

Exhibit No.:
Issues: Capital Structure, Long-Term Debt
Cost, and Common Equity Infusion
Witness: Scott W. Rungren
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Sponsoring Party: Missouri-American Water Company
Case No.: WR-2010-0131
SR-2010-0135
Date: May 6, 2010

MISSOURI PUBLIC SERVICE COMMISSION

**CASE NO. WR-2010-0131
SR-2010-0135**

SURREBUTTAL TESTIMONY

OF

SCOTT W. RUNGREN

ON BEHALF OF

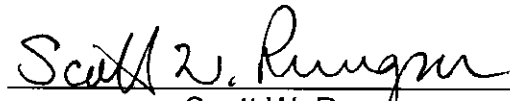
MISSOURI-AMERICAN WATER COMPANY

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-2010-0131 CASE NO. SR-2010-0135
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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.



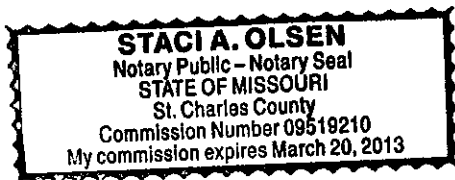
Scott W. Rungren

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 30th day of April 2010.



Notary Public

My commission expires:



**SURREBUTTAL TESTIMONY
SCOTT W. RUNGREN
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2010-0131
SR-2010-0135**

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SURREBUTTAL TESTIMONY

SCOTT W. RUNGREN

I. INTRODUCTION

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

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

4

5 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

6 A. I am employed by American Water Works Service Company ("Service
7 Company") as a Financial Analyst III. The Service Company is a subsidiary of
8 American Water Works Company, Inc. ("American Water") that provides various
9 services to American Water's utility subsidiaries. In this proceeding I am
10 testifying on behalf of Missouri-American Water Company ("MAWC" or "the
11 Company").

12

13 **Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?**

14 A. No, I have not. I am, however, adopting the prepared Direct and Rebuttal
15 Testimony of Company witness Michi Q. Chao.

16

17 **Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.**

18 A. In May of 1983, I received a Bachelor of Science degree in Business

1 Administration with a major in Energy Management from Eastern Illinois
2 University. In May of 1986, I received a Master of Business Administration
3 degree with a specialization in Finance from Northern Illinois University.

4
5 **Q. PLEASE SUMMARIZE YOUR EMPLOYMENT EXPERIENCE.**

6 A. From 1986 to 1999 I was employed by the Illinois Commerce Commission
7 ("Commission"). I held various positions while employed there. I joined the
8 Finance Department in 1987, and was promoted to Senior Financial Analyst in
9 1989. In 1993 I transferred to what was then called the Energy Programs
10 Division, returning to the Finance Department in 1995, again as a Senior
11 Financial Analyst. I remained in the Finance Department until my departure from
12 the Commission in February of 1999. In March of 1999 I began employment with
13 Cinergy Corp. (now known as Duke Energy), working in the Retail Commodity
14 Services group and focusing on their Real Time Pricing program. While at
15 Cinergy I was also responsible for managing the company's interruptible load
16 that was under special contract. In 2001 I began performing long-run electric
17 generation planning studies for Cinergy's Kentucky and Indiana service areas.
18 Most of these planning studies were performed for the Company's least cost plan
19 filings required by the regulatory commissions in Kentucky and Indiana. In May
20 of 2007 I joined American Water (Service Company) as a Senior Financial
21 Analyst. My present duties with the Service Company include the preparation of
22 financing and rate-related filings for American Water's central states.

23
24 **Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION?**

1 A. Yes, I testified before this Commission on behalf of MAWC in Case No. WR-
2 2008-0311/SR-2008-0312, which is MAWC's most recent previous rate case.

3

4

II. PURPOSE

5

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

7 A. The purpose of my surrebuttal testimony is to respond to certain arguments set
8 forth in the rebuttal testimony of David Murray, witness for the Missouri Public
9 Service Commission Staff ("Staff"), concerning MAWC's capital structure in this
10 proceeding. I also address Staff's methodology for computing MAWC's cost of
11 long-term debt and provide an update concerning MAWC's 2010 common equity
12 infusions.

