Exhibit No.
Issue: Cost of Capital
Witness: Dylan W. D'Ascendis
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Raccoon Creek
Case No.: SR-2016-0202
Date: October 13, 2016

Missouri Public Service Commission

Rebuttal Testimony

of

Dylan W. D'Ascendis, CRRA, CVA

On Behalf of

Raccoon Creek Utility Operating Company, Inc.

October 13, 2016

AFFIDAVIT

STATE OF NEW JERSEY)
) ss
COUNTY OF BURLINGTON)

I, Dylan W. D'Ascendis, state that the answers to the questions posed in the attached Direct Testimony are true to the best of my knowledge, information and belief.

____

Subscribed and sworn to before me this 13th day of October, 2016.

____
Notary Public

My Commission Expires:

DANA DiDONATO
NOTARY PUBLIC OF NEW JERSEY
My Commission Expires 9/18/2020

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DIRECT TESTIMONY OF
DYLAN W. D’ASCENDIS, CRRA, CVA

WITNESS INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dylan W. D’Ascendis. I am a Director at ScottMadden, Inc. My business address is 1900 West Park Drive, Suite 250, Westborough, MA 01581.

Q. ARE YOU THE SAME DYLAN W. D’ASCENDIS WHO PREVIOUSLY SUBMITTED PREPARED DIRECT TESTIMONY ON BEHALF OF RACCOON CREEK UTILITY OPERATING COMPANY, INC (“RACCOON CREEK” OR THE “COMPANY”) IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose is to provide testimony responding to the direct testimony of Keri Roth, who represents the Office of the Public Counsel (“OPC”) in this proceeding.

Q. HAVE YOU PREPARED A SCHEDULE IN SUPPORT OF YOUR TESTIMONY IN THIS CASE?

A. Yes. It is designated as Rebuttal Schedule DWD-02 and consists of Sub-Schedule DWD-1.

SUMMARY

Q. WHAT IS YOUR RECOMMENDED COST OF CAPITAL FOR RACCOON CREEK?

A. I continue to recommend that the Missouri Public Service Commission ("MO PSC" or the "Commission") authorize the Company the opportunity to earn an overall rate of return of 14.20% based on its actual capital structure as of the end of the test year. The capital structure consists of 88.60% long-term debt at an embedded debt cost rate of 14.00% and 11.40% common equity at my recommended common equity cost rate of 15.75%. My recommended overall rate of return is summarized on Schedule DWD-01, Sub-Schedule DWD-1 and in Table 1, below:

Table 1: Summary of Overall Rate of Return

Type of Capital	Ratios	Cost Rate	Weighted Cost Rate
Long-Term Debt	88.60%	14.00%	12.40%
Common Equity	11.40%	15.75%	1.80%
Total	100.00%		14.20%

Q. DO YOU HAVE ANY GENERAL COMMENTS REGARDING OPC'S COST OF CAPITAL RECOMMENDATION IN THIS CASE?

A. Yes. OPC's recommended 9.15% overall rate of return, which is derived using the Missouri Public Service Commission Staff's ("Staff") hypothetical capital structure of 75.00% long-term debt and 25.00% common equity, a hypothetical marginal debt cost rate of 8.15%, and a cost of common equity of 12.15%, is woefully inadequate for ratemaking purposes. OPC's recommendation is so inadequate that, if approved, it would not even allow the Company to pay its contractual debt service, let alone compensate equity investors.

To further accentuate the point, as shown in Table 2 below (also included in Sub-Schedule DWD-1), the OPC position in this case does not provide enough operating income[1] to the Company through the recommended return to satisfy the Company's annual debt payment of approximately $205,000[2], let alone provide for any equity return. My recommendation, however, allows Raccoon Creek to fully satisfy its debt obligations while providing a fair return for investors.

