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Service Commission

Exhibit No.:	213
Issue:	Cost of Capital
Witness:	Michael P. Gorman
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Missouri Office of Public Counsel
Case No.:	WR-2017-0259
Date Testimony Prepared:	October 13, 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

Direct Testimony and Schedules of

Michael P. Gorman

On behalf of

Missouri Office of Public Counsel

OPC Exhibit No. 213
Date 11-30-17 Reporter KF
File No. WR-2017-0259

October 13, 2017



BRUBAKER & ASSOCIATES, INC.

**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

Direct 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 PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.

8 A This information is included in Appendix A to this testimony.

9 Q ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

10 A This testimony is presented on behalf of the Missouri Office of Public Counsel.

11 Q WHAT IS THE PURPOSE OF YOUR TESTIMONY?

12 A I will provide testimony on the overall rate of return for setting rates for Indian Hills
13 Utility Operating Company, Inc. ("IHUOC" or "Company").

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1 Based on Staff's Partial Disposition Agreement Pleading and its attached
2 Capital Structure Schedule, as shown in my Schedule MPG-1, the Staff's capital
3 structure schedule shows an overall rate of return of 12.37%, and a pre-tax rate of
4 return of 13.18%. This return is based on a capital structure composed of 35%/65%
5 common equity and debt, a return on equity of 9.34%, and a debt cost rate of 14%.

6 **Q DO YOU BELIEVE THAT THE STAFF'S OVERALL RATE OF RETURN IN ITS**
7 **CAPITAL STRUCTURE SCHEDULE FOR IHUOC IS REASONABLE?**

8 **A** No. I believe the Staff has not adequately supported the reasonableness of the
9 Company's claimed debt cost of 14%, and its recommended capital structure.
10 Indeed, as outlined in the testimony of my colleague, Mr. Greg R. Meyer, the
11 Company's efforts to secure an arm's length bank agreement has not resulted in a
12 loan agreement that supports the use of a 14% loan interest rate as reasonable for
13 setting rates. Indeed, Mr. Meyer believes the loan agreement is not reasonable
14 based on the arm's length transaction and does not reflect current market capital
15 costs.

16 **Q WHAT DO YOU PROPOSE?**

17 **A** Based on a review of the Staff's Capital Structure Schedule, and the circumstances
18 for this company, I recommend the following overall rate of return of 8.045% and pre-
19 tax rate of return of 9.874% (using a composite tax rate of 27.98%). This rate of
20 return is developed on my Schedule MPG-2.

21 In developing my recommended overall rate of return for the Company, I
22 adjusted Staff's capital structure mix of debt and equity, and reflected a verifiable

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1 below investment grade cost of debt to use as a proxy for the Company's market cost
2 of debt in this proceeding.

3 Q WHY IS AN ADJUSTMENT TO STAFF'S PROPOSED CAPITAL STRUCTURE
4 REASONABLE?

5 A While I understand that IHUOC does not currently have much common equity in its
6 capital structure, I believe the ratemaking capital structure should reflect what the
7 Company should be working toward, over time, in order to improve its financial
8 standing. Many utility companies finance utility infrastructure with 50% debt and 50%
9 equity. As such, I believe that this is a minimum capital structure mix target that
10 IHUOC should be working toward.

11 As such, I recommend the Commission set an overall rate of return at this
12 utility capital structure mix and provide clear expectations that this utility should work
13 toward adjusting its actual capital structure to be consistent with this ratemaking
14 capital structure within a reasonable period of time. However, the Company should
15 provide the Commission with an outlook as to what time period will be necessary to
16 achieve this modification to its actual capital structure mix to conform to this
17 ratemaking capital structure mix. I also recommend annual reports to the
18 Commission apprising Staff and the Commission of its efforts to achieve this target
19 capital structure.

20 Once the utility achieves this capital structure mix, I believe its credit standing
21 will improve and its access to external capital will also improve. For these reasons, I
22 believe this is a constructive and balanced ratemaking overall rate of return that
23 ensures customers are not burdened by excessive debt and cost of capital costs, and
24 the utility has a clear message and an opportunity to modify its actual capital structure

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1 mix to conform to one that the Commission has found to be reasonable for supporting
2 utility infrastructure investments in the state of Missouri.

3 **Q WHY DO YOU BELIEVE THAT STAFF'S USE OF A 14% COST RATE FOR DEBT**
4 **IS NOT REASONABLE?**

5 A As stated above, the Company's proposed loan agreement which includes a 14%
6 interest rate, and a non-refinanceable provision over the term of the loan is not
7 reasonable. My colleague, Mr. Greg R. Meyer, will address this issue. For
8 ratemaking purposes, the Commission should approve an overall rate of return that
9 reflects prudent utility management, and a verifiable effort to minimize its cost of
10 service to ratepayers, while preserving its financial integrity and access to capital. As
11 such, I propose to use an imputed cost of debt which has been shown to comply with
12 these objectives.

