Exhibit No.:	
Issue:	*Cost of Debt*
Witness:	*Peter Chari*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*WR-2020-0275*
Date Testimony Prepared:	*December 2, 2020*

MISSOURI PUBLIC SERVICE COMMISSION

FINANCIAL and BUSINESS ANALYSIS DIVISION

FINANCIAL ANALYSIS DEPARTMENT

SURREBUTTAL TESTIMONY

OF

PETER CHARI

ELM HILLS UTILITY OPERATING COMPANY, INC.

CASE NO. WR-2020-0275

Jefferson City, Missouri
December 2020

TABLE OF CONTENTS OF

SURREBUTTAL TESTIMONY OF

PETER CHARI

ELM HILLS UTILITY OPERATING COMPANY, INC.

CASE NO. WR-2020-0275

SURREBUTTAL TESTIMONY

OF

PETER CHARI

ELM HILLS UTILITY OPERATING COMPANY, INC.

CASE NO. WR-2020-0275

Q. Please state your name.

A. My name is Peter Chari.

Q. Are you the same Peter Chari who prepared the rebuttal testimony and filed the Rate of Return Section of Staff's Cost of Service Report in this proceeding?

A. Yes.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of David Murray. Mr. Murray sponsored Direct and Rebuttal testimonies on behalf of the Office of the Public Counsel ("OPC") for this case. Within this testimony, Staff will address issues related to estimation of reasonable debt cost for Elm Hills for ratemaking purposes in this proceeding.

<u>EXECUTIVE SUMMARY</u>

Q. What disagreements do you have with Mr. Murray?

A. Staff disagrees with Mr. Murray's conclusions regarding Staff's estimated credit ratings and the effect of those rating on Elm Hills' cost of debt.

Specifically, Staff disagrees with Mr. Murray's assertion that Staff's estimation of Elm Hills' credit ratings, and in particular its business ("BRP") and financial ("FRP") risk profiles, is wrong and inconsistent with the approach provided within Staff's "Small Utility

Return on Equity (ROE)/Rate of Return (ROR) Methodology" ("Staff ROE/ROR Guide") (see Schedule PC-s1). The Staff ROE/ROR Guide, which relies on Standard & Poor's (S&P) corporate rating methodology (see Schedule PC-s2), allows Staff to estimate a credit rating based on an assessment of the BRP and FRP for a small water and sewer utility.

BUSINESS RISK PROFILE

Q. Did Staff use the Staff ROE/ROR Guide to estimate Elm Hills' credit ratings?

A. Yes. The methodology outlined in the Staff ROE/ROR Guide allows Staff to estimate debt cost for small water and sewer utilities for which a reasonable debt cost cannot be calculated. In order to estimate the debt cost, Staff must first assess the utility's approximate credit ratings. The Staff ROE/ROR Guide relies on S&P's corporate rating methodology to estimate the credit ratings for these small water and sewer utilities. The credit ratings are estimated by combining the small water and sewer utility's BRP and FRP using the May 27, 2009, S&P ratings matrix as a guide. The Staff ROE/ROR Guide provides for two methods for estimating the BRP. The first method is through the use of S&P Global Credit Ratings guidelines.[1] The second method is through an assessment of a utility's access or potential access to debt capital. If a company proves to Staff that they either cannot obtain a loan, or that the company can obtain a loan but has to pledge personal assets in order to do so, then Staff would classify the company's BRP as "Satisfactory." If the company can obtain a commercial loan without having to pledge personal assets, then Staff would classify the company as having a "Strong" BRP. If a company or its parent can issue debt directly to capital providers, then Staff would classify the company as having an "Excellent" BRP.

[1] Staff used the November 30, 2007 Ratings Direct guide (*U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Ratings Matrix*.

Q. What method did Staff use to estimate Elm Hills' BRP?

A. Staff used the S&P Global Ratings guidelines.

Q. What did Mr. Murray say about Staff's BRP Methodology in his rebuttal?

A. Mr. Murray asserted that Staff incorrectly applied the Staff ROE/ROR Guide methodology in following the S&P Global Ratings guidelines and lowering Elm Hills' BRP to 'satisfactory'.

Q. Is Mr. Murray correct?

A. No. Staff did not incorrectly apply the Staff ROE/ROR Guide methodology. Mr. Murray coauthored the Staff ROE/ROR Guide when he worked for the Missouri Public Service Commission, and correctly pointed out in his rebuttal, that the criteria for assessing BRP within the Staff ROE/ROR Guide is a matter of "incorporating practical and objective characteristics in assigning BRP,", and for that reason may not be entirely consistent with the specific nuances outlined in the S&P methodology [S&P Global Ratings guidelines].[2] Due to this potential inconsistency, Staff is of the view that the appropriate criteria for assessing Elm Hills BRP in this particular case are the S&P Global Ratings guidelines.

Q. Why are the S&P Global Ratings guidelines more appropriate for assigning a BRP rating to Elm Hills than the alternative approach of assessing Elm Hills' ability to access debt capital?

