Exhibit No.: 105
Issues: Capital Structure, Long-Term Debt Cost, and Overall Rate of Return
Witness: Michi Q. Chao
Exhibit Type: Rebuttal
Sponsoring Party: Missouri-American Water Company
Case No.: WR-2010-0131
SR-2010-0135
Date: April 15, 2010

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2010-0131
SR-2010-0135

REBUTTAL TESTIMONY

OF

MICHI Q. CHAO

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

IN THE MATTER OF MISSOURI-AMERICAN WATER COMPANY FOR AUTHORITY TO FILE TARIFFS REFLECTING INCREASED RATES FOR WATER AND SEWER SERVICE)	**CASE NO. WR-2010-0131** **CASE NO. SR-2010-0135**

AFFIDAVIT OF MICHI Q. CHAO

Michi Q. Chao, being first duly sworn, deposes and says that she is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Michi Q. Chao"; that said testimony and schedules were prepared by her and/or under her direction and supervision; that if inquires were made as to the facts in said testimony and schedules, she would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of her knowledge.

MQChao

Michi Q. Chao

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 14th **day of** April **2010.**

Staci A. Olsen

Notary Public

My commission expires:

STACI A. OLSEN
Notary Public – Notary Seal
STATE OF MISSOURI
St. Charles County
Commission Number 09519210
My commission expires March 20, 2013

REBUTTAL TESTIMONY
MICHI Q. CHAO
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2010-0131
SR-2010-0135

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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2010-0131
SR-2010-0135

REBUTTAL TESTIMONY

OF

MICHI Q. CHAO

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REBUTTAL TESTIMONY
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REBUTTAL TESTIMONY
OF
MICHI Q. CHAO

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Michi Q. Chao and my business address is 727 Craig Road, St. Louis, Missouri, 63141.

Q. ARE YOU THE SAME MICHI Q. CHAO WHO PREVIOUSLY SUBMITTED PREPARED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

II. PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to address, on behalf of Missouri American Water Company (MAWC or the Company), the capital structure proposed by the Staff of the Missouri Public Service Commission (Commission) for determining MAWC's Weighted Average Cost of Capital (WACC) in this proceeding. The capital structure proposal of the Commission's Staff (Staff) and discussion are contained on pages 21 to 24 of the Staff report entitled "Staff Report – Cost of Service" (Staff Report) I also address Staff's methodology for computing MAWC's cost of long-term debt.

III. OVERVIEW

Q. PLEASE PROVIDE A BRIEF OVERVIEW OF YOUR REBUTTAL TESTIMONY.

A. My rebuttal testimony explains why MAWC's capital structure is appropriate for determining MAWC's WACC, or overall rate of return on rate base. The Staff Report incorrectly relies upon the September 30, 2009 consolidated capital structure ratios of American Water Company (American Water), MAWC's parent, for determining the Company's WACC. The reasons cited by the Staff Report for using American Water's consolidated capital structure ratios are the following:

1. MAWC does not operate as an independent entity in terms of the procurement of its financing and the cost of that financing.
2. The debt issued by American Water Capital Corp. (AWCC) is rated based on the consolidated credit quality of American Water. Thus, the cost of debt MAWC receives on issuances placed through AWCC is based on the consolidated creditworthiness of American Water.
3. The business risks of American Water and MAWC are similar and, therefore, their financial risks and capital structures should be similar.
4. American Water employs double leverage, which refers to the situation in which a parent company, purportedly, uses funds raised from the issuance of debt to make equity infusions in a subsidiary.
5. All debt issued by AWCC and loaned to MAWC is, in essence, according to the Staff Report, guaranteed by American Water. That is, the ultimate responsibility for principal and interest payments related to

debt securities issued by MAWC through AWCC rests with American Water (Staff Report, pp. 22-24).

