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Date Testimony Prepared:

216
Cost of Capital
Michael P. Gorman
Surrebuttal Testimony
Missouri Office of Public Counsel
WR-2017-0259
November 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

Surrebuttal Testimony of

Michael P. Gorman

On behalf of

Missouri Office of Public Counsel

OPC Exhibit No. 216
Date 11-30-17 Reporter KE
File No. WR-2017-0259

November 13, 2017



BRUBAKER & ASSOCIATES, INC.

Project 10499

**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.)
_____)

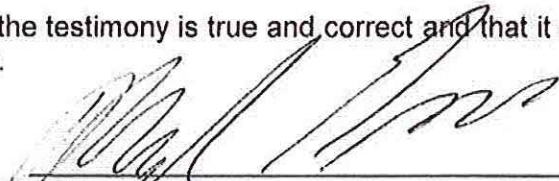
Case No. WR-2017-0259

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

Affidavit of Michael P. Gorman

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

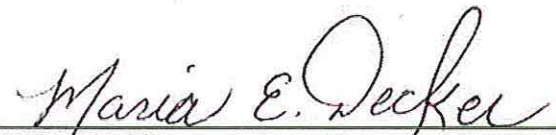
1. My name is Michael P. Gorman. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, Missouri 63017. We have been retained by the Missouri Office of Public Counsel in this proceeding on its behalf.
2. Attached hereto and made a part hereof for all purposes is my surrebuttal 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 13th day of November, 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
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Surrebuttal 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 and October 27, 2017, I filed direct and rebuttal testimony,**
10 **respectively, on behalf of the Missouri Office of Public Counsel.**

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

12 **A I will respond to the rebuttal testimony of Indian Hills Utility Operating Company, Inc.**
13 **("IHUOC" or "Company") witnesses Dylan W. D'Ascendis and Michael E. Thaman, Sr.**

**Michael P. Gorman
Page 1**

1 **Response to Mr. D'Ascendis**

2 **Q DOES MR. D'ASCENDIS TAKE ISSUE WITH YOUR PROPOSED OVERALL RATE**
3 **OF RETURN FOR IHUOC IN THIS PROCEEDING?**

4 A Yes. Mr. D'Ascendis argues that my recommended overall rate of return is
5 unreasonable because it will not even pay the debt cost on IHUOC's 14% outstanding
6 bond issue. He states that setting a rate of return that does not fully recover the
7 utility's cost of debt resulted in the utility recording negative earnings which will
8 eliminate all equity capital in the Company through a reduction in retained earnings
9 account. He states that the rate of return should be sufficient to maintain the
10 soundness of the utility, and that my recommended rate of return does not
11 accomplish this objective. (Rebuttal Testimony of Mr. D'Ascendis at 2-4).

12 **Q PLEASE RESPOND.**

13 A Mr. D'Ascendis' argument largely relies on the presumption that the 14% loan
14 included in the Company's proposed cost of service represents a reasonable and
15 prudent debt financing agreement and debt cost for IHUOC. My colleague, Mr. Greg
16 R. Meyer, addresses this issue and concludes that it is not a reasonable agreement,
17 nor debt cost.

18 Based on that determination, IHUOC's debt instrument should not be used to
19 measure a reasonable return on equity or overall rate of return.

20 With this as an initial step, Mr. D'Ascendis' arguments are simply not reliable,
21 because they are largely based on an unsupported assumption that the 14% loan is
22 prudent and reasonable.

1 Q DOES MR. D'ASCENDIS ALSO BELIEVE THAT YOUR DEVELOPMENT OF AN
2 IMPUTED DEBT COST FOR IHUOC OF 6.75% USING A DAYTON POWER AND
3 LIGHT COMPANY ("DPL") BOND ISSUE IS UNREASONABLE?

4 A Yes. Mr. D'Ascendis shows that DPL and IHUOC are not directly comparable utility
5 companies, and he states that using DPL's below investment grade bond issue cost
6 is simply not appropriate for developing an imputed debt cost of IHUOC.

7 Q DID MR. D'ASCENDIS OFFER ANY OTHER EVIDENCE THAT A 14% LOAN FOR
8 IHUOC IS REASONABLE?

9 A No.

10 Q IS THERE A REASON WHY YOU USED DPL AS AN ESTIMATE OF AN
11 APPROPRIATE IMPUTED DEBT COST FOR IHUOC?

12 A Yes. This was the only below investment grade utility bond issue that I was able to
13 identify over the last few years. That in conjunction with an indexed bond yield shows
14 that below investment grade debt is currently demanding an interest rate of around
15 6.5% up to 7%. From this data, I imputed a below investment grade debt instrument
16 cost for IHUOC of 6.75%. To the extent the Commission does not find the
17 Company's loan agreement to be reasonable, then my methodology provides the
18 most appropriate proxy for debt interest costs for IHUOC. Mr. D'Ascendis' testimony
19 simply does not address this important prudent debt agreement issue and should,
20 therefore, be set aside.

