

Exhibit No.:
Issues: Capital Structure and Overall Rate
of Return
Witness: Scott W. Rungren
Exhibit Type: Direct
Sponsoring Party: Missouri-American Water Company
Case No.: WR-2008-XXXX
SR-2008-XXXX
Date: March 31, 2008

MISSOURI PUBLIC SERVICE COMMISSION

**CASE NO. WR-2008-XXXX
CASE NO. SR-2008-XXXX**

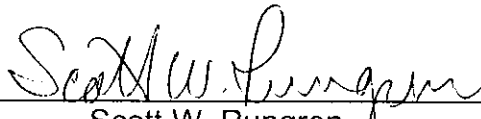
**DIRECT TESTIMONY
OF
SCOTT W. RUNGREN
ON BEHALF OF
MISSOURI-AMERICAN WATER COMPANY**

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

IN THE MATTER OF MISSOURI-AMERICAN)	
WATER COMPANY FOR AUTHORITY TO)	
FILE TARIFFS REFLECTING INCREASED)	CASE NO. WR-2008-XXXX
RATES FOR WATER AND SEWER)	CASE NO. SR-2008-XXX
SERVICE)	

AFFIDAVIT OF SCOTT W. RUNGREN

Scott W. Rungren, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Direct Testimony of Scott W. Rungren"; that said testimony and schedules were prepared by him and/or under his direction and supervision; that if inquires were made as to the facts in said testimony and schedules, he would respond as therein set forth; and that the aforesaid testimony and schedules are true and correct to the best of his knowledge.



Scott W. Rungren

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 19th day of March 2008.



Notary Public

My commission expires:

Staci A. Olsen
Notary Public - Notary Seal
State of Missouri
St. Charles County
Commission # 05519210
My Commission Expires: March 20, 2009

**DIRECT TESTIMONY
OF
SCOTT W. RUNGREN
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR.2008.XXXX
CASE NO. SR.2008.XXXX**

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**DIRECT TESTIMONY
OF
SCOTT W. RUNGREN**

WITNESS INTRODUCTION

1

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

3 A. My name is Scott W. Rungren, and my business address is 727 Craig Road, St. Louis,
4 Missouri 63141.

5

6 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

7 A. I am employed by American Water Works Service Company ("Service Company") as a
8 Financial Analyst III. The Service Company is a subsidiary of American Water Works
9 Company, Inc. ("American") that provides various services to American's water utility
10 subsidiaries. In this proceeding I am testifying on behalf of Missouri-American Water
11 Company ("MAWC" or "the Company").

12

13 **Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.**

14 A. In May of 1983, I received a Bachelor of Science degree in Business Administration with
15 a major in Energy Management from Eastern Illinois University. In May of 1986, I
16 received a Master of Business Administration degree with a specialization in Finance
17 from Northern Illinois University.

18 **Q. PLEASE SUMMARIZE YOUR EMPLOYMENT EXPERIENCE.**

1 A. From 1986 to 1999, I was employed by the Illinois Commerce Commission. I held
2 various positions while employed there. I joined the Finance Department in 1987, and
3 was promoted to Senior Financial Analyst in 1989. In 1993, I transferred to what was
4 then called the Energy Programs Division, returning to the Finance Department in 1995,
5 again as a Senior Financial Analyst. I remained in that position until February of 1999.
6 In March of 1999, I began employment with Cinergy Corp., working in the Retail
7 Commodity Services group focusing on their Real Time Pricing program. In 2001, I
8 began performing long-run generation planning studies for Cinergy's Kentucky and
9 Indiana service areas. In May of 2007, I joined American Water as a Financial Analyst
10 III. My present duties with American Water include the preparation of financings and
11 rate case related filings for the Company's Central Region.

12 **PURPOSE OF TESTIMONY**

13 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?**

14 A. The purpose of my testimony is to present the capital structure that I recommend be used
15 for computing the Company's weighted average cost of capital ("WACC") in this
16 proceeding. The Company's WACC, or overall rate of return, reflects, among other
17 things, the rate of return on common equity recommendation presented in the Direct
18 Testimony of MAWC witness Ms. Pauline Ahern.

