriate for determining whether UE's actions during the course of the project were prudent.
>
> Re: Union Electric Company (Callaway Nuclear Plant), 27 Mo.PSC (N.S.) 183, 192-194 (1985) (emphasis added).

In a November 14, 1990 water rate case Report and Order, this Commission again applied the reasonable care standard and ordered a prudence disallowance based upon a contract that Capital City Water Company had entered into with a water district, and this decision was upheld by the Western District Court of Appeals in State ex rel. Capital City Water v. PSC, 850 S.W.2d 903 (Mo.App. W.D. 1993). The finding that that water company had entered into an imprudent contract was based upon a cost/benefit comparison of the terms of the contract to the cost of an alternative. Id. at 907-908. The comparison was made between the cost of the contract, which included rent, maintenance costs, and the provision of unlimited water to the

water district in return for use of the district's storage tanks, and on the side of the cost/benefit analysis the hypothetical and less expensive cost that the water company would have incurred if it had built its own water storage facility. Id.

The Commission is called upon in the instant rate case to make a similar comparison between the cost of an alternative that Company management chose (building an expensive groundwater treatment facility) and the cost of a cheaper alternative for which Company management was aware when it made the decision (rehabilitating and upgrading an existing river treatment facility).

Other precedent exists for a prudence disallowance based upon comparisons to more economical alternatives. In a recent United Water Idaho, Inc. (UWI) rate case, the Idaho Commission Staff contended that the construction of a $940,000 pipeline was not needed, as there were other, less costly alternatives than the Northwest Pipeline available to UWI. 187 P.U.R.4th 312 (1998). In its Order of July 6, 1998 (Idaho Commission Case No. UWI-W-97-6; Order No. 27617), the Idaho Commission agreed. While allowing the Company to depreciate the asset in recognition of its being "used and useful" in the provision of water service to customers, the Idaho Commission disallowed UWI's request for inclusion of the pipeline construction costs in rate base:

> **The Company has failed to persuasively demonstrate that its decision to construct a pipeline was for its customers a prudent decision, that it was the best economic and planning alternative available to it or that it was even needed at this time.** It is undisputed that by completing the pipeline the Company is able to transport surplus water from the Eagle area to Hidden Hollow Reservoir; that its ability to do so provides it with an additional resource to reduce or mitigate capacity deficiencies in the main service level; that it provides a benefit to customers outside the Eagle area; and that it is otherwise 'used and useful.' It is also undisputed that the Floating Feather well waters will provide the Company with a supply of high quality water for its main service level, water without elevated levels of iron and/or manganese.

Despite the foregoing findings, our decision in this matter is directed by the Company's failure to avail itself of what we find to be other, more economic alternatives.

Id., at p. 321-322.

The Kansas Corporation Commission (KCC) has also recognized that it is appropriate to disallow construction costs when it finds that a utility has not chosen the most cost-effective alternative available to it. When Kansas City Power & Light Company (KCPL) requested rate base inclusion for expenditures incurred in the construction of its Wolf Creek Nuclear Generation Facility at Burlington, Kansas, the Kansas Commission, in its Order of September 27, 1985, concluded that a prudence disallowance was necessary: "As indicated in Section VI of this Order, the Commission has found that Wolf Creek capacity is not fully cost justified in relation to alternative generation resources at the present time." (KCC Docket No. 120, 924-U; 142, 099-U; 84-KCPE-198-R, p. 52).

B. History of Company Planning For St. Joseph Water Treatment Improvements

The most important document uncovered by Public Counsel witness Ted Biddy in his prudence review is a Company memorandum describing an evaluation of alternatives to improve the river treatment plant in St. Joseph, dated August 14, 1991 ("1991 Report"). (Biddy Direct, Exibit 19, Schedule TLB-6). This document was obtained from the files of Staff witness James Merciel. It reveals that Company had fully-developed plans proposing improvements to the existing surface water supply and treatment facilities that would have been necessary to upgrade those facilities to meet environmental standards and to increase capacity to 30 million gallons per day (MGD). (Ex.19, p.6). Significantly, this 1991 Report was not submitted to the Commission in Company's pre-approval attempt in Case No. WA-97-46 nor was it included in its 1996 Feasibility Study, entitled "St. Joseph Groundwater Source of Supply and Water Treatment Plant Feasibility Study." (Ex.19, Sched. TLB-3) (separate volume).

The 1991 Report was prepared following Company's 1988 Comprehensive Planning Study, which had indicated the need to improve treatment processes in order to meet the requirements of the Safe Drinking Water Act and to upgrade aging filter facilities. (Ex. 19, Sched. TLB-6, pp. 1-2). The 1991 Report examined six treatment improvement alternatives that were developed to address these requirements as well as to improve chemical feeding facilities, laboratory equipment, and general plant support facilities, including offices and restrooms, transfer pumping stations, and additional clearwell storage. Id. The alternatives reviewed in this document were comprehensive and compared the total project costs that would result from each alternative. Id.

The 1991 Report represented Company's best judgment at the time it decided to address the improvement of its water treatment in St. Joseph, Missouri. See Callaway Nuclear Plant

Case at 193-194. The increase in capacity that was analyzed in the 1991 Report was an increase to 30 MGD, the same capacity as the new groundwater facility. (Ex.19, p.17). This 1991 Report shows the most objective and reliable analysis of the upgrades that were actually needed in order to upgrade the existing river plant. (Ex.19, p.18).

The 1991 Report was developed prior to the time that Company officials had contemplated a "state-of-the-art" groundwater facility, and thus Company had no incentive to artificially inflate cost estimates for the various components studied to rival the cost of such a groundwater facility. Six alternatives were thoroughly studied by Company's System Engineering, Regional Engineering, Regional Water Quality departments and St. Joseph management and were recommended by Company's Regional Manager, R. H. Moon. Id., p. 20-22. The 1991 Report shows, of all the alternatives, that "Concept III(b)" (Ex.19, Sched. TLB 6, pp.16-19) was the most reasonable. Concept III(b) was the alternative analyzed that proposed the most extensive improvements and was the most costly alternative analyzed at an estimated cost of $22,600,000. Id. Concept III(b) was described as the "most logical" plan to adopt as it would "provide the reliability needed, expand plant capacity and meet the new water quality regulations." Id., page 20. Mr. Moon endorsed Concept III(b) and recommended the budget projections included to Company's Board of Directors. Id. The higher costs of Concept III(b) were said by Company to be "more than offset by the elimination of the problems and operating costs of the other concepts." Id. Public Counsel witness Biddy reviewed the 1991 Report during his prudence review and agreed with its conclusion that Concept III(b) would have been the most logical plan to adopt for upgrading the St. Joseph River Treatment Plant. (Ex. 19, p. 17-21).

Perhaps the second most important documents uncovered through Public Counsel's prudence review were contained in a series of correspondence regarding Concept III(b) between

Company and the Missouri Department of Natural Resources ("DNR"). In its approval letter, dated February 11, 1991, (attached as Exibit TLB-7 to Exibit 19), DNR granted conditional approval to the Company to proceed with its plans to upgrade its river treatment facility under Concept III(b) of the 1991 Report. It is now apparent that when Company officials represented to the Commission in 1997 that DNR regulations and letters were "not consistent" with improving its existing river treatment site, and thus alternatives at that site were "not feasible" (Exibit 19, 1996 Feasibility Study, Schedule TLB-3, Ex. A, p. 4), such representations were made with the full knowledge that DNR had already approved just such a project five years earlier.

Company claimed that all alternatives associated with the existing plant were not feasible for implementation pursuant to DNR Regulation 10 CSR 60-10 (Ex. 19, Sched. TLB-3, Ex. A, Appendix D); however, this regulation was promulgated and became effective in 1979, significantly prior in time to DNR's approval of Concept III(b) of the 1991 Report. Schedule TLB-10 to Mr. Biddy's prepared direct testimony (Ex. 19) contains a chronological collection of correspondence between DNR and Company officials illustrating that both parties were aggressively working toward completion of the environmental approval process for the Concept III(b) upgrade of the river treatment plant over a two-and-a-half year time period up to and well beyond the occurrence of the 1993 flood:

- The conditional approval granted by DNR on February 11, 1991 was conditional in only one respect: it was subject to a pilot test of the proposed superpulsator solids contact units (Ex.19, p. 20, Sched. TLB-7).
- American Water Works Service Company then prepared superpulsator pilot studies and presented the results to DNR on October 16, 1992 (Ibid., Sched. TLB-10).

- On November 16, 1992, American Water Works Service Company sent a letter to DNR repeatedly describing the results of the pilot-testing program as "excellent." Id.
- On November 19, 1992, Mr. Rolando A. Bernabe sent a letter back stating that the pilot test results were "impressive." Id.
- On January 27, 1993, Mr. Bernabe sent a letter to Mr. William F. L'Ecuyer, then Company's Vice-President and Manager, granting approval of the proposed water treatment plant improvements for a period of at least one year. Id.
- On December 24, 1992, Mr. Breck E. Summerford, DNR Chief of Engineering and Compliance, sent a letter to Company acknowledging that Company had submitted an engineering construction report for review and approval to DNR. Id.
- On March 30, 1994, Mr. Summerford sent a letter to Company stating that it needed only an engineering report regarding the pilot testing to be submitted in order to receive a DNR report that would serve as authorization to award contracts and begin construction. Id.

Obviously, the 1993 Flood did not cause DNR to determine that the proposed improvements at the river treatment plant were not feasible.

Company cites in its 1996 Study two letters from DNR which the utility claims provided "guidance" to the effect that a new or expanded treatment plant could not be located in the floodplain. (Ex. 19, Sched. TLB-3, Attachment 1). Although artfully worded in a manner that avoids misrepresentation, the 1996 Study leaves the impression that DNR forbade any expansion of the existing plant on the Missouri River because its location was within the floodplain. Id., Exhibit A, p.4. However, a close reading of both letters and DNR Rule 10 CSR 60-10 reveals that the relocation of an existing plant is to be done only if such relocation outside the floodplain

is practical and economical. (Ex.19, p.11). On this issue, the wording of Company's 1996 Feasibility Study which was submitted to the Commission in Case No. WA-97-46, attempting to justify the decision to abandon the existing plant and to construct a very costly groundwater source and treatment plant, was very misleading. Id.

Furthermore, Public Counsel obtained a copy of DNR's letter of July 25, 1996 to Company, authored by Rolando A. Bernabe, DNR Environmental Engineer (Ex.19, Sch.TLB-5), which states as follows:

> Existing water treatment plants that are already in the floodplain may be expanded if it is practical and economical. Structures that will protect the plant from flooding or prevent interruption of operation during flooding must be included with the expansion.
>
> Ibid. (emphasis added).

It is clear from the letters sent by DNR officials and from the DNR rule itself that an existing treatment plant within a floodplain can be expanded if no other more practical or more economical alternative exists and provided further that flood-proofing features are installed around the plant. (Ex. 19, p. 12).

In order to further confirm that Company's representations in its 1996 Feasibility Study were in fact misleading, Public Counsel interviewed the following DNR officials on March 1, 2000, each of whom has been responsible for reviewing Company's water treatment proposals over the past few years:

> Mr. Jerry Lane, Director, Public Drinking Water Program
>
> Mr. Breck Summerford, Chief, Permit Section

Mr. Rolando Bernabe, Environmental Engineer, Permit Section

Mr. Bill Hills, Environmental Engineer, Kansas City DNR Area Office

Each of these officials acknowledged that if Company had flood-proofed its existing water treatment plant, there would have been nothing to prevent Company from expanding the existing plant. (Ex. 19, pp. 12-13). Furthermore, each of these officials acknowledged that he was not aware of any DNR notices of violation, pending enforcement actions, or any other mandate that would have forced the utility to relocate and construct a new water source and treatment plant. (Ex. 19, p. 13). Each official acknowledged that Company had been under no pressure from DNR to build a new groundwater treatment plant. (Ex. 19, p. 14).

The prepared rebuttal testimony of Company witness John Young (Ex. 17) consists largely of an attempt to explain away Company's original estimates for upgrading the existing river plant. Mr. Young supplies a long list of events that he considers significant from December 1990 through April 2000. Ib. at pp. 2-3. Interestingly, Mr. Young omits reference to the fact that Company was still working with DNR to receive approval of the construction of the superpulsator clarifiers as late as January 27, 1993. Mr. Young attempts to downplay the 1991 Report by labeling it the "MAWC Filter Report." (Ex. 17, p.2). However, Mr. Young cannot simply make the 1991 Report go away by giving it another name, nor can he claim that it referenced only filter improvements, when in fact, the 1991 Report detailed the costs of a fully developed project.

