

Exhibit No.:  
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Witness: Scott W. Rungren  
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Sponsoring Party: Missouri-American Water Company  
Case No.: WR-2008-0311  
SR-2008-0312  
Date: October 16, 2008

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. WR-2008-0311  
CASE NO. SR-2008-0312**

**SURREBUTTAL TESTIMONY**

**OF**

**SCOTT W. RUNGREN**

**ON BEHALF OF**

**MISSOURI-AMERICAN WATER COMPANY**

**BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI**

<b>IN THE MATTER OF MISSOURI-AMERICAN )</b>	
<b>WATER COMPANY FOR AUTHORITY TO )</b>	
<b>FILE TARIFFS REFLECTING INCREASED )</b>	<b>CASE NO. WR-2008-0311</b>
<b>RATES FOR WATER AND SEWER )</b>	<b>CASE NO. SR-2008-0312</b>
<b>SERVICE )</b>	

**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

State of Missouri  
County of St. Louis  
SUBSCRIBED and sworn to  
Before me this 15<sup>th</sup> day of October 2008.

  
\_\_\_\_\_  
Notary Public

**My commission expires:**

Staci A. Olsen  
Notary Public - Notary Seal  
State of Missouri  
St. Charles County  
Commission # 05519210  
My Commission Expires: March 20, 2009

**SURREBUTTAL TESTIMONY  
SCOTT W. RUNGREN  
MISSOURI-AMERICAN WATER COMPANY  
CASE NO. WR-2008-0311  
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**SURREBUTTAL TESTIMONY  
OF  
SCOTT W. RUNGREN**

**I. WITNESS INTRODUCTION AND PURPOSE**

**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 TESTIMONY IN THIS PROCEEDING?**

A. Yes, I have submitted direct and rebuttal testimony in this proceeding.

**Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Missouri Commission Staff (Staff) witness Matthew J. Barnes on the issue of the appropriate capital structure to use for determining Missouri-American Water Company's (MAWC) weighted average cost of capital (WACC) in this proceeding.

**II. REBUTTAL TESTIMONY OF STAFF WITNESS BARNES**

**Q. IN HIS REBUTTAL TESTIMONY, PAGE 3, LINES 5-6, STAFF WITNESS MATTHEW J. BARNES ASSERTS THAT USE OF MAWC'S PRO FORMA CAPITAL STRUCTURE, SUCH AS THAT PRESENTED IN YOUR DIRECT**

1           **TESTIMONY IN THIS PROCEEDING, SHOULD BE NOT USED BECAUSE IT**  
2           **IS NOT KNOWN AND MEASURABLE. HOW DO YOU RESPOND?**

3    A.       Putting aside the merits of a pro forma capital structure for ratemaking  
4           purposes, Mr. Barnes' concern on this issue should be alleviated when the  
5           Company files its true-up in October. That true-up will include MAWC's actual  
6           capital structure as of September 30, 2008.

7    **Q.       ON PAGE 3 OF HIS REBUTTAL TESTIMONY, BEGINNING AT LINE 6, MR.**  
8           **BARNES MAINTAINS THAT BECAUSE MAWC DOES NOT ISSUE ALL OF**  
9           **ITS OWN DEBT, IT IS INAPPROPRIATE TO USE MAWC'S CAPITAL**  
10          **STRUCTURE FOR RATEMAKING PURPOSES IN THIS PROCEEDING. DO**  
11          **YOU AGREE?**

12   A.       First, as I noted on page 12 of my rebuttal testimony, as of September 30,  
13           2008, MAWC will have approximately \$386 million of long-term debt  
14           outstanding. Of that amount, approximately \$213 million, or 55.2%, will have  
15           come from sources other than AWCC, including \$57.48 million of tax-exempt  
16           bonds MAWC issued on December 21, 2006 through the Missouri State  
17           Environmental Improvement and Energy Resources Authority ("EI ERA"). Since  
18           only 44.8% of MAWC's current debt was placed through AWCC, it is apparent  
19           that MAWC does not rely solely on AWCC as a source of debt financing. In  
20           fact, third-party lenders have been MAWC's major source of long-term debt  
21           capital.

