Exhibit No.:	_______________
Issue(s):	Rate of Return (ROR)/ Capital Structure
Witness/Type of Exhibit:	Murray/Surrebuttal
Sponsoring Party:	Public Counsel
Case No.:	WR-2020-0275

SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

Submitted on Behalf of the Office of the Public Counsel

ELM HILLS UTILITY OPERATING COMPANY

FILE NO. WR-2020-0275

** **

Denotes Confidential Information that has been Redacted

December 2, 2020

NON-PROPRIETARY

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of the Application of Elm Hills	)	
Operating Company, Inc.'s Request for a Sewer	)	Case Nos. WR-2020-0275
And Water Increase	)	

VERIFICATION OF DAVID MURRAY

David Murray, under penalty of perjury, states:

1. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony in the above-captioned case.

2. My answer to each question in the attached surrebuttal testimony is true and correct to the best of my knowledge, information, and belief.

_/s/David Murray_____________
David Murray
Utility Regulatory Manager
Office of the Public Counsel

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SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

ELM HILLS UTILITY OPERATING COMPANY

FILE NOS. SR-2020-0274 AND WR-2020-0275

Q. Please state your name and business address.

A. My name is David Murray and my business address is P.O. Box 2230, Jefferson City, Missouri 65102.

Q. Are you the same David Murray who previously filed Direct and Rebuttal Testimony in this case?

A. Yes.

Q. What it the purpose of your surrebuttal testimony?

A. To respond to the rebuttal testimonies of Elm Hills Utility Operating Company (Elm Hills) witnesses Josiah Cox and Martin Moore. I will also respond to Staff witness Peter Chari's rebuttal testimony.

<u>MARTIN MOORE:</u>

Q. On pages 2-3 of Mr. Moore's rebuttal testimony, he explains his experience in raising capital over the last 25 years. Over the last ten years, has Mr. Moore participated in raising any debt that had an interest rate in excess of 7%?

A. No. In response to OPC DR No. 3058, Mr. Moore indicated he could not provide any information as it relates to any debt deals he was involved with over the last ten years because of confidentiality issues. However, he did confirm that he has not been involved in debt deals with an interest rate that exceeds 7%.

Q. In your experience as a regulator, do you recall any debt transactions that had interest rates that exceeded 7%?

A. At this time, I can recall two debt financing transactions that exceeded 7%. The first was an Aquila proposed financing transaction in 2002 when Aquila was trying to avoid bankruptcy. It issued debt at an initial rate of around 11.875% with a conversion to 14.875% if its credit rating deteriorated. The other transaction I recall was debt issued at a rate of 9.25% by Southern Missouri Natural Gas Company to its equity sponsors, JP Morgan Infrastructure Investment Fund that was issued to subordinate the managing partner, Sendero Asset Management. Similar to the Fresh Start Venture loan to Elm Hills, this transaction was not an arms-length transaction.

Q. Did each of those transactions involve financially distressed utilities?

A. Yes.

Q. Is Elm Hills a financially distressed utility?

A. Not unless we pretend Elm Hills isn't going to receive fair and reasonable rate relief in the current rate case. However, Elm Hills' current situation does not reflect its expected financial situation. In fact, as I explained in my direct testimony, because Staff and Elm Hills have already negotiated a Non-Unanimous Stipulation & Agreement, Elm Hills' expected financial performance can be estimated based on the ratemaking parameters contained in that agreement.

Q. Given this, is it reasonable for Elm Hills to be charged an interest rate that exceeds 5%, let alone 7%?

A. No.

Q. What are Mr. Moore's concerns about your use of Terre Du Lac Company's ("TDL") debt cost as a proxy for Elm Hills?

A. Mr. Moore believes either the lender, First State Community Bank ("FSCB"), overestimated the value of TDL's assets and/or relied on credit enhancement in making its decision to grant TDL loans at a combined interest rate of 4.62%. Mr. Moore believes this information demonstrates that the ability for TDL's current owners to obtain these loans and receive reasonable interest rates has little to do with the anticipated cash flows from TDL and more to do with other extraneous factors. In my opinion, the fact that TDL was able to procure reasonably priced debt financing to fund all of its utility construction needs, demonstrates that TDL's owners were interested in keeping financing costs affordable for their customers. Therefore, I still consider the TDL loan to be a fair proxy for reasonably priced debt for utility investment needs.

Q. Mr. Moore indicates that the debt TDL issued represents approximately 90% of the book value of TDL's assets. Do you agree?

A. No. TDL actually has more debt outstanding than net assets as of December 31, 2019. Mr. Moore failed to subtract TDL's contributions in aid of construction ("CIAC") when determining the book value of TDL's assets. After netting out CIAC, this results in a net asset base of $783,170. TDL had $934,983 of total debt outstanding as of December 31, 2019.

Q. Mr. Moore indicates that First State Community Bank ("FSCB") either believed the underlying assets were worth much more than book value or the lender relied on credit enhancement. Do you know if FSCB required an appraisal on TDL assets?

A. Yes. In context of the Confluence/TDL acquisition case, Case No. WM-2020-0403, OPC discovered an appraisal was done in conjunction with the loan. The appraised value does not support Mr. Moore's suggestion that FSCB concluded the assets were worth more than either his estimated book value or the corrected book value I provided.

Q. Does this mean that FSCB relied on credit enhancement in deciding to underwrite the loans and in determining the interest rates to charge on the loans?

A. I don't know if FSCB would have underwritten the loan without credit enhancement, but Mr. Moore is correct that TDL's owners and spouses executed commercial guarantees when they executed the loans. I also don't know how much consideration FSCB gave to these guarantees when determining the other terms of the loan, such as the interest rates.

Q. Mr. Moore argues that the terms of the loan to TDL should not be used as a proxy for Elm Hills because of the high loan-to-value ratio. Is he correct?

