

FILED

MAY 25 2000

Missouri Public
Service Commission

Exhibit No.:

Issue(s):

Rate of Return/

Prudence Disallowance

Witness/Type of Exhibit:

Burdette/Surrebuttal

Sponsoring Party:

Public Counsel

Case Nos.:

WR-2000-281 and SR-2000-282

SURREBUTTAL 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 25, 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)

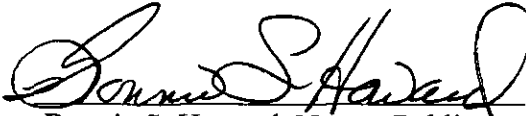
Mark Burdette, of lawful age and being first duly sworn, deposes and states:

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 surrebuttal testimony consisting of pages 1 through 11.
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 25th day of May, 2000.



Bonnie S. Howard, Notary Public)

My Commission expires May 3, 2001.



SURREBUTTAL TESTIMONY

OF

MARK BURDETTE

MISSOURI AMERICAN WATER COMPANY

CASE NO. WR-2000-281 / SR-2000-282

TABLE OF CONTENTS

Introduction _____ 1

Cost of Common Equity _____ 2

Plant Disallowance _____ 5

1 **SURREBUTTAL TESTIMONY**

2 **OF**

3 **MARK BURDETTE**

4
5 **MISSOURI AMERICAN WATER COMPANY**

6 **CASE NO. WR-2000-281 / SR-2000-282**

7
8
9 **INTRODUCTION**

10 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

11 A. Mark Burdette, P.O. Box 7800, Jefferson City, Missouri 65102-7800.

12 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

13 A. I am employed by the Office of the Public Counsel of the State of Missouri (OPC or Public
14 Counsel) as a Public Utility Financial Analyst.

15 Q. ARE YOU THE SAME MARK BURDETTE WHO FILED DIRECT AND REBUTTAL
16 TESTIMONY IN THIS PROCEEDING?

17 A. Yes.

18 Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

19 A. I will respond to the Rebuttal testimony of Missouri-American Water Company (Missouri-
20 American, MAWC, the Company) witnesses Harold Walker, III and James Jenkins.

COST OF EQUITY

Q. DO YOU HAVE COMMENTS REGARDING MR. WALKER'S REBUTTAL OF YOUR RECOMMENDED COST OF COMMON EQUITY?

A. Yes. Mr. Walker compares my recommended ROE to the returns of public utility bonds. This comparison is essentially a risk premium approach. As I said in my Rebuttal testimony (Burdette-rebuttal, page 11, lines 10-20), I believe risk premium models are subject to manipulation.

Q. HAS THE MISSOURI PUBLIC SERVICE COMMISSION RECOGNIZED THE LIMITATIONS OF RISK PREMIUM MODELS?

A. Yes. In the Report and Order from Case Nos. WR-91-172 / SR-91-174, dated September 20, 1991, the MPSC stated:

...the risk premium method was not as acceptable as the discounted cash flow analysis in determining cost of common equity, as the spread between either treasury bills or bonds and the common stock of non-regulated enterprises could be affected by the choice of time periods when notes, bonds, or stocks were issued or examined, the nature of the enterprise whose stock was being used to establish the spread, and the reliance on purely historical data to establish a return for a future time period.

Emphasizing the ease with which risk premium methods can be manipulated as well as their reliance on historical data, the Commission also said:

In addition, the amount of "spread" can be dictated by one's choice of the time periods when either the notes, bonds, or stocks are issued or examined, the nature of the enterprises whose stock is being used to establish the "spread", and by the reliance on purely historical data to establish a return for a future time period.

Q. WHAT OTHER COMPARISONS WERE MADE BY MR. WALKER?

A. Continuing the misguided approach that Mr. Walker used in his Direct testimony, he compared my recommendation for an *authorized* cost of common equity to Value Line's projected returns to common equity.

Moreover, Value Line's projected returns on common equity for its water utilities, for the period 2002 to 2004, is 12%, or 208 basis points higher than Mr. Burdette's recommendation. (Walker-rebuttal, page 17, line 22 – page 18, line 2)

When determining the appropriate authorized return, Value Line's projections of actual earnings are irrelevant for corroboration or comparison. Mr. Walker should be aware of the difference between a regulatory authorized cost of common equity and an actual earned return. As I said in my Rebuttal testimony:

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. (Burdette-rebuttal, page 2, lines 15-26).

Mr. Walker has attempted to justify his own inflated 11.70% ROE recommendation as well as challenge my 9.92% recommendation by comparing them to Value Line's projected *earned* returns. This comparison is invalid.