13

14

III. OVERVIEW

15

16 **Q. PLEASE PROVIDE A BRIEF OVERVIEW OF YOUR SURREBUTTAL**
17 **TESTIMONY.**

18 A. My surrebuttal testimony explains why Mr. Murray's proposed use of American
19 Water's September 30, 2009 consolidated capital structure rather than MAWC's
20 capital structure for determining MAWC's weighted average cost of capital
21 (WACC) is inappropriate. In an effort to justify his proposal for using American
22 Water's capital structure, Mr. Murray refers to the fact that MAWC does not
23 currently have a stand-alone credit rating and that the debt obtained through its
24 affiliate, American Water Capital Corporation ("AWCC"), is supported by

1 American Water's creditworthiness. Mr. Murray also asserts that MAWC has
2 centralized most of its financing functions through AWCC, MAWC can receive
3 equity infusions through debt raised by American Water, and that American
4 Water is predominately a regulated water utility. My testimony will explain that
5 Mr. Murray has ignored the fact that MAWC is a separate legal entity that is
6 responsible for making its own decisions regarding its financing sources and its
7 overall capital structure.

8 In my surrebuttal testimony, I address each of Mr. Murray's points individually
9 and illustrate how some of his underlying assumptions, and thus his overall
10 conclusion on using American Water's capital structure, are not supported by the
11 facts in this case. I will demonstrate that none of these reasons provides any
12 basis for using American Water's consolidated capital structure for determining
13 MAWC's overall rate of return on rate base (i.e., WACC) in this proceeding.
14 Finally, I will explain that MAWC's cost of long-term debt should be calculated
15 using MAWC's long-term debt schedule, and not American Water's consolidated
16 long-term schedule, as was done by the Staff.

17 **IV. REBUTTAL TESTIMONY OF DAVID MURRAY**

18
19 **Q. IN HIS REBUTTAL TESTIMONY STAFF WITNESS MURRAY PRESENTS A**
20 **SERIES OF REASONS FOR WHY HE BELIEVES THE USE OF MAWC'S**
21 **CAPITAL STRUCTURE IS INAPPROPRIATE FOR RATE MAKING**
22 **PURPOSES IN THIS PROCEEDING. DO YOU AGREE WITH THE POINTS**
23 **PRESENTED BY MR. MURRAY?**

24 **A.** No, I do not. Significantly, Mr. Murray does not claim that MAWC's capital

1 structure is unreasonable from a cost standpoint. As such, there is no
2 compelling reason to not use MAWC's capital structure to determine its WACC.
3 Furthermore, Mr. Murray's reasoning for rejecting use of the Company's capital
4 structure in favor of American Water's consolidated capital structure ratios for
5 setting rates in this proceeding is illogical and not based on sound financial
6 theory. The specific points he raises to support this position, which are listed on
7 page 2, lines 4 through 13 of his rebuttal testimony, relate to the manner in which
8 MAWC is financed, the lack of a stand-alone credit rating for MAWC, equity
9 infusions by American Water using debt, the impact of American Water's
10 creditworthiness on AWCC debt, and his characterization of American Water as
11 a regulated utility. I will respond to each of his reasons below.

12
13 **Q. IN AN ATTEMPT TO SUPPORT HIS POSITION THAT MAWC'S CAPITAL**
14 **STRUCTURE IS INAPPROPRIATE FOR RATEMAKING PURPOSES, MR.**
15 **MURRAY ARGUES THAT MAWC'S CAPITAL STRUCTURE "DOES NOT**
16 **REFLECT THE REALITY OF HOW MAWC IS, AND WILL BE, FINANCED."**
17 **(MURRAY REB. TESTIMONY, P. 2). PLEASE RESPOND.**

18 **A.** As noted on page 7, starting at line 14 of his rebuttal testimony, Mr. Murray is
19 referring to the fact that MAWC does not issue all of its own debt to third party
20 lenders, using its financing affiliate (AWCC) in many instances in recent years.
21 He also notes that AWCC is performing the role of a corporate treasury for
22 American Water, by aggregating all the cash transactions for MAWC. The fact
23 that AWCC has been frequently used as a long-term debt financing conduit for
24 MAWC does not call into question the propriety of using MAWC's capital