A. No. In fact, the converse is true. The fact is that TDL and its owners, Mike Tilley and Paul Tilley, obtained reasonably priced debt capital based on their relationship with FSCB. It defies reason and logic that Elm Hills cannot obtain capital at better terms than TDL and its owners considering the following factors: (1) Elm Hills' affiliates have received very credit supportive rate orders from this Commission, (2) Elm Hills' parent company, CSWR, had **________________ ** of assets as of June 30, 2020, (3) CSWR and its subsidiaries use Enterprise Bank and Trust for all of its commercial banking needs, and (4) Elm Hills is indirectly owned by a sophisticated private equity capital group, Sciens Capital.

Q. Mr. Moore claims that he has no idea why you would not consider Elm Hills as riskier than Missouri's largest utilities.[1] Why do you consider Elm Hills as having a similar risk profile to Missouri's larger utilities?

A. Although ratemaking in Missouri uses an historical test year, updated for known and measurable changes through an update period, the objective is to set rates based on investment through the updated test year, recurring expenses going forward, and the cost to service capital going forward. The Commission is not setting rates for Elm Hills based on its past underinvestment. It is setting rates based on a significant increase in its rate base and on costs assigned to it from CSWR. The approach for setting rates for Elm Hills seems to be fairly similar to the approach for setting rates for its sister subsidiaries,

[1] Moore Rebuttal, p. 7, ll. 5-11.

Hillcrest, Raccoon Creek, Indian Hills and Confluence. As I detail in my direct testimony, the cash flows produced after rates increases for those utilities have been remarkably healthy and stable. In fact, the two companies that have had increased rates in effect for the last three years, Hillcrest and Raccoon Creek, have had financial metrics that rival or are even healthier than Missouri's larger utilities. While the amount of the cash flows generated by these systems are small compared to Missouri's larger utilities, the volatility of the cash flows are low.

Q. Does Mr. Moore express amazement that you would compare Elm Hills to Empire in deciding on a fair and reasonable allowed ROE to recommend for Elm Hills?

A. Yes. Mr. Moore specifically indicates the following:

> I remain unable to explain Mr. Murray's assertions and assumptions given higher rates for **much, much, much** more financially stable, and less financially challenged regulated utilities. Furthermore, I am not aware of large existing environmental compliance issues that threatened Empire's ability to provide safe and reliable service to its customers. Elm Hills has faced numerous environmental, health, safety, and reliability issues when the subject assets were acquired, as outlined in Mr. Cox's testimony. (emphasis added)

Mr. Moore focuses on Elm Hill's past operational and financial issues. Elm Hills purchased these systems for a nominal amount knowing they would be able to increase rates and create value for their investors through a return on their investment. Through rates authorized by the Commission in this case, Elm Hills will be allowed to recover reasonable costs, a return on and a return of its investment, which includes capitalization of costs (soft costs) added to capital expenditures directly related to construction (hard costs). These improvements eliminate the risks Mr. Moore claims the Commission should consider in its authorized return.

Regardless, Mr. Moore does not address the fact that Schedule DM-D-7 attached to my direct testimony shows that Empire has had more volatility in its funds from operations ("FFO") than Elm Hills' affiliates, Hillcrest and Raccoon Creek. Considering that Elm Hills' customers are also captive water and sewer customers, there is no reason to expect

Elm Hills' FFO to be any more volatile than those of Hillcrest's or Raccoon Creek's. Hence, my use of them as proxies.

Q. Mr. Moore indicates that you suggest that Summit Natural Gas of Missouri's (SNGMO) earned ROE of 2% is similar to that of Elm Hills.[2] Did you suggest this?

A. No. I noted SNGMO's earned ROE because it was able to issue reasonably priced debt to finance up to 50% of its capital structure. However, SNGMO also had the support of its equity sponsor, JP Morgan IIF, when it issued this debt.

Q. In addition to mischaracterizing your testimony as it relates to your discussion of SNGMO's earned ROEs, does Mr. Moore also miss the point in his comparison of Elm Hills to SNGMO?

A. Yes. Mr. Moore compares Elm Hills' historical financial results (prior to the expected rate increase in this case) to SNGMO's current financial results (subsequent to the rate increase it received in December 2014). The purpose of my comparison was to provide an example of a company investing significant amounts of capital for expansion of its utility infrastructure with no assurance of a captive customer base. SNGMO has embarked on several large construction projects, with the most notable being in the Lake of the Ozarks and the Branson areas, with the goal of trying to get customers to convert from propane and electric energy to natural gas. Consequently, while SNGMO is still a utility with rates approved by the Missouri Public Service Commission, there is an element of competition to its service. The same is not true as it relates to Elm Hills' service and customer base. To my knowledge, its customers do not have a choice but to take water and utility service from Elm Hills. The customers' only other choice is to move, not to disconnect. If Elm Hills' customers are as captive as Hillcrest's, Raccoon Creek's and Indian Hill's, then Elm Hills' should not have a problem earning a stable and healthy ROE based on an assumed 50% common equity ratio. After backing out the Fresh Start 14% financing agreement (this should be classified as equity because US Water Systems LLC owns both CSWR and Fresh Start), and adjusting the cost of debt to a 4.62% interest rate, I determined the earned

[2] Moore Direct, p. 8

ROEs for the last-twelve-months through June 30, 2020 for each company. As can be seen on Schedule DM-S-1, Hillcrest, Raccoon Creek and Indian Hills had earned ROEs of 19.49%, 11.28% and 6.9% respectively. These implied ROEs assumed each company paid income taxes, which they did not. The earned ROEs without subtracting taxes for Hillcrest, Raccoon Creek and Indian Hills was 25.6%, 14.81% and 9.06%, respectively. Although SNGMO was authorized a 10.8% allowed ROE on 57% equity in its 2014 rate case, it has never earned above a 2% ROE. However, it was still able to negotiate reasonably priced debt financing with its lender, CoBank. Elm Hills, which is highly likely to earn well above a 2% ROE, based on a similar equity ratio, should not have a problem negotiating reasonably priced debt financing with a lender like CoBank as well.

Q. Based on the terms of the Non-Unanimous Stipulation and Agreement, what did you estimated Elm Hills' earned ROE could be if it was capitalized with at least 50% of reasonably priced debt?

A. I estimated a pro-forma earned ROE of 13.71% if Elm Hills' incurs income taxes. If it does not incur taxes, which, again, has been the case for Hillcrest, Raccoon Creek and Indian Hills, its earned ROE would be 18%.

