Exhibit No. _____
Issue: Cost of Capital
Witness: Dylan W. D'Ascendis
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Indian Hills
Case No.: SR-2017-0259
Date: October 27, 2017

Missouri Public Service Commission

Rebuttal Testimony

of

Dylan W. D'Ascendis, CRRA, CVA

On Behalf of

Indian Hills Utility Operating Company, Inc.

October 27, 2017

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 Rebuttal Testimony are true to the best of my knowledge, information and belief.

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Subscribed and sworn to before me this 27 day of October, 2017.

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Notary Public

My Commission Expires:

BRIDGET D JUNGBLUT
My Comm. Exp. 01-25-2022
NOTARY PUBLIC
No. 2283356
NEW JERSEY

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I. INTRODUCTION AND PURPOSE

Q. Please state your name and business address.

A. My name is Dylan W. D'Ascendis. My business address is 3000 Atrium Way, Suite 241, Mount Laurel, NJ 08054.

Q. By whom are you employed and in what capacity?

A. I am a Director at ScottMadden, Inc.

Q. Are you the same Dylan W. D'Ascendis that provided direct testimony in this proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to the direct testimony of Mr. Michael P. Gorman, witness for the Missouri Office of Public Counsel ("OPC") concerning the weighted average cost of capital ("WACC") of Indian Hills Utility Operating Company, Inc. ("Indian Hills" or the "Company"). I continue to maintain that my recommended WACC of 14.28% is both reasonable and conservative, given the Company's significant risks compared to other water utilities, and is consistent regarding the relative riskiness of long-term debt versus common equity.

II. RESPONSE TO MICHAEL P. GORMAN

Q. Do you have any general comments regarding Mr. Gorman's cost of capital recommendation in this case?

A. Yes. Mr. Gorman's recommended WACC of 8.045%, derived using a hypothetical capital structure of 50.00% long-term debt at a cost rate of 6.75% and 50.00% common equity at a cost rate of 9.34%, is inadequate for ratemaking purposes. It is inadequate for the following four reasons: 1) Mr. Gorman's recommended WACC does not provide sufficient funds to Indian Hills to pay the interest due on its existing debt; 2) Mr. Gorman's recommended hypothetical capital structure is based on a faulty premise that Indian Hills will be able to obtain traditional utility financing in the near future; 3) Mr. Gorman's recommended long-term debt cost rate does not reflect the reality of Indian Hills' investment options; and 4) Mr. Gorman's recommended ROE ignores the basic financial precept that debt investments are less risky than equity investments.

Q. Please explain how Mr. Gorman's recommended WACC is not sufficient for Indian Hills to pay its debt obligations.

A. Mr. Gorman's recommended WACC is 8.045%.[1] When applied to his assumed rate base of $1,793,334, [2] it results in annual net operating income of $144,273.72.[3] The annual interest payment on Indian Hills' debt is $203,000.00, which is derived by multiplying the face amount of the loan ($1,450,000) by the

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[1] Gorman Direct Testimony, at Schedule MPG-2.

[2] *Ibid.*

[3] This net operating income figure assumes that Indian Hills would be able earn the full return recommended by Mr. Gorman.

interest rate, 14.00%. As one can plainly see the annual net operating income that results from Mr. Gorman's recommended WACC is approximately $60,000 less than the Company's annual debt obligations. This will cause Indian Hills to dip into its already low level of retained earnings to pay the shortfall, eventually becoming unable to meet its debt obligations at all.

Q. Using Mr. Gorman's recommended WACC, how many years would it take for Indian Hills to be in a negative equity position?

A. Given the value of Indian Hills' capital stock of $234,560 from its 2016 Annual Report to the Commission, Indian Hills' equity balance will become negative in four years assuming that Indian Hills actually achieves its authorized ROE, which is not guaranteed.

Q. In general, should an allowed return be sufficient to assure confidence in the financial soundness of the utility?

A. Yes. The return allowed for utilities should be sufficient for them to maintain their credit and attract capital. *Hope* states:

> But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company of whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.[4]

Bluefield states:

> The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under

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[4] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

> efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[5]

Mr. Gorman's recommended WACC clearly does not meet the *Hope* and *Bluefield* guidelines stated above and should be rejected.