1 structure for rate making purposes. The use of AWCC by MAWC is based solely
2 on the attainment of a cost advantage to MAWC. That is, MAWC issues long-
3 term debt through AWCC only if doing so will result in a lower overall cost to
4 MAWC and, thus, its ratepayers. The Financial Services Agreement between
5 MAWC and AWCC provides MAWC with the ability to issue long-term debt
6 directly to a non-affiliated third party if it so chooses. MAWC will exercise this
7 right, which it also considers an obligation, if it is able to issue long-term debt at a
8 lower overall cost than if it were to issue long-term debt through AWCC. This is
9 purely an economic decision, and the potential for using AWCC to reduce
10 MAWC's debt cost does not justify the use of American Water's actual capital
11 structure in lieu of MAWC's capital structure. In short, the only relevant impact of
12 MAWC using AWCC as a debt financing conduit is on the cost of MAWC's debt,
13 which is fully accounted for in the calculation of MAWC's overall WACC. In
14 addition, the fact that AWCC is handling the cash receipts and disbursements for
15 MAWC and all the other American Water operating subsidiaries is also irrelevant
16 to the capital structure decision.

17
18 **Q. HOW DOES MAWC MANAGE ITS FINANCING FUNCTION?**

19 A. MAWC, as a separate legal entity, is responsible for making its own decisions
20 regarding its sources of financing and its overall capital structure. These sources
21 of financing include funds from related entities – such as long-term and short-
22 term notes issued to AWCC or equity infused by American Water – and funds
23 from unrelated third parties – such as taxable debt issued under MAWC's
24 indenture, tax-exempt debt issued under MAWC's indenture through a

1 governmental conduit such as the EI ERA, state revolving fund loans, and
2 preferred stock.

3
4 **Q. DO YOU AGREE WITH MR. MURRAY'S ASSERTION ON PAGE 2, LINES 7-8**
5 **OF HIS REBUTTAL TESTIMONY THAT MAWC "HAS CENTRALIZED MOST**
6 **OF ITS FINANCING FUNCTIONS THROUGH ITS AFFILIATE, AMERICAN**
7 **WATER CAPITAL CORPORATION (AWCC)"?**

8 A. No, I do not. Mr. Murray has confused the issue. Stated clearly, MAWC is
9 responsible for making all of its own financing decisions. AWCC is a potential
10 source of financial services that MAWC can use at its discretion. Those financial
11 services may include, but are not limited to, short-term notes, long-term notes,
12 and cash management services. As noted previously, MAWC retains the right to
13 obtain these financial services from other third party sources and is under no
14 obligation to use AWCC if MAWC does not desire to do so.

15
16 **Q. ON PAGE 9 OF HIS REBUTTAL TESTIMONY, LINES 1-5, MR. MURRAY**
17 **NOTES THAT S&P DOES NOT ISSUE A CREDIT RATING FOR MAWC, BUT**
18 **DOES SO FOR AMERICAN WATER. MR. MURRAY THEN CLAIMS THAT IF**
19 **S&P WERE TO ASSIGN A CREDIT RATING TO MAWC IT WOULD BE**
20 **BASED ON THE CONSOLIDATED OPERATIONS OF AMERICAN WATER.**
21 **DO YOU AGREE WITH MR. MURRAY'S ASSERTION?**

22 A. No, I do not. Although this has little, if any, bearing on the ratemaking capital
23 structure decision for MAWC, Mr. Murray has overstated the weight that would
24 be given American Water's consolidated operations by S&P in a credit rating

1 analysis on MAWC. It is S&P's practice, such as it did recently with
2 Pennsylvania American Water Company (PAWC), to base their ratings on the
3 financial statements of the specific company to which the rating pertains. For
4 example, the latest publication from S&P regarding PAWC states that their rating
5 reflects the consolidated credit quality of the parent (AWW), but does not say it is
6 based on the credit quality of AWW. Thus, if MAWC and AWW have dissimilar
7 financial credit metrics, MAWC would not be rated similar to AWW. If MAWC's
8 credit metrics were riskier than the parent, MAWC would be rated lower.