Q. HOW DOES THE VALUE LINE INVESTMENT SURVEY DEFINE PROJECTED RETURN TO COMMON EQUITY?

A. Value Line calculates "percent earned common equity" as "net profit less preferred dividends divided by common equity, expressed as a percent." This calculation requires the use of actual net profit – what the company **actually** earned – to calculate a *historical* accounting ratio. It does not consider nor is it a proxy for an appropriate authorized return. Also, even though Value Line's projected "percent earned to common equity" is indeed a

1 projection, the projection is for actual accounting net profit divided by common equity. It is
2 a guess as to what a particular accounting ratio will be in the future. When that “future”
3 value is calculated, it will be calculated using, what is at that time, historical data.

4 The comparison of actual earned returns to common equity and regulatory
5 authorized returns is not appropriate.

6 Q. AS IN HIS DIRECT TESTIMONY, MR. WALKER CLAIMS MAWC’S SMALLER SIZE
7 INCREASES ITS RISK (WALKER-REBUTTAL, BEGINNING ON PAGE 18, LINE 21).
8 HAS THE MISSOURI PUBLIC SERVICE COMMISSION RECOGNIZED THE LIKELY
9 BENEFITS A SMALL COMPANY COULD RECEIVE FROM BEING A PART OF A
10 LARGE, HOLDING-COMPANY ORGANIZATION?

11 A. Yes. In the Report and Order from Case Nos. WR-91-172 / SR-91-174, Missouri Cities
12 Water Company, dated September 20, 1991, the MPSC stated:

13 Nor is Company weaker or “less able” to weather unexpected events than
14 the surrogates. As one of several operating utilities in a holding company
15 structure, Company may enjoy more support than its publicly traded
16 surrogates, not less.
17

18 Q. DO YOU BELIEVE MAWC’S PARENT, AMERICAN WATER WORKS COMPANY,
19 RECOGNIZES THIS RELATIONSHIP?

20 A. Yes. As I mentioned in my Direct testimony, the American Water Works Company 1998
21 Annual Report to Shareholders states:

22 American Water Works includes 23 subsidiaries... ..each of these utility
23 subsidiaries draws strength and economies of scale from the group as a
24 whole. [Page 9]
25

26 The American Water Works Service Company, a subsidiary, provides
27 professional services as required to affiliated companies. These services
28 include accounting, administration, communication, corporate secretarial,
29 engineering, financial, human resources, information systems, operations,
30 rates and revenue, risk management and water quality. This arrangement,
31 which provides these services at cost, affords affiliated companies
32 professional and technical talent otherwise unavailable economically or on
33 a timely basis. [Page 23]
34
35

PLANT DISALLOWANCE

Q. HAS PUBLIC COUNSEL ANALYZED THE FINANCIAL EFFECTS OF ITS RECOMMENDED PLANT DISALLOWANCES ON MAWC?

A. Yes. Public Counsel performed an analysis of the interest coverage for MAWC assuming OPC's recommended plant disallowance is adopted as well as OPC's recommendations concerning revenue requirement.

Q. WHAT DID THIS ANALYSIS SHOW?

A. The analysis showed that MAWC will **not** be in default of their Indenture of Mortgage interest coverage requirement of 1.5 times if Public Counsel's recommendations for disallowance, cost of service, and rate of return are adopted by the Commission. The following table shows Public Counsel's pro forma interest coverage ratio.

OPC net operating income:	\$10,305,918
Income taxes (test year):	\$1,893,497
Additional income taxes	
associated with revenue requirement:	<u>\$2,300,326</u>
Income available for debt service:	\$14,499,741

Long term interest requirement:	\$6,077,123
---------------------------------	-------------

Time interest covered: = $\$14,499,741 / \$6,077,123 = 2.39$ times

This calculation shows that assuming OPC's recommendations for plant disallowance, cost of service and rate of return, MAWC will have a times-interest-earned ratio of 2.39 times, which is greater than the restriction in the Company's indenture.

The level of long term debt interest expense included in this calculation is the pro forma value. It was calculated using the embedded cost of long term debt (6.77%) and level of long term debt (\$89,765,483) as of 30 April 2000, as agreed to by Staff and Public Counsel for the true-up in this case. The level of long term interest expense is therefore a

1 forward-looking value, and is not historical. OPC witness Trippensee provided the
2 operating income and tax amounts used in this calculation.

3 Q. HAS THE MISSOURI PUBLIC SERVICE COMMISSION EXPRESSED AN OPINION AS
4 TO THE ROLE FINANCIAL INDICATORS SUCH AS INTEREST COVERAGE RATIOS
5 HAVE IN DETERMINING A COMPANY'S REVENUE REQUIREMENT?