1 Q IS MR. D'ASCENDIS' CONCERN ABOUT YOUR RELIANCE ON STAFF'S
2 RETURN ON EQUITY APPROPRIATE?

3 A No. Once again, Mr. D'Ascendis assumes that the 14% bond loan agreement for
4 IHUOC is a reasonable interest rate and loan agreement, but he has not supported
5 this assumption.

6 If the 14% loan agreement is not shown to be a reasonable and prudent loan
7 agreement for IHUOC, then awarding a return on equity with a premium to this loan
8 agreement would not be appropriate. For these reasons, Mr. D'Ascendis' arguments
9 concerning an appropriate rate of return on equity based on IHUOC's current 14%
10 loan agreement should be disregarded.

11 Q DOES MR. D'ASCENDIS ALSO TAKE ISSUE WITH YOUR PROPOSED
12 HYPOTHETICAL CAPITAL STRUCTURE FOR IHUOC?

13 A Yes. He states that assuming the Company has access to traditional utility capital is
14 not reasonable. (Rebuttal Testimony of Mr. D'Ascendis at 4-5). He goes on to state
15 a ratemaking capital structure for Hillcrest Utility Operating Company, but provides no
16 evidence of what IHUOC's actual capital structure is. Mr. D'Ascendis continues to
17 rely, presumably, on the Company's representation to him on its capital structure mix.

18 Q DO YOU BELIEVE IT WOULD BE APPROPRIATE FOR THE COMMISSION TO
19 USE IHUOC'S ACTUAL CAPITAL STRUCTURE FOR SETTING RATES?

20 A No. IHUOC's actual capital structure has a *de minimis* amount of common equity.
21 Effectively, this utility is almost exclusively debt financed. I recommend the
22 Commission set a ratemaking capital structure that sends clear signals to IHUOC
23 management to improve its balance sheet strength by retaining all equity in the utility,

1 and investing new equity in the utility as needed, in order to achieve a capital
2 structure mix and balance sheet strength the Commission finds appropriate for
3 supporting a regulated water and wastewater utility in the state of Missouri. If the
4 Company is willing to pursue these objectives, then I believe it is reasonable for the
5 Commission to set a hypothetical capital structure with clear stated expectations that
6 IHUOC will attempt to modify its actual capital structure to conform with a hypothetical
7 capital structure used by the Commission to set rates in this proceeding. IHUOC
8 should provide evidence that it is moving toward adjusting its actual capital structure
9 to conform over time to the hypothetical capital structure used to set rates.

10 **Response to Mr. Thaman**

11 **Q DID IHUOC WITNESS MR. MICHAEL THAMAN PROVIDE EVIDENCE ON AN**
12 **APPROPRIATE PROXY FOR DEBT COST FOR IHUOC IN THE EVENT THE**
13 **COMMISSION FINDS A 14% LOAN AGREEMENT TO BE AN UNREASONABLE**
14 **AGREEMENT BETWEEN AFFILIATES?**

15 **A** No. He, like Mr. D'Ascendis, simply observes that DPL and IHUOC are not risk
16 comparable companies. However, they are both financially distressed companies,
17 and this is observable market evidence on how the market prices debt costs for a
18 financially distressed company. Therefore, it is the best information available to set
19 reasonable and just prices in this proceeding.

1 Q DID MR. THAMAN PROVIDE EVIDENCE ON IHUOC'S ACTUAL CAPITAL
2 STRUCTURE, OR SHOW A MORE REASONABLE IMPUTED DEBT COST
3 APPROPRIATE FOR USING FOR RATEMAKING PURPOSES?

4 A No. Like Mr. D'Ascendis, Mr. Thaman supports the Company's 14% loan agreement
5 to use for ratemaking purposes, and provides an opinion that the loan agreement is
6 reasonable. However, Mr. Thaman did not provide any proof that a 14% loan in the
7 current market is reasonable to IHUOC.

8 Therefore, the Commission should reject this loan agreement for ratemaking
9 purposes.

10 Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

11 A Yes, it does.

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