

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the matter of U.S. Water/Lexington,)
 Missouri, Inc., to file tariffs designed)
 to effectuate a general revenue increase)
 attributable to the meter rate for water) CASE NO. WR-88-255
 service provided to customers inside and)
 outside of the City of Lexington, Missouri.)

APPEARANCES: Gary W. Duffy, Attorney at Law, Hawkins, Brydon, Swearingen
 & England, P.C., P. O. Box 456, Jefferson City, Missouri 65102,
 for U.S. Water/Lexington, Missouri, Inc.

Lewis R. Mills, Jr., Assistant Public Counsel, Office of the
 Public Counsel, P. O. Box 7800, Jefferson City, Missouri 65102,
 for Office of the Public Counsel and the public.

William K. Haas, Assistant General Counsel, Missouri Public
 Service Commission, P. O. Box 360, Jefferson City, Missouri 65102,
 for Staff of the Missouri Public Service Commission.

HEARING
 EXAMINER: Beth O'Donnell

REPORT AND ORDER

Date Issued: March 10, 1989

Date Effective: March 21, 1989

U.S. Water/Lexington, Missouri, Inc.

Case No. WR-88-255

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Procedural History

On April 25, 1988, U. S. Water/Lexington, Missouri, Inc. (Company), submitted to this Commission tariffs reflecting increased rates for water service provided to customers in its Missouri service area. The proposed tariffs are designed to produce an increase of approximately 27.29 percent (\$195,000) in charges for water service. By order issued May 20, 1988, the Commission suspended these tariffs to March 22, 1989, established an intervention deadline for proper entities and set a procedural schedule.

By order issued June 29, 1988, the Commission granted intervention status to the City of Lexington, Missouri, and scheduled a public hearing for November 10, 1988, in the City of Lexington. At that hearing, the Office of the Public Counsel (Public Counsel), the Commission's Staff (Staff) and Company appeared by counsel. No representative of the City of Lexington appeared and no customers of Company appeared.

A prehearing conference among the Staff, Public Counsel and Company was held November 15 through 18, 1988. The City of Lexington was not present and did not participate. The parties participating in the prehearing conference produced a hearing memorandum setting forth, among other things, the matters at issue herein. The hearing memorandum was executed by the three parties participating in the prehearing conference and sponsored by them as Joint Exhibit 1.

The matters at issue in this case were heard at the Commission's hearing room December 12 and 13, 1988. The City of Lexington was not present and did not participate.

Pursuant to the briefing schedule established by the hearing examiner, simultaneous initial briefs were filed January 23, 1989, and simultaneous reply briefs were filed February 3, 1989.

Findings of Fact

The Missouri Public Service Commission having considered all the competent and substantial evidence upon the whole record makes the following findings of fact.

I. Test Year and True-Up

The parties have agreed to use a test year ending December 31, 1987, updated for known and measurable changes through July 31, 1988. Company did not request a true-up audit.

The Commission finds reasonable the agreed upon test year as updated for known and measurable changes.

II. Operating Expenses

A. Rate Case Expense

Company argues that its proposed rates should include the costs of its present rate case plus the costs of its previous rate case amortized over a three-year period. This approach would result in a rate case expense of \$18,385. Public Counsel argues that only the amount of rate case expense incurred during the test year ending December 31, 1987, should be reflected in rates. This approach would result in a rate case expense of \$7,774. Staff proposes normalizing over a three-year period the expenses incurred for this rate case up to the time of the prehearing conference held in mid-November, 1988. Staff's approach would result in a rate case expense of \$12,118.

The Commission determines that Staff's approach is consistent with the principles established by this Commission in previous cases. Re: Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104, 114 (July 8, 1983). Re: Missouri Cities Water Company, 26 Mo. P.S.C. (N.S.) 1, 8 (May 2, 1983). The Commission finds that there is no reason to deviate from those principles in this case. Therefore, the Commission determines that Staff's method is reasonable and should be adopted.

B. Capitalization of Expenses to Construction

Staff recommends that 16 percent of the pro forma payroll for all employees be capitalized to reflect Company's construction activity. This figure is based upon the average capitalization of payroll by Company for 1986 and 1987. Company contends that there was an abnormal level of capital improvements in 1987 and that it should not be used in setting future rates. In support of its argument, Company states that 4,400 feet of spiral pipe were replaced in 1987, compared to 650 feet in 1986 and 600 feet in 1988. Company proposes a capitalization ratio of 12 percent which is comparable to the ratio of 11.51 percent experienced in 1986 and 11.65 percent experienced in 1988. If Company's ratio is utilized in setting rates, Staff's calculation of operation and maintenance expenses would be increased by approximately \$12,698 for payroll and benefits, \$456 for pensions and \$939 for payroll taxes.

