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

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

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

Scott W. Rungren

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 9th **day of** February **2016.**

Donna S. Singler
Notary Public

My commission expires: July 17, 2016

DONNA S. SINGLER
Notary Public, Notary Seal
State of Missouri
St. Louis County
Commission # 12368409
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

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

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

A. Yes, I did.

II. PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

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

III. OVERVIEW

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

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

I will demonstrate that none of these reasons provides any justification for using American Water's consolidated capital structure for determining MAWC's overall rate of return on rate base (i.e., WACC) in this proceeding. Finally, I will explain that MAWC's costs of long-term debt, preferred stock, and short-term debt (when applicable) should be calculated using MAWC's financial data, and not that of American Water consolidated, as was done by the Staff.

IV. CAPITAL STRUCTURE RATIOS

A. STAFF'S PROPOSED CAPITAL STRUCTURE

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

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

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

A. The Company's projected January 31, 2016 capital structure is more appropriate for ratemaking purposes for four reasons; 1) MAWC is a separate corporate entity that issues its own debt and common stock and, therefore, has an independently determined capital structure, 2) MAWC's stand-alone capital structure represents the actual capital financing MAWC's jurisdictional rate base, to which the overall rate of return set in this proceeding will be applied, 3) the January 31 pro forma date will be close in time to when the rates set in this case will go into effect; and 4) MAWC's stand-alone capital structure is consistent with the capital structure ratios maintained, on average, by other water companies.

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

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

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

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

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

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

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

A. It is relevant and appropriate for ratemaking purposes because it represents the actual dollars that are financing MAWC's jurisdictional rate base to which the rate of return authorized in this proceeding will be applied. In contrast, the consolidated American Water capital structure proposed by the Staff contains capital that <u>was not</u> used to finance MAWC's jurisdictional rate base. For example, it includes the long-term debt capital of American Water's other operating water subsidiaries, in addition to MAWC, which finances the jurisdictional rate bases of those subsidiaries.

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

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

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

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

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

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

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

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

A. The Company's pro forma January 31, 2016 capital structure ratios are consistent with those maintained, on average, by the eight water companies in Staff's comparable water utility group, as shown on Schedule 10 attached to the Staff Report. These are the same eight companies I assessed in my Direct Testimony when discussing the reasonableness of MAWC's proposed capital structure, since these companies also comprise Company-witness Dr. Morin's proxy group (see Rungren DT, pp. 5-6). As noted in my Direct Testimony, I did exclude one company in Dr. Morin's proxy group, Consolidated Water Company, because it had an equity ratio of 100%. With that exclusion, Dr. Morin's proxy group and the Staff's comparable water utility group are identical. As I noted in my Direct Testimony, the average equity ratio of this comparable water utility group was 54.54% as of December 31, 2014. Thus, the equity ratio of MAWC's proposed capital structure, 52.37%, is lower than that of the average equity ratio of the water sample used by both Dr. Morin and Staff in their respective cost of equity analyses.

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

B. <u>THE STAFF REPORT</u>

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

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

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 <u>cost</u> 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 <u>amount</u> of debt in MAWC's capital structure.

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

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

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

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

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

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

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

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

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

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

A. American Water has not guaranteed any debt issued by MAWC through AWCC. The Support Agreement does not relieve MAWC of its financial obligation associated with debt issued through AWCC. The Support Agreement, in essence, affords the financial backing and credit risk of American Water to AWCC, as signified by bond rating agencies typically assigning the same rating to AWCC as they do to American Water. The extent to which risk associated with debt issued by MAWC through AWCC is mitigated by the Support Agreement between American Water and AWCC will be reflected in a lower interest rate to MAWC, which is then reflected in the Company's WACC, but has no bearing on determining the appropriate capital structure to use for ratemaking purposes.

