

Exhibit No.:

25

Issue(s):

Rate of Return

Witness/Type of Exhibit:

Burdette/Rebuttal

Sponsoring Party:

Public Counsel

Case Nos.:

WR-2000-281 and SR-2000-282

REBUTTAL TESTIMONY

OF

MARK BURDETTE

Submitted on Behalf of
the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

Case Nos. WR-2000-281 and SR-2000-282

May 4, 2000

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

In the matter of Missouri-American Water)
Company's tariff sheets designed to)
Implement general rate increases for water)
And sewer service provided to customers)
In the Missouri area of the company.)


Case Nos. WR-2000-281 and
SR-2000-282

AFFIDAVIT OF MARK BURDETTE

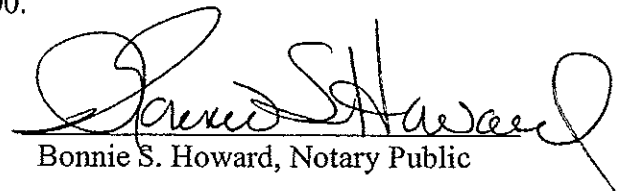
STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Mark Burdette, of lawful age and being first duly sworn, deposes and states:

1. My name is Mark Burdette. I am the Public Utility Financial Analyst for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony consisting of pages 1 through 14.
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.


Mark Burdette

Subscribed and sworn to me this 4th day of May, 2000.


Bonnie S. Howard, Notary Public

My Commission expires May 3, 2001.

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COMPARABLE GROUP

Q. DO YOU HAVE COMMENTS ON MR. WALKER'S SELECTION AND USE OF HIS COMPARABLE GROUP?

A. Yes. On page 3 of Walker-direct, Mr. Walker states:

As a check on the reasonableness of my common equity cost rate recommendation, I reviewed Value Line's projected returns on common equity for my comparable group of water utilities for the period 2002 to 2004. Value Line is relied on by investors and is the only investment advisory service of which I am aware that projects return on equity. Value Line's projected returns on common equity average 11.8% to 12.2%. The range of projected returns suggests that my recommendation of 11.7% for MAWC is reasonable, if not conservative. [Page 3, lines 7-14]

Q. IS THIS COMPARISON VALID?

A. No, it is not. Using Value Line's projected returns as a check of reasonableness for a recommended cost of common equity is an apples-to-oranges misguided comparison. The projected returns to common equity from Value Line are projected **actual** returns – not authorized returns. The purpose of this rate case is to set the authorized return that MAWC will have the opportunity to earn. The utility is unlikely to earn exactly at that level, but will instead earn at various levels both above and below the authorized return. Returns consistently above the authorized level are certainly possible. For example, MAWC may have been able to cut costs that were formerly included in cost of service. To the extent that costs decreased, the Company could earn extra money until a rate case, when the actual costs would be reflected in a new cost of service. Obviously, authorized returns would be lower than actual returns in this situation. Value Line's projections of actual earnings at some particular level are irrelevant when determining the appropriate authorized return.

1 Q. DO YOU HAVE COMMENTS REGARDING MR. WALKER'S SELECTION OF A
2 COMPARABLE GROUP OF WATER UTILITIES?

3 A. Yes, I do. Mr. Walker chose to use all water companies covered by The Value Line
4 Investment Survey (Value Line). However, many of those companies are unsuited for the
5 purposes of comparison due to particular factors for each company.

6 For example, as I previously stated, Mr. Walker looked to Value Line's projected
7 return on common equity for the comparable group in order to substantiate his
8 recommended ROE. But several of Mr. Walker's comparable companies don't have ROE
9 projections, nor any financial projections in Value Line. The lack of financial projections
10 also means no growth rate projections for those companies. The following companies were
11 included by Mr. Walker yet Value Line does not print financial projections: Artesian
12 Resources; Connecticut Water Services; Middlesex Water Company; SJW Corporation; and
13 Southwest Water Co.

