

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

In the Matter of the General Rate Increase)	
for Water and Sewer Service Provided)	<u>Case No. WR-2007-0216</u>
by Missouri-American Water Company.)	

STAFF'S PREHEARING BRIEF

COMES NOW the Staff of the Missouri Public Service Commission, by and through the Commission's General Counsel, and for its Prehearing Brief, states as follows:

Introduction

Procedural History:

Missouri-American Water Company (MAWC) filed its tariffs seeking a general rate increase for water service in its Missouri service areas on December 125, 2006, together with its direct testimony and other minimum filing requirements pursuant to Commission Rule (Case No. WR-2007-0216). It filed its tariffs seeking a general rate increase for sewer service on the same day (SR-2007-0217). The Commission consolidated the two cases for all purposes on January 17, 2007, and designated Case No. WR-2007-0216 as the lead case. The tariffs, effective thirty days later on January 14, 2007, seek a water service gross annual revenue increase of \$41,387,823 (24.8%) and a sewer service gross annual revenue increase of \$73,795 (25.7%), exclusive of gross receipts and sales taxes.

On January 3, 2007,¹ the Commission suspended the tariffs until November 14.

¹ Unless otherwise specified, all dates are 2007.

A number of entities sought, and were permitted, to intervene, including: AG Processing (a cooperative), the City of Jefferson, the City of Joplin, the City of Parkville, the City of St. Joseph, the City of Warrensburg, the Metropolitan St. Louis Sewer District, the Missouri Energy Group ("MEG"),² the Missouri Industrial Energy Consumers ("MIEC"),³ Public Water Supply Districts No. 1 and No. 2 of Andrews County and No. 1 of DeKalb County, and the Utility Workers Union of America ("UWUA"), Local 335. Pursuant to the procedural schedule adopted by the Commission on February 22, and thereafter modified on July 10, July 27 and July 30, the several parties to this matter have filed three rounds of prepared testimony, participated in prehearing conferences and settlement discussions, attended local public hearings, and worked cooperatively to establish a list of issues and schedule of witnesses for the evidentiary hearing set to commence on August 6, 2007.

The Ratemaking Process:

Just and reasonable rates are determined in a two-step analytical process.⁴ In the first step, the revenue requirement is calculated; that is, the amount of income required by the utility on an annual basis. This amount is simply the sum of its prudent operating and maintenance expenses plus a fair return on the depreciated or net value of the assets dedicated to the public service. The second step in determining just and reasonable rates is designing a rate plan whereby to collect the required revenue from

² An unincorporated association consisting of Barnes-Jewish Hospital and SSM HealthCare.

³ An unincorporated association consisting of The Boeing Company, DaimlerChrysler, GKN, Hussmann Refrigeration, Monsanto Company, and Pfizer.

⁴ It is worth noting here that Missouri recognizes two distinct ratemaking methods: the "file-and-suspend" method and the complaint method. The former is initiated when a utility files a tariff implementing a general rate increase and the second by the filing of a complaint alleging that the subject utility's rates are not just and reasonable. See *Utility Consumers Council, supra*, 585 S.W.2d at 48-49; *St. ex rel. Jackson County v. Pub. Serv. Comm'n*, 532 S.W.2d 20, 28-29 (Mo. banc 1975), *cert. denied*, 429 U.S. 822, 50 L.Ed.2d 84, 97 S.Ct. 73 (1976).

the utility's customers in a fair and equitable manner that matches costs to cost causers. This step is driven by a Class Cost of Service Study in which the utility's cost of service is assigned by various means to the several customer classes. Customers are classed according to their consumption characteristics and rates are generally designed so that the revenue realized from each customer class will cover its cost of service.

Burden of Proof:

Section 393.150.2 provides in part, "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 . . . water corporation or sewer corporation, and the commission shall give to the hearing and decision of such questions preference over all other questions pending before it and decide the same as speedily as possible."

Staff's Role:

Staff's role in a rate case is to provide the Commission with reliable and unbiased information on each contested issue. Because the Staff is not a stakeholder, the Commission may use Staff's position as a standard against which the positions of the other parties may be measured. While the Commission may sometimes find the arguments of other parties to be more persuasive, the Commission must understand that they are intended to confer a direct economic benefit on the party in question.

On each issue, Staff is guided by the policy decisions announced by the Commission in its decisions in prior rate cases. For this reason, Staff cites to prior Commission cases as controlling authority, although it is well-established that the rule of *stare decisis* does not apply in administrative law. In a few instances, where the Commission's policy decisions depart from best practice, Staff will attempt to persuade

the Commission to alter its policy on the theory that best practice is most likely to serve the public interest.

Due to the large number of issues – nearly forty! -- that the Commission must resolve in this case, Staff's treatment of each issue in its prehearing brief is necessarily concise.

Argument

I. REVENUE REQUIREMENT:

Revenue requirement is “the amount of revenue the utility must receive to pay the costs of producing the utility service while yielding a reasonable rate of return to the investors.”⁵ Revenue requirement is usually established based upon a historical test year which focuses on four factors:⁶ (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses.⁷ The calculation of revenue requirement from these four factors is expressed in the following formula:

$$RR = C + (V - D) R$$

where: RR = Revenue Requirement;
 C = Prudent Operating Costs, including Depreciation
 Expense and Taxes;
 V = Gross Value of Utility Plant in Service;
 D = Accumulated Depreciation; and
 R = Overall Rate of Return or Weighted Cost of Capital.

⁵ *In the Matter of The Empire District Electric Co.*, 13 Mo.P.S.C.13 350, 368 (March 10, 2005).

⁶ In the present case, the test year is the twelve months ending June 30, 2006, updated for known and measurable changes through December 31, 2006, and trued-up through May 31, 2007 (Rackers Dir., 2).

⁷ *St. ex rel. Capital City Water Co. v. Missouri Pub. Serv. Comm'n*, 850 S.W.2d 903, 916 n. 1 (Mo. App., W.D. 1993).

A. Expense Issues:

Revenue requirement consists of two components, the first of which is the utility's test year normalized and annualized operating and maintenance expenses.⁸

1. Depreciation:

What are the appropriate depreciation rates to be applied to MAWC's depreciable plant?

MAWC seeks approximately \$3.25 million more revenue in depreciation expense annually.

Depreciation is an accounting convention under which the value of an asset is reduced proportionately over the course of its useful life.⁹ At the end of its life, the asset is considered to have lost all value except residual salvage value. If the accounting convention were perfect, an asset would be fully depreciated at the time it is actually retired, that is, removed from service.¹⁰ In ratemaking, depreciation is an operating expense, the purpose of which is to return to the investors their original investment in an asset as it is consumed in the public service. "The purpose of the annual allowance for depreciation and the resulting accumulation of a depreciation reserve is . . . to enable the utility to recover the cost of such property to it."¹¹ Depreciation expense is booked to the depreciation reserve, which amount is deducted in ratemaking from the original cost basis of the utility's plant-in-service or rate base. The resulting net rate base is the

⁸ See 13 Mo.P.S.C.3d at 369. "Normalization" is the process whereby extreme values, although historical, are "smoothed" in order to better predict likely experience in the years when the rates will be in effect. "Annualization" is the process whereby some sporadic cost is distributed evenly over a year.

⁹ See 13 Mo.P.S.C.3d at 376-377.

¹⁰ See *In the Matter of St. Louis County Water Company*, 4 Mo.P.S.C.3d 94, 102-3 (1995); *In the Matter of Depreciation*, 25 Mo.P.S.C. (N.S.) 331.

¹¹ *St. ex rel. Martigney Creek Sewer Co. v. Pub. Serv. Comm'n*, 537 S.W.2d 388, 396-397 (Mo. banc 1976).

present value of the investors' capital assets devoted to public service.