I will demonstrate that none of these reasons provides any basis for using American Water's consolidated capital structure for determining MAWC's overall rate of return on rate base (i.e., WACC) in this proceeding. Finally, I will explain that MAWC's cost of long-term debt should be calculated using MAWC's long-term debt schedule, and not American Water's consolidated long-term schedule, as was done by the Staff.

IV. CAPITAL STRUCTURE RATIOS

A. STAFF'S PROPOSED CAPITAL STRUCTURE

Q. THE STAFF REPORT RECOMMENDED THAT THE COMMISSION ADOPT AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE COMPONENT RATIOS FOR THE PURPOSE OF DETERMINING MAWC'S OVERALL RATE OF RETURN ON RATE BASE IN THIS PROCEEDING. DO YOU AGREE WITH THE STAFF'S RECOMMENDATION?

A. No, I do not. The Commission should not set rates for MAWC in this proceeding based upon American Water's consolidated capital structure ratios. Rather, the Commission should adopt MAWC's capital structure at the true-up date of April 30, 2010. As will be discussed later in this testimony, MAWC's pro forma April 30, 2010 capital structure shown on Schedule MQC-1, page 1, attached to my direct testimony in this proceeding, has been corrected. In addition, that schedule will be updated with actual April 30, 2010 MAWC capital component balances when the Company files its true-up testimony and schedules in May.

Q. WITH RESPECT TO MAWC'S UPCOMING TRUE-UP FILING IN MAY, WILL THERE BE ANY CHANGE TO THE METHODOLOGY THE COMPANY USES TO CALCULATE THE BALANCE OF SHORT-TERM DEBT TO INCLUDE IN THE CAPITAL STRUCTURE?

A. Yes. The projected April 30, 2010 balance of short-term debt of $5,374,481, which is shown on Schedule MQC-1, pages 1 and 3, filed with MAWC's direct case, was not netted against the projected April 30, 2010 balance of Construction Work in Progress (CWIP). For ratemaking purposes, the correct methodology for determining the amount of short-term debt to include in the capital structure is to subtract the balance of CWIP from the balance of short-term debt. That incremental portion of short-term debt that exceeds CWIP is, in effect, the portion of short-term debt that could be attributed to financing rate base assets. This methodology, which is also used by the Staff, will be used in the Company's true-up filing to compute the balance of short-term debt for the capital structure.

Q. **USING THE CORRECT METHODOLOGY IDENTIFIED IN YOUR PREVIOUS ANSWER, WHAT IS THE COMPANY'S PRO FORMA APRIL 30, 2010 BALANCE OF SHORT-TERM DEBT?**

A. As previously noted, the projected April 30, 2010 short-term debt balance is $5,374,481. However, subtracting MAWC's projected April 30, 2010 CWIP balance of $20,835,767 from the short-term debt balance results in a negative value. Thus, the correct short-term debt amount to include in the capital structure for rate making purposes is zero, as shown on Schedule MQC.Reb-1, page 2. The projected CWIP balance was derived from the same balance sheet data the Company used to compute the capital structure for its direct case in this proceeding.

Q. WHAT IS THE UPDATED CAPITAL STRUCTURE THAT YOU RECOMMEND BE USED FOR COMPUTING MAWC'S WACC FOR RATEMAKING PURPOSES?

A. I have updated the capital structure the company filed in its direct case in this proceeding to reflect the correction to the short-term debt balance discussed previously. The updated pro forma April 30, 2010 capital structure is comprised of 50.40% long-term debt, 0.00% short-term debt, 0.33% preferred stock, and 49.27% common equity, as shown on Schedule MQC.Reb-1, page 1.

Q. WHAT IS MAWC'S UPDATED OVERALL WEIGHTED AVERAGE COST OF CAPITAL?

A. Based on the updated pro forma short-term debt balance and the updated cost of common equity recommendation of 11.35% from Company witness Pauline Ahern, MAWC's updated WACC is 8.83%, as shown on Schedule MQC.Reb-1, page 1.

