BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Confluence Rivers Utility Operating Company, Inc.'s Request for Authority to Implement a General Rate Increase for Water Service and Sewer Service Provided in Missouri Service Areas	)))))	**Case No. WR-2023-0006**

STAFF'S INITIAL BRIEF

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STAFF'S INITIAL BRIEF

COMES NOW the Staff of the Missouri Public Service Commission, by and through counsel, and tenders this *Initial Brief,* in satisfaction of the Commission's *Order Granting Motion to Amend Procedural Schedule,* issued herein on April 25, 2023:

Introduction:

Your duty in a general rate case is to set just and reasonable prospective rates after consideration of all relevant factors.[1] "Just and reasonable" means fair to the ratepayers and fair to the shareholders.[2] Just and reasonable rates have been characterized as not

[1] "The Commission is vested with the state's police power to set 'just and reasonable' rates for public utility services, subject to judicial review of the question of reasonableness." ***St. ex rel. City of Harrisonville v. Pub. Serv. Comm'n of Missouri,*** 291 Mo. 432, 236 S.W. 852 (1922); ***City of Fulton v. Pub. Serv. Comm'n,*** 275 Mo. 67, 204 S.W. 386 (1918), *error dis'd,* 251 U.S. 546, 40 S.Ct. 342, 64 L.Ed. 408; ***City of St. Louis v. Pub. Serv. Comm'n of Missouri,*** 276 Mo. 509, 207 S.W. 799 (1919); ***Kansas City v. Pub. Serv. Comm'n of Missouri,*** 276 Mo. 539, 210 S.W. 381 (1919), *error dis'd,* 250 U.S. 652, 40 S.Ct. 54, 63 L.Ed. 1190; ***Lightfoot v. City of Springfield,*** 361 Mo. 659, 236 S.W.2d 348 (1951).

[2] Section 393.130, RSMo 2000, in pertinent part, requires a utility's charges to be "just and reasonable" and not in excess of charges allowed by law or by order of the commission. Section 393.140, RSMo 2000, authorizes the Commission to determine "just and reasonable" rates. A "just and reasonable" rate is one that is fair to both the utility and its customers; ***St. ex rel. Valley Sewage Co. v. Pub. Serv. Comm'n,*** 515 S.W.2d 845 (Mo. App., K.C.D. 1974), it is no more than is sufficient to "keep public utility plants in proper repair for effective public service, [and] . . . to insure to the investors a reasonable return upon funds invested." ***St. ex rel. Washington University et al. v. Pub. Serv. Comm'n,*** 308 Mo. 328, 344-45, 272 S.W. 971, 973 (banc 1925). It is the "lowest possible reasonable rate consistent with the maintenance of adequate service in the public interest." ***In re Permian Basin Area Rate Cases,*** 390 U.S. 747, 793, 88 S. Ct. 1344, 1373, 20 L. Ed. 2d 312 (1968).

one penny more than is required to cover the cost of service and offer a reasonable opportunity for the shareholders to earn a fair return on their investment.[3] The Company has the burden of proof.[4]

There are two halves to a rate case: the first is the determination of the revenue requirement, which is the total amount of additional rate revenue that the Company needs on an annual basis;[5] the second is rate design, which is the creation of rates that will collect the necessary additional revenue from the Company's ratepayers. With respect to the revenue requirement:

> The determination of utility rates focuses on four factors. These factors include: (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses. The revenue allowed a utility is the total of approved operating expenses plus a reasonable rate of return on the rate base. The rate of return is calculated by applying a rate of return to the cost of property less depreciation. The utility property upon which a rate of return can be earned must be utilized to provide service to its customers. That is, it must be used and useful. This used and useful concept provides a well-defined standard for determining what properties of a utility can be included in its rate base.[6]

When a company files a general rate request, Staff embarks on an audit that

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[3] "What the company is entitled to ask is a fair return upon the value of that which it employs for the public convenience. On the other hand, what the public is entitled to demand, is that no more be exacted from it . . . than the services rendered by it are reasonably worth." ***State ex rel. Missouri Water Co. v. Public Service Commission,*** 308 S.W.2d 704, 714 (Mo.1957), *quoting* ***Smyth v. Ames,*** 169 U.S. 466, 546-7, 18 S.Ct. 48, ___, 42 L.Ed. 819, ___ (1898).

