Exhibit No.:	
Issues:	Rate of Return, Capital Structure and Acquisition Adjustment
Witness:	Stephen D. Wurtzler
Exhibit Type:	Rebuttal
Sponsoring Party:	St. Joseph Water Rate Coalition
Case No.:	WR-2003-0500
Date:	November 10, 2003

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2003-0500

REBUTTAL TESTIMONY

OF

STEPHEN D. WURTZLER

ON BEHALF OF THE

ST. JOSEPH WATER RATE COALITION

FILED[2]

NOV 10 2003

Missouri Public Service Commission

JEFFERSON CITY, MISSOURI
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-2003-0500**

AFFIDAVIT OF STEPHEN D. WURTZLER

Stephen D. Wurtzler, being first duly sworn, deposes and states that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Stephen D. Wurtzler," 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.

Stephen D. Wurtzler

State of Missouri)
) ss
County of ~~Buchanan~~ JACKSON)

Subscribed and sworn to before me this 6 day of November 2003.

DEANNA R. HUGHES
Notary Public - Notary Seal
State of Missouri
County of Jackson
My Commission Exp. 11/18/2006

Deanna R. Hughes
Notary Public

My commission expires: 11/18/2006

Rebuttal Testimony of
Stephen D. Wurtzler
On behalf of the St. Joseph Water Rate Coalition

Case No. WR-2003-0500

Q. Please state your name, occupation, and business address.

A. My name is Stephen D. Wurtzler. I have most recently served as a consultant to businesses in the Midwest. On October 30, 2003, I became the Chief Financial Officer of Fairbanks Scales, Inc., 821 Locust Street, Kansas City, Missouri 64106.

Q. Please summarize your educational background and professional experience.

A. I am a graduate of the University of Missouri – Columbia, where I received a Bachelor of Science in Business Administration in Economics in 1969. After serving as an officer in the United States Navy from 1969 to 1972, I returned to the University of Missouri – Columbia and received a Master of Business Administration with honors in 1973.

I joined Wire Rope Corporation of America, Incorporated in 1973 at its headquarters in St. Joseph, Missouri. I was assistant Treasurer until 1976 when I became Vice President Finance for the corporation. In that capacity, I acted as Chief Financial Officer, Secretary and Treasurer for the corporation. During my tenure with the company, WRCA grew to the largest producer of wire rope in the United States and became one of the largest producers in the world. My functional responsibilities in the company included supervision of all financial activities, human resources, legal, and information technology functions within the corporation. Within those functional responsibilities, I worked on 11 acquisitions and three divestitures for the corporations. I was responsible for all banking relations, and I negotiated six financings totaling $231,650,000 in the past 15 years. The company was privately held with financings requiring debt issues along with discussions with mezzanine and venture capital lenders. The company filed for bankruptcy in May of 2002. I worked with the restructuring group during the bankruptcy and left the company at the filing of the reorganization plan. The company emerged from bankruptcy in June of 2003 under new ownership.

Since leaving WRCA, I have consulted with companies in Missouri and Oklahoma regarding senior debt financing due diligence, information technology, insurance, and turnaround strategies. My most recent engagement was at the recommendation of a Chicago bank to a Kansas City venture capital firm and involved turnaround work at one of the venture capital company's holdings.

I am a member of Financial Executives International, which is an association of corporate financial officers. In the organization, I have served in various capacities including President of the Kansas City chapter.

Q. Have you filed testimony in other cases before this Commission?

A. No.

Q. What is the purpose of your testimony?

A. My testimony is presented to offer my opinion to the Commission concerning a fair and reasonable rate of return on the utility rate base of Missouri-American Water Company ("Company" or "MAWC"), in rebuttal to testimony filed by witnesses on behalf of the Company, the Staff of the Missouri Public Service Commission (Staff), and the Office of the Public Counsel (OPC).

