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Issues:	Capital Structure and Overall Rate of Return
Witness:	Scott W. Rungren
Exhibit Type:	Surrebuttal
Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2017-0285 SR-2017-0286
Date:	February 9, 2018

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2017-0285
CASE NO. SR-2017-0286

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-2017-0285** **CASE NO. SR-2017-0286**

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 Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 7th **day of** February **2018.**

Mary Beth Hercules

Notary Public

My commission expires:

MARY BETH HERCULES
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires April 26, 2020
Commission # 96546828

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SCOTT W. RUNGREN
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CASE NO. WR-2017-0285
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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, MO, 63141.

Q. Are you the same Scott W. Rungren who previously submitted direct and rebuttal testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond, on behalf of Missouri-American Water Company ("MAWC" or the "Company"), to the Rebuttal Testimony of Jeffrey Smith of the Missouri Public Service Commission Staff ("Staff") and the Rebuttal Testimony of Michael P. Gorman of the Office of the Public Counsel ("OPC") and the Missouri Industrial Energy Consumers ("MIEC"). My surrebuttal testimony is focused on the issue of the appropriate capital structure that should be used to calculate MAWC's weighted average cost of capital ("WACC") in this proceeding. Although I continue to disagree with Mr. Smith's recommended costs of long-term debt and preferred stock, I fully addressed the issues related to those costs in my rebuttal testimony.

II. RESPONSE TO THE REBUTTAL TESTIMONY OF STAFF WITNESS SMITH

Q. What is your general reaction to the rebuttal testimony of Staff witness Smith on the issue of capital structure?

A. Mr. Smith presented his case as to why the Commission should adopt American Water Company's ("AWW's") consolidated capital structure in place of MAWC's stand-alone capital structure for the purpose of calculating the WACC in this proceeding. Alternatively, I advanced numerous reasons in my rebuttal testimony for why Staff's advocacy for using the AWW consolidated capital structure to set rates should be rejected, and in so doing demonstrated why the MAWC stand-alone capital structure proposed in this case should be used to calculate the WACC, or allowed rate of return on rate base. I continue to strongly believe that the proper capital structure to use for MAWC in this case is MAWC's stand-alone capital structure.

Q. Before you address the specifics of Staff witness Smith's capital structure arguments, are there any errors in his testimony that should be noted?

A. Yes, there are some items that appear to be typos. On page eight, line eleven, of his Rebuttal Testimony, Mr. Smith noted that his recommended ratios for common equity and short-term debt are 43.66% and 4.87%, respectively, as shown on Schedule 6 of Appendix 2 attached to the Staff Cost of Service Report. My review of Schedule 6 of Appendix 2 indicates, however, that the Staff's recommended common equity ratio is 43.99% and its recommended short-term debt ratio is 4.91%.

Q. In addition to opposing the use of MAWC's stand-alone capital structure in this case, Mr. Smith also criticizes use of a capital structure based on "pro forma

assumptions," such as that stemming from use of MAWC's proposed future test year (Smith Reb., p. 8). Do you agree with Mr. Smith?

A. No, I do not. The Company's explanation of the appropriateness of using a future test year is presented in the direct, rebuttal and surrebuttal testimonies of MAWC witness James M. Jenkins.

Q. One of the factors Staff witness Smith claims as a basis for not using MAWC's stand-alone capital structure is his belief that "MAWC is not viewed, nor financially managed, as an independent operating company with capital costs based on its stand-alone business risk and financial risk." (Smith Reb., p. 9). Is Mr. Smith correct?

