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Witness: Matthew J. Barnes
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MISSOURI PUBLIC SERVICE COMMISSION

REGULATORY REVIEW DIVISION

SURREBUTTAL TESTIMONY

OF

MATTHEW J. BARNES

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2011-0337

Jefferson City, Missouri
February 2012

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement A General Rate Increase for Water and Sewer Service Provided in Missouri Service Areas)	Case No.: WR-2011-0337

AFFIDAVIT OF MATTHEW J. BARNES

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Matthew J. Barnes, of lawful age, on his oath states: that he has participated in the preparation of the following Surrebuttal Testimony in question and answer form, consisting of 8 pages of Surrebuttal Testimony to be presented in the above case, that the answers in the following Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true to the best of his knowledge and belief.

Matthew J. Barnes

Matthew J. Barnes

Subscribed and sworn to before me this 1st day of February, 2012.

LAURA HOLSMAN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: June 21, 2015
Commission Number: 11203914

Laura Holsman

Notary Public

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Q. Please state your name.

A. My name is Matthew J. Barnes.

Q. Are you the same Matthew J. Barnes who previously prepared and caused to be filed in File No. WR-2011-0337 the Rate of Return (ROR) Section of the Staff's Cost of Service Report and Rebuttal Testimony related to ROR?

A. Yes, I am.

Q. In the ROR Section of the Staff's Cost of Service Report, and as corrected in your Rebuttal testimony, did you provide your expert opinion on what you consider to be a fair and reasonable rate of return on the Missouri jurisdictional water utility rate base for Missouri-American Water Company (MAWC or Company)?

A. Yes, I did.

Q. What is the purpose of your Surrebuttal Testimony?

A. The purpose of my Surrebuttal Testimony is to respond to the Rebuttal Testimonies of MAWC witnesses Pauline M. Ahern and William D. Rogers. Ms. Ahern sponsored ROR Direct and Rebuttal testimony in this case dealing with both the cost of common equity and capital structure issues. Mr. Rogers sponsored Rebuttal Testimony on capital structure issues.

EXECUTIVE SUMMARY

Q. Please provide an executive summary of your surrebuttal testimony.

A. I will address Ms. Ahern's criticisms of Staff's reliance on the Discounted Cash Flow Model (DCF) and the use of the Capital Asset Pricing Model (CAPM) as a check of reasonableness. I will also address Mr. Rogers' claims that the Commission should adopt MAWC's stand-alone capital structure.

Q. Why shouldn't the Commission adopt MAWC's stand-alone capital structure for ratemaking purposes in this case?

MAWC's debt is not separately rated by credit rating agencies such as Standard and Poor's (S&P) to assist investors with their evaluation of the credit quality of its debt. MAWC can have equity capital infused into it by the parent company even though the source of the capital infused into it was debt issued by the parent company. The Company will then have the opportunity to earn equity returns on debt dollars. This is commonly referred to as double leverage.

The existence of double leverage is one of the criteria that is often considered when determining if the subsidiary or parent company capital structure is appropriate for ratemaking purposes. In this case, the existence of double leverage supports the use of the parent company's consolidated capital structure. The parent's consolidated capital structure is less likely to be manipulated for ratemaking purposes because it is also the capital structure that has the most bearing on the financial stability of American Water and its subsidiaries' operations.

Although the debt that MAWC receives from American Water Capital Corporation (AWCC) is not directly guaranteed by American Water, Staff maintains that, because the AWCC debt issued to third parties is supported by American Water in a "Support Agreement" that Staff quoted in its Rebuttal Testimony in the case, from a financial analysis perspective, this would appear to be better than a guarantee because the third parties that buy AWCC's debt do not have to pursue payment through American Water's individual water utility subsidiaries.

RESPONSE TO MR. ROGERS' REBUTTAL TESTIMONY

Q. On page 6; line 24 through 28, of his Rebuttal Testimony, Mr. Rogers says, "Each regulated subsidiary of AWW, including MAWC, is responsible for developing a capital structure that reflects its risk profile. Therefore, the appropriate capital structure for ratemaking purposes is the capital structure of MAWC, not AWW whose capital structure is reflective of a different risk profile." Do the credit rating agencies such as S&P issue a separate credit rating for MAWC's risk profile than that from AWW's risk profile?

A. No. S&P currently issues a long-term credit rating of BBB+ with a "Stable" Outlook for both AWCC and American Water. This rating currently reflects the stand-alone credit quality of American Water.

Q. Continuing with the previous question, is it true that MAWC issues common stock to third-party investors?

A. No. American Water issues common stock to obtain proceeds for its subsidiaries. Any stock MAWC has outstanding is owned wholly by the parent company, American Water.

Q. Can you provide a good example of the uncertainty surrounding MAWC's capital structure?

A. Yes. A good example of the uncertainty surrounding MAWC's capital structure and whether the dollars associated with that capital structure are separate and distinct is the fact that AWCC issued $1.5 billion of debt on October 22, 2007, apparently with two different terms and two different costs. The difference in cost between these debt issues is approximately 50 basis points, with the longer-term and higher-cost issues assigned to MAWC's capital structure and debt costs. Staff could understand the higher-cost, longer-term bond being assigned to MAWC if the current debt maturities associated with MAWC were shorter-term in nature, but the nearest maturity was approximately eight years later than the lower-cost, shorter term debt that could have been assigned to MAWC. Although MAWC already has two bonds maturing within three years of the longer-term, higher-cost bond, this bond was still assigned to MAWC.

Because this process appears to be quite subjective, Staff does not consider it to be market-driven based on analysis of MAWC's capital structure and debt maturities, which supports Staff's position that MAWC is not managed independently from a financial perspective.