Staff argues that its approach is a more realistic assessment of future developments given Company's admitted need to make many capital improvements. Public Counsel argues that Staff's approach is more valid given Public Counsel's belief that the Safe Drinking Water Act will require a high rate of construction in the future.

The Commission determines that Company's approach is the more reasonable of the two methods in these circumstances. It is clear from the record that 1987 was an abnormal year for capital construction by Company. Company's witness, Long, testified that Company was unable to afford the same level of capital construction in 1988. He also stated that there was more capital construction in 1987 than in any other of his thirteen years with the utility. It is speculative to establish this ratio based upon a prediction of capital improvements Company would make if it had the money. It is equally speculative to establish this ratio based upon the as yet unknown effects of the Safe Drinking Water Act.

C. Management Fee

Company paid a total of \$63,231 in 1987 to its sister company, U.S. Utility Management and Services, Inc. (Management), pursuant to a management agreement under which Management is to provide management services to Company. Both companies are

wholly-owned subsidiaries of The Utility Group, Inc. (TUG or parent company), which is owned by the sole stockholder, Charles P. Schleicher. The management agreement was entered into at the time that Company was purchased by TUG from Missouri Water Company.

Public Counsel argues that only \$8,863 of the management fee paid during the test year should be reflected in rates since that was the amount expended by the management company in rendering management services for the utility. Staff concurs in Public Counsel's position. Public Counsel and Staff argue that almost none of the services contemplated in the management agreement have been provided by the management company and that most of these management services are actually being performed by Company.

Company opposes this adjustment by arguing that, without the management fee, it would have insufficient cash flow to meet current obligations to service its debt and add necessary plant. Company further argues that the management fee was discussed and approved in the Commission's order of October, 1983, approving the sale and transfer of this utility to TUG. Company asserts that disallowance of this expense would be inconsistent with the Commission's order approving the sale.

Company further argues that, if Public Counsel's disallowance is granted, an equivalent amount would need to be generated from some other source in order to meet the cash flow needs of the Company. Company suggests that an adjustment for the increased risk associated with operating this Company be made to the rate of return calculation to achieve this result.

The Commission determines that Public Counsel's adjustment is justified. The evidence indicates that the vast majority of the management services enumerated in the management agreement are not provided by the management company. Company's cost of service should not reflect fees paid for services not rendered. In addition, service on the debt and capital improvements should be accounted for appropriately. Capital improvements are usually funded through debt or equity and then added to rate base. It is not appropriate to expense these items through a management fee as

suggested by Company. Further, payments for service on debt should not be accounted for as an operating expense.

The recitation of the provisions of the management fee in the Commission's order approving the sale of this utility to Company in 1983, does not constitute approval of future actions taken by parties to that contract. Therefore, the Commission does not believe this disallowance is in any way inconsistent with its decision in that case.

Staff's witness, Cox, testified that Company could benefit from a review of its management practices. In view of the problems with Company's management services arrangement discussed above, the Commission sees merit in Staff's suggestion. Therefore, the Commission will direct its Management Services Staff to investigate the need for a management audit of the Company.

III. Rate Base

Negative Acquisition Adjustment

Public Counsel recommends that Company's rate base be reduced by \$338,892 to reflect what Public Counsel asserts is its true market value. In purchasing its assets in 1983 Company executed a noninterest note in the amount of \$1,063,339. Public Counsel argues that a ten percent interest rate should be imputed on the note leaving a value of the note at the time of purchase of \$652,794. Public Counsel adds to the value of the note the amount of the down payment made upon the assets and the amount of the accounts receivable for a total value for Company's assets at the time of purchase of \$823,357. Public Counsel asserts that when the note is discounted to reflect its true value it becomes apparent that Company is asking for a return on more than it invested. Staff does not concur in Public Counsel's position.

The Commission determines that Public Counsel's recommendation is unreasonable and should be rejected. There is no evidence that Company could have bought the assets for less. The evidence supports a finding that the principal of the loan would have been the same had Company been unable to obtain an interest-free loan. Therefore, the Commission finds that the original cost rate base agreed to by

Company and Staff in the amount of \$1,601,987 is reasonable and should be used in determining Company's rates in this case.