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

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

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

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

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

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

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

A. The Staff Report states as follows:

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

I would note that Staff does not provide any evidence to support this speculative assertion. Of course, Staff is mistaken when it claims that MAWC does not issue its own debt. MAWC has issued its own debt, witness the EIERA financing discussed previously, and may do so in the future. Furthermore, it is a stretch to claim that American Water is manipulating MAWC's equity ratio given that MAWC's equity ratio is actually lower than that of the water proxy group used by Staff. In fact, American Water generally targets a 50% equity ratio for its regulated subsidiaries, although actual equity ratios across the system will, of course, tend to be somewhat higher or lower than 50% depending on factors such as earnings growth, the company's financing cycle, market conditions, etc. That is, it would not be practical, if indeed possible, to maintain an equity ratio of exactly 50% at each subsidiary. In addition, Staff has failed to demonstrate that a higher pre-tax return would result in a higher earned return to American Water (the Parent). That is, a higher equity ratio will produce a higher operating income, all else equal, but the return on investment may not necessarily be higher. This is because the amount of the investment needed to produce the higher level of operating income is greater.

C. OPC WITNESS GORMAN'S PROPOSED CAPITAL STRUCTURE

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

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

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

A. To arrive at his recommendation, Mr. Gorman reduced the Company's 2015 equity infusion from $30 million to $12 million, and increased the long-term debt issuance planned for August 2015 (at the time of our filing) from $20 million to $38 million (Gorman DT, pp. 23-24). I would note that just prior to the filing of our rate case on July 31, 2015, the Company determined to increase the debt financing from $20 million to $50 million. Unfortunately, reflecting this change in our filing was problematic, but it will be included in the Company's true-up filing on February 19. The Company's <u>expectation</u> is that the equity ratio at true-up will be lower than 52.37% as proposed in its initial filing.

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

A. Yes, on a conceptual basis I disagree with the arguments Mr. Gorman presented as support for making his adjustments. As I understand his testimony, his principal argument relates to MAWC's equity ratio in its last rate case relative to that of American Water's at that time, and the S&P and Moody's ratings upgrades to American Water and AWCC that have occurred since then. Mr. Gorman notes that the American Water consolidated equity ratio has remained largely unchanged at approximately 47% since 2012, but that its bond rating has been upgraded in spite of the equity ratio remaining the same over that period. Mr. Gorman then makes the leap that MAWC's equity ratio, which was 50.57% as determined by settlement in its 2012 rate case, "contributed to the capital structure at the parent company in its last rate case which was a strong investment grade bond rating" (Gorman DT, p. 21). American Water's S&P bond rating in 2012 was BBB+, which was certainly an investment grade rating, but not one I would characterize as "strong". That point notwithstanding, Mr. Gorman's argument is that American Water has seen its bond rating upgraded by S&P and Moody's since 2012 without increasing its equity ratio. Mr. Gorman's conclusion is that MAWC has unnecessarily increased its equity ratio, evidenced by the fact that American Water has not increased its equity ratio since 2012 and has still seen its bond rating improve. Mr. Gorman's argument seems to ignore the fact that other factors besides equity ratio can, and have, influenced American Water's bond rating. Ironically, Mr. Gorman noted these factors when discussing S&P's and Moody's rationale for upgrading American Water in 2015 (Gorman DT, pp. 18-19). In addition, S&P modified its corporate ratings criteria in 2013, noting its expectation that the ratio of upgrades to downgrades in the industrial and utility sectors would be 3 to 1 (see Standard & Poor's *RatingsDirect*, November 19, 2013). In short, American Water's improved bond rating is not an argument for maintaining its equity ratio at 47%, or MAWC's at 50.57% as it was back in 2012.

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

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

V. SUMMARY

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

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

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

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

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

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

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

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

A. Yes, I have. I recommended that MAWC's costs of long-term debt and preferred stock be calculated using MAWC's debt and preferred stock schedules, and not American Water's consolidated debt and preferred stock schedules, as was inappropriately done by Staff.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.