BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Review of Economic, Legal	)	
And Policy Considerations of District-Specific	)	**Case No. SW-2011-0103**
Pricing and Single-Tariff Pricing.	)	

REPLY BRIEF OF THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

PURSUANT TO COMMISSION ORDER

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I. INTRODUCTION

On November 16, 2010, the Missouri Public Service Commission ("the Commission") issued an *Order Establishing Briefing Schedule and Filing Deadline*, allowing any interested entity to file by December 15, 2010, a brief concerning the economic, legal and policy considerations of district-specific and single-tariff pricing. The Commission directed that any reply briefs be filed no later than January 12, 2011. Following a one-week extension, Aqua Missouri, Inc. ("Aqua Missouri"), Missouri-American Water Company ("MAWC"), the City of Joplin, Missouri ("Joplin"), and Ag Processing Inc a Cooperative ("AGP") filed briefs in response to the Commission's November 16, 2010 order. The purpose of this document is to respond to certain points contained in those briefs. Any decision by the Staff of the Missouri Public Service Commission ("Staff") to omit a response to a particular point, argument or concept should not be construed as an acceptance of such. Staff has attempted in this document to highlight, based upon available resources, Staff's principle concerns.

II. STAFF'S RESPONSE TO AQUA MISSOURI'S REPLY BRIEF

In the *Aqua Missouri Reply Brief* filed on December 22, 2010, Aqua Missouri responds primarily to two concerns expressed by Staff during the on-the-record presentation held in this matter on November 9, 2010. Specifically, those concerns include Staff's belief that a movement to single-tariff pricing may result (1) in system overinvestment and (2) in an inequitable distribution of costs between "causers" and "payers." Although Staff would point out that many other consequences were presented in Staff's initial brief on this topic, Staff will focus primarily on the above issues for the purpose of its response.

Aqua Missouri argues that Staff's concerns regarding overinvestment are overblown in light of the fact that the vast majority of Aqua's Missouri's capital improvements are tied to environmental compliance mandates. Assuming that such environmental compliance measures

are mandated by state and/or federal authorities, Staff would argue that single-tariff pricing is not necessary to facilitate these mandatory improvements. Staff is unaware of, and would be shocked to encounter, any situation in the past where Aqua Missouri has not had sufficient capital necessary to meet environmental compliance requirements.

Aqua Missouri also contends that any particular concern about system overinvestment can be adequately addressed in a rate proceeding, stating that "[e]ach and every infrastructure improvement can be reviewed and challenged in the confines of a rate case." *Aqua Missouri Reply Brief*, p. 3. While technically true, proving that a company acted in an imprudent manner regarding system overinvestment is a very difficult proposition. As pointed out by Aqua Missouri, much of the investment that is made by the water and sewer industries is closely related to environmental compliance. However, not all investments made to meet environmental compliance mandates are necessarily prudent or cost-effective. Environmental compliance mandates (i.e. environmental regulations) focus largely on ends, as opposed to means. In other words, these regulations generally dictate the results that must be reached, not the methods that must be employed in reaching them. Engineers often differ on what is a technically appropriate and/or cost-effective solution to an environmental compliance problem, i.e., the means necessary to meet the required end. A company that does not have to focus upon the localized financial impacts of its decisions will have less incentive to keep costs, environmental or otherwise, at a minimum. Staff and other parties will have the difficult task of proving that although some investment was necessary, the specific investment undertaken was excessive, imprudent, or not cost-effective. Staff would point out that as a practical consideration, most environmental compliance measures are undertaken at the direction of the Missouri Department of Natural Resources ("DNR"). Once DNR determines that system upgrades are necessary, DNR approves a company's proposed compliance plans. In Staff's opinion, these approvals are largely based

upon the technical feasibility of the proposed solutions and do not focus upon the bottom line impact of these decisions on ratepayers. Staff is rarely involved in the compliance plan approval process and, therefore, often does not have the practical ability to voice technical or economic opposition at the time such decisions are made. As a result, Staff is left to argue that an investment decision was imprudent, after having been approved by another state agency. This is a very difficult task.

Next, Aqua Missouri contends that no practical and cost-effective method exists for the Company to present its position to the Commission in an effort to achieve a result that is contrary to Staff's policy. Staff agrees that the Commission's small company rate case procedure is not the appropriate avenue to address these concerns - this small company procedure was not designed to tackle these large issues. Staff recognizes that as a result, the Company could, and likely would, incur additional expenses should it file under the traditional "large company" formal rate case procedure; however, in Staff's opinion, Aqua Missouri's $70,000 estimate is drastically overstated.