A. No, he is not. I addressed this point on page six of my rebuttal testimony. MAWC's capital structure is managed and maintained as a stand-alone entity and its financial risk reflects the degree of leverage represented by its capital structure, not that of its parent company or that of AWW consolidated. As I have noted many times, both in this proceeding and in past MAWC rate cases, MAWC's relationship with AWCC, its financing affiliate, allows MAWC to obtain long-term debt, particularly taxable debt, at a lower all-in cost than MAWC would incur from issuing debt directly in the market. This is a financing arrangement that generates cost benefits that inure to the ratepayers of MAWC and the other AWW operating utilities. In other words, this financing arrangement impacts MAWC's <u>cost</u> of debt, but does not impact the manner in which MAWC manages its capital structure. As I noted on page sixteen of my rebuttal testimony, MAWC considers the mix of debt, preferred stock and common equity appropriate for its capital structure irrespective of its parent's capital structure. Thus, MAWC manages its capital structure independently from AWW, constructing its own financing plan with respect to the amounts and timing of debt and equity issuances. In managing its capital structure, the Company's goal is to maintain a reasonable WACC in light of the various business risks it faces. In addition, MAWC assesses its capital structure for reasonableness against that of other publicly-traded water utilities. In short, MAWC's capital structure is managed on a stand-alone basis. Mr. Smith's argument that use of AWCC as a financing affiliate removes MAWC's independence as a financial entity is without merit or credible support.

Q. What would be the consequence of the Commission adopting Staff witness Smith's proposed capital structure?

A. Adoption of Mr. Smith's recommended capital structure in this proceeding would, in essence, penalize MAWC for obtaining lower cost debt financing through AWCC, and constitute an unwarranted regulatory response to a business practice that has resulted in meaningful cost savings to MAWC and its customers. In addition, Mr. Smith seems to be suggesting that all of MAWC's capital costs are impacted by virtue of its ownership by AWW and financing relationship with AWCC; however, the Company's costs of preferred stock and common equity are not impacted by those relationships. MAWC's preferred stock was issued by MAWC, and its cost of common equity, according to the *Hope and Bluefield* standard, should be commensurate with the return required on investments similar in risk to that of MAWC. Since MAWC and AWW clearly do not have the same level of business and financial risks, they should not be expected to have the same investor-required return on equity.

Q. Does Mr. Smith assume that MAWC and AWW have the same level of business risk?

A. Yes, Mr. Smith assumes that MAWC and AWW have similar levels of business risk and, therefore, should be expected to have similar levels of financial risk. The Staff Report states the following:

> " … American Water is primarily a regulated water distribution utility, meaning that the business risks of American Water are similar to that of MAWC. If the business risks of the parent company are similar to that of the subsidiary, then each entity should be able to incur similar amounts of financial risk. Presumably this should cause their capital structures to be fairly similar." (Staff Report, p. 34).

In his rebuttal testimony Mr. Smith claims the following:

> "As long as the risk associated with the consolidated operations is consistent with MAWC's risk, then it is appropriate to not only use the consolidated capital structure, but also the cost of capital associated with this capital structure for ratemaking purposes." (Smith Reb., p. 11).

Q. Does Mr. Smith present any evidence that supports his assumption that MAWC and AWW have similar levels of business risk?

A. No, he does not. Mr. Smith proceeds from the notion that because "American Water is primarily a regulated water distribution utility…." and because MAWC is also a regulated water utility, they have similar levels of business risk and <u>should</u>, therefore, have similar levels of financial risk. Noticeably missing from his argument is any supporting analysis that compares or contrasts the business risks facing MAWC and AWW. Thus, he has no empirical evidence to support his claim that they face similar levels of business risk. In fact, they do not face the same level of business risk, so Mr.

Smith's underlying premise is incorrect. Consequently, Mr. Smith's belief that MAWC and AWW consolidated should have the same level of financial risk is also unfounded.

Q. What is the basis for your conclusion that MAWC and AWW do not have the same level of business risk?

A. MAWC's business risk profile is significantly different than the business risk profile of AWW. AWW is composed of regulated utility operations in many different states, as well as a relatively small segment of non-regulated operations. MAWC, in contrast, is a much smaller, entirely regulated water utility operating solely in the state of Missouri, and thus, does not achieve the level of diversification reflected in AWW's business risk profile. Because the capital structure of a business should reflect its business risk profile, it is reasonable to expect that the risk profiles and, thus, the capital structures, of MAWC and AWW would be different.