[4] Section 393.150.2, RSMo.

[5] "The revenue requirement in the context of ratesetting is the amount of revenue ratepayers must generate to pay the costs of producing the water received by such ratepayers while yielding a reasonable rate of return to investors." ***State ex rel. Capital City Water Co. v. Missouri Pub. Serv. Comm'n***, 850 S.W.2d 903, 907 (Mo.App. W.D. 1993). The term "revenue requirement" may refer to either the amount of additional revenue sought by a Company or the total revenue required on an annual basis.

[6] ***State ex rel. Union Electric Co. v. Public Service Commission,*** 765 S.W.2d 618, 622 (Mo. App., W.D. 1988).

generally last about four months. The purpose of the audit is to determine whether the transactional evidence supports the Company's rate request. Staff evaluates each test year transaction to determine whether it actually occurred; whether it was correctly booked under the Uniform System of Accounts; and whether each transaction was truly a Missouri transaction, an important consideration with a company like Confluence, that operates in multiple states. Staff also asks whether each transaction was reasonable, necessary, prudent, and beneficial to ratepayers such that it is equitable for them to pay for it. "Reasonable" means the price paid was equivalent to the value received given prevailing conditions. "Necessary" asks whether the expense was required in order to provide utility service. "Prudent" asks whether the expenditure was sensible in the circumstances, given what the Company management knew or should have known. "Beneficial to ratepayers" means exactly that – who got the benefit of the expenditure?

Sometimes an audit takes more than four months; that was the case here. Staff's audit takes longer when a company's accounts are in disarray, when requested explanations and corrections are not forthcoming, when responses to data requests are incomplete, and when the company has not complied with the Uniform System of Accounts. The first issue you heard, Recommended Reports, reflected Staff's determination to improve this Company's accounting practices and audit responsiveness.[7]

A rate case is not only about money. It is also about how the company operates. Does it employ good business practices? Are its facilities in good repair? Is it responsive

[7] This issue has been settled via a non-unanimous stipulation and agreement.

to its customers? Is the water safe and the service adequate? You heard from customers at the Local Public Hearings, and from Staff witnesses at the evidentiary hearing, that this Company has some operational issues. Most of those issues were settled upon the Company's agreement to change its ways and improve its practices. Time will tell.

In deciding these issues, the Commission should be mindful that the Company is a private, profit-seeking enterprise, and its management is accountable to its owners for keeping expenses down and returns high. Staff's guiding principle in this case is that the Company should recover every dollar whose expenditure was necessary, reasonable, prudent, and beneficial to ratepayers, plus an allowance for a reasonable return, but no more than that.

Kevin A. Thompson

Argument:

With respect to the several issues submitted to the Commission for resolution, Staff states:

1. Income Taxes:

With respect to income tax—

a. How should income tax expense be set for purposes of establishing the revenue requirements?

b. If the Commission allows Confluence to recover income tax expense in an amount greater than what would be remitted to the IRS in a given tax year, should the excess income tax expense be booked to a deferred liability account that will offset rate base?

Introduction:

The Company seeks to recover in rates, with respect to Income Tax expense, an amount that is more than it will ever actually pay to the IRS or the Missouri Department of Revenue ("DOR"). The Company attempts to justify its position by characterizing it as an "incentive" rewarding it for its business plan of purchasing and rehabilitating derelict water and sewer systems, particularly as a return to it of the excess operational costs incurred between the purchase and the effective date of new rates resulting from this case. Staff responds that the Commission may not grant the Company's request because it is frankly illegal as retroactive ratemaking as well as being unjust and unreasonable. Should the Commission desire to provide an incentive to the Company, and Staff urges it not to do so, there are lawful mechanisms available.