14 Q. WHAT ARE YOUR OTHER COMMENTS REGARDING THE COMPANIES MR.
15 WALKER CHOSE AS COMPARABLE TO MAWC?

16 A. Following are some of the companies Mr. Walker chose to include in his analysis and the
17 reasons I believe inclusion is inappropriate.

18 Aquarion Company: not covered by Value Line.

19 Artesian Resources: no financial projections.

20 Connecticut Water Services: no financial projections.

21 Middlesex Water Company: no financial projections.

22 Pennichuck Corp.: not covered by Value Line

23
24 SJW Corp: in addition to the lack of financial projections, SJW Corp. is
25 involved in a merger negotiation with American Water Works, the parent
26 of MAWC. When a company is involved in a merger, market information
27 such as stock price becomes "tainted" due to the market's opinion of the
28 merger and therefore unsuitable for comparison purposes.
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32

Southwest Water Co.: no financial projections.

United Water Resources: has subsidiaries regulated by the MPSC, including United Water Resources in Jefferson City, which is involved in a merger transaction with MAWC.

York Water Co.: not covered by Value Line.

Q. WHY IS IT IMPORTANT TO NOTE THAT VALUE LINE DOES NOT PROVIDE PROJECTED FINANCIAL INFORMATION FOR THESE COMPANIES?

A. If Value Line provides no projected financial data, then estimates of future values of items such as earnings per share and expected dividends are unavailable. Also, there are no projected growth rates to use to formulate a sustainable growth rate for use in the Discounted Cash Flow model.

I also believe it is important, when possible, to take historical and projected data from the same source. The use of the same source is important for consistency in the way calculations are performed, for example.

Q. MR. WALKER INCLUDES SEVERAL COMPANIES THAT ARE NOT COVERED BY VALUE LINE INVESTMENT SURVEY, YET HE STATES THAT COVERAGE BY VALUE LINE IS THE CRITERION HE USED TO CHOOSE COMPARABLE COMPANIES. IS THIS INCONSISTENT?

A. Apparently, Value Line has discontinued coverage of these companies since Mr. Walker performed his analysis. Because of this, I believe his analysis should be updated and these companies excluded.

I do not believe Mr. Walker was intentionally being inconsistent at the time he performed his analysis, but I do believe that his analysis should be updated to reflect such major changes in his source material. Otherwise, the MPSC should view the analysis and resulting recommendations with caution.

1 Q. WILL EXCLUDING THESE COMPANIES FROM THE COMPARABLE GROUP LEAVE
2 ENOUGH COMPANIES FOR AN ANALYSIS?

3 A. Yes, I believe so. The question comes down to a choice between using more companies
4 even though some of them are not particularly appropriate for comparison or using fewer
5 companies but having each of them more appropriate for analysis. I believe the utilization
6 of fewer but more appropriate companies is the better choice.

7
8 **CAPITAL STRUCTURE**

9 Q. DOES MR. WALKER RECOMMEND A CAPITAL STRUCTURE THAT SHOULD BE
10 USED TO CALCULATE MAWC'S OVERALL RATE OF RETURN?

11 A. Yes, he does. However, MAWC (as represented by Mr. James Salser), OPC and Staff have
12 agreed conceptually on all aspects of capital structure. The parties have agreed to update
13 capital structure (including all component levels as well as embedded costs of long term
14 debt and preferred stock) to the true-up date in this proceeding. Therefore, I will not
15 directly comment on Mr. Walker's recommendations concerning capital structure or
16 embedded cost rates.

17 Q. WHAT COMMENTS DO YOU HAVE CONCERNING MR. WALKER'S CAPITAL
18 STRUCTURE RECOMMENDATION?

19 A. Mr. Walker used a pro forma (forecasted) capital structure as of 30 April 2000 when he
20 wrote his direct testimony dated 19 November 1999. However, the test year for this case is
21 30 September 1999, with selected updates and a true-up as of 30 April 2000. It is not
22 appropriate to ignore and fail to present an analysis in direct testimony based on the
23 Commission-determined test year for a rate case. Subsequent rounds of testimony may
24 focus on alternative dates, after discussion between the parties has taken place. But the test
25 year is the proper place to begin.