Table 2: Comparison of OPC and Company Positions

	OPC	**Raccoon Creek**
Rate Base	$1,564,376	$1,654,177
Overall Rate of Return	9.15%	14.20%
Utility Operating Income	$143,140	$234,893
Annual Debt Service	$205,181	$205,181
Income Available for Common Shareholders	($62,041)	$29,712
Return on Common Equity[3]	-32.90%	15.75%

As shown above, OPC's recommendation results in a negative return for equity holders and the potential default by the Company on its loan. Raccoon Creek's request for relief is both reasonable and conservative given the Company's significant risks.

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1 Operating income is derived by multiplying the overall rate of return by the rate base.

2 Loan amount of $1,406,700 and PSC determined AFUDC of $58,882, at 14.00% interest results in an annual debt service payment of $205,181.48

3 Book common equity of Raccoon Creek is $188,595. To derive return on equity, one must divide income available for common shareholders by the amount of book common equity.

Additionally, OPC did not perform any independent cost rate or capital structure analysis whatsoever, relying upon Staff for their recommended cost rates[4] and capital structure in this proceeding.

CAPITAL STRUCTURE

Q. DO YOU AGREE WITH OPC'S RECOMMENDED HYPOTHETICAL CAPITAL STRUCTURE CONSISTING OF 75% LONG-TERM DEBT AND 25% COMMON EQUITY AT THIS TIME?

A. No, I do not. As discussed in my direct testimony, I am recommending the actual capital structure of Raccoon Creek in this case. Raccoon Creek's actual capital structure consists of 88.60% long term debt and 11.40% common equity. I recommend the Company's actual capital structure in this case based on Commission precedent as referred to in my direct testimony, where in Case No. WR-2016-0064, most recently dated July 12, 2016, this Commission authorized the actual capital structure of Hillcrest Utility Operating Company, Inc.("Hillcrest")[5]

COST OF LONG-TERM DEBT

Q. WHAT IS OPC'S RECOMMENDED COST OF LONG-TERM DEBT IN THIS CASE?

A. OPC is recommending a hypothetical cost of long-term debt of 8.15%.

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[4] Staff, in its initial application, recommended an 8.15% debt cost rate for Raccoon Creek. They since amended their recommendation to 14.00%, which is the Company requested debt cost rate.

[5] Hillcrest Utility Operating Company is a sister company to Raccoon Creek.

Q. WOULD YOU LIKE TO COMMENT ON OPC'S RECOMMENDED LONG-TERM DEBT COST RATE OF 8.15%?

A. Yes. OPC accepted Staff's initial position of 8.15%, which is derived by adding a current Moody's Baa utility bond yield to a current spread between BBB and B rated corporate yields provided by Bank of America. Staff subsequently accepted the Company's requested cost of long-term debt of 14.00%. As of the filing of this testimony, OPC has not accepted the Company's request.

There are at least three major problems with adding a Moody's Baa bond yield to a current spread between BBB and B rated corporate bonds. First, there is no indication that Raccoon Creek would be able to be rated by any rating agency, let alone have a credit rating as high as B. As stated in Mr. Cox's direct testimony, small, distressed water and wastewater systems are shut off from traditional capital markets due to significant operating risks[6]. These operating risks are echoed in the direct testimonies of Mr. Kain[7] and Mr. Thaman[8]. Examples of some of the business risks that lenders take note of are as follows:

- Compliance failures and associated penalties
- Lack of professional management
- Lack of record retention
- High capital intensity

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[6] Cox Direct Testimony at 32-33.
[7] Kain Direct Testimony at 4.
[8] Thaman Direct Testimony at 4.

- Lack of sufficient current income to pay debt
- Lack of secondary or tertiary sources to repay loan
- Cannot assess credit worthiness of end users
- Potential for unknown contingent liabilities

Mr. Thaman says it best when he states on page 4 of his direct testimony that "no bond rating, stated, adjusted, or otherwise, could apply to this risk profile." This is why the 8.15% B rated yield is not applicable to Raccoon Creek.

