

FILED  
September 1, 2023  
Data Center  
Missouri Public  
Service Commission

# Exhibit No. 211

OPC – Exhibit 211  
Murray Surrebuttal  
File No. WR-2023-0006

**Exhibit No.:**

**Issue(s):**

**Witness/Type of Exhibit:**

**Sponsoring Party:**

**Case No.:**

Rate of Return (ROR)/  
Capital Structure

Murray/Surrebuttal

Public Counsel

WR-2023-0006

**SURREBUTTAL TESTIMONY**

**OF**

**DAVID MURRAY**

Submitted on Behalf of the Office of the Public Counsel

**CONFLUENCE RIVERS UTILITY  
OPERATING COMPANY, INC.**

CASE NO. WR-2023-0006

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Denotes Confidential Information that has been redacted

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July 21, 2023

**PUBLIC**

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**SURREBUTTAL TESTIMONY**

**OF**

**DAVID MURRAY**

**CONFLUENCE RIVERS UTILITY OPERATING COMPANY, INC.**

**FILE NO. WR-2023-0006**

1 **Q. Please state your name and business address.**

2 A. My name is David Murray and my business address is P.O. Box 2230, Jefferson City,  
3 Missouri 65102.

4 **Q. Are you the same David Murray who filed direct and rebuttal testimony in this case?**

5 A. Yes.

6 **Q. What is the purpose of your testimony?**

7 A. I will respond to the rebuttal testimonies of Confluence Rivers Utility Operating Company,  
8 Inc.'s ("Confluence" or "Company") witnesses, Dylan W. D'Ascendis and Brent Thies.

9 **Q. Which issues in your direct testimony does Mr. D'Ascendis address in his rebuttal**  
10 **testimony?**

11 A. Mr. D'Ascendis replies to my recommended ratemaking capital structure, my  
12 recommended allowed return on common equity ("ROE"), and my recommended cost of  
13 debt.

14 **Q. Which issues in your direct testimony does Mr. Thies address in his rebuttal**  
15 **testimony?**

16 A. Mr. Thies addresses my consideration and analysis of Confluence's financial covenants in  
17 its loan agreement with CoBank ACB ("CoBank").

1 **BRENT THIES**

2 **Q. Can you briefly summarize Mr. Thies' main disputes relating to your analysis of**  
3 **CoBank's financial covenants for purposes of supporting your recommended**  
4 **ratemaking capital structure?**

5 A. Yes. First, Mr. Thies expresses a broad concern about the reasonableness of setting  
6 Confluence's ratemaking capital structure consistent with the maximum 55% debt ratio  
7 contained in the financial covenants of CoBank's December 5, 2022, Credit Agreement  
8 with Confluence. He reasons that using the maximum debt ratio does not allow  
9 consideration of potential additional acquisitions which increases the risk that Confluence  
10 may violate this covenant. Second, Mr. Thies testifies that I made an error in the amount  
11 of CSWR LLC's overhead I included in calculating Confluence's credit metrics.

12 **Q. Is Mr. Thies' rationale related to not using the maximum debt ratio allowed under**  
13 **CoBank's financial covenant reasonable?**

14 A. No. Mr. Thies testifies that my capital structure recommendation does not consider  
15 Confluence's potential additional acquisitions. According to Mr. Thies, because  
16 Confluence anticipates acquiring additional systems, which are likely to incur net operating  
17 losses ("NOL"), this increases the risk that Confluence may violate its loan covenants.  
18 Apparently Mr. Thies believes Confluence's current ratepayers should fund a capital  
19 structure and ROR that compensates investors for risks incurred related to acquisitions. In  
20 this regard, Mr. Thies and I have a fundamental disagreement about the types of costs that  
21 are recoverable in utility ratemaking. An authorized ROR on utility investments should be  
22 consistent with the business/asset risks related to current systems, not risks incurred  
23 through acquisitions of additional systems. Risks related to potential future acquisitions  
24 should be incurred by Confluence's shareholders, not Confluence's current ratepayers.  
25 Consequently, the debt capacity of the current rehabilitated systems should not be  
26 appropriated to shareholders to help fund future acquisitions. Confluence's current  
27 ratepayers should pay for a capital structure consistent with the risks related to recovery of  
28 costs for investment in their systems.

1 **Q. Has CSWR admitted that some Missouri systems are already subsidizing the losses**  
2 **of not only other Missouri systems, but also losses of other states' systems?**

3 A. Yes. CSWR's 2021 budget presentation to the US Water Systems LLC's ("US Water")  
4 Board of Directors stated the following related to requests for rounds of equity funding:

5 \*\* \_\_\_\_\_  
6 \_\_\_\_\_  
7 \_\_\_\_\_  
8 \_\_\_\_\_  
9 \_\_\_\_\_  
10 \_\_\_\_\_  
11 \_\_\_\_\_  
12 \_\_\_\_\_  
13 \_\_\_\_\_ \*\*1

14 **Q. Which Missouri systems have been providing the most subsidization to CSWR's other**  
15 **utility operating companies ("UOCs")?**

16 A. The systems previously held by Hillcrest Utility Operating Company ("Hillcrest"),  
17 Raccoon Creek Utility Operating Company ("Raccoon Creek"), and Indian Hills Utility  
18 Operating Company ("Indian Hills").

19 **Q. Was the ROR set too high on these systems?**

20 A. Yes.

21 **Q. Based on Staff's most recent accounting schedules filed with their rebuttal testimony,**  
22 **what were the earned ROEs for these companies?**

23 A. 34.26% for Hillcrest, 35.09% for Raccoon Creek and 12.79% for Indian Hills.

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<sup>1</sup> CSWR 2021 Budget Presentation to US Water Systems Board of Directors, p. 18.

1 **Q. Are there other systems that are overearning based on Staff's most recent accounting**  
2 **schedules?**

3 A. Yes. The other two legacy companies that have undergone rate increases, Elm Hills Utility  
4 Operating Company<sup>2</sup> and Confluence Rivers Utility Operating Company<sup>3</sup> (systems prior  
5 to the merger and subsequent directly-acquired systems).

6 **Q. What were the earned ROEs for these systems based on Staff's accounting schedules?**

7 A. 11.71% for Elm Hills and 14.51% for Confluence.

8 **Q. What error did Mr. Thies claim you made in your calculation of Confluence's**  
9 **financial ratios consistent with CoBank's financial covenants?**

10 A. Mr. Thies testifies that I erroneously concluded that the total amount of Confluence's  
11 *General and Administrative* ("G&A") expense for 2022 (\$2,405,003) consisted of CSWR  
12 overhead. He indicates that \$1,002,978 of G&A is related to CSWR overhead.

13 **Q. Was this amount discernable from Confluence's financial statements provided to you**  
14 **in response to OPC DR No. 3018?**

15 A. No.

16 **Q. Is this more detailed information specifically identified in Confluence's 2022 Annual**  
17 **Report filed with the Missouri Public Service Commission ("2022 Annual Report")?**

18 A. No. Although not specifically identified in Confluence's 2022 Annual Report, it appears  
19 that Confluence reported CSWR overhead under line 21, "Other Expenses," in its 2022  
20 Annual Report. The total of "Other Expenses" for Confluence's water and sewer income  
21 statements is \$1,122,762 (\$509,038 – water and \$613,724 – sewer).

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<sup>2</sup> Case Nos. WR-2020-0275 and SR-2020-0274.

<sup>3</sup> Case Nos. WR-2020-0053 and SR-2020-0054.

1 **Q. What information did Mr. Thies rely on to identify the CSWR overhead allocated to**  
2 **Confluence?**

3 A. He relied on Confluence's general ledger, which is not generally available to the public.

4 **Q. Does CoBank need this financial data to determine whether Confluence complies with**  
5 **the financial covenants set out in the December 5, 2022, Credit Agreement?**

6 A. Yes.

7 **Q. Did Confluence, or any of its affiliates, provide this detail to CoBank for purposes of**  
8 **setting the financial covenants?**

9 A. If they did, it was not included in the correspondence Confluence provided in response to  
10 Staff Data Request No. 17 in Case No. WF-2023-0023 nor OPC Data Request No. 3002 in  
11 context of this rate case.

