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**Missouri Public  
Service Commission**

*Exhibit No.:*

*Issue: Rate of Return/Capital  
Structure*

*Witness: Shana Atkinson*

*Sponsoring Party: MoPSC Staff*

*Type of Exhibit: Surrebuttal Testimony*

*Case No.: WR-2013-0461*

*Date Testimony Prepared: January 31, 2014*

**MISSOURI PUBLIC SERVICE COMMISSION**

**UTILITY SERVICES DIVISION**

**SURREBUTTAL TESTIMONY**

**OF**

**SHANA ATKINSON**

**LAKE REGION WATER & SEWER COMPANY**

**CASE NO. WR-2013-0461**

*Staff* Exhibit No. 7  
Date 2/18/14 Reporter PSG  
File No. WR-2013-0461

Jefferson City, Missouri  
January 2014

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**SHANA ATKINSON**  
**LAKE REGION WATER & SEWER COMPANY**  
**CASE NO. WR-2013-0461**

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1 I will also address Mr. Gorman's testimony as it relates to Staff's hypothetical  
2 capital structure recommendation consisting of 25% equity and 75% debt. Mr. Gorman  
3 supports the supposed "actual" capital structure created by Lake Region since its last rate  
4 case, but also provides his views as to why he doesn't agree with Staff's hypothetical capital  
5 structure recommendation.

6 **RESPONSE TO MR. SUMMERS' REBUTTAL TESTIMONY**

7 Q. According to Mr. Summers' rebuttal testimony in this case, Mr. Summers  
8 does not believe it is proper for Staff to include a loan made to shareholders in Staff's  
9 analysis of the Company's capital structure. What was Mr. Summers' position in Lake  
10 Region's last rate case, Case Nos. WR-2010-0111 and SR-2010-0110 ("SR-2010-0110")?

11 A. On page 8, line 20 through page 9, line 2 of his rebuttal testimony in the last  
12 rate case, Mr. Summers stated the following:

13 Q. Does the Company have an opinion on which approach the  
14 Commission should adopt in this case?

15 A. I believe the approach proposed by Staff ***most accurately***  
16 ***reflects the costs of capital employed in*** [sic] ***Company's***  
17 ***operation.*** However, I am authorized to state that the  
18 Company has no objection to Public Counsel's  
19 recommendation of using the actual capital structure recorded  
20 on Company's books. (emphasis added)

21 Q. Did Staff include the loan made to shareholders ("acquisition loan" or  
22 "shareholder loan") in its capital structure recommendation in Case No. SR-2010-0110 that  
23 Mr. Summers stated "***most accurately reflects the costs of capital employed in*** [sic]  
24 ***Company's operation***" (emphasis added)?

25 A. Yes. We included the entire amount of the acquisition loan in our capital  
26 structure recommendation in Lake Region's previous rate case, Case No. SR-2010-0110, and

1 in the current rate case. Because Staff included the entire amount of the acquisition loan in  
2 our recommendation in the last case, rather than capping debt at 75%, Staff is actually  
3 recommending an equity return be allowed on a portion of the capital structure that is still  
4 supported by the acquisition debt. Staff chose to cap the debt ratio because it becomes  
5 increasingly difficult to accurately and reliably estimate the cost of common equity for  
6 companies that have extreme amounts of leverage in their capital structure.

7 Q. Were the issues of capital structure and rate of return litigated in the last Lake  
8 Region rate case, Case No. SR-2010-0110?

9 A. No. Lake Region and Staff agreed, and the Office of the Public Counsel  
10 (“OPC”) did not oppose, that Staff’s proposed capital structure was the most accurate.  
11 Consequently, the Report and Order stated the following:

12 Staff’s proposed capital structure most accurately reflects the  
13 costs of capital employed in Lake Region’s operation.<sup>1</sup>

14 Q. Why did Staff include the acquisition loan in its capital structure  
15 recommendation in the last rate case?

16 A. First, in response to Staff Data Request No. 0052 in the last rate case, Lake  
17 Region provided copies of all loan documents that were “incurred by/for Lake Region.” By  
18 providing the loan incurred to acquire Lake Region, the Company clearly tied the use of the  
19 proceeds to the Lake Region acquisition. This response included certain information about  
20 the acquisition loan. Staff further inquired about the specifics of this loan through  
21 conversations with Lake Region. During these discussions in Lake Region’s last rate case,

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<sup>1</sup> Lake Region Ex. 5, Summers Rebuttal, pp. 8-9. OPC’s subject matter expert, Ted Robertson, testified that while there were some concerns with the matter in which debt and the value of equity were determined, since Lake Region believed that Staff’s proposed capital structure was most accurate that it would not oppose Staff’s recommended capital structure. OPC Ex. 4, Robertson Surrebuttal, pp 2-3.