RISK

Q. MR. WALKER MAKES SEVERAL COMPARISONS OF RISK FACTORS FOR MAWC AND OTHER COMPANIES IN ORDER TO INCREASE HIS ROE RECOMMENDATION. COULD YOU PLEASE COMMENT?

A. Yes. Mr. Walker makes several comments regarding MAWC's size as compared to other companies and how this relates to risk. However, a direct comparison of the size of MAWC to other water utilities is not necessarily appropriate, especially if that analysis fails to consider MAWC's actual business and financial conditions.

MAWC is a wholly-owned subsidiary of American Water Works (AWK), the largest investor-owned water company in the United States. MAWC is not just some small isolated water company slugging it out with the larger companies. MAWC is backed by the strength and name of AWK. Because MAWC is wholly-owned by AWK, MAWC is not threatened by hostile takeover, for example. Also, MAWC is not at the mercy of the market to raise its equity capital – all equity is supplied by AWK. Additionally, MAWC operates under the umbrella of AWK's corporate structure, including common functions for many aspects of operations such as accounting, human resources, risk management and water quality. MAWC has advantages over some other water utility of comparable size that is NOT under a corporate umbrella as extensive as American Water Works'.

Q. DOES MR. WALKER ACTUALLY COMPARE MAWC TO ITS VERY OWN PARENT, AMERICAN WATER WORKS (AWK), IN AN ATTEMPT TO HIGHLIGHT RISK?

A. Yes. In an attempt to show risk differences between MAWC and "larger" water utilities,

Mr. Walker states:

For example, the operations of AWK and United Water Resources, Inc. (UWR), both are part of the Value Line group, provide water service in 22 states for 1,942,000 customers and 13 states and 581,000 customers, respectively. The population of the communities served by AWK are more than 7,000,000 people and 2,000,000 people for UWR. These wide ranging operations provide AWK and UWR shareholder's substantial geographic,

1 economic, regulatory, weather and customer diversification. MAWC
2 provides water service to a population of about 260,000 people and to
3 94,000 customers. [Walker-direct, page 16, lines 13-20]
4
5

6 What Mr. Walker fails to consider is that *MAWC is a wholly-owned subsidiary of AWK*.
7 AWK's shareholders are in effect MAWC's shareholders because AWK owns every share
8 of MAWC's common equity. The assets held by AWK are the stocks of other water
9 utilities, such as MAWC. MAWC's service area is included in AWK's service territory;
10 MAWC's customers are included in AWK's customers. The "wide ranging operations" of
11 AWK **includes** MAWC. The "substantial geographic, economic, regulatory, weather and
12 customer diversification" benefits of AWK exist because AWK owns many companies,
13 including MAWC.

14 Q. DOES AWK RECOGNIZE THIS RELATIONSHIP?

15 A. Yes. The American Water Works 1998 Annual Report to Shareholders states:

16 American Water Works includes 23 subsidiaries, each of which is
17 independently operated. That said, we should quickly add that **each of**
18 **these utility subsidiaries draws strength and economies of scale from**
19 **the group as a whole.** [page 9]
20

21 The American Water Works Service Company, a subsidiary, provides
22 professional services as required to affiliated companies. These services
23 include accounting, administration, communication, corporate secretarial,
24 engineering, financial, human resources, information systems, operations,
25 rates and revenue, risk management and water quality. **This arrangement,**
26 **which provides these services at cost, affords affiliated companies**
27 **professional and technical talent otherwise unavailable economically or**
28 **on a timely basis.** [Page 23]
29

30 Q. WHY IS THIS IMPORTANT IN THIS PROCEEDING?

31 A. The relationship between MAWC and AWK is important because Mr. Walker would have
32 the MPSC believe that MAWC is a small, isolated, risky company trying to make a go of it

1 all alone against so many other larger water companies. Mr. Walker's direct testimony
2 states (page 17, line 20 – page 18, line 12):

3 Q. IS THE IMPACT OF SIZE COMMONLY RECOGNIZED?

4
5 A. The National Association of Regulatory Utility Commissioners
6 (NARUC) recognizes that size affects business risk.