Q. What would the earned and pro-forma ROEs be for these systems if they were capitalized by only 30% equity?

A. Assuming they paid taxes, which they have not, Hillcrest, Raccoon Creek and Indian Hills earned ROEs on a 30% equity ratio would be 32.49%, 18.80%, and 11.49%, respectively. Based on the reality that they didn't pay taxes, Hillcrest, Raccoon Creek and Indian Hills earned ROEs on a 30% equity ratio would be 42.66%, 24.68%, and 15.09%, respectively. Based on Elm Hills' pro forma expectations from the Non-Unanimous Stipulation and Agreement, its expected earned ROE would be 30% if no taxes are paid and 22.85% if taxes are paid.

Q. What were some of the other reasons you compared CSWR/Elm Hills to SNGMO?

A. SNGMO and Elm Hills are similar in the fact that each company is indirectly owned by a private equity sponsor, JP Morgan IIF and Sciens, respectively. JP Morgan IIF has shown a much stronger commitment to facilitate the raising of debt capital at the operating utility level and now at an intermediate holding company level. As I indicated in my direct and rebuttal testimonies, I have yet to see this commitment from Sciens, despite their communication to Staff and OPC in May 2019 that they were going to be an active participant in strategic and financial management of CSWR. As the Commission is aware, OPC has been actively pursuing financial information of companies created for the purposes of holding the CSWR investment.

The other primary reason I discussed SNGMO was because one of its previous smaller Missouri utilities, Missouri Gas Utility (MGU),[3] had received an offer in 2010 from CoBank for a $15 million loan with a 20-year term at a rate of 5.7%. I was familiar with CoBank before I knew of its willingness to provide MGU with reasonably priced debt because it had been an active participant in providing rural local exchange telephone companies (the old landline systems) with affordable debt financing options, despite the fact that these rural local exchange telephone companies were investor-owned utilities. My knowledge of CoBank's involvement in United States Department of Agriculture ("USDA") financing arrangements caused me to seek out additional information from CoBank as it relates to their potential financing of other rural infrastructure projects, such as the small water and sewer projects pursued by the CSWR companies.

Q. Have you contacted CoBank before to determine if it may be a viable and affordable debt financing option for small, rural, investor-owned water and utility systems in Missouri?

A. Yes. As a Staff employee, I and a couple of other Staff members, Jeffrey Smith and Robert Bickel, contacted CoBank in 2017 to inquire as to their potential interest in underwriting loans for investor-owned small water and sewer utilities needing to make improvements to

[3] MGU and Southern Missouri Natural Gas Company merged in 2013 to form Summit Natural Gas of Missouri.

comply with environmental and safe drinking water regulations. CoBank indicated these type of loans were very much consistent with their mission, which is to support financing needs for water and sewer systems in rural areas. Although in the past they had focused on cooperatives, they were expanding their business into making loans to investor-owned utilities. They indicated they could provide all debt financing needs, from construction loans, lines of credit and long-term loans up to thirty years.[4]

Q. Do you believe CoBank is still a viable option for reasonably priced debt capital for investor-owned small water and sewer companies in Missouri?

A. Yes. I contacted CoBank again recently to inquire as to their current activity in the investor-owned small water and sewer space and I am still confident they are a viable option.

Q. Has CSWR contacted CoBank in the past to solicit debt financing?

A. Yes. Subsequent to Staff's interaction with CoBank in 2017, Mr. Cox contacted CoBank. Mr. Cox interacted with the same CoBank representative, Bryan Ervin, that Staff had corresponded with earlier.

Q. Did Mr. Cox solicit financing from CoBank for purposes consistent with CSWR's needs related to rehabilitating systems and then seek rate recovery?

A. No. Attached is the response Mr. Cox received from CoBank in November 2017. See Confidential Schedule DM-S-2. Mr. Cox provided this response to Staff DR No. 47 in Case No. WR-2017-0259. Mr. Cox presented his understanding of the reason CoBank rejected his request for debt financing as follows:

1. The lack of regulatory recognized existing rate base (collateral) associated with these small distressed systems.

[4] https://www.cobank.com/corporate/industry/water

2. The lack of existing cash flow from the current rates associated with typical small distressed utility systems.

3. Backward looking rate making and the length of small system rate making format of the MO PSC which requires all of the required utility investments to be in use and useful before customer rates can be raised to recover these costs (small rate cases currently take up to 11 months once a rate case is initiated).

4. The potential existence of environmental liabilities associated with small distressed systems before they are recapitalized.

5. The lack of initial rate relief at the time of acquisition offered by regulators to cover increased operating costs associated with the licensed, technically proficient, and professional management of existing distressed utilities.

6. The use of historic test years for rate making versus a reasonableness test for small utility rate making when the existing ownership has not run a system in regulatory compliance and/or the existing small utility is currently operating at a financial loss.

Mr. Cox indicated that based on the above factors, he understood that CoBank was not interested in providing debt financing for "small distressed individual water and wastewater utility projects" in Missouri.

Q. Why did you receive a much different response from CoBank than Mr. Cox?

A. Because Mr. Cox's scenario focuses on soliciting a loan for purposes of acquiring a small water and sewer system that have the following characteristics: (1) little to no rate base, (2) low cash flow based on the existing cost structure and rates, and (3) the likelihood that the newly acquired company will have even poorer financial results after the additional costs of new ownership are added to existing expenses. I can understand why CoBank would reject Mr. Cox's proposal based on the scenario he provided.