Mr. Young also blames a "local contractor" for providing inaccurate information that was used in the development of the 1991 Report. (Ex. 17, p. 9). Mr. Young states that Company had thought that "a contractor familiar with the plant would help provide third-party credibility to the magnitude of the investment required for treatment plant improvements." Id. Mr. Young states

that the local contractor was employed because of his ability to access the site impacts on construction costs and "to better define regional costs impacts." (Ex. 17, p. 9). Now in this rate case, when it serves Company's interest to do so, Mr. Young criticizes the fact that the local contractor played a lead role, as opposed to an advisory role, in the development of the 1991 Report. Id.

Mr. Young's prepared testimony in this case proceeds with several generalized statements to the effective that the 1991 Report was not "adequately defined." Mr. Young further attempts to downplay the 1991 Report as a "initial vehicle to communicate internally" and that the "scope of work" was not "fully defined." (Ex. 17, pp. 7-8). But none of this after-the-fact criticism of his own work can erase the fact that the 1991 Report was prepared as a complete project cost estimate and that it was submitted to DNR for approval as a total project. (Ex. 20, p. 8).

On cross-examination, Mr. Young acknowledged that he was responsible for the supervision and preparation of the cost estimates and the scope of the project for the 1991 Report. (Tr. 1205). If Mr. Young's work in the 1991 Report was so incomplete and inaccurate in its cost estimation, is it reasonable to rely upon any of the other statements he makes about the ever-expanding scope of this project or the later cost estimates for which he is also responsible for supervising and preparing? After Mr. Biddy reviewed the estimates for the continual scope additions presented by Company in this case, he stated under oath that they were the most incompetent estimates he had reviewed in thirty-seven years of engineering practice. (Ex. 20, p. 11). Mr. Biddy's engineering review concluded that the continual "scope addition" that Company made from 1991 through 1994 appeared to be "skewed" in an attempt to justify the decision to build a more expensive groundwater facility. (Ex. 20, pp. 11-12). The 1991 Report

with its complete estimate of $22,600,000 (including engineering, construction supervision, community relations, interest and various "soft costs") evolved over time until basically the same project was being estimated at a cost of between $63 million and $78 million. The record of this case shows the incredible story of how this cost expanded until miraculously, evolving until it matched the cost of Company's desired groundwater facility project.

Mr. Young's timeline indicates that the firm of Gannett Fleming was awarded the design contract for the improvements to the existing river plant in February, 1993 and that this firm produced a preliminary construction cost estimate in May, 1993. (Ex. 17, p. 2). The May 27, 1993 Gannett Fleming Estimate ("Gannett Fleming Estimate") is attached to Mr. Young's Rebuttal Testimony as Exhibit 17, Schedule JSY-5 and to the Surrebuttal Testimony of Mr. Biddy as Exhibit 20, Schedule TLB-14. Gannett Fleming's total cost estimate for this project was $26,630,000 and includes new superpulsator clarifiers, new filters, a new chemical building, a new clearwell, a new filter building, a new transfer/H.S. pump station, all electrical work, all process related equipment, pumps and piping, HVAC systems, plumbing, instrumentation, and complete site work down to every minute item of the project. This estimate is very detailed and includes all construction necessary to upgrade the existing plant to 30 MGD capacity and state-of-the art condition. (Ex. 20, pp. 8-9; Sched. TLB-14). The cover sheet attached to the Gannett Fleming Estimate (which was omitted from the copy attached to Mr. Young's Schedule JSY-5) states that "We feel we have estimated this project conservatively so that a large contingency factor need not be added at this time." Ibid., p. 1.

The Gannett Fleming Estimate is the only cost estimate produced by Company, either in reports or through data request responses, which includes the normally detailed information that an engineering cost estimate should always contain. (Ex. 20, p. 9). All other so-called Company

"estimates" simply state a total cost for major items providing almost no detail at all. Id. After adjustment for the time difference of costs, the Gannett Fleming Estimate would be very close to the original 1991 Report total estimate of $22,600,000 for all upgrade facilities proposed at the existing plant. Id.

The very next item in Mr. Young's timeline following the Gannett Fleming Estimate is the June 4, 1993 Estimate. (Ex. 17, Sched. JSY-7). This revised estimate adds $17,500,000 (66%) to the Gannett Fleming construction cost estimate to arrive at a total project cost estimate of $44,100,000. Again, Company's so-called estimate only lists lump sum amounts for major costs with no detail. Mr. Biddy explains his disagreement with these added costs that Company lists for time updates of construction costs, contingencies, engineering and other items that add to the project costs in Schedule TLB-15, showing how Company overstated the costs for most of these items. (Ex. 20, Sched. TLB-15, pp. 1-2).

The June 4, 1993 estimate, prepared by Mr. Young nearly eight days after receipt of the Gannet-Fleming Estimate, includes large "scope additions" that inflate Company's estimate of the cost for upgrading the river treatment plant to $44,100,000. (Ex. 17, Sched. JSY-7). The large size of the additions which pad earlier estimates, along with the lack of detail, strain Mr. Young's credibility and render this estimate unreliable as competent and substantial evidence. For instance, the construction cost estimate is increased by over $470,000 over the Gannet-Fleming Estimate, with no explanation. (Ex. 20, Sched. TLB-15, p. 15). The 1993 Cost Estimate escalates the Phase I costs by $127,987 above the construction cost increases based upon *Engineering-News Record* indices, and also escalates Phase II cost estimates by $768,970. Id. The June 4, 1993 Estimate adds an additional ten percent factor for "omissions and contingencies," despite the fact that Gannett Fleming designed the project with up to fifteen

percent contingencies included. Id. On cross-examination, Mr. Young characterized the original contingencies contained in the Gannett Fleming Estimate as "ten to fifteen percent conservative." (Tr. 1226). Mr. Young acknowledged that the June 4, 1993 Cost Estimate he developed includes a twenty-five percent factor merely for omissions and contingencies -- a factor totaling over $7 million. (Tr. 1227-1238).

Mr. Biddy details a series of costs in the June 4, 1993 Estimate labeled as Consultant's Fees and Utility Company's Fees. Mr. Biddy explains that the various charges under the label of Consultant's Fees total 8.35% of the total construction costs, well within the industry standard of seven to ten percent for this type of professional service, and Public Counsel alleges no over-statement of these costs. (Ex. 20, Sched. TLB-15, p. 2). However, Mr. Biddy identifies six overstated items under the heading of Utility Company's Fees that were apparently to be paid to Company itself and which total 2.17% of the construction cost. Id., pp. 2-3. Since the industry standard for such administration costs is 0.5%, Company overstated these engineering costs to be paid to itself by $509,000. Id. The June 4, 1993 Estimate includes several other items that appear grossly overstated and are supported by no detail or explanation. Id., pp. 3-4. Some examples include:

- Company lists unexplained items in an amount of $1,698,000, identified as Water Company Expenses. This is an unexplained amount that would be charged by the Company to itself and is an amount too large to account merely for temporary power and wasted water usage. Id.
- Company lists $1,020,000 for Community Relations-an amount that is so ridiculously high that it should, on its face, be recognized as unreasonable since Company's normal

budget for community relations should have been sufficient for the development of simple announcements regarding an upgrade to the existing water plant. Id.

- Company lists a total of $250,00 for Attorneys Fees, an amount that is also so large as to be unreasonable on its face. The simple task of examining construction contracts should not reach nearly this level of expense. Id.
- Company also includes a total of $91,000 for Builders Risk Insurance, an unreasonable amount because this type of insurance is always carried by the contractor, not by the owner. Id.
- Company also includes $164,000 for Water Company Supplied Material without any explanation or detail at all.
- Company's June 4, 1993 Estimate used an AFUDC Rate of 10%, as opposed to a more reasonable AFUDC allowance of 6%. Id.

If all of the items that Mr. Biddy identified as invalid or unsupportable were discounted, the 1993 Cost Estimate for upgrading the river treatment plant would be reduced to a total project cost of $33,741,965. Id.

The date given in Mr. Young's timeline for the initiation of the Feasibility Analysis and the initiation of the design of the new groundwater source and treatment plant is illuminating. (Ex. 17, pp. 2-3). His chart shows a feasibility analysis being initiated in January, 1995 and the design of the groundwater source and treatment plant being initiated in December, 1995. The 1996 Feasibility Study, which is described by Mr. Young throughout his testimony as the "decision making document" was not actually completed until November, 1996, yet Company chose to begin the design of the new groundwater source and treatment plant in December, 1995, almost a year before the feasibility study was completed. This action casts serious doubt on

Company's purported effort to make a meaningful comparison between the alternatives. (Ex. 20, p. 10). It appears that Company had already made the decision to go forward with the new groundwater source and treatment plant almost a full year before the 1996 Feasibility Study was completed. Id.

The 1996 Feasibility Study was filed in the 1997 certificate case, Case No. WA-97-46. As discussed previously, this study made no mention of the 1991 Report or the fact that this report had been submitted and conditionally approved by DNR. As is discussed in a following section, Company used this case as a vehicle to attempt to receive an order from the Commission preapproving its selection of alternatives. Public Counsel vigorously opposed this attempt at pre-approval and criticized Company for more thoroughly not investigating other alternatives than the building of an extremely expensive groundwater treatment facility. When new information surfaced after the hearing in Case No. WA-97-46 regarding the potential alternative of building a pipeline to receive wholesale water from the city of Kansas City, Missouri, Company refused to investigate further and opposed Public Counsel's Motion to Open the Record and receive additional evidence on that alternative. See "MAWC's Response and Opposition to OPC's Petition to Reopen and Accept New Evidence," filed on August 15, 1997 in Case No. WA-97-46.

The transcript of the hearing in Case No. WA-97-46 provides further indication that Company had already closed its mind to any other alternative than its desired groundwater facility alternative. Although Company stated that a Community Advisory Council ("CAC") set up in St. Joseph was "instrumental in identifying the groundwater option as the most appropriate for the community (Ibid., Tr. 142), then-Company President William F. L'Ecuyer admitted that Company's strategic business plan, which included the groundwater alternative, had already

been developed and that Company's Board of Directors approved it in April, 1995, after only one meeting of the CAC. Ibid., Tr. 145. The members of the CAC were hand-picked by Company management and included only one representative of residential customers. Ibid., Tr. 146-147. At the local public hearing held at St. Joseph on May 31, 2000 in this case, one former member of the CAC, John Peter Barkley, Jr., CEO of Wire Rope Corporation of America, had this to say to the Commission:

> The citizens advisory committee or council was proposed, formed, and met periodically. I served on that committee. I attended few meetings when it became very apparent to me that the purpose was strictly public relations and that the agenda had been set for a $70 million investment and single tariff pricing to be brought to Missouri. I [have polled] most of the members of that advisory board, and those that I have been able to reach have agreed that advisory is not the appropriate name for that citizens council. Someone in my own office when I discussed this subject suggested that it be called the "rubber stamp committee." At no time were specifics such as comparative costs, amortization rates and schedules, [depreciation] costs and schedules and rates, proposed water rates and rate structures ever discussed in detail with the members of that committee, to the best of my knowledge.
>
> Case No. WA-97-46, Tr. Vol. 8, pp 58-59.

At the hearing in Case No. WA-97-46, Mr. L'Ecuyer admitted that no press releases were sent to inform the public of the exact construction costs of the desired groundwater facility and only one press release, issued in October, 1996, stated any potential costs – claiming the rate impact would be approximately $5 per customer per month (based upon an *implicit* assumption of a single tariff rate design). Case No. WA-97-45, Tr.133, 149.

C. Company Maneuvers Toward Preapproval Rejected By Commission

The Commission has already received Company's Motion for Summary Determination, filed on June 1, 2000, arguing that the Commission had in some manner previously pre-approved the prudence of Company's decision to build a groundwater treatment facility in the certificate case, Case No. WA-97-46, and thus a prudence disallowance based upon a comparison of alternatives in this rate case would be equitably estopped. The Commission has also received Public Counsel's Response to that motion, filed on June 5, 2000. Since the Commission has indicated from the bench that it would "take this issue with the case," Public Counsel hereby incorporates the arguments from its June 5, 2000, pleading in this initial brief by reference.

Furthermore, Public Counsel would point out that the two most relevant cases to this issue were utility rate cases in which a prudence disallowance was ordered by the Commission and which were also preceded by Commission (non-rate case) decisions reviewing the subject matter. The Callaway Nuclear Plant rate case was preceded by a certificate case. In 1974, Union Electric filed an application for a certificate for permission to build a multi-unit nuclear electric generating plant in Callaway County, Missouri, outside of its then-existing service territory (just as the new Company wells were to be located in Andrew County outside of Company's certificated boundaries). After reviewing extensive testimony regarding the technological alternative, the Commission granted Union Electric authority to construct and operate multiple nuclear plants, but made no findings whatsoever with regard to prudence, stating in its Report and Order that its decision should "...in no way be construed as acceptance by this Commission of cost data or amount of land required to be devoted to plant in-service for future ratemaking purposes, or specific approval of long range financing of the facility." Ibid. at 36., Re. Union

Electric Company, Case No. 18,117 (March 14, 1975). This Commission included similar caveats in its certificate case Report and Order in Case No. WA-97-46.

