

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case Nos. WM-92-138, WF-92-139, WF-92-140, WA-92-141
Osage Water Company

FROM: David Winter *DW*
Utility Services Division

THRU: Sherry Boldt *SB*
Director, Utility Services Division

SUBJECT: Staff's Recommendation In
Case Nos. WM-92-138, WF-92-139, WF-92-140, WA-92-141
Osage Water Company

DATE: July 16, 1992

Reviewed By: *Steve Goldhammer* 7/16/92
Utility Operations Division/Date

Robert J. Hank
General Counsel's Office/Date

RT

FILED

JUL 22 1992

PUBLIC SERVICE COMMISSION

On December 19, 1991, Osage Water Company filed four applications before the Commission. By application in Case No. WA-92-141, Osage Water Company seeks an extension of its current certificate of public convenience and necessity to include an area including part of the City of Osage Beach, Missouri, all of the Village of Sunrise Beach, plus unincorporated portions of Camden and Miller Counties, Missouri, in an area extending from Wilson Bend on the west to Shawnee Bend and Linn Creek Bend on the east. Simultaneous applications in Case Nos. WM-92-138, WF-92-139, and WF-92-140 seek permission for William Patterson Mitchell, an individual, to acquire the stock of Osage Water Company he does not presently own and for permission to issue additional stock. The four (4) cases were consolidated by the Commission in its Order and Notice dated January 10, 1992.

The Application was reviewed by the Accounting, Financial Analysis, and Water and Sewer Departments. Memoranda from the aforementioned Departments are attached hereto. These memoranda include the details of the review and analysis conducted.

Based upon the review of the Applications as amended filed in this proceeding, the Staff recommends approval of the amended Applications subject to several caveats. The Staff advocates that the Commission's Report and Order pertaining to Osage Water Company include the following provisions:

- (1) the current tariffs and rates shall be used for customers in the newly certificated service area;

- (2) Osage Water Company file tariff sheets updating the service area map and the description within twenty (20) days of the effective date of the Commission's order; and
- (3) include language making it clear that approval does not constitute any determination of the ratemaking treatment to be accorded the transactions that will occur as a result of approval of the Application.

attachments

copies:

**Sam Goldammer
Bill Sankpill
William Mitchell**

**Gordon Persinger
Mark Oligschlaeger
Nathan Williams**

**Jay Moore
Internal Accounting
Office of Public Counsel**

92-141

MEMORANDUM

TO: Sherry Boldt
Director - Utility Services Division

FROM: Martin Hummel
Water and Sewer Department *MMH 7/10/92* *[Signature] 7/13/92*

SUBJECT: Water and Sewer Department's Recommendation
Case No. WA-92-141
Osage Water Company

DATE: July 10, 1992

On December 19, 1991, Osage Water Company (OWC), an existing company providing service to a certificated area in Camden County, filed an application to extend its service area in Camden County. This application (Case No. WA-92-141) was filed along with three additional filings (Case Nos. WM-92-138, WF-92-139, and WF-92-140) pertaining to stock issue and financial reorganization. On January 10, 1992, the Commission consolidated the four cases.

After a review of the Application, the Staff requested that OWC reduce the requested service area to that area which OWC can provide service and can show a need for service in the near future. After discussions and study of the specifics of the service areas with the Staff, on July 6, 1992, OWC amended its application to revise the requested service area.

OWC has proposed to use its present tariff and rates for customers in the new area. The Staff is in agreement with this approach, since systems in the proposed service area are similar to OWC's existing system and service. OWC will need to amend its tariff to reflect the additional service area.

I recommend that the Commission take the following action:

1. Grant the addition to OWC's Certificate of Convenience and Necessity as requested in the application as amended;
2. Order the current rates and rules be used;
3. Order OWC to file tariff sheets updating the service area map and the description within twenty (20) days of the effective date of the Commission's Order .