The Constitution requires that the investors' original capital outlay be returned to them in rates as the utility's assets are expended in the public service:

A water plant, with all its additions, begins to depreciate in value from the moment of its use. Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation and replacing the parts of the property when they come to the end of their life. . . . [The Company] is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning.¹²

It is well-established that depreciation is to be based on the original cost of the utility assets. "[T]his Court recognized in *Lindheimer v. Illinois Bell Tel. Co.*,¹³ the propriety of basing annual depreciation on cost. By such a procedure the utility is made whole and the integrity of its investment maintained. No more is required."¹⁴ Section 393.240, RSMo 2000, authorizes the Commission to require water utilities in Missouri to maintain depreciation accounts.

The Commission recently gave direction in Case No. ER-2004-0570, *In the Matter of The Empire District Electric Company*, regarding the factors that should be part of the computation of depreciation for utilities.¹⁵ The factors delineated by the Commission include the value of the asset, its average service life and net salvage. The Commission explained in its Report & Order in Case No. ER-2004-0570¹⁶ why lifespan and terminal net salvage estimates were not appropriate variables to be

¹² *Knoxville v. Knoxville Water Co.*, 212 U.S. 1, 13-14, 29 S.Ct. 148, 152, 53 L. Ed. 371, 381 (1909).

¹³ 292 U.S. 151, 54 S.Ct. 658, 78 L.Ed. 1182 (1934).

¹⁴ *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 606-607, 64 S.Ct. 281, 289-90, 88 L.Ed. 333, 347 (1944).

¹⁵ *In the Matter of the Empire District Electric Co.*, 13 Mo.P.S.C.3d 350, 376-377 (March 10, 2005).

¹⁶ *Id.*

included in the depreciation computation.¹⁷

Company witness Spanos disagrees with the Commission's policies as adopted in the *Empire* case and seeks to introduce additional parameters and alternative methods that result in the Company appearing to require additional depreciation accruals. The Company then seeks to mitigate the necessity of an increase in depreciation expense by a phased increase in depreciation rates starting with estimated depreciation rates, representing less than a \$600,000 increase, that would transition to calculated depreciation rates, based on their recommended parameters and methods, resulting in nearly a \$4 million increase.

Mr. Spanos disagrees with the Commission's previous order and seeks to introduce a lifespan component to the computation of depreciation rates. Use of the lifespan method reduces the time ratepayers have to return the Company's investment and net salvage and, therefore, results in a higher revenue requirement.

Mr. Spanos also includes amortization of the General Plant accounts in direct contradiction to the Commission's rules. The rules address the depreciation of plant accounts, not the amortization of plant accounts. Another contradiction of the Commission rules arises from the fact that the Company has adopted a numerical system of accounts that is different from that stated in the Commission rules.

MAWC uses a 65-year life span for its production facilities. It would be unprecedented for a water utility company of MAWC's size to replace all of its production facilities in 65 years. For example, MAWC acquired the St. Joseph water treatment facility that was still in use although it was approximately 100 years old.

¹⁷ The Commission rejected the Life Span approach for production assets because there was no evidence that Empire had ever retired a plant. *Id.*, at 378. For the same reason, the Commission refused to allow Terminal Net Salvage on production accounts. *Id.*, at 379.

MAWC later sold the facility prior to green-fielding the site. The plant was still operable at that time. There is simply no evidence that supports a 65-year average lifespan for water treatment plants.

2. Pension/OPEB Methodology:

How should pension and OPEB expense be treated for purposes of the revenue requirement and how should it be accounted for on a going forward basis?

Staff's calculations of pension and OPEB expenses are consistent with the Financial Accounting Standards Board Statements 87 and 106, respectively. Although Mr. Grubb opposes Staff's approach, the "corridor" defined in these statements specifies the minimum amortization of unrecognized gains and losses as explained by Staff witness Hagemeyer in his direct testimony (Hagemeyer Surr., 5). Paragraphs 33 and 60 from FAS 87 and 106, respectively, allow for different approaches for amortizing unrecognized gains and losses. Due to this allowance, the Staff's approach for dealing with pensions and OPEBs is consistent with Statements 87 and 106.

3. Amortization of Pension/OPEB Assets:

What is the appropriate level of expense to be included in MAWC's cost of service related to recovery of the regulatory asset created by the transition to accrual accounting for pensions and OPEBs?

Staff has reviewed Mr. Grubb's rebuttal testimony and has made a change in the OPEB expense to include \$31,901 for the amortization of the MAWC FAS 106 deferred costs. Staff is able to justify this amount based on the Commission's Order in Case No. WR-95-205 (Hagemeyer Surr., 4). However, Staff has not found support for the remainder of the Company-proposed amortization expense in past Commission orders

or approved Stipulation and Agreements.

4. Main break expense:

What is the appropriate level of expense to be included in MAWC's cost of service related to main break expense?

Staff recently received information regarding the main break cost through May 31, 2007. After reviewing this information, Staff believes that the Company's proposed annual cost of \$2,100,046 is appropriate (Hagemeyer Surr., 6).

5. Insurance Other than Group:

What is the appropriate level of expense to be included in MAWC's cost of service related to insurance other than group?

After discussions with the Company, and reading its rebuttal testimony, the Staff has changed the capitalization rate for the general-liability-related insurance to 10% from the 43.7% proposed in its direct filing. This change also impacts the brokerage fee capitalization rate (Hagemeyer Surr., 3).

With respect to kidnap and ransom insurance, Staff continues to believe that the operations of MAWC would most likely not be materially affected in the unlikely event that a Company employee were ever kidnapped and held for ransom. Due to this lack of benefit to MAWC's consumers, the Staff disputes Mr. Grubb's claim that this insurance is a prudent cost (*Id.*).

With respect to directors' and officers' insurance, Staff has determined that MAWC's expense is about \$7,000 per year rather than the \$241,744 asserted by Mr. Grubb (*Id.*). The Company is currently covered under a global policy procured by RWE and this coverage will remain in place well beyond the true up period.

6. Vehicle Leases:

What is the appropriate level of expense to be included in MAWC's cost of service related to vehicle leases?

Staff has changed its position to reflect the correction suggested by Mr. Thakadiyil related to vehicle leases and there is now no difference between the Company and the Staff on this issue (Hagemeyer Surr., 6).

7. Uncollectible-Present Rates:

What amount of uncollectibles/bad debt should be included in MAWC's cost of service?

Company witness Petry states in his Rebuttal testimony (p. 1) that Staff "calculated the net write-off amount based on a five year average, with the exception of St. Louis and St. Joseph. For those two Districts, Staff used the 2006 actual numbers." MAWC believes that a two-year average should be used in all districts, as Staff used in Warren County and Cedar Hill. Staff disagrees. Staff believes a two-year average is not a sufficient basis on which to determine a normal ongoing level of bad debt expense for Missouri-American Water Company (MAWC) (Grissum Surr., 1-2).

Staff believes that two years is an insufficient period of time to use to normalize and/or identify trends. For this reason, the Staff examined five-years of data where available (Grissum Surr., 2). Based on this examination, the Staff was able to identify trends in the St. Joseph and St. Louis operating districts and fluctuations in the remaining districts, except for Cedar Hill and Warren County. The St. Joseph operating district shows a three-year downward trend while the St. Louis operating district shows a three-year upward trend in bad debt expense. As a result, the actual net write-offs in these two districts for the twelve-months ending December 2006 are more reflective of

the ongoing levels of bad debt expense. This trend could not have been identified using Mr. Petry's method of only using two years of data.

The remaining districts showed fluctuating levels of bad debt write-offs during the five-year period, making the average of this period the best indicator of the ongoing level of bad debt expense. In the Warren County and the Cedar Hill operating districts, Staff simply used an average of the data available to determine the ongoing levels of bad debt expense. It is true that Staff has used a three-year average in the past (Grissum Surr., 3). However, that was in circumstances where five years' of data was not available.

8. Uncollectible-Rate Increase:

Should the uncollectibles/bad debt expense be adjusted to reflect the total revenues, including any rate increase in Missouri jurisdictional retail revenues awarded in this proceeding?

