

Exhibit No.:
Issue: Cost of Capital
Witness: Michael P. Gorman
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Missouri Office of Public Counsel
Case No.: WR-2017-0259
Date Testimony Prepared: October 27, 2017

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

**In the Matter of the Rate Increase
Request of Indian Hills Utility Operating
Company, Inc.**

)
)
) **Case No. WR-2017-0259**
)
)

Rebuttal Testimony of

Michael P. Gorman

On behalf of

Missouri Office of Public Counsel

PUBLIC VERSION
****Denotes Confidential Information**
that has been Redacted**

October 27, 2017



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Case No. WR-2017-0259

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

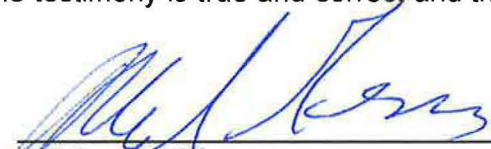
Affidavit of Michael P. Gorman

Michael P. Gorman, being first duly sworn, on his oath states:

1. My name is Michael P. Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. We have been retained by the Missouri Office of Public Counsel in this proceeding on its behalf.

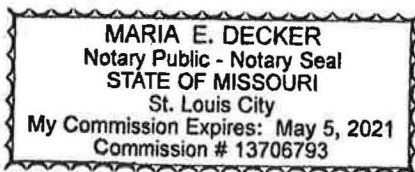
2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony which was prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. WR-2017-0259.

3. I hereby swear and affirm that the testimony is true and correct and that it shows the matters and things that it purports to show.



Michael P. Gorman

Subscribed and sworn to before me this 27th day of October, 2017.





Notary Public

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

_____))
In the Matter of the Rate Increase))
Request of Indian Hills Utility Operating))
Company, Inc.))
_____))

Case No. WR-2017-0259

Rebuttal Testimony of Michael P. Gorman

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

2 A Michael P. Gorman. My business address is 16690 Swingley Ridge Road, Suite 140,
3 Chesterfield, MO 63017.

4 **Q WHAT IS YOUR OCCUPATION?**

5 A I am a consultant in the field of public utility regulation and a Managing Principal of
6 Brubaker & Associates, Inc., energy, economic and regulatory consultants.

7 **Q ARE YOU THE SAME MICHAEL P. GORMAN WHO PREVIOUSLY FILED**
8 **TESTIMONY IN THIS PROCEEDING?**

9 A Yes. On October 13, 2017, I filed direct testimony on behalf of the Missouri Office of
10 Public Counsel.

11 **Q WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

12 A I will respond to the direct testimony of Indian Hills Utility Operating Company, Inc.
13 ("IHUOC" or "Company") witness Dylan W. D'Ascendis.

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1 Q PLEASE DESCRIBE THE ISSUES ADDRESSED BY MR. D'ASCENDIS TO WHICH
2 YOU PLAN TO RESPOND.

3 A I will respond to his proposal that the overall rate of return should be based on the
4 Company's "actual" capital structure, and his support for embedded cost of debt and
5 a fair return on common equity.

6 Q WHAT CAPITAL STRUCTURE DOES MR. D'ASCENDIS PROPOSE TO USE TO
7 SET IHUOC'S OVERALL RATE OF RETURN?

8 A At page 3 of his direct testimony, he recommends a capital structure composed of
9 77.12% long-term debt and 22.88% common equity. This capital structure weight is
10 applied then to the Company's proposed embedded cost of debt of 14%, and a return
11 on common equity of 15.2%. Using these capital structure weights, and component
12 costs, he recommends an overall rate of return for IHUOC of 14.28%.

13 Q DOES MR. D'ASCENDIS PROVIDE COMMENTS CONCERNING THE
14 REASONABLENESS OF HIS PROPOSED RATE OF RETURN?

15 A Yes. Mr. D'Ascendis asserts that it is appropriate to use IHUOC's actual capital
16 structure for ratemaking purposes, and he opposes the use of a hypothetical capital
17 structure as proposed by Staff.

18 Q DID MR. D'ASCENDIS PROVIDE PROOF THAT HIS PROPOSED CAPITAL
19 STRUCTURE IS BASED ON THE COMPANY'S ACTUAL CAPITAL STRUCTURE?

20 A No. As noted on his Schedule DWD-01, Sub-Schedule DWD-1, page 1 in footnote 1,
21 Mr. D'Ascendis simply states that he was provided the capital structure weights by the
22 Company. He offered no corroborating evidence that his proposed capital structure
23 reflects the Company's actual capital structure.

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1 Q DO YOU BELIEVE THAT THE CAPITAL STRUCTURE USED BY MR.
2 D'ASCENDIS REFLECTS THE COMPANY'S ACTUAL CAPITAL STRUCTURE
3 MIX?

4 A No. Based on the Company's response to data provided to the OPC from IHUOC's
5 attorneys, Mr. D'Ascendis' capital structure is not based on IHUOC's "actual" capital
6 structure as reported by the Company in its Consolidated Financial Statements and
7 Independent Auditors' Report for Indian Hills Utility Holding Company, Inc.

