

MAWC 30

Exhibit No.:  
Issues: Capital Structure, Long-Term Debt  
Cost, and Overall Rate of Return  
Witness: Scott W. Rungren  
Exhibit Type: Rebuttal  
Sponsoring Party: Missouri-American Water Company  
Case No.: WR-2015-0301  
SR-2015-0302  
Date: February 11, 2016

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. WR-2015-0301  
CASE NO. SR-2015-0302**

**REBUTTAL TESTIMONY**

**OF**

**SCOTT W. RUNGREN**

**ON BEHALF OF**

**MISSOURI-AMERICAN WATER COMPANY**

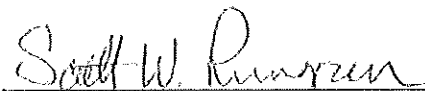
*MAWC* Exhibit No. 30  
Date 3-21-16 Reporter JR  
File No. WR-2015-0301

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI

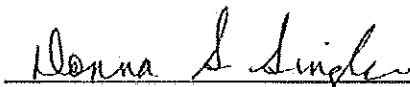
IN THE MATTER OF MISSOURI-AMERICAN )	
WATER COMPANY FOR AUTHORITY TO )	
FILE TARIFFS REFLECTING INCREASED )	CASE NO. WR-2015-0301
RATES FOR WATER AND SEWER )	CASE NO. SR-2015-0302
SERVICE )	

AFFIDAVIT OF SCOTT W. RUNGREN

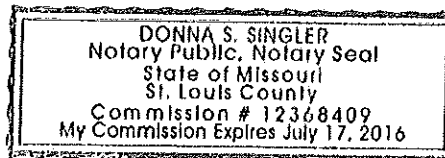
Scott W. Rungren, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Scott W. Rungren"; that said testimony was prepared by him and/or under his direction and supervision; that if inquiries were made as to the facts in said testimony, he would respond as therein set forth; and that the aforesaid testimony is true and correct to the best of his knowledge.

  
\_\_\_\_\_  
Scott W. Rungren

State of Missouri  
County of St. Louis  
SUBSCRIBED and sworn to  
Before me this 9<sup>th</sup> day of February 2016.

  
\_\_\_\_\_  
Notary Public

My commission expires: July 17, 2016



**REBUTTAL TESTIMONY  
SCOTT W. RUNGREN  
MISSOURI-AMERICAN WATER COMPANY  
CASE NO. WR-2015-0301  
CASE NO. SR-2015-0302**

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## REBUTTAL TESTIMONY

SCOTT W. RUNGREN

### I. INTRODUCTION

1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

2 A. My name is Scott W. Rungren and my business address is 727 Craig Road, St.  
3 Louis, Missouri, 63141.

4

5 Q. DID YOU PREVIOUSLY SUBMIT PREPARED DIRECT AND SUPPLEMENTAL  
6 DIRECT TESTIMONY IN THIS PROCEEDING?

7 A. Yes, I did.

8

### II. PURPOSE

9 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

10 A. The purpose of my rebuttal testimony is to address, on behalf of Missouri  
11 American Water Company ("MAWC" or the "Company"), the capital structure  
12 proposed by the Staff ("Staff") of the Missouri Public Service Commission  
13 ("Commission") for determining MAWC's Weighted Average Cost of Capital  
14 ("WACC") in this proceeding. The capital structure proposal of the Staff and  
15 discussion are contained on pages 24 to 27 of the Staff report entitled "Staff  
16 Report – Revenue Requirement Cost of Service" ("Staff Report"). I also address  
17 Staff's methodology for computing MAWC's costs of long-term debt, preferred  
18 stock, and short-term debt. In addition, with respect to the Direct Testimony of  
19 OPC witness Michael P. Gorman, I will address his criticisms of MAWC's

1 proposed capital structure, as well as the capital structure he has recommended  
2 the Commission adopt for MAWC.

3 **III. OVERVIEW**

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

5 A. My rebuttal testimony explains why MAWC's actual capital structure is appropriate  
6 for determining MAWC's WACC, or overall rate of return on rate base. The Staff  
7 Report incorrectly relies upon the December 31, 2014 consolidated capital  
8 structure ratios of American Water Works Company, Inc. (American Water) for  
9 determining the Company's WACC. The Staff Report claims the following as  
10 reasons for using American Water's consolidated capital structure ratios: 1)  
11 MAWC does not operate as an independent entity in terms of the procurement of  
12 its financing; 2) the debt issued by American Water Capital Corp. ("AWCC") is  
13 rated based on the consolidated credit quality of American Water; 3) the business  
14 risks of American Water and MAWC are similar; 4) American Water allegedly  
15 employs double leverage; and 5) all debt issued by AWCC and loaned to MAWC  
16 is, in essence, according to the Staff Report, guaranteed by American Water.  
17 (Staff Report, pp. 25-26).