Copies: Director - Utilities Operations Division
Lee Tieman
Tom Imhoff
Mark Caplinger

MEMORANDUM

TO: Sherry Boldt
Director - Utility Services Division

FROM: Tom Imhoff *TMI MLO*
Accounting Department

SUBJECT: Accounting Department's Recommendation
Case No. WA-92-141
Osage Water Company

DATE: May 27, 1992

Osage Water Company (Company) filed an Application for a certificate of public convenience and necessity on December 19, 1991. At this time, the Accounting Staff was notified and subsequently became involved in this docket.

The Accounting Staff requested information from the Company on December 31, 1991. Responses to these data requests were not received by the Accounting Staff until April 17, 1992. The Company filed an amended application on March 3, 1992 as a result of some of the data requests submitted by the Accounting Staff. Additional information was requested by the Accounting Staff on May 7 and 21, 1992. The Company supplied the information on May 8 and 22, 1992, respectively.

The Accounting Staff reviewed the Company's application and subsequent responses to several Staff data requests. The Company has agreed to decrease its requested service area to a size the Staff believes the Company can manage. The Company will utilize its tariffs currently on file for any new customer who comes on the Company's system.

Based on the results of its audit and the Company's verbal agreement concerning its certificated area, the Accounting Staff recommends approval of the Company's Application. The Accounting Staff also notes that by recommending approval of this certificated area, it does not acquiesce to any specific ratemaking treatment applicable to the Company now or in the future.

TMI/sm

cc: Director - Utility Operations Division
Mark Oligschlaeger
Jim Schwieterman
Mark Caplinger
Jim Merciel
Lee Tieman
Martin Hummel

MEMORANDUM

TO: Sherry Boldt, Director, Utility Services Division

FROM: Mark A. Caplinger *MAC*
Financial Analysis Department *gwm*

RE: Staff's Recommendation in the matter of the Osage Water Company to transfer ownership, issue stock, recapitalize, and obtain a certificate of convenience and necessity to operate a water system.

DATE: June 8, 1992

Osage Water Company

In Case Number WM-89-73, the Missouri Public Service Commission (PSC, Commission) issued an order granting to the Osage Water Company (Company, OWC) permission to acquire and operate a water system rendering water service in a portion of Camden County, Missouri. On December 19, 1991, the Company filed a series of applications regarding the sale of existing stock, the issuance of new stock, permission to recapitalize, and to extend its service area. By Order dated January 10, 1992, the Commission moved to consolidate the four cases and set an intervention date of January 31, 1992. The recommendation of the Financial Analysis Department and synopses of the contents of each of the four cases are spelled out in the following sections:

Case No. WM-92-138

The Osage Water Company currently has three shareholders:

William P. Mitchell	50% (25 shares)
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William R. and Martha M. Mitchell	50% (25 shares)
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Applicant states that William R. and Martha M. Mitchell desire not to sign personal guarantees required for OWC to obtain loans. This application is a request by William P. Mitchell to acquire their stock and thereby become the sole shareholder of OWC. William P. Mitchell is experienced in the management of the Company, and this changeover should not be detrimental to the continued successful operations of OWC or to its ratepayers. Staff believes this request is reasonable and recommends approval of this application, Case No. WM-92-138 ("138").

Case No. WF-92-139

This Application is a request by the OWC to issue Class A common stock for retention of the services of an attorney-at-law and the services of an expert in constructing sewer systems. The Company also wishes to issue Class A preferred stock for the acquisition of water and sewer systems, all to improve service. Finally, OWC wishes to issue sixty-two shares of Class B preferred stock to compensate their attorneys for services already rendered. The resolution of the Board of Directors of OWC (attached to the Application) states, " . . . it is in the best interests of Osage Water Company and to its advantage to issue sixty-two (62) shares of Class B preferred stock to the firm of Williams & Williams for legal services rendered to the corporation as shown on the bill presented to the board and attached to these minutes." The bill referenced in this quote is in the amount of \$7,003.00.