The situation faced by Union Electric in that certificate case has striking parallels to the Commission. In both situations, a large company planned to build a state-of-the-art facility in a county outside of its current certificated area. Both certificate cases reviewed technological alternatives to the planned projects. In each instance, the utility was planning a project, which has/had the potential to dramatically increase the rate base of the entire company. As it was in the Union Electric certificate case, the Commission and the ratepayers it serves were well served by the Commission decision to refrain from any statement of pre-approval.

Likewise, estoppel was raised in the Capital City Water Company case discussed previously at length. When the Missouri Court of Appeals reviewed its 1990 rate case, it was made clear that, despite a Commission statement in 1977 that it did not object to the execution of a certain contract by a water company, the Commission was not estopped from later ruling that the contract was imprudent.

> The Commission's principal interest is to serve and protect ratepayers, *State ex rel. Crown Coach Co. v. Pub. Serv. Comm'n.* 238 Mo. App. 287, 179 S.W.2d 123, 126 (1994), and as a result, the Commission cannot commit itself to a position that, because of varying conditions and occurrences over time, may require adjustment to protect the ratepayers. *State ex rel. Chicago Rock Island & Pacific Railroad Co.*, 312 S.W.2d at 796.
>
> State ex. rel. Capital City Water Co. v. PSC, 850 S.W.2d 903 (Mo.App W.D. 1993)

In it's Motion for Summary Determination, Company has clearly misread the Commission's Order in WA-97-46 by implying findings that were not made by the Commission in that case, has misstated the positions that Public Counsel took in that case, and furthermore, has based its arguments on a misapplication of the law. The case

in which the Company claims that the prudence of the St. Joseph Project has been prejudged was a *certificate* case, not a rate case. It is important to realize that utility construction projects are simply not pre-approved in Missouri. Unlike other states, Missouri has no "pre-approval statute" granting the Commission specific authority to "site" new plants or to predetermine the prudence of projects such as the one at issue in this case. The Missouri Commission has never pre-approved the prudence of a construction project and certainly did not do so in WA-97-46.

A Commission certificate merely sets the boundaries of a utility's service territory. Pursuant to § 393.170 RSMo. 1994, Company already enjoyed a certificate of convenience and necessity to provide water in St. Joseph, Missouri, so if Company had planned to build its entire St. Joseph Project within the existing boundaries of that certificate, there would never have been a certificate case at all. The certificate relief that was requested and which was granted covered only the geographic area that would contain the future well field and pipeline, not the proposed treatment plant. Case No. WA-96-47, Report and Order, p. 15.

The purpose of a case to extend certificated boundaries is not to obtain a pre-approval of prudence or make any ratemaking determinations as such relief is beyond the statutory authority of §393.170 RSMo.1994. Nonetheless, in its Application in WA-97-46 at p. 8, Company made the unique request that the Commission not only extend its service territory north into Andrew County, but that it also make the additional finding that the St. Joseph Project "is the **most appropriate and cost effective** method of meeting [the need to improve its water treatment system]" Ibid. (emphasis supplied).

The Commission did not grant Company's extra-legal request in Case No. WA-97-46. The Commission merely noted in passing that the construction of a new groundwater facility at a remote site was "a reasonable alternative" (Report and Order, Ibid. at 11); however, there were four alternatives discussed in that case (including the improvement and upgrading of the existing river treatment facility in St. Joseph), none of which the Commission found to be unreasonable. Despite Company's desire to proceed forward with its favorite alternative risk-free, the Commission did not find in Case No. WA-97-46 that the construction of a new groundwater facility at a remote site was the most reasonable alternative discussed in that case, nor did the Commission find that it was the most cost-effective alternative.

During the litigation of the certificate case, Public Counsel agreed that there was a need to either improve the existing source of supply, construct new facilities, secure an independent source of supply, or pursue some combination of these alternatives, but Public Counsel did not take a position regarding which alternative would be the most cost effective. Public Counsel did offer some testimony and commentary on the analysis (and lack thereof) in the Company's 1996 Feasibility Study. However, Public Counsel did not conduct a prudence review in the certificate case, and did not offer any witness qualified to perform such an analysis.

Public Counsel earnestly cautioned the Commission in that certificate case against any pre-approval of prudence or pre-judgment of any issue relevant to ratemaking, because such findings would be of no legal effect and very bad public policy (as Public Counsel reiterates below). (See the Initial and Reply Briefs of the Office of the Public Counsel in Case No. WA-97-46; Hearing Memorandum, p. 7; Tr. 30-42). Even Staff

counsel, who recommended pre-approval of prudence in that case, admitted that pre-approval would have been a risky approach for the Commission to take. (Case No. WA-97-46, Tr. 25).

Public Counsel further explained how a "bifurcation" of the prudence issue between the selection of the alternative and the management of the project was a false distinction because the two aspects are inherently interrelated. Public Counsel was very forthright about the possibility that it would perform a prudence review of the St. Joseph Project in the appropriate rate case and that only during a rate case was it proper under the law to determine the ratemaking impact of Company's decisions.

Nowhere in the Report and Order, issued on October 9, 1997 in Case No. WA-97-46, did the Commission state that it was pre-approving the prudence of any Company decision or pre-determining any ratemaking issue whatsoever. In fact, the only mention of prudence in the "ORDERED" section of the Report and Order is a caveat that states as follows:

> 5. That nothing in this Report and Order shall be considered a finding by the finding by the Commission of the prudence of either the proposed construction project or financial transaction, or the value of this transaction for ratemaking purposes, and the Commission reserves the right to consider the ratemaking treatment to be afforded the proposed construction project and financial transaction and their result in cost of capital in any future proceeding (emphasis supplied).
>
> Ibid., pp. 16-17.

In the body of the Report and Order, the Commission discussed why pre-approval of construction projects outside of a rate case proceeding would be bad public policy, upsetting the regulatory balance inherent in rate of return regulation:

> In the regulation of monopoly providers, one of the basic functions of this Commission is to stand in the stead of competition. The Commission

> performs this function principally in the context of a rate proceeding, authorizing recovery through rates of only those costs which were prudently incurred, that is to say spent as if the utility were operating in a competitive environment.
>
> Id. at 10.

The fact that large construction projects will be scrutinized upon completion in the course of a rate case in order to determine whether those projects are prudent and cost effective is arguably the most important consumer safeguard in place for the captive utility ratepayer. The risk borne by Company's shareholders is already recognized through the return on equity component of ratemaking. Ratepayers already compensate the utility for the risks that it takes through the rate of return and utilities know that their actions will be reviewed after-the-fact, thereby providing a vital incentive to manage utility projects operations in a prudent manner. The Commission recognized this function of utility regulation when it explained:

> The Commission's duty to balance investor and consumer interests does not amount to a guarantee that utility management is operating in a risk-free environment and thus the shareholder's investment is also risk free.
>
> Although the ratepayer has a right to demand service from the utility, the ratepayer is captive of the utility's monopoly power and must look to the regulator to protect his interest. The ratepayer does not participate in the company's generation planning.
>
> Re. Kansas City Power & Light Co., 75 P U R 4th 1, 125 (April 23, 1986) (Case No. EO-85-185 et al).

The Commission's WA-97-46 Report and Order further recognized that any statement of pre-approval in the certificate case would not even be legally binding upon the Commission in the future:

> Authority exists supporting the position that the Commission may not legally take any further action regarding the pre-approval of the proposed

project. In State ex rel. Capital City Water Co. v. Public Service Commission, 850 S.W.2d 903 (Mo.App. W.D. 1993) the Court stated:

> "The Commission's principal interest is to serve and protect ratepayers, *State ex rel. Crown Coach Co. v. Pub. Serv. Comm'n,* 238 Mo.App. 287, 179 S.W.2d 123, 126 (1944), and as a result, the Commission cannot commit itself to a position that, because of varying conditions and occurrences over time, may require adjustment to protect the ratepayers, *State ex rel. Chicago, Rock Island & Pacific Railroad Co.*, 312 S.W.2d at 796."

and in re Union Electric Company (Callaway Nuclear Plant), 27 Mo. PSC (N.S.) 183, the Commission states:

> "...the appropriate time for the Commission to inquire regarding the prudence of a capital improvement project is a rate case in which a utility attempts to recover the associated costs of such a project..."

Id. at 15.

In the recent appellate case, Missouri Gas Energy v. PSC, 978 S.W.2d 434 (Mo.App. W.D. 1998), the Western District Court of Appeals addressed the issue of estoppel as it relates to Commission ratemaking:

> Equitable estoppel is not applicable if it will interfere with the proper discharge of governmental duties, curtail the exercise of the state's police power or thwart public policy, and is limited to those situations where public rights have to yield when private parties have greater equitable rights. *State ex rel. Capital City Water Co. v. Missouri Public Service Comm'n,* 850 S.W.2d 903, 910 (Mo.App.1993). The setting and regulation of utility rates by the PSC is a duty of state government.

Id. at 439.

D. Estimated Cost to Rehabilitate and Flood-Proof the St. Joseph River Treatment Facility

Public Counsel engineering witness Ted Biddy, an expert witness with over 37 years of experience in water and wastewater engineering issues, was retained by Public Counsel to

perform a comprehensive prudence review of Company's decision to construct a new groundwater facility. (Biddy Direct, Ex. 19, pp. 3-4). Mr. Biddy studied the 1996 Feasibility Study, (attached as Schedule TLB-3 to his prepared direct testimony), as well as all original case materials filed in Commission Case No. WA-97-46. Mr. Biddy also reviewed numerous data request responses and testimony submitted by Company, and all contracts, change orders and cost data work which Company has caused to be performed for the new groundwater supply and treatment plant. (Ex. 19, p. 5). Mr. Biddy also reviewed prior Commission rulings in other cases concerning prudence and "used and useful" issues and also inspected the new groundwater facility as well as the existing surface water supply and treatment facilities. Id., p. 7. Based upon his studies, investigations and analysis, Mr. Biddy formed a professional opinion that Company's construction of a new groundwater source and treatment plant and abandonment of its existing river treatment plant without the benefit of detailed studies of the economic and engineering feasibility to expand and upgrade the existing river plant was not prudent and in fact, was very ill-advised. Id., pp. 7-9.

After extensive study of the 1991 and 1993 cost estimates prepared by and for Company (and discussed in section II. B. of this Initial Brief), Mr. Biddy developed a recommended cost estimate that more than fairly reflects the costs that Company would have incurred to upgrade and expand its river treatment plant to a 30 MGD capacity and to a level of service and efficiency comparable to the groundwater facility the Company ultimately chose to build. The following is a summary of Mr. Biddy's cost estimate:

1991 Estimate by MAWC	=	$22,600,000
Addition for costs increase from 1991-1998 (21.48%)	=	4,854,480

Add Ozone Facilities	=	4,000,000
New Raw Water Intake and Low Service Pumping	=	4,600,000
Flood-proofing around plant	=	500,295
Access Road Improvements	=	125,000
TOTAL REVISED ESTIMATE	=	$36,679,775

(Ex. 19, p. 21; Ex. 20, pp. 16-17). A side by side comparison of Mr. Biddy's cost estimate with the other cost estimates developed by Company is reproduced in Exhibit 86 to this case and is attached at the end of this Initial Brief.

Inflationary Cost Increase

Mr. Biddy began with the 1991 Report which estimated the total project cost for upgrading the river plant at $22,600,000, including modifications to existing filters, four superpulsators, new building additions, new filtration, clearwells, transfer pumping station, laboratory improvements, support facilities, final filtration facilities, and also including engineering design, omissions and contingencies, interest during construction, engineering supervision during construction, and community relations. Mr. Biddy then adjusted the 1991 estimated project costs to 1998 dollars based upon the construction industry standard for historical cost increases as contained in the *Engineering News-Record* cost indices, attached to Exibit 19 as Schedule TLB-9. This brings the cost estimates for rehabilitating the river treatment plant up to a level comparable to the groundwater facility for which construction was begun by Company in 1998. (Ex. 19, p. 22).

Ozone Facilities, New Raw Water Intake and Low Service Pumping

Mr. Biddy has added to his cost estimate for rehabilitation of the river treatment plant the estimate amounts for ozone facilities, for raw water intake and low service pumping as estimated by Company, even though Mr. Biddy testified that these amounts were high and possibly over-estimated. (Ex. 19, p. 22). If there is any error in the estimation of these items, it is an error on the high side, giving Company the benefit of the doubt. Id. These additional items were added on top of the estimate of costs needed for any environmental requirements at the immediate time.