Q. **DOES STAFF'S RECOMMENDED AMERICAN WATER CONSOLIDATED CAPITAL STRUCTURE CONTAIN SHORT-TERM DEBT?**

A. Yes, it does. The Staff included the balance of short-term debt from American Water's consolidated September 30, 2009 balance sheet, which was $76,556,000. The Staff Report also noted that because Staff did not have American Water's outstanding balance of CWIP at September 30, 2009, Staff included the entire amount of American Water's short-term debt in its recommended capital structure (Staff Report, Schedule 8). Staff also noted, however, that it has requested more detailed information pertaining to American Water's short-term debt and CWIP balances. The Company has subsequently provided to Staff, as an update to MoPSC data request S0103, American Water's consolidated CWIP balance at September 30, 2009. This consolidated CWIP balance should be subtracted from American Water's consolidated short-term debt balance to arrive at the correct balance of short-term debt to include in American Water's consolidated capital structure, assuming that capital structure is used for ratemaking purposes.

Q. WHY IS MAWC'S PROJECTED APRIL 30, 2010 CAPITAL STRUCTURE APPROPRIATE FOR RATEMAKING PURPOSES?

A. The Company's projected April 30, 2010 capital structure is appropriate for ratemaking purposes for four reasons; 1) MAWC is a separate corporate entity that issues its own debt and common stock and, therefore, has an independently determined capital structure, 2) MAWC's stand-alone capital structure represents the actual capital financing MAWC's jurisdictional rate base, to which the overall rate of return set in this proceeding will be applied, 3) the April 30th pro forma date will be close in time to when the rates set in this case will go into effect; and 4) MAWC's stand-alone capital structure is consistent with the capital structure ratios maintained, on average, by other water companies.

Q. PLEASE EXPLAIN HOW MAWC MANAGES ITS CAPITAL STRUCTURE AND MAKES FINANCING DECISIONS INDEPENDENTLY OF ITS PARENT, AMERICAN WATER.

A. In conjunction with all of its financing requirements, MAWC considers the appropriate mix of debt, preferred stock and common equity appropriate for its capital structure. This decision is made independently of its parent's financing and capital structure decisions. Thus, MAWC's determination of whether to issue equity or debt, and the type of debt, is made by MAWC based on its capital structure objectives and on capital market conditions at the time the security is to be issued.

In addition, MAWC adheres to a policy of obtaining the most favorable financing terms possible. The Financial Services Agreement (FSA) between MAWC and AWCC does not preclude MAWC from issuing debt to non-affiliated entities. Paragraph 7 of the FSA, which addresses the issue of non-exclusivity, specifically states:

> "Nothing in this Agreement prohibits or restricts the Company from borrowing from third parties, or obtaining services described in this Agreement from third parties, whenever and on whatever terms it deems appropriate."

Thus, MAWC will not issue Notes to American Water's financing subsidiary, AWCC, unless it can determine, based on market conditions applicable at the time, that such issuance will result in the lowest overall cost available to MAWC when compared to securities of comparable type, maturity, and terms. With respect to equity capital, there is no requirement that MAWC receive its equity in whole, or in part, from its parent, however, the Company foresees the continuation of American Water as the sole source of equity funding.

The above discussion illustrates that MAWC has autonomy with respect to the issuance of both its debt and equity securities and, thus, the management of its capital structure.

Q. YOU NOTED THAT USE OF MAWC'S CAPITAL STRUCTURE, RATHER THAN AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE, IS APPROPRIATE BECAUSE MAWC'S STAND-ALONE CAPITAL STRUCTURE REPRESENTS THE ACTUAL CAPITAL THAT FINANCES MAWC'S JURISDICTIONAL RATE BASE. WHY IS THE ACTUAL CAPITAL FINANCING MAWC'S JURISDICTIONAL RATE BASE RELEVANT AND APPROPRIATE FOR RATEMAKING PURPOSES?