18

19 I will demonstrate that none of these reasons provides any justification for using  
20 American Water's consolidated capital structure for determining MAWC's overall  
21 rate of return on rate base (i.e., WACC) in this proceeding. Finally, I will explain  
22 that MAWC's costs of long-term debt, preferred stock, and short-term debt (when

1 applicable) should be calculated using MAWC's financial data, and not that of  
2 American Water consolidated, as was done by the Staff.

3 **IV. CAPITAL STRUCTURE RATIOS**

4 **A. STAFF'S PROPOSED CAPITAL STRUCTURE**

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

10 A. No, I do not. The Commission should not set rates for MAWC in this proceeding  
11 based upon American Water's consolidated capital structure ratios. Rather, the  
12 Commission should adopt MAWC's actual capital structure at the true-up date of  
13 January 31, 2016. MAWC will present its updated actual January 31, 2016 capital  
14 component balances when the Company files its true-up schedules on February  
15 19, 2016.

16  
17 **Q. WHY IS MAWC'S PROJECTED JANUARY 31, 2016 CAPITAL STRUCTURE**  
18 **MORE APPROPRIATE FOR RATEMAKING PURPOSES?**

19 A. The Company's projected January 31, 2016 capital structure is more appropriate  
20 for ratemaking purposes for four reasons; 1) MAWC is a separate corporate entity  
21 that issues its own debt and common stock and, therefore, has an independently  
22 determined capital structure, 2) MAWC's stand-alone capital structure represents

1 the actual capital financing MAWC's jurisdictional rate base, to which the overall  
2 rate of return set in this proceeding will be applied, 3) the January 31 pro forma  
3 date will be close in time to when the rates set in this case will go into effect; and  
4 4) MAWC's stand-alone capital structure is consistent with the capital structure  
5 ratios maintained, on average, by other water companies.

6

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

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

17

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

1 "Nothing in this Agreement prohibits or restricts the Company  
2 from borrowing from third parties, or obtaining services described  
3 in this Agreement from third parties, whenever and on whatever  
4 terms it deems appropriate."  
5

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

13  
14 The above discussion illustrates that MAWC has autonomy with respect to the  
15 issuance of both its debt and equity securities and, thus, the management of its  
16 capital structure.

17  
18 **Q. YOU NOTED THAT USE OF MAWC'S CAPITAL STRUCTURE, RATHER THAN**  
19 **AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE, IS**  
20 **APPROPRIATE BECAUSE MAWC'S STAND-ALONE CAPITAL STRUCTURE**  
21 **REPRESENTS THE ACTUAL CAPITAL THAT FINANCES MAWC'S**  
22 **JURISDICTIONAL RATE BASE. WHY IS THE ACTUAL CAPITAL FINANCING**  
23 **MAWC'S JURISDICTIONAL RATE BASE RELEVANT AND APPROPRIATE**  
24 **FOR RATEMAKING PURPOSES?**

25 **A.** It is relevant and appropriate for ratemaking purposes because it represents the



1 actual dollars that are financing MAWC's jurisdictional rate base to which the rate  
2 of return authorized in this proceeding will be applied. In contrast, the  
3 consolidated American Water capital structure proposed by the Staff contains  
4 capital that was not used to finance MAWC's jurisdictional rate base. For  
5 example, it includes the long-term debt capital of American Water's other  
6 operating water subsidiaries, in addition to MAWC, which finances the  
7 jurisdictional rate bases of those subsidiaries.

8 MAWC's rate base is financed in a manner that reflects MAWC's capital structure  
9 ratios, not American Water's consolidated capital structure ratios. That is,  
10 MAWC's rate base is financed by the capital components that comprise MAWC's  
11 capital structure, in the ratio of each capital component's proportion to total  
12 capital. It is this capital structure that should be used to determine the weighted  
13 cost of each of the individual capital components, because the sum of these  
14 weighted component costs is the overall cost of capital. It is this overall cost of  
15 capital that represents the rate of return MAWC needs to earn on its rate base to  
16 satisfy the contractual obligations to, and the return requirements of, its investors.