In addition, contrary to the Company's contentions, Staff is not likely to propose a disallowance to prudently-incurred rate case expenses should Aqua Missouri or any other small company elect to file under the large company rate case procedure, especially for the purpose of litigating such large policy issues. Take, for example, the recent rate case filed by Lake Region Water and Sewer Company ("Lake Region"), Case No. WR-2010-0111. Lake Region filed a large company rate increase request on October 7, 2009, even though Lake Region has fewer than 8,000 customers and thus qualifies to file under the Commission's small company procedure. Staff did not propose to disallow Lake Region's rate case expense on the basis that the company had filed a large company rate increase request as opposed to the small company alternative. In fact, Staff proposed that Lake Region was entitled to its prudently incurred rate

case expense…and the Commission agreed. Further, Lake Region's total cost for rate case expense, as approved by the Commission was approximately $42,000. This amount is far less than the suggested $70,000 proposed by Aqua Missouri and includes the costs of a multiple-day evidentiary hearing.

As with all expenses Staff would review any additional costs in order to determine if they are reasonable in light those incurred by comparable companies and would likely take into consideration the magnitude and public importance of the questions presented…i.e., why the company elected to proceed under the traditional rate case procedures as opposed to the small company alternative. Some of the additional expense may be disallowed, but this opportunity cost would have to be calculated and weighed by the Company.

III. STAFF'S RESPONSE TO THE COMMENTS AND BRIEF OF AGP

In the *Comments and Brief of Ag Processing Inc a Cooperative*, AGP claims that "[w]hen none of the utility districts are interconnected, and none of the customers in any one of the districts is provided service by any of the other districts, any attempt to impute or include in the rates of one district, the costs of providing service to another district, is prohibited by Subsections 1 and 3 of section 393.130." *Comments and Brief of AGP*, p. 5. In reaching this conclusion AGP thoughtfully attempts to draw a distinction between reasonable discrimination against individual consumers located in the same district, which AGP argues is permissible, and any discrimination against localities, which AGP argues, based upon the language of the statute, to be prohibited "in any respect whatsoever." *See Comment and Brief of AGP*, p. 6.

Staff does not agree that the qualifier "in any respect whatsoever," found in Section 393.130.3, RSMo (2000)[1], creates a meaningful distinction between permissible discrimination against individuals and permissible discrimination against districts or interconnected systems.

[1] Unless otherwise noted, all references to statute refer to the Missouri Revised Statutes 2000, as currently supplemented.

To the contrary, in Staff's opinion, "undue" and "unreasonable" are the operative qualifiers found in Section 393.130.3. The Commission is statutorily barred from "unduly" or "unreasonably" discriminating against either individuals or localities, at least implicitly indicating that the Commission has the inherent authority to approve some degree of lesser discrimination against either. *See* Section 393.130.3.

AGP attempts to address this belief in arguing that the application of single-tariff pricing amounts to "undue" or "unreasonable" discrimination. *See generally Comment and Brief of AGP,* pp. 6-8. AGP would have the Commission believe that the cases cited in its brief clearly support this, and only this conclusion. While these cases do present a number of important principles that the Commission should consider in its examination of this matter, these cases do not provide such a clear-cut resolution of this controversy.

As far as the public policy concerns presented in AGP's brief, Staff concurs in large part with many of AGP's arguments. Single tariff pricing can have the consequence of distorting price signals, interfering with public feedback regarding appropriate levels of investment, and masking costs of acquisitions.

IV. STAFF'S RESPONSE TO JOPLIN'S BRIEF

On page 1 of the *Brief of the City of Joplin Regarding Legal Prohibition on Single-Tariff Pricing* Joplin makes the blanket statement that "[i]n the area of water and sewer, pure or even primarily STP is unlawful absent physical interconnection or continuity among districts…" Similarly, Joplin states on page 2 that "[s]witching to a pure STP would violate the law." While Staff appreciates Joplin's straightforward interpretation, this position is incorrect, (admittedly) without direct support, and is internally inconsistent with the statement found in Joplin's conclusion that "…STP might pass muster in limited circumstances…" *Brief of the City of Joplin Regarding Legal Prohibition on Single-Tariff Pricing*, p. 6 (emphasis in original).