A. It is relevant and appropriate for ratemaking purposes because it represents the actual dollars that are financing MAWC's jurisdictional rate base to which the rate of return authorized in this proceeding will be applied. In contrast, the consolidated American Water capital structure proposed by the Staff contains capital that <u>was not</u> used to finance MAWC's jurisdictional rate base. For example, it includes the long-term debt capital of American Water's other operating water subsidiaries, in addition to MAWC, which finances the jurisdictional rate bases of those subsidiaries.

MAWC's rate base is financed in a manner that reflects MAWC's capital structure ratios, not American Water's consolidated capital structure ratios. That is, MAWC's rate base is financed by the capital components that comprise MAWC's capital structure, in the ratio of each capital component's proportion to total capital. It is this capital structure that should be used to determine the weighted cost of each of the individual capital components, because the sum of these weighted component costs is the overall cost of capital. It is this overall cost of capital that represents the rate of return MAWC needs to earn on its rate base to satisfy the contractual obligations to, and the return requirements of, its investors. Interestingly, the Staff Report even notes the important relationship between the capital a utility raises and the assets it finances:

> "Each different form of capital has a cost, and these costs are weighted proportionately to fund each dollar invested in the assets. Assuming that the various forms of capital are reasonably balanced and are valued correctly, the resulting total WACC, when applied to rate base, will provide the funds necessary to service the various forms of capital" (Staff Report, p. 21).

Using the consolidated capital structure of American Water will <u>not</u> ensure that MAWC is provided the funds necessary to service its various forms of capital, as the excerpt from the Staff Report above clearly and correctly asserts is central to determining a utility's weighted average cost of capital. In addition, no party in this proceeding, including Staff, has argued that MAWC's proposed capital structure is not reasonable for ratemaking purposes.

Q. **WILL THE USE OF AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE, RATHER THAN MAWC'S CAPITAL STRUCTURE, RESULT IN AN OVERALL RETURN ON RATE BASE THAT IS NOT REASONABLE FOR RATEMAKING PURPOSES?**

A. Using American Water's consolidated capital structure will produce an overall rate of return on rate base that may not reflect MAWC's cost of capital. Thus, the overall rate of return authorized by the Commission could be higher or lower than that needed to satisfy the return requirements of MAWC's investors. If that were to occur, then the overall authorized rate of return will not be reasonable from a regulatory standpoint.

Q. SHOULD THE MOPSC BE CONCERNED WITH DETERMINING A REASONABLE COST OF CAPITAL FOR MAWC?

A. Yes, it should. Although an important objective of regulation is to minimize the cost of reliable service to ratepayers, it is equally important to also allow public utilities the opportunity to earn a fair and reasonable rate of return. When a public utility is authorized a rate of return equal to a reasonable cost of capital, the interests of ratepayers and investors are properly balanced. If the authorized rate of return is greater than a reasonable cost of capital, ratepayers are burdened with excessive rates. Conversely, if the authorized rate of return is less than a reasonable cost of capital, the utility may be unable to raise capital at a reasonable cost and ultimately may be unable to raise sufficient capital to meet demands for service. Therefore, the interests of ratepayers and investors are best served when a utility's allowed rate of return is set equal to a reasonable overall cost of capital.

Q. YOU NOTED THAT THE APRIL 30, 2010 PRO FORMA DATE IS CLOSE IN

TIME TO WHEN THE RATES ESTABLISHED IN THIS PROCEEDING WILL GO INTO EFFECT. PLEASE EXPLAIN WHY THAT IS SIGNIFICANT.

A. The April 30, 2010 pro forma date, currently being used by the Company to calculate its capital structure, will be updated with actual April 30, 2010 data when the Company files its true-up in May, as previously noted. Since this proceeding will determine rates for future service, it is reasonable for the capital structure components to reflect the forecasted balances for those components during the time that those rates will be in effect. On that basis, the Company's capital structure measurement date of April 30, 2010 is preferable to the Staff's measurement date of September 30, 2009.