Q. Does American Water hold debt that could have been loaned to MAWC rather than invested as equity?

A. Yes. American Water holds approximately $1.2 billion of debt. Because American Water infuses equity into its subsidiaries through the use of these funds, American Water makes a conscious decision to infuse these funds as equity investments rather than loan them to its subsidiaries.

Q. Do the debt funds received by American Water come from the same pool of debt funds received by American Water's subsidiaries?

A. Yes. For example, AWCC loaned American Water $302,750,000 from 6.593 percent debt issuance, most likely for purposes of equity infusions into its subsidiaries, and at the same time loaned MAWC $103,000,000 from the same debt issuance.

Q. Has this Commission relied on the fact that the consolidated capital structure is the capital structure analyzed by credit analysts to adopt the consolidated capital structure in past decisions?

A. Yes. In the Report and Order in the Missouri Gas Energy (MGE) rate case in 2004, Case No. GR-2004-0209, the Commission stated the following: "When a business analyst such as Moody's or Standard & Poor's examines Southern Union to assess its credit worthiness, it looks to that unadjusted consolidated capital structure to make its determination." *In the Matter of Missouri Gas Energy,* 12 Mo.P.S.C.3d 581, 589 (September 21, 2004).

Q. In the past, which other rate cases has the Commission adopted a consolidated capital structure approach?

A. The Commission adopted a consolidated capital structure approach in the following cases: MGE rate cases, Case No. GR-2004-0209 and Case No. GR-2006-0422; the Empire rate cases, Case Nos. ER-2004-0570, ER-2006-0315, and ER-2008-0093; the Kansas City Power & Light (KCPL) rate cases, Case No. ER-2006-0314 and Case No. ER-2007-0291; and the Aquila rate case, Case No. ER-2007-0004. In fact, the Commission adopted the parent's consolidated capital structure of Algonquin Water Resources of Missouri, LLC, in Case No. WR-2006-0425, even though the parent company, Algonquin Power Income Fund, is a Canadian company.

RESPONSE TO MS. AHERN'S REBUTTAL TESTIMONY

Q. On page 3; line 21, through page 12; line 18, of her Rebuttal Testimony, Ms. Ahern discusses why she believes it is inappropriate to rely on the fact that American Water employs double leverage to recommend the use of American Water's consolidated capital structure for ratemaking purposes. How do you respond?

A. As I indicated previously in my response to Mr. Rogers' testimony, American Water employs double leverage to create higher equity ratios at its regulated subsidiaries, including MAWC. While I agree with Ms. Ahern that the cost of capital is based on the risk of the investment, I do not agree that American Water is capitalizing its regulated water utility subsidiaries with the amount of leverage they consider optimal. The capital structure that American Water maintains more accurately reflects the cost of capital investors required to invest in regulated water utility operations. Because this is the capital structure that third party investors evaluate when investing in American Water's equity and American Water's debt through AWCC, this is the capital structure that provides a reasonable estimate of the cost of capital to invest in American Water's regulated water utility operations, including MAWC.

Q. On page 12; line 22, through page 16; line 14, of her Rebuttal Testimony, Ms. Ahern claims that you should not have relied exclusively on the DCF method to estimate MAWC's cost of common equity. Did you rely exclusively on the DCF model in determining a reasonable recommended ROE in this case?

A. No. I performed a CAPM to test the reasonableness of my recommended return of equity (ROE). I chose not to average my CAPM estimates with my DCF estimate because of the significant decline in equity market return since 2008, which causes a downward bias to cost of equity estimates when adding these lower risk premiums to lower risk-free rates.

Q. If you had used your CAPM results, either by averaging the results with your DSC estimated cost of common equity or using them in a range similar to Ms. Ahern's approach, what impact would this have had on your recommended cost of common equity?

A. It would have been lower.

Q. Ms. Ahern indicates that your use of a current risk-free rate in your application of the CAPM is inappropriate because it is not prospective. Do current bond yields reflect investors' expectations of changes in interest rates in the future?

A. Yes. This is the same logic that is used in the DCF methodology for estimating the dividend yield. The expected dividend is applied to recent stock prices to determine the dividend yield. The expected dividend is not applied to expected or predicted stock prices. The current stock prices reflect all known information, which is the premise for the efficient market hypothesis. Current bond yields similarly reflect all known information.

Q. Ms. Ahern believes it is improper to estimate the cost of common equity using geometric averages rather than arithmetic averages. How do you respond?

A. While Staff asserts there is merit to using arithmetic averages to estimate the cost of common equity for a short investment horizon, such as one year, utility stocks are considered long-term investments and the estimate of utilities' costs of common equity should therefore be based on estimated risk premiums based on longer holding periods. Consequently, it is more appropriate to estimate the cost of common equity using geometric averages.

SUMMARY AND CONCLUSIONS

Q. Please summarize the conclusions of your Surrebuttal Testimony.

A. My conclusions regarding the capital structure and cost of common equity are listed below:

1. The use of MAWC's capital structure as proposed by MAWC is inappropriate. It does not reflect American Water's actual support of the capital of its subsidiary, MAWC. The calculation of the cost of capital for MAWC should be based on American Water's actual consolidated capital structure as of December 31, 2010; and

2. My cost of common equity, which is 8.95 percent to 9.95 percent, would produce a fair and reasonable rate of return of 7.37 percent to 7.80 percent for the Missouri jurisdictional water utility rate base for MAWC.

Q. Does this conclude your Surrebuttal Testimony?

A. Yes, it does.