19 **RECOMMENDED OVERALL RATE OF RETURN AND CAPITAL STRUCTURE**

20 **Q. WHAT CAPITAL STRUCTURE DO YOU RECOMMEND BE USED FOR**
21 **COMPUTING THE COMPANY'S WACC FOR RATEMAKING PURPOSES?**

1 A. Since this proceeding will set rates for future service, the capital structure components
2 should be developed from estimates for the period during which those rates will be in
3 effect. As a starting point, I used MAWC's actual capital structure as of December 31,
4 2007. I then adjusted the component balances in that capital structure to reflect all
5 changes expected to occur by September 30, 2008, which is the end of the true-up period.
6 That resulted in a pro-forma September 30, 2008 capital structure that is comprised of
7 51.99% long-term debt, 0.36% preferred stock, and 47.65% common equity, as shown on
8 Schedule SWR-1, page 1.

9
10 **Q. DO YOU BELIEVE THAT MAWC'S PRO-FORMA SEPTEMBER 30, 2008**
11 **CAPITAL STRUCTURE IS REASONABLE FOR RATEMAKING PURPOSES?**

12 A. Yes, I do.

13
14 **Q. HOW DID YOU DETERMINE THAT CAPITAL STRUCTURE IS**
15 **REASONABLE?**

16 A. To determine whether MAWC's pro-forma September 30, 2008 capital structure is
17 reasonable for ratemaking purposes, I examined the average common equity ratios of the
18 two proxy groups of water utility companies discussed in the Direct Testimony of
19 MAWC witness Pauline Ahern. Specifically, I compared my proposed common equity
20 ratio for MAWC to that of Ms. Ahern's six AUS Utility Reports water companies and to
21 her group of four Value Line (Standard Edition) water companies. These utilities and
22 their corresponding financial data are shown on Schedules PMA-4 and PMA-5,
23 respectively, attached to the Direct Testimony of Ms. Ahern. For the year ended 2006,
24 the average common equity ratio of Ms. Ahern's six AUS Utility Reports water

1 companies was 48.74%, with a standard deviation of 5.98%. For the same period, the
2 average common equity ratio of Ms. Ahern's four Value Line (Standard Edition) water
3 companies was 51.52%, with a standard deviation of 4.61%. Thus, MAWC's pro-forma
4 September 30, 2008 equity ratio of 47.65% is within one standard deviation of the
5 average common equity ratio of both Ms. Ahern's six AUS Utility Reports water
6 companies and to her group of four Value Line (Standard Edition) water companies.

7
8 To further check the reasonableness of my proposed capital structure, I also considered
9 projected equity ratios from Value Line Investment Survey¹. Value Line estimates that
10 the composite common equity ratio for the water utility industry will be 52.0% in 2007,
11 51.0% in 2008, and 50.0% over the 2010-2012 time period. Thus, MAWC's pro-forma
12 September 30, 2008 equity ratio is also relatively close to Value Line's projected
13 common equity ratios for the water utility industry.

14
15 Based on these comparisons, I concluded that MAWC's pro-forma September 30, 2008
16 capital structure is reasonable and, thus, should be used to compute the Company's
17 WACC in this proceeding. The WACC is used, of course, as the authorized overall rate
18 of return on rate base.

19
20 **Q. PLEASE EXPLAIN WHY YOU HAVE NOT INCLUDED SHORT-TERM DEBT**
21 **IN YOUR PROPOSED CAPITAL STRUCTURE.**

22 **A.** MAWC's pro-forma September 30, 2008 short-term debt balance is projected to be
23 zero, as shown on Schedule SWR-1, page 2. The short-term debt balance is being paid

¹ Value Line Investment Survey, January 25, 2008, p. 1424.

1 down during 2008 by funds obtained from MAWC's planned long-term debt issuance
2 and common equity infusion. These financings are discussed below.

3
4 **Q. PLEASE EXPLAIN THE PRO-FORMA ADJUSTMENTS YOU MADE TO**
5 **MAWC'S LONG-TERM DEBT BALANCE.**

6 A. Starting with the Company's actual long-term debt schedule as of December 31, 2007, I
7 made a pro-forma adjustment to reflect the anticipated \$70,000,000 debt issuance
8 projected for July 31, 2008. Proceeds from this planned issuance will be used to finance
9 utility property that will be placed in service and to pay down short-term bank debt that is
10 expected to build up through the normal course of business. I also adjusted the long-term
11 debt schedule to capture the proper amount of debt issuance expense amortization as of
12 September 30, 2008. The Company's pro-forma adjusted long-term debt balance is
13 \$374,119,164, as shown on Schedule SWR-1, pages 1 and 3.