Q. HOW DO THE COMPANY'S PRO FORMA CAPITAL STRUCTURE RATIOS AT APRIL 30, 2010 COMPARE WITH THOSE MAINTAINED BY OTHER WATER COMPANIES?

A. The Company's pro forma April 30, 2010 capital structure ratios are consistent with those maintained, on average, by the four water companies in Staff's comparable group, as shown on Schedule 20 attached to the Staff Report. Specifically, the common equity ratios of Staff's four water companies, based upon total capital including short-term debt, are estimated to average 51.22% for the year 2009, ranging from 46.00% to 54.00%. Also, I compared MAWC's updated pro forma April 30, 2010 equity ratio to that of Ms. Pauline Ahern's six

AUS Utility Reports water companies and to her group of eight AUS Utility Reports natural gas distribution companies. My analysis showed that MAWC's updated pro forma April 30, 2010 equity ratio of 49.27% is within one standard deviation of the average common equity ratio of Ms. Ahern's six AUS Utility Reports water companies, and only slightly greater than one standard deviation above the average common equity ratio of her group of eight AUS Utility Reports natural gas distribution companies.

I also analyzed projected equity ratios from Value Line Investment Survey. I found that MAWC's updated pro forma April 30, 2010 equity ratio is relatively close to Value Line's projected water utility industry common equity ratios of 46.0% in 2009, 47.5% in 2010, and 50.0% over the 2012-2014 time period. Thus, MAWC's updated pro forma April 30, 2010 common equity ratio of 49.27% is similar to the average equity ratios of Staff's comparable group of water utilities and both of Ms. Ahern's proxy groups. Since MAWC's pro forma April 30, 2010 capital structure ratios are consistent with those maintained, on average, by the four water companies in Staff's comparable group, and both of Ms. Ahern's proxy groups, MAWC's proposed capital structure is reasonable for ratemaking purposes in this proceeding.

B. THE STAFF REPORT

Q. THE FIRST REASON PRESENTED IN THE STAFF REPORT AS A BASIS FOR USING AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT "MAWC IS NOT OPERATING AS AN INDEPENDENT ENTITY, AT

LEAST WHEN CONSIDERING MAWC'S PROCUREMENT OF FINANCING AND THE COST OF THAT FINANCING" (STAFF REPORT, P. 22). PLEASE RESPOND.

A. The Staff Report notes that MAWC has a Financial Services Agreement with AWCC, which provides MAWC with short-term borrowing and cash management services. In fact, AWCC is also MAWC's typical source for long-term debt, though as previously noted, MAWC is not required to finance through AWCC and will choose the least-cost debt financing option available at the time. However, the financial services provided to MAWC by AWCC and noted in the Staff Report are not a basis for using American Water's consolidated capital structure. The financial services made available by the FSA do have an impact on MAWC's <u>cost</u> of short-term debt and, potentially, <u>cost</u> of long-term debt, but they have nothing whatever to do with the sources and proportions of capital used to finance MAWC's rate base. Thus, the point being made here by Staff may be correct in the context of MAWC's cost of capital, but has no bearing on the determination of the appropriate capital structure to use for ratemaking purposes. It does not follow that because there is a financial relationship between AWCC and MAWC that American Water's consolidated capital structure ratios should be used in place of MAWC's capital structure ratios for computing the WACC.

Q. **THE SECOND REASON PRESENTED IN THE STAFF REPORT FOR USING AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT**

"DEBT ISSUED BY AWCC IS RATED BY CREDIT RATING AGENCIES BASED ON THE CONSOLIDATED CREDIT QUALITY OF AMERICAN WATER", WHICH IMPACTS THE COST OF DEBT THAT MAWC OBTAINS THROUGH AWCC (STAFF REPORT, P. 23). PLEASE RESPOND.