12 **Q. Mr. Thies testifies that adjusting Confluence's EBITDA (earnings before interest,**  
13 **taxes, depreciation and amortization) for the corrected amount of CSWR overhead**  
14 **would only allow for \$5,840,028 of debt based on Confluence's 2022 financial results.**  
15 **Does this make sense in light of the fact that CoBank loaned Confluence \$7 million?**

16 A. No.

17 **Q. Did Confluence provide supporting financial analysis to demonstrate the maximum**  
18 **amount of debt CoBank was willing to loan to Confluence?**

19 A. No. In response to OPC DR No. 3013.1 (attached as Schedule DM-S-1), Confluence  
20 indicated that "...it was determined that under current (trailing) conditions, the Company  
21 could support up to \$7mm of debt and meet the lender's requirements." However,  
22 Confluence did not provide its or CoBank's financial analysis to determine the maximum  
23 amount of debt CoBank may have been willing to loan Confluence. As indicated in the  
24 attached email communication between Marty Moore and Bryan Ervin (Schedule DM-S-  
25 2), this was a matter of inquiry. According to Confluence, no written correspondence or



1 analysis was exchanged subsequent to CoBank’s inquiry as to Confluence’s current and  
2 projected cash flows. Mr. Moore verbally communicated to CoBank that Confluence  
3 Rivers needed a “successful rate case in order to provide adequate cash flow to service the  
4 debt that was being discussed” (see Schedule DM-S-3).

5 **Q. Was CSWR ordered to involve the OPC and Staff in its interactions with CoBank or  
6 other possible lenders when pursuing debt financing?**

7 A. Yes. This was ordered in the Elm Hills rate case as part of Condition 11. in the December  
8 14, 2020, Non-Unanimous Disposition Agreement Regarding Disposition of Small Utility  
9 Company Revenue Increase Request. This condition stated in part as follows:

10 From the effective date of any order issued by the Public Service  
11 Commission approving this disposition agreement until Elm Hills’  
12 next request for a rate increase/decrease, Elm Hills will involve  
13 Public Counsel (and Staff, to the extent it wants to be involved) in  
14 financing discussions with prospective lenders, such as CoBank, in  
15 an effort to enhance the chances of obtaining lower-cost debt  
16 financing for purpose of funding CSWR, LLC’s past, current, and  
17 future investments in its Missouri subsidiaries.

18 **Q. Did CSWR include OPC in its conversations/interactions with CoBank?**

19 A. No.

20 **Q. Would doing so have allowed for transparency and understanding as to the  
21 methodology/process CoBank and Confluence underwent in determining the amount  
22 of debt Confluence borrowed as compared to its borrowing potential?**

23 A. Yes.

1 **Q. How much debt could Hillcrest, Raccoon Creek and Indian Hills support on their**  
2 **own if they weren't subsidizing Confluence's other systems' NOLs?<sup>4</sup>**

3 A. Applying CoBank's 6x EBITDA to Hillcrest's 2021 EBITDA of \$224,265 (without adding  
4 back CSWR overhead allocated to Hillcrest) suggests Hillcrest could issue up to  
5 \$1,345,591 of debt, which is 117.15% of Hillcrest's net plant in service. Applying  
6 CoBank's 6x EBITDA to Raccoon Creek's 2021 EBITDA of \$258,207 would allow  
7 Raccoon Creek to issue up to \$1,549,243 of debt, which is 103.39% of Raccoon Creek's  
8 net plant in service. Applying CoBank's 6x EBITDA to Indian Hill's 2021 EBITDA of  
9 \$276,484 would allow \$1,658,904 of debt, which is 82.04% of Indian Hill's net plant in  
10 service. In aggregate, Hillcrest, Raccoon Creek and Indian Hills 2021 EBITDAs could  
11 support approximately \$4.5 million of debt.

12 **Q. If you followed Mr. Thies' approach for determining capital structure (subtracting**  
13 **debt from rate base), what percentage of common equity is implied after consolidating**  
14 **Hillcrest's, Raccoon Creek's and Indian Hill's current rate bases?**

15 A. Based on Staff's rate base recommendations for these three legacy companies, the total rate  
16 base is \$4,135,882. Therefore, the current rate levels for these three companies could  
17 support over 100% debt capitalization.

18 **Q. If you netted CSWR overhead from EBITDA, how much additional debt would these**  
19 **legacy companies' 2021 cash flows support?**

20 A. Approximately \$1.7 million in additional debt or \$6.26 million total. Consequently, the  
21 NOLs of Confluence's recently acquired systems reduces the debt capacity of the  
22 rehabilitated systems that have been charging their customers significantly higher rates  
23 over the last several years.

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<sup>4</sup> According to Staff's June 2023 Accounting Schedules, the following systems are currently operating at losses: Branson Cedars, Cedar Green, Clemstone, Deer Run, Glen Meadows, Missing Well, Osage Utilities, Port Perry, Prairie Heights, Spring Branch, and Terre Du Lac

1 **Q. Would your lower ROR recommendation result in lower EBITDA levels for these**  
2 **three legacy companies?**

3 A. Yes. My ROR recommendation compared to those previously authorized for these legacy  
4 companies reduces the revenue requirement for each legacy company as follows: Hillcrest  
5 - \$64,047, Raccoon Creek - \$81,438 and Indian Hills - \$65,545.

6 **Q. Are there any additional legacy companies that have received rate increases which**  
7 **contribute to Confluence's debt capacity based on existing cash flows?**

8 A Yes. Confluence Rivers Utility Operating Company (before the merger with its sister  
9 subsidiaries) was granted rate relief in Case Nos. WR-2020-0053 and SR-2020-0054. Elm  
10 Hills Utility Operating Company was granted rate relief in Case No. WR-2020-0275 and  
11 SR-2020-0274.

12 **Q. Is it equitable for ratepayers of these legacy companies to subsidize CSWR's**  
13 **acquisition of other troubled systems operating at NOLs?**

14 A. No. This risk should be borne by CSWR's equity investors. As demonstrated by Sciens  
15 Capital's willingness to pay CSWR's previous investors over \*\* \_\_\_\_\_  
16 \_\_\_\_\_ \*\* in assets at  
17 December 31, 2018 is attributable to the excess of Sciens' purchase price over the book  
18 value of investments made by CSWR's prior investors), capital invested in CSWR has been  
19 handsomely rewarded.

20 **Q. Are you suggesting retroactive ratemaking as it relates to the legacy companies?**

21 A. No. I am simply emphasizing the fact that customers of the systems owned by these  
22 companies paid a higher than necessary ROR over the last several years. If the Commission  
23 adopts my recommended ROR for all of Confluence's current systems, then this is fair and  
24 reasonable for the customers of these systems. However, if the Commission were to  
25 consider Confluence's recommended equity-rich capital structure and high ROE, then I  
26 recommend the Commission only apply such higher costs of capital to Confluence's  
27 systems that have yet to have rates adjusted.

1 **Q. To be clear, what is your recommendation?**

2 A. I still recommend all of Confluence's systems' revenue requirements be set based on the  
3 ROR I recommended in my direct testimony. However, if the Commission is persuaded  
4 that the risks of the recently acquired systems increases Confluence's overall risk profile,  
5 then a more leveraged capital structure should be used to set the authorized ROR for  
6 stabilized systems and a less leveraged capital structure should be used to set the authorized  
7 ROR for the new systems. This approach is consistent with CSWR's own logic to its  
8 investors that it will need to call equity capital to fund newly acquired systems until rates  
9 are reset to allow operating profits.

10 **Q. Will the rates authorized in this case impact the credit metrics and debt capacity for**  
11 **all of the systems subject to this rate case?**

12 A. Yes. This is especially true for the newly-acquired systems that have yet to have their rates  
13 adjusted subsequent to CSWR's acquisition and investment. Therefore, the past financial  
14 performance of these systems is irrelevant to their *pro forma* credit risk. Creditors, such  
15 as CoBank, are more concerned about *pro forma* estimates, post rate increases, rather than  
16 historical financial performance for systems that have been neglected. CoBank would  
17 likely place much more weight on the historical experience of the legacy companies, such  
18 as Hillcrest, Raccoon Creek and Indian Hills, which have several years of financial  
19 experience post-rehabilitation and rate increases.

20 **Q. Can you provide *pro forma* estimates of the impact of the Company's, Staff's and**  
21 **OPC's recommended revenue requirements on Confluence's projected credit**  
22 **metrics?**

23 A. Yes. My analysis is shown on Schedule DM-S-4. Confluence's recommended revenue  
24 requirement as compared to the debt ratio assumed in its recommended ROR implies a  
25 'Modest' amount of financial risk (consistent with at least an 'A' S&P credit rating).  
26 Confluence's Debt/EBITDA ratio would be 1/3 of the maximum allowed pursuant to  
27 Confluence's financial covenant (*i.e.* assuming Confluence did not acquire additional  
28 troubled systems, Confluence could **triple** the amount of debt in its capital structure post

1 rate adjustment). Staff's recommended revenue requirement implies a 'Significant'  
2 amount of financial risk (consistent with at least a 'BBB' S&P credit rating). Confluence's  
3 Debt/EBITDA ratio would be approximately 3.5x. OPC's recommended revenue  
4 requirement would also imply a 'Significant' amount of financial risk (consistent with a  
5 'BBB' S&P credit rating), but at the lower-end (more financial risk) of the 'Significant'  
6 category as compared to Staff's recommended revenue requirement. Under OPC's  
7 scenario, Confluence's Debt/EBITDA would be approximately 4.0x or 2/3 of the  
8 maximum allowed pursuant to Confluence's financial covenant.