14
15 **Q. PLEASE DESCRIBE THE LONG-TERM DEBT INSTRUMENT THE COMPANY**
16 **INTENDS TO ISSUE.**

17 A. In Commission Case No. WF-2007-0279 the Company received approval to issue up to
18 \$200 million of long-term debt and \$105 million of common equity. The Company has
19 issued \$103 million of long-term debt under authority granted by the Order in that case;
20 thus, MAWC has remaining approval to issue up to \$97 million of long-term debt. The
21 approval granted by the Missouri PSC was for incurring indebtedness to American Water
22 Capital Corporation ("AWCC"). Thus, the planned \$70 million issuance will be in the
23 form of notes payable to AWCC, at a forecasted interest rate of 6.243%. In addition, the
24 Company has estimated that the debt issuance costs will total \$231,000, which, consistent

1 with treatment previously accepted by the Missouri PSC, MAWC proposes be amortized
2 and recovered over the thirty-year life of this new issuance. The debt rate and issuance
3 costs can easily be adjusted to actual amounts before the operation of law date in this
4 proceeding.

5
6 **Q. WHAT IS MAWC'S COST OF LONG-TERM DEBT?**

7 A. MAWC's pro-forma September 30, 2008 cost of long-term debt is 6.17%. The
8 computation of this cost is shown on Schedule SWR-1, page 3.

9
10 **Q. PLEASE EXPLAIN THE PRO-FORMA ADJUSTMENT YOU MADE TO**
11 **MAWC'S PREFERRED STOCK BALANCE.**

12 A. I started with the Company's preferred stock balance as of December 31, 2007 and made
13 an adjustment to reflect the appropriate amortization of the issuance expense associated
14 with the \$2,500,000 of preference stock. The Company's pro-forma adjusted preferred
15 stock balance is \$2,600,573, as shown on Schedule SWR-1, pages 1 & 4.

16
17 **Q. WHAT IS MAWC'S COST OF PREFERRED STOCK?**

18 A. MAWC's pro-forma September 30, 2008 cost of preferred stock is 9.17%, as shown on
19 Schedule SWR-1, pages 1 and 4.

20
21 **Q. PLEASE EXPLAIN THE PRO-FORMA ADJUSTMENTS YOU MADE TO**
22 **MAWC'S COMMON EQUITY BALANCE.**

23 A. Starting with the Company's actual common equity balance as of December 31, 2007, I
24 made a pro-forma adjustment to reflect MAWC's planned common equity infusion of

1 \$35,000,000 in the form of paid-in capital from its parent, American Water Works
2 Company. American Water Works Company currently owns 100% of the outstanding
3 common stock of MAWC. This equity infusion is expected to occur by September 30,
4 2008, which is the end of the true-up period in this case. The funds from this equity
5 infusion will be used to finance utility property that will be placed in service and to pay
6 down short-term debt that is expected to build up through the normal course of business.

7
8 **Q. PLEASE EXPLAIN ANY OTHER ADJUSTMENTS YOU MADE TO MAWC'S**
9 **COMMON EQUITY BALANCE.**

10 A. I also adjusted MAWC's December 31, 2007 retained earnings balance, which is a
11 component of common equity, to capture the changes expected to occur by the end of the
12 true-up period ending September 30, 2008. Specifically, net income during the period is
13 projected to be \$15,736,894, resulting in expected dividends of \$6,445,756. Thus, the net
14 pro-forma increase to retained earnings is projected to be \$9,291,138, and the total pro-
15 forma common equity balance at September 30, 2008 is \$343,216,593, as shown on
16 Schedule SWR-1, pages 1 and 5.

17
18 **Q. WHAT COST RATE HAVE YOU APPLIED TO MAWC'S COMMON EQUITY**
19 **COMPONENT?**

20 A. As shown on page 1 of Schedule SWR-1, MAWC's common equity component has been
21 assigned a cost of 11.25%. This cost of common equity was developed and
22 recommended by Ms. Pauline Ahern of AUS Consultants—Utility Services, MAWC's
23 consultant on this issue, who has concluded that MAWC should be afforded the

1 opportunity to earn a return on common equity between 11.075 and 11.425%, with a
2 midpoint of 11.25%.

3

4 **Q. WHAT IS MAWC'S OVERALL WEIGHTED AVERAGE COST OF CAPITAL?**

5 A. The overall weighted average cost of capital is calculated by summing the component
6 costs of the capital structure, with each component weighted by its respective proportion
7 to total capitalization. Based on the pro-forma capital component balances and
8 component costs I have described, MAWC's WACC is 8.60%, as shown on Schedule
9 SWR-1, page 1. Thus, I recommend that MAWC be authorized an overall rate of return
10 on rate base in this proceeding of 8.60%.