IV. Rate of Return

The capital structure of Company is 100 percent equity. All of Company's debt has been incurred on its behalf by its parent company. Company proposes that this 100 percent equity structure be considered in setting its rates. Company argues that the Commission must accept this approach because, according to Company, the Commission approved this segregated capital structure in approving the sale of this utility to Company in 1983. Company also argues that this approach reflects reality since Company asserts it is unable to borrow money on its own behalf.

Staff argues that a consolidated capital structure is appropriate in this case since this approach would reflect both Company's equity and the debt incurred on its behalf by the parent company. Staff's recommended capital structure consists of 22.87 percent common equity and 77.13 percent long-term debt. Public Counsel concurs in Staff's position on this matter.

The Commission believes that the consolidated capital structure proposed by Staff is reasonable. Company is the sole source of revenue enabling the parent to pay debt incurred for the Company. Therefore, the Commission determines that the consolidated capital structure reflects Company's financial reality while allowing ratepayers to benefit from the tax deduction for interest payments made on that debt.

The Commission believes no impediment to Staff's approach arises from the order approving the sale of this utility to Company. Therein the Commission observed, without comment, that Company's capital structure was to be 100 percent equity. At that time, the Commission noted that the segregated structure was chosen to enable Company to raise capital for any necessary improvements. The evidence indicates that Company has not made any effort to borrow money on its own behalf. The evidence further indicates that similar small companies have been able to obtain financing on their own behalf.

Finally Company argues that the integrated capital structure will produce such a low pretax return that the Company would be in a loss position on a consolidated basis after refinancing its debt in December, 1988. Staff responds that the consolidated companies should look to the \$361,000 in notes receivable from their sole shareholder for a return on the consolidated capital not included in rate base. The Commission is of the opinion that there is merit to Staff's argument since removal of debt service on this amount will decrease the debt service obligations of Company by approximately \$67,000. This amount, combined with non-cash expenses such as depreciation and deferred taxes, plus cash presently available and the increase approved herein, is more than sufficient to meet Company's debt service obligations.

Company has refinanced its debt in December, 1988, at an interest rate of 13.75 percent plus a 2.50 percent commitment fee resulting in a 14.25 percent annualized cost of debt. Staff recommends using this refinanced debt in determining Company's rate of return in this case. Although the refinancing occurs outside the known and measurable period, Staff argues that its consideration in this case would eliminate the need for Company to file another rate case in a few months.

Staff recommends that an imputed interest rate be used for this refinanced debt. Staff argues that the 14.25 percent annualized cost for the refinanced loan is unreasonably high. Staff expresses its concern that this interest rate might not be the product of an arms-length negotiation. Staff observes that the loan has been obtained from the J. C. Nichols Company (J. C. Nichols) which has many ties to the consolidated companies and their sole shareholder.

As a result of this concern Staff examined fourteen small Missouri utilities which have borrowed debt between 1976 and 1988 to ascertain a more reasonable interest rate to be imputed to the refinanced debt. The results of Staff's study indicate that the average interest rate at which these companies have borrowed money has been two points above the prime interest rate. Staff suggests that an additional half point of interest be added to recognize that the parent company's equity ratio is lower than the average of the 14 companies studied and to

compensate for any commitment fees associated with the refinancing. With the prime interest rate at 10.50 percent at the time of Staff's recommendation, Staff suggests a total imputed rate of 13 percent on the refinancing.

Staff has determined an embedded cost of long-term debt for parent company of 12.26 percent. This is based upon the imputed interest rate of 13 percent for the refinanced debt and the actual rate of 10 percent on the existing loan to parent company from J. C. Nichols.

Company disagrees with Staff that an interest rate needs to be imputed on the refinancing. Company argues that the actual interest rate should be used in calculating Company's embedded cost of long-term debt. Company notes that one of the companies included in Staff's study borrowed money at a rate 4.10 percent above the prime interest rate. Company points out that its refinancing is only 3.75 percent above the prime interest rate used by Staff. Since the Commission approved this financing in 1986 at 4.10 percent above the prime, Company argues that the Commission should accept Company's actual interest rate in determining Company's embedded cost of long-term debt.