A. The S&P Global Ratings guidelines provide a more objective and reliable assessment of Elm Hills' BRP than assessing the ability of Elm Hills to access debt capital. Elm Hills' ability to access debt capital is in dispute in this case. Such investment information has a bearing on Elm Hills' ability to access debt capital; however, this information is not

[2] David Murray's Rebuttal, pg. 12.

currently available.[3] Therefore, Staff takes the position that it is not appropriate at this moment to use Elm Hills' ability to access debt capital as a criteria for assessment of BRP.

Q. Can you explain how you estimated Elm Hills' BRP?

A. Yes. Staff realizes that determination of BRP is mostly qualitative as opposed to quantitative; therefore, some perspective from S&P Global Ratings is important in its estimation of Elm Hills' BRP. According to the S&P Global Credit Ratings guideline published on November 30, 2007, regulated utilities and holding companies that are utility-focused virtually always fall in the upper range ("Excellent" or "Strong") of BRP.[4] The regulated utilities and holding companies in question (major water utilities rated by S&P Global Ratings) are both vastly bigger in size and have much higher levels of revenue and profitability than Elm Hills. Such differences mean that a reasonable BRP assessment for Elm Hills, by necessity, denotes higher business risk than for the utilities receiving either the "Excellent" or "Strong" ratings. The following chart compares Elm Hills total revenue, net income, level of earnings before interest, tax, depreciation and amortization ("EBITDA") and total assets (000's omitted) to the largest seven major water utilities that are rated by S&P Global Ratings, as of December 2019. The chart also shows the respective BRP and credit ratings for those utilities:

Chart s1. Comparison of Major Water Utilities to Elm Hills

	Total Revenue	Net Income	EBITDA	Assets	Business Risk Profile	Credit Ratings
American Water Works	$ 3,610,000	$ 621,000	$ 1,801,000	$ 22,682,000	Excellent	A
American States Water Company	$ 473,869	$ 84,342	$ 169,311	$ 1,641,331	Excellent	A+
California Water Service Group	$ 714,557	$ 63,116	$ 216,966	$ 3,111,308	Excellent	A
Essential Utilities Inc.	$ 889,692	$ 224,543	$ 517,127	$ 9,361,985	Excellent	A+
Middlesex Water Company	$ 134,598	$ 33,888	$ 55,244	$ 909,878	Excellent	A
SJW Group	$ 420,482	$ 23,403	$ 132,142	$ 68,489	Excellent	A-
The York Water Company	$ 48,437	$ 13,376	$ 28,386	$ 345,140	Excellent	A-
Elm Hills	$ 138	$ (392)	$ (208)	$ 2,281		

[3] OPC continues to seek additional information concerning Elm Hills' and its affiliates' sources of investment; Staff is supportive of those continued efforts.
[4] November 30, 2007 Ratings Direct guide (*U.S. Utilities Ratings Analysis Now Portrayed In The S&P Corporate Ratings Matrix.*

Elm Hills' total assets of about $2.2 million are a far cry from the smallest water utility shown on the chart, SJW Group, which has about $68.4 million in assets. The largest of the water utilities, American Water Works, has about $22.6 billion in assets. In terms of revenues, Elm Hills had about $138,000 in 2019 compared to an average of $898.8 million for the seven water utilities rated by S&P Global Ratings shown above. In terms of profitability, Elm Hills' net income and EBITDA were negative not only in 2019, but in all the years since 2017, when Elm Hills first started operation as a subsidiary of CSWR. Elm Hills had a negative $392,000 net income and a negative $208,000 EBITDA for the year 2019. The average net income for the top seven water utilities was about $152 million in 2019. The largest water utility, American Water Works, had a net income of about $621 million in 2019. The top seven water utilities' average EBITDA was $417.2 million in 2019. American Water Works, the largest water utility, had an EBITDA of about $1.8 billion. With a BRP of "Excellent" and credit ratings ranging from A- to A+ for the seven water utilities, it is reasonable to assign Elm Hills a BRP of "Satisfactory" and a credit rating of "B+," given its much poorer financial results and much smaller size. Given the differences between Elm Hills and the much larger and more profitable water utilities listed above, Mr. Murray's position that a "Strong" BRP rating should be assumed for Elm Hills is unreasonable.

Q. Why is Mr. Murray's assessment on page 12 of his rebuttal testimony that Elm Hills should be assumed to have a "Strong" BRP rating inappropriate?

A. Mr. Murray is incorrect in his assessment that Elm Hills should be assumed to have a "Strong" BRP rating because he incorrectly assumes that Staff's assessment of BRP is only qualitative.[5] Staff understands that although BRP assessment is largely qualitative,

[5] David Murray's Rebuttal, pg. 12, lines 6 to 10

"the analytic factors within the business risk profile generally are a blend of qualitative assessments and quantitative information."[6] According to the S&P Global Ratings Corporate Methodology released on November 19, 2013, "Quantitative information includes, for example, historical cyclicality of revenues and profits that we review when assessing industry risk. It can also include the volatility and level of profitability we consider in order to assess a company's competitive position."[7] Upon analysis of Elm Hills' current level of profitability, which is very poor as Staff explained above, it is unreasonable for Mr. Murray to insist that only qualitative factors matter in the assessment of BRP.