9
10 **Q. DOES THE ABSENCE OF A STAND-ALONE CREDIT RATING FOR MAWC**
11 **MEAN THAT MAWC'S CREDITWORTHINESS CANNOT BE JUDGED?**

12 A. No, it does not. Any entity that is considering the possibility of providing
13 financing to MAWC can perform its own due diligence to determine MAWC's
14 stand-alone credit quality.

15
16 **Q. DOES THE ABSENCE OF A STAND-ALONE CREDIT RATING MEAN THAT**
17 **MAWC CAN ONLY USE AMERICAN WATER AND AWCC FOR ITS CAPITAL**
18 **NEEDS?**

19 A. No, it does not. MAWC has the ability to utilize financing sources outside of
20 AWCC or American Water such as, but not limited to, taxable debt issued under
21 MAWC's indenture, tax-exempt debt issued under MAWC's indenture through a
22 governmental conduit such as the EI ERA, state revolving fund loans, and/or
23 preferred stock issued to third parties, as well as utilizing retained earnings.
24 Partly in consideration of MAWC's credit quality, the third party financing sources

1 will independently determine under what terms, including interest and/or dividend
2 rates, they would be willing to provide capital to MAWC.

3
4 **Q. DOES MR. MURRAY BELIEVE THAT THE RELATIVE RISKS OF AMERICAN**
5 **WATER AND MAWC ARE THE SAME?**

6 **A.** On page 9, lines 5-8, Mr. Murray states the following in his Rebuttal Testimony:

7 As long as the risk associated with the consolidated
8 operations is consistent with MAWC's risk, then it is
9 appropriate to not only use the consolidated capital
10 structure, but also the cost of capital associated with this
11 capital structure for ratemaking purposes.

12 In the Executive Summary of his Rebuttal Testimony, Mr. Murray states the
13 following on page 2, lines 10-13:

14 Because American Water is predominately a regulated water
15 utility, it is appropriate to use the parent company's capital
16 structure in this case because it is consistent with the way in
17 which American Water believes its regulated water utility
18 operations should be capitalized.

19 Since Mr. Murray concludes that "it is appropriate to use the parent company's
20 capital structure" and states that "[a]s long as the risk associated with the
21 consolidated operations is consistent with MAWC's risk" then it is appropriate to
22 use the parent company's capital structure, I can only assume that Mr. Murray
23 believes that the risks for American Water and MAWC are the same.

24
25 **Q. DOES THE FACT THAT BOTH AMERICAN WATER AND MAWC ARE**
26 **ENGAGED PRIMARILY IN THE REGULATED WATER AND WASTEWATER**
27 **BUSINESS MEAN THAT THE RISKS ASSOCIATED WITH THE**

1 **CONSOLIDATED OPERATIONS OF AMERICAN WATER AND MAWC ARE**
2 **CONSISTENT?**

3 A. No, it does not. An entity's general business focus is only one of many factors
4 that are considered when judging an entity's credit risk. The investing
5 community's need to evaluate and consider all factors that might impact credit
6 drives the rating agencies' need to issue stand-alone credit ratings for individual
7 businesses, even if those businesses are all engaged in the same general line of
8 business.

9
10 **Q. IS IT POSSIBLE FOR BUSINESSES IN THE SAME GENERAL LINE OF**
11 **BUSINESS TO HAVE DIFFERENT CREDIT RATINGS?**

12 A. Yes, it is. In fact, the S&P credit ratings for U.S. Investor-Owned Water Utilities
13 as of April 5, 2010 range from "BBB+" to "AA".