6 A. Yes. In the Report and Order from Case Nos. WR-91-172 / SR-91-174, Missouri Cities
7 Water Company, dated September 20, 1991, the MPSC stated:

8 **Return §§4,13.**Interest coverage ratios may not be used to determine a
9 company's revenue requirement, as company management could then
10 determine rate of return simply by incurring debt.
11

12 Q. MR. JENKINS CLAIMS THAT MAWC'S FINANCIAL INTEGRITY WILL BE
13 IMPAIRED IF PUBLIC COUNSEL'S DISALLOWANCE IS ADOPTED (JENKINS-
14 REBUTTAL, PAGE 4, BEGINNING ON LINE 9). COULD YOU PLEASE COMMENT?

15 A. The appropriateness of the disallowance is not determined by whether that disallowance
16 would negatively impact MAWC's financial statements or if there are repercussions to
17 shareholders. On the contrary, MAWC's management should have been aware of and
18 planned for the possibility of a disallowance as part of the analysis of the overall project. It
19 was poor planning on the part of MAWC's management if they decided to build a new plant
20 and assumed the entire plant would off-handedly be included in rate base, without
21 considering the potential for disallowance and associated financial impacts. Any risky
22 project has potential downsides that must be considered and factored into the decision to do
23 the project. Regulated companies cannot take on "risky" projects without also assuming the
24 risk associated with that project. It is not appropriate to shunt all risk to ratepayers because
25 ratepayers already pay MAWC a return that compensates the Company for risk.

1 Q. HAS THE MPSC ADDRESSED THE INDEPENDENCE OF MANAGEMENT
2 DECISIONS FROM COMMISSION CONTROL AND MANAGEMENT'S
3 RESPONSIBILITY FOR THOSE DECISIONS?

4 A. Yes. In the Report and Order from Case Nos. WR-91-172 / SR-91-174, the Commission
5 makes it clear that while management is free to make decisions as they see fit, the
6 Commission is under no responsibility to adapt regulation to fit management's decisions.
7 And in fact, the Commission goes so far as to say "To do so would turn this or any other
8 Commission into something other than a regulatory body inasmuch as Company
9 management could determine rate of return simply by incurring debt." The Report and
10 Order stated:

11 Interest coverage ratios are driven in large part by management decisions
12 over which this Commission has little or no control, at least in the first
13 instance. **Whether characterized as "prerogatives" of management or**
14 **simply as a company's decision to, say, construct a new office building,**
15 **these debt creating "events" cannot, in and of themselves, provide**
16 **support for a company's estimate of its cost of equity or its revenue**
17 **requirement.** To do so would turn this or any other Commission into
18 something other than a regulatory body inasmuch as Company management
19 could determine rate of return simply by incurring debt. **This Commission**
20 **cannot, as suggested by Company, use interest coverage ratios to arrive**
21 **at Company's revenue requirement.** [Emphasis added]
22

23 Adverse financial conditions created or potentially created for MAWC due to decisions
24 made by management are not sufficient reason to adjust revenue requirement. Not only was
25 this concept stated by the Commission in Case Nos. WR-91-172 / SR-91-174, the concept
26 makes sense from the context of just and reasonable rates for Missouri ratepayers.

27 Q. IF THE MISSOURI PUBLIC SERVICE COMMISSION ADOPTS PUBLIC COUNSEL'S
28 RECOMMENDATIONS AND DISALLOWS A PORTION OF MAWC'S PLANT, WHO IS
29 RESPONSIBLE FOR ANY FINANCIAL CONSEQUENCES FROM SUCH A
30 DISALLOWANCE?

31 A. MAWC's management had sole discretion to make the decision concerning plant additions
32 and capital investment. MAWC's shareholders, as owners of the Company, bear any

1 financial consequences from management's actions. If shareholders are dissatisfied, they
2 should raise the issue with management.

3 Q. MR. WALKER MAKES THE CLAIM THAT THE RISK ASSOCIATED WITH POSSIBLE
4 PLANT DISALLOWANCES IS NOT REFLECTED IN MAWC'S CURRENT RATES. COULD YOU PLEASE COMMENT?
5

6 A. Mr. Walker's assertion that present rates do not reflect any risk for disallowance is false
7 (Walker-rebuttal, page 24, lines 15-18). *The possibility of regulatory disallowance is a*
8 *fundamental business risk for a regulated utility, and as such, has been taken into*
9 *consideration by the market.* Mr. Walker's claim to the contrary is an attempt to create
10 additional, phantom risk associated with MAWC, and should be flatly rejected by the
11 MPSC.

12 The possibility of disallowance or actual disallowance is certainly within the realm
13 of business risk faced by a regulated utility, just as Commission-ordered rate reductions,
14 regulatory lag, indeed the entire rate case process, are also within the realm of business risk
15 faced by a regulated public utility.

