Exhibit No. _______
Issues: Cost of Capital
Witness: Josiah Cox
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Sponsoring Party: Elm Hills Utility Operating Company, Inc
File Nos.: WR-2020-0275
Date: November 10, 2020

Missouri Public Service Commission

Rebuttal Testimony

of

Josiah Cox

On Behalf of

Elm Hills Utility Operating Company, Inc

November 10, 2020

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**REBUTTAL TESTIMONY OF
JOSIAH COX
ELM HILLS UTILITY OPERATING COMPANY, INC.**

WITNESS INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Josiah Cox. My business address is 1650 Des Peres Road, Suite 303, St. Louis Missouri, 63131.

Q. ARE YOU THE SAME JOSIAH COX WHO FILED DIRECT TESTIMONY IN THIS CASE?

A. Yes, I am.

PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony will focus primarily on two recommendations made in the direct testimony of the Office of the Public Counsel's ("OPC") witness David Murray. First, I will address his recommendation that 9.25% is the fair, reasonable, and appropriate rate of return on equity ("ROE") for Elm Hills Utility Operating Company, Inc. ("Elm Hills" or "the Company") in this case. Second, I will address Mr. Murray's recommendation the Commission should utilize 6.93% (computed on an after-tax basis) and 8.83% (computed on a pre-tax basis) as the fair, reasonable, and appropriate overall rate of return ("ROR") on rate base.

In addition, I will present evidence regarding the difficulties small water and wastewater utilities like Elm Hills have raising debt capital from commercial lenders, why interest rates charged for such debt are higher than other larger investor-owned utilities, and why those higher interest rates must be recognized for ratemaking purposes if the Company is to be provided a reasonable return on the value of its investment devoted to the public service as required by law.

<u>RETURN ON EQUITY</u>

Q. DO YOU AGREE WITH MR. MURRAY THAT 9.25% IS A FAIR, REASONABLE, AND APPROPRIATE RATE OF RETURN TO USE FOR RATEMAKING PURPOSES IN THIS CASE?

A. No, I do not. Mr. Murray's recommended ROE fails to satisfy basic constitutional standards applicable to the Commission's determination of a fair rate of return to use for ratemaking purposes. In its landmark decision in *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923), the United States Supreme Court set the standard by which the ROE used to set rates must be judged:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.

Twenty-one years later, in *Federal Power Commission v. Hope Natural Gas Co.*, 329 U.S. 391 (1944), the Court further elaborated the constitutional standard for a fair and reasonable ROE when it said:

> [T]he return to the equity holder should be commensurate with return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital.

Q. WHY DO YOU BELIEVE MR. MURRAY'S RECOMMENDATION FAILS TO SATISFY THE CONSTITUTIONAL STANDARDS YOU JUST DESCRIBED?

A. The ROE Mr. Murray recommends falls short of those standards because, with but one exception, 9.25% is below rates of return this Commission has recently granted to other Missouri investor-owned utilities much less risky than Elm Hills. The sole exception is the 9.25% ROE the Commission granted The Empire District Electric Company in File No. ER-2019-0374. It goes without saying that an ROE for Elm Hills that is below those granted other, less risky Missouri utilities cannot be commensurate with other enterprises having corresponding risks at the same time and in the same general part of the country as *Hope* and *Bluefield* expressly require.

Q. YOU CLAIM MR. MURRAY'S ROE RECOMMENDATION FOR ELM HILLS IS BELOW RETURNS ON EQUITY THE COMMISSION RECENTLY HAS GRANTED OTHER LESS RISKY INVESTOR-OWNED UTILITIES IN MISSOURI. WHAT IS THE BASIS FOR THAT STATEMENT?

A. Generally speaking, a company's business risk profile is determined by several factors that affect its ability to achieve its business and financial goals. The factors I was referring to in my previous answer include company size, the geographic diversity of its market (or with respect to public utilities their service area), and its earnings record. On each of those measures, Elm Hills has a risk profile with significantly greater business risk than any of the investor-owned utilities to which I referred.