11

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

13 A. Yes, it does.

Missouri-American Water Company
Weighted Average Cost of Capital
 Pro Forma at 9/30/08
 Case No. WR-2008-XXXX
 Case No. SR-2008-XXXX

<u>Class of Capital</u>	<u>Amount</u>	<u>Percent of Total</u>	<u>Cost Rate</u>	<u>Weighted Cost of Capital</u>
Long-Term Debt	\$ 374,411,531	51.99%	6.17%	3.21%
Short-Term Debt	-	0.00%	0.00%	0.00%
Preferred Stock	2,600,573	0.36%	9.17%	0.03%
Common Equity	<u>343,216,593</u>	<u>47.65%</u>	11.25%	<u>5.36%</u>
Total Capitalization	<u>\$ 720,228,697</u>	<u>100.00%</u>		<u>8.60%</u>

Missouri-American Water Company
Pro Forma Cost of Long-Term Debt at 9/30/08
Case No. WR-2008-XXXX
Case No. SR-2008-XXXX

JDE Object	Rate	Issue Date	Maturity Date	Principal Amount	Amount Outstanding @ 12/31/07	Pro Forma Adjustments	Pro Forma Amount Outstanding @ 9/30/08	Unamortized Issuance Expense @ 12/31/07	Pro Forma Adjustments	Monthly Amortization Debt Expense	Unamortized Issuance Expense @ 9/30/08	Net Proceeds @ 9/30/08	Annual Amortization Debt Expense	Annual Interest Expense	Total Cost
General Mortgage Bonds															
BD170005	6.243%	07/31/08	07/31/38	70,000,000	8,000,000	70,000,000	70,000,000	73,778	231,000	642	229,717	69,770,283	7,700	4,370,100	4,377,800
BD170006	7.790%	06/01/97	06/01/27	8,000,000	3,000,000	8,000,000	8,000,000	73,778	231,000	316	70,931	7,929,069	3,795	623,200	626,995
BD170007	8.580%	04/21/85	03/01/25	3,000,000	12,500,000	12,500,000	12,500,000	44,541	219,076	216	42,595	2,957,405	2,595	257,400	259,995
BD170008	7.140%	03/16/94	03/01/34	12,500,000	4,950,000	4,950,000	4,950,000	219,076	194,710	698	212,797	12,287,203	8,372	892,500	900,872
BD170009	5.500%	05/18/93	01/01/23	4,950,000	4,500,000	4,500,000	4,500,000	194,710	237,601	1,082	184,975	(184,975)	12,981	-	12,981
BD170010	5.850%	02/01/88	02/01/28	6,000,000	6,000,000	6,000,000	6,000,000	237,601	275,436	986	228,728	4,271,272	11,831	225,000	236,831
BD170011	5.900%	07/26/96	07/01/26	18,745,000	18,745,000	18,745,000	18,745,000	275,436	874,783	1,241	264,270	(264,270)	14,889	937,250	14,889
BD170012	5.900%	11/01/98	11/30/28	19,000,000	29,000,000	29,000,000	29,000,000	874,783	1,095,473	3,499	843,290	17,901,710	41,990	1,711,000	1,752,990
BD170013	5.900%	03/01/00	03/01/30	29,000,000	14,990,000	14,990,000	14,990,000	1,095,473	728,685	4,118	1,058,411	27,941,589	49,416	778,480	778,480
BD170014	5.200%	04/01/02	04/01/32	15,000,000	57,480,000	57,480,000	57,480,000	728,685	1,475,827	2,513	706,070	14,283,930	30,153	2,644,080	2,674,233
BD170017	4.600%	12/20/06	12/01/36	57,480,000	103,000,000	103,000,000	103,000,000	1,475,827	1,011,565	4,241	1,437,659	56,042,341	50,891	6,790,790	6,842,592
BD170018	6.593%	10/22/07	10/15/37	103,000,000	-	103,000,000	103,000,000	1,011,565	21,318	2,817	986,214	102,013,766	33,802	-	102,047,568
BD350005 - P				-	-	-	-	21,318	3,876	1,938	3,876	(3,876)	23,256	-	23,256
BD350006 - Q				-	-	-	-	624,625	2,375	2,375	603,250	(603,250)	28,500	-	28,500
BD350007 - R				-	-	-	-	866,326	5,518	5,518	816,660	(816,660)	66,221	-	66,221
BD350008 - S				-	-	-	-	916,487	5,423	5,423	867,678	(867,678)	65,079	-	65,079
BD350009 - T	5.500%	02/01/93	02/01/23	15,000,000	12,000,000	12,000,000	12,000,000	392,217	372,715	2,167	372,715	(372,715)	26,003	-	26,003
BD350010 - U	5.700%	06/01/95	06/01/25	12,000,000	19,900,000	19,900,000	19,900,000	916,487	343,701	1,645	328,901	(328,901)	19,734	-	19,734
BD350011 - V	5.500%	11/01/96	11/01/26	19,900,000	24,930,000	24,930,000	24,930,000	343,701	598,016	2,646	574,202	(574,202)	31,752	-	31,752
BD350013 - X	5.100%	03/01/98	03/01/28	25,000,000	39,880,000	39,880,000	39,880,000	598,016	1,164,916	2,819	656,890	24,273,110	33,831	1,271,430	1,305,261
BD350014 - Y	5.000%	03/01/99	03/01/29	40,000,000	316,025,000	316,025,000	316,025,000	1,164,916	11,841,346	4,586	11,233,639	38,756,361	55,035	1,984,000	2,049,035
				444,330,000	316,025,000	70,000,000	386,025,000	11,841,346	51,485	617,825	374,411,531	22,496,230	23,114,055		