CSWR's need for debt financing is not related to the acquisition of the companies that require investment (in fact, in most instances, CSWR has been able to acquire such systems at a nominal price), but rather the significant improvements that need to be made subsequent to the acquisition. Based on CSWR's investment in Elm Hill's and its affiliates, this investment has typically been in the $1 million to $2 million range for each system. After the improvements have been made to the systems, then the CSWR companies have significant rate base to justify significant rate increases, which CSWR has already successfully executed for four of its systems – Hillcrest, Raccoon Creek, Indian Hills and Confluence. While it is true that it may take some time after improvements are made to have rates reset, there is undoubtedly a road map based on the experience of Elm Hills' affiliates to illustrate the Missouri Public Service Commission's supportiveness of CSWR's rate increase requests. As I demonstrated in my direct testimony, the rate levels authorized by the Commission to date for Elm Hill's affiliates are allowing for approximately $250k of EBITDA for each system. Based on a recent conversation I had with Bryan Ervin at CoBank, this amount of cash flow would be more than sufficient to support CoBank providing a loan amount of at least $1 million, which is the smallest loan amount CoBank desires to execute. If CSWR consolidated the financing needs of the systems it has already rehabilitated into one loan at the CSWR Capital level, then this would support at least $6 million of potential long-term loans, based on CoBank's required minimum debt service coverage ratio of around 1.5x (see Confidential Schedule DM-S-1). Of course, the fact that Hillcrest, Raccoon Creek and Indian Hills current cash flows can support over $6 million of debt should cause the Commission to reconsider whether these rates have been set too high.

Q. If CoBank executed long-term (approximately 20-years) loans with CSWR or its subsidiaries, what would the likely interest rate be?

A. It would be around 4.5%.

Q. Mr. Moore takes issue with your credit metric evaluation to assess a potential credit rating assignment to Elm Hills and its affiliates. What is his main issue?

A. Mr. Moore seems to believe that because my assessment is guided by S&P's benchmarks for a potential indicative rating, this means I am advocating for Elm Hills and/or CSWR to obtain a credit rating. This was not my intent. I agree with Mr. Moore that this is not necessary or appropriate for Elm Hills or CSWR. As I explained in my direct testimony, Sciens paid a significant premium for CSWR and Fresh Start. I have full confidence that Sciens is quite capable of evaluating and assessing the credit quality of the CSWR operating utility companies. As I indicated in my direct testimony, based on the amount of EBITDA and the low volatility of the EBITDA generated by the companies after their rates are adjusted, Sciens should have no problem procuring debt at reasonable costs. It's just a matter of whether Sciens will do so as an entity in which it provides full disclosure to the Commission.

Banks that provide loans to entities owned and/or affiliated with private equity groups are entirely capable of assessing the creditworthiness of the borrower. The credit metrics I reviewed and that S&P uses to assign credit ratings are the same credit metrics banks use to determine how much they are willing to lend. My experience with past utility finance cases demonstrates that banks' financial loan covenants almost always include a debt/EBITDA threshold for at least pricing, if not a requirement for additional equity contributions. CoBank also relies heavily on a minimum debt-service-coverage ("DSC") ratio, which gives consideration to not only interest expense, but the required amortization of principal.[5] CoBank's DSC ratio minimum is typically around 1.5x, but may be lower depending on the expected certainty of the company's cash flows. Based on Elm Hill's pro forma expected cash flows, it could issue over $2.71 million of debt and still have a 1.5x DSC. This debt capacity exceeds Elm Hills' rate base (approximately $1.95 million) by ~$750 thousand.

[5] Debt Service Coverage Ratio is typically defined as the ratio derived by dividing (A) EBITDA by (B) the sum of (i) all scheduled principal payments and interest payments on any outstanding debt. If cash taxes are paid, then this should be deducted from cash flows, but the CSWR companies have not had cash tax payments to date.

Q. Mr. Moore indicates you are opposing Elm Hills requested rate increase.[6] Are you opposing the Elm Hills rate increase?

A. No. I am just arguing for a fair and reasonable allowed ROR. Even if the Commission adopted my initial recommended allowed ROR of 6.93%, Elm Hills' projected EBITDA would still be high enough to allow for a loan of $2.284 million and still meet a 1.5x DSC ratio. This amount of debt capacity exceeds Elm Hills' rate base of $1.95 million.

Q. Mr. Moore claim that "all bond ratings are based upon trailing economic results…"[7] Does he provide any evidence to support his position other than his statement?

A. No.

Q. Is Mr. Moore's statement correct?

A. No. Mr. Moore's statement is not consistent with S&P's corporate ratings guidance. S&P states the following in describing how it assesses a company's financial risk:

> A company's credit ratios may vary, often materially, over time due to economic, competitive, technological, or investment cycles, the life stage of the company, and corporate or strategic actions. Thus, we evaluate credit ratios on a time series basis with a **clear forward-looking bias**. The length of the time series is dependent on the relative credit risk of the company and other qualitative factors and the weighting of the time series varies according to transformational events. A transformational event is any event that could cause a material change in a company's financial profile, whether caused by changes to the company's capital base, capital structure, earnings, cash flow profile, or financial policies. Transformational events can include mergers, acquisitions, divestitures, management changes, structural changes to the industry or competitive environment, and/or product development and capital programs. This section provides guidance on the timeframe and weightings the criteria apply to calculate the indicative ratios.[8]

The S&P Ratings Methodology goes on further to state the following about standard weightings for historical versus forward-looking financial expectations:

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[6] Moore Rebuttal, p. 11, ll. 7-10
[7] *Id.*, p. 11, ll. 12-13.
[8] Criteria, Corporates, General: Corporate Methodology, S&P Global Ratings, November 19, 2013, paragraph 112.

> The criteria generally place greater emphasis on forecasted years than historical years in the time series of credit ratios when calculating the indicative credit ratio. For companies where we have five years of ratios as described in section E.3, generally we calculate the indicative ratio by weighting the previous two years, the current year, and the forecasted two years as 10%, 15%, 25%, 25%, and 25%, respectively.[9]

S&P went on further to qualify the standard weightings by indicating the following:

> This weighting changes, however, to place even greater emphasis on the current and forecast years when: The issuer meets the characteristics described in paragraph 113, and either shorter- or longer-term forecasts are applicable. The weights applied will generally be quite forward weighted, particularly if a company is undergoing a transformational event and there is moderate or better cash flow certainty…[10]

I think all of the parties agree that these systems are undergoing transformational change in order to address their environmental and safety issues. While they certainly had operational issues in the past, the significant investments CSWR has made to ensure safe and adequate service have eliminated these risks. The rates for these systems must be increased to reflect such, but only at a ROR that properly considers their forward-looking risk profile, which allows for significant debt capacity.