The Commission determines that it is reasonable to impute an interest rate for Company's refinancing and that the method employed by Staff in doing so is sound under these circumstances. In this instance the Commission believes it is valid to use the average of interest rates incurred by comparable companies. The actual interest rate for the refinancing is above the average elicited from Staff's study. This, plus the many ties between J. C. Nichols and the Company, lends weight to the concern about the refinancing. Therefore, the Commission will adopt Staff's imputed interest rate of 13 percent for the refinancing and Staff's embedded cost of long-term debt of 12.26 percent.

Company examined the interest rates on various types of debt instruments in determining the return on common equity they suggest. Company's witness, Dunn, consulted the Bank Credit Analyst, Interest Rate Forecast dated March, 1988, to ascertain average interest rates during the first three months of 1988 for 30-year

government bonds, newly issued AAA utility bonds and corporate BAA bonds. The average rate for corporate BAA bonds was 11.25 percent. Dunn, therefore, assumed that the BBB bond rate would be at 11 percent. Since Dunn believes that Company's risks are somewhat higher than a BBB corporate bond, he recommends that Company's return on equity be 11.5 percent on a capital structure reflecting 100 percent common equity. If any debt is added to the capital structure, Dunn recommends a much higher, but unspecified, rate of return. Dunn bases this higher rate of return on his belief that Company could not obtain debt financing for an interest rate of less than 15 to 20 percent.

Staff uses the discounted cash flow analysis (DCF) to arrive at a recommended cost of common equity. The DCF analysis estimates the required return on common equity by dividing the stocks' expected dividend by the stocks' current price to produce a yield which is then added to its expected growth rate.

Since Company's stock is not publicly traded, Staff chose 10 water utilities with publicly traded stock as surrogates for Company in determining the growth rate and yield factors in the formula. Staff's witness, Moore, recommends a rate of growth factor for the DCF formula ranging from 5.8 to 6.8 percent. These growth rates are based on the average historical dividends per share of the 10 companies analyzed. The average for the 5-year periods ending in 1986 and 1987 represents the low end of the growth range while the average for the 10-year periods ending in 1986 and 1987 represents the high end.

To determine the dividend yield portion of the DCF model Staff examined the monthly average dividend yields for each of the 10 surrogate water companies for the period January, 1985 through October, 1988. These dividend yields were calculated by dividing each company's indicated dividend by the average of the high and low stock prices for each month. From this data Staff compiled an overall composite average for the 10 companies for the period January, 1985 through October, 1988.

Staff chose the composite dividend yields of the 10 water utilities for July through October, 1988, to produce a dividend yield range of 6.2 to 6.4 percent.

Staff reasoned that this period reflects the most recent market conditions as well as a stable level following the readjustment to the stock market correction of October, 1987. Staff adjusted its composite yield range to account for expected dividend growth which assumes that the current dividend increase is halfway between the last increase and the next increase. This adjustment resulted in a range of 6.4 to 6.6 percent for the yield factor to be used in the DCF formula.

From a growth rate range of 5.8 to 6.8 percent and a dividend yield range of 6.4 to 6.6 percent, Staff calculated a cost of equity for Company ranging from 12.2 to 13.4 percent. This range, combined with Staff's embedded cost of long-term debt of 12.26 percent, results in Staff's recommended weighted cost of capital of 12.25 to 12.52 percent. Public Counsel supports Staff's recommended rate of return.

The Commission has adopted the DCF model in previous cases as a reasonable method for determining the return on equity for a public utility company. Re: Arkansas Power and Light Company, 28 Mo. P.S.C. (N.S.) 435, 472 (1986). The Commission determines that Staff's application of the DCF model, including use of the 10 surrogate water companies, is reasonable in establishing the appropriate range for this Company's return on equity.

Company takes issue with Staff's return on equity arguing that it should be higher than the cost of debt because, according to established financial theory, equity is riskier than debt. Company also argues that it is subjected to greater risk than the publicly traded companies used by Staff as surrogates in determining Company's appropriate return on equity. Company attributes this greater risk to its relatively smaller size. As an example, Company notes that its sole shareholder, unlike shareholders in larger companies, has had to cosign the debt incurred on Company's behalf.

The Commission is of the opinion that there is some merit to Company's viewpoint on these matters. Therefore, the Commission determines that the upper end of Staff's range for return on common equity is more appropriate in establishing Company's rate of return. Staff having established an embedded cost of long-term

debt of 12.26 percent, the Commission is of the opinion that a return on equity of 12.9 percent is appropriate for Company. This results in a weighted cost of capital for Company of 12.41 percent.

