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Issue(s):	*Cost of Debt*
	Return on Equity
Witness:	*Peter Chair*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Rebuttal Testimony*
Case No.:	*WR-2020-0275*
Date Testimony Prepared:	*November 10, 2020*

MISSOURI PUBLIC SERVICE COMMISSION

FINANCIAL and BUSINESS ANALYSIS DIVISION

FINANCIAL ANALYSIS DEPARTMENT

REBUTTAL TESTIMONY

OF

PETER CHARI

ELM HILLS UTILITY OPERATING COMPANY, INC.

CASE NO. WR-2020-0275

Jefferson City, Missouri
November 2020

****** Denotes Confidential Information ******

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REBUTTAL TESTIMONY

OF

PETER CHAIR

ELM HILLS UTILITY OPERATING COMPANY, INC.

CASE NO. WR-2020-0275

Q. Please state your name.

A. My name is Peter Chari.

Q. What is your education and experience?

A. I hold Bachelor of Arts (Economics and Finance) and Masters of Business Administration (Finance) degrees from North Central in Naperville, Illinois. I recently sponsored a rate of return recommendation for Staff in Case No. ER-2019-0374. For more on my experience and a list of cases I have sponsored, please see attached Schedule PC-r1.

Q. Are you the same Peter Chari who prepared the Rate of Return Section of Staff's Cost of Service Report 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 testimonies of David Murray and Martin W. Moore. Mr. Murray sponsored rate of return ("ROR") testimony on behalf of the Office of the Public Counsel ("OPC"). Mr. Moore sponsored testimony on debt cost on behalf of Elm Hills Utility Operating Company, Inc. ("Elm Hills"). Within this testimony, Staff will address issues related to a reasonable debt cost, as well as a fair and reasonable ROR for Elm Hills, for ratemaking purposes in this proceeding.

EXECUTIVE SUMMARY

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

A. Staff disagrees with Mr. Murray's recommendations for the cost of debt, the authorized return on equity ("ROE") and, consequently, the overall ROR for Elm Hills.

In particular, Staff disagrees with how Mr. Murray estimated his cost of debt using a proxy method. Staff finds that the utility chosen by Mr. Murray as a proxy for Elm Hills' cost of debt estimation is not truly comparable with Elm Hills.

For Elm Hills, Mr. Murray recommended the same ROE authorized by the Commission in a recent rate case for The Empire District Electric Company ("Empire"). This is not appropriate as, again, Empire is in no way a comparable company to Elm Hills.

Q. What disagreement do you have with Mr. Moore?

A. Staff disagrees with Mr. Moore's presentation of prospective bank loans as reasonable proxies for appropriate debt cost for Elm Hills.

COST OF DEBT

Q. What cost of debt did you recommend for Elm Hills in this proceeding?

A. Staff recommended a 7.51% cost of debt be used in the calculation of Elm Hills' ROR.

Q. What cost of debt did Mr. Murray recommend?

A. Mr. Murray recommended that a 4.46% cost of debt be used in the calculation of Elm Hills' ROR.

Q. How did Staff determine Elm Hills' cost of debt?

A. Staff estimated Elm Hills' cost of debt using the *S&P's Criteria Methodology: Business Risk/Financial Risk Matrix* as a guide to estimate the cost of debt ("S&P Credit Matrix").[1] The S&P Credit Matrix allowed Staff to estimate Elm Hills' business and financial

[1] Standard & Poor's Financial Services LLC, Published in May 27, 2009.

risk and match it to a credit rating as indicated by the matrix. After performing its analysis, Staff concluded that Elm Hill has business and financial risk profiles of ‘Satisfactory’ and ‘Highly Leveraged,’ which correspond to a credit rating of ‘B+.’ The ‘B+’ credit rating corresponds to a debt cost of 7.51%, as of May 1, 2020, according to the S&P analysis.

Q. How did Mr. Murray determine Elm Hill’s recommended cost of debt?

A. Mr. Murray estimated Elm Hills’ cost of debt using a proxy method. The proxy method estimates cost of capital for one company based on the cost of capital of another company or group of companies that share comparable business and financial characteristics. The business and financial characteristics considered within a proxy analysis include industry, geographical location, and profitability, just to name a few. Mr. Murray based his recommendation on two loans issued to Terre Du Lac Utilities Corporation (“TDL”) by commercial banks in 2016 and 2017. TDL is a Missouri-based small water and wastewater company.