The Company's Tax Situation:

Because of the excess operating expenses referred to above, the Company has operated at a loss and has therefore accumulated Net Operating Losses ("NOLs") that will shield it from taxes whenever its operations begin to produce a positive net income stream. It does not owe any taxes for the years it has operated at a loss and those losses, carried forward, mean it will not actually pay income taxes to the taxing authorities for some years to come. Nonetheless, the Company asks the Commission to include Income Tax expense in its rates as though the NOLs do not exist. This money would simply belong to the Company, to do with whatever it chooses. It would never be paid to the taxing authorities nor returned to the ratepayers.

Income tax expense should be set for purposes of establishing the revenue requirements as follows: first, multiply taxable income by the composite tax rate (the current federal tax rate of 21% and the state tax rate of 4% are added to produce the composite rate of 23.83%) to determine the actual amount of taxes to be paid absent the existing NOLs; then, compare the amount of NOLs available for each utility holding company to determine if each one of the holding companies would be required to pay any income taxes in the first year after the rates from this case become effective. If there are enough NOLs to offset the taxable income, there is no income tax liability. The Commission should therefore include approximately $31,465 for income taxes in the cost of service.[8]

NOLs are not tax timing differences that will be reversed over a set time. Thus for ratemaking purposes, they do not need to be normalized and can be used to offset income tax expense. NOLs never expire. They may be retained until used.[9]

Retroactive Ratemaking:

As noted above, the Commission *cannot* grant the Company's request because it is illegal as retroactive ratemaking. It is well-established that the Public Service Commission may not engage in "retroactive ratemaking."[10] "Retroactive ratemaking is defined as 'the setting of rates which permit a utility to recover past losses or which require it to refund past excess profits collected under a rate that did not perfectly match expenses

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[8] Ex. 101, Bolin Direct, p. 6, ll. 9-15; Ex. 123, Bolin Surrebuttal, p. 1, ll. 19-20, p. 2, ll. 15-18.

[9] *Id.*

[10] ***Office of the Public Counsel v. Evergy Missouri West, Inc.,*** 609 S.W.3d 857, 872 (Mo. App., W.D. 2020).

plus rate-of-return with the rate actually established.'"[11] The Missouri Supreme Court stated:

> The [PSC] has the authority to determine the rate [t]o be charged. In so determining it may consider past excess recovery insofar as this is relevant to its determination of what rate is necessary to provide a just and reasonable return in the future, and so avoid further excess recovery. It may not, however, redetermine rates already established and paid without depriving the utility (or the consumer if the rates were originally too low) of his property without due process.... The utilities take the risk that rates filed by them will be inadequate, or excessive, each time they seek rate approval. To permit them to collect additional amounts simply because they had additional past expenses not covered by either clause is retroactive rate making . . . . **Past expenses are used as a basis for determining what rate is reasonable to be charged in the future in order to avoid further excess profits or future losses, but under the prospective language of the statutes, they cannot be used to set future rates to recover for past losses due to imperfect matching of rates with expenses.**[12]

The recovery of past losses is precisely the justification used by the Company with respect to its requested treatment of Income Tax expense. Consequently, it is frankly illegal and the Commission cannot do it. As the Western District has explained, the Company could have attempted to preserve those losses for later rate recovery by seeking an Accounting Authority Order ("AAO"), but it did not.[13] Therefore, they are lost forever.

Just and Reasonable Rates:

The Company's proposed treatment of Income Tax expense is also illegal because it is neither just nor reasonable. A utility's charges must be "just and reasonable" and not

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[11] ***State ex rel. Noranda Aluminum, Inc. v. Public Service Commission,*** 356 S.W.3d 293, 316–17 (Mo. App., S.D. 2011) (*quoting* ***State ex rel. AG Processing, Inc. v. Public Service Commission,*** 311 S.W.3d 361, 365 (Mo. App., W.D. 2010) (internal quotation omitted)); *see also* ***State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Service Commission*** **(*"UCCM"*),** 585 S.W.2d 41, 58-59 (Mo. banc 1979).

[12] ***UCCM,*** *supra,* at 58-9 (emphasis added).

