Exhibit No.:	
Issues:	Capital Structure
Witness:	Scott W. Rungren
Exhibit Type:	Surrebuttal
Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2015-0301 SR-2015-0302
Date:	March 4, 2016

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2015-0301
CASE NO. WR-2015-0302

SURREBUTTAL 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 "Surrebuttal 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 New Jersey
County of Camden
SUBSCRIBED and sworn to
Before me this 4th **day of** March **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

SURREBUTTAL TESTIMONY
SCOTT W. RUNGREN
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2015-0301
CASE NO. WR-2015-0302

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SURREBUTTAL 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. HAVE YOU PREVIOUSLY SUBMITTED PREPARED TESTIMONY IN THIS PROCEEDING?

A. Yes, I have submitted Direct Testimony, Supplemental Testimony, and Rebuttal Testimony on behalf of Missouri-American Water Company ("MAWC" or "the Company").

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my Surrebuttal Testimony is to address the Rebuttal Testimony of Staff Witness David Murray, specifically the capital structure discussion on pages 7 to 17 of his testimony.

Q. WHAT IS YOUR GENERAL IMPRESSION OF MR. MURRAY'S POSITION REGARDING THE CAPITAL STRUCTURE TO USE FOR RATEMAKING IN THIS CASE?

A. Mr. Murray's view is that the appropriate capital structure to use for determining MAWC's weighted average cost of capital ("WACC") is the consolidated capital structure of American Water Works Company, Inc. ("American Water"). He provides a number of arguments that are intended to support that view, most of which center around his claim that MAWC is not managed financially as an independent operating company and the fact that MAWC receives most of its debt financing from American Water Capital Corp. ("AWCC"), which is American Water's financing subsidiary and an affiliate of MAWC. My Surrebuttal Testimony will both dispel the notion that MAWC is not an independent entity from a financial standpoint, and demonstrate that MAWC's attainment of a portion of its debt financing through AWCC has no bearing on the determination of the appropriate capital structure to use for MAWC.

II. <u>MR. MURRAY'S ARGUMENTS ON CAPITAL STRUCTURE</u>

Q. MR. MURRAY STATES AT PAGE 8 OF HIS REBUTTAL TESTIMONY THAT "MAWC IS NOT VIEWED AND/OR FINANCIALLY MANAGED AS AN INDEPENDENT OPERATING COMPANY WITH CAPITAL COSTS BASED ON ITS STAND-ALONE BUSINESS RISK AND FINANCIAL RISK". DO YOU AGREE WITH THIS STATEMENT?

A. No, I do not. It can be stated unequivocally that, from a financial standpoint, MAWC's financing decisions are made by MAWC and not by the Treasury Department of American Water. The plan for MAWC's external financings, both debt and equity capital, is developed annually by MAWC and approved by MAWC's Board of Directors. The only issue controlled by American Water's

Treasury Department is the timing of long-term debt issuances. Debt Issuances by AWCC are typically executed once per annum, so if MAWC is participating in an offering it will be limited to obtaining the debt during the month AWCC places an issuance. However, the size of the debt issuance allocated to MAWC, if any, is completely within the control of MAWC. With respect to equity infusions from MAWC's parent, they can occur during any month that MAWC determines is appropriate. These facts demonstrate that the control of MAWC's financial management rests with MAWC. The second half of Mr. Murray's statement, which claims that MAWC's capital costs are not based on its stand-alone business and financial risks, whether completely accurate or not, is irrelevant to the determination of the appropriate capital structure to use for calculating MAWC's WACC.

Q. DO MAWC'S CAPITAL COSTS FULLY REFLECT THE BUSINESS AND FINANCIAL RISKS OF MAWC?

A. First of all, as of January 31, 2016, only 84.4% of MAWC's long-term debt outstanding was issued through AWCC. The remainder was issued through debt facilties of the State of Missouri. Of the portion of MAWC's debt structure issued through AWCC, it reflects the credit ratings and interest rates obtained by AWCC at the time it was issued. It should be noted that the all-in costs of the issues placed through AWCC are lower than they would have been if MAWC had issued this debt directly to third party lenders, largely due to lower issuance cost rates resulting from economies of scale associated with a larger AWCC issuance. This is a clear benefit to MAWC's ratepayers. Of the remaining capital costs of MAWC, the Company's preferred stock was issued to a third party and not through AWCC, so its cost reflected MAWC's risk profile at the time it was issued. Finally, the Company's authorized return on equity should reflect the relevant risk of MAWC, not American Water. Mr. Murray confuses the source of the capital (AWW) with the cost of the capital,

Q. YOU STATED ABOVE THAT MAWC'S CAPITAL COSTS ARE NOT RELEVANT TO THE DETERMINATION OF THE APPROPRIATE CAPITAL STRUCTURE TO USE FOR CALCULATING MAWC'S WACC. PLEASE EXPLAIN THE BASIS FOR YOUR STATEMENT.