Staff does not agree with Company witness Petry's proposal that an increased allowance for bad debt should be recognized in a percentage equivalent to the increase in rates granted in this case. The fact is, there is *not* a linear relationship between increased revenues and increased uncollectibles (Grissum Surr., 3). Staff has collected data illustrating this fact (Grissum Surr., Sch. 1). The Commission did allow just such an estimated increased allowance in the recent KCPL rate case, Case No. ER-2006-0314. Staff will track the actual change in uncollectibles experienced by KCPL and present that evidence to the Commission in KCPL's present rate case. In any event, the Commission's decision in Case No. ER-2006-0314 was based on the competent

and substantial evidence of record in that case. MAWC has presented no such evidence here.

9. Audit Fees:

What is the appropriate level of expense to be included in MAWC's cost of service related to audit fees?

MAWC expects that its share of its parent's annual audit fees will increase when American Water is again a publicly-traded company. The fees relate to SOX compliance required for publicly traded companies. However, the amount of the increase, if any, is as yet unknown (Hanneken Surr., 8). It is not appropriate to require ratepayers to pay a cost that is not yet known and measurable.

10. Tank Painting Expense:

What is the appropriate level of expense to be included in MAWC's cost of service related to tank painting expense?

Staff and MAWC disagree on the amount of tank painting expense to recognize in rates. Staff believes that Company witness Petry has ignored the reality of the tank painting costs actually being incurred by MAWC.

Petry states that "[t]he Staff's method ignores the current condition of the tanks and the work that must be performed to keep those tanks in working order" (Petry Reb., 3). However, the past five years of actual experience indicates that less tank painting expense is required to be performed to keep those tanks in working order. In its review of the issue, the Staff examined the Company's work papers and found that, even by their own measurements, the Company had only maintained its schedule of internal tank painting 48% of the time and external tank painting 35% of the time (Hagemeyer

Surr., 2). Such performance does not indicate that the Company requires an increased expense level and, in fact, shows that the Staff's method is the appropriate level. Increasing the cost of service for additional tank painting expense is contrary to the costs actually being incurred.

11. Capitalized Software:

Should any of the costs associated with computer software and/or maintenance agreements be capitalized? If so, what amount?

After discussing the matter with the Company, Staff feels that the portion of software maintenance fees related to customer billing software should not have been capitalized. This represents \$18,002, of the \$30, 887 identified by Mr. Grubb in his rebuttal testimony. The remaining software supports all of the functions of the Company: operations and capital projects. Therefore, the Staff continues to support capitalization of the remaining software maintenance fees in the amount of \$12,885 (Hagemeyer Surr., 2).

12. Incentive Compensation:

What is the appropriate amount of costs associated with MAWC's incentive compensation plan that MAWC should recover from its customers?

MAWC witness Petry contends that Staff should have included that portion of AIP and SMIP related the individual portion of the plans. He asserts that they assist the Company to provide better service to the customers. However, Staff has analyzed the plans and determined that they provide no ratepayer benefit. Therefore, the ratepayers should not be required to pay for them (Hanneken Surr., 5). .

13. External Affairs:

What is the appropriate level of expense to be included in MAWC's cost of service related to its external affairs department/employees?

Staff disallowed the personnel and related expenses for MAWC's external affairs director as being lobbying expenses (Hanneken Surr., 4). The title of the position is "Manager of Government and Regulatory Affairs" (*Id.*). MAWC witness Petry responded that only 5% of this employee's time is spent on lobbying. However, the official job description states that this employee will:

Improve business climate for the Company through positive interactions with legislators and regulators and external opinion formers. Influence at state level to promote initiatives that support Company and other stakeholder goals and objectives.

Staff asserts that MAWC has not shown that these expenses should be included in rates.

14. Overtime Hours:

What is the appropriate level of expense to be included in MAWC's cost of service related to employee overtime?

The Company's approach simply used the overtime experienced during the test year to reflect its ongoing level of expense, while Staff analyzed each district's hours and employees to determine the ongoing level it presented (Hanneken Surr., 2).

Staff utilized a 4-year average for districts with significant fluctuation, while it used the calendar year level for other districts that exhibited a steady upward trend. The exception was the Jefferson City district, for which Staff utilized a historic 2-year average based on information from the Company explaining that the dramatic increases seen over the past two years were due to abnormal circumstances and should be

normalized (*Id.*). Company witness Petry finds Staff's method unreasonable and asserts that use of Staff's method of analyzing and addressing each district's unique situations has the effect of "finding the lowest revenue requirement" (Petry Reb., 4).

Petry's criticism is incorrect. Staff's method seeks to examine the causes underlying the level of overtime in each district and normalizes as appropriate. In fact, Staff's adjustment actually *increased* the test year level of expense of five districts in which it recognized an upward trend in the level of overtime (Hanneken, *supra*).

With respect to Jefferson City, the Company explained the increase in overtime hours from 1,291 hours in 2004 to 4,381 in 2006, a 239% increase (a difference of over 3,000 hours) by pointing out that two workers previously ineligible begin incurring overtime in 2005 (Petry Reb., 4). However, the Company's explanation is illogical. The entire district's 17 employees only incurred 1,291 hours of overtime in 2004 (Hanneken Surr., 3). It does not seem reasonable that two employees incurred an additional 3,000 hours. In its response to Staff's Data Request No. 249, the Company stated that "... the high level of O&M overtime in 2005 and 2006 in comparison to more normal levels seen in 2003 and 2004 was driven by ... the levels of vacancies and sick leave in the operator ranks as well as the two job shifts" (*Id.*) Based on this information, the Staff's utilization of a historical average adjusts the test year overtime level to the more normal levels seen in 2003 and 2004.

15. Fuel & Power/Chemicals Due to Unaccounted-for Water:

What is the appropriate amount of fuel & power/chemical expenses to be included in MAWC's cost of service for weather-normalized sales?

Staff disallowed a portion of MAWC's fuel and power and chemical expenses

because Staff assigned a 15% loss factor cap in its calculation of system delivery (Weeks Reb., 4). This reflects Staff's long-standing view that water losses in excess of 15% are abnormal (Grissum Surr., 4). All of MAWC's districts except Brunswick and St. Louis County have been able to operate within the 15% limit (Grissum Surr., Sch. 2). Staff's 15% figure is simply the average of a rule-of-experience referred to by MAWC witness Weeks himself:

Unbilled water can be less than 10 percent in a relatively new, well-managed system. It is not uncommon to find unbilled water to be over 20 percent in an older system.

(Weeks Reb., 5).

16. Belleville Lab:

What is the appropriate amount of costs to be included in MAWC's cost of service for its use of the Belleville Laboratory facility?

MAWC proposes that the costs of the Belleville Lab be allocated based on customer counts. Staff, on the other hand, proposes allocation based on the number of analyses actually performed over a five-year period. While either method is rational, Staff's proposal is superior because it is based upon the actual amount of work performed at the lab. "By using the customer count methodology the Company is forcing MAWC ratepayers to pay for more than 14% of non-direct Belleville Lab costs while on average only 7.04% of the testing work at Belleville Lab is actually performed for MAWC" (Cassidy Surr., 6).

EXAMPLE – California-American (5 years ending 12-31-06):

12 Months YTD	Test Analysis Allocation Percentage	Customer Count Allocation Percentage
12/31/02	14.3%	5.8%

12/31/03	42.4%	5.8%
12/31/04	23.2%	5.4%
12/31/05	15.9%	5.3%
12/31/06	17.86%	5.4%

MAWC's method depends on the assumption that the use of the lab by the operating companies is directly proportional to the number of customers served by each operating company. In fact, it is not, as Company Witness Grubb's testimony clearly indicates (Grubb Reb., 14). For this reason, Staff believes that use of the Company's method will result in Missouri ratepayers subsidizing other operating companies in other states (Cassidy Surr., 2-3). It is true that Staff's method may vary widely from year-to-year, however, Staff corrects for this variability by using a five-year average (Cassidy Surr., 4-5).

MISSOURI-AMERICAN (5 years ending 12-31-06):

<u>Period</u>	<u>Staff Test Analysis Allocation</u>	<u>Company Customer Count Allocation</u>
12 months YTD 12/31/02	8.18%	15.27%
12 months YTD 12/31/03	6.52%	15.27%
12 months YTD 12/31/04	8.97%	14.23%
12 months YTD 12/31/05	6.40%	14.14%
12 months YTD 12/31/06	6.04%	14.10%
Five Year Average	7.04%	14.57%

17. Management Fees Capitalized:

Should some portion of the management fee paid by MAWC be capitalized? If so, what amount?