Flood-proofing

Flood-proofing the existing river plant would not have been impractical, and in fact, would have been extremely more cost effective and economical than the construction of the expensive groundwater facility that the Company imprudently chose to build. In its 1996 Feasibility Study, Company asserted that rehabilitation of the existing plant was "not feasible," but did acknowledge that "the site can be improved to provide greater levels of flood protection." (Ex. 19, p. 8, Sched. TLB-3). Neither at the time the 1996 Feasibility Study was developed nor at any time afterward had Company explored the option of building a flood-proof levy or attempted to coordinate with the Burlington Northern Santa Fe Railway in order to construct flood-proofing facilities that would prevent flooding through the ballast (supporting rocks below rail and cross-ties), where the 1993 Flood actually affected the river plant through a "french drain" action from the east side of the plant. (Ex. 19, pp. 9-10).

Mr. Biddy estimated that the "french drain" problem could be corrected for approximately $128,111, but instead chose to ultimately include in his estimate the cost of the more extensive and more expensive flood-proofing solution of increasing the levy to four feet above the 500 year flood level and extending the length of the levy that would be so extensive as

to assuredly render the river treatment plant site flood-proof. (Ex. 20, pp. 17-19). This flood-proofing solution includes levies with a top elevation of 830.39 feet along the length of the east side of the plant at the north to the entrance drive at Water Works Road on the south, as well as including a new levy along the entrance road along the south and west sides for about 14,000 feet to the intersection of the existing levy near the center of the plant area and raises the existing north side levy for its full length to the intersection with the new east side levy. (Ex. 20, p. 18). This levy would include a densely compacted earthen structure with an impervious clay core, a gravel surface topping, and seepage collars for all pipelines which cross the levies. (Ex. 20, pp. 18-19).

Ironically, Company's new source of raw water supply at the groundwater facility is much less flood-proof than the intake structure at the old plant river plant. (Ex. 20, p. 20). Mr. Biddy, whose career experience has included extensive engineering work on the Mississippi River and the very "flashy" Arkansas River, stated his professional opinion that Company made a fundamental error in locating its new raw water supply wells in areas subject to frequent flooding and has thus rendered its new source of supply even more unreliable than the river plant had been to the ravages of the river. Id. Picture No. 4 of the new groundwater facility contained in Exhibit 19, Schedule TLB-2, shows one of the seven new vertical wells which are located inside the Missouri River levy system and is a relatively short distance from the river bank. Id. It is not unreasonable to expect that several of these vertical wells may be put out of service in every flood event. Floating limbs would be a constant hazard as they could easily reach the vertical well pumps and electrical switchgear and wreak havoc with these facilities. Id.

Access Road Improvements

The two-mile paved road whereby the river plant can be accessed from the south is occasionally flooded under severe flooding conditions and cannot be used in those emergency situations. (Ex. 19, p. 14). However, a road connects to the river treatment plant from the north as can be seen in photograph No. 8 of the photographs of the river plant contained in Exibit 19, TLB-2. This roadway is higher than the crest of the 1993 Flood and can adequately serve for access and materials delivery to the treatment plant provided that minor improvements are made. Id. In Company's 1996 Feasibility Study this alternative access route is discussed as "barely passable using four wheel drive trucks. For example, vehicles must ford one or two creeks." (Ex. 19, Sched TLB-3, Appendix A, p. 26). Therefore, Mr. Biddy included in his cost estimate $50,000 per culvert and $25,000 for a ramp to provide direct access to the flood-protected plant site ($125,000 total) in order to improve this road to a condition better than "barely passable." (Ex. 19, pp. 14-15). Although Company claimed $700,000 would be needed to improve an alternative access route, this estimate contained no detail or engineering documentation to support it. Mr. Biddy's recommended budget for access road improvements is reasonable considering the fact that this alternative route is currently passable and will only be needed in rare emergency flooding events. (Ex. 20, p. 21).

Residual Handling Facilities

Mr. Biddy's cost estimate does not include an addition for residual handling facilities. Missouri DNR officials responsible for regulating safe drinking water stated in a Public Counsel interview that Company could have continued to return residuals to the Missouri River for the foreseeable future and that facilities for handling such residuals are not currently needed. (Ex. 20, p. 22, Sched. TLB-17).

Even if, in the distant future, residual handling facilities are required by environmental authorities, such facilities could be added at no extra cost at the time they were needed. Even if such facilities were required in the future, the cost would not be anywhere near the lump sum amount asserted by Company. Dewatering, drying and hauling 2500 tons of residuals to a landfill would amount to 125 trips per year for a 2-ton loaded truck or about 2.4 truckloads per week (Ex. 20, p. 22). Public Counsel has made no estimate for the cost of such facilities but it is obvious that Company's suggested $8,000,000 lump sum amount is grossly overstated. Dewatering and drying beds for 2500 tons/yr. of residuals could not cost over $1,000,000 even if Company had to purchase the land. Id. The cost per truckload of haul might cost $100 per trip if Company contracted the haul to a landfill ten miles away. Id. Hauling under this contract basis would then cost about $12,500 per year. Id. at 23.

E. Of "Intangibles" and "Taking Advantage of the Situation"

The Staff of the Commission ("Staff") presents an interesting perspective on the issue of whether it was prudent for Company to abandon its river water treatment facility. Staff does not base its position that such action was prudent upon any cost/benefit analysis that compares and analyzes the respective rate impacts between the various alternatives for upgrading water treatment facilities in St. Joseph; rather, it takes the position that building an expensive groundwater facility was prudent because of a variety of "intangible benefits." (Merciel Rebuttal, Ex. 49, pp. 9-12). In fact, Staff Engineering witness James Merciel acknowledges that his opinion regarding the prudence of Company's actions was not based upon a finding that those actions were more economical than an upgrade of the river treatment plant. (Ex. 49, p. 9,

lines 11-15). In fact, Mr. Merciel states that alternatives involving an upgrade of the river treatment plant appear "quite attractive when only economics are considered." Id.

Mr. Merciel criticizes Mr. Biddy for not placing a value on "intangible benefits." Id. However, Mr. Merciel himself does not place a monetary value on these intangibles and it is difficult to imagine how any of the non-quantified "intangibles" he mentions could offset the dramatic gap (approximate $34 million difference) between the cost of the groundwater facility that Company built and the estimated cost to upgrade the river treatment plant as it was originally planned, plus all of the additional improvements Mr. Biddy includes in his estimate, including flood-proofing an access road improvements. (Ex. 19, p. 21; Ex. 20, pp. 17-19). Mr. Merciel cites consistency of temperature, hardness, mineral content, organic content, and turbidity and states that there is "some value in minimizing these problems and risks," but is unable to quantify these risks. (Ex. 49, pp. 10-11). Mr. Merciel also admits that "many of these are not completely absent from groundwater," acknowledging any value in minimizing these risks would need to be offset by the cost of minimizing these risks with the groundwater facility that Company ultimately built. Id. at 11, lines 17-20.

Mr. Merciel emphasizes that the potential of flooding at the river treatment plant is an important issue, something that no one can deny. Mr. Merciel criticized Mr. Biddy for suggesting that the "french drain" problem involving the railroad could be flood-proofed for approximately $128,000. (Ex. 49, p. 3). Of course, Mr. Biddy ultimately recommended in his cost estimate that the much higher cost of building a levy completely around the river plant at a height of four feet above the crest of the 1993 Flood be included in his cost estimate, as discussed previously. (Ex. 20, pp. 17-18). Mr. Merciel further acknowledged that it would be possible to construct a facility at the site of the river treatment plant that would be completely

protected from flooding. (Ex. 49, p. 4). The costs to protect the river treatment plant from a flooding event even greater than one that would typically occur one in every five hundred years has been adequately included in Public Counsel's cost estimate, along with the cost to improve access to the plant during lesser flood events. This "intangible" has been move than adequately addressed in Public Counsel's recommendation and cost estimate.

Mr. Merciel states that even if the river treatment plant were completely protected from flooding, he still believes it was more prudent to abandon the river treatment plant. Id. at 5. Mr. Merciel states that the flood risk is still very important to the customers of St. Joseph and thus it was not imprudent for Company to provide an "assurance" that its water supply will not be affected by river conditions in the future. It is important to recognize that Company's new groundwater facility will be far from immune from the risk of outage due to flood events. (Ex. 20, pp. 19-20). Furthermore, it is interesting to note that none of the many residential customers that spent their evening at the local public hearing held in St. Joseph testified about any "assurances" they felt came with the new groundwater facility or that such "assurances" were worth an additional $34 million of rate base (equivalent to an addition to their water bill of several dollars a month). (Tr. Vol. 8).

Mr. Merciel even goes so far as to say that he believes it was prudent for Company to "take advantage" of the 1993 Flood by constructing its new plant in a location where "operation and access during flooding is not an issue." (Ex. 49, pp. 5-6). This statement is amazing when the cost comparisons to rehabilitation of the river plant are examined and one realizes that "taking advantage of the situation" will increase Company's rate base by approximately $34 million! Prudence involves much more that an impressive engineering design; it contemplates a cost-effective solution that will produce safe and adequate service at just and reasonable rates.

F. Financial Impact of Prudence Disallowance on Company

Despite Company witness James Jenkins' claim that Public Counsel's recommended plant disallowance would cause the Company to violate the restrictive convenants within its mortgage indenture, Public Counsel's analysis has proven that Company will, in fact, not be in default of its Indenture of Mortgage interest coverage requirement if the Commission adopts Public Counsel's proposed prudence disallowance, cost of service and rate of return. (Ex. 4, p. 4-5; Ex. 26, p. 5-7). The Company's indenture requires it to maintain a times-interest-earned ratio of 1.5. (Ex. 26, p. 5). Public Counsel's pro forma interest coverage ratio analysis is as follows:

Net operating income:	$	10,305,918
Income taxes (test year):		1,893,497
Additional income taxes associated with revenue requirement:		2,300,326
Income available for debt service:		14,499,741
Long term interest requirement:		6,077,123

Time interest covered: $14,499,741 / $6,077,123 = **2.39 times**

The above calculation demonstrates that if the Commission adopts Public Counsel's proposed prudence disallowance, cost of service and rate of return, Company's times-earned-ratio will be 2.39 which is greater than is required by the restrictive covenant in its indenture. Id.

It is important to note, however, that even if the Commission were convinced that the Company would not be able to meet its coverage ratio, it would not be an appropriate factor upon which to base its decision regarding the Company's total revenue requirement. In Missouri Cities Water Company, Case Nos. WR-91-172 and SR-91-174, the Commission, in its Report

and Order of September 20, 1991, found that interest coverage ratios may not be used to determine revenue requirement:

> Interest coverage ratios are driven in large part by management decisions over which this Commission has little or no control, at least in the first instance. **Whether characterized as "prerogatives" of management or simply as a company's decision to, say, construct a new office building, these debt creating "events" cannot, in and of themselves, provide support for a company's estimate of its cost of equity or its revenue requirement.** To do so would turn this or any other Commission into something other than a regulatory body inasmuch as Company management could determine rate of return simply by incurring debt. **This Commission cannot, as suggested by Company, use interest coverages to arrive at Company's revenue requirement.**
>
> Ibid., p. 7. (emphasis added).

Under cross-examination by Public Counsel, Company witness Jenkins acknowledged that, despite his testimony, a Commission should never allow recovery of an investment that it deemed to be imprudent. (Tr. 1484). Captive ratepayers must not be made to pay for the negative impact that errant management decisions might have on the Company's financial situation; instead, that burden should be borne by the Company's shareholders, who are already being compensated for the risk of their investment.

G. St. Joseph Water Quality and its Economic Impact on Consumers

In Case No. WA-96-47, et al., Public Counsel forewarned the Commission that water from a groundwater facility would likely be considered by customers to be of lesser quality than that supplied by Company's river water treatment facility. Ibid., Tr. Vol. 1, pp. 38-39. See also "Lee Rebuttal" attached to Ex. 17 in the instant case as Sched. JSY-1, pp. 9-11. Public Counsel also predicted in that certificate case that additional expenses for softening the groundwater to improve its quality would be a significant uncertainty if Company management were to pursue construction of the already expensive groundwater source of supply and treatment facility. Id.

Company witness Wayne Morgan contended in Case No. WA-96-47, et al. that the groundwater would not be significantly harder than the water being provided to St. Joseph by the river water facility Ibid., Tr. 105. Additionally, in response to questioning from Vice-Chair Dianne Drainer, William F. L'Ecuyer, then - Company President, stated that he did not believe that customers would notice any difference in the hardness of the water after a switch to the proposed groundwater facility. (WA-96-47, et al., Tr. 157).