17  
18 Using the consolidated capital structure of American Water will not ensure that  
19 MAWC is provided the funds necessary to service its various forms of capital, as  
20 the excerpt from the Staff Report above clearly and correctly asserts is central to  
21 determining a utility's WACC.

22

1 Q. HOW WILL THE USE OF AMERICAN WATER'S CONSOLIDATED CAPITAL  
2 STRUCTURE, RATHER THAN MAWC'S CAPITAL STRUCTURE AFFECT THE  
3 OVERALL RETURN ON RATE BASE THAT IS REASONABLE FOR  
4 RATEMAKING PURPOSES?

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

11  
12 Although an important objective of regulation is to minimize the cost of reliable  
13 service to ratepayers, it is equally important to allow public utilities the opportunity  
14 to earn a fair and reasonable rate of return. When a public utility is authorized a  
15 rate of return equal to a reasonable cost of capital, the interests of ratepayers and  
16 investors are properly balanced. If the authorized rate of return is greater than a  
17 reasonable cost of capital, ratepayers are burdened with excessive rates.  
18 Conversely, if the authorized rate of return is less than a reasonable cost of  
19 capital, the utility may be unable to raise capital at a reasonable cost and  
20 ultimately may be unable to raise sufficient capital to meet demands for safe and  
21 reliable service. Therefore, the interests of ratepayers and investors are best  
22 served when a utility's allowed rate of return is set equal to a reasonable overall  
23 cost of capital.

1

2 **Q. YOU NOTED THAT THE JANUARY 31, 2016 PRO FORMA DATE IS CLOSE IN**  
3 **TIME TO WHEN THE RATES ESTABLISHED IN THIS PROCEEDING WILL GO**  
4 **INTO EFFECT. PLEASE EXPLAIN WHY THAT IS SIGNIFICANT.**

5 A. The January 31, 2016 pro forma date, currently being used by the Company to  
6 calculate its capital structure, will be updated with actual January 31, 2016 data  
7 when the Company files its true-up on February 19, as previously noted. Since  
8 this proceeding will determine rates for future service, it is reasonable for the  
9 capital structure components to reflect the forecasted balances for those  
10 components during the time that those rates will be in effect. On that basis, the  
11 Company's capital structure measurement date of January 31, 2016 is preferable  
12 to the Staff's measurement date of December 31, 2014.

13

14 **Q. HOW DO THE COMPANY'S PRO FORMA CAPITAL STRUCTURE RATIOS AT**  
15 **JANUARY 31, 2016 COMPARE WITH THOSE MAINTAINED BY OTHER**  
16 **WATER COMPANIES?**

17 A. The Company's pro forma January 31, 2016 capital structure ratios are consistent  
18 with those maintained, on average, by the eight water companies in Staff's  
19 comparable water utility group, as shown on Schedule 10 attached to the Staff  
20 Report. These are the same eight companies I assessed in my Direct Testimony  
21 when discussing the reasonableness of MAWC's proposed capital structure, since  
22 these companies also comprise Company-witness Dr. Morin's proxy group (see  
23 Rungren DT, pp. 5-6). As noted in my Direct Testimony, I did exclude one

1 company in Dr. Morin's proxy group, Consolidated Water Company, because it  
2 had an equity ratio of 100%. With that exclusion, Dr. Morin's proxy group and the  
3 Staff's comparable water utility group are identical. As I noted in my Direct  
4 Testimony, the average equity ratio of this comparable water utility group was  
5 54.54% as of December 31, 2014. Thus, the equity ratio of MAWC's proposed  
6 capital structure, 52.37%, is lower than that of the average equity ratio of the  
7 water sample used by both Dr. Morin and Staff in their respective cost of equity  
8 analyses.

9 I also noted in my Direct Testimony, page 6, that the equity ratio of MAWC's  
10 proposed capital structure is lower than Value Line's projected equity ratios for  
11 these eight water companies. However, I have updated that analysis for this  
12 rebuttal filing by examining the Value Line Investment Survey reports published  
13 on October 16, 2015. Value Line projects an average common equity ratio for the  
14 eight water utilities of 53.9% in 2015, 53.5% in 2016, and 52.8% over the 2018-  
15 2020 period. Again, MAWC's proposed common equity ratio of 52.37% is in each  
16 case lower. These comparisons confirm my opinion of the reasonableness of  
17 MAWC's proposed capital structure. Since MAWC's pro forma January 31, 2016  
18 capital structure ratios are consistent with those maintained, on average, by the  
19 eight water companies in MAWC's and Staff's comparable water group, MAWC's  
20 proposed capital structure is reasonable for ratemaking purposes in this  
21 proceeding.

