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Missouri Public
Service Commission

Exhibit No.:

Issue:

Cost of Capital

Witness:

Roberta A. McKiddy

Sponsoring Party:

MoPSC Staff

Type of Exhibit:

Surrebuttal Testimony

Case Nos.:

WR-2000-281 and

SR-2000-282

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

ROBERTA A. McKIDDY

MISSOURI-AMERICAN WATER COMPANY

CASE NOS. WR-2000-281 AND SR-2000-282

Jefferson City, Missouri
May, 2000

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Return on Common Equity for MAWC

Q. On page 3, lines 2 through 19, of Mr. Walker's rebuttal testimony, he implies that the Commission should authorize a ROE sufficient for MAWC to maintain an "A" bond rating. Do you agree with Mr. Walker's recommendation?

A. No. As stated in my rebuttal testimony, Standard and Poors does not believe that a credit rating should be considered a recommendation to purchase, sell or hold a particular security. The rating performs the isolated function of evaluating credit risk, which is only one aspect of the investment decision-making process. A specific bond rating does not take into consideration market risk or an individual investor preference of risk. Therefore, I believe Mr. Walker's suggestion that ROE be set in order to maintain a particular bond rating is inappropriate.

Q. On page 4, lines 11 through 21 and page 5, lines 1 through 9, Mr. Walker provides an explanation of MAWC's level of risk in relation to its small size. Do you agree with Mr. Walker's analogy?

A. No, I do not believe that MAWC has a higher level of risk than its parent, American Water Works Company (AWWC). As stated in my direct testimony, MAWC and AWWC are in the same general line of business and MAWC and AWWC (consolidated basis) both have comparable capital structures; therefore, I do not believe that there is a need to make any adjustments to AWWC's cost of equity before applying it to MAWC. I have made numerous checks to the validity of the results of my discounted cash flow (DCF) cost of equity analysis for AWWC to ensure that it is appropriate to be applied to MAWC. The Financial Analysis Department of the Commission Staff believes that, whenever possible, actual market data should be used to determine the cost of equity for a company. Investors in

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1 AWWC are investing in the consolidated company of AWWC, which includes MAWC, and
2 there seems to be minimal risk differences to justify an adjustment up or down to the
3 investors' required ROE. Therefore, I believe that it is reasonable to apply the required ROE
4 of AWWC on a consolidated basis as a reasonable authorized ROE for MAWC.

5 Mr. Walker characterizes MAWC in his testimony as though it were a
6 stand-alone company trading publicly on the open market. It is not. It is fully backed by its
7 parent company, AWWC. All equity is issued through and by AWWC. It does not have to
8 go to the market looking for equity investors.

9 Q. On page 8, Mr. Walker states that Staff has failed to adjust ROE to reflect
10 future increases in interest rates. Do you agree with Mr. Walker that Staff should have
11 adjusted its ROE calculation to reflect the effects of future increases in interest rate?

12 A. No. Mr. Walker's testimony clearly shows that he wants the Commission to
13 approve a return on equity based on "what-ifs." Mr. Walker has filed his entire testimony
14 based on pro forma (projected) information, failing to acknowledge the test year, update and
15 true-up periods ordered in this proceeding.

16 In calculating the recommended ROE for MAWC, I employed the DCF and
17 CAPM models in accordance with "accepted" cost of capital analysis. In this proceeding, I
18 was asked to derive a return on common equity that was fair and reasonable for the test year
19 ending September 30, 1999 updated through December 31, 1999. I have done just that.
20 MAWC has every opportunity to address any adverse affects of changing economic
21 conditions by filing additional rate case applications once the Operation of Law date or the
22 effective date of the Report and Order has passed in this instant case. It is Staff's belief that
23 returns should not be recommended to protect a company from unknown and uncertain

1 changes in economic conditions. Staff's only role is to perform an independent analysis and
2 recommend a fair and reasonable return, which will provide MAWC with an opportunity to
3 earn a fair return on its capital. Staff believes its recommendation will provide such an
4 opportunity.

5 Q. On page 9, lines 20-22, of Mr. Walker's rebuttal testimony, he states that Staff
6 has used an incorrect beta for AWK. Do you agree with this statement?

7 A. No. According to Value Line's Ratings and Reports dated February 4, 2000,
8 AWK's beta is 0.50. Therefore, Mr. Walker's statement is incorrect.