FINANCIAL RISK PROFILE

Q. How did Staff estimate Elm Hills' FRP?

A. Staff assigned a FRP of "Highly Leveraged" to Elm Hills based on the capital structure that shows that Elm Hills has a current debt-to-capital ratio of 94%. The debts that appear on Elm Hills books are from Fresh Start Ventures. According to the S&P Global Credit Ratings guideline published on November 30, 2007, a utility with more than 50% debt-to-capital ratio is considered to have a BRP of "Highly Leveraged." The May 27, 2009, S&P Global Credit Ratings guide, on which the Staff ROE/ROR Guide is based, sets the debt-to-capital ratio threshold at 60% or more for a utility to be considered "Highly Leveraged."

Q. Given Mr. Murray's statement, on page 14, that Staff should not have viewed Fresh Start financing as leverage in Elm hills' capital structure, why did Staff assume that Fresh Start Ventures financings should be classified as 'debt'?

[6] S&P Global Ratings Corporate Methodology released on November 19, 2013.
[7] Ibid.

A. Staff agrees with Mr. Murray that the Fresh Start Ventures 'debt' should not be regarded as legitimate for purposes of setting Elm Hills' rates. The use of the 94% debt ratio capital structure for assessment of Elm Hills' financial risk profile is unreasonable; this determination is consistent with the Commission's Order in Case No. WR-2017-0259 that found the specific debt rates included within the capital structure to be "not just and unreasonable."[8] In that proceeding, the Commission set a 50% debt ratio capital structure as being just and reasonable. Consequently, Staff changed its capital structure from the actual 94% debt ratio to an assumed 50% debt ratio for the purpose of assessing Elm Hills' FRP in this proceeding.

Q. Does the change to a hypothetical 50% debt capital structure mean that Staff's assessment of a "Highly Leveraged" FRP for Elm Hills is incorrect?

A. No. Because Elm Hills' actual financial results since its formation show that a "Highly Leveraged" FRP rating for Elm Hills was appropriate. Staff's original conclusion remains the same regardless of the assumed capital structure.

S&P Global Ratings occasionally issues guides on how to estimate credit ratings. On November 30, 2007, Global Ratings issued a guide on estimating FRP based on the following three ratios: Funds from Operation to Debt (FFO/Debt), Funds from Operation to Interest (FFO/Interest) and Debt ratio. A utility considered "Highly Leveraged" would have the following ratios: FFO/Debt (below 15), FFO/Interest (below 2.5) and Debt ratio (above 50%). A utility considered "Aggressive" would have the following credit metrics: FFO/Debt (10-30), FFO/Interest (2.0 - 3.5) and Debt ratio (45 – 60). On May 27, 2009, Global Ratings issued

[8] In Case No. WR-2017-0259, the Commission ruled, "Indian Hills' cost of debt is the direct result of dealings among entities closely inter-related with Indians Hills through chains of common ownership on both sides of the transaction".

another guide[9] with the following benchmarks for a company considered “Highly Leveraged”: FFO/Debt (below 12), Debt/EBITDA (greater than 5) and Debt/Capital (greater than 60%). For a company considered “Aggressive,” its credit metrics would be FFO/Debt (12 – 20), Debt/EBITDA (4 – 5) and Debt ratio (50% – 60%).

As Staff’s analysis explained in its rebuttal testimony showed, Elm Hills’ financial records show that it had negative EBITDA and negative FFO in each year since 2017. Such poor financials translate into credit metrics that clearly fit a utility that is “Highly Leveraged” by the standards of either S&P guide (November 30, 2007, or May 27, 2009). For the years 2017 to 2019, Elm Hills’ FFO/Debt averaged negative (-23), and FFO/Interest averaged negative (-12.41). For all the years, the Debt/EBITDA measurement for Elm Hills was meaningless due to the existence of the negative EBITDA.

Whether one considers the 94% debt ratio capital structure or the 50% debt ratio hypothetical capital structure for Elm Hills, the conclusion is the same: Elm Hills’ financial risk profile should be considered “Highly Leveraged.” At best, Elm Hills’ FRP lies somewhere between “Highly Leveraged” and “Aggressive,” not the “Minimal” level as Mr. Murray claims in his rebuttal testimony.

CONCLUSION

Q. Please summarize Staff’s current position on Elm Hills’ business risk and financial risk profiles.

A. Elm Hills’ business risk profile should be assessed as “Satisfactory,” as Staff’s analysis showed in this testimony and its previous testimonies (Direct and Rebuttal

[9] To Staff’s knowledge, the 2007 and 2009 S&P publications remain the most current and relevant guides for assessment of financial risk for utilities.

Testimonies). Likewise, Elm Hills' financial risk profile should be assessed as "Highly Leveraged." Both of these assessments support Staff's recommendations concerning Elm Hills' cost of debt allowance for this proceeding. Mr. Murray's contrary positions concerning Elm Hills' debt costs should be disregarded as unreasonable.

Q. Does this conclude your surrebuttal testimony?

A. Yes.