22

1 **B. THE STAFF REPORT**

2 **Q. THE FIRST REASON PRESENTED IN THE STAFF REPORT AS A BASIS FOR**  
3 **USING AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS**  
4 **THAT "MAWC IS NOT OPERATING AS AN INDEPENDENT ENTITY, AT**  
5 **LEAST WHEN CONSIDERING MAWC'S PROCUREMENT OF FINANCING**  
6 **AND THE COST OF THAT FINANCING" (STAFF REPORT, P. 25). PLEASE**  
7 **RESPOND.**

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

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**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. 25). PLEASE RESPOND.**

A. The cost of debt issued by AWCC does reflect the credit quality of American Water consolidated. This has no relation, however, to the sources of capital that comprise MAWC's capital structure. The cost of debt to AWCC only impacts MAWC's cost of borrowing through AWCC, which is quite advantageous. 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 amount of debt in MAWC's capital structure.

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

3 A. Referring to page 2 of Schedule SWR-1 attached to my Direct Testimony, as of  
4 the pro forma date of January 31, 2016, MAWC will have approximately \$488.6  
5 million of long-term debt outstanding. Of that amount, approximately \$81 million,  
6 or 16.6%, will have come from sources other than AWCC. This includes \$57.48  
7 million of tax-exempt bonds the company issued on December 21, 2006, using  
8 the Missouri State Environmental Improvement and Energy Resources Authority  
9 ("EIERA") as a conduit. In fact, in its recent financing application filed with the  
10 Commission and approved in Case No. WF-2015-0209, the Company requested  
11 authority to pursue tax-advantaged debt financing options, such as funding  
12 through the Water Pollution Control Program administered by the Missouri  
13 Department of Natural Resources, which would occur outside of the AWCC  
14 arrangement. The Company also requested authority to obtain funding from the  
15 Missouri State Revolving Fund administered by the U.S. Environmental Protection  
16 Agency and the State of Missouri, as well as from the EIERA. Again, funding from  
17 any of these options would be obtained directly by MAWC and not through  
18 AWCC.

19

20 Q. THE THIRD REASON PRESENTED IN THE STAFF REPORT FOR USING  
21 AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT  
22 BECAUSE AMERICAN WATER IS PRIMARILY A REGULATED WATER  
23 DISTRIBUTION UTILITY, THE BUSINESS AND FINANCIAL RISKS OF

1           **AMERICAN WATER ARE SIMILAR TO THAT OF MISSOURI-AMERICAN**  
2           **(STAFF REPORT, PP. 25-26). WHAT IS YOUR RESPONSE?**

3    A.    The Staff Report asserts that because, in its view, American Water consolidated  
4           and MAWC have similar levels of business risk they can be expected to have  
5           similar levels of financial risk. And further, because their business and financial  
6           risks are similar, they should be expected to have similar capital structures. This  
7           argument makes an unwarranted and unjustified assumption regarding the risk  
8           profile of two separate entities. Staff has offered no extrinsic evidence showing  
9           that American Water and MAWC have similar levels of business and financial risk.  
10          Two firms that exist within the same industry do not necessarily possess the same  
11          risk profile, or have the same cost of capital. These determinations are firm-  
12          specific, as should be the capital structure and resulting weighted average cost of  
13          capital. Rather than simply assuming that American Water and MAWC have  
14          similar levels of business and financial risk to justify use of American Water's  
15          consolidated capital structure, it is more reasonable and prudent to just use  
16          MAWC's capital structure. It is the risks facing MAWC and their impact on the  
17          management of MAWC's capital structure that are relevant to MAWC's  
18          ratepayers, not the risk profile of American Water consolidated. Further, a logical  
19          extension of Staff's position suggests that the capital structure of any water utility  
20          could be used as a proxy for MAWC's capital structure, including that of any of the  
21          firms in Staff's comparable group, all of which (with the exception of American  
22          Water) have a higher equity ratio than that of MAWC.