Q. Mr. Moore suggests that the Commission should use the 9% interest rate from the two Letters of Intent ("LOI") as a base to add an equity risk premium to set Elm Hills' allowed ROE. Do you agree?

A. No. In my rebuttal testimony I expressed my concerns about whether this should be considered a "market" rate because of various relationships these banks have had with CSWR and its investors over the last several years. I still have those concerns. Based on the financial soundness achieved after resetting rates for these systems, it simply makes no sense for a bank to charge Elm Hills a rate that is consistent with a 'CCC' credit rating. A 'CCC' credit rating implies the company is on the verge of default. As I proved in my analysis of Elm Hills' affiliates' credit metrics and Elm Hills' pro-forma credit metrics,

[9] *Id.*, Paragraph 116.
[10] *Id*, Paragraph 117.

after rates are increased for these systems, the credit profiles of these systems are consistent with a high-grade (above investment-grade) credit rating.

Q. How did the banks determine the 9% interest rate they offered Elm Hills?

A. American Bank's LOI indicates it is offering a floating rate based on a margin of 5.75% over the current Wall Street Journal ("WSJ") Prime rate of 3.25%, with a floor of 9%. Enterprise Bank's LOI indicates it is offering a floating rate based on a margin of 3.00% over the current Wall Street Journal ("WSJ") Prime rate of 3.25%, but no less than 9%.

Q. Do you know why Enterprise Bank will not offer an interest rate consistent with a 3% margin over Prime?

A. No. If Enterprise Bank offered the loan without setting the floor at the same rate offered by American Bank, the offered rate would be 6.25%.

Q. Do you know how either bank determined the margin over Prime they decided to offer?

A. No.

Q. Why would Enterprise Bank set a floor of 9% when it indicates it would charge a 3% margin over the current Prime rate of 3.25%?

A. I don't know, but considering that a margin of 5.75% over Prime is extremely high, I imagine Enterprise Bank doesn't have any other commercial loans in which it charges this high of a margin over Prime.

Q. What debt cost did Elm Hills use to develop its requested revenue requirement when it filed its rate increase request in this case?

A. 9%.[11]

[11] See Elm Hills response to Staff DR No. 17

Q. When did Elm Hills file its request to increase its rates?

A. March 6, 2020.

Q. When did Elm Hills receive the offers for debt at a 9% interest rate from American Bank of Missouri and Enterprise Bank?

A. Enterprise Bank's LOI is dated October 20, 2020 and American Bank's LOI is dated October 2, 2020.

Q. Are corporate borrowers with credit metrics consistent with investment-grade credit ratings generally considered to be "Prime" credit risks?

A. Yes. Moody's classifies borrowers with investment-grade credit ratings as "Prime" credit risks.[12]

Q. Are you aware of much more reasonable margins charged to companies that are not rated, but have actual and anticipated credit metrics that are used to price the debt?

A. Yes. In Case No. GO-2012-0102, a bridge loan offered by CoBank to Missouri Gas Utility ("MGU") offered a margin of 250 basis points over the London Inter-Bank Offered Rate ("LIBOR"). At the time of this offer, LIBOR was approximately 0.5%, which would result in an all-in rate of approximately 3%.

Q. Was MGU's parent company, Summit Utilities Inc., and its equity sponsor, JP Morgan IIF, involved with negotiating this bridge loan?

A. Yes.

Q. Do you know why this bridge loan was priced based on LIBOR rather than Prime?

A. I am not entirely certain, but my experience has been that the larger loan markets used by bigger companies and equity sponsors, typically receive loans priced off LIBOR as the

[12] https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004

base rate. My experience with CoBank's loan products is that its short-term credit facilities and/or larger variable rate loans are typically priced by applying a margin to LIBOR.

Q. Mr. Moore indicates he does not agree with your statement in your direct testimony that "the recovery of investment and costs from existing customers has been fairly certain" for Elm Hills' affiliates. Why does Mr. Moore disagree with your testimony?

A. Mr. Moore indicates my analysis was incomplete because I did not analyze all of Elm Hills' affiliates or Elm Hills itself. Mr. Moore does not dispute my analysis and conclusions of Hillcrest's and Raccoon Creek's financial performance. As I indicated in my direct testimony, since these companies' rates were increased three years ago, they have generated significant amounts of steady cash flow. This cash flow certainly provides debt capacity for some entity or entities active in CSWR's financial strategies.

Mr. Moore is incorrect in his statement that I did not perform an analysis of Indian Hills. Indian Hills' rates were increased in early 2018. Therefore, at the time I did my analysis of the cash flows generated by the Commission's authorized rate increases, Indian Hills only had two years of results subsequent to its rate increase. However, based on this information, I determined that Indian Hills' credit metrics support an investment grade credit profile, which is not addressed in Mr. Moore's rebuttal testimony.

Mr. Moore also indicates that I failed to do a complete analysis on Elm Hills because I did not consider the past financial results. Elm Hills' past financial results are no more significant to Elm Hills' credit profile as are Hillcrest's, Raccoon Creeks' and Indian Hills' financial results before they received their rate increases. These companies have gone through such a fundamental change that their past financial results are no longer relevant to their current or expected credit profile. This would be akin to evaluating a recent college graduates' past income (or non-income) as being a reflection of their ability to generate income to cover debt obligations. While the creditor may wait until the college graduate lands a new career before providing funds, the creditor certainly isn't going to consider the individual/s past income as reflective of his/her debt capacity. Elm Hills' affiliates that have already received significant rate increases, and Elm Hill's pro-forma financial expectations based on the Non-Unanimous Stipulation and Agreement show it will have significant cash flows to support a sizeable amount of debt.

For the same reasons I explained that Elm Hill's past financial results have no relevance to its debt capacity, the same holds true for evaluating the financial results of Elm Hills' affiliates that have not reset their rates to consider all costs and investments made to the systems.

Q. On pages 14 through 16 of his rebuttal testimony, Mr. Moore provides a qualitative explanation of various costs, investments and lags Mr. Moore believes you should have taken into consideration in your analysis. Did he provide any quantitative support as to how these issues would specifically impact your estimate of Elm Hills' internal rate of return ("IRR")?