A. While it is true that the cost of debt issued by AWCC will reflect the credit quality of American Water consolidated, this has no relation to the sources of capital that comprise MAWC's capital structure. The cost of debt to AWCC will only impact MAWC's <u>cost</u> of borrowing through AWCC. Since this has no bearing on MAWC's capital structure, this point is irrelevant to determining the appropriate capital structure to use for computing MAWC's WACC. MAWC is a separate legal entity, responsible for making its own decisions regarding its financing sources and the composition of its capital structure. MAWC does not issue Notes to AWCC unless it can determine, based on market conditions applicable at the time, that such issuance will result in the lowest overall cost to MAWC when compared to securities of comparable type, maturity, and terms that MAWC could issue to third parties. Thus, the cost of AWCC's debt will determine whether MAWC uses that as a source of debt financing, but the cost will not impact the <u>amount</u> of debt in MAWC's capital structure.

Q. HOW MUCH OF MAWC'S EXISTING LONG TERM DEBT CAPITAL WAS RAISED THROUGH SOURCES OTHER THAN AWCC?

A. Referring to page 2 of Schedule MQC-1 attached to my Direct Testimony, as of the pro forma date of April 30, 2010, MAWC will have approximately $410 million of long-term debt outstanding. Of that amount, approximately $212 million, or 51.8%, will have come from sources other than AWCC. This includes $57.48 million of tax-exempt bonds the company issued on December 21, 2006, using the Missouri State Environmental Improvement and Energy Resources Authority ("EIERA") as a conduit.

Q. THE THIRD REASON PRESENTED IN THE STAFF REPORT FOR USING AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT BECAUSE AMERICAN WATER IS PRIMARILY A REGULATED WATER DISTRIBUTION UTILITY, THE BUSINESS AND FINANCIAL RISKS OF AMERICAN WATER ARE SIMILAR TO THAT OF MISSOURI-AMERICAN (STAFF REPORT, P. 23). WHAT IS YOUR RESPONSE?

A. The Staff Report asserts that because, in its view, American Water consolidated and MAWC have similar levels of business risk they can be expected to have similar levels of financial risk. And further, because their business and financial risks are similar, they should be expected to have similar capital structures. This argument makes a bold and unwarranted assumption regarding the risk profile of two separate entities. Staff has offered no evidence showing that American Water and MAWC have similar levels of business and financial risk. Two firms that exist within the same industry do not necessarily possess the same risk profile, or have the same cost of capital. These determinations are firm-specific, as should be the capital structure and resulting weighted average cost of capital. Rather than simply assuming that American Water and MAWC have similar levels of business and financial risk to justify use of American Water's consolidated capital structure, it is more reasonable and prudent to just use MAWC's capital structure. It is the risks facing MAWC and their impact on the management of MAWC's capital structure that are relevant to MAWC's ratepayers, not the risk profile of American Water consolidated. Further, a logical extension of Staff's position suggests that the capital structure of any water utility could be used as a proxy for MAWC's capital structure, including that of any of the firms in Staff's comparable group.

Q. ON THIS SAME POINT, STAFF CLAIMED THAT "BECAUSE IT IS THE PARENT COMPANY'S CONSOLIDATED OPERATIONS THAT DRIVE THE COST OF DEBT CAPITAL AND EQUITY CAPITAL, THE PARENT COMPANY'S CAPITAL STRUCTURE IS THE CAPITAL STRUCTURE THAT WILL BE ANALYZED BY INVESTORS WHEN DETERMINING THE REQUIRED RATE OF RETURN FOR DEBT ISSUED BY AWCC AND EQUITY ISSUED BY AMERICAN WATER (STAFF REPORT, P. 23). PLEASE COMMENT.