23



1 Q. ON THIS SAME POINT, STAFF CLAIMED THAT “BECAUSE IT IS THE  
2 PARENT COMPANY’S CONSOLIDATED OPERATIONS THAT DRIVE THE  
3 COST OF DEBT CAPITAL AND EQUITY CAPITAL, THE PARENT  
4 COMPANY’S CAPITAL STRUCTURE IS THE CAPITAL STRUCTURE THAT  
5 WILL BE ANALYZED BY INVESTORS WHEN DETERMINING THE REQUIRED  
6 RATE OF RETURN FOR DEBT ISSUED BY AWCC AND EQUITY ISSUED BY  
7 AMERICAN WATER (STAFF REPORT, P. 25). PLEASE COMMENT.

8 A. The above statement has nothing to do with determining the appropriate capital  
9 structure to use in this proceeding. The cost of debt issued by AWCC is indeed a  
10 function of American Water’s consolidated operations, as is American Water’s  
11 cost of common equity. However, MAWC’s capital structure is not impacted by  
12 these costs. The only financial impact of American Water’s consolidated  
13 operations on MAWC is related to MAWC’s costs of short-term and long-term  
14 debt, to the extent MAWC issues long-term debt through AWCC. Therefore,  
15 Staff’s point on this topic is simply not relevant to the determination of an  
16 appropriate capital structure for MAWC.

17  
18 Q. THE FOURTH REASON PRESENTED IN THE STAFF REPORT FOR USE OF  
19 AMERICAN WATER’S CONSOLIDATED CAPITAL STRUCTURE IS THAT  
20 AMERICAN WATER EMPLOYS DOUBLE LEVERAGE, A SITUATION IN  
21 WHICH AMERICAN WATER SUPPOSEDLY USES PROCEEDS RECEIVED  
22 FROM DEBT FINANCINGS TO INFUSE EQUITY INTO ITS SUBSIDIARIES  
23 (STAFF REPORT, P. 26). PLEASE RESPOND.

1 A. The Staff Report does not explain the relevance of double leverage to MAWC's  
2 capital structure, and why this is a basis to use American Water's consolidated  
3 capital structure. This issue is addressed in the Rebuttal Testimony of Company  
4 witness Dr. Roger Morin.

5

6 **Q. THE FIFTH AND FINAL REASON PRESENTED IN THE STAFF REPORT FOR**  
7 **USE OF AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS**  
8 **THAT IN STAFF'S VIEW "IT APPEARS THAT ALL DEBT ISSUED BY AWCC**  
9 **AND LOANED TO MAWC IS ESSENTIALLY GUARANTEED BY AMERICAN**  
10 **WATER." THE STAFF REPORT GOES ON TO SAY THAT "THE**  
11 **SUBSIDIARY'S USE OF DEBT FINANCING THAT IS BACKED BY THE**  
12 **PARENT SUPPORTS STAFF'S RECOMMENDATION TO USE AMERICAN**  
13 **WATER'S CONSOLIDATED CAPITAL STRUCTURE" (STAFF REPORT, PP.**  
14 **26). PLEASE RESPOND.**

15 A. American Water has not guaranteed any debt issued by MAWC through AWCC.  
16 The Support Agreement does not relieve MAWC of its financial obligation  
17 associated with debt issued through AWCC. The Support Agreement, in essence,  
18 affords the financial backing and credit risk of American Water to AWCC, as  
19 signified by bond rating agencies typically assigning the same rating to AWCC as  
20 they do to American Water. The extent to which risk associated with debt issued  
21 by MAWC through AWCC is mitigated by the Support Agreement between  
22 American Water and AWCC will be reflected in a lower interest rate to MAWC,

1           which is then reflected in the Company's WACC, but has no bearing on  
2           determining the appropriate capital structure to use for ratemaking purposes.

3

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

6   A.   Yes, in addition to improperly using American Water's consolidated capital  
7   structure, Staff chose to calculate the embedded cost of long-term debt for MAWC  
8   by using American Water's consolidated total annual long-term debt costs and  
9   carrying value (Staff Report, Schedule 7). This methodology results in a long-  
10   term debt cost of 5.69%, rather than the correct cost of 5.47%, as shown on  
11   Schedule SWR-1, page 2 of 4, attached to my direct testimony. Clearly, the  
12   computation of MAWC's embedded cost of long-term debt should be performed  
13   using MAWC's long-term debt schedule, which represents its actual contractual  
14   commitments to bond holders. Using inputs that are applicable for calculating  
15   American Water's consolidated cost of long-term debt rather than MAWC's is  
16   entirely inappropriate and cannot be expected to provide MAWC the ability to  
17   meet the contractual obligations it has to its bondholders. Thus, the methodology  
18   Staff used to compute MAWC's embedded cost of long-term debt should be  
19   rejected by the Commission.