1 Second, as explained in detail on pages 5-6 of my rebuttal testimony, MAWC  
2 manages its capital structure and makes financing decisions, including the  
3 source of its debt financing, independently of its parent, American Water Works  
4 Company, Inc. (American Water or AWK). MAWC is not required by AWK to  
5 use AWCC for debt financing. MAWC considers various options when it  
6 wishes to secure debt financing, and uses AWCC as a source of debt capital  
7 financing only if it is the least cost of the various options available.  
8 Significantly, Staff does not dispute the fact that AWCC has been the lowest  
9 cost source of long-term debt for the issuances that MAWC has placed through  
10 it.

11 Finally, Staff witness Barnes provides no basis for why the use of AWCC as a  
12 funding source should cause the Commission to adopt American Water's  
13 consolidated capital structure for ratemaking purposes, rather than MAWC's  
14 actual capital structure, particularly in the absence of evidence that it is  
15 unreasonable (a point I will address below).

16 **Q. IS THERE ANOTHER POINT YOU WISH TO MAKE WITH REGARD TO THE**  
17 **USE OF AWCC AS A SOURCE OF DEBT FINANCING?**

18 A. Yes, there is. MAWC'S use of AWCC as a source of debt financing impacts  
19 MAWC. However, the impact is only on MAWC's composite cost of debt. Staff  
20 witness Barnes stated on page 5, lines 2-3, of his rebuttal testimony that "the  
21 cost of capital provided to MAWC is driven by the consolidated operations of  
22 American Water," which overstates American Water's and, thus, AWCC's,

1 impact on MAWC. In fact, only 44.8% of MAWC's currently outstanding debt  
2 was raised through AWCC. Thus, while the consolidated operations of  
3 American Water can impact MAWC's cost of debt to the extent that MAWC  
4 uses AWCC as a debt funding source, the fact that MAWC's cost of debt is  
5 impacted does not justify or necessitate use of American Water's consolidated  
6 capital structure for ratemaking purposes. There is simply no basis for  
7 contending that there is a relationship between the composition of MAWC's  
8 capital structure and the manner in which the entities that provided that capital,  
9 including American Water, are capitalized. The key point is that MAWC's rate  
10 base is financed by capital raised by MAWC, in the ratio of each capital  
11 component's proportion to total capital. MAWC's rate base is not financed by  
12 capital in the proportions that comprise American Water's consolidated capital  
13 structure. Thus, using American Water's consolidated capital structure would  
14 result in a disconnect in that the computed overall rate of return on rate base,  
15 or weighted average cost of capital, may not reflect MAWC's cost of capital. In  
16 such a circumstance, the overall rate of return authorized by the MoPSC could  
17 be higher or lower than that needed to satisfy investors' return requirements. If  
18 that were to occur, then the overall authorized rate of return would not be  
19 reasonable from a regulatory standpoint. For these reasons, the MoPSC  
20 should reject use of American Water's consolidated capital structure for use in  
21 determining MAWC's weighted average cost of capital in this proceeding.

22 **Q. WHAT ADDITIONAL REASON IS THERE FOR USING MAWC'S PROPOSED**  
23 **CAPITAL STRUCTURE FOR CALCULATING THE WEIGHTED AVERAGE**

**COST OF CAPITAL IN THIS PROCEEDING?**

A. Significantly, no party in this proceeding, including Staff witness Barnes, has presented any evidence that MAWC's proposed capital structure is unreasonable for ratemaking purposes. In fact, I have demonstrated in both my direct and rebuttal testimony that MAWC's pro forma capital structure is reasonable for ratemaking purposes. Specifically, I showed that MAWC's pro forma capital structure ratios are consistent with those maintained, on average, by the four water companies in Staff's comparable group and both of Company witness Ahern's proxy groups. Since MAWC's capital structure has been demonstrated to be reasonable, and no party has disputed that claim, there is no basis for rejecting MAWC's pro forma September 30, 2008 capital structure. Further, MAWC's actual September 30, 2008 capital structure, to be provided with the October true up, is not materially different from its pro forma September 30, 2008 capital structure.