A. No. Mr. Moore does not attach any quantitative support for his view that I did not adequately consider these factors in my analysis. As I indicated on page 14 of my direct testimony, I specifically considered Elm Hills' capital expenditures related to its investment in plant, which is reflected in its rate base in this case. If Mr. Moore is aware of other specific cash inflows and outflows he believes I should consider in my IRR analysis, I would consider such. However, it is also important to capture the amount of leverage (i.e. debt) being used at the investment level in order to determine the expected levered IRR based on cash outflows and inflows related to the Elm Hills investment. This would require Sciens to comply with the Commission's Order to produce the documents OPC requested.

Q. Mr. Moore indicates that CSWR's acquisitions and subsequent investments result in cash outflows that have to be borne by investors before rate stabilization is achieved. He indicates that these issues are part of the reason these opportunities cannot attract traditional capital. Do you know this to be true?

A. No. The only way the Commission can ascertain whether Mr. Moore's testimony is true is to require Sciens to produce the documents OPC requested through its subpoenas. I also find Mr. Moore's position to be highly suspect considering Sciens paid **____________** to purchase CSWR and Fresh Start. If the rates being allowed by the Commission were not sufficient to create value for its investors, then the previous investors would not have been able to sell at **__________** over the amount of capital invested.

JOSIAH COX:

Q. What is the main focus of Mr. Cox's rebuttal testimony?

A. Mr. Cox's rebuttal testimony focuses on his opinion that if the Commission authorizes a ROR premised off my recommended ROE and cost of debt, this authorized ROR would not be consistent with the legal standards outlined in the *Hope* and *Bluefield* cases.

Q. What comparison does Mr. Cox make to attempt to establish that your recommended ROE would not be fair as it relates to the *Hope* and *Bluefield* standards?

A. Mr. Cox compares Elm Hills' customer, revenue and income information to that of Missouri's larger utilities. Mr. Cox claims that because Elm Hills is smaller, less geographically diversified and it has a poor earnings record, this demonstrates that an ROE less than those granted Missouri's larger utilities would not be fair because Elm Hills has more business risk.

Q. Is Mr. Cox's assessment that Elm Hills has more business risk correct?

A. Yes, but as I explained in my direct testimony, because Elm Hills' affiliates have demonstrated healthy and stable credit metrics, its expected financial risk profile combined with its business risk profile, results in at least a 'BBB' expected credit profile, which is similar to Missouri's larger utilities.

Q. Does Mr. Cox compare Elm Hills to Missouri-American Water Company (MAWC)?

A. Yes.

Q. Do MAWC's assets consist of one large interconnected water and sewer system?

A. No. MAWC is comprised of larger systems, such as St. Louis, Joplin, St. Joseph and Jefferson City, and small systems, such as Hickory Hills, Rogue Creek, Taos, Wardsville, etc.

Q. Did MAWC create separate subsidiaries to hold each of these systems?

A. No.

Q. How does MAWC finance each of these systems?

A. From capital it receives at the corporate level.

Q. Is the same ROR applied to all of MAWC's separate systems?

A. Yes. The ROR is determined based on the corporate level capital structure and capital costs used to finance investments in these fragmented systems.

Q. Has MAWC acquired any troubled utilities over the last several years?

A. Yes. MAWC acquired Hickory Hills Utility System in 2016 (WA-2016-0019). This system had been placed into receivership in 2014 because of DNR's concerns that its owners were not providing safe and reliable service. MAWC was aware that DNR had cited Hickory Hills lagoon system for non-compliance with environmental regulations and would require up to $700 thousand in improvement after it was acquired. MAWC proposed to consolidate this system with the rates for its St. Louis Metro District.

MAWC acquired the Rogue Creek system (WM-2019-0018) in 2019. Rogue Creek was administratively dissolved in 2004 and ultimately placed into receivership in early 2018. Although MAWC's application to acquire the Rogue Creek system did not identify the expected amount of investment needed to rehabilitate the system, it did indicate that it anticipated the need for significant upgrades to the wastewater systems and the water distribution systems. These systems were under the supervision of the Missouri

Department of Natural Resources due to their ongoing issues. MAWC proposed to consolidate the Rogue Creek water system with the "All Missouri Service Areas Outside of St. Louis County and Outside of Mexico" rate district. MAWC proposed to consolidate the Rogue Creek sewer system with the " Cedar Hill, Jefferson City, Cole, Callaway and Benton Counties, Emerald Pointe, Branson, Canyon, Incline Village, Ozark Meadows, Platte County, Stonebridge Village, Saddlebrooke, Village, Wardsville, Pevely Farms, Homestead Estates, and Radcliffe Place" rate district.

Q. If MAWC had created separate subsidiaries to hold the Rogue Creek and Hickory Hills systems, do you think they would have had trouble raising capital independently?

A. Yes.

Q. Does MAWC request a higher ROR on these systems?

A. No.

Q. What ROE has been charged to these systems?

A. Only Hickory Hills was part of the MAWC system in its 2017 rate case, but as Mr. Cox identified in his schedule, an ROE in the range of 9.5% to 10% was identified in MAWC's settlement in 2017.

Q. What was the cost of debt in the 2017 rate case?

A. The embedded cost of debt was in the range of 5.11% to 5.35%.

Q. What is the cost of debt in MAWC's current rate case?

A. In the range of 4.29% to 4.86%.

Q. Has MAWC been willing to purchase systems ultimately purchased by CSWR?

A. Yes. Osage Utility Company is one such example. There may be others that I am not aware of at this moment.

Q. If MAWC had been the winning bidder for Osage Water, what ROR would have applied to this system?

A. The same ROR as applied to the rest of MAWC's assets.

Q. Mr. Cox indicates that all parties to the case agree that a hypothetical capital structure consisting of 50% common equity and 50% debt is appropriate for setting Elm Hills' ROR in this case.[13] Does OPC agree that this should be the capital structure used to set Elm Hills' allowed ROR?