7
8 Also, because of their relative size, small companies cannot
9 take advantage of certain economies of scale available to larger
10 companies... Finally, small companies have less access to capital
11 markets.

12
13 Being owned by the largest investor-owned water company in the U.S. means MAWC (in
14 the words of MAWC's own parent) **"draws strength and economies of scale from the**
15 **group as a whole."** AWK makes this point to its shareholders in the annual report.

16 Also, MAWC need not go to the market for equity capital. All of MAWC's equity
17 capital comes from AWK. Similarly, MAWC is owned by and backed by AWK. Investors
18 know this relationship. I do not believe that the average investor considers it likely that
19 MAWC could fold or become financially unstable under the watchful corporate thumb of
20 American Water Works.

21 Q. WHY IS THIS IMPORTANT?

22 A. The companies can't have it both ways. AWK can't use the economies of scale as well as
23 the existence of its Service Company as selling points to its shareholders and selling points
24 to the MPSC in, for example, merger applications, and then turn around and claim extra risk
25 for MAWC based on it being a small company with none of these advantages.

26 The existence of the Service Company is a fact. All of the services they provide
27 MAWC at cost is a fact. American Water Works talks about these economies of scale and
28 the various advantages to their subsidiaries in its Annual Report – that is a fact. MAWC

1 need go no further than AWK – its parent – to raise equity capital; the Company does not
2 face the market as a whole. That is also a fact.

3 *All of these facts must be considered when evaluating Mr. Walker's claims that*
4 *MAWC suffers from extra risk due to it being a small company.*

5 Q. MR. WALKER ATTEMPTS TO IMPUTE A CREDIT RATING FOR MAWC BASED ON
6 FINANCIAL RATIOS. COULD YOU PLEASE COMMENT?

7 A. Yes. MAWC does not have debt securities that are rated by Standard & Poor's (S&P). Mr.
8 Walker attempts to assign, or at least pinpoint a "better or worse" relationship between the
9 actual ratings for his comparable group and a potential rating for MAWC. He does so by
10 looking at five financial ratios (Schedule HW-2.11) and comes to the conclusion "Based
11 solely upon these ratios, MAWC's debt would likely be rated lower than the comparable
12 group." (Walker-direct, page 20, lines 6-7)

13 Standard & Poor's fortunately does not attempt such rough or "better or worse"
14 analysis. The 1999 S&P Corporate Ratings Criteria states:

15 Standard & Poor's provides a rating only when there is adequate
16 information available to form a credible opinion and only after applicable
17 quantitative, qualitative, and legal analyses are performed.

18 The analytical framework is divided into several categories to
19 ensure salient qualitative and quantitative issues are considered...

20 **The rating process is not limited to an examination of various**
21 **financial measures.** Proper assessment of credit quality for an industrial
22 company includes a thorough review of business fundamentals, including
23 industry prospects for growth..... (page 5) [Emphasis added]
24

25 Q. DOES MR. WALKER WORK FOR STANDARD & POOR'S?

26 A. No.

1 Q. DOES HE FOLLOW S&P'S DESCRIBED PROCEDURE TO ASSIGN CREDIT
2 RATINGS?

3 A. No. In fact, Mr. Walker's attempt at assigning even a better or worse rating to MAWC is in
4 direct contradiction to S&P's philosophy of NOT looking only at a few financial ratios.