[13] ***Office of the Public Counsel v. Evergy Missouri West, Inc.,*** *supra.*

in excess of the amount allowed by law or by order of the commission.[14] The Commission is required to determine "just and reasonable" rates.[15] A “just and reasonable” rate is one that is fair to both the utility and its customers.[16] Using the tests described above in the *Introduction* that Staff employs to determine whether or not an expense may be recovered in rates, excess Income Tax expense is clearly unreasonable, since it exceeds the Company’s actual liability; it is unnecessary, since it is in excess of the amount required to cover the actual cost of service; and it is not beneficial to the ratepayers, since they receive nothing in exchange for it. Its inclusion in rates, consequently, is not lawful.

Incentives:

The Company has argued that the inclusion of excess Income Tax expense in its rates is justifiable as an incentive for its practice of buying and rehabilitating dilapidated water and sewer systems. Assuming that an incentive is appropriate, the Company’s proposal is not a permissible way to provide it.

As Staff Counsel suggested at the hearing, an incentive may be awarded via an upward adjustment to the Return on Equity (“ROE”).[17] Missouri appellate decisions clarify, for example, that the Commission may consider service quality in setting the authorized return on equity and may award a higher return for superior service.[18] In the same way,

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[14] Section 393.130, RSMo.

[15] Section 393.140, RSMo.

[16] ***State. ex rel. Valley Sewage Co. v. Public Service Commission,*** 515 S.W.2d 845 (Mo. App., K.C.D. 1974).

[17] Such an adjustment should not exceed the high end of Mr. Walters’ reasonable range of 9.2-9.8. *See* Walters Direct, p. 3, l. 7 through p. 4, l. 8.

[18] ***State ex. rel. Public Counsel v. Public Service Commission,*** 274 S.W.3d 569, 573 (Mo. App., W.D. 2009).

the Commission may incentivize desired behavior by awarding a higher return than is otherwise warranted. There are also other permissible methods of providing incentives.[19] However, Staff urges the Commission to not provide any sort of rate incentive to the Company in this case.

The facts of this case establish that no incentive is required. The Company has engaged, and continues to engage, in the practice of acquiring and rehabilitating decrepit systems at such a rate that it frankly may be exceeding its ability to operate them properly. Consumer complaints expressed at the Local Public Hearings in this case certainly raise that question. Since it is already engaging in the desired conduct, why should an incentive be provided? The costs of rehabilitating the systems the Company has acquired will necessarily result in rate shock for many customers as it is. Why should these customers pay even more to provide a palpably unnecessary incentive to the Company?

The Commission should also consider whether this Company deserves an incentive. Staff's audit was impeded in this case, whether by design or due to poor recordkeeping and inadequate staffing. Customers complain that the Company is unresponsive. The Company has sought to improperly subsidize its unregulated activities through rates, as the discussion of the next two issues demonstrates. It has also tried to pad the cost of service to inflate its rate revenue, by including non-existent income taxes and via a grossly overstated cost of capital recommendation. Staff repeats: there should be no incentive granted to this Company in this case.

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[19] These could be briefed by the parties if the Commission so desires.

What If?

In the event that the Commission agrees with Confluence's position on the NOL issue in this case and normalizes that item for ratemaking purposes, it would be authorizing the collection of amounts in current rates that would never be paid to the taxing authorities. In that case, the Commission would require Confluence's customers to involuntarily contribute cost-free capital to Confluence. Therefore, if the Commission adopts the Company's position, the Commission should order in this proceeding that any amounts of income tax expense collected in rates in excess of the amount of income taxes actually paid to the taxing authorities in future years be used as an offset to rate base in future rate proceedings to recognize the capital being forcibly contributed to Confluence by its ratepayers.[20]

Conclusion:

Staff urges the Commission to include in rates exactly as much Income Tax expense as the Company will actually pay to the taxing authorities. The testimony provided in this case shows that the Company may not actually pay any taxes for the next six years and continue to increase the NOL. Therefore, the amount to include in rates in this case is approximately $31,465 based upon Staff's surrebuttal revenue requirement.

Kevin A. Thompson

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[20] Ex. 123, Bolin Surrebuttal, p. 6, l. 16, to p. 7, l. 2.