9 **Q. Would issuing more debt at the utility operating company level impact the returns to**  
10 **US Water, and ultimately the private equity investors investing capital with Sciens**  
11 **Water Opportunities Fund?**

12 A. Yes, but only if such debt is reflected in the company's revenue requirement, which  
13 normally lowers the revenue requirement. As I discussed in my rebuttal testimony,  
14 apparently US Water must approve debt issuances at the utility operating company level.  
15 Because cash flows to US Water may be reduced if more debt is reflected in a utility  
16 operating company's ratemaking capital structure, US Water is unlikely to approve the  
17 most efficient amount of debt in the utility operating company's capital structure from a  
18 ratepayers' perspective (lower cost of capital and therefore, a lower ROR charged to  
19 ratepayers).

20 **DYLAN W. D'ASCENDIS**

21 **Q. What are Mr. D'Ascendis' major criticisms related to your recommended ROR?**

22 A. It appears Mr. D'Ascendis believes the principles specified in the *Hope* and *Bluefield*  
23 Supreme Court decisions require the authorized ROE to be set equal to the "investor-  
24 required ROE" (*i.e.* the cost of equity). Therefore, it is his opinion that unless my ROE  
25 recommendation is supported by an analysis that indicates the COE is at parity with my  
26 ROE recommendation, my ROR recommendation is not supported by my analysis. Mr.  
27 D'Ascendis also criticizes the fact that I did not consider recommending an ROE above  
28 recent average authorized ROEs as it relates to my testimony discussing the Commission's

1 general zone of reasonableness of +/- 100 basis points around recent average authorized  
2 ROEs in other jurisdictions.

3 Mr. D'Ascendis criticizes my recommended capital structure because it is based on the  
4 maximum debt ratio CoBank allows pursuant to the December 5, 2022 Credit Agreement.  
5 Similar to Mr. Thies' testimony, he explains that if Confluence targeted a capital structure  
6 with 55% long-term debt, this would not allow for a margin of error if Confluence acquires  
7 systems generating NOLs.

8 Mr. D'Ascendis also disagrees with my recommended cost of debt because it considers  
9 anticipated patronage credit. Mr. D'Ascendis testifies that because this credit \*\* \_\_\_\_  
10 \_\_\_\_\_ \*\* offsetting the cost of debt with the patronage credit would increase the  
11 perceived risk of the Company. As I will explain, the patronage credit has a significant  
12 impact on Confluence's effective cost of debt. It is disturbing that Confluence resists  
13 recognizing a credit that CoBank has always paid to other borrowers.

14 **Q. Does Mr. D'Ascendis' criticisms of your recommended capital structure further**  
15 **demonstrate the fundamental disagreement between you and Confluence as it relates**  
16 **to setting a fair and reasonable ROR in this case?**

17 A. Yes. If a company desires to pursue additional value for its investors by acquiring  
18 additional troubled systems in which to invest, the risk of this strategy should be placed  
19 squarely on investors, not subsidized by ratepayers of current systems. The debt capacity  
20 associated with the current systems is clearly defined in CoBank's financial covenants,  
21 which allows for up to 55% debt in Confluence's capital structure. The ratepayers of  
22 Confluence's current systems are not responsible for subsidizing capital needs related to  
23 CSWR's desire to grow through acquisitions and subsequent investment in other systems.  
24 As argued by CSWR itself, equity funds should finance operating losses related to newly  
25 acquired systems. Additionally, a typical financing strategy related to construction of  
26 improvements is to initially fund such capital expenditures with bank/debt funds through a  
27 line of credit and/or revolving credit facility. It is noteworthy that this was consistent with  
28 CSWR's initial financing strategy when its debt financing affiliate, Fresh Start, advanced

1 capital at a 14% interest rate. Subsequent to construction and implementation of new rates,  
2 ratepayers receiving service from the rehabilitated system should only be funding a cost of  
3 capital consistent with the risk of the cash flows they provide through the rates they are  
4 charged. As demonstrated by CSWR Missouri's legacy subsidiaries' financial  
5 performance, this risk is very low.

6 **Q. Did CoBank communicate to Marty Moore, Chief Financial Officer and Treasurer of**  
7 **CSWR, how much debt it was willing to lend to Confluence?**

8 A. Not directly. As I mentioned in responding to Mr. Thies' rebuttal testimony, CoBank  
9 communicated it would lend an amount consistent with the lender's requirements.

10 **Q. Are the systems subject to this rate case likely to generate NOLs as speculated by Mr.**  
11 **D'Ascendis and Mr. Thies?**

12 A. No. While no two utility systems are exactly alike, based on the financial experience of  
13 Confluence's legacy systems, after rates are increased to reflect the new investment, the  
14 risk of these systems incurring losses is very low.

15 **Q. What type of loan did CoBank execute with Confluence?**

16 A. An amortizing loan similar to that of a mortgage loan on a home.

17 **Q. Why is it important to recognize the type of loan?**

18 A. Because payments on an amortizing loan include not only interest, but also principal. The  
19 amount of the payment related to principal gradually reduces the loan balance over time.  
20 Therefore, the percentage of debt in Confluence's capital structure would likely decline as  
21 the loan amortizes. This typically causes borrowers to seek out the maximum amount of  
22 debt they can borrow at the inception of the loan.

1 **Q. Why does Mr. D’Ascendis disagree with your recommended cost of debt?**

2 A. He disagrees with my consideration of the patronage credit CoBank provides to borrowers.  
3 He claims that because the \*\* \_\_\_\_\_ \*\* that it is inappropriate  
4 to consider this credit in determining the effective cost of debt.

5 **Q. Is the patronage credit associated with CoBank’s loan to Confluence known and**  
6 **measurable?**

7 A. Yes. CoBank indicated that it is \*\* \_\_\_\_\_  
8 \_\_\_\_\_ \*\*

9 **Q. Is the patronage credit material?**

10 A. Yes. Despite Confluence’s position that the patronage credit would not be material,<sup>6</sup> the  
11 net impact on Confluence’s cost of debt is 42 basis points.

12 **Q. \*\* \_\_\_\_\_**

13 A. \_\_\_\_\_ \*\*

14 **Q. If the Commission does not factor the patronage credit into the cost of debt, should**  
15 **ratepayers receive specific consideration for this credit in future rate cases?**

16 A. Yes. At the very least, the Commission should require this amount to be tracked on a  
17 cumulative basis, with carrying costs based on the 6.6% interest rate. The balance of  
18 accumulated patronage credits should be applied as a rate base offset in future rate cases  
19 or as a direct offset to the allowed ROR.

<sup>5</sup> Murray Direct, Schedule DM-D-9, p. 2.

<sup>6</sup> *Id.*, p. 1.



1 **Q. Mr. D’Ascendis testifies that Confluence is saving its customers \$518,000 annually**  
2 **because it refinanced the 14% Fresh Start debt.<sup>7</sup> Should Confluence’s action in this**  
3 **regard be praised?**

4 A. Absolutely not. The 14% Fresh Start contract was a result of self-dealing of the same  
5 equity investors in CSWR and Fresh Start. At the time of the execution of the Fresh Start  
6 contracts, the only party subordinated by the affiliate finance agreement was Josiah Cox.  
7 Now, Mr. Cox and other officers of CSWR own membership interests (*i.e.* equity) in U.S.  
8 Water which owns both CSWR and Fresh Start. At least since Sciens acquired CSWR in  
9 November 2018, no party’s financial interest has been subordinated by the Fresh Start  
10 contract. The Fresh Start finance contracts could have been eliminated at least as soon as  
11 Sciens completed its acquisition of CSWR and Fresh Start. However, because the previous  
12 owners of CSWR and Fresh Start were also the same investors, these contracts could have  
13 been eliminated before Sciens purchased the companies.

14 **Q. Mr. D’Ascendis testifies that he disagrees with your opinion that the utility industry’s**  
15 **COE is consistently lower than authorized ROEs.<sup>8</sup> What is the basis for his**  
16 **disagreement?**

17 A. Mr. D’Ascendis cites the *Hope* and *Bluefield* US Supreme Court decisions as support for  
18 his view that “the ROE equals the investor-required ROE [*i.e.* the cost of equity] which  
19 equals the allowed ROE.” He indicates that this relationship holds because utility  
20 regulation “...acts as a substitute for competition.”

21 **Q. Do the decisions in the *Hope* and *Bluefield* cases define a fair ROE as equivalent to**  
22 **the COE?**

23 A. No. In fact, at the time these decisions were made (1923 for *Bluefield* and 1943 for *Hope*),  
24 the modern capital market methodologies, principally the DCF method (more specifically  
25 and accurately defined as the Gordon Growth Model) and the Capital Asset Pricing Model  
26 (“CAPM”), used to estimate the COE had not been developed. Therefore, the US Supreme

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<sup>7</sup> D’Ascendis Rebuttal, p. 48, lines 14-19.