Q. Does this relative risk difference indicate greater business risk for MAWC as compared to AWW?

A. I believe so. This can be shown by a simple illustration. Consider a scenario in which AWW, which is an unregulated holding company, owns only one operating water utility, and that utility is MAWC. In that situation, the business risks of AWW and MAWC are virtually identical. If AWW were to then add water utilities to its portfolio through acquisition, with these utilities operating in different states, AWW's exposure to business risk would decline as utilities are added because AWW would benefit from the operational, geographical, and regulatory diversification provided by these acquired companies. In this example, the business risk faced by shareholders of MAWC is greater than that faced by the shareholders of the diversified AWW. This is because the impact of a negative event to the operation of MAWC will impact MAWC much more than it will impact AWW, since AWW owns numerous water utilities across many states.

Q. What is the significance of MAWC having greater business risk than AWW?

A. The greater level of business risk faced by MAWC, relative to that faced by AWW, suggests that MAWC's proposed equity ratio, although higher than AWW's actual equity ratio, is justified. This is because a higher equity percentage and, thus, lower financial risk, will help ensure that MAWC can meet its financial obligations. In addition, adoption of Mr. Smith's proposed AWW consolidated capital structure would impute AWW's higher level of financial risk to MAWC and its ratepayers. A higher level of financial risk, or leverage, increases a firm's costs of capital because a firm with a higher percentage of debt capital will incur higher costs for both its debt and equity than a firm with a greater proportion of equity capital, all other risk factors held constant.

Q. Has Mr. Smith examined the impact that adoption of his proposed AWW consolidated capital structure would have on MAWC's risk and WACC?

A. No, he has not presented any such analysis. Thus, without examining the impact of his proposed capital structure on MAWC's cost of capital and reflecting its associated higher capital costs, Mr. Smith cannot know whether he has imputed a capital structure to MAWC that, if implemented, would result in a higher weighted average cost of capital than would use of MAWC's proposed capital structure. Further, using an imputed capital structure based on AWW's capital structure for ratemaking purposes, without adjusting the capital component costs to reflect the higher level of financial risk, will not provide MAWC with adequate cash flow to service the return requirements of its investors.

Q. Why would an increase in risk lead to a higher WACC?

A. It is essential that MAWC maintain a reasonable stand-alone capital structure and related financial ratios that will allow it to attract capital in the market on reasonable terms. MAWC has the ability to issue debt capital on its own through public or private issuances, or through AWCC, provided that AWCC is determined to be the least cost source. To date, MAWC has not chosen to obtain debt capital via a public offering due to, among other factors, higher issuance costs associated with such a placement. Thus, MAWC has not been required to obtain a bond rating from a rating agency, such as Standard & Poor's ("S&P"). MAWC has, however, issued debt through private offerings, primarily to institutional investors. In connection with such issuances, the investors involved analyze financial ratios and other data comparable to the data that is examined by rating agencies in connection with the assignment of debt ratings. In effect, the private investor will assign its own "rating" developed in a manner similar to that used by the rating agencies for public debt. Staff's proposed capital structure would result in a lower "rating" for MAWC. This would result in an increase to both MAWC's cost of debt, due to the lower rating, and to its cost of common equity, as investors would demand higher returns to compensate them for MAWC's increased risk.

Q. Is Staff witness Smith's proposal consistent with the capital structure of his water utility proxy group?

A. No, it is not. The average equity ratio of the water utility proxy group, as of December 31, 2016, was 52.2% using S&P data and 54.7% using Value Line data. Thus, Mr. Smith's imputed equity ratio of 43.99% is 8.2 percentage points lower than the S&P average and 10.7 percentage points lower than the Value Line average. The difference between the Value Line and S&P averages is largely due to the fact that Value Line excludes short-term debt in its calculation.

Q. Is Staff witness Smith's imputed capital structure proposal consistent with his recommended return on common equity in this proceeding?

A. No, it is not. As noted previously, Mr. Smith did not adjust his cost of equity recommendation to reflect his imputed capital structure. This issue is explained in greater detail in the testimony of MAWC witness Ann Bulkley.

Q. Staff witness Smith argues that if the Commission adopts "a more equity rich capital structure" than what he has proposed, then the Commission should lower MAWC's debt cost because of the implied lower level of financial leverage (Smith Reb., p. 15). How do you respond?