13 **Q HOW DID YOU ARRIVE AT AN IMPUTED COST OF DEBT FOR IHUOC IN THIS**
14 **PROCEEDING?**

15 A I investigated the current cost of debt for a below investment grade utility company
16 that is currently supporting investment in utility plant and equipment. There was one
17 below investment grade utility that recently issued bonds. That was Dayton Power
18 and Light, a subsidiary to AES Corp. As shown on my attached Schedule MPG-3,
19 Dayton Power and Light ("DP&L") issued three bonds with interest rates in the range
20 of 6.41% to 7.25%, with a median of 6.75%. DP&L has a below investment grade
21 bond rating from both S&P and Moody's.

22 I believe using DP&L's recent debt issuance cost is an appropriate
23 hypothetical cost of debt for IHUOC because it reflects a below investment grade

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1 utility debt issuance in the current marketplace, which also is reflective of a financially
2 distressed utility. More specifically, a below investment grade cost of debt of 6.75% is
3 2 to 2.5 percentage points greater than the cost of debt for an investment grade utility
4 company of about 4.0%. Using this observable market cost of debt as a proxy for
5 IHUOC's cost of debt will ensure that the rate of return included in rates charged to
6 retail customers is reasonable, and also provides a reasonable benchmark from
7 which IHUOC can use to negotiate a competitively priced loan agreement to support
8 its investment in utility infrastructure.

9 **Q ARE YOU TAKING ISSUE WITH STAFF'S RETURN ON EQUITY AS IT APPEARS**
10 **IN THE PARTIAL DISPOSITION AGREEMENT?**

11 **A** No.

12 **Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

13 **A** Yes, it does.

Appendix A

Qualifications 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 PLEASE STATE YOUR OCCUPATION.

5 A I am a consultant in the field of public utility regulation and a Managing Principal with
6 the firm of Brubaker & Associates, Inc. ("BAI"), energy, economic and regulatory
7 consultants.

8 Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK
9 EXPERIENCE.

10 A In 1983 I received a Bachelors of Science Degree in Electrical Engineering from
11 Southern Illinois University, and in 1986, I received a Masters Degree in Business
12 Administration with a concentration in Finance from the University of Illinois at
13 Springfield. I have also completed several graduate level economics courses.

14 In August of 1983, I accepted an analyst position with the Illinois Commerce
15 Commission ("ICC"). In this position, I performed a variety of analyses for both formal
16 and informal investigations before the ICC, including: marginal cost of energy, central
17 dispatch, avoided cost of energy, annual system production costs, and working
18 capital. In October of 1986, I was promoted to the position of Senior Analyst. In this
19 position, I assumed the additional responsibilities of technical leader on projects, and

1 my areas of responsibility were expanded to include utility financial modeling and
2 financial analyses.

3 In 1987, I was promoted to Director of the Financial Analysis Department. In
4 this position, I was responsible for all financial analyses conducted by the Staff.
5 Among other things, I conducted analyses and sponsored testimony before the ICC
6 on rate of return, financial integrity, financial modeling and related issues. I also
7 supervised the development of all Staff analyses and testimony on these same
8 issues. In addition, I supervised the Staff's review and recommendations to the
9 Commission concerning utility plans to issue debt and equity securities.

10 In August of 1989, I accepted a position with Merrill-Lynch as a financial
11 consultant. After receiving all required securities licenses, I worked with individual
12 investors and small businesses in evaluating and selecting investments suitable to
13 their requirements.

14 In September of 1990, I accepted a position with Drazen-Brubaker &
15 Associates, Inc. ("DBA"). In April 1995, the firm of Brubaker & Associates, Inc. was
16 formed. It includes most of the former DBA principals and Staff. Since 1990, I have
17 performed various analyses and sponsored testimony on cost of capital, cost/benefits
18 of utility mergers and acquisitions, utility reorganizations, level of operating expenses
19 and rate base, cost of service studies, and analyses relating to industrial jobs and
20 economic development. I also participated in a study used to revise the financial
21 policy for the municipal utility in Kansas City, Kansas.

22 At BAI, I also have extensive experience working with large energy users to
23 distribute and critically evaluate responses to requests for proposals ("RFPs") for
24 electric, steam, and gas energy supply from competitive energy suppliers. These
25 analyses include the evaluation of gas supply and delivery charges, cogeneration

1 and/or combined cycle unit feasibility studies, and the evaluation of third-party
2 asset/supply management agreements. I have participated in rate cases on rate
3 design and class cost of service for electric, natural gas, water and wastewater
4 utilities. I have also analyzed commodity pricing indices and forward pricing methods
5 for third party supply agreements, and have also conducted regional electric market
6 price forecasts.