2. Acquisition-Related Costs:

What legal and preliminary engineering costs related to acquisitions and applications for certificates of convenience and necessity should be capitalized?

Introduction:

Public utilities that engage in both regulated and unregulated activities often seek to have their ratepayers subsidize their unregulated activities. The Commission's duty is to prevent this evil. "The purpose of such regulatory laws is to allow a utility to recover a just and reasonable return while at the same time protecting the consumer from the natural monopoly power that the public utility might otherwise enjoy as the provider of a public necessity."[21] "[T]he dominant thought and purpose of the [Public Service Commission Law] is the protection of the public while the protection given the utility is merely incidental."[22] It is the Commission's duty to protect the ratepayers from the utility.

None of These Costs Should be Recovered:

None of the costs at issue in this case should be capitalized or, in fact, recovered at all.[23] Like any company engaged in acquisitions, Confluence incurs expenses related to those transactions. Since the acquisition transaction is for the benefit of the shareholders, those expenses are not recoverable in rates.[24] Staff's audit revealed that Confluence

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[21] ***State ex rel. Sprint Missouri, Inc. v. Public Service Com'n of State,*** 165 S.W.3d 160, 161 (Mo. banc 2005) (internal citations omitted).

[22] ***State ex rel. Crown Coach Co. v. Public Service Com'n,*** 238 Mo.App. 287, ___, 179 S.W.2d 123, 126 (1944).

[23] Except to the extent they "were incurred for the betterment of the entire system and for customers." Tr. 9.5, p. 92, ll. 19-20 (Majors).

[24] Ex. 110, Majors Direct, p. 14, ll. 18-23; Tr. 9.5, p. 90, ll. 19-21: (Majors) "it's unprecedented to recover any kind of explicit transaction costs."

nonetheless recorded substantial acquisition costs to its various plant-in-service accounts, including real estate closing costs, legal expenses, and engineering expenses.[25] Confluence's accounting does not reflect the way these kinds of expenses are typically treated.[26]

There are two categories of acquisition-related costs: transaction costs and transition costs.[27] Transaction costs are costs incurred by the purchaser and seller to effectuate the financial, legal, and regulatory requirements of the merger.[28] These costs are incurred prior to and immediately after the merger or acquisition.[29] Transition costs, by contrast, are costs incurred to combine the entities participating in the acquisition or to combine their operations.[30] These costs are incurred after the transaction is consummated.[31] Unlike transaction costs, transition costs may be recoverable in rates if they are reasonable, necessary, prudent, and beneficial to the ratepayers. Staff makes an item-by-item determination with respect to the recovery of transition costs.[32] Even if recoverable, they are not generally capitalized.[33]

[25] *Id.*, ll. 8-10.

[26] *Id.,* ll. 11-12.

[27] *Id.,* ll. 12-13.

[28] *Id.,* ll. 12-17; Ex. 129, Majors Surrebuttal, p. 4, ll. 6-10.

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] Tr. 9.5, p. 85, ll. 1-5, and p. 85, l. 16, to p. 86, l. 1.

[33] A capitalized cost is not only recovered, it becomes part of rate base and the Company would earn a return on the unrecovered portion until it is fully amortized. Tr. 9.5, p. 90, l. 25, through p. 91, l. 6, and l. 23, through p. 92, l. 4.

The Commission has consistently denied recovery in the cost of service of transaction costs because they are costs incidental to ownership that should be retained by the purchaser or investors.[34] Transition costs have been included in cost of service in some prior rate cases depending on the individual circumstances in those cases.[35] The acquisition costs capitalized by Confluence are transaction costs and therefore typically not recovered in rates.[36] In fact, Confluence incurred no recoverable transition costs in the test year.[37] The costs listed by Mr. Thies in his Rebuttal Testimony are transaction costs, not transition costs.[38] They include engineering costs, title costs, and the cost of filing a CCN application.[39] They are part of the "due diligence" performed by the purchaser in deciding whether or not to complete a purchase and how much to pay.[40] They are not recoverable from the ratepayers, no matter whether they were incurred within 50 days of the transaction or at some other time.[41] Staff does not have, and has never had, a "fifty-day rule" that governs the recoverability of acquisition costs.[42]

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[34] Ex. 110, Majors Direct, *supra,* ll. 18-23.