However, in the instant case the water quality from the new facility has indeed become a concern among customers in the Company's St. Joseph District. The transcript from the local public hearing held in St. Joseph on May 31, 2000, is replete with references to the poor quality, high hardness levels and additional expenses being experienced by customers who are now receiving their water from the groundwater treatment facility. (Tr. Vol. 8). In addition to the "aesthetic" complaints raised, such as taste, odor, greasy film, clarity, and white residue the water leaves behind, many customers testified that they have had to purchase water filters and softeners in order to make the water palatable. (Tr. Vol. 8, pp. 79, 81, 120, 130, 135, 154, 161). Many customers also remarked that they have had to resort to purchasing bottled water for drinking and cooking purposes--yet another expense directly resulting from Company's switch to the groundwater source of supply. Id. at pp. 77, 81, 93, 117, 128, 148, 161, 164. Further expenses incurred by some customers as a result of the switch to groundwater include the chemicals that Company has warned customers must be added to fish tanks and ponds in order to prevent the groundwater now being supplied from killing fish and other aquatic life. Id. at p. 94.

At the local public hearing in Warrensburg held on May 31, 2000, one MAWC customer who operates a retail appliance business testified regarding certain additional expenses that are necessitated by harder water. (Tr. Vol. 7, p. 61). His experience in Warrensburg, which has a

longstanding reputation for having hard water (see Case No. WO-98-203), has been that hard water is "great" for his appliance business: "it destroys water heaters, it destroys dishwashers, ice makers, washing machines....When a washing machine should last 20 years and it rusts out in 10 years. That's not good, our customers deserve more than that." Id.

It is important for the Commission to keep in mind that, in addition to any rate increase that is ordered in this case, customers in the St. Joseph District may be subjected to long-term, recurring expenses far beyond just the increase in their water bills. For these reasons, Public Counsel believes that it is in the best interest of the public for the Commission to open a separate case for the purpose of investigating the water quality issues in St. Joseph along with any solutions that might be available. The customers deserve, at the very minimum, an inquiry into the quality of water they are drinking and for which they are being asked by the Company to pay substantially more. This is particularly true since the record in this case indicates that they are facing potential property damage and myriad expenses beyond the increase in rates as a direct result of the switch from river water to groundwater.

H. Recommended Valuation

It was a decision completely within the discretion of Company management to build a new groundwater facility. Neither the Commission nor any of Company's customers had a say in that decision—nor should they. Public Counsel is not proposing that Company physically abandon its new facility and begin to rehabilitate its river water treatment facility. However, because it has been proven that Company's decision to build the groundwater facility was imprudent and uneconomical, ratepayers should simply not be held responsible through water rates for the Company's imprudent management decisions. (Trippensee Direct, Ex. 33, p.16).

Including the excess costs associated with the new facility (above and beyond the cost of the more economical decision of expanding and updating the existing river water treatment plant) would reward Company for imprudent decisions. This is why Public Counsel is recommending that Company's revenue requirement reflect no more than the cost that would have been incurred had Company chose to upgrade and expand its river treatment plant. The Commission should disallow costs above this amount.

In order to develop the appropriate recommendation for the valuation of appropriate water treatment for the St. Joseph district, it is necessary to add Mr. Biddy's cost estimate for rehabilitating and upgrading the river treatment plant along with the cost of flood-proofing and access road improvements ($36,679,775 as detailed above) to the value of the existing rate base (net plant) that would have remained at the river treatment facility ($1,888,063). (Trippensee Direct, Ex. 33, p.16; Bolin Direct, Ex. 21, p. 5). The revenue requirement impact of this rate base recommendation including modifications to the "return on" of the plant value as well as the "return of" (i.e., depreciation expense) of the plant value is discussed and illustrated in the testimony and schedules of Public Counsel witness Russell Trippensee (Ex. 33, pp. 16-19; Ex. 35, pp. 15-16, Sch. RWT-5-Revised). The total valuation recommended by Public Counsel is $38,567,838.

III. "USED AND USEFUL CAPACITY ADJUSTMENT"

Public Counsel is recommending that the Commission make a "used and useful" capacity adjustment, allowing the Company to recover at this time 80.45% of the amount it determines was prudently invested in the construction of the St. Joseph groundwater treatment facilities. (Ex. 19, pp. 23-26; Ex. 20, p. 6; Ex. 33, p. 18) This recommendation is independent from all of the other recommendations made by Public Counsel regarding prudence disallowances, cost of service and revenue requirement; that is, it applies regardless of whether the Commission adopts Public Counsel's, Staff's or Company's valuation of the St. Joseph plant, or whatever other figure the Commission determines is appropriate. The reason for the 19.55% downward "used and useful" capacity adjustment is simply, as both Mr. Biddy and Staff witness James Merciel point out, that the new plant contains capacity over and above that which is needed to serve current customers. (Ex. 19, pp. 23-26; Ex. 49, pp. 16-18).

Only 80.45% of the new treatment plant is necessary for the provision of water service to current customers in St. Joseph. (Ex. 19, p. 25). The other 19.55% is excess capacity for which current customers should not have to pay. Mr. Biddy arrived at this percentage by dividing the maximum day water usage for the year 2002 as determined by Company by the capacity built into the new plant. Id., Scheds. TLB-11 and TLB-12. The projected maximum day water usage for 2002 is 24.135 million gallons per day (MGD) and the capacity of the plant is 30 MGD. Id. at 25. The calculation yields a percentage of 80.45%, which is the percentage of the plant that is currently "used and useful." Id.

Public Counsel's recommended valuation of the St. Joseph plant, based on Mr. Biddy's total estimate of the cost of refurbishing the river water treatment plant plus existing rate base that would remain, is $38,567,838. Id. at 21. A 19.55% reduction for plant that is not currently

"used and useful" results in a valuation of $31,027,825. If the Commission adopts a valuation of a 30 MGD alternative other than that proposed by Public Counsel, it should reduce that figure by 19.55% to adjust for excess capacity. This adjustment should be made to whatever valuation amount the Commission believes was prudent for the Company to have invested in the new plant.

Even if the Commission finds that Company was prudent in building the excess capacity, it should not require current customers to pay for the part of the plant that will benefit only future customers (if, in the distant future, Company management's predictions regarding growth prove correct). It should be noted that adoption of this "used and useful" capacity disallowance would not preclude the Company from fully recovering the investment at a later date when and if the excess capacity becomes necessary to serve customers. This adjustment merely places the responsibility for paying for that capacity on the customers who will actually be using it, not the current customers who are already paying for the capacity of the plant being used by them.

IV. PREMATURE RETIREMENT OF RIVER TREATMENT PLANT

Company chose to replace its river water treatment plant in St. Joseph with a new groundwater source and treatment facility. The "old" plant has been retired and is no longer used to provide water service to the public. (Tr. 1443). Company has included in its rate base recommendation the amount of $3,332,906 which represents the net plant investment associated with the river water treatment plant in St. Joseph and related facilities, less the accumulated depreciation on those facilities, attempting to treat this premature retirement as a normal retirement. (Ex. 6, p. 24).

MAWC witness James Salser states that this figure includes the net original cost of the river water treatment plant ($2,832,906) plus MAWC's estimate of "cost of removal" expenses ($500,000). Id. at lines 15-18. He argues that the Company should be permitted to include the premature retirement amount in rate base since the plant was not fully depreciated at the time that it was taken out of service. (Ex. 7, p. 9).

Accounting practice dictates that in a "normal" (as opposed to "premature") plant retirement, plant-in-service is decreased by the net original plant cost, and the depreciation reserve is decreased by the same amount. (Ex. 23, p. 1, 3). In this case, however, there is not enough depreciation reserve from which to deduct the net original cost of the plant. Doing so results in a negative depreciation reserve and a negative plant-in-service amount, causing an increase in the Company's rate base of $2,832,906. (Ex. 23, p. 2).

As explained by Public Counsel witness Kimberly Bolin (Ex. 22), it would be improper for the Commission to include the net original cost of the river water treatment plant and the

associated cost of removal as suggested by MAWC in its cost of service computation for two reasons:

1. The plant was taken out of service in early April, 2000, and has not provided water service to customers since that time. The Company freely admits that the river water treatment plant has been abandoned; therefore, it is no longer "used and useful." (Tr. 1443). Inclusion in rate base of MAWC's suggested amounts related to the retired plant would violate the longstanding "used and useful" test. This Commission has historically allowed rate base treatment only for plant and property that is currently providing service to the public. In United Telephone Company of Missouri, Case No. TR-93-181, the Commission's October 27, 1993 Report and Order at page 9 reiterated the proper ratemaking principle:

> The Commission adopts the Staff's position that, even though UTM gained savings in closing the center, the equipment involved is no longer in service. **For purposes of calculating rates for current and future ratepayers, it is inappropriate to place the cost of items in the rate base, which are no longer used and useful.** The Commission has consistently taken this position in the recent past. (emphasis supplied).

Company is entitled to an opportunity to earn a fair return only on that plant and property which is currently "used and useful" in providing service to the public; ratepayers should not be shouldered with the burden of paying for plant that is providing them no benefit. (Ex. 22, p. 5).

2. As a result of true-up information, some level of rate base recognition or valuation for the new St. Joseph groundwater source and treatment facilities will be built into the cost of service. (Ex. 22, p. 2). Ratepayers, if forced to continue paying for the disconnected plant, will be paying for two water plants when only one is necessary to provide them with water service.

In GTE North, Inc., Case No. TR-89-182, this Commission determined that the unamortized investment associated with the premature retirement of an EAX switch should not remain in rate base until recovered, but that the reserve deficiency associated with it should be

amortized over a five-year period. Ibid, Report and Order, February 9, 1990, p. 8. The Commission's rationale was that, "since the EAX switch is no longer used and useful it should be removed from rate base since the ratepayers are receiving no benefit from it." Id., at p. 8.

Staff witness Jolie Mathis claims that the plant account and the depreciation reserve account should be reduced by the remaining net original cost of the river water treatment plant "until a depreciation study is performed," and that the costs of removal ($500,000) reduce the depreciation reserve when actually incurred. (Ex. 44, p. 4). She recommends, as does the Company, that the estimated unrecovered investment in the old plant be kept in rate base until a depreciation study is completed. Id. It is important to note that the only reason the depreciation study that the Staff and the Company feel is necessary has not been performed to date is, according to the Staff, that "the Company was unable to provide updated actuarial data based on year-end 1998 plant balances for all related accounts, requested in [Staff] Data Request No. 4701, in a timely manner." Id. at p. 2.

Company bears the burden of proof in a rate case. Company was clearly unable to provide Staff with the data it needed to be convinced regarding how much rate base should be included. Ratepayers should not be forced to pay in the meantime, while Staff and Company study this issue! This is no remedy to retroactively correct such a mistake and compensate ratepayers for the amounts they would overpay while a study is pending.

If the Commission were to adopt the approach suggested by Staff and the Company, allowing the estimated undepreciated investment to remain in rate base until some future date when a depreciation study is performed, it would be requiring the ratepayers to pay for two water plants simultaneously, only one of which is providing them with water service. The Commission would also be giving the Company a return on its investment during the entire pendency of any

depreciation study and until the next rate case, when it might be determined by Staff and Company just how much water customers have been overpaying, a situation for which no retroactive remedy would be available. Further, it would be rewarding the Company for failing to provide, in a timely manner, the data requested by Staff which would have allowed the depreciation study to have been completed already. (Ex. 44, p. 4).

Furthermore, Public Counsel submits that no depreciation study is actually necessary at all. The Company made a management decision to construct a new plant knowing full well that part of its investment in the river water treatment plant was not fully depreciated and was yet to be recovered. It does not matter how much of the old plant's original cost has not been recovered; the retired plant is no longer "used and useful." As a result of true-up information, the Company will be benefiting from the inclusion of the new treatment plant (at least to some degree in rate base) but it also hopes to "double-dip" by forcing the customers to pay for the retired plant at the same time they are paying for the new one. This is unreasonable.

V. ACCOUNTING AUTHORITY ORDER ISSUE

In November, 1999, Company filed a Motion for an Accounting Authority Order in this case, seeking authority to capitalize allowance for funds used during construction (AFUDC) and to defer "post-in-service" AFUDC and depreciation on the new St. Joseph Water Treatment Plant for the four and one-half months between the date that the new plant goes on-line and the date that new tariffs are expected to go into effect by operation of law. Ibid., pp. 1-2. Following extended negotiations that subsequently followed between Public Counsel, Staff, and Company, a Non-unanimous Stipulation and Agreement was filed on February 23, 2000, in which Public Counsel would have agreed to allow Company to defer certain revenue contingent upon certain Company agreements, including an agreement that increased rates would become effective for Company's customers for seven and one-half months following the operation of law date in this rate case. The Commission refused to approve the Non-unanimous Stipulation and Agreement, and Company continued forward with its rate request, whereby it is expected that new water rates will go into effect only four and one-half months following the new water plant going on-line.