8 At year-end 2016, this document shows that IHUOC includes ** _____ **
9 of long-term debt, and ** _____ ** of common equity. As such, the Company's
10 actual capital structure has a common equity ratio of approximately ** _____ ** and debt
11 ratio of ** _____ **.

12 Q DO YOU BELIEVE THAT THE COMPANY'S ACTUAL CAPITAL STRUCTURE MIX
13 IS REASONABLE FOR RATEMAKING PURPOSES?

14 A No. The Company's actual capital structure contains little to no common equity. As
15 such, it would not be appropriate for setting rates based on the Company's actual
16 capital structure. For that reason, Staff's proposal to use a hypothetical capital
17 structure as a means of setting rates in a manner that gives IHUOC an opportunity to
18 improve its financial standing and strengthen its balance sheet would be in the public
19 interest. Again, as I stated in my direct testimony, IHUOC should provide reports to
20 the Commission demonstrating that it is actually attempting to achieve this
21 strengthening of its balance sheet and improving its financial standing.

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1 **Q IS MR. D'ASCENDIS' USE OF IHUOC LOAN DEBT COST APPROPRIATE IN A**
2 **RISK PREMIUM STUDY TO ESTIMATE A FAIR RETURN FOR THIS UTILITY?**

3 A No. As outlined in my direct testimony, my colleague, Mr. Greg R. Meyer, responded
4 to the Company's estimated cost of debt based on this loan agreement. This loan
5 agreement and cost are not appropriate for setting rates, because it does not reflect
6 an arm's length affiliate interest transaction.

7 Further, Staff's estimated return on equity does reflect a reasonable premium
8 to a below investment grade utility company debt cost. As such, a hypothetical
9 capital structure, return on equity and a hypothetical below investment grade utility
10 debt cost are reasonable to setting an overall rate of return for IHUOC in this case.

11 **Q IS MR. D'ASCENDIS' ESTIMATED RETURN ON EQUITY FOR IHUOC**
12 **REASONABLE?**

13 A No. As shown on his Schedule DWD-01, Sub-Schedule DWD-1, page 2,
14 Mr. D'Ascendis estimates a return on equity of 8.63% using the Discounted Cash
15 Flow ("DCF") model, and a Capital Asset Pricing Model ("CAPM") return of 10.21%.
16 These models do not use the 14% bank loan which the Company represents as its
17 cost of debt to measure a fair return on equity.

18 Mr. D'Ascendis' DCF return on the market is reasonably consistent with a
19 reasonable estimate of current market costs. However, his CAPM return estimate
20 recommendation of 10.21% is based on a traditional CAPM return estimate of 9.94%,
21 and an ECAPM return estimate of 10.49%. The traditional CAPM return is
22 reasonable but his ECAPM return is not reasonable.

1 **Q PLEASE EXPLAIN WHY MR. D’ASCENDIS’ ECAPM IS NOT REASONABLE.**

2 A Mr. D’Ascendis’ ECAPM return estimate is unreasonable because it uses *Value Line*
3 “adjusted” betas within an ECAPM study. This methodology is not reasonable
4 because it double counts the adjustment to the CAPM return estimate for companies
5 with betas less than 1, which includes IHUOC and his proxy group. The *Value Line*
6 adjusted beta is based on a Blume methodology of adjusting a raw beta estimate
7 developed from historical beta. The Blume adjustment takes the measured beta and
8 adjusts it to reflect the tendency for all historical betas to converge prospectively on
9 the market beta of 1. This beta adjustment has the effect of increasing the CAPM
10 return estimates for companies with betas less than 1, and decreasing the CAPM
11 return estimates for companies with betas greater than 1.

12 This is the same effect on the CAPM return created by use of an ECAPM
13 study. Specifically, the ECAPM study also increases the intercept point on the
14 security market line and flattens its slope. The effect of an ECAPM on a CAPM return
15 estimate is nearly identical to that of use of an adjusted *Value Line* beta.

16 Importantly, there is no academic research that supports the use of an
17 adjusted *Value Line* beta within an ECAPM study. These methodologies are not
18 compatible, and should be used exclusive of one another. The effect of Mr.
19 D’Ascendis’ use of an adjusted beta in an ECAPM study results in the double
20 counting of the CAPM return to convert a historical beta to the forward-looking beta.
21 For these reasons, Mr. D’Ascendis’ ECAPM study should be disregarded.

22 **Q DO MR. D’ASCENDIS’ RETURN ON EQUITY STUDIES DEMONSTRATE A FAIR**
23 **RETURN FOR THE COMPANY IN THIS CASE?**

24 A Yes. A reasonable range in return on equity estimates for IHUOC should be
25 considered to reflect his DCF return estimate of 8.63%, and his traditional CAPM

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1 result of 9.94%. Staff's recommended return on equity for IHUOC falls within this
2 range, and thus Mr. D'Ascendis' testimony supports the reasonableness of this
3 finding. However, all of Mr. D'Ascendis' other risk premium studies and external
4 adjustments for IHUOC are without merit and should be disregarded.

5 **Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

6 **A** Yes, it does.

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