Staff believes that a portion of the costs directly associated with the accounting for and placement of fixed assets (capital items) are appropriately capitalized as a cost of the associated assets (Hanneken Surr., 9). MAWC witness Grubb asserts that the

management fees associated with the Fixed Asset group should not be capitalized.

18. Dues, Donations, Advertising and Promotions:

What is the appropriate amount of expense to be included in MAWC's cost of service for dues, donations, advertising and promotional items?

a. Allocated Dues & Donations:

Staff disallowed dues and donations expense of \$281,985. Much of this disallowance was based on MAWC's failure to provide sufficient documentation to Staff. After reviewing additional detail provided by the Company, Staff will allow \$9,936 of this (Hanneken Surr., 6-7).

b. Allocated Advertising Expense:

MAWC provided about 200 pages of documentation that Staff reviewed just before it filed Surrebuttal testimony (Hanneken Surr., 7). Based on its review of this material, Staff has determined that \$2,260 was allowable advertising (*Id.*). Staff has also determined that \$24,408 should be disallowed (*Id.*). The remainder of the \$72,693 originally disallowed by Staff has not yet been clarified, so, Staff continues to take the position that it should be disallowed.

B. Rate Base Issues:

Rate base is "the original cost of the assets dedicated to public service less accumulated depreciation."¹⁸ The investors are entitled to both a return *of* and a return *on* these assets. The return *of* is provided by Depreciation Expense, a component of Operating and Maintenance Expense. The return *on* the rate base is provided by including in Revenue Requirement an amount calculated by multiplying the rate base by

¹⁸ 13 Mo.P.S.C. at 369.

the utility's composite cost of capital.¹⁹

19. Warren County Sewer Plant and Cedar Hill Sewer Plant:

Should the entire cost of construction of the Warren County and Cedar Hill sewer plants be included in plant in service?

MAWC has constructed new sewer treatment facilities in its Warren County and Cedar Hill operating districts (Merciel, Surr. 1). As discussed in the Direct and Surrebuttal Testimony of Staff witness James A. Merciel, 60% of the Warren County facility and 100% of the Cedar Hill facility were disallowed as not being required to serve current customers (Merciel Surr., 1-2; Rackers Surr., 5-6). Neither DeBoy nor Jenkins disputes that these plants are intended for future expansion; instead, they merely point out that building a whole new plant is ultimately cheaper than expanding by increments.

These new plants were not inappropriately or imprudently constructed (Merciel Surr., 2). In the case of Warren County, the expanded facilities are desperately needed both for existing customers and future customers who own property and have been waiting on capacity in order to construct new homes, as well as a more uncertain level of customers who will need service within the next, say, seven or eight years (*Id.*) In the case of Cedar Hill, the previous owner of that system was a family that was interested in divesting itself of utility ownership, and while new ownership was not so desperate, it was desirable. The new plant is needed to serve developments within the service area that are in need of service (*Id.*).

While the Company's activity in building these plants should be encouraged, it is simply unfair to ask current ratepayers to foot the bill for plants that are not needed to

¹⁹ *Id.*

serve them (Merciel Surr., 2-3). Staff's solution is that the Commission authorize the Company to place the excess capacity associated with the new sewer treatment plants back in construction-work-in-progress (CWIP) and allow continued capitalization of accumulated funds used during construction (AFUDC) (Rackers Surr., 5-6). As new customer are added, incremental amounts will be removed from CWIP and included in plant-in-service. The rates paid by the new customers will provide recovery of the cost of the transfers to plant-in-service.

Staff recommends that the AFUDC rate utilized by MAWC be calculated as discussed below. This is the method used by electric and gas utilities. It was also found to be appropriate for MAWC by the Commission in Case No. WR-2000-281:

- 1) The AFUDC rate should first reflect all of the outstanding amount of short-term debt available to the Company as the primary source of financing for construction.

- 2) The rate associated with any construction balance in excess of the outstanding amount of short-term debt should then be calculated based on the composite rate of the outstanding amounts of other sources of financing available to the Company (long-term debt, equity and preferred stock) during the construction period.

If this recommendation does not address the concern expressed by Mr. Jenkins and the entire cost of the plants must be included in this case to prevent a write-off, then Staff recommends the inclusion in plant-in-service of the excess capacity *and* the customers it designed to serve, in the determination of rates in this case. Although these customers are not yet taking service from MAWC, this recommendation would

match the investment in excess capacity with the revenues from the customers it was designed to serve. The level of these customers, by district appears on Schedule 1 to this testimony (Rackers Surr., 7).

20. Shared Services and Call Center Transition Costs:

What is the appropriate way in which to recognize the costs which MAWC has incurred in transitioning to its National Shared Services Center and Call Center?

Company witness Grubb proposed that MAWC's transition costs should be capitalized. However, Staff has never allowed rate base treatment or a "return on" unrecovered transition costs. It is inappropriate for MAWC to capitalize expenses that were incurred by MAWC in order to transition to these affiliate services. While MAWC may have participated in the planning and development of the CSC and SSC, the assets of these affiliates are not on the books of MAWC. Staff contends it is inappropriate for MAWC to capitalize these one-time transition expenses related to assets that it does not own and business processes that are not under its control (Hanneken Surr., 8-9).

If the Commission does not accept the Staff's position, the Staff definitely believes that no return on and only a return of these costs would be appropriate. Staff feels that an amortization period of at least fifty (50) years would be appropriate (Hanneken Surr., 9).

21. Cash Working Capital (Management Fee Lag):

What is the appropriate amount to be included in MAWC's rate base for cash working capital as it relates to the management fees expense lag?

Company witness Edward J. Grubb testified that the expense lag for

management fees supplied by an affiliated service company should be negative 8.99 days versus the positive 21.41 days utilized in Staff's Accounting Schedule 8, "Cash Working Capital." Contrary to the statements of Mr. Grubb, however, Staff does not agree that ratepayers should provide the cash working capital requirements of an affiliated company who provides services to the utility (Hanneken Surr., 9-10). This situation results from requiring the utility to prepay management fees to the affiliated service company, while the affiliate pays its disbursements to vendors in arrears. Affiliated companies should not receive preferential treatment. Rather, the affiliate should be treated like other third-party vendors who supply services to the utility. Therefore, Staff has assigned the same expense lag to the disbursements for management fees from an affiliated service company that it has utilized for general cash vouchers for goods and services from third-party vendors, that is, positive 21.41 days (*Id.*).

22. Rate Base for Security Deferral:

What is the appropriate ratemaking treatment to be given to the costs deferred by MAWC pursuant to the Commission's Security AAO?

In Case No. WO-2002-273, the Commission approved the deferral of costs related to the improvement and enhancement of security at MAWC's facilities. The Company was allowed to accumulate the deferral for two years following the terror attacks of September 11, 2001, through September 11, 2003.

MAWC seeks recovery of all of the deferred security costs and inclusion of the unamortized balance in rate base.

Staff proposes to disallow from recovery (1) legal expenses incurred in obtaining the AAO, and (2) security costs incurred after the September 11, 2003, cut-off date specified by the Commission. With respect to legal expenses, those are not security-related expenditures and so are outside of the terms of the AAO. Additionally, Staff points out that MAWC incurred these expenses in order to protect the shareholders' assets from harm (Rackers Surr., 3).

Staff opposes MAWC's recommendation that the unamortized balance of the security-related deferrals be included in rate base. In other cases involving AAOs, the Commission has allowed a return *of*, but not a return *on*, the deferred expense. This is because AAOs protect shareholder earning and not customers (Rackers Surr., 3). Costs are deferred so that the expenses do not reduce earnings in the year they are incurred. These costs, if allowed, increase earnings in a subsequent year.