20

21   **Q.   DOES THE STAFF REPORT INCLUDE ANY ERRORS WITH RESPECT TO**  
22   **THE CALCULATION OF MAWC'S EMBEDDED COST OF PREFERRED**  
23   **STOCK?**

1 A. Yes, the Staff used the same methodology for computing the cost of preferred  
2 stock as it did for computing the cost of long-term debt. That is, Staff improperly  
3 used American Water's consolidated capital structure and calculated the  
4 embedded cost of preferred stock for MAWC by using American Water's  
5 consolidated total annual preferred stock costs and carrying value (Staff Report,  
6 Schedule 8). This methodology results in a preferred stock cost of 8.64%, rather  
7 than the correct cost of 9.46%, as shown on Schedule SWR-1, page 3 of 4,  
8 attached to my direct testimony. Thus, Staff's methodology and cost of preferred  
9 stock should be rejected by the Commission for the same reasons noted above in  
10 the discussion of the cost of long-term debt.

11

12 **Q. DOES THE STAFF REPORT INCLUDE ANY ERRORS WITH RESPECT TO**  
13 **THE CALCULATION OF THE COST OF SHORT-TERM DEBT?**

14 A. Yes, the Staff used the balance of short-term debt in American Water's  
15 consolidated capital structure rather than calculating MAWC's balance of short-  
16 term debt. The balance of short-term debt, if any, in MAWC's capital structure  
17 should be based on MAWC's short-term debt balance, not that of American Water  
18 consolidated. In addition, Staff's short-term debt cost of 0.31% is based on the  
19 average cost of the twelve months ended December 31, 2014 (Staff Report, page  
20 27). However, Staff should have used more recent data to derive its cost  
21 recommendation since short-term rates have changed significantly in recent  
22 months. Thus, Staff's methodology and cost of short-term debt should be rejected  
23 by the Commission.

1

2 **Q. THE STAFF REPORT CONCLUDES ITS DISCUSSION OF MAWC'S CAPITAL**  
3 **STRUCTRE BY SUGGESTING THAT AMERICAN WATER MANIPULATES**  
4 **MAWC'S EQUITY RATIO TO ACHIEVE A HIGHER PRE-TAX RETURN. WHAT**  
5 **IS YOUR RESPONSE?**

6 A. The Staff Report states as follows:

7 "Because MAWC does not issue its own debt, Staff believes  
8 American Water maintains a higher equity ratio at its MAWC  
9 (sic) for the purpose of attempting to achieve a higher  
10 revenue requirement in the form of a higher pre-tax return.  
11 The Commission can prevent American Water from  
12 receiving an unreasonable rate of return from its MAWC  
13 subsidiary by setting MAWC's rate of return based on  
14 American Water's capital structure, which reflects the capital  
15 structure that American Water targets for purposes of  
16 capitalizing all of its regulated water utility operations" (Staff  
17 Report, pp. 26-27).

18 I would note that Staff does not provide any evidence to support this speculative  
19 assertion. Of course, Staff is mistaken when it claims that MAWC does not issue  
20 its own debt. MAWC has issued its own debt, witness the EI ERA financing  
21 discussed previously, and may do so in the future. Furthermore, it is a stretch to  
22 claim that American Water is manipulating MAWC's equity ratio given that  
23 MAWC's equity ratio is actually lower than that of the water proxy group used by  
24 Staff. In fact, American Water generally targets a 50% equity ratio for its  
25 regulated subsidiaries, although actual equity ratios across the system will, of  
26 course, tend to be somewhat higher or lower than 50% depending on factors such  
27 as earnings growth, the company's financing cycle, market conditions, etc. That  
28 is, it would not be practical, if indeed possible, to maintain an equity ratio of

1 exactly 50% at each subsidiary. In addition, Staff has failed to demonstrate that a  
2 higher pre-tax return would result in a higher earned return to American Water  
3 (the Parent). That is, a higher equity ratio will produce a higher operating income,  
4 all else equal, but the return on investment may not necessarily be higher. This is  
5 because the amount of the investment needed to produce the higher level of  
6 operating income is greater.