A. I believe this point goes to the fundamental flaw in Mr. Murray's position that MAWC's actual capital structure should be ignored and replaced with that of American Water consolidated for ratemaking purposes. Mr. Murray is, in essence, basing his position on the fact that the long-term debt MAWC obtains through AWCC is based on the credit quality of AWCC and American Water, and not that of MAWC. Continuing with Mr. Murray's logic, since it is the leverage represented by the capital structure of American Water, among other metrics, that the interest rate on debt issued by AWCC reflects, it follows that American Water's capital structure should be used for determining MAWC's WACC. Putting aside the fact that only MAWC's long- and short-term debt component costs are impacted by its relationship with American Water, the fatal flaw in using the American Water consolidated capital structure is that doing so will guarantee the calculation of inaccurate weighted costs for each capital component.

Q. **PLEASE EXPLAIN WHY MR. MURRAY'S PREFERENCE FOR THE CAPITAL STRUCTURE OF AMERICAN WATER WILL PRODUCE INCORRECT CAPITAL COST RATES FOR MAWC?**

A. As I mentioned, MAWC has its own capital structure that is determined by MAWC and its Board of Directors. MAWC has its own independent corporate existence and some of its debt and preferred stock are not even raised at the American Water corporate level by AWCC. Furthermore, because this capital is determined by the needs of MAWC, the capital structure of MAWC naturally differs from that of the parent. This difference, in turn, will cause the calculation of revenue levels that are either higher or lower than that which the Company needs to service each class of investor in the capital components that are unique to MAWC. In this case, the weighted cost of long-term debt established by Mr. Murray is too high which, all else equal, will cause the calculation of revenue that is higher than if the Company's actual capital structure and weighted cost of long-term debt were used. This is exacerbated by the fact that Mr. Murray uses the consolidated long-term debt cost of 5.69%, rather than MAWC's actual cost of 5.47% (use of MAWC's capital structure and cost rates in the true-up filing and American Water consolidated data at December 31, 2015 would also result in over statement of revenue). Mr. Murray's methodology also results in the calculation of revenue above that which would result from using the Company's actual weighted cost of preferred stock. Even though Mr. Murray used the lower preferred stock cost of American Water consolidated, the ratio of preferred stock is higher at the consolidated level, resulting in a weighted cost of preferred stock higher than MAWC's. Of course, all else equal, the lower equity ratio in the consolidated capital structure will not provide the revenue necessary for the Company to earn its authorized return on equity, even the lower return on equity recommended by Mr. Murray. Unfortunately, Mr. Murray did not address the fact that his proposed capital structure would not allow MAWC to recover its <u>actual</u> costs of capital, which should be of concern to both the Commission and ratepayers.

Q. IS THERE ANY BASIS FOR USING A CAPITAL STRUCTURE THAT DIFFERS FROM THE MAWC STAND-ALONE CAPITAL STRUCTURE?

A. The only basis that would support the use of an alternative or hypothetical capital structure is a finding that MAWC's capital structure is unreasonable from a cost standpoint. That, however, is clearly not the case here. As noted in the Company's true-up filing, MAWC's actual equity ratio is 50.05%, which is below that of the projected water industry averages of approximately 53% to 54% for the 2015 to 2020 time period, as reported in the <u>Value Line Investment Survey</u> published on October 16, 2015 (see Rungren RT, p. 9). Thus, there is simply no reason to reject MAWC's stand-alone capital structure as Mr. Murray has done, particularly when doing so will produce capital costs that are <u>not</u> those of MAWC, and when MAWC's actual capital structure is slightly less leveraged than that of the water industry, in general.

Q. DOES MR. MURRAY PRESENT ANY OTHER REASON WHY MAWC'S STAND-ALONE CAPITAL STRUCTURE SHOULD BE DISCARDED?

A. Yes, Mr. Murray argues that since MAWC does not issue its own debt it has no reason "to manage its financial risk, i.e., capital structure, to appease potential debt investors" (Murray RT, p. 10). He goes on the state that "no debt investors are evaluating MAWC's stand-alone financial risk for purposes of determining a required return on debt investments. Consequently, MAWC's capital structure appears to only be consequential for ratemaking purposes." Id. The error in this argument is that MAWC manages its capital structure on a stand-alone basis and attempts to maintain a financial profile that will allow it to issue debt externally to third parties in the event that AWCC debt is unavailable, or that third-party debt is available at a lower all-in cost than that from AWCC. MAWC does not, and should not, assume that debt financing through AWCC is the only available financing option. AWCC has been a reliable and lower-cost financing option, but it would not be financially prudent for MAWC to disregard its fiduciary responsibility to maintain a reasonable capital structure, which is necessary to enable it to attract capital from external sources. Thus, MAWC's effort to maintain a reasonable capital structure is not just for ratemaking purposes as alleged by Mr. Murray. The Company can, and does, avail itself of outside financing sources when it is appropriate to do so.