C. Rate of Return Issues:

The return on the rate base is calculated by applying a rate of return, that is, the weighted cost of capital, to the original cost of the assets dedicated to public service less accumulated depreciation.²⁰ The Public Service Commission Act vests the Commission with the necessary authority to perform these functions. Section 393.140(4) authorizes the Commission to prescribe uniform methods of accounting for utilities and Section 393.140(8) authorizes the Commission to examine a utility's books and records and, after hearing, to determine the accounting treatment of any particular transaction. In this way, the Commission can determine the utility's prudent operating costs. Section 393.230 authorizes the Commission to value the

²⁰ See *St. ex rel. Union Elec. Co. v. Pub. Serv. Comm'n*, *supra*.

property of electric utilities operating in Missouri, that is, to determine the rate base.²¹ Section 393.240 authorizes the Commission to set depreciation rates and to adjust a utility's depreciation reserve from time-to-time as may be necessary.

23. Capital Structure:

What capital structure should be used for determining MAWC's rate of return?

The composition of the utility's capital structure and the embedded cost of the components other than common equity is usually not difficult to ascertain. Difficulty arises in the present case from the fact that neither the utility itself, Missouri-American, nor its corporate parent, American Water, are publicly-traded corporations.

In his True-up Direct testimony, Staff witness Murray proposed that the Commission use the capital structure of Thames Water Aqua US Holdings, Inc. ("Thames"), as of May 31, 2007, for ratemaking purposes (Ahern Surr., 3). Thames is the entity formerly known as American Water and the corporate parent of MAWC (*Id.*). Because Thames is in the process of becoming a publicly-traded company, the numbers themselves are highly confidential. MAWC's witness Ahern testified that Murray's proposal is inappropriate and that the Commission should use MAWC's own, "stand alone" capital structure (*Id.*).

Murray's position is based upon the fact that MAWC does not operate as an independent entity with respect to the procurement of financing and the cost of that financing (Murray Dir., 16). While it is true that MAWC does access the capital markets by issuing tax-advantaged bonds through the State Environmental Improvement and Energy Resources Authority ("EI ERA"), the fact is, as indicated in MAWC's response to

²¹ Section 393.135 expressly prohibits the inclusion in electric rates of costs pertaining to property that is not "used and useful."

Staff Data Request No. 0102, “American Water Capital Corporation is the primary source of long-term debt and short-term debt for Missouri-American Water Company.” Therefore, the cost of any debt that MAWC receives from AWCC is, and will be, based on the consolidated creditworthiness of American Water, which is based not only on the business risk associated with American Water’s consolidated operations, but also on the financial risk inherent in the parent company capital structure and not on MAWC’s business risk and capital structure (*Id.*).

A point of particular importance is that American Water employs double leverage, which is a situation in which the parent company uses debt financing at the parent company level to infuse equity in its subsidiaries (*Id.*, at 17; Murray Reb., 14). Because the consolidated capital structure is the one evaluated by investors when providing American Water with debt and equity capital, this capital structure is the most appropriate one to use for ratemaking purposes in this case (Murray Reb., 15).

Another important consideration is that Standard & Poor’s (S&P) does not provide credit ratings for American Water’s individual subsidiaries as it does for some other Missouri utilities, such as AmerenUE and Kansas City Power and Light (Murray Reb., 8). The credit analysis performed by S&P is based on the consolidated credit risk profile of American Water, which is primarily based on its regulated subsidiaries, but does include some non-regulated operations. Consequently, the cost of capital provided to MAWC is driven by the consolidated operations of American Water (*Id.*). As long as the risk associated with the consolidated operations is consistent with MAWC’s risk, then it is appropriate to not only use the consolidated capital structure, but also the cost of capital associated with this capital structure for ratemaking purposes.

For these reasons, Staff suggests that the Commission should use the capital structure of MAWC's parent rather than that of MAWC itself.

24. Return on Common Equity:

What return on common equity should be used for determining MAWC's rate of return?

One of the most important, and most difficult, tasks facing the Commission in this case is to estimate the cost of common equity capital. This is a difficult task, as academic commentators have recognized.²² The United States Supreme Court, in two frequently-cited decisions, has established the constitutional parameters that must guide the Commission in its task.²³ In the earlier of these cases, *Bluefield Water Works*, the Court stated that:

Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the services are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.²⁴

In the same case, the Court provided the following guidance as to the return due to equity owners:

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and

²² C.F. Phillips, Jr., *The Regulation of Public Utilities*, 394 (1993); L.S. Goodman, 1 *The Process of Ratemaking*, 606 (1998).

²³ *Fed. Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); *Bluefield Water Works & Improv. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

²⁴ *Bluefield*, *supra*, 262 U.S. at 690, 43 S.Ct. at 678, 67 L.Ed. at 1181.

economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.²⁵

The Court restated these principles in *Hope Natural Gas Company*, the later of the two cases:

‘[R]egulation does not insure that the business shall produce net revenues.’ But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.²⁶

Two principal methods have emerged for determining the cost of Common Equity: these are the "market-determined" approach and the "comparable earnings" approach.²⁷ The market-determined approach relies upon stock market transactions and estimates of investor expectations.²⁸ Examples of market-determined methods are the Discounted Cash Flow method ("DCF") and the Capital Asset Pricing method ("CAPM").²⁹ The comparative earnings approach is a comparative method and relies upon the concept of "opportunity cost," that is, the return the investment would have earned in the next best alternative use.³⁰ The comparative earnings approach requires a comparative study of earnings on common equity in both regulated and unregulated

²⁵ *Id.*, 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183.

²⁶ *Hope Nat. Gas Co.*, *supra*, 320 U.S. at 603, 64 S.Ct. 288, 88 L.Ed. 345 (citations omitted).

²⁷ Phillips, *supra*, 394.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*, at 397.

enterprises of similar risk.³¹ None of the analyses performed in the present case utilized the comparative earnings approach.

It is said that this "is an area of ratemaking in which agencies welcome expert testimony and yet must often make difficult choices between conflicting testimony."³² Three expert witnesses offered testimony on this issue: Pauline M. Ahern for MAWC, David Murray for Staff and Michael Gorman for Intervenor MIEC. Their recommendations are as follows:

WITNESS	RANGE	MID-POINT
Murray (Staff)	8.5 – 9.5	9.0
Gorman (MIEC)	9.2 – 10.1	9.70
Ahern (MAWC)	11.025 – 11.575	11.3

II. RATE DESIGN/COST OF SERVICE

Rate design is the second half of every rate case, that is, the process of constructing tariffs that will collect the necessary revenue requirement from the ratepayers. The Commission is required to set just and reasonable rates, without undue preferences or discrimination against any customer. The governing principle is the matching of costs to the cost causers. Ratepayers are generally organized into classes based upon significant, measurable differences in the cost of serving each defined group. Within classes, ratepayers generally pay the same rates. The central focus of rate design is generally a Cost of Service Study, a mathematical exercise that apportions every cost to every customer class. Rates traditionally consist of a fixed component, often termed a "customer charge," and a variable component, which is based on usage of the service the utility sells.

³¹ *Id.*, at 397-98.

³² Goodman, 1 *The Process of Ratemaking*, *supra*, 606.

A. Revenue Issues:

25. Revenue Normalization (Weather):

What is the appropriate weather-normalized revenue to be included in MAWC's cost of service?

Staff witness Patterson was required to reconstruct MAWC's billing determinants because Staff could not verify the Company's reports of customer numbers with the required degree of confidence. For example, St. Louis County Water Quarterly Residential Customer counts from 2002-2005 were 317,639; 303,890; 320,918; and 321,262 (Dr. Spitznagel's Direct Testimony in this case). The customer count for 2006 was initially reported as 340,698 (Company's monthly STAT13 reports); it was later amended to 315,905 (Cust Annual.xls spreadsheet), and again to 318,372 (2006 Bill Analysis STL April Update From Thakadiyil.xls). These customer counts are illustrated at Patterson's Schedule 1-1. It was not advisable to rely on Company's reports of Mgallon sales given the instability in reported customer counts. Staff believes that the situation arose because the Company's account closing schedule did not correspond with the requirements of Article 8, "Weather Reporting," of the Stipulation and Agreement As To Revenue Requirement in MAWC's most recent rate case, Case No. WR-2003-0500 (Stipulation). This lack of correspondence would make it very difficult for the Company itself to crosscheck its own results.