Q. Is use of a proxy method an acceptable method for determining a utility’s cost of debt?

A. Yes, under the right conditions. It is acceptable to use the proxy method only if the company or companies used as a proxy are reasonably comparable to the utility in question.

Q. Is TDL a comparable company to Elm Hills?

A. No. Mr. Murray argues that because several years ago TDL was able to access bank loans at an average cost of 4.62%, despite facing some of the same financial problems as Elm Hills, Elm Hills should be able to access similar bank loans at similar debt cost. Mr. Murray argues that Elm Hills and TDL are ‘similarly situated,’ and were both subject to the same 'Department of Natural Resources ("DNR") Violations and Notices.'[2] However, Mr. Murray does not present a complete set of facts regarding TDL and Elm Hills. Upon closer examination, Staff determined that TDL and Elm Hills differ significantly in their past and present profitability, and subsequently, credit risk. The differences in profitability and credit risk could have played a major role in the approval or disapproval of bank loans.

Q. Explain how TDL's and Elm Hills' profitability is different and how that affects their cost of debt.

A. To understand the profitability of TDL and Elm Hills, Staff analyzed each company's level of earnings before interest, tax, depreciation and amortization ("EBITDA"). EBITDA is a key profitability metric that indicates whether a company is generating enough revenue to pay its interest on debt, among other important obligations. Elm Hills' financial statements indicate that it generated negative EBITDA (ranging from negative $377,695 to negative $207,551) in all the years from 2017 to 2019.[3] Not only did Elm Hills generate negative EBITDA, its funds from operations ("FFO") results for that period were negative. FFO is also an important profitability measure. On the other hand, TDL not only generated positive EBITDA ($61,277.00 to $159,698.00) in all the years from 2015 to 2019, it generated positive FFO in all those years.

Rating agencies use credit metrics to assess a company's credit worthiness. Important credit metrics include Debt to EBITDA, FFO- to-Interest and FFO-to-Debt. TDL's credit metrics show that Debt/EBITDA averaged 7.41; FFO-to-Interest averaged 10.08; and FFO-to-Debt averaged 10.24% in the years 2015 through 2019. In contrast, Elm Hills' profitability was so poor over this period that calculating meaningful or comparable credit

[2] David Murray's Direct Testimony, pages 3 and 4.
[3] Elm Hills started operations in 2017.

metrics was effectively impossible. The profitability and credit worthiness of the two companies could not be more different. In other words, because of present and past lack of profitability, Elm Hills' credit risk is much higher than TDL's risk. It is hard to believe that any prudent loan officer or creditor would look at the two companies' financials and arrive at the same terms regarding issuance of debt. For these reasons, Staff's position is that TDL's debt cost is not a good proxy for Elm Hills' cost of debt.

Q. Mr. Murray argues that Elm Hills' sister companies' current financial strength is sufficient to support use of a debt cost below 5.0% for Elm Hills. Do you agree?

A. I do not agree. Elm Hills' sister companies' financial records are important in assessing Elm Hills' profitability potential. Staff agrees that Elm Hills may be expected to achieve greater levels of profitability and financial health in the future, and thus could attain similar financial strength to that claimed by Mr. Murray for CSWR, LLC sister companies. However, a company's potential to be profitable is not the only consideration in assessing credit worthiness. Mr. Murray's analysis gives the impression that Elm Hills' profitability potential is the be-all and end-all. Credit rating agencies, when assessing a company's credit worthiness, consider historical financial records as well as a company's business prospects. It is Staff's position that Elm Hills' sister companies' financial strength is not enough to support a debt cost below 5.0% for Elm Hills.

Q. Is use of estimated values the usual way of determining cost of debt to be used for calculation of ROR?

A. No. Usually, the cost of debt used in recommended allowed ROR is based on actual embedded costs calculated from contractual costs charged to the utility by third part debt investors. In situations where the actual cost of debt is unreasonable and or deemed not a result of 'arms-length' transaction, the cost of debt must be estimated.[4]

Q. Does Staff agree that the actual cost of debt presented by Elm Hills is unreasonable and/or not a result of 'arm's-length' transaction?