Company's Motion for an Accounting Authority Order is nothing more than an attempt to insulate its shareholders from "regulatory lag." (Ex. 33, p. 4). Refers to the difference in timing of a decision by management and the Commission's recognition of that decision, and its effect, if any, on the rate base/rate of return/revenue/expense relationship in the determination of a company's revenue requirement. Id. Management has the potential to increase the profitability of the firm in the short-run, until such time as the Commission reestablishes rates which properly match the new levels of the overall cost of service components. Companies are

allowed to retain cost savings, (i.e., excess profits) during the lag period between rate cases. When faced with escalating costs that will change the rate base/rate of return/revenue/expense relationship adversely with respect to profits, regulatory lag places pressure on management to take actions to minimize the change in the relationship and the resulting decrease in profitability. Regulatory lag, stated another way, provides management with real financial incentives to operate the business in an efficient manner. Id.

The main problem with an Accounting Authority Order (AAO) which authorizes the deferral of a cost is the requirement that all relevant factors be determined when establishing rates. Isolating only one component of the overall cost of service (such as expenditures for a new water plant) neglects other relevant factors, which may have a corresponding increase or decrease on the overall cost of service. (Ex. 33, p. 5). For this reason, the Commission has heard many litigated cases regarding the special circumstances that should be established before extraordinary rate-making relief be granted, and has wisely restricted the standard for allowing such relief.

The Commission addressed the propriety of granting an AAO for the purpose of lessening regulatory lag in the seminal case of Missouri Public Service Company (Cases Nos. EO-91-358 and EO-91-360):

> Lessening the effect of regulatory lag by deferring costs is beneficial to a company but not particularly beneficial to ratepayers. Companies do not propose to defer profits to subsequent rate cases to lessen the effects of regulatory lag, but insist it is a benefit to defer costs. Regulatory lag is a part of the regulatory process and can be a benefit as well as a detriment. Lessening regulatory lag by deferring costs is not a reasonable goal unless the costs are associated with an extraordinary event.
>
> Maintaining the financial integrity of a utility is also a reasonable goal. The deferral of costs to maintain current financial integrity though is of questionable benefit. If a utility's financial integrity is threatened by high costs so that its ability to provide service is threatened, then it should seek

> interim rate relief. If maintaining financial integrity means sustaining a specific return on equity, this is not the purpose of regulation. It is not reasonable to defer costs to insulate shareholders from any risks. If costs are such that a utility considers its return on equity unreasonably low, the proper approach is to file a rate case so that a new revenue requirement can be developed which allows the company the opportunity to earn its authorized rate of return. Deferral of costs just to support the current financial picture distorts the balancing process used by the Commission to establish just and reasonable rates. Rates are set to recover ongoing operating expenses plus a reasonable return on investment. Only when an extraordinary event occurs should this balance be adjusted and costs deferred for consideration in a later period. (Emphasis added). Ibid., Report and Order, p. 36.

The Western District Court of Appeals affirmed the Commission's decision in Missouri Public Service Company, recognizing that:

> [An AAO deferral]...distorts the balancing process utilized by the Commission to establish just and reasonable rates. Because rates are set to recover continuing operating expenses plus a reasonable return on investment, only an extraordinary event should be permitted to adjust the balance....
>
> State ex. Rel. Missouri Office of the Public Counsel v. Public Service Commission. 858 S.W.2d 806, 810 (Mo.App. 1993).

The Court of Appeals also noted that the Uniform System of Accounts (USOA) defines "extraordinary items" as:

> [t]hose items related to the effects of events and transactions which have occurred during the current period and which are not typical or customary business activities of the company ... Accordingly, they will be events and transactions of significant effect which would not be expected to recur frequently and which would not be considered as recurring factors on any evaluation of the ordinary operating processes of business...
>
> Id. at 810.

The new St. Joseph Water Treatment Facility, despite the assertions of Company, was not the result of an "Act of God" (Ex. 35, pp. 11-12). Company's planning process for its new facility dates back to project reports in 1991, and a comprehensiveplanning study as early as 1988. Although the size of this project is extremely large and could result in a dramatic increase

in rates, it remains simply a construction project. (Ex. 33, p. 12). The construction of water treatment facilities is obviously a normal part of doing business for any water utility. The new facility itself is designed so that it can expand for additional capacity. The expansion reemphasizes that the construction is a normal activity, and not the result of an unpredictable event. Therefore the Commission should remain consistent with recent decisions as in the Report and Order issued in St. Louis County Water Company, Case No. WR-96-263, in which the Commission stated:

> As both the OPC and the Staff point out, the Commission has, to date granted AAO accounting treatment exclusively for one-time outlays of capital cuased by unpredictable events, acts of government, and other matters outside the control of the utility or the Commission. It is also pointed out that the terms (infrequent, unusual and extraordinary" connote occurrences which are unpredictable in nature."
>
> Ibid., p. 13.

The extent and timing of the construction of the new St. Joseph Water Treatment Plant was an event completely in within control of Company's management; ratepayers did not participate in this management decision. Clearly, the triggering event set out by Company in its motion for an AAO does not meet the Commission's requirements.

Moreover, Company is essentially requesting a deferral of earnings, a component of the cost of service for which USOA Account 186 does not provide authority to defer. (Ex. 33, pp. 8-9). It is critical to realize that earnings are only recorded in two accounts, USOA Account 435, Balance Transferred from Income, and USOA Account 216, Unappropriated Retained Earnings. Neither of these accounts are expense accounts, nor are they asset accounts. (Ex. 33, p. 9). Earnings are simply the product of all activities of the firm during a specified period. Therefore as long as a utility's earnings for any period are positive, all expenses associated with the revenue produced for the period have been recouped by the utility. Id.

Although it should not be the responsibility of the ratepayers to compensate Company has timed the filing of this rate case so that the new water plant will be in-service approximately four and one-half months prior to the time new rates will be placed into effect. The financial impact due to the loss of AFUDC and the resulting deduction in earnings over this short period did not place Company in financial distress. (Ex. 33, p. 13). Earnings for the rolling twelve-month periods ending May, 2000 through August, 2000 were projected to remain above 8.6%. Id. It was also projected that interest coverage for the same rolling twelve-month periods will remain in excess of 2.5 times, well above Company's required 1.5 times coverage. Company's prepared testimony in this case does not dispute that it will be able to meet its interest coverage during this short time period; however, Company witness James Salser analyzes Company's financial condition (as opposed to a twelve month analysis) producing a distorted picture of Company's actual financial condition. (Salser Rebuttal, Ex. 7, pp. 2-3). Mr. Salser's analysis should be discounted because it is not based upon annual information. The Commission sets rates based upon a twelve month time period and Company's debt holders recognize this. (Ex. 35, p. 12).

Staff witness Steven Rackers analyzes the projected return on equity for the annual period ending each month beginning with April 30, 2000. (Rackers Rebuttal, Ex. 53, p. 6). Staff's analysis actually shows the minimum earnings of Company to be slightly higher than is shown under Public Counsel's analysis. According to Staff's analysis, Company would earn in excess of Staff's recommended mid-point return on equity in four of the six months and above Staff's low end of the return on equity range in five months. (Ex. 35, p. 12). Allowing Company to defer cost during a period of over earning and subsequently allow recovery of deferred costs from the ratepayer would clearly result in double recovery of these costs. (Ex. 35, p. 13).

VI. RETURN ON EQUITY

Public Counsel financial analyst Mark Burdette, using Company's capital structure as of September 30, 1999, has determined that the Commission should allow MAWC an overall return on its net original cost rate base of 8.24%. This return is based on a 9.08% embedded cost of preferred stock, a 6.92% embedded cost of long-term debt, and a return on common equity of 9.92%. (Ex. 24, p. 5). Since the parties have conceptually agreed upon the embedded costs of preferred stock and long-term debt, this discussion will focus primarily on Public Counsel's recommended 9.92% return on common equity. (Ex. 25, p. 1).

In order to calculate a fair return on common equity for MAWC, Mr. Burdette performed the standard Discounted Cash Flow (DCF) analysis applied to the common stock of American Water Works (AWK), MAWC's parent company. AWK is the largest investor-owned water utility in the United States, with 23 regulated subsidiaries. Id.; Value Line, February 4, 2000. AWK is the sole owner of MAWC common equity and receives all such dividend distributions by MAWC. AWK's common stock is publicly traded on the New York Stock Exchange; MAWC does not issue its own publicly traded common stock. For that reason, it would be impossible to perform a DCF analysis on the common stock of MAWC. (Id., at p. 3-4).

Mr. Burdette then applied the DCF methodology to the stocks of a group of comparable publicly traded water companies in order to further his analysis as to the proper return on common equity for MAWC, and finally, substantiated his results with Capital Asset Pricing Model (CAPM) analyses on AWK, on the initial group of comparable water companies, and on five additional companies. Id. at 4.

MAWC's capital structure as of September 30, 1999, which is not at issue in this proceeding, consists of the following: 42.31% common equity, 2.41% preferred stock and

55.28% long-term debt. This capital structure has remained relatively steady for the past four years. Id. at 5. AWK and MAWC's common equity levels indicate that they are less risky in terms of capital structure than the group of comparison companies. Id. at 7.

Discounted Cash Flow (DCF) Analysis

The companies Mr. Burdette chose as the comparison group for purposes of his DCF analysis were American States Water Company, California Water Service, E-town Corporation and Philadelphia Suburban Corporation. Id., Sched. MB-3. These companies are the only water utilities covered by Value Line Investment Survey (Value Line) which meet both of the following criteria: 1) forecasted financial information about the company is available from Value Line; and 2) the company is not currently in the process of being sold. (Ex. 24, p. 14).

Mr. Burdette's DCF analysis yielded a recommendation of a 9.92% return on common equity. This recommendation resulted from his calculations of a 5.00% sustainable growth rate, a 4.67% dividend yield, and an increase of 25 basis points in recognition of likely interest rate increases in the future. Id. at 7-9, 19.

In measuring the investor-expected sustainable growth rate utilized in the DCF model, Mr. Burdette employed all of the following techniques: historical growth in earnings per share (EPS), dividends per share (DPS) and book value per share (BVPS); historical retention growth; projections of growth in EPS, DPS and BVPS; and projected retention growth. Id. at 13; Sched. MB-7. Additionally, Mr. Burdette analyzed the comparable group of water companies to gain further insight as to a reasonable sustainable growth rate for MAWC. The resulting growth rate was 5.00%. Id. at 14.

Mr. Burdette's calculation of the dividend yield (4.67%) was derived from the average stock price over a recent six-week period, expected divided yields taken from Value Line and his

calculations on Sched. MB-8 (Ex. 24) of dividend yields for AWK and the comparison companies. Ibid. at 18. Mr. Burdette then made a 25 basis point upward adjustment in consideration of likely interest rate increases. These calculations yielded a DCF cost of common equity for MAWC of 9.92%. Id. at 19.

Mr. Walker's DCF cost of common equity for MAWC is 10.5%. (Ex. 12, Sched. 13). The disparity between Mr. Walker's and Mr. Burdette's recommendations results from the unreasonably high growth rate used by Mr. Walker in performing his analysis. (Ex. 25, p. 12). The growth rate was too high because Mr. Walker calculated it based on estimations of future actual earnings rather than on its own merits. As a result, the growth rate as adjusted by Mr. Walker was inappropriate for MAWC and caused his DCF recommendation to be too high as well. Id.

Company witness Harold Walker used four of the five comparable companies chosen by Mr. Burdette for his own analysis; unlike Mr. Burdette, he did not use American States. Mr. Walker included Aquarion Company and United Water Resources in his comparable group, even though Aquarion was taken over in January, 2000, and United Water Resources is in the midst of a merger transaction with MAWC. Id. at 14. Additionally, Mr. Walker chose to use several companies which were not covered by Value Line, and therefore, for which no forecasted financial information and no growth rate projections were available: Aquarion Company, Pennichuck Corporation and York Water Company. Further, some of Mr. Walker's comparable companies, although they are covered by Value Line, do not have financial projections available: Artesian Resources, Connecticut Water Services, Middlesex Water Company, SJW Corporation and Southwest Water Company. (Ex. 25, p. 3). For these reasons, most of companies selected by Mr. Walker as "comparables" were not appropriate for comparison purposes.

Capital Asset Pricing Model (CAPM) Analysis

Mr. Burdette's substantiating CAPM analysis, discussed in Exhibit 24 at page 21, performed on AWK, on the four initial comparison companies, and on additional five water utilities not covered by Value Line. Since MAWC does not have an independent "beta" (risk measure), the analysis could not be performed directly on Company. However, the overall CAPM costs of common equity for AWK and the two groups of companies mentioned above was 9.90%, a result which provides substantial support for Mr. Burdette's recommendation of a 9.92% cost of equity for MAWC. Id.

Mr. Walker's CAPM analysis yielded a historical CAPM of 11.3% and a projected CAPM of 12.3%. The reason his CAPM cost of equity is so much higher is that Mr. Walker makes numerous adjustments to increase his recommendation, including a 0.5% upward adjustment for risk associated with "small size." Id. at 13.