14
15 **Q. WHAT ARE SOME OF THE FACTORS OTHER THAN GENERAL BUSINESS**
16 **FOCUS THAT RATING AGENCIES TAKE INTO ACCOUNT WHEN**
17 **EVALUATING A COMPANY'S RISK?**

18 A. Based on the December 21, 2009 S&P research report published on American
19 Water referenced on page 10, lines 8-9 of Mr. Murray's rebuttal testimony, some
20 of the factors that S&P considers when evaluating a company's stand-alone
21 credit quality are geographic diversity, regulatory diversity, number of customers,
22 regulatory environment, and non-regulated operations.

23

1 **Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARD TO**
2 **GEOGRAPHIC DIVERSITY?**

3 A. American Water owns operations in over 20 states while MAWC operates only in
4 Missouri. Thus, American Water has more geographic diversity and thus would
5 tend to have less credit risk than MAWC, all else being equal.

6
7 **Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARD TO**
8 **REGULATORY DIVERSITY?**

9 A. American Water owns operations that are regulated in over 20 states while
10 MAWC is regulated only by Missouri. Thus, American Water has more
11 regulatory diversity and thus would tend to have less credit risk than MAWC, all
12 else being equal.

13
14 **Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARD TO**
15 **NUMBER OF CUSTOMERS?**

16 A. American Water's regulated subsidiaries serve over 3,300,000 customers while
17 MAWC serves less than 500,000 customers. Thus, American Water has more
18 customers and thus would tend to have less credit risk than MAWC, all else
19 being equal.

20
21 **Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARD TO**
22 **REGULATORY ENVIRONMENT?**

23 A. This is a subjective question that S&P would need to evaluate using its own
24 criteria.

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Q. HOW DO AMERICAN WATER AND MAWC COMPARE WITH REGARD TO NON-REGULATED OPERATIONS?

A. American Water has more non-regulated operations. However, S&P noted in its report that it views "AWW's operating risks associated with its non-regulated operations as fairly low."

Q. PLEASE SUMMARIZE YOUR COMMENTS TO MR. MURRAY'S REBUTTAL TESTIMONY AS IT RELATES TO MAWC NOT HAVING A STAND-ALONE CREDIT RATING.

A. On page 9, lines 1-8, Mr. Murray attempts to make a connection between S&P not currently providing a stand-alone credit rating for MAWC and the costs of capital at MAWC being driven by the consolidated operations of American Water. This connection simply does not exist. The costs of capital at MAWC are driven by the creditworthiness of MAWC. An S&P credit rating for MAWC, to the extent it is available, is only one measure of this creditworthiness. In any event, MAWC's creditworthiness can be evaluated on a stand-alone basis since it is independent of its parent company. Moreover, based on the criteria outlined in the S&P research report cited by Mr. Murray, it is fair to assume that MAWC's and American Water's business risk profiles are different.

Q. WHAT DOES MR. MURRAY STATE ABOUT AMERICAN WATER'S SOURCE OF FUNDS FOR EQUITY INFUSIONS INTO MAWC?

A. On page 2, lines 8-9, Mr. Murray states in his Rebuttal Testimony that:

1 MAWC...can receive equity infusions through debt raised at
2 American Water...

3 Further, on page 9, lines 15-17, Mr. Murray states in his Rebuttal Testimony that:

4 For example, American Water receives debt from AWCC just
5 as its subsidiaries do. American Water uses this debt to
6 make equity contributions to its subsidiaries. As such, these
7 transactions result in the appearance of less leveraged
8 capital structures for the subsidiaries.

9

10 **Q. HAS MR. MURRAY IDENTIFIED SPECIFIC INSTANCES WHERE HE**
11 **BELIEVES THAT MAWC HAS RECEIVED EQUITY INFUSIONS THROUGH**
12 **DEBT RAISED AT AMERICAN WATER?**

13 A. Although the source of funds for equity infusions is irrelevant to the form that
14 capital takes in an independent subsidiary's capital structure, I am not aware of
15 any statements in Mr. Murray's Rebuttal Testimony where he cites specific
16 instances where MAWC has received equity infusions through debt raised at
17 American Water.

18

19 **Q. WHEN AMERICAN WATER MAKES AN EQUITY INFUSION INTO MAWC**
20 **DOES MAWC HAVE ANY OBLIGATIONS TO MAKE A REGULAR FIXED**
21 **PAYMENT TO AMERICAN WATER, SIMILAR TO AN INTEREST PAYMENT?**

22 A. No. MAWC is not obligated to make any payments to American Water as a
23 result of an equity infusion by American Water.