[35] *Id.* For example, if they were part of a "black box" settlement, *see* Tr. 9.5, p. 89, l. 18, through p. 90, l. 5.

[36] *Id.*

[37] *Id.*

[38] Majors Surrebuttal, p. 5, ll. 4-23.

[39] Tr. 9.5. p. 64, ll. 2-3.

[40] Majors Surrebuttal, p. 5, ll. 4-23.

[41] Tr. 9.5, p. 84, l. 16, to p. 86, l. 3.

[42] Tr. 9.5, p. 86, l. 17, through p. 87, l. 5; and l. 23, through p. 88, l. 4; p. 90, ll. 6-9.

Staff did not include these transaction costs in the plant in service or accumulated reserve balances in any of the water or sewer systems.[43] Confluence improperly recorded these costs to the plant accounts of several water and sewer systems.[44] Staff removed them and is not aware of any acquisition costs currently in the cost of service.[45] To the extent these costs have not been removed, they should not be included in the cost of service.[46]

Conclusion:

It is a sad reality that utility holding companies attempt to subsidize their unregulated activities by improperly charging them to the ratepayers of their regulated subsidiaries. Staff is always on guard against such attempts to covertly require ratepayers to underwrite the costs of shareholder activity. The Commission should deny recovery of the acquisition costs at issue in this case, except to the extent that an item-by-item review establishes that some costs were beneficial to ratepayers. Any such costs should be recovered via a five-year amortization, without rate base treatment.[47]

Kevin A. Thompson

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[43] Majors Surrebuttal, p. 15, ll. 1-9.

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] Tr. 9.5, p. 91, l. 7, through p. 93, l. 16.

3. Timesheets:

Should the Commission order Confluence to require its employees, including executives, to keep timesheets that show the activities performed and where they were performed?

Yes, detailed timesheets should be maintained for all CSWR employees. In a general rate case, Staff reviews the historical levels of labor that have been utilized for both capital and expense and develops a percentage reflecting a normalized level of labor that is considered expense as opposed to capital.[48]

In Confluence's last general rate case, Case No. WR-2020-0053, the *Unanimous Stipulation and Agreement,* signed by Josiah Cox, states:

> …the Company shall begin tracking all work conducted on its behalf by CSWR, LLC in the form of a time record. This time record will include a description of the job performed, length of time to complete, name/title of the employee who conducted the work, and tracked by each system. The time record information should be maintained in sufficient detail to capture the amount of time each employee spends on operation and maintenance activities, as opposed to construction activities. The Company also agrees that detailed timesheets will be maintained for any future employees Confluence Rivers Utility Operating Company, Inc. may retain.

Despite agreeing to do so, and including a timesheet requirement in its employee handbook, seven CSWR executives have not maintained timesheets.[49] Case No. WR-2020-0053 is not the first time that Confluence has agreed to timesheet requirements; including Case No. WR-2020-0053, Confluence has signed seven disposition agreements

[48] Ex. 107, Direct Testimony of Ashley Sarver, p. 26, ll. 12-14.

[49] CSWR Employee Handbook, effective June 1, 2021, section IV, Personnel Administration, section B, "all employees are required to accurately complete and confirm a timesheets in the HRIS system (Paycor). Failure to submit a properly executed timesheet may cause a delay in the processing of the payroll check."

since 2016 that include timesheet requirements.[50] Confluence has continued to agree to timesheet requirements as the Company grew; Staff does not dispute that CSWR executives are busy, but it does dispute the contention that timesheets are unimportant. Staff witness Ashley Sarver testified that she spends approximately two minutes per week on timesheets and would expect the same of CSWR executives.[51] For the sake of accuracy, the timesheets of each and every CSWR employee are necessary; the effort needed to complete them is not arduous and does not diminish their importance.