Following issuance, the ownership of OWC would be as follows:

CLASS A COMMON

<u>Owner</u>	<u>Shares</u>
William P. Mitchell	50
Gregory D. Williams	50
David L. Hancock	50

CLASS A PREFERRED

<u>Owner</u>	<u>Shares</u>
William P. Mitchell	75
Hurricane Deck Holding Company	51
Hancock Construction Company	30

CLASS B PREFERRED

<u>Owner</u>	<u>Shares</u>
Williams & Williams, P.C.	62

The descriptions of these various classes of stock are contained in the analysis of Case No. WF-92-140 ("140"). In the "140" case the Company requests Commission approval and authority to create these new classes of stock. Prior to the filing of these cases, the Company has only been authorized to issue three thousand (3,000) shares of Class A Common Stock (Old Common) and has fifty (50) shares of Old Common outstanding. Assuming the Commission approves Case No. WM-92-138 ("138"), all fifty shares will be held by William P. Mitchell. The current shareholders of OWC Old Common are listed above in the recommendation for "138".

Both WF-92-139 ("139") and WF-92-140 are closely related, and it is difficult to discuss one case independent of the other. For this reason I will discuss the provisions of each of these classes of stock more completely in the analysis of "140". I will make my recommendation as to the disposition of Case No. WF-92-139 at the end of the following section.

Case No. WF-92-140

The Osage Water Company requests permission to recapitalize through authority to issue the following classes and number of shares of stock:

<u>Class</u>	<u># of Shares</u>	<u>Par Value</u>
Class A Common (New Common)	3,000	\$1.00
Class A Preferred	4,500	\$1,000.00
Class B Preferred	3,000	\$100.00

The Company currently is authorized to issue 3,000 of Class A common stock (Old Common), of which fifty (50) shares are outstanding and would be held by William P. Mitchell (pending approval by the Commission of WM-92-138). Under the plan proposed in "140", this Old Common stock would be exchanged for New Common stock and Class A Preferred stock as follows:

" . . . to issue one share of New Class A common stock plus one and one-half (1.5) shares of Class A preferred stock in exchange for each share of Old Common"
(Application, p.1)

The Class B Preferred would be issued in lieu of cash to satisfy the payment of obligations of the corporation as previously mentioned in "139". The schedules attached to this recommendation show a capital structure analysis of OWC. Schedule 1 contains the Company's capital structure as of December 31, 1991. It clearly shows the Applicant to be highly leveraged, with 96.80% of its total capital in short-term debt. The pro-forma capital structure proposed by OWC (see Schedule 2) indicates that, pending approval of the applications "138", "139", and "140", the capital structure will consist of 95.85% preferred stock. While this particular capital structure is far from what might be considered "normal" for a utility company, I do not believe that it will be detrimental to the operations of the firm or its ratepayers.

The Class A Preferred Stock shall be entitled to cumulative preferred dividends at the rate of eight percent (8%) per annum from and after the date of issuance of same. Owners of Class A Preferred Stock shall have no voting rights unless five consecutive years of Class A Preferred Dividends have not been paid. The Class B Preferred Stock is callable and pays an eight percent (8%) cumulative dividend. Class B Preferred Stock carries no voting rights. The stock will be issued through a private placement. Staff has reviewed the resolution of the directors of the Applicant, the pro-forma financial statements, and capital expenditure schedules.

Preferred stock is a unique form of capital financing. Debt, long or short term, carries a specific interest rate and stated payment schedule. Common stock, in contrast, carries no set return, and receives no predetermined payments. All other investors' claims take precedence before common shareholders receive dividends. Common shareholders stand to receive the most gain, but they also must bear the most risk. Preferred stock is a unique combination, or hybrid, of debt and equity. Preferred stock generally carries a stated rate of interest, or percentage return on the par value of the preferred issue. However, the firm is not obligated to make this interest (or dividend) payment until the creditors of the firm have been satisfied. The preferred dividends must be paid before the common shareholders receive any dividends. If the company is unable to make a preferred dividend payment, the dividends will accumulate until they are paid. There will be no common stock dividends paid until all unpaid cumulative preferred dividends have been satisfied. Preferred shareholders hold no mortgages on the firm, and therefore the firm's leverage risk does not increase due to preferred stock issuances.