7 **C. OPC WITNESS GORMAN'S PROPOSED**  
8 **CAPITAL STRUCTURE**

9 **Q. WHAT CAPITAL STRUCTURE DOES OPC WITNESS MICHAEL P. GORMAN**  
10 **RECOMMEND BE USED FOR COMPUTING MAWC'S WACC IN THIS CASE?**

11 A. Mr. Gorman has adjusted MAWC's proposed capital structure based on his view  
12 that a reasonable capital structure for MAWC should contain a mix of 50% debt  
13 and 50% equity (Gorman DT, p. 22). As a result, Mr. Gorman proposes a capital  
14 structure consisting of 49.28% long-term debt, 0.12% preferred stock, and 50.59%  
15 common equity (Gorman DT, p. 24).

16  
17 **Q. HOW DID MR. GORMAN ADJUST THE COMPANY'S CAPITAL STRUCTURE?**

18 A. To arrive at his recommendation, Mr. Gorman reduced the Company's 2015  
19 equity infusion from \$30 million to \$12 million, and increased the long-term debt  
20 issuance planned for August 2015 (at the time of our filing) from \$20 million to \$38  
21 million (Gorman DT, pp. 23-24). I would note that just prior to the filing of our rate  
22 case on July 31, 2015, the Company determined to increase the debt financing  
23 from \$20 million to \$50 million. Unfortunately, reflecting this change in our filing

1 was problematic, but it will be included in the Company's true-up filing on  
2 February 19. The Company's expectation is that the equity ratio at true-up will be  
3 lower than 52.37% as proposed in its initial filing.  
4

5 **Q. DO YOU DISAGREE WITH THE ADJUSTMENTS MADE BY MR. GORMAN TO**  
6 **ARRIVE AT HIS PROPOSED CAPITAL STRUCTURE?**

7 A. Yes, on a conceptual basis I disagree with the arguments Mr. Gorman presented  
8 as support for making his adjustments. As I understand his testimony, his  
9 principal argument relates to MAWC's equity ratio in its last rate case relative to  
10 that of American Water's at that time, and the S&P and Moody's ratings upgrades  
11 to American Water and AWCC that have occurred since then. Mr. Gorman notes  
12 that the American Water consolidated equity ratio has remained largely  
13 unchanged at approximately 47% since 2012, but that its bond rating has been  
14 upgraded in spite of the equity ratio remaining the same over that period. Mr.  
15 Gorman then makes the leap that MAWC's equity ratio, which was 50.57% as  
16 determined by settlement in its 2012 rate case, "contributed to the capital  
17 structure at the parent company in its last rate case which was a strong  
18 investment grade bond rating" (Gorman DT, p. 21). American Water's S&P bond  
19 rating in 2012 was BBB+, which was certainly an investment grade rating, but not  
20 one I would characterize as "strong". That point notwithstanding, Mr. Gorman's  
21 argument is that American Water has seen its bond rating upgraded by S&P and  
22 Moody's since 2012 without increasing its equity ratio. Mr. Gorman's conclusion  
23 is that MAWC has unnecessarily increased its equity ratio, evidenced by the fact

1 that American Water has not increased its equity ratio since 2012 and has still  
2 seen its bond rating improve. Mr. Gorman's argument seems to ignore the fact  
3 that other factors besides equity ratio can, and have, influenced American Water's  
4 bond rating. Ironically, Mr. Gorman noted these factors when discussing S&P's  
5 and Moody's rationale for upgrading American Water in 2015 (Gorman DT, pp.  
6 18-19). In addition, S&P modified its corporate ratings criteria in 2013, noting its  
7 expectation that the ratio of upgrades to downgrades in the industrial and utility  
8 sectors would be 3 to 1 (see Standard & Poor's *RatingsDirect*, November 19,  
9 2013). In short, American Water's improved bond rating is not an argument for  
10 maintaining its equity ratio at 47%, or MAWC's at 50.57% as it was back in 2012.