<sup>8</sup> D’Ascendis Rebuttal, p. 43, lines 18-23.

1 Court could not have possibly reconciled a fair authorized ROE as being specifically  
2 premised on an estimate of the COE.

3 **Q. If that’s the case, then what basis was used to determine if an authorized ROR was**  
4 **fair and reasonable during this period?**

5 A. As it relates to the *Bluefield* case, the main principles, as outlined in *The Cost of Capital –*  
6 *A Practitioner’s Guide* by David C. Parcell,<sup>9</sup> for a fair return were as follows:

- 7 1. Comparable earnings – a utility is entitled to a return similar to that being earned  
8 by other enterprises with similar risks, but not as high as those earned by highly  
9 profitable or speculative ventures;
- 10 2. Financial integrity – a utility is entitled to a return level reasonably sufficient to  
11 assure financial soundness;
- 12 3. Capital attraction – a utility is entitled to a return sufficient to support its credit  
13 and raise capital; and
- 14 4. Changing level of returns – a fair return can change along with economic  
15 conditions and capital markets.

16 The first principle measures a fair rate of return based on whether the return is consistent  
17 with those *earned* by other enterprises with similar risk. This principle does not state that  
18 the fairness of the rate of return is measured against the required rate of return (*i.e.* the cost  
19 of capital and more specifically the cost of equity). The second principle does not specify  
20 that authorizing an ROE consistent with the COE ensures financial soundness. In fact,  
21 creditors usually analyze aggregate cash flows, which typically includes consideration for  
22 non-cash tax expense (deferred income taxes), depreciation, net income and other non-cash  
23 expenses. The third principle, capital attraction, is somewhat redundant of the second  
24 principle because “supporting credit” is similar to ensuring “financial soundness.”  
25 However, the third principle also indicates a return should be set high enough to allow the  
26 company to attract capital. This principle, although not explicitly stated, has some  
27 similarity to COE principles. Economic theory dictates that a company cannot raise  
28 additional equity capital unless, at a minimum, it earns at least its COE. However, if a

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<sup>9</sup> David C. Parcell, “*The Cost of Capital – A Practitioner’s Guide*,” 2020 Edition, p. 26.

1 company earns a return equivalent to its cost of capital, its investments will not create  
2 additional shareholder value over the initial book value of the investment. Therefore, if a  
3 ROR is set higher than the cost of capital, this typically causes the market value of the  
4 invested capital to exceed the principal amount invested. The fourth principle simply states  
5 that a fair return can change with conditions, but does not indicate that a fair return is based  
6 on the cost of capital.

7 As it relates to the *Hope* case, the US Supreme Court also hinted at the cost of capital  
8 concept without specifically identifying an approach to estimate the COE. In the *Hope*  
9 case the Court reiterated *Bluefield's* standards of a fair ROR based on comparable earnings,  
10 financial integrity, and capital attraction. The key language consistent with the economic  
11 theory that a company should not invest unless it earns at least its cost of capital was as  
12 follows:

13 From the investor or company point of view it is important that there be  
14 enough revenue not only for operating expenses but also for the **capital**  
15 **costs of the business**. These include **service on the debt and dividends**  
16 **on the stock**. By that standard the return to the equity owner should be  
17 commensurate with returns on investments in other enterprises having  
18 corresponding risks. That return, moreover, should be sufficient to assure  
19 confidence in the financial integrity of the enterprise, so as to maintain  
20 credit and to attract capital. The conditions under which more or less might  
21 be allowed are not important here. (emphasis added)

22 As is clear from the language, the US Supreme Court introduces its fair ROR standard by  
23 explaining that it should be sufficient to cover capital costs, which it identifies as debt  
24 service and stock dividends. The Court, then explains that to meet this standard the return  
25 should be similar to the returns of other similar-risk enterprises and sufficient to assure  
26 financial integrity/soundness so as to maintain credit and attract capital.

27 Therefore, while the Court indicates that a ROR commensurate with capital costs would  
28 be fair and reasonable, it indicates a primary barometer to measure whether the return is  
29 sufficient to do so is to compare it to earned returns of other enterprises.

1 **Q. Do the standards communicated by the US Supreme Court through these decisions**  
2 **explicitly state that the authorized ROR must be equivalent to the cost of capital in**  
3 **order to be constitutionally reasonable for the ratepayer?**

4 A. No.

5 **Q. Are there situations in which commissions knowingly set the authorized ROR higher**  
6 **than the cost of capital?**

7 A. Yes. The Federal Energy Regulatory Commission (“FERC”) has consistently applied  
8 incremental adjustments above a base ROE for interstate transmission assets. These  
9 adjustment are not risk-based, but rather incentive-based, such as the FERC’s 50 basis point  
10 “adder” if a transmission company is a member of a regional transmission organization.<sup>10</sup>  
11 To my knowledge, in these circumstances, setting the authorized ROR based on  
12 considerations other than the cost of capital has not been found unconstitutional.

13 **Q. Why are you confident that the general level of authorized ROEs are higher than**  
14 **utility companies’ COE?**

15 A. Because participants in the investment community freely admit such in their published  
16 research. I have frequently and consistently provided examples of equity analysts using a  
17 COE in the 6% range to estimate a fair value for water utility stocks. For example, in the  
18 last two Missouri American Water Company rate cases, I provided examples from Wells  
19 Fargo, Evercore ISI, U.S. Capital Advisors, HSBC Global Markets, and Morningstar.  
20 However, these analysts’ do not expect commissions to lower utilities’ authorized ROEs  
21 to be at parity with their COE. If they communicate any expectations as it relates to the  
22 relationship between the COE and authorized ROEs, it may be related to an expected  
23 spread between authorized ROEs and the utility industry’s COE.<sup>11</sup>

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<sup>10</sup> Jim O’Reilly, “Proposed FERC revisions to transmission ROE incentives await final resolutions,” S&P Global Market Intelligence, July 5, 2023.

<sup>11</sup> Murray Direct Testimony, p. 35; Case No. WR-2020-0344, Murray Direct Testimony, p. 16, ln. 9 – p. 18, ln. 2; Case No. WR-2022-0303, Murray Direct Testimony, p. 19, l. 3 – p. 20, l. 12, p. 27, lns. 7-8, p. 28, lns. 9-23; *Id.* Murray Surrebuttal, p. 23, lns. 1-17

1 **Q. Can you provide some specific excerpts from any of the aforementioned firms’**  
2 **research that demonstrate that they use a COE that is lower than typical average**  
3 **authorized ROEs?**

4 A. Yes. Evercore ISI consistently provides the following commentary related to various  
5 projected scenarios for the utility industry:

6 Our historical base case (“case 1”) assumed an orderly transition to higher  
7 interest rates, with authorized ROEs falling to 9.25% from 9.75%, and 10-  
8 year Treasury yields rising over the next several years, resulting at the end  
9 in a **2.50%** spread between the return on equity and the calculated cost of  
10 equity (emphasis in original).<sup>12</sup>

11 Morningstar stated its view about the spread more generally as follows:

12 Morningstar currently rates American Water as 2 out of 5 stars and that its  
13 stock price is overvalued, but Morningstar states it is confident that  
14 American Water’s “**returns on invested capital will remain at a healthy**  
15 **spread over its cost of capital for the foreseeable future**” (emphasis  
16 added)<sup>13</sup>

17 Wells Fargo identifies the 6.5% COE it uses to estimate the value of American Water  
18 Works Company Inc.’s stock price in the following commentary:

19 Our \$156/sh [share] price target is based on a blend of (1) a P/E multiple  
20 analysis (~\$156/sh) – apply a 0-5% discount to the ’23 median P/E multiple  
21 of our covered pure play water utilities of 31.0-31.5x to our 24E EPS of  
22 \$5.13 and (2) a DDM [dividend discount model or DCF in utility regulatory  
23 terminology] analysis (~\$155/sh), which assumes a **6.5% discount rate**  
24 **[cost of equity]** (emphasis added).<sup>14</sup>

---

<sup>12</sup> Dugesh Chopra, Michael Lonagan and Sharon Wang, “How it’s Divvied Up – A Look at June Sector Allocation Survey Results,” Evercore ISI, June 25, 2023, p. 8.

<sup>13</sup> Andrew Bischof, “American Water’s Regulated Water Growth Should Top Most Electric Utilities,” Morningstar Investor, November 8, 2022.

<sup>14</sup> Jonathan Reeder and Neil Kalton, CFA, “AWK: EPS Outlook Updated Following Q1’23 Report; Muni M&A Momentum Continues,” Wells Fargo, April 27, 2023, p. 4.