Mr. Walker's many references to MAWC's "small size" do not take into consideration the reality of MAWC's business and financial conditions. Id. at 6. Company is wholly owned by the largest investor-owned water utility in the United States; as pointed out to shareholders in AWK's Annual Report, MAWC operates under the umbrella of AWK's corporate structure and enjoys the many benefits that come from the strength and economies of scale derived from its parent company's position in the water industry. Id. at 6-7. MAWC is by no means a small, risky company that is so financially unstable that it requires the type of "small company" adjustment applied by Mr. Walker in his CAPM analysis. When Mr. Walker's inappropriate upward adjustments are removed from his calculations, his CAPM analysis shows substantial

support for Mr. Burdette's recommended cost of common equity of 9.92% and for the lower end of the range calculated by Staff witness Roberta McKiddy. Id. at 14.

Return on Equity Recommendations

Company witness Walker ultimately recommends a return on common equity of 11.654%. (Ex. 12, p. 2, corrected on direct examination). He states on page 3 of Exibit 12 that "as a check on the reasonableness of my common equity cost rate recommendation, I reviewed Value Line's projected returns on common equity for my comparable group of water utilities." Ibid., p. 3. Mr. Walker concludes that since Value Line's projected returns on common equity for his comparable group of water utilities average 11.8% to 12.2%, his recommendation of 11.7% for MAWC is "reasonable, if not conservative." Id. However, this comparison is meaningless because Mr. Walker has "checked" his recommendation for an authorized rate of return by comparing it with Value Line's projected actual rates of return. Projections of actual earnings are irrelevant when determining an appropriate authorized rate of return, since companies earn at various levels both above and below their authorized return. (Ex. 24, p. 2).

The Commission should adopt Mr. Burdette's recommendation of 9.92%, which is supported not only by Mr. Burdette's own DCF and CAPM analyses, but is also within the range recommended in the testimony of Ms. McKiddy, and is consistent with Mr. Walker's CAPM calculations (Ex. 25, p. 14). Public Counsel is thus recommending the most reasonable and appropriate return on common equity for MAWC, and the Commission should thus allow Company an opportunity to earn an overall return on its net original cost rate base of 8.24%.

VII. RATE DESIGN

A. District Revenue Responsibility

By adopting Public Counsel's rate design proposal the Commission can achieve a beneficial compromise between the extreme positions of single tariff pricing (STP) and district specific pricing (DPD) because Public Counsel's proposed rate design balances the benefits of cost-based rates with the benefits of tempering rate shock.

Public Counsel recognizes that in this case there are attractive aspects to each of the extremes and has tried to incorporate those aspects into its recommendation. On one hand, Public Counsel supports movement toward pricing that is based on district specific costs. Company witness Stout acknowledged that MAWC's seven districts are stand-alone systems that share only a limited amount of overhead costs. (Tr. 199). The seven districts have substantially different production characteristics including the source of supply, processing and treatment requirements, and distribution characteristics. Additionally, there is clear evidence that the quality attributes of the finished product differ by district (Busch Direct, Ex. 27, p. 6). The local public hearing transcripts attest to the fact that customers percieve significant differences in the quality of the water delivered in their district as opposed to the water delivered elsewhere. (Warrensburg Public Hearing, Tr. Vol. 7; St. Joseph Public Hearing, Tr. Vol. 8). On the other hand, given that movement to district specific pricing would result in district revenue adjustments ranging from a decrease of 9.43% for the Joplin district to an increase of 262.6% for the Brunswick district (Hu Rebuttal, Ex. 31, Sched. HH REB-1), Public Counsel believes that some level of sharing is necessary to ensure the reasonableness of rates in this case.

Under Public Counsel's revenue requirement and rate design proposal, the district increases are limited to no more than 50%[1] (Busch, Rebuttal Testimony, p. 9). Public Counsel's rate design results in Warrensburg and St. Joseph moving to their full cost of service because the necessary rate increases to achieve cost of service do not exceed 50%. In the Mexico, Brunswick, and Parkville districts, where the rate increases would otherwise exceed the 50% cap, the difference between the district specific cost and the cap will be supported by contributions from Joplin and St. Charles. Under Public Counsel's rate design, Joplin will receive no rate increases and St. Charles would receive an approximate 8.5% increase in rates. The result of this recommendation on the Joplin and St. Charles districts would limit revenue collection to 9.43% above cost in the Joplin district and less than 4% above cost in the St. Charles district. (Busch Rebuttal, Ex. 28, Sched. JAB R1).

In the event that the revenue requirement proposals of Staff or Company are adopted, Public Counsel cannot support implementing a 50% cap for the St. Joseph revenue increase as would be applied to Brunswick, Mexico and Parkville. In such a scenario, Public Counsel recommends a modification of its proposal because the magnitude of the support that would be needed to fund the cap for St Joseph would impose an unreasonable burden on the other districts (Ex. 28, p. 9). Capping the St. Joseph district increase at 50% would require the St. Charles district to contribute approximately 25% above their cost of service and the Joplin district to contribute approximately 44% above their cost of service to support St. Joseph and the three smaller districts. Id. This equates to between twenty and thirty cents of every dollar billed to the customers in these districts flowing to support other districts. This level of sharing is between four and five times the level proposed by Public Counsel. We believe that this amount of

[1] In cases of phase-in, due to carrying cost, a district's total revenue increase may exceed 50% in the final year that rates are increased.

sharing is excessive, an undue burden and unreasonable.

Furthermore, Public Counsel opposes any methodology that would necessitate Warrensburg or the other smaller districts contributing to support St. Joseph, the largest of all seven districts, because it is contrary to the traditional regulatory policies that encourage the viability of small districts through support following from large districts. Ms. Jan Beecher, testifying on behalf of the city of St. Joseph and the water districts served by the St. Joseph plant, even recognizes that support for the viability of smaller systems is one of the main regulatory goals cited in favor of STP. (Beecher Report, Ex. 58, p. 57, Sched. JB-2, Table E1).

By adopting Public Counsel's rate design proposal, the Commission will achieve a balance that serves the interests of the public by ensuring just and reasonable rates for ratepayers in all of Company's districts, as opposed to serving the interests of only a subset of Company's customer base. Given the disparity in capital improvements and other cost characteristics Exibited by Company's seven districts and the potential rate shock that could occur under a STP scheme, it is reasonable to move the revenue generated in each district closer to cost, while mitigating rate shock through the limited sharing of cost recovery and through phase-ins. (Ex. 27, pp. 4, 7, 9; Ex. 28, pp. 3-4, 7-9).

Through the course of this proceeding, Company has developed three alternative rate design proposals. In its initial filing, the Company proposed single tariff pricing which would result in a 48% across-the-board rate increase based on the Company's adjusted revenue requirement. (Stout Rebuttal, Ex. 10, p. 19) In response to concerns raised by other parties, the Company in its prepared rebuttal testimony, proposed two alternatives that would involve applying a surcharge to St. Joseph consumers while maintaining uniform Company-wide customer and usage charges. The first of these alternatives would establish a 48.356% surcharge

on St. Joseph with a 28% increase in Company-wide charges. (Stout Rebuttal, Ex. 10, p. 19). The second alternative would establish a 34.882% surcharge on St. Joseph with a 33% increase in Company-wide charges. Id. Each of these three Company proposals, albeit to different degrees, suffers from the same shortcomings. They do not adequately reflect the disparity in sources of supply, processing and treatment requirements, and distribution systems between the districts, and as a result, the Company's proposals do not promote efficient investment (Ex. 28, p. 3). Also, despite evidence contained in the Company's cost studies that class cost differentials exist and that inter-class shift might be justified, the Company's proposals ignore this evidence by in stead recommending a "one-size fits all" application of uniform rate increases for all customer classes.

Under all three Company proposals, consumers in the Joplin and St. Charles districts are forced to shoulder too large a share of the cost attributable to other districts. For example, under the various Company proposals an average residential customer in the Joplin district will be required to pay an additional $5 to $8 per month to support primarily the St. Joseph Ex. 10, Table 3-B) despite the fact that Joplin is currently contributing approximately 9% above its cost of service. Because St. Charles has a relatively high monthly usage, the impact of all three proposals would be even greater, increasing the average St. Charles residential customer's monthly bill from $5 to $10[2] above the district cost to support other districts.

In addition, there is a specific concern with Company's proposed surcharge alternatives. The methodology used to reduce the disparity between rates and cost in St. Joseph would have the exact opposite effect of increasing the disparity between rates and cost for the other supported districts. The surcharge alternatives therefore do not offer the supporting districts of

[2]Stout Rebuttal Table 3-B assuming 5% increase in St. Charles is needed to achieve cost of service.

Joplin and St. Charles reassurance that their burden will be reduced in the future due to other districts achieving meaningful movement toward the cost of service.

Initially, in the Commission Staff's prepared direct testimony, the Staff supported absolute District Specific Pricing. Based on updated information that became available through the course of this proceeding, the Staff has modified its position to allow limited sharing and phase-ins. Staff's Statement of Positions on Issues, pp. 3-4. The Staff's recommendation shows substantial movement toward Public Counsel's proposal in that the Staff is recommending phases-ins for four of the five districts that Public Counsel recommended: Brunswick, Mexico, Parkville and St. Joseph. The Staff's final proposal also reflects a cap on the total post phase-in Brunswick revenue requirement. (Ex. 105). These modifications reflect that the Public Counsel and the Staff share common ground on the importance of mitigating the rate shock that would result from immediate and substantial rate increases.

There are three remaining areas regarding rate design for which Public Counsel and the Staff differ. First, the Staff does not cap the overall revenue requirement at 50% for Mexico, Parkville and Brunswick at the end of phase-ins as does Public Counsel. Instead, the Staff would increase the revenue requirement for Mexico by 83%, Parkville by 78%, and Brunswick by 108%.[3] We believe that a movement of 50% in this case constitutes meaningful and sufficient movement toward cost of service that can be achieved with minimal impact on the contributing districts. The tradeoff for capping these district increases to 50% is that Joplin's rates remain constant and St. Charles receives an increase of less than 5% in order to accommodate these caps, but the second area where the proposals of Public Counsel and Staff differ is that both Public Counsel and Staff agree that interclass shifts and phase-ins are

[3] Exhibit 105, calculated by dividing year 6 revenue after increase by year 1 revenue prior to increase – 100%.

appropriate, Staff fails to provide a detailed recommendation of how interclass shifts and phase-ins will be integrated. The Staff's final interclass shift recommendation is contained in Mr. Hubbs rebuttal testimony. (Ex. 42). However, as Mr. Hubbs acknowledged in response to cross-examination that his schedules do not reflect the Staff's phase-in proposal over a five-year period (Tr. 1005). Likewise, Staff's final phase-in proposal reflects only district revenue requirements, providing no information on how interclass shifts will be handled. Assuming the Commission adopts the Staff's phase-in recommendation and its proposal to move customer classes within a district to their cost of service, for the Mexico district, this would produce a 22% annual increase in average district revenue concurrent with a total revenue increase of 197% for the sales for resales class. (Ex. 105). The Staff did not identified a methodology as to the rate at which each class will move toward its cost of service over the phase-in period while maintaining a 22% annual increase. Without this information, it is impossible to fully evaluate the combined impacts of or reasonableness of rates for specific customer classes. In contrast, the rate design described in Public Counsel's rebuttal testimony integrates Public Counsel's phase-in and interclass shift proposals, allowing for a complete evaluation of the combined impacts of these proposals on the yearly revenue increases for each classes in each district. (Ex. 28, Sched. JAB R3-1 through R3-7).

The third area of disagreement relates to the impacts of interclass shifts. For districts not subject to a phase-in, it appears that the Staff is recommending a one time adjustment for customer classes in these districts. (Ex. 105). An example of the impact of this recommendation is that the sales for resale class in Warrensburg would experience a one time increase of 148%. Id. We believe that for districts where rates are phased-in, similarly large increases could occur for some classes; however, the exact impact is difficult to determine given that Staff has not

provided a integrated phase-in rate design proposal. Public Counsel considered and addressed this problem in the development of its method to achieve interclass shifts. The end result of Public Counsel's rate design proposal is that no class in any district would receive more than a 25% increase in any year. (Ex. 34, Sched. RWT-2).

B. Customer Class Revenue Responsibility

Some parties have requested that the Commission use a strict cost of service approach to designing rates and not consider any other factors such as the reasonableness of those rates or the rate impacts those rates would have on customers. Public Counsel believes that its cost of service study should be used as a general guide in designing just and reasonable rates. In addition, to ensure the reasonableness of rates, they should be set to reflect public policy objectives including affordability, gradualism and avoidance of rate shock. (Ex. 27, p. 7). The Commission has broad authority and discretion in setting rates to balance cost with policy objectives. State ex rel. Associated Natural Gas v. PSC, 706 S.W.2d 870, 879-880 (Mo.App.W.D. 1985). The results of Public Counsel's cost of service study, as well as those performed by other parties, suggested that immediate movement to cost of service would produce severe rate impacts on various customer classes in a number of districts. In response to this concern, Public Counsel developed its comprehensive proposal, limiting customer impacts through district caps, limited sharing and phase-ins.