Q. Why does Mr. Gorman's recommended WACC not meet the *Hope* and *Bluefield* guidelines?

A. His WACC does not meet those guidelines because his unrealistic hypothetical capital structure and debt cost rate, in combination with his adoption of a recommended ROE from the Missouri Public Service Commission Staff ("Staff"), does not support the financial integrity of the company or raise sufficient money for the proper discharge of the company's duties as a public utility.

A. Capital Structure

Q. What capital structure is Mr. Gorman recommending in this proceeding?

A. Mr. Gorman is recommending a hypothetical capital structure of 50% long-term debt and 50% common equity.

Q. Is Mr. Gorman's recommended hypothetical capital structure appropriate in this proceeding?

A. No. As mentioned above, the hypothetical capital structure recommended by Mr. Gorman is based on the faulty premise that Indian Hills is or could be traditionally financed. As discussed in detail in the direct testimonies of Messrs. Cox and

[5] *Bluefield Water Works Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679 (1922).

Thaman, the operations of Indian Hills cannot be traditionally financed.[6] Also, as noted above, Mr. Gorman's recommended WACC will actually serve to further decrease the equity ratio of Indian Hills, not move it into line with other traditionally financed utility companies.

Q. How has the Commission recently ruled regarding the use of actual capital structures in small utility rate cases?

A. As discussed in my direct testimony, in a Report and Order in Case No. WR-2016-0064, issued on July 12, 2016, this Commission authorized the actual capital structure of Hillcrest Utility Operating Company, Inc.,[7] which consisted of 81.00% long-term debt and 19.00% common equity. The Commission stated:

> The Commission concludes that in calculating Hillcrest's cost of capital and cost of debt, the appropriate capital structure to use is the actual capital structure of Hillcrest as of September 2015, which was 19% equity and 81% debt.

Q. Given the above, is Mr. Gorman's recommendation of a hypothetical capital structure in this proceeding reasonable?

A. No. Mr. Gorman should have used Indian Hills' actual capital structure in its analysis.

Q. Has the level of debt proposed in this case already been approved by the Commission?

A. Yes. The original indebtedness Indian Hills sought was authorized in File No. WO-2016-0045.

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6 Cox Direct Testimony, at 24-28. Thaman Direct Testimony, at 4-5.

7 Hillcrest Utility Operating Company is a sister company to Indian Hills.

B. Cost of Long-Term Debt

Q. Mr. Gorman attempts to introduce an imputed debt cost rate of 6.75% for Indian Hills using recent debt issuances of Dayton Power and Light Company ("DPL"). Are recent debt issuances by DPL germane to this proceeding?

A. No. Since Indian Hills' debt is measurable and current,[8] its cost rate is the correct one to use in this proceeding. DPL's debt issuances are not comparable to Indian Hills' debt issuance because they are not comparable companies. Therefore, their debt cost rates are not comparable. Table 1 provides a simple comparison of DPL and Indian Hills.

Table 1: Comparison between DPL and Indian Hills

Measure	DPL[9]	Indian Hills[10]	Times Smaller
Service Provided	Electric	Water	
Customers	519,000	715	725.87
Service Area	6,000 mi^2	6.5 mi^2	923.08
Assets	$1,935,316,257	$2,225,816	869.49
Revenues	$1,346,554,101	$73,120	18,415.67
2016 Actual Capital Structure	67.73% debt, 32.26% equity	87.46% debt, 12.53% equity	
Debt Issue (Size)	$200,000,000[11]	$1,450,000	137.93
Debt Issue (Coupon Rate)	6.75%[12]	14.00%	

8 Indian Hills' current debt of $1,450,000 at a coupon of 14% was issued in March, 2016

9 Dayton Power and Light Company 2016 FERC Form 1.

10 Indian Hills' 2016 Annual Report filed with the Missouri PSC.

11 From Schedule MPG-3.

12 *Ibid.*

As can be plainly seen in Table 1, DPL is several magnitudes larger, significantly less leveraged, and operates in a different industry than Indian Hills. Therefore, there is no applicability of DPL's marginal cost of debt to Indian Hills' marginal cost of debt. As such, Mr. Gorman's recommended debt cost rate should be dismissed by the Commission.

Q. Do you have any additional observations regarding DPL?

A. Yes. I will note that DPL has a capital structure containing approximately 68% long-term debt. I find it curious that Mr. Gorman would use DPL's debt cost rate, but neglect to also use the capital structure that gave rise to that debt cost rate.