A. The above statement is accurate; however, it has nothing to do with determining the appropriate capital structure to use in this proceeding. The cost of debt issued by AWCC is indeed a function of American Water's consolidated operations, as is American Water's cost of common equity. However, MAWC's capital structure is not impacted by these costs. The only financial impact of American Water's consolidated operations on MAWC is related to MAWC's costs of short-term and long-term debt, to the extent MAWC issues long-term debt through AWCC. Therefore, Staff's point on this issue is simply not relevant to the determination of an appropriate capital structure for MAWC.

Q. THE FOURTH REASON PRESENTED IN THE STAFF REPORT FOR USE OF AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT AMERICAN WATER EMPLOYS DOUBLE LEVERAGE, A SITUATION IN WHICH AMERICAN WATER SUPPOSEDLY USES PROCEEDS RECEIVED FROM DEBT FINANCINGS TO INFUSE EQUITY INTO ITS SUBSIDIARIES (STAFF REPORT, P. 23). PLEASE RESPOND.

A. The Staff Report does not explain the relevance of double leverage to MAWC's capital structure, and why this is a basis to use American Water's consolidated capital structure. This issue will be addressed in the Rebuttal Testimony of Company witness Pauline Ahern.

Q. THE FIFTH AND FINAL REASON PRESENTED IN THE STAFF REPORT FOR USE OF AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT IN STAFF'S VIEW "IT APPEARS THAT ALL DEBT ISSUED BY AWCC AND LOANED TO MAWC IS ESSENTIALLY GUARANTEED BY AMERICAN

WATER." THE STAFF REPORT GOES ON TO SAY THAT "THE SUBSIDIARY'S USE OF DEBT FINANCING THAT IS BACKED BY THE PARENT SUPPORTS STAFF'S RECOMMENDATION TO USE AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE" (STAFF REPORT, PP. 23-24). PLEASE RESPOND.

A. First, it is important to note that American Water has not guaranteed any debt issued by MAWC through AWCC. Also, the extent to which the risk of debt issued by MAWC through AWCC is mitigated by the Support Agreement between American Water and AWCC will be reflected in the lower cost of that debt to MAWC, but has no bearing on determining the appropriate capital structure to use for ratemaking purposes. Furthermore, the Support Agreement does not relieve MAWC of its debt obligations issued through AWCC. The Support Agreement, in essence, provides the financial backing and credit risk of American Water to AWCC, as signified by bond rating agencies typically assigning the same rating to AWCC as they do to American Water.

V. COST OF LONG-TERM DEBT

Q. DOES THE STAFF REPORT INCLUDE ANY ERRORS WITH RESPECT TO THE CALCULATION OF MAWC'S EMBEDDED COST OF LONG-TERM DEBT?

A. Yes, in addition to improperly using American Water's consolidated capital structure, Staff chose to calculate the embedded cost of long-term debt for

MAWC by using American Water's consolidated total annual long-term debt costs and carrying value (Staff Report, Schedule 8). This methodology results in a long-term debt cost of 6.18%, rather than the correct cost of 6.36%, as shown on Schedule MQC-1, page 2 of 5, attached to my direct testimony. Clearly, the computation of MAWC's embedded cost of long-term should be performed using MAWC's long-term debt schedule. Using inputs that are applicable for calculating American Water's consolidated cost of long-term debt rather than MAWC's is entirely inappropriate and cannot be expected to provide MAWC the ability to meet the contractual obligations it has to its bondholders. Thus, the methodology Staff used to compute MAWC's embedded cost of long-term debt should be rejected by the Commission.

VI. SUMMARY

Q. **PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY WITH RESPECT TO THE ISSUE OF THE APPROPRIATE CAPITAL STRUCTURE TO USE FOR DETERMINING MAWC'S OVERALL RATE OF RETURN ON RATE BASE.**

A. I have demonstrated the erroneous assumptions underlying Staff's recommendation in this proceeding to use American Water's consolidated capital structure, rather than MAWC's capital structure, by noting that:

- MAWC manages its capital structure and makes financing decisions independently from its parent, American Water.