Q. What experience and knowledge do you possess in offering an opinion in this matter?

A. As Chief Financial Officer at Wire Rope Corporation of America, Incorporated, I was responsible to secure funding for numerous acquisitions along with the company's operational capital needs. As part of this process, I worked with commercial banks, investment banks, subordinated debt lenders and venture capital sources dealing with pricing and valuation issues from these sources of capital. As trustee to the company's pension trusts, I worked with investment management professionals adopting investment objectives and monitoring the performance of those investment managers. Asset allocation, investment quality, and risk measurement were key elements of our monitoring process.

Cost of Capital and Return on Equity

Q. What do you conclude is the cost of capital for MAWC?

A. In my opinion, the cost of capital for MAWC is in the range of 7.33% to 7.54%.

Q. Please describe the approach you employed to determine MAWC's cost of capital.

A. My experience in valuation relies on three approaches – the Discounted Cash Flow (DCF) model, the Capital Asset Pricing model, and the Risk Premium model. I studied the testimony provided in this case by MAWC Witness Pauline M. Ahern, Staff Witness David Murray, and OPC Witness Mark Burdette, and utilized information contained in their work. I performed my own calculations and discussed this information with colleagues. From this work, I projected a cost of equity for MAWC and utilized that cost in a capital structure and other capital costs suggested in the earlier testimony.

Q. What was the result of the application of the DCF model?

A. The DCF calculation requires two assumptions – the projected dividend yield and the projected growth rate for MAWC. The three witnesses reached a similar conclusion regarding the projected dividend yield, which they estimated between 3.40% and 3.54%. However, their assessment of expected growth differed significantly, with a range from

4.89% to 7.3%. This difference in opinion is attributable to the significance they each attached to 5-year historical information in comparison to analysts' 5-year growth projections. Company Witness Ms. Ahern assumed a growth rate of 7.30% rate, while Staff Witness Mr. Murray assumed a 4.89% rate and OPC Witness Mr. Burdette a 6.25% rate. Averaging historical and projected growth would yield a 5.9% growth rate providing the investor with a more conservative basis for valuation. Applying this conservative approach suggesting a 5.9% growth factor, the DCF calculation yields a range of 9.30% to 9.44% when adding the projected dividend yield.

Q. What was the result of the application of the Capital Asset Pricing model?

A. In prior work as a pension trustee, I applied this model and relied on Ibbotson's work in analyzing potential investments. Ibbotson's Annual Valuation publication (in this case, the 2003 edition) is a well-utilized basic reference in this area of study. Using the assessment of beta provided by Value Line (as referenced in the other witnesses' testimony) and Ibbotson's SBBI Annual Valuation Index 2003, I arrived at a valuation of 9.21% for the cost of equity. The summary page to the annual valuation states a 7.0% long horizon equity risk premium should be employed along with a 4.8% long-term riskless rate. Employing the .63 beta rate yields a 4.41% equity risk premium for MAWC. The projected cost of equity is the sum of the riskless rate and the adjusted equity risk premium. The riskless rate that I used is the average 20-year bond rate stated in the Ibbotson Valuation Edition 2003 Yearbook, which is 4.80%. Adding the equity premium and the risk free rate yields a project cost of equity of 9.21%.

Q. What was the result of the application of the Risk Premium model?

A. Using expected market returns based upon my survey of current data and opinions, I projected a 12% market rate of return on equity. Offsetting this rate by a 6.30% expected Aaa bond yield (the riskless rate) and applying a .63 Beta, the equity risk premium was calculated at 3.59%. This yields a 9.89% return on equity. The disparity in testimony offered previously is related to the use Ms. Ahern made of the 5-year Value Line projection. The testimony of Mr. Murray and Mr. Burdette took a longer view of projected growth. I believe an investor projects beyond 5 years in his or her thinking and follows a process similar to Ibbotson's three-stage approach to estimating growth rates. In Ibbotson's Cost of Capital Yearbook, the 3-stage method is used. In the first five years, a consensus of analysts' estimates of earnings growth for a company is utilized. In the second stage, the second five years, the average analyst consensus for the industry is used. In the third stage, years 11 and beyond, an estimate of the growth rate for the entire economy is employed. Utilizing a 3-stage approach explains the difference in the market rates found in the testimony of the Company, Staff and OPC. I believe this approach supports a lower rate.