Q. WHAT EVIDENCE CAN YOU PROVIDE TO SUPPORT YOUR CLAIM THAT ELM HILLS HAS SIGNIFICANTLY GREATER BUSINESS RISK?

A. I have prepared an exhibit to illustrate my point. **Schedule JC-1R** lists each of the major, investor-owned Missouri utilities for which the Commission has established an ROE since March 2018. For each of those companies, my schedule shows the current authorized ROE, the number of customers served, and the amount of net income reflected in each utility's most recent annual report, which reflects earnings for calendar year 2019. For comparison, I also included Elm Hills on the schedule. Each of the companies on my schedule is significantly larger than Elm Hills (in terms of both the number of customers served and the size of its service area) and showed a substantial, positive net income for 2019. Yet despite these differences, which present a substantially lower risk profile to potential investors in those other companies, each, except for Empire, has been awarded an ROE greater than Mr. Murray recommends for Elm Hills.

Q. WHAT OTHER EVIDENCE DO YOU HAVE THAT SUGGESTS MR. MURRAY'S RECOMMENDED ROE IS TOO LOW?

A. In addition to the Missouri-specific information presented on **Schedule JC-1R**, data from Regulatory Research Associates ("RRA") indicates that for the three-year period 2017-2019 the average ROE authorized by utility regulatory commissions nationwide was 9.60%. Because RRA only covers rate cases where a utility requested a rate change of at least $5 million or was authorized a rate change of at least $3 million, this average was calculated using utilities significantly less risky than Elm Hills.

Q. WHAT DO THE DATA YOU JUST DISCUSSED SUGGEST TO YOU ABOUT THE APPROPRIATE ROE FOR ELM HILLS?

A. The information I have reviewed and presented in my testimony regarding recently authorized rates of return on common equity awarded by this Commission and by other utility regulatory commissions nationwide compel a conclusion that Mr. Murray's ROE recommendation is too low because it fails to compensate Elm Hills' investors for the company's significantly greater risk profile. Therefore, the Commission should reject Mr. Murray's recommendation and instead set the ROE to be used for ratemaking purposes in this case at least 100 basis points above the ROE he recommends.

Q. IN ADDITION TO YOUR TESTIMONY, IS THERE OTHER EVIDENCE THAT SUPPORTS AN ADJUSTMENT ABOVE MR. MURRAY'S RECOMMENDED ROE OF 9.25 PERCENT?

A. Yes, there is. The *Nonunanimous Disposition Agreement Regarding Disposition of Small Utility Company Revenue Increase Request* ("Disposition Agreement") filed in this case by the Commission Staff ("Staff") and the Company recommends an ROE within a range of 11.5%-12.00% calculated on a hypothetical capital structure of 50% equity and 50% debt. In addition, Mr. Murray appears to realize his ROE recommendation, which was based on the Commission-authorized ROE for The Empire District Electric Company in File No. ER-2019-0374, is too low because it fails to adjust for the fact "Elm Hills is a small system that doesn't have an identifiable credit profile other than through estimates provided in this case." (Murray Direct, page 20, lines 20-23) Because of that fact, Mr. Murray states an ROE adjustment of approximately 100 basis points is appropriate, which increases his recommendation from 9.25% to 10.25%. If that is his recommendation in this case, an ROE of 10.25% still is well below the range recommended by Staff and the Company in the Disposition Agreement.

Q. WHAT ROE DO YOU RECOMMEND THE COMMISSION ADOPT IN THIS CASE?

A. I recommend the Commission approve the revenue requirement Staff and Elm Hills agreed to in the Disposition Agreement. However, if the Commission believes it must specify an ROE in its final order, the Company would not object to an ROE anywhere within the range recommended in the Disposition Agreement, provided the stated ROE does not reduce the agreed upon revenue requirement.