24

1 Q. WHEN AMERICAN WATER MAKES AN EQUITY INFUSION INTO MAWC
2 DOES MAWC HAVE ANY OBLIGATIONS TO RETURN THAT CAPITAL TO
3 AMERICAN WATER AT SOME FIXED DATE IN THE FUTURE, SIMILAR TO A
4 PRINCIPAL REPAYMENT RELATED TO DEBT ISSUANCES?

5 A. No. MAWC is not obligated to return the capital associated with the equity
6 infusion to American Water as a result of an equity infusion by American Water.
7

8 Q. IF AMERICAN WATER IS NOT GUARANTEED A REGULAR PAYMENT,
9 SIMILAR TO AN INTEREST PAYMENT, AND IT IS NOT GUARANTEED A
10 RETURN OF THE CAPITAL IT HAS INVESTED, WHY WOULD IT MAKE AN
11 EQUITY INFUSION INTO MAWC?

12 A. Similar to any investor who provides equity to an entity, American Water makes
13 an equity infusion into MAWC on the expectation that the potential dividends
14 and/or appreciation in value in that investment will provide it with a return
15 commensurate with the risk it takes in making that equity infusion.
16

17 Q. DOES AMERICAN WATER ASSUME MORE RISK WHEN IT MAKES AN
18 EQUITY INFUSION INTO MAWC THAN DOES AWCC OR ANOTHER ENTITY
19 WHEN IT LOANS FUNDS TO MAWC?

20 A. Yes, it does. An equity infusion into MAWC is a riskier investment for American
21 Water than is a debt investment in MAWC for AWCC or any other investor.
22 MAWC is not obligated to make any payments related to the equity infusion nor
23 is it obligated to return the capital associated with the equity infusion. In the

1 event of bankruptcy, equity investors may receive little or no value for their
2 shares since they are lowest in priority for receiving compensation.

3
4 **Q. ALL ELSE BEING EQUAL, SHOULD AMERICAN WATER EXPECT A HIGHER**
5 **RETURN ON ITS EQUITY INVESTMENT IN MAWC THAN AWCC OR**
6 **ANOTHER ENTITY SHOULD EXPECT ON A DEBT INVESTMENT IN MAWC?**

7 A. Yes, it should. Because American Water assumes more risk by making an
8 equity infusion into MAWC than AWCC or any other entity assumes when it loans
9 funds to MAWC, American Water should expect a higher return on its equity
10 infusion.

11
12 **Q. WHAT IS FUNDAMENTALLY WRONG WITH MR. MURRAY'S SUGGESTION**
13 **THAT THE COMMISSION SHOULD LOOK AT THE SOURCE OF FUNDS TO**
14 **DETERMINE THE CAPITAL STRUCTURE TO USE FOR RATEMAKING**
15 **PURPOSES?**

16 A. Mr. Murray is ignoring the fact that the cost of capital, regardless of how that
17 capital is supplied, is based on the risks associated with that capital. Regarding
18 the true cost of capital, Morin¹ states:

19 Financial theory clearly establishes that the cost of equity is
20 the risk-adjusted opportunity cost to the investors and not
21 the cost of the specific capital sources employed by
22 investors. The true cost of capital depends on the use to
23 which the capital is put and not on its source.

24

¹ Roger A. Morin, New Regulatory Finance, Public Utilities Reports, Inc., 2006, page 523.

1 Q. ARE THERE OTHER ISSUES WITH MR. MURRAY'S SUGGESTION THAT
2 THE COMMISSION SHOULD LOOK AT THE SOURCE OF FUNDS TO
3 DETERMINE THE CAPITAL STRUCTURE TO USE FOR RATEMAKING
4 PURPOSES?