Instead of providing the billing cycle data in the form that it had specifically agreed to, the Company instead provided data in a different format. The Company separately describes their 4-4-5 account closing schedule, where books are closed in the 4th, 8th and 13th weeks, four times each year (see the question and answer

beginning at Page 5, Line 5, of the Direct Testimony of Edward L. Spitznagel, Jr. in the present case.) The result is that the Company's data is not readily usable and Staff has had to reconstruct, project and estimate the necessary billing determinants (Patterson Dir., 3-4).

Based on the careful use of sophisticated analytical methods, Patterson determined that the billed accounts totaled 320,060 Quarterly Residential customers in 2002 with excellent reliability, that average meters-in-use for that year numbered 337,980, and that the ratio of billed quarterly residential accounts to meters-in-use, or 92.92 per cent, was therefore sufficiently reliable for the purpose of projecting billed accounts for subsequent periods, to include through the true-up date of May 31, 2007. These quantities are illustrated in the graph at Revised Schedule 1-1, attached to Patterson's Supplemental Direct Testimony. Revised Schedule 1-1 provides updates to the Schedule 1-1 attached to my original Direct Testimony in this case, replacing this Schedule entirely.

Staff's revised estimates of weather-adjusted Residential and Commercial gallons-per-customer-per-day ("GCD") by service area for the twelve billing months ending December, 2006, are presented in Revised Schedules 2-1 through 2-9 attached to Patterson's Supplemental Direct testimony, which replace the like-numbered Schedules attached to his Direct testimony. Revised Schedule 2-1 includes projections of customer counts as well as the projections of actual and normalized annual water sales that result. The table at Revised Schedule 2-2 shows that the projection of the 2006 combined actual Residential sales, for the districts analyzed, were 40,068,090 M gallons, and that the corresponding projection of normalized 2006 Residential sales

was 38,176,320 Mgallons, implying a downward weather adjustment of (1,891,771) Mgallons for these districts. Revised Schedules 2-3, 2-4 and 2-5 illustrate the annual changes in projected Residential customer counts; projections of actual and normal Residential GCD; and projections of actual and normal Residential Mgallons respectively. The parts of Schedule 2-1 that pertain to Commercial customers have not been revised, nor have the underlying Schedules 2-6 through 2-9. However, these are included in the Revised Schedules 2-1 through 2-9 for use in Staff's calculations for the true-up, and are labeled as Revised Schedules 2-6 through 2-9 for consistency.

Patterson's estimates were used by Staff witness Roberta Grissum in her calculations of customer counts and weather normalized water sales volumes (See Patterson Direct, Supplemental Direct, Rebuttal, and Surrebuttal).

26. Revenue Annualization:

What is the appropriate level of customers and revenues to be used in determining MAWC's test year annualized revenue?

27. Customer Charge Revenue:

Should there be any adjustment related to the capacity charge MAWC has proposed in Case No. ST-2007-0443?

29. District Specific Revenues:

What are the normalized revenues associated with each district?

MAWC is comprised of ten (10) operating water districts and three (3) sewer districts (Grissum Dir., 4). The ten operating water districts are referred to by location and include: Brunswick, Jefferson City, Joplin, Mexico, Parkville Water (Platte County), St. Charles, St. Joseph, St. Louis, Warren County Water (Incline Village) and

Warrensburg. The three operating sewer districts are also referred to by location and include: Cedar Hill, Parkville Sewer (Platte County) and Warren County Sewer (Incline Village). In addition to the operating districts, the Company has a non-operating Corporate District. Costs recorded by the Company on the books and records of the Corporate District are generally costs that are for the benefit of the system as a whole that cannot be directly assigned to a specific operating district. The majority of customer accounting and administrative functions for all operating districts, as well as income tax expense, are recorded on the books and records of the Corporate District, which is physically located in the St. Louis District.

With regards to revenues, normalizing refers to the process of calculating revenues that will reflect the impact of “normal” weather and rainfall on usage. Annualization is the process of calculating an on-going level of annual revenues based on the billing determinants, customer count, meter count by meter size, and normalized volumes of water consumed by the customer. Total tariff rates for the Residential, Commercial and Industrial rate classifications include both a minimum charge and a volumetric charge. The minimum charge is a specified monthly or quarterly charge for each customer or meter depending on the individual customer.

The minimum charges for the operating districts of Jefferson City (JFC) – Residential, Joplin (JOP) – Residential and Commercial, St. Joseph (SJO) – Residential and Commercial, St. Charles (STCH) – Residential and Commercial and St. Louis (STL) – Residential and Commercial Monthly & Quarterly, were determined by first multiplying the number of normalized customers at December 31, 2006, provided by Staff Witness Dennis L. Patterson by the applicable minimum charge. The product of this calculation

was multiplied by the number of billing periods in a year, four for quarterly-billed customers and twelve for monthly-billed customers, to produce the annualized minimum charge revenues for these districts.

The minimum charges for the operating districts of Brunswick (BRU) – Residential and Commercial, Jefferson City (JFC) - Commercial, Mexico (MEX) – Residential and Commercial, Parkville (PKW) – Residential and Commercial, Warren County (WCW) – Residential and Commercial, Warrensburg (WAR) – Residential and Commercial were determined by first multiplying the number of meters at December 31, 2006, provided in updated Company workpapers by the applicable minimum charge, to produce the annualized minimum charge revenues for these districts.

The annualized and normalized volume of water sold for the operating districts of Jefferson City (JFC) – Residential, Joplin (JOP) – Residential and Commercial, St. Joseph (SJO) – Residential and Commercial, St. Charles (STCH) - Residential and Commercial and St. Louis (STL) – Residential and Commercial Monthly & Quarterly was determined as of December 31, 2006, by Staff Witness Patterson. The annualized and normalized volume of water sold for the operating districts of Brunswick (BRU) – Residential and Commercial, Jefferson City (JFC) – Commercial, Mexico (MEX) – Residential and Commercial, Parkville (PKW) – Residential and Commercial, Warren County (WCW) – Residential and Commercial, Warrensburg (WAR) – Residential and Commercial were determined by first multiplying the weather adjusted average gallons used per day per customer (GCD) found in Company's workpapers by the actual number of customers at December 31, 2006, provided by Company in response to Staff Data Request No. 200, to determine total usage in gallons per day. The total gallons

per day were then multiplied by the average days per year (365.25) to determine total annual usage for these districts. The total normalized and annualized usage was then multiplied by the tariff cost per gallon for each specific district and customer class to determine the annualized and normalized revenues associated with water usage for each district.

The annualized revenues for the three sewer operating districts were developed by taking the actual customer count or meter count at December 31, 2006, whichever was more appropriate based on type of customer, and multiplying by the current tariff rate to develop the annualized revenues. The Cedar Hill Sewer operating district also had a small amount of volumetric sales. As such, Staff employed the volumetric charge methodology described above for developing the annualized revenues associated with the volumetric charge for the Cedar Hill operating district (See Grissum, Direct & Surrebuttal, and Patterson, Direct, Supplemental Direct, Rebuttal, and Surrebuttal).

28. AWR Compensation to MAWC:

What amount of revenues, if any, should be included in MAWC's cost of service as a result of American Water Resources' activities?

Staff proposes to include revenue of \$137,449 in the cost-of-service calculation to compensate MAWC for services that it has provided to its non-regulated affiliate, AWR. MAWC recognizes the value of these services but proposes to add revenue of only \$7,500 for them (Grubb Reb., 4-5). These services have allowed AWR to profit from those MAWC customers who have signed up with AWR for a water-line, sewer-line, or in-home-plumbing- protection plan. Staff's proposal results in a more equitable sharing of resulting profits between MAWC, its ratepayers and AWR, in contrast to the

compensation that Company witness Grubb suggests might be appropriate.