<u>OVERALL RATE OF RETURN</u>

Q. DO YOU AGREE WITH MR. MURRAY'S OVERALL RATE OF RETURN RECOMMENDATION IN THIS CASE?

A. No, I do not. Mr. Murray's recommendation is based on a hypothetical capital structure composed 50% debt and 50% equity, a proxy debt cost of 4.62%. and an ROE of 9.25%. As shown in the table below, that translates to a recommended ROR for Elm Hills of 6.935%.

Q. DO YOU OBJECT TO THE HYPOTHETICAL CAPITAL STRUCTURE MR. MURRAY PROPOSES?

A. No. The revenue requirement in the Disposition Agreement is based on a hypothetical capital structure identical to the one proposed by Mr. Murray. It appears all parties to this case agree on what capital structure is appropriate.

Q. WHY DO YOU DISAGREE WITH MR. MURRAY'S RECOMMENDED ROR?

A. I disagree with the recommended ROR for at two reasons: 1) there is no evidence the debt cost Mr. Murray uses in a proxy for Elm Hills is reasonable or represents the interest rate the Company actually would have to pay for debt capital from a commercial lender; and 2) an ROR based on Mr. Murray's proxy debt cost fails to meet the minimum constitutional standards set out in the *Bluefield* and *Hope* cases I previously described.

Q. PLEASE EXPLAIN WHY YOU BELIEVE THE PROXY DEBT COST MR. MURRAY PROPOSES TO USE IN THIS CASE IS UNREASONABLE?

A. I disagree with Mr. Murray for a very simple reason: an average of interest rates on loans First Community State Bank ("FCSB") made to Terre Du Lac Utilities Corporation ("TDL") in 2016 and 2017 is not a valid proxy if facts clearly establish FCSB will not currently lend Elm Hills debt capital at the same interest rate. Indeed, as Mr. Martin Moore explains in his rebuttal testimony, FSCB has recently advised Elm Hills the bank is not interested in lending the Company funds at ***ANY*** interest rate. A copy of FSCB's October 29, 2020, letter accompanies Mr. Moore's rebuttal testimony as **Schedule MWM-2R**. The letter states, in relevant part, FSCB "needs to pass on this [debt financing] proposal due to the type of business and the bank's overall lack of in depth experience and comfort" in the regulated water and wastewater utility industry.

Mr. Moore's direct and rebuttal testimonies describe efforts by CSWR, LLC ("CSWR"), during the past several months to secure debt capital from non-affiliated commercial lenders for Elm Hills and its affiliated utility operating companies. For the most part, lenders have refused to offer debt financing at any cost. Only two lenders were willing to make a financing offer. The floating interest rate offered by Enterprise Bank & Trust would be the prime rate published in the *Wall Street Journal* ("WSJ") plus 300 basis points with a floor of 9.00%. The interest rate proposed by American Bank of Missouri was similar: a floating rate based on the WSJ prime rate plus 575 basis points with a floor of 9.00%. The floor rate offered by both banks is roughly twice the proxy interest rate Mr. Murray proposes to use to calculate the ROR.

Q. WHAT ROR WOULD RESULT IF THE CORRECT COSTS OF DEBT AND EQUITY WAS INCLUDED IN THE HYPOTHETICAL CAPITAL STRUCTURE MR. MURRAY PROPOSES?

A. Using Mr. Murray's proposed hypothetical capital structure (50% debt/50% equity), an ROE of 10.25% (the ROE most recently authorized for The Empire District Electric Company with the 100 basis point adjustment Mr. Murray says is appropriate), and a cost of debt of 9.00% (the floor rate offered the two banks willing to lend Elm Hills and its affiliates debt capital) yields an ROR for Elm Hills of 9.6%, which is almost 300 basis points greater than the ROR Mr. Murray actually recommends.

Q. PLEASE EXPLAIN WHY YOU BELIEVE MR. MURRAY'S RECOMMENDED ROR DOES NOT COMPLY WITH CONSTITUTIONAL STANDARDS SET OUT IN THE SUPREME COURT'S *BLUEFIELD* AND *HOPE* DECISIONS.