V. Revenue Requirement

The Commission has found that the rate base used for purposes of setting Company's rates in this case should be the original cost rate base agreed to by Staff and Company in the amount of \$1,601,987. Applying the rate of return found reasonable in this case of 12.41 percent results in a return on Company's investment of approximately \$198,807. Combined with expenses of approximately \$586,839, this yields a net operating income requirement of approximately \$785,646. The net income available is \$713,261. Therefore the Commission finds that the Company requires an increase of approximately \$72,385 or 10.2 percent.

VI. Rate Design

There is no issue among the parties as to rate design. The Commission finds that the agreed upon rate design is reasonable and adopts it for purposes of this case.

Conclusions of Law

The Missouri Public Service Commission has arrived at the following conclusions of law.

Company is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 393, RSMo 1986, as amended. Company's tariffs herein were suspended pursuant to authority vested in this Commission by Section 393.150, RSMo 1986, as amended, which places upon Company the burden of proof to show that the proposed increase in rates is just and reasonable.

Pursuant to Section 393.270(4), RSMo 1986, as amended, the Commission may consider all facts which in its judgment have any bearing upon a proper determination of the price to be charged for water service with due regard, among other things, to a reasonable average return upon capital actually expended. This statute confers on the Commission the authority to consider, among other things, the financial structure

of the corporate parent in determining the service rates of the subsidiary. State ex rel. Associated Natural Gas Company v. Public Service Commission of Missouri, 706 S.W.2nd 870 (Mo. App. 1985).

Based upon the revenue requirement found reasonable herein the Commission concludes that Company should be allowed to file revised tariffs designed to increase revenues exclusive of gross receipts and franchise taxes by approximately \$72,385 on an annual basis.

Since the increase in rates found reasonable herein exceeds 7 percent, the Commission will order Company, pursuant to Section 393.275, RSMo 1986, as amended, to file with this Commission a list of the cities and counties imposing a business license tax on Company's gross receipts and an estimate of the annual increase in gross receipts resulting to said cities and counties from this approved revenue increase.

It is, therefore,

ORDERED: 1. That pursuant to the findings and conclusions in this Report and Order the proposed tariffs filed by U.S. Water/Lexington, Missouri, Inc., are disapproved hereby and U.S. Water/Lexington, Missouri, Inc., is authorized to file in lieu thereof, for the approval of this Commission, tariffs designed to increase gross revenues exclusive of gross receipts and franchise taxes by the amount of approximately \$72,385 on an annual basis over the currently effective rates.

ORDERED: 2. That the tariffs authorized herein shall reflect the rate design agreed to by the parties.

ORDERED: 3. That the tariffs to be filed pursuant to this Report and Order shall become effective for service rendered on and after March 22, 1989.

ORDERED: 4. That Late-Filed Exhibit 31 containing the answers of Charles B. Schleicher to the joint questions propounded by the Commission's Staff and the Office of the Public Counsel is received hereby into evidence.

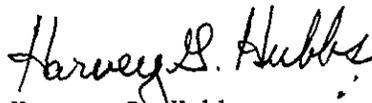
ORDERED: 5. That any objections not heretofore ruled upon are overruled hereby and any outstanding motions are denied hereby.

ORDERED: 6. That U.S. Water/Lexington, Missouri, Inc., is directed hereby pursuant to Section 393.275, RSMo 1986, as amended, to file with this Commission on or before April 10, 1989, a list of the cities and counties which impose a business license tax on its gross receipts and an estimate of the annual increase in gross receipts resulting to said cities and counties from the revenue increase approved herein.

ORDERED: 7. That the Commission's Management Services Staff is directed hereby to investigate the need for a management audit of U.S. Water/Lexington, Missouri, Inc., and to file a report on its investigation with the Commission on or before April 10, 1989.

ORDERED: 8. That this Report and Order shall become effective on the 21st day of March, 1989.

BY THE COMMISSION


Harvey G. Hubbs
Secretary

(S E A L)

Steinmeier, Chm., Hendren and
Fischer, CC., Concur and
certify compliance with the
provisions of Section 536.080,
RSMo 1986.
Mueller, C., Absent.

Dated at Jefferson City, Missouri,
on this 10th day of March, 1989.