MAWC provides customer lists to AWR on an on-going basis. Contrary to MAWC's assertions, Staff's research shows that AWR cannot obtain mailing lists on the open market comparable to the customer lists provided by MAWC. (Cassidy Sur., 10). In the past, has provided endorsements and allowed AWR to use its logo in mailings. MAWC deserves compensation for these services. Additionally, it appears that MAWC employees direct ratepayers to AWR for repair services:

If a customer experiences a water leak, they are instructed to "...call the toll free number shown on your water bill from Missouri-American Water Company. In the event Missouri-American determines the leak is to your customer-owned water line. We will arrange to have an approved independent contractor call you to set up a time...to arrange for repair of your customer-owned water line." This statement indicates that AWR enlists the involvement of MAWC employees to inspect and determine the source of any leaks. Currently, AWR does not compensate MAWC for the use of its employees who determine the source of water leaks.

(Cassidy Sur., 10).

Staff has only received information regarding the revenues that AWR generated from MAWC customers. MAWC objected to providing the Staff with the level of expenses AWR has experienced in relation to serving MAWC customers for the three programs. Staff finds it astonishing that MAWC would obstruct its attempts to determine the actual profit margin of this activity – what is MAWC trying to hide?. MAWC's obstructive tactics prevented Staff from determining the exact AWR profits that have resulted from transactions with MAWC customers. In the absence of the objected-to-AWR expense and profit information, Staff assumed a 50% profit margin for the water, sewer and in-home plumbing protection programs that are being offered to MAWC customers. Staff believes that MAWC is fairly entitled to 50% of AWR's estimated

profits associated with the water line program, which results in \$93,450 of compensation to MAWC, and 25% of AWR's estimated profit associated with its sewer line program and in-home plumbing programs, which results in \$41,132 and \$2,867 of compensation to MAWC, respectively.

B. Rate Design & Cost of Service Issues:

30. Implementation of any Rate Increase:

How should any revenue increase for MAWC that results from this case be implemented in rates?

31. District Pricing v. Other:

What is the appropriate way to allocate costs among MAWC's various operating districts?

31. District Specific Costs:

What are the costs of each district?

32. Class Identification/Cost of Service:

What is the appropriate way in which to identify classes and to allocate costs among customer classes within each operating district?

Staff witness Russo performed a Class-Cost-of-Service Study ("CCOS") (Russo Dir., 3; see Schedules 2-9). The customer classes used in this study are: Residential, Commercial, Industrial, Other Public Authority, Other Water Utilities, and Private Fire Protection. These are the same classes used in the Company's current tariff. The purpose of Staff's CCOS study is to determine, and provide the Commission with, a measure of relative class cost responsibility for MAWC's overall revenue requirement on a district specific basis. For individual items of cost, class cost responsibility can be

either directly assigned or allocated to customer classes using reasonable methods for determining the class responsibility for that item of cost. The results are then summarized so that they can be compared to revenues being collected on current rates.

Costs that could not be directly assigned were allocated to the districts using the "base-extra capacity" method. This method involves allocating the various cost components based on data pertaining to operating costs, operating revenues, system capacity, customer usage and customer numbers. The results of these allocations show the relative cost levels that should be recovered from each customer class. Rates are then designed to recover the costs that are allocated to each class. In the base-extra capacity method, costs are generally separated into four primary cost components: base costs, extra capacity costs, customer costs, and direct fire protection costs. Base costs vary with water consumption and are allocated to customer classifications according to the amount of water consumed. Extra capacity costs are the costs associated with meeting the requirements that are in excess of the average load conditions. They are divided into costs to meet maximum-day-extra demand and maximum-hour-extra demand. Customer costs are those costs associated with the number of customers, regardless of consumption. These costs include customer accounting and collection expenses, meter-reading expenses, billing expenses and return on and of plant related to meters and services. Fire protection costs are those costs directly assigned to fire protection functions. Allocation of each cost is accomplished by applying class allocation factors. These class allocation factors are applied to the annualized and normalized expenses, plant, rate base, and return on investment to determine the total costs to be recovered in each district. The results are

presented in terms of class revenue requirements before any increase or decrease in MAWC's revenue requirement. The methodology used is the same one that MAWC's current rates are based on and the results show that revenues should be collected in a different manner going forward (Russo Dir., 5).

MAWC proposed a 25.9% increase in rates to be spread evenly over each district and each class within each district. Staff's rate design for the Company's water operations is based on the actual CCOS for each district and the increase/decrease for each district is determined by the revenue requirement for that district. Staff's rate design for the Company's sewer operations is based on the Water & Sewer Department's small company rate design methodology. Staff developed rates to recover the CCOS allocated to each class in each of the Company's districts. The rates generally consist of a fixed monthly customer charge and a usage (commodity) charge, which are generally based upon the number of customers in the class and the usage characteristics of those customers. To determine the commodity rates from the CCOS study, Staff subtracted the dollars collected from the customer charges from each class' revenue requirement and divided the remaining class revenue requirement by the total class-billed water volumes. However, The CCOS for the Brunswick District continues to be extremely high compared to the other districts. Staff recommends that the Commission establish rates for the Brunswick District similar to the manner in which the rates were set in Case Nos. WR-2003-0500 and WC-2004-0618. For those cases, the rates were established by using the customer charges and commodity charges from the District that had the second highest rates. This will shift revenue responsibility from the Brunswick District customers to other parties. This is subsidization and will result in

other Districts or the Company being responsible for the shortfall of the cost of service for the Brunswick District.

III. MISCELLANEOUS ITEMS:

33. Joplin Overcharge (WR-2000-281 Appeal):

Should an adjustment be made related to the appeal of Commission Case No. WR-2000-281? If so, what adjustment should be made?

The Commission already determined that this issue is not properly before it in this case by refusing to consolidate the two cases.

34. Jefferson City Issues:

Are MAWC's Jefferson City facilities adequate as related to back-up power generation, storage and small main replacement?

MAWC's water system in Jefferson City is the essential component to fire suppression in the city. Jefferson City's first concern is the ability of the water company to produce the adequate flows needed for fire suppression. Part of the city-wide insurance rating from the ISO is contingent upon the water company's capability of producing water and adequately distributing and delivering that water to various locations throughout the city (Rennick Dir., 2). In MAWC's rate case of 2003, the City offered testimony about several important subjects related to fire safety in the city. Those included 1) reliable power supplies for the Company's pumping operations; 2) planning for population growth and related building construction in the Jefferson City area; 3) continued replacement of outdated hydrants and narrow dimension water mains; and 4) adequate shallow water pumping equipment in view of lower Missouri River water levels. These issues were treated in the Joint Study, filed July 1, 2004.

There are two areas which continue to be of high importance to the city even though they were given considerable treatment in the study. Those areas are the power sources for the Company's pumping equipment and the reliability of those sources, and storage. The first area is of course a major concern from the fire protection perspective; the second is a matter not necessarily restricted to fire suppression but is important to the convenience of each Company customer located in the city.

The pressure in the Company's distribution system is maintained by high pressure pumps powered by electricity. If the pumps are disconnected from electrical power, the pressure and volume of water in the system cannot be maintained at adequate levels not only for general distribution but particularly for fire suppression. The energy supplier for the pumping operation is AmerenUE and power to the plant is provided from one of two feeder circuits. The primary source of power for MAWC's pumping operations is a feeder line that serves western portions of Jefferson City and parallels Industrial Drive until it reaches a point south of MAWC's plant. MAWC's pumping operations are also connected to a secondary source of power supplied by a feeder line that is extended from AmerenUE's facilities in the "Mill Bottoms" just west of the Capitol. While some improvements have been made to safeguard this power supply, other areas of concern remain.