A. Earlier in my testimony I quoted excerpts from each of those decisions, and Mr. Murray's ROR recommendation fails to comply with the standards set out in those excerpts. As I will explain later in my testimony, an ROR of 6.935% is not "commensurate with return on investments in other enterprises having corresponding risks at the same time and in the same general part of the country," as *Bluefield* requires. Mr. Murray's recommendation also would deny the Company the opportunity "to earn a return . . . equal to that generally being made at the same time and in the same general part of the country" on similar investments as mandated by *Hope*.

But another portion of *Hope* opinion also is noteworthy because it addresses the capital attraction aspect of an ROR:

> [t]he return should be reasonable, sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise money necessary for the proper discharge of its public duties.

As I previously stated, Elm Hills currently is attempting to raise debt capital from commercial lenders. As detailed in Mr. Moore's direct and rebuttal testimonies, many lenders have refused to even make an offer to lend debt capital because of Elm Hill's financial condition (i.e. it has negative net income and is not cash flow positive) and the environmental risks associated with distressed water and wastewater businesses. Granting Elm Hills an ROR that fails to acknowledge and account for such risks would not likely induce currently reluctant prospective lenders to change their minds.

Q. WHEN IT DETERMINES AN ROR FOR OTHER UTILITIES IN MISSOURI, HOW DOES THE COMMISSION ENSURE THE RETURN ACCURATELY REFLECTS THE UTILITY'S RISK PROFILE?

A. The Commission ensures an ROR accurately reflects risk by using a reasonable capital structure, a reasonable ROE, and a reasonable cost of debt. For utilities with debt, the appropriate cost is the interest charged by the lender(s) because it is reasonable to assume the lender(s) fully considered the borrower's risk profile and determined an appropriate interest rate on that basis. Therefore, if the Commission is 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 respective risks, the debt cost used to determine the Company's ROR must be reasonable. The proxy debt cost Mr. Murray proposes is not reasonable. To set an ROR commensurate with Elm Hills risk profile, the Commission must us an interest cost no less than the 9.00% floor rate offered by the two lenders that gave the Company term sheets for debt capital.

<u>ADDITIONAL COMMENTS REGARDING DIFFICULTIES ELM HILLS FACES TRYING TO RAISE DEBT CAPITAL FROM COMMERCIAL SOURCES</u>

Q. PRIOR TO MR. MOORE'S RECENT CONTACT, DID YOU PREVIOUSLY APPROACH FSCB AS A POTENTIAL LENDER TO ELM HILLS?

A. Yes, I personally contacted FSCB in 2018.

Q. WHAT WAS FSCB'S RESPONSE TO YOUR CONTACT?

A. FSCB told me the bank was not interested in lending money to investor-owned water and wastewater companies. During the course of our discussions, the bank explained the circumstances that led them to make their only loans to an investor-owned water and sewer company – the loans to TDL that Mr. Murray relied on for his proxy interest cost.

FSCB has a branch at the entrance to the Terre Du Lac community (pictured below) and thus is heavily invested in that community. The bank explained that at the time it made its first loan to TDL FSCB was the primary mortgage bank for homes in the Terre Du Lac community.

One of the many enforcement actions brought against TDL by the Missouri Department of Natural Resources ("MDNR") and Missouri Attorney General ("AG") enforcement actions' against TDL concerned drinking water contaminated with radio nuclides. Radio nuclides are radioactive isotopes found in some Missouri ground water, a contaminant the EPA has designated as a potential human health risk. At the time of the enforcement action, TDL had approximately 10 years of radionuclide violations and the Terre Du Lac community had become very vocal about their fear about the drinking water violations, their fear for their personal health and safety, their fear about their home values, and their frustration with TDL's lack of response to the MDNR and AG. FSCB explained the combination of TDL's MDNR violations, the AG enforcement action, resident fears and frustrations, and the presence in the local water supply of an EPA-designated pollutant created concerns for FSCB that the value of its large Terre Du Lac community mortgage portfolio was at risk of being devalued or worse.