1 **Q. What purpose did your COE analysis serve in determining your recommendation in**  
2 **this case?**

3 A. I used it to determine the floor of a potential authorized ROE in this case. The Commission  
4 has repeatedly articulated its view in its Report and Orders that in order to comply with  
5 *Hope* and *Bluefield* principles, it must consider average authorized ROEs in setting a fair  
6 and reasonable ROE. Therefore, I also consider such benchmarks in arriving at my  
7 recommended authorized ROE range.

8 **Q. What has the Commission generally considered as a reasonable range for an**  
9 **authorized ROE?**

10 A. An ROE within the range of 100 basis points above and below a recent average authorized  
11 ROE. In my direct testimony I testified that this range is 8.6% to 10.6% based on recent  
12 average authorized ROEs or around 9.6%.<sup>15</sup>

13 **Q. Has the Commission previously dismissed consideration of a ROR witnesses'**  
14 **testimony if his/her recommendation fell outside the Commission's zone of**  
15 **reasonableness?**

16 A. Yes. The Commission has dismissed consideration of ROR witness' recommendations if  
17 his/her recommendation fell outside the Commission's identified zone of reasonableness.<sup>16</sup>

18 **Q. If this Commission follows past Missouri Commissions' approaches, would the**  
19 **Commission dismiss Mr. D'Ascendis' recommended ROE?**

20 A. Yes. His 11.35% ROE recommendation is well above the 10.6% high-end of the  
21 Commission's past quantifications of the zone of reasonableness. If the Commission  
22 adopts my recommended capital structure, Mr. D'Ascendis' downward adjustment of 51  
23 basis points would no longer be relevant, causing his estimate of a reasonable ROE to be

---

<sup>15</sup> Murray Direct Testimony, p. 22, lns. 1-17.

<sup>16</sup> Case Nos. GR-2004-0209 and ER-2008-0318, but not an exhaustive list.

1 11.86%. This ROE is even further outside the Commission's general zone of  
2 reasonableness.

3 **Q. Does Mr. D'Ascendis' belief that authorized ROEs are consistent with the COE cause**  
4 **him to make inappropriate conclusions?**

5 A. Yes. Mr. D'Ascendis concludes that because my COE estimates of 6.25% to 6.75% for  
6 the water utility industry are well below average authorized ROEs, my COE estimates  
7 cannot be reliable.

8 **Q. What are more appropriate benchmarks for assessing whether your COE estimates**  
9 **are accurate and reliable?**

10 A. COE estimates used by investors to value utility stocks. Other than during the financial  
11 crisis in 2008 to 2009, I have yet to discover practical investment analysis that determines  
12 the value of utility stock based on a cost of equity consistent with average authorized ROEs.

13 **Q. What is Mr. D'Ascendis' primary criticism of your multi-stage DCF analysis?**

14 A. My perpetual growth rate assumption, which is no higher than projected long-term CAGR  
15 for GDP in the United States.

16 **Q. What is Mr. D'Ascendis basis for rejecting the assumption that a perpetual growth**  
17 **rate is not restrained by GDP?**

18 A. First, Mr. D'Ascendis testifies that "it is well established in the financial literature that  
19 projected growth in EPS is the superior measure of dividend growth in a DCF model."<sup>17</sup>  
20 Second, Mr. D'Ascendis claims that because GDP is the "sum of all private industry and  
21 government output in the United States, and its growth rate is simply an average of the  
22 value of those industries," it is not industry-specific. He then provides GDP data from  
23 1947 to 2022 to illustrate that some industries, including utilities, have grown faster than  
24 GDP over this period, which he then concludes disproves the assumption that projected

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<sup>17</sup> D'Ascendis Rebuttal, p. 23, lines 4-7.

1 long-term sustainable GDP growth is an upper constraint for perpetual growth in a DCF  
2 analysis.

3 **Q. Mr. D’Ascendis testifies that it is “well established in the financial literature that**  
4 **projected growth in EPS is the superior measure of dividend growth in a DCF**  
5 **model.”<sup>18</sup> Does he specify the duration of the projected EPS growth as it relates to**  
6 **his conclusion?**

7 A. No.

8 **Q. As it relates to his own DCF analysis, what is the duration of the projected CAGR in**  
9 **EPS Mr. D’Ascendis uses as a proxy for constant/perpetual growth (the constant**  
10 **growth rate in his single-stage DCF analysis)?**

11 A. Approximately 3-to-5-years.

12 **Q. Is he correct that it is “well established” in the financial literature that these growth**  
13 **rates are superior for purposes of performing a DCF analysis?**

14 A. No. As I discuss below, the foundational study regarding the influence of equity analysts  
15 on stock prices established that equity analysts’ projections and stock recommendations  
16 influence stock prices more than historical growth rates, not that investors use equity  
17 analysts’ projected CAGR in EPS as a constant growth rate when performing a DCF  
18 analysis.

19 **Q. What foundational study is used to support the proposition that investors use equity**  
20 **analysts’ EPS CAGR estimates as a proxy for constant-growth in DPS?**

21 A. The foundational study cited to support the use of equity analysts’ consensus projected 5-  
22 year CAGRs in EPS as a proxy for perpetual dividend growth (*i.e.* constant growth) in the  
23 DCF is that of Burton G. Malkiel and John G. Cragg, “*Expectations and the Structure of*  
24 *Share Prices.*” This academic study’s conclusion was that equity analysts’ expectations

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<sup>18</sup> *Id.*, p. 23, lines 4-7.



1 had a greater influence on stock prices compared to simple extrapolations of historical  
2 financial data. This conclusion is logical considering the vast amount of resources  
3 dedicated to the discipline of securities analysis. However, I am not sure how subsequent  
4 studies leapt to the conclusion that the results of this study translated into a proof that  
5 investors use 5-year CAGR in EPS forecasts as a constant growth rate in the single-stage  
6 DCF methodology. In fact, the Cragg and Malkiel paper does not even use the DCF  
7 valuation model when testing their hypothesis regarding the influence of analysts'  
8 projections on stock prices. It is more plausible to conclude that, because investors rely on  
9 equity analysts' expectations, they rely on these analysts' investment recommendations  
10 (e.g. buy, sell or hold). Equity analysts' investment recommendations are based on their  
11 assessment of the intrinsic value of a given stock. Analysts' methodologies for estimating  
12 a fair price varies, but most at least assess the current price-to-forward earnings ratios both  
13 on a consensus basis and on the analysts' own estimates.

14 Cragg and Malkiel specifically indicated the following in their study:

15  
16 We would not argue that these estimates necessarily give an accurate picture  
17 of general market expectations. It would, however, seem reasonable to  
18 suggest that they are representative of opinions of some of the largest  
19 professional investment institutions and that they may not be wholly  
20 unrepresentative of more general expectations. **Since investors consult**  
21 **professional investment institutions in forming their own expectations,**  
22 **individuals' expectations may be strongly influenced—and so reflect—**  
23 **those of their advisers.** That several of our participating firms find it  
24 worthwhile to publish these projections and provide them to their customers  
25 provides prima facie evidence that a certain segment of the market places  
26 some reliance on such information in forming its own expectations. Also,  
27 insofar as other security analysts and investors follow the same sorts of  
28 procedures as those used by our sample analysts in forming expectations,  
29 general investors' expectations would resemble those of the analysts.  
30 Consequently, these predictions may well serve as acceptable proxies for  
31 general expectations and surely seem worthy of detailed analysis. (emphasis  
32 added)

33 Considering the above, in which the foundation for the study concludes that investors rely  
34 and depend on their investment advisors, and therefore, stock prices reflect these  
35 expectations, it is reasonable to conclude that the COE assumptions used by these

1 investment analysts are reflected in share prices. To assume that investors utilize the  
2 information provided by equity analysts in a way that is wholly inconsistent with how these  
3 analysts use the data in their own analysis, is not credible. Equity analysts often use the  
4 dividend discount model (“DDM”) to estimate a fair price to pay for the stock. The DDM  
5 is synonymous with the DCF in utility ratemaking settings. The DCF in utility ratemaking  
6 is simply solving for the required return/cost of equity variable. In valuation, the goal is to  
7 solve for the fair price of the stock. Consequently, if equity analysts are of value to their  
8 clients, then the stock prices will reflect their estimates of future dividends and the required  
9 return from these dividends. Consequently, if one accepts the studies that security analysts’  
10 expectations influence investors, which is Malkiel and Cragg’s conclusion, then this means  
11 that stock prices reflect the cost of equity used by these very same analysts. My experience  
12 has been that these equity discount rates are much lower than Mr. D’Ascendis cost of equity  
13 estimates, and often even lower than my own COE estimates.