5 A. Since it is unlikely that the source of funds of individual investors would be
6 scrutinized if they were the owners of the equity in a utility, Mr. Murray's proposal
7 is arbitrary and discriminatory, based solely on who the owner of the equity is.
8 Following are a few examples, provided by Morin², that illustrate the potential
9 illogical outcomes that accompany Mr. Murray's approach if that approach was
10 applied to an entity whose equity was owned by individual investors:

11 To illustrate, let us say that an individual investor borrows
12 money at the bank at an after-tax cost of 8% and invests the
13 funds in a speculative oil exploration venture. Clearly, the
14 required return on the oil venture investment is not the 8%
15 cost but rather the return foregone in speculative projects of
16 similar risk, say 20%. Yet, under the double leverage
17 approach, the individual's fair return on this risky venture
18 would be 8%, which is the cost of the capital source, and not
19 20%, which is the required return on investments of similar
20 risk. Double leverage implies that for all investors who
21 inherited stock or received stock as a gift, the allowed return
22 on equity would be zero, since the cost of the stock to the
23 investors is zero.

24 In addition, using Mr. Murray's logic, if a subsidiary of a company was sold to
25 individual investors, then the cost of capital for that subsidiary would change for
26 no other reason than the fact it has new owners. In reality, the composition of
27 the subsidiary's ownership has no bearing on its cost of capital.

28

² Id., at pages 523-524.

1 Q. DO YOU BELIEVE THAT MR. MURRAY'S ASSERTION THAT MAWC "CAN
2 RECEIVE EQUITY INFUSIONS THROUGH DEBT RAISED AT AMERICAN
3 WATER" IS A BASIS FOR USING AMERICAN WATER'S CONSOLIDATED
4 CAPITAL STRUCTURE INSTEAD OF MAWC'S CAPITAL STRUCTURE?

5 A. No, I do not. MAWC's capital structure is independent of American Water's
6 capital structure. As illustrated in the previous series of questions, the risks
7 investors take when providing capital to MAWC is dependent on the form of their
8 investment, not on the source of funds used to fund that investment.

9
10 Q. WHAT DOES MR. MURRAY STATE WITH RESPECT TO THE TYPE OF
11 COMPANY AMERICAN WATER IS?

12 A. On page 2, line 9 of his rebuttal testimony, Mr. Murray states that "American
13 Water is predominately a regulated water utility..."

14
15 Q. DO YOU AGREE WITH MR. MURRAY'S STATEMENT THAT "AMERICAN
16 WATER IS PREDOMINATELY A REGULATED WATER UTILITY"?

17 A. No, I do not. American Water itself is not a regulated utility. In fact, the Missouri
18 Commission specifically found in its Order Closing Case issued December 13,
19 2001, in Case No. WO-2002-206 as follows:

20 American Water Works Company owns Missouri American
21 Water Company, a Missouri corporation that operates as a
22 regulated utility in Missouri. American Water is not a
23 regulated water corporation or a public utility, nor is RWE.

24 Although many of American Water's wholly-owned subsidiaries are regulated
25 utilities in the states that they do business, these subsidiaries, each a separate

1 legal entity, have the independence to adjust their business practices to meet the
2 regulatory requirements and other unique aspects of doing business within their
3 respective states.

4 5 **V. COST OF LONG-TERM DEBT**

6
7 **Q. MR. MURRAY COMPUTED HIS RECOMMENDED COST OF LONG-TERM**
8 **DEBT FOR MAWC BASED ON THE DEBT ISSUED BY AMERICAN WATER,**
9 **AWCC, AND MAWC (MURRAY REBUTTAL, P. 6, LINES 9-13). PLEASE**
10 **COMMENT.**

11 **A.** Mr. Murray's recommended cost of long-term debt, and the methodology he used
12 to compute it, should be rejected by the Commission. It is inappropriate to
13 calculate the cost of long-term debt for MAWC by using debt of the parent and
14 AWCC. Mr. Murray compounds the error by applying his calculated cost of debt
15 to American Water's consolidated debt balance. That is, the carrying value of
16 long-term debt Mr. Murray used to calculate his long-term debt cost of 6.18% is
17 \$3,394,498,755, whereas the amount of long-term debt in his recommended
18 consolidated American Water capital structure is \$5,180,587,000. Thus, the
19 long-term debt cost Mr. Murray calculated doesn't even apply to the long-term
20 debt balance he proposes. The correct cost of long-term is the cost that will
21 provide MAWC the ability to meet the contractual obligations it has to its
22 bondholders. That cost is determined by dividing MAWC's total annual cost of
23 long-term debt (i.e., annual interest plus debt expense amortization) by the total
24 carrying value of its long-term debt. This methodology results in the correct long-