To illustrate the potential value of FSCB's mortgage portfolio, I did a range of values calculation that assumed a median house value of $166,000 and further assumed FSCB held the mortgage on half the homes (551) in the Terre Du Lac community. Based on those assumptions, I estimated FSCB's portfolio risk potentially could be between $69 million and $124 million.

Although the bank lent money to TDL because of the factors I just described, FSCB explained it is not interested in lending money to another investor-owned water and wastewater utility. FSCB told me it made loans to TDL only because of the bank's local presence and potential risk to FSCB's Terre Du Lac mortgage portfolio. FSCB's senior vice president at the time also expressed frustration that the OPC had suggested FSCB as a potential lender to investor-owned water and wastewater utilities. FSCB further stated it was not interested in making loans attached to water and wastewater improvements anywhere else in Missouri or to a company that had the ability to fix TDL.

Q. IN ADDITION TO THE DISCUSSIONS YOU JUST DESCRIBED, HAVE YOU MADE AN EFFORT TO RAISE DEBT CAPITAL FROM COMMERCIAL LENDERS PREVIOUSLY IDENTIFIED BY THE OPC?

A. Yes, I have. All of the other commercial lenders suggested by the OPC in previous discussions or cases declined to provide debt financing to investor-owned water and wastewater utilities.

Q. WHAT REASONS DID COMMERCIAL LENDERS YOU CONTACTED GIVE FOR THEIR REFUSAL TO PROVIDE DEBT FINANCING?

A. The banks I contacted had three main reasons for their refusal: 1) the type of collateral a utility can provide as support for debt financing; 2) the banks' lack of experience (or bad experience) with investor-owned water and wastewater companies; and 3) concerns about the backward-looking nature of ratemaking, which forces investments to be made before rates can be put into place to support those investments.

Q. WHY DID THE BANKS NOT LIKE THE COLLATERAL WATER AND WASTEWATER COMPANIES COULD OFFER TO SUPPORT DEBT FINANCING?

A. The banks' collateral concerns center on the nature of the physical assets and the fact those assets have environmental, health, and safety implications. The types of water and wastewater assets CSWR and its affiliates typically acquire and operate have historical environmental, health, safety compliance issues; current environmental, health, safety compliance issues; and environmental, health, safety issues likely to arise in the future. All these issues mean that the physical infrastructure available for collateral pose an environmental, health, safety liability banks are unwilling to accept.

Q. DO ELM HILLS' WATER AND SEWER ASSETS POSE A POTENTIAL ENVIRONMENTAL, HEALTH, AND SAFETY RISK?

A. Yes, they do. As I described in my direct testimony in this case, the water and wastewater assets Elm Hills purchased all had significant environmental, health, and safety compliance issues that potentially threatened the health, and safety of residents living near those assets. In addition, many of the acquired assets could not be used to provide safe and reliable service. These issues included, but were not limited to, wastewater pollution going to a state park, rust in consumers' drinking water, and wastewater treatment lagoons overflowing and polluting regulated waters of the state.

Q. WHAT DID THE BANKS EXPRESS REGARDING WHETHER THEY HAD THE EXPERIENCE NECESSARY TO UNDERWRITE LOANS TO WATER AND WASTEWATER UTILITIES?

A. All the banks I approached, including those that previously made loans to finance water and wastewater infrastructure, expressed a belief they did not have the requisite experience to underwrite loans to investor-owned water and wastewater utilities. Because large utilities do not use local banks for financing, it is hard for such banks to develop the niche capability necessary to support loans to utility companies like Elm Hills.

Q. DID ANY COMMERCIAL LENDERS BELIEVE THEY HAD THE REQUISITE EXPERIENCE TO MAKE LOANS TO ELM HILLS?

A. No, the lenders I originally approached stated they did not have the experience or skill set necessary to underwrite financing to Elm Hills.