11  
12 **Q. DO YOU DISAGREE WITH ANY OTHER OF MR. GORMAN'S FINDINGS?**

13 A. Yes, I do. In his discussion of MAWC's investment risk, Mr. Gorman claims that  
14 MAWC "issued tax exempt senior secured debt with a credit rating of AA+"  
15 (Gorman DT, p. 18). This refers to long-term debt that was issued by MAWC in  
16 2006 through the EI ERA, which is part of the Missouri Department of Natural  
17 Resources. The key point is that the AA+ rating was attained as a result of the  
18 purchase, by MAWC, of bond insurance through the Ambac Assurance  
19 Corporation, which essentially guaranteed principal and interest payments would  
20 be made to bondholders. These MAWC bonds would not have had a AA+ rating  
21 without purchasing bond insurance, which calls into question Mr. Gorman's  
22 assessment of MAWC's investment risk.

23



1 **V. SUMMARY**

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

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

- 8 • MAWC manages its capital structure and makes financing decisions  
9 independently from its parent, American Water.
- 10 • Using American Water's consolidated capital structure will result in  
11 capital component ratios that produce an overall rate of return on rate  
12 base that may be higher or lower than that needed to satisfy the return  
13 requirements of, and the contractual obligations to, MAWC's investors.
- 14 • Using MAWC's pro forma January 31, 2016 capital structure will result  
15 in a WACC, or an overall rate of return on rate base, that will provide  
16 the Company the opportunity to satisfy the return requirements of its  
17 investors.
- 18 • MAWC's pro forma January 31, 2016 capital structure is consistent with  
19 that of the proxy water company groups used by Staff, OPC, and  
20 Company witness Roger Morin in this proceeding.

- 1           •     Staff's point that MAWC is not operating as an independent entity, at  
2                     least when considering MAWC'S procurement of financing and the cost  
3                     of that financing, is not a valid reason for using American Water's  
4                     consolidated capital structure ratios. To the contrary, it actually  
5                     penalizes MAWC for using a least-cost source of debt capital by taking  
6                     the cost benefit for the purpose of calculating the weighted average cost  
7                     of debt and then using that prudent corporate decision as evidence of a  
8                     lack of independence.
- 9           •     Staff's point that debt issued by AWCC is rated based on the credit  
10                    quality of American Water has no bearing whatever on determining the  
11                    appropriate capital structure for MAWC.
- 12          •     Staff's contention that because American Water is primarily a regulated  
13                    water distribution utility, the business and financial risks of American  
14                    Water are similar to those of MAWC, is not supported and does not  
15                    justify use of American Water's consolidated capital structure.
- 16          •     Staff's assertion that American Water employs double leverage is not  
17                    explained and does not support use of American Water's consolidated  
18                    capital structure.
- 19          •     Staff's view that all debt issued by AWCC and loaned to MAWC is  
20                    guaranteed by American Water, which supports its recommendation to

1 use American Water's consolidated capital structure, is incorrect and, in  
2 any event, irrelevant to the management of MAWC's capital structure.

3 Therefore, Staff's proposal to use American Water's consolidated capital structure  
4 ratios for computing MAWC's WACC should be rejected by the Commission. I  
5 have demonstrated that the Commission should adopt MAWC's actual capital  
6 structure as of the true-up date of January 31, 2016.

7

8 I have also demonstrated that Mr. Gorman's recommendation to adjust MAWC's  
9 proposed capital structure to a debt/equity mix that is closer to 50%/50% is  
10 arbitrary and without merit. The fact that American Water's bond rating has  
11 improved since 2012 while its equity ratio has remained approximately 47%  
12 during that time does not suggest that MAWC's proposed capital structure in this  
13 case is inappropriate. Other factors have influenced the increase in American  
14 Water's bond rating during that time and do not necessarily have a bearing on  
15 MAWC's financial condition. I also pointed out the error of Mr. Gorman's claim  
16 that MAWC's investment risk is represented by the Company's issuance of senior  
17 unsecured debt in 2006 with a rating of AA+. As I noted, this debt was secured by  
18 MAWC's purchase of bond insurance through Ambac, which resulted in the AA+  
19 rating.

20

21 **Q. HAVE YOU PROVIDED ANY OTHER RECOMMENDATIONS IN YOUR**  
22 **REBUTTAL TESTIMONY?**

23 **A.** Yes, I have. I recommended that MAWC's costs of long-term debt and preferred

1 stock be calculated using MAWC's debt and preferred stock schedules, and not  
2 American Water's consolidated debt and preferred stock schedules, as was  
3 inappropriately done by Staff.

4

5 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

6 **A.** Yes, it does.