Q. What is the resulting cost of equity for MAWC?

A. The three methodologies that I utilized yielded similar results. The DCF calculated cost of capital was 9.30 to 9.44%. The cost calculated in the Capital Asset Pricing model was 9.21%. The cost in the Risk Premium method was 9.89%. From this information, I recommend that the Commission order a return on common equity in the range of 9.25% to 9.75%.

Capital Structure

Q. Utilizing your calculated cost of equity, what is your estimate of the cost of capital for MAWC?

A. To calculate the cost of capital for MAWC, an assumption must be made concerning the capital structure of the organization.

Q. Please summarize the prior testimony on capital structure.

A. The prior testimony differed as to what the Commission should use as the correct capital structure. Company Witness Ms. Ahern and OPC Witness Mr. Burdette believed that the proper capital structure should be based on MAWC's actual capital structure. However, Staff's Witness Mr. Murray believed the appropriate structure was that of the parent company, American Water Works Company, Inc.

Q. What do you believe is the appropriate capital structure?

A. I support the view that MAWC's capital structure should be utilized, but that some consideration should exist in the structure for short-term debt since utilization of a short-term financing facility (known as American Water Capital Corp.) appears ongoing. In accessing the capital markets, American Water Works Company's capital structure is the appropriate basis for an analyst's view of the pricing of any prospective investment. However, that structure is made up of the sum of the parts, which mainly consists of the subsidiary companies like MAWC. Those subsidiary companies when assessed individually would have different structures and different levels of financial risk associated with them. Since information on MAWC's structure is available, that information should be used in this rate case.

Q. Based upon your experience, can you make a comparison to the non-regulated field of business?

A. Yes. In parent/subsidiary relationships in non-regulated businesses, the absence of a guarantee by a parent to a lender or investor would lead the lender or investor to consider the capital structure of the subsidiary, not the parent, in the pricing of the debt or investment in the subsidiary. Since I found no evidence of a such a guarantee by American Water Works Company, Inc. to MAWC, it is appropriate to employ this principal to the subject rate case and to utilize the MAWC capital structure.

Cost of Capital

Q. What is your estimate of MAWC's cost of capital?

A. Calculating the cost of capital for MAWC requires the assumption of a capital structure, along with assumptions as to the cost of short-term debt, long-term debt and preferred stock, as well as the cost of equity. In their prior testimony, Ms. Ahern, Mr. Burdette, and Mr. Murray projected a similar cost for short-term debt and preferred stock. Since both represent a small percentage of the overall capital structure, the differences are not that significant in the overall assessment of cost of capital. I believe the cost of capital is 7.33% to 7.54%, as depicted in Table 1, below.

Table 1

	Capital Structure Ratios	Cost Rate	Weighted Return
Short-Term Debt	3.50%	2.80%	0.10%
Long-Term Debt	55.58%	6.20%	3.45%
Preferred Stock	0.55%	9.00%	0.05%
Common Equity	40.37%	9.25-9.75%	3.73-3.94%
Total	100.00%		7.33-7.54%

Acquisition Premium

Q. Should any acquisition premium paid by MAWC in acquiring other assets become part of the rate structure for MAWC?

A. No. Although my experience is in non-regulated businesses, all investors have similar motivations in evaluating financial risks and benefits. Investors in a non-regulated company are aware that the price they pay for acquiring a business will have no effect on the amount of revenue earned by that business in its sales of goods and services. The investment decision of the acquiring company is based upon the underlying fundamentals of the business to be acquired and the target company's prospects in the markets that it serves. Investors in MAWC faced the same considerations. I doubt that the investors concluded that MAWC's paying an acquisition premium for these companies would improve their revenue streams.

Q. Does the fact that the acquired companies are not part of the MAWC system in the St. Joseph District affect your analysis?

A. It simply reinforces my opinion that the Commission should not allow any acquisition premium to be recovered in rates since there are no apparent benefits to the St. Joseph District ratepayers.

Q. Does this conclude your testimony?

A. Yes.