Q. IN AN ATTEMPT TO BUTTRESS HIS CLAIMS, MR. MURRAY REFERENCES STANDARD & POOR'S ("S&P") AND HOW IT WOULD ASSESS MAWC. PLEASE COMMENT.

A. There are two notable inaccuracies in Mr. Murray's discussion of the rating process. First, Mr. Murray states that "S&P does not issue a credit rating for MAWC, but it does issue a credit rating on American Water" (Murray RT, p. 12). To clarify this, S&P will rarely issue a credit rating for any company, including American Water, unless enagaged to do so. If either MAWC or American Water wants an S&P credit rating, it must engage the services of S&P. And there is no reason why MAWC could not purchase a credit rating if it needed to do so to issue debt externally. Secondly, and a more troubling statement, is Mr. Murray's claim that if "S&P did assign a credit rating to MAWC, it would be based on the consolidated operations of American Water." Id. Mr. Murray does not explain the basis for this statement and, in fact, it is not accurate. If MAWC were rated by S&P it would be based on MAWC's credit quality, otherwise there would be no point to the rating. Mr. Murray is essentially saying that all of American Water's operating subsidiaries have the same credit quality and thus, would have the same rating. This is clearly not an accurate claim as demonstrated by the fact that both Pennsylvania-American Water and New Jersey-American Water have A+ ratings from S&P, whereas American Water and AWCC both have an A rating.

Q. MR. MURRAY POSES THE QUESTION OF WHETHER "CONSOLIDATION OF FINANCING NEEDS THROUGH AWCC MAKE[S] MAWC'S CAPITAL STRUCTURE INAPPROPRIATE FOR PURPOSES OF DETERMINING A FAIR AND REASONABLE ALLOWED ROR FOR MAWC," ANSWERING IN THE AFFIRMATIVE (MURRAY RT, P. 12). WHAT IS YOUR REPONSE?

A. Mr. Murray discusses the flow of funds between AWCC and American Water, and how American Water (the parent stand-alone company) obtains debt funding through AWCC as well. He noted how American Water uses proceeds from this debt to make equity infusions into its subsidiaries, resulting in less leveraged capital structures at the subsidiary level (Murray RT, p. 12). Mr. Murray suggests that American Water's subsidiaries could have, in the alternative, received this capital in the form of debt directly from AWCC, in which case, "the subsidiary capital structures would be more consistent with the amount of financial risk that American Water's subsidiaries could optimally incur" (Murray RT, pp. 12-13).

I have two concerns with this line of thought. First, Mr. Murray seems to be saying that if subsidiaries such as MAWC incurred additional debt, this higher debt ratio would either represent an optimal capital structure, or be closer to an optimal capital structure. However, Mr. Murray does not provide any support as to why this would be a more "optimal" capital structure, nor does he specify the ratio of debt that would represent an optimal capital structure. He also fails to explain why the water industry equity ratio in the range of 53 to 54% I noted previously would somehow be rendered "sub-optimal" under his analysis. Implicit in his testimony is the suggestion that MAWC's stand-alone capital structure is not reasonable, but he does not provide any evidence for why this might be the case. Interestingly, the companies in his own proxy group of water utilities have an average equity ratio that is very much in line, and actually slightly higher, than that of MAWC.

The other concern I have is that Mr. Murray's math does not work. If the subsidiaries obtained debt funding through AWCC rather than those proceeds going to American Water for the purpose of making equity infusions into the subsidiaries, then the American Water consolidated equity ratio would fall, perhaps to a precariously low level since the Company's equity balance could only grow through increases to retained earnings and public stock offerings by American Water.

Q. MR. MURRAY CONCLUDES THIS ANSWER BY STATING THAT "THE USE OF THE CONSOLIDATED CAPITAL STRUCTURE FOR RATEMAKING PURPOSES IS MOST LIKELY TO PRODUCE A ROR THAT IS CONSISTENT WITH THE COST OF CAPITAL ASSOCIATED WITH MAWC'S RISK PROFILE" (MURRAY RT, P. 13). DO YOU AGREE?

A. No, I do not. That is exactly what using the consolidated capital structure will <u>not</u> do. Using the consolidated capital structure with the consolidated company capital costs, as Mr. Murray proposes, produces the consolidated company's cost of capital, not MAWC's. If Mr. Murray's objective is to produce a ROR consistent with MAWC's risk profile, then his starting point should be MAWC's capital structure, not American Water's consolidated capital structure.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.