1 term debt cost of 6.36%, as shown on Schedule MQC-1, page 2 of 5, attached to
2 my direct testimony (originally filed by Michi Q. Chao). Thus, 6.36% is the cost
3 rate that, when applied to the long-term debt balance in MAWC's capital
4 structure, will provide MAWC the ability to meet the contractual obligations it has
5 to its bondholders.

6
7 **VI. COMMON EQUITY INFUSION**

8
9 **Q. PREVIOUSLY IN YOUR SURREBUTTAL TESTIMONY YOU NOTED THAT**
10 **AMERICAN WATER CAN PROVIDE CAPITAL TO MAWC IN THE FORM OF**
11 **AN EQUITY INFUSION. PLEASE PROVIDE AN UPDATE REGARDING THE**
12 **STATUS OF AMERICAN WATER'S EQUITY INFUSIONS INTO MAWC.**

13 **A.** The capital structure contained in the Company's direct case in this proceeding
14 included a \$15 million equity infusion planned for March 2010. That infusion was
15 the product of a preliminary business plan prepared in mid-2010. Subsequent to
16 the filing of MAWC's direct case, the Company finalized its 2010 business plan,
17 which contained a revision to the planned March 2010 equity infusion.
18 Specifically, the amount was changed to \$30 million, though the planned timing
19 for the infusion remained in March. In the March 2010 time frame, based on
20 MAWC's outstanding short-term debt balance at that time, the Company decided
21 to reduce the March equity infusion to \$15 million, and to reassess the need for
22 the remaining \$15 million amount in April. In April, the Company decided to
23 complete the remaining \$15 million equity infusion. Thus, in 2010 the Company
24 has received two equity infusions of \$15 million, one each in March and April.

1 The total amount of the infusions, \$30 million, is consistent with the Company's
2 2010 business plan, though the timing was changed slightly. The Company's
3 actual April 30, 2010 capital structure provided with the true-up will include these
4 equity infusions.

5
6 **VII. SUMMARY**

7
8 **Q. PLEASE SUMMARIZE YOUR SURREBUTTAL TESTIMONY AS IT RELATES**
9 **TO CAPITAL STRUCTURE.**

10 A. In addition to the erroneous assumptions in the Staff's capital structure
11 recommendation noted in the rebuttal testimony of Michi Q. Chao, I explained
12 that the numerous assumptions in Mr. Murray's rebuttal testimony regarding his
13 recommendation to use American Water's capital structure are not valid, or
14 supported by sound financial theory. More specifically:

- 15 • I have shown that MAWC's creditworthiness can be judged on a stand-
16 alone basis without having a current stand-alone credit rating. Thus, its
17 stand-alone costs of capital can be determined.
- 18 • I have shown that MAWC alone is responsible for its financing function.
- 19 • I have shown that the cost of capital is determined by its form and not its
20 source.
- 21 • I have shown that American Water's support for debt raised at AWCC is
22 irrelevant to this proceeding.
- 23 • I have shown that American Water is not a regulated utility.

1 Q. **WHAT OTHER RECOMMENDATION AND UPDATE HAVE YOU PROVIDED IN**
2 **YOUR SURREBUTTAL TESTIMONY?**

3 A. I recommended that MAWC's cost of long-term debt be calculated using
4 MAWC's debt schedule, and not American Water's consolidated debt schedule,
5 as was inappropriately done by Staff. With respect to the update, I noted that the
6 Company has received equity infusions from American Water in March and April
7 of 2010, each in the amount of \$15 million. The combined amount of these
8 infusions is consistent with MAWC's 2010 business plan.

9

10 Q. **DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

11 A. Yes, it does.