**Q. DOES ANY OTHER PARTY TO THIS PROCEEDING SUPPORT USE OF THE COMPANY'S PROPOSED CAPITAL STRUCTURE?**

A. Yes. In its response to Company Data Request No. 12, the MIEC stated, in part, that its return on equity witness, Mr. Janous, "found Missouri-American's capital structure appropriate to set rates in this case." And in its response to Company Data Request No. 13, the MIEC stated that "Mr. Janous used the Company's recommended capital structure for the purposes of his proposed rate of return in this case as indicated in Schedule BAJ-1."



1 Q. ON PAGE 5 OF HIS REBUTTAL TESTIMONY, BEGINNING AT LINE 4,  
2 STAFF WITNESS BARNES CONTENDS THAT USE OF AWCC AS A  
3 FINANCING SUBSIDIARY MAKES MAWC'S CAPITAL STRUCTURE  
4 INAPPROPRIATE FOR COMPUTING THE RECOMMENDED RATE OF  
5 RETURN ON RATE BASE FOR MAWC. DO YOU AGREE WITH MR.  
6 BARNES?

7 A. No, I do not. A fundamental flaw in Mr. Barnes' argument is demonstrated by  
8 the following statement on page five of his rebuttal testimony:

9 "By carrying most of this debt at the parent company level rather  
10 than at the subsidiaries, American Water is able to produce  
11 subsidiary capital structures that are more heavily weighted in  
12 equity, which would not be the case otherwise."

13 Mr. Barnes has presented no support for his view that carrying debt at the  
14 parent company level (i.e., AWCC) provides American Water the ability to  
15 maintain higher equity ratios for its subsidiaries, such as MAWC. In fact, there  
16 is no relationship between the amount of debt held by AWCC and the equity  
17 ratios of American Water's subsidiaries, including MAWC. American Water  
18 infuses equity to its subsidiaries to maintain reasonable capital structure ratios,  
19 and the fact that debt is raised by AWCC does not enable American Water to  
20 maintain higher equity ratios at its subsidiaries than it would have otherwise. If  
21 AWCC did not exist as a means to provide pooled debt financing for American  
22 Water, as well as its subsidiaries, American Water would issue its own debt  
23 directly to the financial markets and, of course, American Water's subsidiaries  
24 would do the same. There is no reason to presume, however, that the absence

1 of AWCC as a funding source would have any impact on the equity ratios of  
2 either American Water or its subsidiaries, including MAWC. It is also  
3 somewhat misleading to characterize the AWCC debt as being held at the  
4 parent company level. While from the subsidiary perspective AWCC is the  
5 holder of all debt it issues on behalf of American Water's subsidiaries, this debt  
6 ultimately resides on the balance sheets of the subsidiaries in the amount that  
7 the funds are distributed to each respective subsidiary.

8 **Q. ON PAGE 5, LINES 11-13 OF HIS REBUTTAL TESTIMONY, MR. BARNES**  
9 **CLAIMS THAT SINCE AMERICAN WATER'S EQUITY INVESTMENTS ARE**  
10 **"SOURCED BY THE DEBT AT AWCC," AMERICAN WATER AND ITS**  
11 **SUBSIDIARIES EARN "EQUITY RETURNS ON DEBT." WHAT IS YOUR**  
12 **RESPONSE?**

13 A. Mr. Barnes' argument is not a basis for using American Water's consolidated  
14 capital structure instead of MAWC's capital structure. The source of funds  
15 used by American Water for an equity infusion is irrelevant to the form that  
16 capital takes in an independent subsidiary's capital structure. Thus, an equity  
17 investment by American Water in MAWC through the use of funds obtained, in  
18 part, from debt issued by AWCC, does not justify use of American Water's  
19 consolidated capital structure for ratemaking purposes. Put another way, the  
20 source of the funds used to provide the capital comprising MAWC's capital  
21 structure has no bearing on the determination of the appropriate capital  
22 structure to use for MAWC in this proceeding.