14 Consider further how one of the co-authors of the Cragg and Malkiel paper has estimated  
15 required returns on stocks in his past studies and how he estimated required returns  
16 recently. In his May 1979 study, “*The Capital Formation Problem in the United States*,”  
17 Malkiel estimated the required returns on the Dow Jones Industrial Average by using Value  
18 Line growth rates for the first five years. He then reduced this growth rate over time to that  
19 of the expected real growth rate of the economy, which was 3.6% at the time.

20 Mr. Malkiel has been consistent with his views on constraints on long-term growth for the  
21 market. Mr. Malkiel has provided expected long-term market returns at various times since  
22 2012.<sup>19</sup> In his long-term return projection that he made at the end of 2012, he used a  
23 projected growth rate of 5% based on the long-run history of earnings and dividend growth  
24 in the United States. Mr. Malkiel simply added the long-term growth rate of 5% to the  
25 S&P 500 dividend yield of approximately 2% for a total return estimate of 7%.

26 Investors’ focus on earnings growth rates is understandable in the context of security  
27 analysts’ stock price estimates derived from P/E multiples. Security analysts provide this

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<sup>19</sup> Burton G. Malkiel, “Where to Put Your Money in 2012,” *Wall Street Journal*, January 5, 2012; Burton G. Malkiel, “A 2015 ‘Rebalancing’ Act for Investors,” *Wall Street Journal*, December 31, 2014.

1 information to evaluate potential P/E ratios as they compare to consensus P/E ratios. The  
2 ability of the analyst to accurately project future earnings and justified P/E ratios will  
3 determine whether that analyst is successful. Consequently, the focus on analysts' EPS  
4 projections is understandable in this context, but not in the context of absolute valuation  
5 methods such as a DCF analysis.

6 **Q. What data does Mr. D'Ascendis offer to support his position that utility companies  
7 can grow in perpetuity at a rate higher than the overall economy?**

8 A. He provides value added figures by industry and overall GDP for the years 1947 and 2022.  
9 He then computes the CAGR over this period for each industry and aggregate GDP. He  
10 concludes that because the CAGR in the utility industry over this period was 6.66% as  
11 compared to the CAGR in aggregate GDP of 6.36% for the same period, this supports his  
12 position that earnings growth is not constrained by GDP growth.

13 **Q. Why do knowledgeable investors assume that earnings cannot grow more than GDP  
14 over the long-run?**

15 A. Because they understand that the contribution of corporate profits (*i.e.* earnings) cannot  
16 overtake all other contributions to GDP, such as labor, causing corporate profits to  
17 overwhelm all other factors contributing to GDP. The following explanation is found in  
18 the Chartered Financial Analyst ("CFA") Program curriculum:

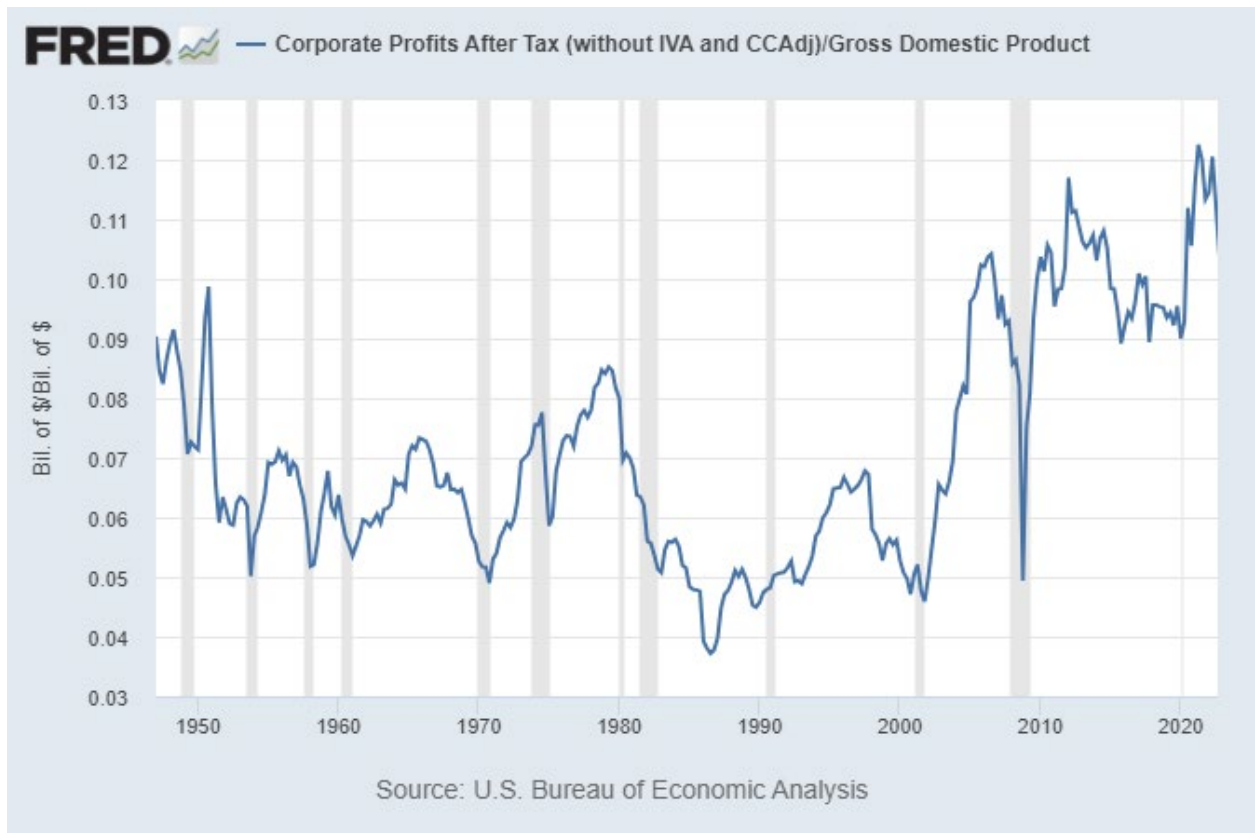
19 ...A key question for equity investors, therefore, is whether earnings  
20 growth is also bounded or limited by the growth rate of potential  
21 GDP.

22 For earnings growth to exceed GDP growth, the ratio of corporate  
23 profits to GDP must trend upward over time. I should be clear that  
24 the share of profits in GDP cannot rise forever. At some point,  
25 stagnant labor income would make workers unwilling to work and  
26 would also undermine demand, making further profit growth  
27 unsustainable. Thus, in the long run, real earnings growth cannot  
28 exceed the growth rate of potential GDP.<sup>4[footnote omitted]</sup> Exhibit 11-2  
29 [not included, but the same chart from the Federal Reserve Bank of  
30 St. Louis provided below] illustrates the long-run stability of after-  
31 tax profits as a share of GDP using U.S. data derived from the

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National Income and Produce Accounts (NIPA). The chart shows that since 1947, after-tax profits have ranged between 3.1 percent and 10.1 percent of GDP and have averaged around 6 percent of GDP. Note that there is neither an upward trend in the ratio of after-tax profits to GDP nor a move to a permanent increase in the ratio. The share of profits in 1947, at 8.5 percent, was essentially equal to the 9.4 percent share at the end of the period in 2010.<sup>20</sup>

The below graph is an update of Exhibit 11-2 contained in the above-quoted source:



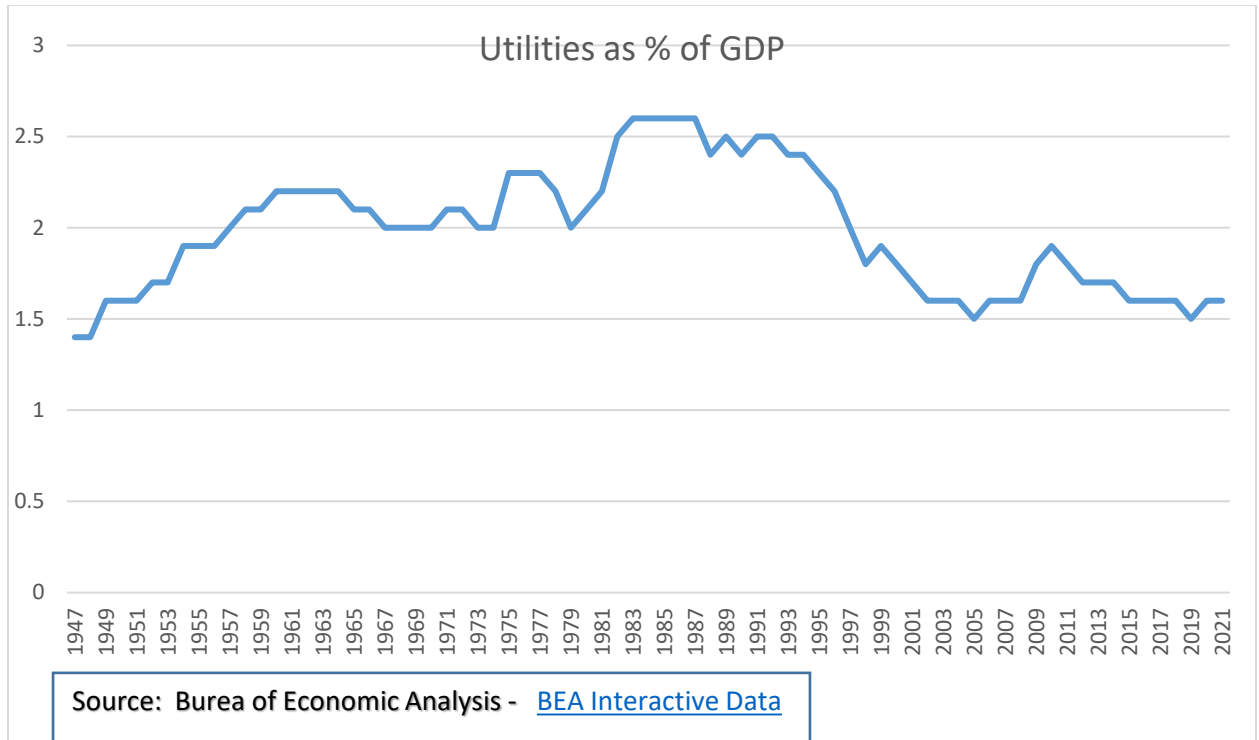
10  
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15