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1 Lake Region communicated to Staff that they could have issued the debt at the Lake Region  
2 level instead of the partnership level but chose not to. This loan was primarily secured by the  
3 assignment of RPS Properties, LP's ("RPS") and Sally Stump's investment property/  
4 securities in Lake Region.

5 Staff stated this understanding in its Cost of Service ("COS") Report in Lake  
6 Region's last rate case. On page 12 to 13 of Staff's COS Report, Staff indicated the  
7 following:

8 It is Staff's understanding that the owners of Lake Region decided to  
9 issue debt at the partnership level rather than the Lake Region level for  
10 their own personal reasons.

11 Staff also discussed the impact on the capital structure if the acquisition debt had  
12 been issued directly by Lake Region. Staff's testimony was very clear about why Staff  
13 thought it was appropriate to include this debt for purposes of setting Lake Region's allowed  
14 rate of return.

15 Q. Did the Company object to or refute any part of Staff's rate of return  
16 recommendation in the last rate case?

17 A. No. In fact, as Staff has already stated, Mr. Summers believed Staff's  
18 approach was more appropriate than OPC's approach of only including debt issued directly  
19 by Lake Region.

20 Q. Did Staff provide any other evidence in the last Lake Region case to illustrate  
21 how Lake Region viewed the acquisition loan from a practical perspective?

22 A. Yes. Staff discovered that Lake Region was being charged a management fee  
23 by its owners, which included the debt service charges associated with the acquisition loan.  
24 Consequently, Lake Region was being charged for the interest expense associated with the

1 loan, as well as the principal. This further supports the reason why the Company supported  
2 Staff's position in the last rate case.

3 Q. What has happened since Lake Region's last rate case in which they agreed  
4 with Staff's position?

5 A. The Company filed a finance case, Case No. WF-2013-0118, to move a  
6 portion of the acquisition loan to the Lake Region level.

7 Q. What bank loaned the proceeds to Lake Region?

8 A. Alterra Bank.

9 Q. Is this the same bank that currently holds the shareholder loan?

10 A. Yes.

11 Q. Does Alterra Bank charge the same rate for both loans?

12 A. Yes.

13 Q. What would have happened if all of the debt had been moved to Lake Region?

14 A. All of this debt would be clearly identifiable on Lake Region's books, and the  
15 capital structure would be approximately the same as it was in the last rate case. Of course,  
16 Alterra bank would still be loaning the same amount with Lake Region still being the  
17 primary asset of interest. Consequently, whether the loan was at the shareholder level or at  
18 Lake Region's level, the assets relied on for the performance of the loan have always been  
19 Lake Region's assets. Therefore, regardless of whether Lake Region's assets were pledged  
20 directly through the assets or indirectly through shareholder interest, the lender would  
21 ultimately take possession of Lake Region if there was a default on the shareholder loan,  
22 which has the same effect as if the lender foreclosed on Lake Region's assets.

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1 Q. On page 13 and 14 of Mr. Summers' rebuttal testimony in this case,  
2 Mr. Summers quotes Staff's explanation for denying the Company's recent Request for  
3 Admission #8. Has the Negative Pledge Agreement referenced in Staff's explanation been  
4 released by Alterra Bank?

5 A. Yes. Staff was informed of this recent change through Mr. Summers'  
6 testimony and later received a copy of the release documents via email.

7 Q. Does the release of the Negative Pledge Agreement change Staff's  
8 recommendation in this case?

9 A. No. The Negative Pledge Agreement was initially executed to preserve  
10 Alterra Bank's interest in Lake Region when there wasn't any debt issued directly by Lake  
11 Region. Because Lake Region used Alterra Bank for its loan, and Alterra Bank still holds the  
12 shareholder loan, Alterra Bank should no longer have any concerns about the shareholder  
13 loan being subordinated to any other third-party loans. Therefore, the release of the Negative  
14 Pledge Agreement does not diminish Alterra Bank's security interest in the value of the Lake  
15 Region operations.

16 **RESPONSE TO MR. GORMAN'S REBUTTAL TESTIMONY**

17 Q. In his testimony, Mr. Gorman stated that Staff's recommended hypothetical  
18 capital structure is not consistent with Standard & Poor's published criteria for estimating a  
19 credit rating for an entity. Do you agree?