Second, the 8.15% debt cost rate is unreasonable in view of Mr. Cox's exhaustive attempts to secure traditional financing and the resultant 14.00% loan he was finally able to secure[9]. The direct testimonies of Messrs. Kain[10] and Thaman[11] indicate that debt cost rates for utilities like Raccoon Creek would range from 14.00% - 20.00% and 15.00% - 21.00%, respectively, which would also indicate that Mr. Cox's efforts resulted in a debt cost rate in the bottom of the indicated ranges of both commercial lending experts.

Third and finally, OPC is understating Raccoon Creek's actual long-term debt cost rate by almost 600 basis points. The 14.00% interest rate is the rate that Raccoon Creek is obligated to pay Fresh Start under its financing agreement, and needs to be recovered through rates. Understating the actual long-term debt cost rate serves to diminish the Company's ability to pay its obligations and introduces unnecessary financial risk.

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[9] Cox Direct Testimony at 33-34.
[10] Kain Direct Testimony at 5.
[11] Thaman Direct Testimony at 5.

Q. HAS THIS COMMISSION RECENTLY RULED IN FAVOR OF USING THE ACTUAL COSTS OF LONG-TERM DEBT IN SMALL WATER UTILITY RATE CASES?

A. Yes. In the previously discussed Case No. WR-2016-0064, dated July 12, 2016, this Commission authorized the actual long-term debt cost rate of Hilcrest,[12] which was 14.00%, equivalent to Raccoon Creek's long-term debt cost rate. The Commission stated:

> Staff's arguments are not persuasive that a hypothetical debt cost should be imposed on Hillcrest in this case. Staff expressed suspicions that the financing agreement with Fresh Start was not an arms-length transaction but did not present sufficient evidence to support that allegation.
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> Staff did not present evidence that Hillcrest failed to seek a lower-cost financing arrangement. On the contrary, Mr. Cox testified credibly that he made significant efforts, although unsuccessful, to obtain financing for more traditional commercial banks and financial institutions. The Commission concludes that Hillcrest has met its burden of proof to demonstrate that it sought the least-cost financing option available to it.
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> ***
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> It is important that utility companies be able to attract sufficient capital to meet their financial obligations and provide adequate service to their customers. Hillcrest acquired these systems when they were in a complete state of disrepair, and the company had to find funds to immediately make necessary improvements to protect the health of its customers and to satisfy MDNR and the Missouri Attorney General. The evidence shows that after diligent efforts to

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[12] Hillcrest Utility Operating Company is a sister company to Raccoon Creek.

> obtain financing from a variety of potential lenders, the only financing available to Hillcrest at that time was the transaction with Fresh Start. Penalizing Hillcrest now for that decision would be unfair and may discourage other companies from acquiring and improving troubled water and sewer utilities in the future, which would be contrary to good public policy. The Commission concludes that the appropriate allowed debt rate to apply to the debt in the ratemaking capital structure is the actual debt cost of 14%.

Note that Staff in Case No. WR-2016-0064 recommended a hypothetical long-term debt cost rate of 9.88%, consistent with OPC's approach in this Case.

Q. IN VIEW OF ALL OF THE ABOVE, IS OPC'S USE OF AN 8.15% COST OF LONG-TERM DEBT REASONABLE?

A. No. The fact that the Company is contractually obligated to pay the 14.00% loan, the facts presented in Messrs. Cox, Kain and Thaman's testimony regarding the unavailability of loans with interest rates as low as 8.15% to small utilities like Raccoon Creek, the Commission's recent authorization of a 14.00% long-term debt cost rate for Raccoon Creek's sister company, and Staff's adoption of the Company's debt cost rate in this case, OPC should have used Raccoon Creek's actual cost of long-term debt in its analysis.