A. This was my initial recommendation before Sciens refused to comply with the Commission's Order to Produce the documents OPC requested in its subpoenas. Because my direct testimony demonstrates that these systems are likely capitalized with much more debt than is reflected in the hypothetical capital structure, I am recommending an alternative ROR based on the evidence that is known to the OPC.

Q. What evidence is known to the OPC about the capital Sciens used to support its purchase of CSWR and Fresh Start?

A. Based on the Form D filings Sciens made with the SEC regarding its private equity raises before acquiring CSWR and Fresh Start, I am only aware of $14,080,000 of equity raised for its purchase of CSWR. ** ________________________________ **

Q. Based on the terms of the current Non-Unanimous Stipulation and Agreement, what is Elm Hills' pro forma debt/EBITDA ratio be if you assumed 70% debt in its capital structure?

A. It is 4.27x. This is consistent with a 'Significant' FRP using S&P's medial volatility tables. Combining Elm Hill's 'Significant' FRP with a 'Strong' BRP implies a credit profile consistent with a 'BBB' rating.

[13] Cox Rebuttal, p 7., ll. 3-5.

Q. Does this imply Sciens could issue debt at fairly low cost to leverage these cash flows?

A. Yes. Loans on high-grade (i.e. investment grade) cash flows can be issued at extremely low costs in the current credit market environment. For example, according to data from S&P Leveraged Commentary & Data (LCD), average spread over LIBOR for 'BBB' rated credits is approximately 240 basis points as of November 30, 2020. With a current 3-month LIBOR of 25 basis points, this results in a current rate of approximately 265 basis points.

Q. If the Commission authorized Elm Hills a ROR based on a capital structure consisting of 70% debt and 30% equity with a 2.65% cost of debt, how would this impact Elm Hills expected EBITDA?

A. Because of the additional risk in this more leveraged capital structure, I would recommend the Commission authorize an ROE at the high-end of my range, which is 10.25%. Based on these parameters, this would lower Elm Hill's revenue requirement by $105 thousand. This would cause Elm Hills' Debt/EBITDA to increase to 6.38x, which would cause Elm Hills' credit profile to be consistent with a junk bond rating.

Q. Does this exercise demonstrate the circularity of utility ratemaking in which a company's debt capacity and its cost of capital can be influenced by the Commission's authorized rates?

A. Yes. If the Commission lowers the allowed ROR too much, then the EBITDA levels may not be sufficient to allow for a less leveraged capital structure, such as the 50/50 all of the parties initially recommended. In the previous answer, I presumed that Sciens is capitalizing its investment consistent with the public information OPC discovered. If Sciens was not being as aggressive with its use of leverage as I suspect, then the projected Debt/EBITDA ratio based on my lower ROR recommendation discussed above would be 4.55x, which implies a credit profile that is borderline investment grade. Bottom line, higher EBITDAs allow more leverage, but this comes at the expense of ratepayers. Lower EBITDAs allow less leverage, but at a savings to ratepayers. This requires the ratepayer vs. investor balancing principle that underlies the *Hope* and *Bluefield* cases.

Q. Can you offer other alternatives that at the very least ensures Elm Hills' ratepayers receive fair consideration for the debt capacity their bill payments will support?

A. Yes. I had been conservative in recommending a 4.62% cost of debt be allowed for Elm Hills. Because CSWR's capital needs are likely being funded by debt capital raised at the investment level, the cost of this debt depends on whether Sciens is using a significant amount of debt to capitalize its investment. Although I believe Elm Hills' assets can support leverage ratios above the 70% I estimated based on public information, use of this much leverage creates more uncertainty in estimating the cost of equity. It is much easier to determine a reasonable equity risk premium for a moderately leveraged capital structure as opposed to a highly-leveraged capital structure. Considering I have already determined Elm Hills' risk profile assuming a 50/50 capital structure is consistent with an investment-grade credit rating, I would consider it reasonable to still authorize a ROR based on such, if the cost of debt is lowered to the likely cost achieved by Sciens, which is a similar margin over LIBOR as paid by SNGMO. This results in a debt cost of 2.25% (3-month LIBOR of 0.25% plus 2%). However, because LIBOR is much lower currently versus its level at the time SNGMO was offered its loan, I will use a 2.65% rate for this analysis as well.

Q. This rate seems quite low. Is it reasonable to expect this low of an interest rate on a loan that is priced based on an approximate investment grade credit profile?

A. Yes. As I indicated in my direct testimony,[14] SNGMO had a cost of debt of 3.21% in 2014. This was a direct function of the fact that it was using shorter-term, variable rate debt to fund its construction of additional natural gas distribution infrastructure. SNGMO was able to achieve this low of a cost of debt at the time even though interest rates were higher and its financial performance was uncertain even after it was allowed a rate increase in 2014.

[14] Murray Direct, p. 22, ll. 3-7.

Q. If the Commission set Elm Hills' allowed ROR based on a 50/50 capital structure, but with a 2.65% cost of debt, how much would this lower Elm Hills' EBITDA?

A. This would lower Elm Hills' revenue requirement by $76 thousand, which would have the same impact on its pro forma EBITDA. This would imply a Debt/EBITDA of 4x, which is still within the benchmark of a 'Significant' FRP, which would correspond with a 'BBB' rating. Sciens could still issue some additional debt over the assumed 50% debt in the capital structure to leverage its equity returns, but at least ratepayers would be charged for a cost of debt capital that is commensurate with the risk related to the revenues they provide to the Company.

Q. What is your opinion of Mr. Cox's statement that the Commission has to set Elm Hills' ROR based on a 9% cost of debt in order to "fulfill its constitutional obligation to authorize an ROR for Elm Hills that is equal to those authorized for other Missouri utilities and commensurate with their risks…"?

A. I will defer to my attorney regarding the legal accuracy of Mr. Cox's statement. However, I do believe that this statement exemplifies how important it is for the Commission to develop a complete record in this case. Mr. Cox indicates that because the 9% represents an arms-length transaction that reflects a risk-adjusted cost of debt, the Commission has to use this 9% to set Elm Hills' authorized ROR. In my opinion, because Mr. Cox is making such a claim, it is even more imperative for CSWR and Sciens to provide full transparency of how it is raising capital at the investment level. If OPC discovers that Sciens is using the low risk profile of CSWR's regulated utility cash flows to raise debt, then this would reveal whether the LOI are reflective of the debt costs of these market transactions.