5 Q. COULD YOU SUMMARIZE YOUR COMMENTS ON MR. WALKER'S TESTIMONY
6 REGARDING RISK FACTORS FOR MAWC?

7 A. Yes. Mr. Walker's analysis of size-based risk factors completely ignores not only that
8 MAWC is a wholly-owned part of the largest public water utility in this country, but goes
9 so far as to compare MAWC to its very own parent. The comparison of size-based risk
10 factors for AWK and MAWC is of questionable validity and is certainly of questionable
11 value for these proceedings. Mr. Walker makes the comparison, stating "The size of a
12 company can be likened to ships on the ocean since a large ship has a much better chance of
13 weathering a storm than a small ship." (Walker-direct, page 16, lines 2-3). MAWC is
14 hardly a small ship alone on the ocean. Rather, MAWC is one of the engines propelling the
15 largest ship, American Water Works, through that very ocean.

16 While Mr. Walker's testimony presents MAWC as a small, risky company, in
17 actuality MAWC is a part of a very large parent company that owns all MAWC common
18 equity and provides MAWC (via the Service Company) the benefits and advantages of
19 being a part of a very large company. The picture Mr. Walker attempts to paint might be
20 appropriate for some small companies, but it certainly is not applicable to MAWC.

21 Q. WHY IS THIS DISCUSSION OF SIZE AND RISK IMPORTANT?

22 A. Mr. Walker would have the MPSC believe that an increased ROE is warranted for MAWC
23 due to risk factors relating to size. Obviously, that is not the case.

COST OF COMMON EQUITY

Q. HOW DOES MR. WALKER CALCULATE A RETURN ON EQUITY RECOMMENDATION FOR MAWC?

A. Mr. Walker utilizes three methods: discounted cash flow (DCF), capital asset pricing model (CAPM), and a risk premium model.

Q. DO YOU AGREE WITH MR. WALKER'S SELECTION OF FINANCIAL MODELS?

A. Two of Mr. Walker's choices, the DCF and the CAPM, are the same methods I utilized in my direct testimony. However, I do not subscribe to risk premium analyses for determining the cost of equity capital.

Q. WHY DO YOU DISAGREE WITH THE USE OF RISK PREMIUM APPROACHES?

A. Risk premium analyses are based on the idea that there is a return premium on common stock over and above the return on bonds. I agree with that. However, risk premium analyses are also based on the ideas that this risk premium is not only measurable, but constant. I do not agree with that. Any risk premium calculation is susceptible to subjective manipulation – the easiest method being by carefully choosing the period in which you observe the returns of stocks as compared to bonds. Because this difference in returns (the premium) is not constant and in fact varies over time, an analyst can come up with just about any premium that suits him by selectively choosing the time period.

The variability of risk premiums can be seen by looking at Mr. Walker's own risk premium analysis (Walker-direct, Schedule 19).

Q. WHAT WAS THE RESULT OF MR. WALKER'S DCF ANALYSIS?

A. As can be seen on Walker-direct, Schedule 13, Mr. Walker's DCF cost of common equity for MAWC is 10.5%. This value is higher than my own recommendation of 9.92%, and

1 falls within the high end of Staff witness McKiddy's range of 9.5% to 10.75% (midpoint
2 10.125%).

3 Q. DO YOU HAVE COMMENTS REGARDING MR. WALKER'S DCF ANALYSIS?

4 A. Yes. Mr. Walker inflated his growth rate calculations by ramping the growth rates up based
5 on projected returns to common equity (Walker-direct, page 26, beginning on line 9;
6 Schedule 15). The two flaws in this analysis are:

7 1) Mr. Walker is calculating a growth rate based on return on equity estimations,
8 rather than calculating a growth rate on it's own merits. He is calculating a growth rate in
9 order to make ROE estimations "fit." This is backwards. It is growth that drives ROE. It is
10 not that ROE is a given and then a growth rate is a fall out number. The entire point of
11 return on equity calculations is to calculate ROE; it is not to start with a favored ROE and
12 then figure out how to make the formulas work out. But that is the result with Mr.
13 Walker's analysis. He used future estimations of actual returns in order to calculate a
14 growth rate rather than calculating a growth rate appropriate for MAWC.