COST OF COMMON EQUITY

Q. DO YOU HAVE ANY GENERAL COMMENTS REGARDING OPC'S RECOMMENDED COMMON EQUITY COST RATE?

A. Yes. OPC's recommended common equity cost rate of 12.15% was also based on Staff's recommendation in this case. I have testified on the unreasonableness of Staff's recommendation in my direct testimony. Therefore, I won't repeat the entire discussion in this testimony. As stated in Staff's "Small Utility Return on Equity (ROE)/Rate of Return (ROR) Methodology" ("Staff Methodology") published in September 2010 and updated in January 2016, Staff was to "estimate the cost of debt for the subject company (assuming there is no current reasonable yield on the subject company's cost of debt)" and then apply a risk premium of 3.00% to 4.00% to that yield to arrive at their recommended ROE. As demonstrated in the Order in Case No. WR-2016-0064, the Commission ruled that a long-term debt cost rate of 14.00% was in fact, reasonable, which is confirmed by the fact that Staff accepted the Company's 14.00% debt cost rate in this case. Staff and OPC should have applied the 3.00% to 4.00% risk premium as prescribed in the Staff Methodology to the 14.00% debt, resulting in a common equity cost rate ranging from 17.00% to 18.00%.

Q. WHAT IS THE IMPACT OF USING THE ACTUAL COST OF DEBT (14.00%) AND APPLYING THE 3.00% TO 4.00% RISK PREMIUM TO DERIVE A 17.00% TO 18.00% ROE ON THE OVERALL RETURN FOR RACCOON CREEK?

A. Substituting the 14.00% cost of long-term debt and 17.00% - 18.00% cost of common equity into OPC's hypothetical capital structure would result in a range of overall cost of capital between 14.75% and 15.00%[13], significantly higher than

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[13] 75% long-term debt ratio x 14% debt cost rate = 10.50% weighted cost of debt. 25% common equity ratio x 17% - 18% common equity cost rate = 4.25% - 4.50% weighted common equity cost rate. 10.50% weighted debt cost rate + 4.25% - 4.50% weighted common equity cost rate =

their original overall return of 9.15%. Applied to Raccoon Creek's actual capital structure, the resultant overall rate of return would range from 14.34% to 14.45%[14], which is similar, but higher than, my recommendation.

Q. WOULD THESE OVERALL RATES OF RETURN ALLOW RACCOON CREEK TO SERVICE ITS DEBT AND COMPENSATE EQUITY INVESTORS?

A. Yes. Based on OPC's recommended rate base of $1,564,376 as shown on Table 2, overall rates of return of 14.34% to 14.45% generate operating incomes of $224,332 to $226,052[15], which are both enough to cover debt service of $205,181 and provide meager returns of $19,150 to $20,871 in earnings for shareholders[16].

CONCLUSION

Q. PLEASE SUMMARIZE YOUR CONCLUSIONS.

A. Once again, I continue to recommend that the Commission authorize the Company the opportunity to earn an overall rate of return of 14.20% based on its actual capital structure as of the end of the test year. The capital structure consists of 88.60% long-term debt at an embedded debt cost rate of 14.00% and

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14.75% - 15.00% overall return on capital.

[14] 88.60% long-term debt ratio x 14% debt cost rate = 12.40% weighted cost of debt. 11.40% common equity ratio x 17% - 18% common equity cost rate = 1.94% - 2.05% weighted common equity cost rate. 12.40% weighted debt cost rate + 1.94% - 2.05% weighted common equity cost rate = 14.34% - 14.45% overall return on capital.

[15] 14.34% x $1,564,376 and 14.45% x $1,564,376, respectively.

[16] $224,332 - $205,181 and $226,052 - $205,181, respectively.

11.40% common equity at my recommended common equity cost rate of 15.75%.

OPC's overall return recommendation of 9.15% is so inadequate that if the Commission approves its recommendation, Raccoon Creek will not be able to service its debt. OPC's recommendation is inadequate because of its assumption that a debt cost rate of 8.15% is attainable by Raccoon Creek. The direct testimonies of Messrs. Cox, Kain, and Thaman describe that debt cost rates that low simply do not exist for small sewer utilities like Raccoon Creek. OPC also ignores a recent Order by the Commission, which approves a 14.00% cost of debt for Raccoon Creek's sister company, Hillcrest.

My overall rate of return of 14.20% provides enough operating income to service the Company's debt and compensate its equity investors.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.