16 Q. MR. WALKER MAKES THE CLAIM THAT PUBLIC COUNSEL'S
17 RECOMMENDATIONS WILL RESULT IN CONFISCATION OF PROPERTY. COULD
18 YOU PLEASE COMMENT?

19 A. Mr. Walker's assertion concerning confiscation is unfounded. Public Counsel's
20 recommendations assure that MAWC will remain financially viable and will not violate the
21 interest coverage requirements of its Indenture of Mortgage. MAWC **will** be able to service
22 the debt obligations for which it is responsible. Public Counsel's recommendations do not
23 constitute confiscation of property. They do appropriately place responsibility for
24 management decisions on management.

1 Q. WHAT WILL BE THE EFFECT OF PUBLIC COUNSEL'S PROPOSED PLANT
2 DISALLOWANCE?

3 A. Everything else equal, a plant disallowance will result in a lower revenue requirement for
4 MAWC as compared to the scenario in which there is no plant disallowance. This decrease
5 will not hinder MAWC's ability to service its debt obligations.

6 The revenue requirement decrease resulting from Public Counsel's proposed
7 disallowance is the result of MAWC management decisions and does not constitute
8 confiscation of property. *Regulation does not and should not shield a company or its*
9 *shareholders from the effects of poor or questionable decisions by management.* Nor does
10 regulation allow for unscrutinized additions to rate base. MAWC management made
11 decisions regarding plant additions and capital outlays. To the extent those additions and
12 expenditures were prudent and economic and contributed to providing safe and adequate
13 service, they should be added to rate base. However, those expenditures and capital
14 additions which are not prudent and economic and do not contribute to providing safe and
15 adequate service should not be included in rate base.

16 Q. WHO IS RESPONSIBLE IF CERTAIN CAPITAL ADDITIONS AND EXPENDITURES
17 MADE BY MAWC ARE FOUND TO BE IMPRUDENT AND ARE NOT INCLUDED IN
18 RATE BASE?

19 A. MAWC's management is responsible for the decisions to make capital additions and
20 expenditures. MAWC's shareholders, as the owners of the firm, are responsible for any
21 financial fallout from those decisions.

22 Q. IS THE CONCEPT THAT SHAREHOLDERS MUST LIVE WITH THE
23 CONSEQUENCES OF MANAGEMENT DECISIONS UNIQUE TO REGULATED
24 COMPANIES?

25 A. Of course not - it is a fundamental tenet of the concept of public companies in general.

26 Shareholders are the ultimate owners of the firm, and they must rely on the board of

1 directors and the management that board hires to look out for shareholder interests. To the
2 extent that management makes good decisions that create wealth for shareholders,
3 shareholders are entitled to receive the benefits of those decisions and shareholders are
4 happy. However, the other side of that arrangement is that when management makes poor
5 decisions, shareholders – as the owners of the firm – must bear the effects of those
6 decisions, and shareholders might be unhappy. Keeping shareholders happy *in spite of*
7 management's decisions is not the charge of the Missouri Public Service Commission or of
8 regulation.

9 Q. DO YOU HAVE ANY FINAL COMMENTS ON PROPOSED PLANT
10 DISALLOWANCES AND RISK?

11 A. Yes. It is very important for the Missouri Public Service Commission to remember that
12 decisions made by regulated utilities do NOT drive regulation – a decision by a company to
13 build a plant does not, by default, mean that plant should be added to rate base. Missouri's
14 ratepayers are not an infinite pool of capital to which utilities can run for recompense every
15 time management makes a poor decision. Shareholders have invested in and are the owners
16 of the firm, and as such, they have taken on certain risks associated with their investment.
17 Regardless of what companies would have the Commission believe, "risk" and the effects
18 of risk within the arena of regulation is NOT just an excuse to increase the recommended
19 cost of common equity. Risk means that sometimes the real outcome might be negative for
20 the shareholders, and the ratepayers are **not** left to pay the bill.

21 MAWC's shareholders, faced with potential plant disallowances and any financial
22 effects from those disallowances, are simply riding the up and down path associated with
23 ANY risky investment. If the MPSC removes the shareholders' downside risk-potential and
24 places that risk squarely on the ratepayers, then MAWC's shareholders will have achieved
25 an essentially risk-free investment. Only through an objective analysis can the balance be

1 found between benefits and costs for ratepayers and shareholders. The MPSC should not
2 tip the cost-side of this balance inappropriately towards ratepayers by shielding MAWC's
3 shareholders from the risks those shareholders willingly took on when they invested in
4 MAWC.

5 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

6 A. Yes, it does.