Joplin is quick to point out on page 2 of its filing that in State ex rel. City of Joplin v. Pub. Serv. Comm'n, 186, S.W.3d 290 (Mo. App. W.D. 2005) "the Court of Appeals found that the Commission exceeded its authority by ordering a switch from STP to DSP…"; however, in that case, which dealt primarily with mootness, the Court remanded the case to the Commission with orders to comply with the circuit court's previous order mandating additional findings of fact to support the Commission's rate design decision[2]. The Court of Appeals did not find single-tariff pricing to be unlawful. As a result of that case and in compliance with the Court's decision, the Commission issued its *Report and Order on Second Remand*. Shortly thereafter Joplin filed a writ of review of the *Report and Order on Second Remand*, which was held by the circuit court to be both lawful and reasonable[3]. Joplin appealed[4], but voluntarily dismissed the appellate action prior to briefing.

Joplin argues that "…the Commission has no authority to authorize single tariff pricing when the tariff sets a single price for customers who are not receiving the same or substantially similar service." *Brief of the City of Joplin Regarding Legal Prohibition on Single-Tariff Pricing*, pp. 5-6. Staff agrees that differences (or similarities) in rates should be established after examining differences (or similarities) with regard to the service that customers receive. Staff does not agree however that any differences (or similarities) in rates must correspond exactly with any such differences in service. The Commission's authority is not that limited. Staff does not agree with Joplin's implicit argument that similar or substantially similar service is not provided anytime a cost differential exists between two districts (or at least anytime a cost differential exists between two districts as a result of one district having received substantial upgrades).

[2] Case No. APWD64944. Reported at 186 S.W.3d 290 (Mo. App. W.D. 2005).
[3] Case. No. 08ACCC00082.
[4] Case No. APWD70218.

MAWC approaches this "same or similar service" issue from a different perspective. In *Missouri-American Water Company's Brief* MAWC focuses more upon the nature of the services provided, as opposed to the costs incurred to providing those services. MAWC essentially argues that each customer class in one district receives the same fundamental services as the corresponding customer classes in each of the Company's other districts, and, therefore, as there is no difference in service, there should be no difference in costs paid for that service. *See Missouri-American Water Company's Brief*, pp. 6-7.

Joplin and MAWC are both half right in their arguments. Staff would point out that that as discussed during the November 9, 2010 on-the-record presentation, equality of service is largely a question of fact, which must be examined in the confines of an actual case or controversy. In any event, Staff's point is that the Commission has a certain degree of latitude in establishing and applying prices for regulated utility service. The Commission is charged with setting just and reasonable rates; this is their responsibility first and foremost. Section 393.130. In doing so, the Commission is statutorily authorized to discriminate, as long as such discrimination is not "unjust" or "unreasonable." As long as the resulting rates are reasonable overall, unjust discrimination does not necessarily occur anytime one district subsidizes another. However, the Commission may not engage in subsidies at the peril of a just and reasonable outcome.

V. CONCLUSION

In conclusion, as contained in Staff's initial brief, it unfortunately appears that there exists no one controlling legal standard that can be used to evaluate what constitutes "undue or unreasonable prejudice" within the confines of Section 393.130.3. Based upon certain guiding cases the Commission can however discern the following helpful principles to apply in the exercise of its discretion: (1) The Commission has a duty, first and foremost, to set just and

reasonable rates; (2) Any Commission decision, including those involving single tariff versus district-specific pricing, must be supported by competent and substantial evidence adduced in the case in which the decision is rendered; (3) Some amount of rate discrimination will always exist. This discrimination can however be deemed to become overly burdensome in cases in which differences in pricing are not based upon factors affecting service and/or rational distinctions in costs incurred in providing those services to consumers; and (4) Due to system-specific cost causation factors there is likely no one rate design philosophy that can be appropriately applied to all companies and/or all consumers at all times.

With these factors in mind, Staff would leave the Commission with the following Missouri Supreme Court quotation:

> We are able to discern no legitimate reason or basis for the view that a utility must operate exclusively either under a systemwide rate structure or a local unit rate structure, or the view that an expense item under a systemwide rate structure must of necessity be spread over the entire system regardless of the nature of the item involved. Experts in utility rates may well conclude that a 'hybrid system' or a 'modified system' of rate making, wherein certain expense items are passed on to certain consumers and certain items are thereby treated on a local unit basis and others on a systemwide basis, is the system which will produce the most equitable rates. <u>And it would appear to be the province and duty of the commission, in determining the questions of reasonable rates, to allocate and treat costs (including taxes) in the way in which, in the commission's judgment, the most just and sound result is reached.</u>

State of Missouri ex rel. City of West Plains, et al. v. Public Service Commission, et al., 310 S.W.2d 925, 933 (Mo. Banc 1958) (emphasis added).

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronic mail to all counsel of record this 12th day of January 2011.

/s/ Eric Dearmont