20 A. No. Mr. Gorman claims that a financial risk profile (FRP) of "Highly  
21 Leveraged" should be capped at a 60% debt-to-capital ratio. This is incorrect because 60% is  
22 merely the threshold for the benchmark in which an entity's capital structure crosses over to



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1 change from an "Aggressive" FRP to a "Highly Leveraged" FRP (see p. 4 of Schedule SA-3,  
2 Appendix 2 attached to Staff's Cost of Service Report). Staff agrees that the debt ratio  
3 should be capped at some level; however, Staff believes a hypothetical capital structure that  
4 allowed 75% debt is appropriate. In cases in which a company uses extreme amounts of  
5 leverage, as is the case here, Staff does not want to completely ignore this extremely  
6 leveraged state by allowing an equity ratio that is not consistent with how the company is  
7 truly capitalized. Doing so would encourage companies to take on too much financial risk to  
8 attempt to achieve higher returns.

9 Mr. Gorman discussed the 10% range of debt ratios from 50% to 60% for a FRP of  
10 "Aggressive" to attempt to support his position. This actually supports Staff's position that  
11 there should be some type of range once a company crosses the 60% threshold and has a FRP  
12 classified as "Highly Leveraged." S&P's criteria simply indicates that any capital structure  
13 that has a debt ratio of greater than 60% is consistent with a "Highly Leveraged" FRP.  
14 Consequently, a strict interpretation of S&P's methodology implies there should be no cap.  
15 However, Staff does recognize that for other categories there are ranges of up to 10%, so  
16 Staff considered this when deciding an allowable reasonable range would be 15% for a debt  
17 ratio of 60% to 75%. Certainly, there should be some type of range, rather than a single  
18 point estimate as Mr. Gorman proposes, even if it is 10% as in the other benchmarks.

19 Q. Do you believe Mr. Gorman is misinterpreting the intent of S&P's credit  
20 rating benchmarks?

21 A. Yes. On page 5, lines 13 through 14 of his rebuttal testimony, Mr. Gorman  
22 implies that an improvement in the business risk profile ("BRP") "prescribes" a specific  
23 capital structure. S&P's benchmarks are not intended to prescribe any capital structure as

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1 being the appropriate capital structure. The intent of S&P's benchmarks are to allow a user  
2 to intersect the FRP and the BRP to estimate a credit rating, as Staff did in this case.

3 Q. Does Staff disagree with Mr. Gorman's description of what S&P  
4 "prescribes?"

5 A. Yes. Mr. Gorman indicated a BRP improvement to "Significant" "prescribes"  
6 a debt ratio of 45% to 50%. The "Aggressive" and "Significant" categories are used by S&P  
7 to classify a company's FRP, not its BRP. Mr. Gorman implies that a change in the  
8 categorization causes a need to change the capital structure. However, as stated above S&P's  
9 benchmarks are not intended to prescribe any capital structure as being the appropriate  
10 capital structure. The intent of S&P's benchmarks are to allow a user to intersect the FRP  
11 and the BRP to estimate a credit rating.

12 Q. Mr. Gorman criticizes Staff's use of a business risk profile of "Strong"  
13 in Staff's use of their methodology. He believes Staff should have used a BRP of  
14 "Satisfactory" for Lake Region because its loan agreement contains a guarantee from its  
15 owners. Does Staff agree with Mr. Gorman?

16 A. No. Staff still believes Lake Region has a "Strong" BRP because they have  
17 continuous access to commercial loans. In Lake Region's response to Staff Data Request  
18 No. 0074, Lake Region stated that Alterra Bank indicated to Lake Region it would consider  
19 favorably extending more debt to the Company as needed for future projects.

20 While Mr. Gorman is correct that Staff has general guidelines for approaching small  
21 water and sewer rate cases, each case has its own specific circumstances. When Staff drafted  
22 its small water and sewer methodology discussing commercial loans being supported by  
23 personal guarantees, it was considering small water and sewer systems in which the lender



1 would not provide a commercial loan but for the owners' willingness to provide personal  
2 guarantees. This is not the case in this circumstance. Staff believes the evidence in the loan  
3 agreement clearly shows that the lender has consistently protected its interests in Lake  
4 Region, whether indirectly through collateralizing the shareholder interest and/or directly by  
5 collateralizing the assets.