A. Yes. Staff deemed the current 14% debt cost, indicated by Elm Hills' financial records, as being unreasonable and excessive. The Commission, in Case No. WR-2017-0259 involving an affiliated utility of Elm Hills,[5] decided that the debt that resulted in the 14% debt cost was not a just and reasonable cost of debt.

Q. Can you explain how the debt that resulted in the 14% debt cost is not just and reasonable?

A. Yes. In Case No. WR-2017-0259, evidence was presented that showed that there was common ownership and control among entities involved in the debt that resulted in the 14% debt cost. In its order 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."[6] Fresh Start Ventures, the entity that loaned money to Elm Hills at 14%, is the same entity that loaned money to Indian Hills. Elm Hills and Indian Hills are sister companies. By the virtue of being a sister company to Indian Hills, Elm Hills' debt transaction with Fresh Start Ventures, its creditor, was not 'at arms-length.'

Q. Can you explain your disagreement with Mr. Moore regarding cost of debt?

[4] An arm's length transaction refers to a business deal in which buyers and sellers act independently without one party having partial or total control over the other.
[5] *In the Matter of the Rate Increase Request of Indian Hills Utility Operating Company, Inc.*
[6] Report and Order, Case No. WR-2017-0259, page 50.

A. Staff disagrees with Mr. Moore's insinuation that the ** ______________ ** represents a reasonable debt cost for Elm Hills. As stated in one of the letter's disclaimer, ** ______________ **[7] Staff's position is that these letters represent nothing but preliminary loan application assessment and so do not offer a reliable basis for Elm Hills' cost of debt estimation and assessment for purposes of setting rates.

<u>RETURN ON EQUITY</u>

Q. What ROE did you recommend in this proceeding?

A. Staff recommended a point value for ROE of 11.51%, but adds that it can support any ROE value in the range of 11.5% and 12.0% as agreed to in the Non-Unanimous Stipulation and Agreement between Staff and Elm Hills.

Q. What ROE did Mr. Murray recommend?

A. Mr. Murray recommended a ROE of 9.25%.[8]

Q. How did you estimate your ROE?

A. Staff simply added a risk premium of 4.0% to the estimated debt cost of 7.51%, as prescribed by the bond yield plus risk premium method ("Risk Premium").[9] The Risk Premium method is premised on the generally accepted notion that cost of equity is higher than

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[7] Moore's Testimony, Schedule mwm-2c.
[8] David Murray's Rebuttal, page 2.
[9] Analysis of Equity Investments: Valuation (2002) by John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey (Used as part of the curriculum in the Chartered Financial Analyst Program).

debt cost; therefore, cost of equity equals a company's own bond yield plus a risk premium. The standard risk premium ranges from 3% to 4%, with riskiest companies assigned a premium of 4%.[10] This estimation procedure is presented in Schedule PC-r2 attached to this testimony.

Q. How did Mr. Murray estimate his ROE?

A. Mr. Murray estimated his ROE of 9.25% based on the Commission's recent decision for Empire in Case No. ER-2019-0374. Mr. Murray reasoned that since he estimated Elm Hills' credit profile to be consistent with 'BBB' rating, the same credit profile currently assigned to Empire, the same ROE of 9.25% authorized for Empire would be reasonable for Elm Hills as well.

Q. Do you agree that Elm Hills' and Empire's credit ratings and, therefore, authorized ROE, are the same?

A. No. As Staff earlier explained in the debt cost section of this testimony, Elm Hills' business and financial risk profiles are not consistent with a 'BBB' rating as Mr. Murray claims. Elm Hills' business and financial risk profiles, as explained in Staff's direct testimony, are 'Satisfactory' and 'Highly Leveraged,' respectively, and consistent with 'B+' rating. Empire's business and financial risk profiles, as determined by S&P Credit Ratings, are consistent with 'BBB' rating. Furthermore, as Mr. Murray admitted in his Direct Testimony, Elm Hills is a much smaller utility than Empire, making the two entities even more incomparable.[11] Assuming there is a direct correlation between credit ratings and ROE, as Mr. Murray implies, a 'BBB' credit rating for Empire and 'B+' credit rating for Elm Hills means that Elm Hills' ROE should be higher than Empire's. A reasonable ROE for Elm Hills,

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[10] Ibid.