9 Q. On page 16 on Mr. Walker's rebuttal testimony, Mr. Walker comments on
10 bond ratings and rate base disallowances as they relate to a company's or MAWC's ability to
11 achieve coverage ratios. Do you agree with Mr. Walker's statements?

12 A. No.

13 Q. Can you provide an example where this issue was addressed by the
14 Commission?

15 A. Yes. Missouri Cities Water Company filed an application requesting an
16 increase in rates for water service on November 1, 1990. In the Report and Order for that
17 case, the Commission states the following:

18 Staff performed a pro-forma interest coverage calculation
19 which reveals that a return of 12.73 to 13.25% to Company
20 will result in a times interest coverage of 2.71 to 2.78 times.
21 Such a coverage ratio compares favorably with the water
22 industries composite average of 2.75 times interest coverage.
23 Company reminds the Commission that Staff's calculation
24 regarding interest coverage does not take Staff's proposed
25 adjustments in this case into account. The Commission finds
26 that even at the lowest end of any range herein proposed,
27 Company will achieve a high enough return to both attract
28 capital and meet the terms of its First Mortgage Bond

1 Indentures, which requires 1.5 times, post-tax, interest
2 coverage before Company may issue bonds.
3

4 Interest coverage ratios are driven in large part by management
5 decisions over which this Commission has little or no control,
6 at least in the first instance. Whether characterized as
7 "prerogatives" of management or simply as a company's
8 decision to, say, construct a new office building, these debt
9 creating "events" cannot, in and of themselves, provide support
10 for a company's estimate of its cost of equity or its revenue
11 requirement. To do so would turn this or any other
12 Commission into something other than a regulatory body
13 inasmuch as Company management could determine rate of
14 return simply by incurring debt. This Commission cannot, as
15 suggested by Company, use interest coverages to arrive at
16 Company's revenue requirement.
17

18 Mr. Walker's arguments presented in this case, regarding plant disallowances
19 and bond ratings, are almost identical to the arguments presented in the case filed by
20 Missouri Cities Water Company. Therefore, Staff believes that the Commission should
21 arrive at the same conclusions as it did in its Report and Order in that case. Mr. Walker
22 would have the Commission negate any finding it made regarding plant disallowances by
23 making a compensating adjustment to increase ROE in an effort to protect or achieve a
24 specific bond rating.

25 Q. Please summarize the conclusions of your surrebuttal testimony.

26 A. I conclude the following:

27 1. Mr. Walker's recommendation on cost of common equity should be
28 rejected since he totally ignored the test year and update periods ordered in this proceeding.
29 Staff's DCF methodology should be adopted as the appropriate method to be used in
30 calculating MAWC's cost of common equity and the Commission should approve a return on
31 common equity based on a range of 9.50 percent to 10.75 percent as recommended by Staff
32 in its direct testimony.

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1 2. Mr. Walker's arguments regarding MAWC's level of risk in relation to
2 its small size should be rejected based on the fact that MAWC is not a stand-alone company,
3 but one whose equity is issued through and by its parent, AWWC.

4 3. Mr. Walker's arguments regarding adjustments to ROE to reflect plant
5 disallowances or to achieve specific bond ratings should be rejected based on the precedent
6 set by the Commission in its Report and Order for Case Nos. WR-91-171 and SR-91-174.

7 Q. Does this conclude your prepared surrebuttal testimony?

8 A. Yes, it does.

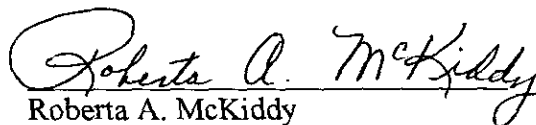
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

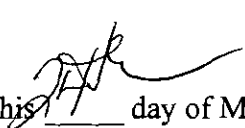
In the Matter of)	
Missouri-American Water Company's)	Case No. WR-2000-281 et al.
Tariff Sheets Designed to Implement)	
General Rate Increases for Water and)	
Sewer Service provided to Customers in)	
the Missouri Service Area of the Company.)	

AFFIDAVIT OF ROBERTA A. McKIDDY

STATE OF MISSOURI)	
)	ss.
COUNTY OF COLE)	

Roberta A. McKiddy, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 6 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.


Roberta A. McKiddy

Subscribed and sworn to before me this  day of May 2000.