1 Staff seems to acknowledge that the source and cost of funds used to make an  
2 investment is irrelevant to the return required on that investment. In a data  
3 request to the Staff, the Company asked whether the Staff believes "that the  
4 market-required return on an investment in common equity is a function of  
5 either the source or the cost of the funds investors use to make that investment  
6 in common equity." The Staff correctly responded that the market-required  
7 return "is based on the risks investors perceive to be present in the  
8 investment." It would be an error, therefore, to consider American Water's  
9 source and cost of funds as relevant to the determination of the appropriate  
10 capital structure for MAWC.

11 **Q. ON PAGE 5, LINES 13-15 OF HIS REBUTTAL TESTIMONY, MR. BARNES**  
12 **STATES THAT "BECAUSE AMERICAN WATER'S CAPITAL STRUCTURE**  
13 **DIRECTLY AFFECTS THE COST OF CAPITAL THAT IS AVAILABLE TO ITS**  
14 **SUBSIDIARIES, IT IS UNLIKELY THAT AMERICAN WATER WOULD**  
15 **MANAGE THIS CAPITAL STRUCTURE IN AN IMPRUDENT MANNER."**  
16 **WHAT IS YOUR RESPONSE?**

17 **A.** American Water's capital structure may impact the cost of equity capital to  
18 American Water; however, there is no relation between American Water's  
19 capital structure and MAWC's cost of equity. MAWC's cost of equity is a  
20 function of the risk that investors price in an investment comparable in risk to  
21 MAWC, not American Water. American Water's capital structure can impact  
22 the cost of debt raised by AWCC, but that is not a basis for using American

1 Water's capital structure for determining MAWC's weighted average cost of  
2 capital in this proceeding.

3 **Q. ON PAGE 5, OF HIS REBUTTAL TESTIMONY, AT LINES 16-18, MR.**  
4 **BARNES STATES THAT "THE USE OF THE CONSOLIDATED CAPITAL**  
5 **STRUCTURE FOR RATEMAKING PURPOSES IS MOST LIKELY TO**  
6 **PRODUCE A ROR THAT IS CONSISTENT WITH THE COST OF CAPITAL**  
7 **AVAILABLE TO MAWC." DO YOU AGREE WITH MR. BARNES'**  
8 **STATEMENT?**

9 **A.** No, I do not. In fact, use of American Water's consolidated capital structure is  
10 not likely to produce an overall rate of return on rate base that reflect MAWC's  
11 cost of capital. I discussed this issue at length on pages 8-9 of my rebuttal  
12 testimony, and on page 4 in this testimony.

13  
14 **III. SUMMARY**

15 **Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY WITH RESPECT**  
16 **TO THE CAPITAL STRUCTURE ARGUMENTS ADVANCED BY MR.**  
17 **BARNES IN HIS REBUTTAL TESTIMONY.**

18 **A.** I have made the following points with respect to Mr. Barnes' rebuttal testimony  
19 on MAWC's capital structure:

- 20 • As of September 30, 2008, 55.2% of MAWC's long-term debt will have  
21 come from sources other than AWCC.

- 1           • MAWC is not required by AWK to issue debt through AWCC. MAWC  
2           makes its financing decisions independently of AWK.
- 3           • Mr. Barnes provided no basis for why the use of AWCC as a funding  
4           source should cause the MoPSC to adopt American Water's consolidated  
5           capital structure, rather than MAWC's, for ratemaking purposes. Use of  
6           AWCC by MAWC as a debt funding source only impacts the cost of debt to  
7           MAWC.
- 8           • No party has presented any evidence that MAWC's proposed capital  
9           structure in this proceeding is unreasonable for ratemaking purposes.
- 10          • There is no evidence to support Mr. Barnes' claim that the use of AWCC  
11          as a source of debt financing to American Water's subsidiaries provides  
12          American Water the ability to maintain higher equity ratios for its  
13          subsidiaries, such as MAWC.
- 14          • An equity investment made by American Water in MAWC sourced by  
15          funds obtained, in part, from debt issued by AWCC does not justify use of  
16          American Water's consolidated capital structure instead of MAWC's for  
17          ratemaking purposes.
- 18          • Use of American Water's consolidated capital structure is likely to produce  
19          an overall rate of return on rate base that does not reflect MAWC's actual  
20          cost of capital.

1 Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

2 A. Yes, it does.