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DEC 1 1 2017

Missouri Public Service Commission

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| Exhibit No.: | 215 |
| 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**

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|---|---|---|
| **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

OPC Exhibit No. 215
Date 11-30-17 Reporter KF
File No. WR-2017-0259

BRUBAKER & ASSOCIATES, INC.

Project 10499

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

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| In the Matter of the Rate Increase Request of Indian Hills Utility Operating Company, Inc. | ) | **Case No. WR-2017-0259** |

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| **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.

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2021
Commission # 13706793

Maria E. Decker
Notary Public

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

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| **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

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

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

**Q WHAT IS YOUR OCCUPATION?**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A Yes. A reasonable range in return on equity estimates for IHUOC should be considered to reflect his DCF return estimate of 8.63%, and his traditional CAPM result of 9.94%. Staff's recommended return on equity for IHUOC falls within this range, and thus Mr. D'Ascendis' testimony supports the reasonableness of this finding. However, all of Mr. D'Ascendis' other risk premium studies and external adjustments for IHUOC are without merit and should be disregarded.

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

A Yes, it does.

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