On August 25, 2006, AmerenUE experienced a power outage on its system which affected most of the downtown Jefferson City area and much of the western side of the city. The outage de-energized both feeder circuits connected to MAWC's treatment plant and may have de-energized the other remote pumps serving the system. The power outage lasted for over two hours. Had a fire emergency developed

during this lengthy outage, the fire department would have been without water flows to extinguish it. Fortunately, no fires were reported during this outage but the event signaled to that power issues at the treatment plant have not been fully resolved. The Joint Study did not directly address the likelihood of this event and did not address the back up plans which should be in place to protect against it. To avoid the problem that occurred on August 25, 2006, the City recommends that back up stationary power generation equipment be installed. The output of the generator should at least be at the level to meet the normal energy demand of the pumping equipment. The generator would be for temporary power but would need to have the capability of supplying power indefinitely until regular power was restored (Rennick Dir., 5-6).

Also in the Joint Study, the parties analyzed storage requirements for Jefferson City. It was determined that clear well storage volume was sufficient to meet daily demand along with providing a 3,500 gallon per minute fire flow for three hours. Future storage capacity needs were also a concern of the study and the Company agreed to make improvements to storage and pumping capacity as demand (such as any redevelopment of the prison site) would require. Notwithstanding the parties' report that storage was sufficient, in July 2005 and again in August of 2006, the Mayor of the City exercised rights conferred by ordinance to curtail water usage in the City because MAWC's water system pumping could not keep up with demand. The conservation measures were required until air temperatures returned to more moderate summer levels and demand subsided. These events are indeed an inconvenience to customers in the city and do pose a threat to fire protection.

Although events of prolonged drought and high temperatures may be classified

as infrequent, they bring to light particularly in the Jefferson City service area of the Company that the system has capacity challenges that in my estimation should be corrected. To avoid imposition of mandatory water restrictions in the Jefferson City service area, the Company should have more storage, or more access to storage, and increased treatment capacity (Rennick Dir., 8).

MAWC has made good progress in replacing the small water mains (mains that are 4" or 14 less in diameter) that are in the downtown area, and is currently working on main upgrades or replacements in areas beyond the downtown area. One such project is in the Old Munichburg area of the City. I believe that MAWC's annual investment in replacement mains and hydrants, if needed, has been in the \$100,000 range that was reported in the Joint Study.

35. Joplin Surcharge:

Should MAWC be allowed to implement its proposed Joplin plant improvement surcharge?

The Company is proposing to increase rates, beginning January 1, 2008, for a surcharge to recover a return on the balance of construction work in progress (CWIP) associated with the Joplin water treatment plant improvement project, that is not expected to be in service until December 31, 2008. In his direct testimony, Company Witness, James M. Jenkins touts this mechanism as a way to reduce the cost and possibly eliminate rate shock associated with this project.

The Staff is opposed to this mechanism, because it would recognize plant in rates that is not completed and currently being used to serve customers. Until the plant is completed it is not capable of providing service to ratepayers and therefore, should

not be included in rates. The final cost of the project will not be known and measurable until construction is completed, which is currently estimated to be December 31, 2008. In addition, MAWC is only proposing to recognize a single cost item in the determination of the surcharge. His mechanism makes no provision to balance the effect of this single item against possible offsetting changes in the cost of service. MAWC's proposal distorts the matching of revenues, expenses and rate base.

Additionally, Staff does not believe the Company's proposal is less costly for ratepayers or that it prevents rate shock. The final cost of the project will be reduced as a result of capitalizing less accumulated funds used during construction (AFUDC). However, this reduction in cost associated with AFUDC is replaced by the up-front collection of revenues, through the surcharge, for the return on plant which is not yet in service. Also, the surcharge will be collected in advance of when the AFUDC would be recovered following completion of the project. The Company's statements regarding cost reductions do not consider the time value of money associated with the advance collection through the surcharge as compared with the recovery of AFUDC over the life of the completed Joplin treatment plant. The AFUDC rate is lower than the rate of return proposed by MAWC. As recognized by the Commission in Case No. WR-2000-281, the AFUDC rate considers short-term debt before any other form of financing for CWIP. The rate of return used by MAWC relies on a capital structure which includes no short-term debt. Its mechanism will charge a higher financing cost than would be incurred under traditional rate-making.

It is not presently known whether completion of the Joplin water treatment plant project result in rate shock for customers in Joplin. The 65% rate increase cited by Mr.

Jenkins is in comparison to current rates. As a result of this case, the Company is proposing approximately a 25% increase in rates for Joplin customers. In addition, as Mr. Jenkins reveals, the Joplin water treatment plant improvement project is only one component of cost increase that will likely be experienced by the customers in this district. Also, customer growth will allow the cost increase to be spread over a larger base and reduce the effect on an individual customer. All these items will reduce the percentage increase resulting specifically from the Joplin treatment plant improvement project. While the percentage of increase resulting from this project will be large, the increase in actual monthly cost cited by Mr. Jenkins is approximately \$10.50 per month. The Staff does not wish to indicate that this amount is insignificant; however it is likely to be more manageable than other increases in costs being experienced by customers, such as heating and cooling costs.

MAWC is proposing to increase rates four times, approximately every three months, prior to the Joplin facility being completed. In December of 2008, Staff would expect the Company to propose another rate increase to include the completed Joplin plant and other cost changes in permanent rates. The Staff believes customers will find these continuous rate increases no less shocking than a single larger increase after the project is complete.

Staff opposes the surcharge proposed by MAWC to collect a return on future plant from Joplin customers. Mr. Jenkins states on page 19, that the Company has the resources and capabilities to see a project such as the Joplin water treatment plant improvement through to completion. The Staff believes seeing a project through should also involve providing the financing while the project is under construction, rather than

asking ratepayers to provide an up-front payment to fund CWIP (see Rackers Rebuttal.).

36. Consolidated Billing:

Should the proposed consolidated billing tariff be approved?

Staff has reviewed MAWC's Consolidated Billing proposal and is in agreement with it.

37. Triumph Foods/ St. Joseph Issue:

Should an adjustment be made associated with the rate paid by Triumph Foods, LLC in St. Joseph?

Staff is opposed to the rate design modifications for the St. Joseph District proposed by AGP witness Donald Johnstone. First, the "Triumph rate" referenced by Mr. Johnstone is a special contract rate established under the alternative incentive provisions of the Company's economic development rider and does not include all of the costs that the Staff believes should be included in a straight fixed-variable cost of service based rate (Russo Reb., 3). Second, Staff does not agree with Mr. Johnstone's proposed volumetric rate design, which is a blatant attempt to shift costs from the large industrial user that Johnstone represents directly to residential users (Russo Reb., 1-2).

Staff disagrees with Johnstone's adjustment of the third and fourth rate blocks, and with the way he allocated the resulting shortfall revenue to the first and second blocks. Staff's understanding of the second step is that Mr. Johnstone used the existing third block of the industrial rates and reduced the existing tail block by 5.1%. The shortfall in revenues was then added to the first and second blocks and the proposed commodity rates were adjusted, with approximately 96.3% of this revenue shortfall

being added to the first block. In the Staff's opinion, the results of this approach place an undue burden of the revenue shift into the first block, which just happens to be predominately the residential customers. If the Commission is to consider this proposed rate design, the Staff believes that either the results generated from using only the first step should be used, or, if step two is used, then the remaining revenue shortfall should be allocated proportionately between the first two blocks. Schedule 2 attached to Staff witness Russo's Rebuttal Testimony shows this allocation to the volumetric rates and the impact on the customer classes.

38. Union Training Issue:

Are MAWC's efforts in regard to asbestos-cement and led jointed piping adequate and appropriate?

Staff's position on this issue is that, to the extent that MAWC's employees are required to work with Asbestos-Cement ("AC") pipe, they should be provided appropriate training (Merciel Surr., 4-5).

Conclusion

WHEREFORE, on account of all the foregoing, Staff prays that the Commission will set just and reasonable rates herein in accordance with Staff's advice; and grant such other and further relief as is just in the circumstances.

Respectfully submitted,

s/ Kevin A. Thompson
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Certificate of Service

I hereby certify that a true and correct copy of the foregoing was served, either electronically or by First Class United States Mail, postage prepaid, on this **3rd day of August, 2007**, to the parties of record as set out on the official Service List maintained by the Data Center of the Missouri Public Service Commission for this case, a copy of which is attached hereto and incorporated herein by reference.

s/ Kevin A. Thompson