The proposed capital structure is far from what might be considered "optimal". However, a significant portion of preferred stock should not increase the risk of financial failure to the firm that would be introduced by the same proportion of debt in the capital structure. The primary problem created by this excessive amount of equity lies in the increased cost of capital to the firm. Preferred stock is more expensive than debt, yet less expensive than common equity. In order to prevent the ratepayers from bearing the burden of this increased capital cost, a hypothetical capital structure should be utilized to determine the appropriate rate of return for OWC during ratemaking proceedings. This procedure should be followed until such time as the Osage Water Company brings its capital structure to a more "normal" capital structure. Industry average capital structures may be considered "normal". Schedule 3, for example, shows the current average capitalization ratios for firms in the water utility industry. The firms listed in Schedule 3 are monitored by the Financial Analysis Department of the Commission and are frequently used as a proxy group for ratemaking purposes. While not common practice in normal ratemaking, it is quite common when dealing with small water and sewer companies to impute a capital structure for cost of capital purposes, and thereby determine a fair and reasonable rate of return for the company's shareholders and customers.

The Financial Analysis Department therefore recommends the approval of Case Nos. WF-92-139 and WF-92-140; it cautions the Commission to note the excessive amounts of preferred stock equity in the Company's proposed capital structure and further notes that it would be appropriate to use an imputed capital structure for ratemaking purposes, until such future time when the OWC capital structure falls more in line with industry standards.

Case No. WA-92-141

In this Application the Company is requesting that the Commission issue a certificate of public convenience and necessity to install, own, acquire, construct, operate, control, manage and maintain a water system for the public in both incorporated and unincorporated areas of Camden and Miller Counties, Missouri. OWC has obtained approval from the two municipalities in the requested area, Osage Beach and Sunrise Beach. Applicant further states that there are no other public utilities or governmental bodies being operated or rendering water service within the area proposed to be served.

The Financial Analysis Department has reviewed the financing applications listed above in "138-140" and believes that the proposed capital structure of the firm will allow it to continue operations and have some financial flexibility in its future operations. The Applicant seems to have developed a feasible business plan, although it is not the place of the Financial Analysis Department to make that determination. The Financial Analysis Department therefore recommends that the Commission approve the application submitted by the OWC in Case No. WA-92-141.

cc: Jay Moore
Mark Oligschlaeger
Tom Imhoff
Bill Sankpill
Martin Hummel
Lee Tieman
Mark Grothoff

OSAGE WATER COMPANY
Case Number WF-92-139
Case Number WF-92-140

Capital Structure
as of December 31, 1991

Capital Component	Dollar Amount	Percentage of Total
Short-term Debt	\$15,133	96.80%
Long-term Debt	0	0.00%
Preferred Stock	0	0.00%
Common Equity	500	3.20%
Total Capital	\$15,633	100.00%

Source: Company Annual Report on file with the Missouri Public Service
Commission, December 31, 1991

OSAGE WATER COMPANY
Case Number WF-92-140
Case Number WF-92-139

Pro-forma
Capital Structure

Capital Component	Dollar Amount	Percentage of Total
Short-term Debt	\$2,500	5.04%
Long-term Debt	1,360	2.74%
Preferred Stock	47,500	95.85%
Common Equity	(1,803)	-3.64%
Total Capital	\$49,557 =====	100.00% =====

OSAGE WATER COMPANY
Case Number WF-92-139
Case Number WF-92-140

List of Water Utility Companies

#	Company Name	Ticker Symbol
1	Aquarion Company (formerly the Hydraulic Company)	WTR
2	California Water Service Company	CWTR
3	Connecticut Water Service, Incorporated	CTWS
4	Consumers Water Company	CONW
5	E'Town Corporation	ETW
6	IWC Resources Corporation	IWCR
7	Middlesex Water Company	MSEX
8	SJW Corporation	SJW
9	Southern California Water Company	SWTR
10	United Water Resources, Incorporated	UWR

Historical Average Long-term Debt Ratios of
Monitored Water Utility Companies

Year	Long-term Debt Ratio
1981	53.28%
1982	54.35%
1983	54.00%
1984	52.65%
1985	52.44%
1986	49.83%
1987	49.51%
1988	51.22%
1989	52.59%
1990	53.89%

Source: Missouri Public Service Commission Water Utility Data Base