6 Q. Mr. Gorman implies that the Commission needs to allow a capital structure  
7 consistent with its proposal to support Lake Region's financial position and allow it to attract  
8 capital. Do you believe this would be a problem if the Commission adopted Staff's  
9 recommendation?

10 A. No. Experience proves that this has not been a problem. In the last case, both  
11 the Company and Staff supported a capital structure that included all of the acquisition debt,  
12 which resulted in a debt ratio of 83.64%. The Company and its shareholders have been able  
13 to continue to attract capital from Alterra Bank since the conclusion of the last rate case,  
14 again, with the primary performing asset of concern being Lake Region's operations.

15 Q. Although you don't agree with Mr. Gorman's or Mr. Summers' recommended  
16 capital structure of 60% debt and 40% equity, would you recommend a lower ROE if this  
17 less-leveraged capital structure were used to set Lake Region's rates?

18 A. Yes. Because Lake Region's FRP would then be on the threshold between  
19 "Highly Leveraged" and "Aggressive," S&P's benchmarks support a credit rating that is  
20 approximately two notches higher than what Staff used for its more leveraged capital  
21 structure recommendation. Staff would lower its recommended ROE to 11.93%, which results  
22 in an overall recommended ROR of 7.77%.



1           Q.     Have Staff's capital structure, ROE and ROR recommendations changed in  
2 this case?

3           A.     No.

4           **SUMMARY AND CONCLUSIONS**

5           Q.     Would you please summarize Staff's conclusions presented in your surrebuttal  
6 testimony?

7           A.     Yes.   Staff continues to believe its capital structure, ROE and ROR  
8 recommendations for Lake Region are reasonable. Staff still believes the acquisition loan  
9 should be included in Lake Region's capital structure and has consistently included the  
10 acquisition loan in its recommendations of Lake Region's capital structure from Lake  
11 Region's last rate case, Case No. SR-2010-0110, and in the current rate case. Lake Region's  
12 owners acknowledged that this debt could have been issued at Lake Region. Therefore, Staff  
13 believes the acquisition loan should be included in the capital structure, but because this  
14 would result in a debt to capital ratio that exceeds 75%, Staff recommends the debt ratio be  
15 capped at this amount. Although this will not reflect all of the debt in Lake Region's  
16 capital structure, it is a reasonable balance for purposes of setting a fair and reasonable  
17 allowed ROR.

18           Although Staff chose to cap its debt ratio in this case, if Mr. Summers had been  
19 consistent with his belief that Staff's approach in the last rate case most accurately reflects  
20 the costs of capital employed in the Company's operation, then he would have included all of  
21 the shareholder debt in the capital structure. Staff is uncertain as to why Lake Region would  
22 make a fundamental change to its position, and considering how difficult it has been for Staff

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1 to evaluate and understand all of the movement of loan balances in this rate case and in the  
2 Company's most recent finance case, the Commission should err on the side of caution in  
3 deciding on a fair and reasonable allowed rate of return for this Company. Staff's approach  
4 has not fundamentally changed since the last rate case but for the cap on the debt ratio at  
5 75%, which Staff applies to all small water and sewer companies. The Commission  
6 approved both the Company and Staff's approach in Case No. SR-2010-0110, which  
7 rightfully included the acquisition loan in Lake Region's rate making capital structure and  
8 resulting ROR.

9 Q. Does this conclude your surrebuttal testimony?

10 A. Yes, it does.

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

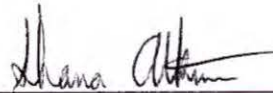
In the Matter of Lake Region Water & Sewer )  
Company's Application to Implement a )  
General Rate Increase in Water & Sewer )  
Service )

Case No. WR-2013-0461

AFFIDAVIT OF SHANA ATKINSON

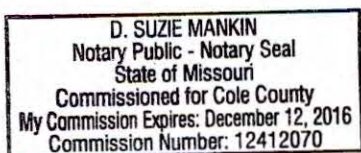
STATE OF MISSOURI     )  
                                  )     ss.  
COUNTY OF COLE     )

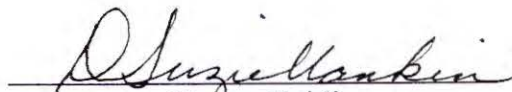
Shana Atkinson, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of   11   pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by her; that she has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of her knowledge and belief.



Shana Atkinson

Subscribed and sworn to before me this   31<sup>st</sup>   day of January, 2014.



  
Notary Public