Cost of Long-Term Debt = [Total Cost / Net Proceeds]

6.17%

Missouri-American Water Company
Pro Forma Cost of Preferred Stock at 9/30/08
Case No. WR-2008-XXXX
Case No. SR-2008-XXXX

JDE Object	215113	181510	Unamortized Issuance Expense @ 12/31/07		Outstanding @ 9/30/08	Unamortized Issuance Expense @ 9/30/08		Carrying Value @ 9/30/08	Annual Amortization	Annual Dividends	Total Cost
Debt Issue Subledger	Date Issued	Par Value	Dividend Rate	5.875%	10/11/1966	100	132,000	132,000	-	7,755	7,755
Cumulative Preferred Stock PS170003	132,000	-	-	-	132,000	-	-	132,000	-	7,755	7,755
	132,000	-	-	-	132,000	-	-	132,000	-	7,755	7,755
Cost of preferred stock [Total Annual Cost/Carrying Value]											
Preference Stock PS170001	2,500,000	2,500,000	9.18%	10/3/1991	100	2,500,000	2,500,000	2,468,573	1,268	229,500	230,768
	2,500,000	-	-	-	2,500,000	-	-	2,468,573	1,268	229,500	230,768
Cost of preference stock [Total Annual Cost/Carrying Value]											
Total Preferred Stock	2,632,000	-	-	-	2,632,000	-	-	2,600,573	1,268	237,255	238,523
Total Cost of Preferred Stock [Total Annual Cost/Carrying Value]											
											9.17%
											5.88%

Missouri-American Water Company
Pro Forma Short Term Debt at 9/30/08
Case No. WR-2008-XXXX
Case No. SR-2008-XXXX

<u>Date</u>	<u>ST Debt Balance</u>	<u>LT Debt Issuance</u>	<u>Common Equity Infusion</u>
9/30/2007	\$ 66,451,729.13		
10/31/2007	14,336,991.10		
11/30/2007	22,211,068.00		
12/31/2007	46,970,722.84		
1/31/2008	47,052,803.52		
2/29/2008	51,780,956.72		
3/31/2008	79,920,764.37		
4/30/2008	94,438,126.82		
5/31/2008	101,725,048.75		
6/30/2008	102,837,506.43		
7/31/2008	34,834,957.54	\$ 70,000,000	
8/31/2008	34,787,923.43		
9/30/2008	(1,007,425.55)		\$ 35,000,000
Balance @ 9/30/08	\$ (1,007,425.55)		

Missouri-American Water Company
Pro Forma Common Equity at 9/30/08
Case No. WR-2008-XXXX
Case No. SR-2008-XXXX

	Balance @ 12/31/2007	Equity Infusion	Adjustments Net Income	Dividends Paid	Balance @ 9/30/2008
Common Stock	95,994,075	-	-	-	95,994,075
Paid-in Capital	70,764,716	35,000,000	-	-	105,764,716
Retained Earnings	132,166,664	-	15,736,894	(6,445,756)	141,457,802
Total Common Equity	298,925,455	35,000,000	15,736,894	(6,445,756)	343,216,593

Pro-Forma Adjustments

Additional Equity 09/30/2008

35,000,000 To maintain capital structure with new LTD

Retained Earnings

Add: Net Income Available to Common

ABP Jan - Sept 08 15,736,894

15,736,894

Less: Common Pro Forma Dividends

ABP Jan - Sept 08 6,445,756

(6,445,756)

Total Pro Forma RE Adjustment

9,291,138