PETER CHARI

Q. What issues does Mr. Chari have with your testimony?

A. Mr. Chari takes issue with my use of Terre Du Lac's (TDL) cost of debt as a proxy to set Elm Hills' ROR. Mr. Chari compares TDL's financial performance from 2015 to 2019 to

Elm Hills' financial performance from 2017 to 2019. Based on Mr. Chari's comparison of these periods, he concludes that Elm Hills' credit risk is much higher than that of TDL's.

Q. If Mr. Chari were correct that banks only evaluate historical financials to determine whether to grant a loan, does it make sense that First State Community Bank ("FSCB") would have provided TDL a loan of over $800k in late 2016 and early 2017?

A. No. FSCB relied on the fact that TDL was using the proceeds from the loan to make improvements to the TDL system. As was demonstrated from TDL's rate case in 2017, these improvements were reflected in rates, which allowed TDL to increase rates by $82,724 annually as of September 29, 2017. This explains why TDL's EBITDA increased by approximately $40k from ~$60k to ~$100k between 2015 to 2019. If FSCB relied on an historical EBITDA of approximately $60k in its decision to provide the $795k loan in July 2016, then TDL would not have likely been able to meet the debt service obligations without the rate increase. FSCB had to have considered the planned improvements before granting the loan.

Although Mr. Chari is correct that Elm Hills has not been profitable from 2017 to 2019, this period is not relevant to the assessment of Elm Hills' credit profile. While it is true that lenders may be hesitant to provide financing to a new company with very little financial experience, it simply makes no sense for a lender to ignore the value the company creates for the system by investing in significant improvements that will be reflected in an upcoming rate case. Elm Hills' affiliates have not had any major rate base disallowances that would cause a creditor to view Missouri's regulatory environment as not credit supportive. If Elm Hills/CSWR were to approach a financial institution, such as CoBank, and provide the financial experience achieved by affiliates that have already had rates stabilized, I am convinced that CoBank would be willing to provide reasonably priced financing for such situations as long as rates were high enough to comfortably meet a DSC ratio of 1.5x.

Q. Why does Mr. Chari disagree with your ROE recommendation for Elm Hills?

A. Mr. Chari disagrees with my use of Empire as a proxy for determining the reasonableness of an ROE for Elm Hills. While I agree that Empire is certainly much larger than Elm Hills or even CSWR, this ignores the fact that the pro forma impact of the rate parameters set out in the Non-Unanimous Stipulation and Agreement are expected to generate credit metrics consistent with those of Empire, which is consistent with at least a 'BBB' credit rating. I have also shown that once rates have been increased for Elm Hills' affiliates, the revenues generated by the systems are remarkably stable (see Schedule DM-D-7 for standard deviation calculations of annual FFOs – Empire's FFO have been twice as volatile as those of Hillcrest and Raccoon Creek for the period 2018 through the LTM of June 30, 2020). Consequently, there are other factors that must be considered other than just the size of the companies.

Q. Did Mr. Chari perform his risk analysis correctly when he estimated a 'B+' credit profile for Elm Hills?

A. No. Despite acknowledging the fact that the Fresh Start financing agreement is not an arms-length negotiation because the owners of CSWR also owned Fresh Start, he still treated this financing agreement as legitimate debt for purposes of his risk assessment. If Mr. Chari had correctly treated the Fresh Start capital as equity, he would have concluded that Elm Hills does not have any debt on its books. This would have caused him to conclude that Elm Hills has no financial risk. Therefore, the credit profile would be based on his assignment of a 'Satisfactory' business risk profile ("BRP") and 'Minimal' financial risk profile ("FRP"). This would have caused him to estimate an 'A' or 'A-' credit profile. However, as I indicate in my rebuttal testimony, the estimated FRP should match the recommended capital structure, because the cost of capital components should match the financial risk implied in such recommended capital structure. Therefore, recognizing such would result in an estimate of a 'BBB-' to 'BB+' credit profile. This would cause Mr. Chari's estimated debt cost to be more consistent with an investment grade credit rating, which has recently been trading at a YTM of around 3.25%.

SUMMARY AND CONCLUSIONS

Q. Can you summarize your main conclusions as it relates to your surrebuttal testimony?

A. Yes. By every objective measure, whether its reviewing actual proxy debt transactions or credit metrics experienced by Elm Hills' affiliates or pro-forma credit metrics for Elm Hills based on the terms of the Non-Unanimous Stipulation and Agreement, it is implausible that CSWR cannot raise reasonably price debt financing for its construction projects TDL, a small water and sewer utility required to make improvements to comply with DNR requirements and attempt to settle an Attorney General lawsuit, raised reasonably price debt capital for its improvements. SNGMO, a company with an equity sponsor just like CSWR, has expended significant amounts of capital for constructing natural gas distribution infrastructure in hopes of converting propane and electric customer to natural gas, has been able to raise reasonably priced debt. The credit metrics of Elm Hills' affiliates shows that their cash flows would allow for the issuance of debt in excess of their rate bases. If Elm Hills is allowed to increase rates to the levels reflected in the Non-Unanimous Stipulation and Agreement, it will support an amount of debt that exceeds its rate base.

The only way to ensure that CSWR and its investors, Sciens, are not gaming the ratemaking system is to require Sciens and any intermediate companies to open their books to regulators. While private equity capital groups may be exempt from disclosing financial information to the Securities and Exchange Commission, this secrecy should not be allowed when private equity groups buy public utilities. While utility customers of the CSWR systems may have to pay for significant improvements to the utility systems, they have a right to the transparency of the profits shareholders are achieving and expect to achieve.

Q. Does this conclude your testimony?

A. Yes.

Case No. WR-2020-0275

Schedule DM-S-1 to David Murray's Surrebuttal Testimony has been deemed "Highly Confidential" in its entirety

Case No. WR-2020-0275

Schedule DM-S-2 to David Murray's Surrebuttal Testimony has been deemed "Highly Confidential" in its entirety