- Using American Water's consolidated capital structure will result in capital component ratios that produce an overall rate of return on rate base that may be higher or lower than that needed to satisfy the return requirements of, and the contractual obligations to, MAWC's investors.

- Using MAWC's pro forma April 30, 2010 capital structure will result in a WACC, or an overall rate of return on rate base, that will provide the Company the opportunity to satisfy the return requirements of its investors.

- MAWC's pro forma April 30, 2010 capital structure is consistent with that of the proxy water company groups used by both Staff and Company witness Pauline Ahern in this proceeding.

- Staff's point that MAWC is not operating as an independent entity, at least when considering MAWC'S procurement of financing and the cost of that financing, is not a valid reason for using American Water's consolidated capital structure ratios. To the contrary, it actually penalizes MAWC for using a least-cost source of debt capital by taking the cost benefit for the purpose of calculating the weighted average cost of debt and then using that prudent corporate decision as evidence of a lack of independence.

- Staff's point that debt issued by AWCC is rated based on the credit quality of American Water has no bearing whatever on determining the appropriate capital structure for MAWC.

- Staff's contention that because American Water is primarily a regulated water distribution utility, the business and financial risks of American Water are similar to those of MAWC, is not supported and does not justify use of American Water's consolidated capital structure.

- Staff's assertion that American Water employs double leverage is not explained and does not support use of American Water's consolidated capital structure.

- Staff's view that all debt issued by AWCC and loaned to MAWC is guaranteed by American Water, which supports its recommendation to use American Water's consolidated capital structure, was shown to be incorrect and, in any event, irrelevant to the management of MAWC's capital structure.

Therefore, Staff's proposal to use American Water's consolidated capital structure ratios for computing MAWC's WACC should be rejected by the Commission. I have demonstrated that the Commission should adopt MAWC's actual capital structure as of the true-up date of April 30, 2010.

Q. HAVE YOU PROVIDED ANY OTHER RECOMMENDATIONS IN YOUR

REBUTTAL TESTIMONY?

A. Yes, I have. Consistent with the Staff approach, I noted that the balance of short-term debt to include in MAWC's capital structure should be reduced by the outstanding CWIP balance. Also, I recommended that MAWC's cost of long-term debt be calculated using MAWC's debt schedule, and not American Water's consolidated debt schedule, as was inappropriately done by Staff.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

Missouri-American Water Company
Weighted Average Cost of Capital
***Pro Forma* at 4/30/10**
Case No. WR-2010-XXXX
Case No. SR-2010-XXXX

Class of Capital	Amount	Percent of Total	Cost Rate	Weighted Cost of Capital
Long-Term Debt	$ 398,761,252	50.40%	6.36%	3.21%
Short-Term Debt	-	0.00%	3.62%	0.00%
Preferred Stock	2,577,680	0.33%	9.20%	0.03%
Common Equity	389,850,573	49.27%	11.35%	5.59%
Total Capitalization	$ 791,189,506	100.00%		8.83%

Missouri-American Water Company
Pro Forma Short Term Debt at 4/30/10
Case No. WR-2010-XXXX
Case No. SR-2010-XXXX

Date	ST Debt Balance	LT Debt Issuance	Common Equity Infusion
4/30/2009	$ 27,295,267		
5/31/2009	34,833,840		
6/30/2009	(1,513)		
7/31/2009	(11,486,563)		
8/31/2009	(13,404,480)		
9/30/2009	(16,679,093)		
10/31/2009	(17,227,587)		
11/30/2009	(7,710,855)		
12/31/2009	2,623,162		
1/31/2010	2,125,013		
2/28/2010	7,958,232		
3/31/2010	(755,160)		$ 15,000,000
4/30/2010	5,374,481		
CWIP Balance @ 4/30/10	20,835,767		
STD Balance @ 4/30/10	$ (15,461,286)		