A. Mr. Smith reasons that if AWW consolidated increased its equity ratio then it would have a lower cost of debt, which would benefit MAWC when it issues debt through AWCC. First, AWW and AWCC are both currently rated 'A' by S&P and 'A3' by Moody's ('A3' is equivalent to an 'A-' rating from S&P). Thus, AWCC is able to issue debt with a single A rating, which as noted by MAWC witness Bulkley, is considered an optimal rating (Bulkley Reb., p. 50). Thus, MAWC is able to obtain debt through AWCC at a reasonable cost, which indicates that no adjustment to MAWC's cost of debt is warranted. Second, adopting MAWC's test year capital structure in this proceeding would not alter AWW's capitalization or result in a higher bond rating for AWW/AWCC; thus, it would not result in any reduction in the cost of debt that MAWC issues through AWCC.

Q. Staff witness Smith also asserts that "MAWC's per books capital structure is not market-tested," and then argues that "[t]he only market capital costs that are known are those that are the result of investors evaluating the business and financial risk of AWK, the owner of MAWC" (Smith Reb., pp. 15-16). Do you agree with Mr. Smith?

A. No, I do not. With respect to MAWC's per books capital structure, MAWC has "tested" its capital structure against that of U.S. market-traded water utilities, which compose the water utility group used by each ROE witness in this case, including Mr. Smith. As noted previously, MAWC's proposed capital structure has a lower equity ratio in comparison to that group. With respect to its capital costs, MAWC's cost of long-term debt reflects the cost of debt it has placed on its own with investors as well as that which it has issued through AWCC. Thus, its cost of debt is reflective of investor-required, or market-determined interest rates. MAWC's preferred stock was issued by MAWC directly to investors and, finally, MAWC's cost of equity has been estimated by MAWC witness Bulkley based on the market's perceived risk of an investment commensurate in risk to that of MAWC, consistent with the *Hope* and *Bluefield* standard.

Q. What is your conclusion with respect to Staff witness Smith's recommended capital structure for MAWC in this proceeding?

A. Mr. Smith fails to recognize that MAWC is responsible for raising its own capital and, therefore, that MAWC manages its capital structure independently of AWW. Mr. Smith also fails to demonstrate that MAWC's capital structure is not reasonable - in fact, he did not assess the reasonableness of MAWC's capital structure with respect to its impact on MAWC's WACC. Similarly, Mr. Smith did not demonstrate that his proposed capital structure is reasonable; rather, he simply imputed the capital structure of AWW consolidated. In addition, Mr. Smith neglected to reflect the impact of his proposed capital structure on MAWC's capital component costs and, as a result, his proposed capital structure is not reflected in his overall WACC recommendation for MAWC. And finally, Mr. Smith ignored the risk profile and capital structure of his own water proxy group which clearly indicates that MAWC's proposed capital structure in this case is reasonable.

MAWC's forecasted capital structure should be used in this case. MAWC's forecasted 51.03% common equity ratio is the appropriate proportion of equity in the capital structure to make certain the Company's operations and investments are financed at the lowest weighted average cost of capital. Holding constant the Company's degree of business risk, a higher equity ratio lowers the cost of each capital component. MAWC's proposed capital structure will enable the Company to raise capital on reasonable terms in most market conditions.

III. <u>RESPONSE TO THE REBUTTAL TESTIMONY OF OPC/MIEC WITNESS GORMAN</u>

Q. Does OPC/MIEC witness Gorman provide a capital structure recommendation in this case?

A. Yes, he does. In his rebuttal testimony he recommends a capital structure consisting of an equity ratio of 50%. Given that this is neither the Company's projected test year equity ratio nor its actual equity ratio, I presume that Mr. Gorman is recommending a hypothetical capital structure.