15 2) Projected growth rates are just that – *projected*. They should not be inflated
16 based on estimated future earnings. Mr. Walker uses estimations of future actual earnings
17 to adjust growth rates, which is inappropriate. He uses those ROE estimations to increase a
18 value (a growth rate *projection*) that already represents future estimations. In effect, he is
19 applying extra growth by using projections and increasing them even further.

20 Q. WHAT IS THE RESULT OF THESE INAPPROPRIATE ADJUSTMENTS?

21 A. Mr. Walker's growth rate that he used in his DCF, and therefore his DCF recommendation,
22 is too high.

1 Q. DOES MR. WALKER ACKNOWLEDGE THIS APPROACH?

2 A. Yes. On page 26, line 20, Mr. Walker states:

3 For example, a 7.6% annual growth **will occur** when the Water Group's
4 ROE increases from the current 10.3% to the projected 12.2% over a five-
5 year period. The EPS growth will be 8.5% is such an increase occurred
6 over a four-year period. [Emphasis added]

7
8 Mr. Walker states that a potential growth rate WILL OCCUR given a change of ROE.

9 Obviously, if I assume a company earns an exorbitant return on equity, I could show that it
10 had a large growth rate. That isn't the point of a return on equity calculation. But that is
11 the method Mr. Walker used in developing his DCF growth rate, and that is why his DCF is
12 overstated.

13 Q. WHAT GROWTH RATE DOES MR. WALKER'S ANALYSIS SHOW IS APPROPRIATE
14 IF YOU REMOVE THE EFFECTS OF HIS ADJUSTMENTS?

15 A. As can be seen in Walker-direct, page 27, Table 4, the majority of Mr. Walker's growth rate
16 calculations are around 5% - 6% rather than the 6.8% he uses to calculate his DCF. This
17 range agrees with my recommended growth rate of 5%.

18 Q. WHAT WOULD MR. WALKER'S DCF RECOMMENDATION BE USING THE
19 APPROPRIATE GROWTH RATE?

20 A. Mr. Walker's actual growth range (unadjusted), taken with his dividend yield calculation of
21 3.6%, gives a **DCF cost of common equity in the range of 8.6% - 9.6%** (3.6% dividend
22 yield plus 5% growth = 8.6% ROE; 3.6% + 6% = 9.6%).

23 Q. DO YOU HAVE COMMENTS REGARDING MR. WALKER'S CAPM ANALYSIS?

24 A. Yes. Mr. Walker made numerous adjustments to his CAPM cost of common equity, all of
25 which worked to increase his recommendation, including an upward adjustment of 0.5% for
26 risk associated with small size.

1 Removing just the upward adjustment for size decreases one of his CAPM
2 estimations to 10.8% from 11.3%.

3 Mr. Walker also adjusts his CAPM analysis by increasing the overall value of the
4 "beta multiplied by the market premium" term in the CAPM. He does so by adding in 25%
5 of the market premium unadjusted by beta. He explains what he does, but not why. The
6 result of this adjustment is that his historical CAPM (11.3%) includes an almost full
7 percentage point upward bump and his projected CAPM (12.3%) includes more than a full
8 percentage point bump.

9 Removing the effect of this adjustment from the 11.3% value, for example, along
10 with removal of the size adjustment, results in a **CAPM cost of common equity of 9.90%**.
11 This result agrees quite well with my CAPM cost of common equity calculations of 10.19%
12 and 9.90% (see Burdette-direct, schedule MB-10).

13 Q. COULD YOU SUMMARIZE YOUR TESTIMONY?

14 A. Yes. MAWC witness Mr. Walker makes several inappropriate adjustments to his cost of
15 equity calculations. When the effects of these adjustments are removed, his calculations
16 show very good support for my recommended cost of common equity of 9.92% and also
17 support an ROE within the lower portion of Staff witness McKiddy's calculated range.

18 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

19 A. Yes, it does.