Given the disparity in capital improvements and other cost characteristics exhibited between MAWC's seven districts, revenue recovery should better reflect district specific class cost and should not be based on simplistic company-wide cost of service studies. In this case, it is the only way to ensure that the rates are just and reasonable for each MAWC district. (Ex. 27,

pp. 3-7). Public Counsel and Staff are the only parties that performed specific class cost of service studies for each district.

Public Counsel's class cost allocation methodology is the most appropriate method because it properly allocates costs to small users with a high peak to average usage ratio while the particular "Base and Extra Capacity" method utilized by Company and Staff over-allocates costs to this group. (Hu Rebuttal, Ex. 31, pp. 8-16). The primary flaw of the basic "Base and Extra Capacity" method is that it skews the allocation of cost toward consumers that have volatile demand such as the residential and small commercial users whose consumption is relatively weather sensitive. This occurs because that method averages extra capacity with base usage instead of averaging peak usage with base usage. (Tr. 699) Although the basic "Base and Extra Capacity" method is proclaimed to balance both the base usage and peak demand usage (Tr., 202), in many instances, the result of this calculation is shown to approximate the result that would occur from allocating cost based only upon the class share of total coincident or non-coincident peak demand (Ex. 31, pp. 11-13; Tr. 698-699). In addition, the Staff witness Hubbs has acknowledged that sometimes this method could allocate more costs to the residential class than a pure peak responsibility allocation method would. (Ex. 43; Tr. 943-947).

Public Counsel believes that a method which is skewed towards or over the peak use allocation is not a proper balance of the base usage and peak usage (Tr. 698-699). Public Counsel has identified that there is an underlying weakness with the basic "Base and Extra Capacity" which is that it fails to take into account the economies of scale that exist in capacity-related facilities. (Ex. 30, pp. 4-6). To correct for this problem, Public Counsel has incorporated an appropriate economies of scale factor into the calculation. Id. Therefore, Public Counsel's study (Ex. 31, pp. 2-3) best captures the true cost relationships between different customer

classes and should guide the Commission in adopting rates that better reflects the district specific class cost of service.

Despite differences in cost study methodology, the Staff, Public Counsel and Company cost studies each produce some similar results. (See table showing "Comparison of Residential Revenue Percentage," Ex. 31, p. 7). Generally, the "sales for resale" and industrial class revenue were below cost of service. In all cases, the studies indicate that rates for residential consumers' exceed cost of service. These results warrant that, to the extent possible, the final rate design adopted by the Commission should accommodate a reasonable level of interclass movement toward costs. Public Counsel's method adjusts district increases to allow for interclass shifts. However, no class will receive a decrease when another customer class in that district is receiving an increase. The development of specific adjustments by class, by district, by year are illustrated in schedule JAB R2-1 through R2-6 of Exibit 28.

C. Phase-In

Public Counsel's phase-in proposal is designed to address rate shock concerns caused by not only a large revenue requirement increase, but also by the shifts in revenue requirement responsibility between districts and customer-classes within the districts. Public Counsel's phase-in is based on the total revenue requirement effect. Public Counsel believes the Commission should authorize a phase-in in order to address the rate shock and equity concerns laid out in Public Counsel's testimony. (Trippensee Rebuttal, Ex. 34 , p. 13)

Public Counsel's rate design methodology provides for a phase-in of no more than 15% for any given district for any given year. This phase-in recommendation provides for three annual rate increases for Warrensburg, four for St. Joseph, and five for Brunswick, Mexico, and

Parkville. This phase-in proposal is designed to provide the Company with full recovery of its revenue requirement and carrying costs incurred during the phase-in period. (Ex. 27, pp. 8-9, 11; Ex. 28, Schedule JAB R3; Ex. 29, JAB SR; Trippensee Rebuttal, Ex. 34, Sched. RWT-2-RWT4, RWT-6; Trippensee Surrebuttal, Sched. RWT-5 Revised). Detailed calculations of the revenue deferral, the associated carrying costs and the specific recovery per year are illustrated in these Schedules, deveoped byPublic Counsel witness Russ Trippensee.

Public Counsel also believes that its phase-in is reasonable because it addresses the total revenue requirement and not simply one component such as plant. The phase-in proposed in Staff's direct testimony is based on only one specific plant, the new water treatment facility at St. Joseph. (Ex. 34, p. 130; Ex. 35, p. 2). Staff's updated recommendation appears to support a phase-in based upon total revenue requirement. (Ex. 105).

Public Counsel's phase-in proposal is completely consistent with Generally Accept Accounting Principles (GAAP). (Ex. 35, pp. 2-10). This proposal is also consistent with the phase-in utilized by the Commission in the Union Electric Callaway Nuclear Plant case discussed above as well as in the recent United Water Missouri rate case, Case No. WR-99-326. (Ex. 35, p. 4). A series of tariffs is to be approved for annual rate changes to take place on the anniversary date of the initial rate change. Id.

Public Counsel's phase-in proposal should have a positive effect with regard to minimizing any demand changes resulting from an increase in the price of water. A phase-in of the necessary price increase over several years will allow customers to adjust spending and/or income streams to compensate for the increased unit price for an essential service. (Ex. 35, p. 5). In contrast, the Company's proposal for an immediate increase in excess of 50% could lead to decreased demand. Id. If demand decreases without a corresponding decrease in the

Company's cost-of-service, the result would be subsequent increases in the tariff rates. The gross revenue requirement wouldn't change but there would be less units of sales over which to collect the revenue, thus an increase in rates per unit of sale. Id.

VIII. CONCLUSION

It is the responsibility of this Commission to protect consumers from the uneconomic decisions of monopolists. Company made an economic mistake by abandoning its St. Joseph River Treatment Facility and choosing to build a groundwater facility, an alternative that was not the most cost effective. To the extent that this decision is deemed imprudent or unreasonable by the Commission, it is a mistake that should not be charged to ratepayers. The rate base approved in this case should reflect the to the total estimated cost of flood-proofing and rehabilitating the river treatment plant plus the existing rate base that would remain -- $38,567,838 ($31,027,825 when further adjusted to reflect a "used and useful" capacity of 80.45%) for water treatment facilities now serving Company's St. Joseph District. This recommendation is the most and reasonable based upon the evidentiary record regarding the facilities that would be necessary to provide safe and adequate service to St. Joseph.

The solemn responsibility of this Commission in performing monopoly utility regulation is to set rates that would emulate the effects of a competitive marketplace. While this concept has been discussed at great length in Commission cases and in appellate court decisions, its relevance to the case at hand may have been expressed best by the simple words of a consumer who spent her evening waiting to comment at the Commission's local public hearing in St. Joseph on May 31, 2000:

> TERRY MCGAUHEY:
>
> Whenever I go shopping anywhere for any product, no matter whether it's in St. Joe or elsewhere, if there is an increase of 50 percent or more in cost and a decrease in performance or in quality, I will shop elsewhere.

Unfortunately in this case I don't have that choice. So I turn to you to help us find some way to make this a fairer situation for the citizens of St. Joseph. Thank you.

(Tr. Vol. 8, p. 125)

Respectfully submitted,

OFFICE OF THE PUBLIC COUNSEL

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COMPARISONS OF COST ESTIMATES FOR UPGRADING & REFURBISHING EXISTING PLANT

MAWC 1991 ESTIMATE (FROM SCHEDULE TLB-6)		MAY 27, 1993 GANNETT FLEMING ESTIMATE (FROM SCHEDULE TLB-14)		JUNE 4, 1993 MAWC ESTIMATE (FROM SCHEDULE JSY-7)		TED L. BIDDY ESTIMATE (FROM SCHEDULE TLB-8) (LINE 5 - 24 IS MAWC's 1991 ESTIMATE)		DECEMBER, 1994 MAWC ESTIMATE (FROM SCHEDULE TLB-16)	
1. Modify Existing Filters	$500,000	1. Superpulsators and Building & Process	$3,627,000	1. Superpulsators and Building & Process	$3,627,000	1. Modify Existing Filters	$500,000	1. Raw Water intake and Pump Station	$7,200,000
2. Four Superpulsators, Building & Chem. Bldg	$11,300,000	2. Chemical Bldg. and Process	$4,335,000	2. Chemical Bldg. and Process	$4,335,000	2. Four Superpulsators, Building & Chem. Bldg	$11,300,000	2. Presedimentation Clarifier No. 3	$700,000
3. New Filtration, clearwell, transfer pump station, laboratory , support facilities	$7,600,000	3.Filter Bldg, Clearwell, and Process	$4,493,000	3.Filter Bldg, Clearwell, and Process	$4,493,000	3. New Filtration, clearwell, transfer pump station, laboratory , support facilities	$7,600,000	3.Superpulsator Clarifiers and Building	$4,000,000
4. Final filtration facilities	$3,200,000	4. Transfer/H.S. Pump Station & Process	$1,569,000	4. Transfer/H.S. Pump Station & Process	$1,569,000	4. Final filtration facilities	$3,200,000	4. New Filters, complete	$6,000,000
TOTAL	$22,600,000	5. Electrical	$2,425,000	5. Electrical	$2,425,000	SUBTOTAL	$22,600,000	5. Transfer Pump/Finished Pump Station	$4,800,000
Above estimates include engineering design, omissions & contingencies, interest during construction, engineering supervision during construction, community relations.		6. HVAC	$776,000	6. HVAC	$776,000	Above estimates include engineering design, omissions & contingencies, interest during construction, engineering supervision during construction, community relations.		6. Clearwell	$200,000
		7. Plumbing	$505,000	7. Plumbing	$505,000			7. Finished Water Piping	$350,000
		8. Instrumentation	$1,550,000	8. Instrumentation	$1,550,000			8. Chemical Systems/ Operation Building	$6,250,000
		9. Site Work	$7,350,000	9. Site Work	$7,350,000	(ADDITIONS BY TED L. BIDDY) 5.Cost Increases (1991-98)	$4,854,480	9. Ozonation Contactor Equipment	$5,500,000
		TOTAL	$25,630,000	Subtotal	$26,630,000	6. Add Ozone Facilities	$4,000,000	10. Residuals	$8,000,000
		Above estimate for site work includes tanks, foundations, water mains, transfer pipe, wastewater lines, sanitary facilities, drain lines, pre-sedimentation basin modifications, chemical feed lines, spill containment stormwater, paving, landscaping and 15% contingencies.		Above estimate for site work includes tanks, foundations, water mains, transfer pipe, wastewater lines, sanitary facilities, drain lines, pre-sedimentation basin modifications, chemical feed lines, spill containment stormwater, paving, landscaping and 15% contingencies.		7. Add new raw water intake & low service pumping	$4,600,000	11. Access Road to Plant	$700,000
						8.Flood-proofing at plant	$128,111	12. Foundation Treatment	$2,200,000
						9. Access road improvements	$125,000	13. Mobilization & General Conditions	$2,295,000
				ABOVE ESTIMATE IS GANETT FLEMING ESTIMATE REPEATED. THE FOLLOWING ARE ADDITIONS WHICH MAWC ADDED		REVISED TOTAL ESTIMATE	$36,307,591	14. Site Work	$4,590,000
				1. Unexplained addition	$470,000	FURTHER ADDITION BY TED L. BIDDY		SUBTOTAL	$52,785,000
				2.Update dollars to 1998	$3,300,000	1. Further Flood Proofing around plant site.	$372,184	OTHER COSTS:	
				3.Added 10% omissions & contingencies	$3,037,000	TOTAL REVISED ESTIMATE	$36,679,775	1. Design & Permitting	$3,500,000
				4. Design overview by AWWSC	$309,000			2. Construction Services	$2,000,000
				5. Design Consultant	$1,360,000			3. Community Relations	$1,500,000
				6. Pilot plant study	$78,000			4. Omissions and Contingencies 15%	$7,917,750
				7.Const. Admin. - AWWSC	$274,000			5. Gran. Activated Carbon	$585,000
				8. Const. Tech. Review- Con	$757,000			6.Demolition	$500,000
				9.Field Inspection	$421,000			7. AFUDC	$9,200,000
				10. Permits	$109,000			TOTAL	$78,000,000
				11. CPS Charges	$63,000				
				12. Water Co. Expenses	$1,698,000				
				13. Community Relations	$1,020,000				
				14. Attorney Fees	$250,000				
				15. Builder's risk ins.	$91,000				
				16. Water Co. Materials	$164,000				
				17. AFUDC	$4,038,000				
				REVISED TOTAL	$44,100,000				

Exhibit 86

CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been mailed or hand-delivered to the following on this 24th day of July, 2000:

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