7 In addition to our main office in St. Louis, the firm also has branch offices in
8 Phoenix, Arizona and Corpus Christi, Texas.

9 **Q HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?**

10 **A** Yes. I have sponsored testimony on cost of capital, revenue requirements, cost of
11 service and other issues before the Federal Energy Regulatory Commission and
12 numerous state regulatory commissions including: Arkansas, Arizona, California,
13 Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas,
14 Louisiana, Michigan, Mississippi, Missouri, Montana, New Jersey, New Mexico, New
15 York, North Carolina, Ohio, Oklahoma, Oregon, South Carolina, Tennessee, Texas,
16 Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming, and before
17 the provincial regulatory boards in Alberta and Nova Scotia, Canada. I have also
18 sponsored testimony before the Board of Public Utilities in Kansas City, Kansas;
19 presented rate setting position reports to the regulatory board of the municipal utility
20 in Austin, Texas, and Salt River Project, Arizona, on behalf of industrial customers;
21 and negotiated rate disputes for industrial customers of the Municipal Electric
22 Authority of Georgia in the LaGrange, Georgia district.

1 Q PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR
2 ORGANIZATIONS TO WHICH YOU BELONG.

3 A I earned the designation of Chartered Financial Analyst ("CFA") from the CFA
4 Institute. The CFA charter was awarded after successfully completing three
5 examinations which covered the subject areas of financial accounting, economics,
6 fixed income and equity valuation and professional and ethical conduct. I am a
7 member of the CFA Institute's Financial Analyst Society.

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Indian Hills Utility Operating Company, Inc.
Case No. WR-2017-0259

Recommended Rate of Return
for Indian Hills Utility Operating Company, Inc.
as of March 31, 2017

<u>Line</u>	<u>Capital Component</u>	<u>Amount</u> (1)	<u>Percentage of Capital</u> (2)	<u>Embedded Cost</u> (3)	<u>Weighted Cost of Capital Using Common Equity Return of: 9.34%</u> (4)	<u>Pre-Tax Rate of Return</u> (5)	<u>Tax Rate</u> (6)	<u>Tax Multiplier</u> (7)
1	Common Stock Equity	\$643,298.95	35.00%	----	3.27%	4.08%		
2	Long-Term Debt	\$1,194,698.05	65.00%	14.00%	9.10%	9.10%		
3	Total Capital	<u>\$1,837,997</u>	<u>100.00%</u>		<u>12.37%</u>	<u>13.18%</u>	<u>19.94%</u>	<u>1.24902</u>

Note:

1. Hypothetical Capital Structure Based on financial covenant typically required in CoBank's loan agreements.

Indian Hills Utility Operating Company, Inc.
Case No. WR-2017-0259

Capital Structure Schedule - Water
Test Year Ending 3/31/2017

Line Number	Description	Dollar Amount	Is Preferred Stock Tax Deductible?		Weighted Cost of Capital
			Percentage of Total Capital Structure	Embedded Cost of Capital	
1	Common Stock	\$896,667	50.00%	9.34%	4.670%
2	Other Security - Non-Tax Deductible	\$0	0.00%	0.00%	0.000%
3	Preferred Stock	\$0	0.00%	0.00%	0.000%
4	Long-Term Debt	\$896,667	50.00%	6.75%	3.375%
5	Short-Term Debt	\$0	0.00%	0.00%	0.000%
6	Other Security - Tax Deductible	\$0	0.00%	0.00%	0.000%
7	TOTAL CAPITALIZATION	<u>\$1,793,334</u>	<u>100.00%</u>		<u>8.045%</u>

To PreTax Return Rate Schedule

Indian Hills Utility Operating Company, Inc.
Case No. WR-2017-0259

Non-Investment Grade Utility Yields

<u>Line</u>	<u>Description</u>	<u>Amount</u> (1)	<u>Issued</u> (2)	<u>Maturity</u> (3)	<u>Rating*</u> (4)	<u>Yield</u> (5)
1	DPL, Inc. ^{1/2}	\$ 200,000,000	7/13/2015	10/1/2019	Ba3/B+	6.75%
2	DPL, Inc. ^{1/2}	\$ 780,000,000	10/16/2012	10/15/2021	Ba3/B+	7.25%
3	B of A Merrill Lynch US High Yield (18-Mo AVG) ³					6.41%

Source/Notes:

¹ SNL Financial, downloaded on October 3, 2017.

² S&P Capital IQ, downloaded on October 3, 2017.

³ Fed St. Louis, for the period ending October 2, 2017.

* The credit rating was issued on March 27, 2017.