[11] David Murray's Direct Testimony, page 20.

based on an estimated credit rating of 'B+,' is 11.51% or any ROE in the reasonable range of 11.5% to 12.0% as agreed to in the Non-Unanimous Stipulation and Agreement, not 9.25%.

Q. Is there anything else you want to add regarding the rate of return issues in this proceeding?

A. Yes. Staff acknowledges and fully supports the effort by OPC to obtain certain Elm Hills' holding company investment information. Staff believes that review of such information could be important in determining the fair and reasonable cost of debt for use in setting the ROR for Elm Hills. Staff welcomes the Commission's order on October 28, 2020, for Elm Hills' affiliates to produce such information. Staff would like to highlight that its recommendations in this proceeding are subject to change based on new information discovered in the requested documents.

CONCLUSION

Q. Please summarize Staff's current position on ROE and cost of debt for Elm Hills.

A. Staff recommends the Commission use a debt cost in the range of 7.5% to 8.0%, and ROE in the range of 11.5% to 12.0%, as agreed to by Elm Hills and Staff in the Non-Unanimous Stipulation and Agreement, to set Elm Hills ROR. The contrary positions on these issues taken by OPC and Elm Hills in this proceeding should be disregarded as being unreasonable and unsupported.

Q. Does this conclude your Rebuttal testimony?

A. Yes it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Elm Hills Utility Operating Company, Inc.'s Request for a Water and Sewer Rate Increase	))))	Case No. WR-2020-0275

AFFIDAVIT OF PETER CHARI

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

COME NOW PETER CHARI and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing *Rebuttal Testimony of Peter Chari*; and that the same is true and correct according to his best knowledge and belief, under penalty of perjury.

Further the Affiants sayeth not.

/s/Peter Chari

PETER CHARI

CREDENTIALS AND CASE PARTICIPATION

PETER CHARI

POSITION:

Senior Utility Regulatory Auditor, Financial Analysis

EDUCATION:

B.A. Economics and Finance, North Central College

MBA Finance, North Central College

Certified Rate of Return Analyst (CRRA)

EXPERIENCE:

I started working at the Commission on June 25, 2018 as a Utilities Regulatory Auditor, Financial Analysis. Before coming to the Commission I worked as in waste disposal and healthcare.

My job duties include providing testimony for Rate Cases, Certificate of Convenience Cases, Finance Cases, Merger Cases and Nuclear Decommissioning Cases. I promoted to Utilities Regulatory Auditor III on June 25, 2019. My job title changed to Senior Utility Regulatory Auditor on July 1, 2020.

I provided recommendations for the following cases:

EF-2019-0215

WF-2019-0206

SA-2019-0161

WR-2019-0158

GA-2020-0105

ER-2019-0374

EF-2021-0011

GF-2020-0334

Elm Hills Utility Operating Company, Inc.
Case Nos. WR-2020-0275 and WA-2020-0274
Weighted Cost of Capital
as of May 20, 2020

Moody's BBB Utility Bond Yields[1]	
March-20	3.59%
April-20	3.31%
May-20	3.22%

		Lower Bound		Upper Bound
	BBB Utility Bond Avg		3.37%	
	B+ - BBB Corporate Bond Spread		4.14%	
	Implied B+ Utility Bond Yield		7.51%	
	Risk Premium		4.00%	
	Range of Cost of Equity	11.01%		12.01%
"Satifactory" Business Risk Profile (BRP)	Cost of Equity		11.51%	
"Highly Leveraged" Financial Risk Profile (FRP)				
B+ rating				

Notes:
Satisfactory' BRP because Elm Hills provided evidence that it could not access bank loan without pledging personal assets.
Highly Leveraged FRP because the Company's debt ratio is more than 100% (with negative equity ratio).

1 Mergent Bond Record, June 2020