Q. WHY ARE COMMERCIAL LENDERS CONCERNED ABOUT THE BACKWARD-LOOKING NATURE OF RATEMAKING?

A. Banks look for steady, positive cash flows to support interest payments on infrastructure loans. Backward-looking rate making doesn't provide that support because utilities are required to make investments in infrastructure and then seek rates necessary to cover interest costs on financing necessary to make those investments. And the process for securing a rate increase can take months to complete, as this case shows. This timing difference between when borrowed funds must be expended and when rates sufficient to cover the cost of those investments are approved means banks cannot underwrite loans to small investor-owned utilities like Elm Hills using existing cash flows. As is the case with Elm Hills, existing cash flows from distressed utilities are typically negative, and thus not sufficient to support loans local banks are asked to underwrite.

Q. BASED ON YOUR EXPERIENCE, ARE THERE ANY FINAL THOUGHTS YOU WANT TO PROVIDE THE COMMISSION REGARDING THE ABILITY OF SMALL WATER AND WASTEWATER UTILITIES LIKE ELM HILLS TO RAISE DEBT CAPITAL FROM COMMERCIAL LENDERS?

A. It is extremely difficult for a company like Elm Hills to find a commercial lender willing to provide debt financing. And as Mr. Moore's direct and rebuttal testimonies in this case make clear, when such lenders can be found they require security a company like Elm Hills cannot provide on a stand-alone basis and charge a risk-adjusted interest rate the lenders feel is appropriate for loans they are willing to make. That is the reality small, distressed utilities like Elm Hills face, and all of Mr. Murray's assumptions regarding the availability of hypothetical debt capital at synthetic proxy rates doesn't change actual market conditions.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

AFFIDAVIT

STATE OF MISSOURI)
) ss
COUNTY OF ST. LOUIS)

I, Josiah Cox, state I am the President of Elm Hills Utility Operating Company, Inc.; the attached Rebuttal Testimony was prepared by me or under my direction and supervision; and, the answers to the questions posed in that testimony are true to the best of my knowledge, information and belief.

____

Subscribed and sworn to before me this 9th day of November, 2020.

____
Notary Public

My Commission Expires:

5/4/24

(SEAL)

DANIEL RYAN JANOWIAK
Notary Public, Notary Seal
State of Missouri
St. Charles County
Commission # 20374795
My Commission Expires 05-04-2024

<u>RETURN ON EQUITY INFORMATION</u>

Last Rate Case for Various Missouri Utilities

	CUSTOMERS	REVENUE	NET INCOME	ROE
Elm Hills Utility Operating Company, Inc.	480	$137,392	($392,000)	
Empire[1]	175,512	$486,230,866	$91,868,068	9.25%
Ameren Electric[2]	1,230,256	$2,768,049,389	$576,771,308[3]	9.4-9.8%
Ameren Gas[4]	133,235	$127,230,469	$10,457,193[5]	9.4-9.95%
Liberty Water[6]	6,471	$2,384,627	$335,696	9.75%
Liberty (MidStates)[7]	52,589	$54,604,450	$5,911,252	9.8%
Missouri-American[8]	484,188	$324,614,677	$62,690,919	9.5-10.0%
Spire[9]	1,186,236	$1,230,206,465	$115,006,863	9.8%

[1] ER-2019-0374, July 1, 2020 (Report and Order)
[2] ER-2019-0335, March 18, 2020 (approving stipulation)
[3] Net Operating Income
[4] GR-2019-0077, August 21, 2019 (approving stipulations)
[5] Net Operating Income
[6] WR-2018-0170, October 24, 2018 (Report and Order)
[7] GR-2018-0013, June 6, 2018 (approving stipulations)
[8] WR-2017-0285, May 2, 2018 (approving stipulations)
[9] GR-2017-0215, March 7, 2018 (Report and Order)