Although corporate profits as a percentage of GDP have increased to around 12% in recent periods, the long-term data does not support the view that profits will grow in perpetuity at a higher rate than overall GDP. As explained in the CFA curriculum, other factors contributing to GDP growth, such as labor, would demand a more equitable balance to the factors of production contributing to GDP growth.

<sup>20</sup> Christopher D. Piros and Jerald E. Pinto, "Economics For Investment Decision Makers," John Wiley & Sons, Inc., 2013, p. 631.

1 **Q. Does the fact that the utility value added CAGR of 6.66% for the period of 1947**  
2 **through 2022 was greater than GDP growth of 6.36% contradict the constraint of**  
3 **GDP growth on perpetual earnings growth?**

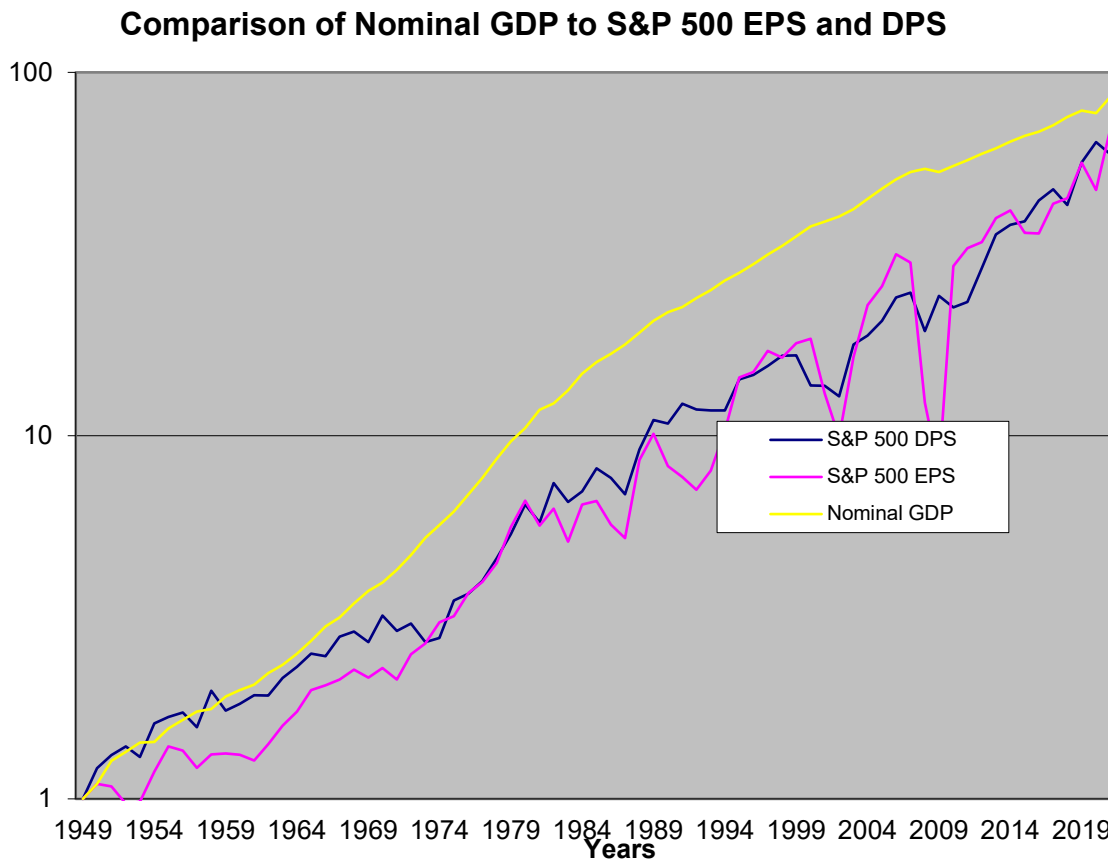
4 **A. No.** For a more complete picture of utility contribution to GDP growth since 1947, see the  
5 following graph:



6  
7 As can be seen in the above chart, the period between 1947 and 2021 which accounts for  
8 utility growth above aggregate GDP growth ended in the early 1980s. For the next twenty  
9 years, utilities grew at a slower rate than the economy. And since the turn of the century,  
10 other than a brief period during the 2008 to 2009 recession, utilities have grown at  
11 approximately the same rate as the economy. This data also supports the CFA curriculum  
12 that maintains a perpetual growth rate should be constrained by potential aggregate GDP  
13 growth.

1 **Q. Have the EPS and DPS of the companies in the S&P 500 been able to grow at the same**  
2 **rate as GDP?**

3 A. No. In an article published in Public Utilities Fortnightly,<sup>21</sup> Steven Kihm addressed the  
4 fallacy of assuming utilities, let alone the S&P 500, would be able to sustainably achieve  
5 EPS and DPS growth above GDP growth. In doing so, Mr. Kihm provided data comparing  
6 U.S. GDP growth to the growth in EPS and DPS for the S&P 500 for the period 1949  
7 through 2009. Mr. Kihm's source for such data was the annual Economic Report of the  
8 President. I updated the data Mr. Kihm analyzed in the below chart:



9  
10 Over the last 70+ years the EPS and DPS growth of companies in the S&P 500 EPS has  
11 not exceeded the nominal GDP growth rate. Consequently, the CFA curriculum's

<sup>21</sup> Steven Kihm, "Rethinking ROE: Rational estimates lead to reasonable valuations," Public Utilities Fortnightly, August 2011, pgs. 16-21.

1           advisement not to use a perpetual growth rate much different than sustainable GDP growth  
2           for purposes of estimating returns for broad stock market indexes is well grounded in  
3           historical experience as well as logic.

4   **Q.    What is your response to Mr. D’Ascendis’ criticisms of the “Rule of Thumb” analysis**  
5           **you provide to test the reasonableness of yours and other parties’ estimated COEs in**  
6           **this case?**

7    A.    Mr. D’ Ascendis attributes the “Rule of Thumb” test to me. This is inaccurate. The test of  
8           reasonableness that I generally classify as a “Rule of Thumb” test is correctly attributed to  
9           the CFA Program curriculum, which I appropriately cited in my direct testimony.  
10          Although this method is very simplistic and generic, that is the point, as emphasized in the  
11          CFA curriculum. If more complex methods, which rely on analysis and manipulation of  
12          obscure data, imply a COE much different than indicated by this simple test, then those  
13          other estimates need to be heavily scrutinized and explained. As I explained in my direct  
14          testimony, the fact that utility industry P/E ratios have been sustained as bond yields have  
15          increased supports an expected outcome that the utility industry’s COE is not much  
16          different than before rapid increases in bond yields in 2022.

17          The CFA curriculum specifically stated the following related to COE estimates from this  
18          simplistic method:

19                           The bond yield plus risk premium method can be viewed as a build-  
20                           up method applying to companies with publicly traded debt. **The**  
21                           **estimate can be a useful check when the explanatory power of**  
22                           **more rigorous models is low.** Given that a company’s shares have  
23                           positive systematic risk, the yield on its long-term debt is revealing  
24                           as a check on cost of equity estimate. For example, Sprint’s 6.875  
25                           debentures (rated BB- by Standard & Poor’s, B1 by Moody’s, and  
26                           B+ by Fitch) mature in 2028 and were priced to yield 7.60 percent  
27                           as of early Augusts 2013, so required return estimates for its stock  
28                           (NYSE: S) not greater than 7.60 percent would be suspect (emphasis  
29                           added).<sup>22</sup>

---

<sup>22</sup> Pinto, Henry, Robinson and Stowe, “Equity Asset Valuation,” Third Edition, 2015, p. 79.