Q. What cost rate for long-term debt is most appropriate for use in a cost of capital determination for Indian Hills?

A. A long-term debt cost rate of 14.00% is reasonable and appropriate as it is the actual cost of the Company's long-term debt outstanding.

Q. Is long-term debt available to Indian Hills at a lower cost rate than 14.00%?

A. No. As mentioned previously and discussed in significant detail in the direct and rebuttal testimonies of Messrs. Cox and Thaman, the operations of small water utilities like Indian Hills cannot attract traditional financing from commercial lenders.

C. <u>Return on Equity</u>

Q. Mr. Gorman accepts Staff's recommended return on common equity of 9.34%. Do you agree with that position?

A. No. As stated in my direct testimony,[13] a common equity cost rate of 9.34% for Indian Hills is inadequate for ratemaking purposes because the recommended ROE ignores the basic financial precept that debt investments are less risky than equity investments. Also, as stated in my direct testimony, the method used by Staff to derive their recommended ROE was the "rule of thumb" method, in which one adds a 3.00% to 4.00% risk premium to the embedded debt cost rate of the subject company. Staff, however, added that risk premium to a recent BB bond yield. While I do not agree with the method, if Staff followed their "rule of thumb" cost of equity model using Indian Hills' actual cost of long-term debt of 14.00%, indicated ROEs of 17.00% and 18.00% would result.[14] Instead of this ad hoc method, I would recommend the Commission to refer to my analysis, which is based on the market data of a proxy group of publicly-traded water utilities, adjusted for Indian Hills' unique risks relative to the proxy group.

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[13] D'Ascendis Direct Testimony, at 3-4.

[14] In this proceeding, Staff applied the 3%-4% equity premium indicated by the "rule of thumb" method to a recent BB bond yield of 5.34% instead of the Company's long-term debt cost rate of 14.00%. What is prescribed in the "rule of thumb" method is to use the target company's long-term debt cost rate. *See*, John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of Equity Investments: Valuation*, Association for Investment Management and Research, 2002, p. 54. I would also note that Staff has agreed to Indian Hills' requested cost of long-term debt in this proceeding.

Q. How does Mr. Gorman's (Staff's) recommended ROE compare with the most recent decision for Missouri-American Water Company ("MAWC") in Case No. WR-2015-0301?

A. Mr. Gorman's (Staff's) recommended ROE of 9.34% is lower than the mid-point of the ROE range cited by the Commission in regard to the Stipulation and Agreement in Case No. WR-2015-0301 involving MAWC of 9.625%.[15] Since MAWC is significantly larger and less leveraged than Indian Hills, their recommendation simply does not make any sense.

Q. Are there any authorized returns for water utilities similar to Indian Hills that the Commission can look to?

A. Yes. In Case No. WR-2016-0064, the Commission awarded Hillcrest Utility Operating Company with a 13.00% ROE, within a range of 12.88% to 14.13. Also, in Case No. SR-2016-0202, the Commission cited a 12.15% ROE in regard to approving a Stipulation and Agreement for Raccoon Creek Utility Operating Company. Both of these utility companies are sister companies of Indian Hills and suffer similar operating and financing risks.

III. <u>CONCLUSIONS AND RECOMMENDATIONS</u>

Q. What are your conclusions regarding the WACC for Indian Hills?

A. I continue to recommend that the Commission allow Indian Hills the opportunity to earn a WACC of 14.28%, based on its actual capital structure as of the end of the test year, which consists of 77.12% long-term debt, at an embedded debt cost rate of 14.00% and 22.88% common equity, at my recommended common

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15 9.625% is the midpoint of the stipulated range of ROEs from 9.50% to 9.75%.

equity cost rate of 15.20%. The capital structure and common equity cost rate reflect Indian Hills' significant investment risk compared to the Utility Proxy Group, due to its necessary, significant investment in the water system after its acquisition on March 31, 2016 to get the system into environmental compliance, and its extremely small size relative to the Utility Proxy Group.

OPC's recommended WACC of 8.045% violates *Hope* and *Bluefield*, as the return is not sufficient for Indian Hills to pay its debt holders, let alone its equity investors. My overall rate of return of 14.28% provides sufficient operating income to service the Company's debt, adequately compensates its equity investors, and is consistent with established financial precepts.

Q. Does that conclude your rebuttal testimony?

A. Yes, it does.