Q. Do you agree with Mr. Gorman's hypothetical capital structure?

A. Although it is certainly more reasonable than Staff's proposed capital structure with its 43.99% equity ratio, there is no reason to use a hypothetical capital structure when MAWC's test year equity ratio of 51.03% is not appreciably different from the 50% equity ratio in Mr. Gorman's hypothetical capital structure. Further, the Company's proposed equity ratio is more in line with the average equity ratio of the water utility proxy group used by each ROE witness in this case, including Mr. Gorman. As Mr. Gorman noted in his Direct Testimony, "[t]he water proxy group has an average common equity ratio of 52.2% from S&P and 54.7% (excluding short-term debt) from *Value Line* for 2016 (Gorman Dir., p. 17).

Q. Mr. Gorman asserts that the equity ratio in MAWC's proposed capital structure represents an increase compared to the Company's actual common equity ratio over the most recent five-year period (Gorman Reb., p. 3). What is your response?

A. From my perspective, the 51.03% equity ratio in MAWC's proposed capital structure is reasonably close to the Company's actual equity ratio over the 2012-2016 period. As Mr. Gorman notes, during that time MAWC's equity ratio ranged from 49.8% to 50.8%, with an average of 50.25% (Gorman Reb., p. 3 and Sch. MPG-R-2). I conclude that MAWC's equity ratio has not trended upward to a significant degree.

Q. Mr. Gorman also offers an interesting observation in his rebuttal testimony regarding MAWC's ability to adjust its equity ratio to match the Commission's finding in this case. Do you have a response to Mr. Gorman's comment?

A. Yes, I do. Mr. Gorman observes at page 6 of his rebuttal:

> Adjusting the Company's forecasted cost of service for the forecasted test year provides the Company an ample opportunity to modify its actual capital structure to conform to what the Commission finds to be reasonable for setting rates. If the Company responds to this regulatory price signal, it will be provided the opportunity to fully recover its cost of service including the Commission authorized return on common equity.

If I understand Mr. Gorman's testimony correctly on this matter, the financial consequence of the Company taking such action has a particularly chilling effect, especially with respect to the very low equity ratio recommended by Staff witness Smith.

Q. Please explain your concern.

A. Although conforming MAWC's equity ratio to the 50% recommended by Mr. Gorman would not have serious implications for the Company, the same cannot be said of Staff witness Smith's recommendation. In relation to Mr. Gorman's observation, if Staff's recommendation to impute an equity ratio of 43.99% were accepted by the

Commission, MAWC should then take steps to significantly reduce its 51.03% equity ratio. This would, of course, require MAWC to divest a portion of its equity and increase its debt burden. This would then result in a significant increase to MAWC's financial risk; also exposing the Company to interest rate risk at a time of potentially rising interest rates. Although Mr. Gorman does not explain how such a reduction to MAWC's equity would be accomplished, one way would be to drain the retained earnings of the Company through dividend payments to the parent, thus reducing the equity balance that supports Missouri rate base, and replacing it with debt in a potentially rising interest rate environment. In my view, this does not represent a prudent financial path for MAWC. It does, however, illustrate the pitfalls of Staff's recommendation to use the AWW consolidated equity ratio to calculate MAWC's WACC.

Q. What would the magnitude of MAWC's dividend payment to AWW need to be to reduce the Company's test year equity ratio from 51.03% to Staff witness Smith's recommended 43.99%?

A. Holding all other variables constant, the total dividend payment needed for MAWC to attain an equity ratio of 43.99% is approximately $90.8 million. This amount is above the amount of its net income, because the Company would have to pay out more than its net income to result in negative, or debit, entries to its retained earnings account. A dividend of $90.8 million represents approximately 14% of MAWC's total common equity as of December 31, 2017. Thus, this would constitute a significant transfer of capital from MAWC to its parent company.

Q. If the Commission were to impose a 43.99% equity ratio on MAWC for ratemaking purposes, why would the Company be compelled to actually reduce its equity ratio to that level?

A. If the Commission determines MAWC's revenue requirement using a rate of return on rate base that reflects a 43.99% equity ratio, it would be problematic, if not impossible, for the Company to earn its authorized return on equity if it maintained its equity ratio at or near 51.03%. This will be true even if the Company's rate base and operating expenses are determined accurately.

Q Does this conclude your surrebuttal testimony?

A. Yes, it does.