1 Although the above refers to the unreasonableness of a COE estimate below that of the  
2 company's own bond yield, based on the CFA Program curriculum, a typical risk premium  
3 based on experience in United States' capital markets is 3 – 4 percent over a company's  
4 own bond yield. Therefore, based on the above example, the upper bound for a reasonable  
5 estimate of Sprint's COE is 10.6% to 11.6%.

6 **Q. Does CSWR have publicly-traded debt?**

7 A. No.

8 **Q. Then what is a reasonable proxy?**

9 A. A bond yield for the utility industry. Based on recent yields to maturity of approximately  
10 5.5% to 5.8% for Moody's A-rated utility bonds and Moody's Baa-rated utility bonds, the  
11 upper bound of a reasonable COE estimate for the utility industry is 8.5% to 9.8%.  
12 However, as I explained in my direct testimony, because utility stock valuation levels did  
13 not contract significantly in response to rapid increases in interest rates in 2022, utility  
14 equity capital market data supports an expectation of a COE below this test of  
15 reasonableness. The utility equity capital market data certainly does not support Mr.  
16 D'Ascendis' COE estimates in the double digits.

17 **Q. How do you respond to Mr. D'Ascendis' criticisms of your estimated market risk  
18 premium estimates used in conjunction with the CAPM?**

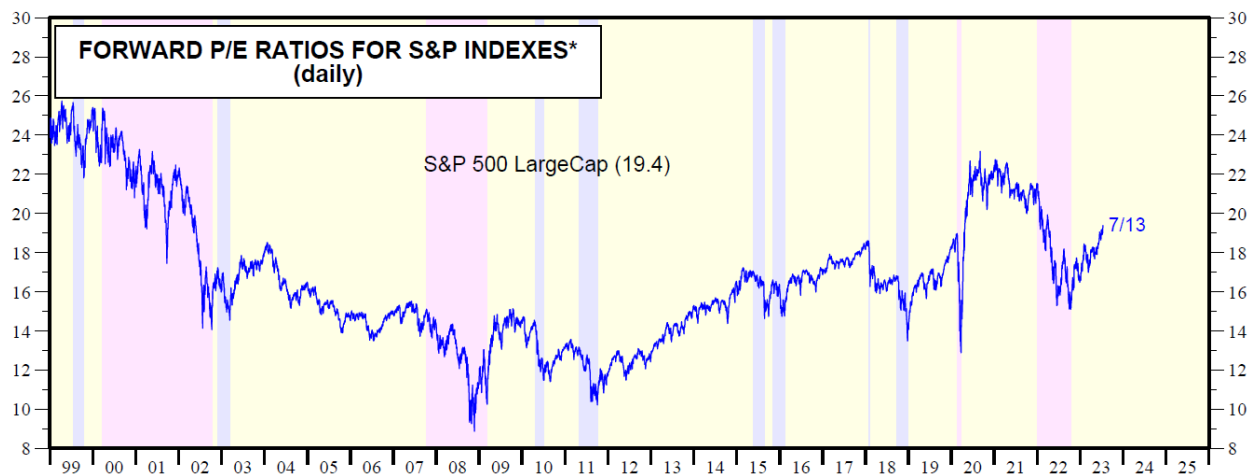
19 A. Despite Mr. D'Ascendis attempts to discredit the market risk premium estimates I used in  
20 the CAPM, my market risk premium of 6% is quite logical, if not too high based on current  
21 capital market conditions. The S&P 500 is currently trading at P/E ratios that are above  
22 historical averages. This supports market risk premium estimates that are lower than  
23 historical averages rather than higher than historical averages as Mr. D'Ascendis numerous  
24 risk premium estimates suggest. In a recent *WSJ* article, the following commentary was  
25 provided as it relates to current higher valuations for the S&P 500:

26 Stocks look pricey again today, and markets and the economy are  
27 facing a new host of challenges. By at least one valuation measure,



1 U.S. stocks are currently more expensive than those of any other  
2 country or region, Research Affiliates' data show. That is based on  
3 the S&P 500's price level relative to inflation-adjusted corporate  
4 earnings over the past 10 years, or the CAPE ratio. Although well  
5 off prior peaks seen in the late 1990s and during the exuberance that  
6 followed the onset of Covid-19, the U.S. stock benchmark now  
7 trades at a multiple of 28.3, pricier than it has been more than 90%  
8 of the time since 1881.<sup>23</sup>

9 This article was published on April 6, 2023. The S&P 500's price level has continued to  
10 surge since April 2023, which is illustrated in the following chart:



11  
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14

13 **Q. How should the above information be interpreted?**

14 A. Increases in long-term interest rates caused the S&P 500 to contract in 2022, but it has  
15 performed quite well in 2023. The fact that the S&P 500's recent P/E ratio is above its  
16 historical average of 15.13x since 1982 supports lower than average market risk  
17 premiums.<sup>25</sup> My market risk premium of approximately 6% is consistent with typical  
18 market risk premiums, whereas Mr. D'Ascendis' market risk premium of approximately  
19 10% is not.

<sup>23</sup> Eric Wallerstein, "Stocks Haven't Looked This Unattractive Since 2007," *Wall Street Journal*, April 6, 2023.

<sup>24</sup> Yardeni Research Inc., July 13, 2023: [Stock Market Briefing: Selected P/E Ratios \(yardeni.com\)](https://www.yardeni.com/stock-market-briefing-selected-pe-ratios/)

<sup>25</sup> *Id.*

1 **SUMMARY AND CONCLUSIONS**

2 **Q. Can you summarize your surrebuttal testimony?**

3 A. Yes. Mr. Thies' and Mr. D'Ascendis' arguments to allow more equity in Confluence's  
4 ratemaking capital structure for purposes of additional acquisitions unfairly burdens  
5 Confluence's current ratepayers with costs that should be incurred by CSWR's  
6 shareholders. All costs, not just the cost of capital, that are associated with CSWR's  
7 growth-through-acquisition strategy, should be incurred by CSWR's shareholders. In the  
8 same breath, Mr. D'Ascendis claims that CSWR saved ratepayers \$518,000 a year by  
9 refinancing the 14% Fresh Start contract, but Confluence should not be required to share  
10 the patronage credit on its loan with ratepayers. The Fresh Start contract proved to be an  
11 abuse of affiliate transactions and only served to provide an exorbitant profit to the previous  
12 owners of CSWR and Fresh Start. Considering that CSWR freely admits that US Water  
13 wholly-owns both CSWR and Fresh Start, I was surprised the Company still used this  
14 discredited contract in an attempt to bolster CSWR's reputation. If CSWR had pursued  
15 CoBank financing for its rehabilitated systems much sooner than 2022, such as those  
16 previously owned by Hillcrest, Raccoon Creek and Indian Hills, the ratepayers of these  
17 systems could have been charged a much lower cost of debt than the 14% embedded in  
18 their rates. Because the patronage credit is known and measurable, it should be factored  
19 into ratepayers' rates now rather than trusting CSWR to share this savings in future rate  
20 cases.

21 Mr. D'Ascendis' arguments related to the COE are driven by his belief that awarded ROEs  
22 are the same as the COE. I can assure the Commission that the investment community  
23 does not share this view. This explains why simple tests of reasonableness suggested by  
24 the CFA curriculum discredit Mr. D'Ascendis' inflated COE estimates in attempt to  
25 support higher authorized ROEs. My COE estimates are consistent with those used by  
26 investors and are logical considering current utility equity market conditions. However, I  
27 do recognize that commissioners and investors judge "fairness" based on other authorized  
28 returns. Therefore, I considered such in developing my recommended ROE range.

1 | **Q. Does this conclude your testimony?**

2 | A. Yes.

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

In the Matter of Confluence Rivers Utility     )  
Operating Company, Inc.'s Request for     )  
Authority to Implement a General Rate     ) Case No. WR-2023-0006  
Increase for Water Service and Sewer     )  
Service Provided in Missouri Service Areas   )

**AFFIDAVIT OF DAVID MURRAY**

STATE OF MISSOURI    )  
  ) ss  
COUNTY OF COLE     )

David Murray, of lawful age and being first duly sworn, deposes and states:

1. My name is David Murray. I am a Utility Regulatory Manager for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

  
\_\_\_\_\_  
David Murray  
Utility Regulatory Manager

Subscribed and sworn to me this 20<sup>th</sup> day of July 2023.



TIFFANY HILDEBRAND  
My Commission Expires  
August 8, 2023  
Cole County  
Commission #15637121

  
\_\_\_\_\_  
Tiffany Hildebrand  
Notary Public

My Commission expires August 8, 2023.