When asked about the *Unanimous Stipulation and Agreement* in WR-2020-0053, CSWR witness Brent Thies had the following exchange when questioned by a Staff Counsel attorney:

> Q: So we can agree that Confluence Hills did not follow what it said it would do in its last rate case?
>
> A: Indian Hills, are you talking about the one that's highlighted in green?
>
> Q: No. In the last rate case – the rate case WR-2020-0053.
>
> A: As Mr. Woodsmall – I'm sorry Mr. Mitten described most employees have kept them but there are certainly some employees who have not kept timesheets properly.
>
> Q: And you are aware that your employee handbook says that you are supposed to keep timesheets?
>
> A: Yes.
>
> Q: And you agreed in this rate case that you would keep timesheets?
>
> A: Our company did, yes.

[50] Ex. 131, Surrebuttal Testimony of Ashley Sarver, p. 6, ll. 3-18. Each disposition agreement has been signed by Josiah Cox and/or Dean Cooper.

[51] Transcript Vol. 9.5, p. 147, ll. 19-23.

> Q: So there has been promises made in this hearing already specifically having to do with customer relations and customer – customer service. It's clear from these documents that Confluence does not keep the promises it said that it would keep so how are we – how can we believe you that you are going to keep the promises regarding customer service?
>
> A: I mean I think promise singular, not promises. I mean this is the only one that's before us as a broken promise so far. So, you know, certainly we're willing to stand before the Commission and own that and so, you know, never say never in terms of like, you know, missing something or something going little sideways in the future but certainly we're talking about one promise here.[52]

CSWR witness Josiah Cox, when asked about timesheets and previous agreements that the Company has been a party to, said,

> …I would say that we're ninety-two percent accurate on keeping timesheets. Only seven employees have not done it. I would say that each one of these orders were a moment in time. These customers represent one one-hundred fiftieth of the entire customer base that we serve across the country.[53]

Not only does Mr. Cox admit to not ensuring that all CSWR employees were keeping accurate timesheets, his statement that Commission orders are "a moment in time" is troubling. While a Commission order for a specific company will change from rate case to rate case, a company should not assume that any portion of an order can be ignored. Confluence may have more customers and more employees than it had during Case No. WR-2020-0053, but the agreement Confluence made to ensure that accurate timesheets were kept did not have a set expiration date; it was not just for "a moment in time."

[52] *Id.* at pp. 123-125.

[53] *Id.* at p. 131, ll. 18-23.

Executive and high-ranking employees have not been exempt from Confluence's promise to keep timesheets. Further, as explained by Staff witness Ashely Sarver:

> …executives set the tone at the top for an organization. Executives should be demonstrating that they too are following the Company policies and procedures as laid out by the Company handbook. In addition, many utilities are busy but still maintain timesheets. While it is true that the allocated costs from CSWR to the affiliates…are less to Missouri because of further acquisitions that spread the costs to more customers; without a timesheet Staff cannot determine if the amount that has been allocated to Missouri would have been more or less than what Confluence recorded in their general ledger.[54]

Staff's goal in its recommendation that all CSWR employees be required to keep timesheets is not to micromanage the Company or create unnecessary work; the goal is to collect accurate information to determine how much time CSWR employees devote to work on Missouri systems. According to Staff witness Ashley Sarver, "…Staff reviews the timesheets to determine what activities are performed by employees and in which state these activities occur, in order to include an accurate and appropriate amount of employee related expenses in Confluence's cost of service."[55]

Staff's recommendation on this issue merely asks that all CSWR employees be held to the same standard and provide the most accurate data possible to Staff. Staff needs timesheets to ensure that Confluence collects its fair share from Missouri ratepayers, no more, no less.

Casi Aslin

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[54] Ex. 131, Surrebuttal Testimony of Ashley Sarver, p. 3, ll. 14-21.

[55] *Id.* p. 2, ll. 11-13.

4. Cost of Capital:

With respect to the cost of capital—

a. What is the appropriate capital structure to use in calculating the Company's rate of return?

b. What is the appropriate cost of debt to use in calculating the Company's rate of return?

c. What is the appropriate return on common equity to use in calculating the Company's rate of return?

Introduction

One component of the cost of service is the cost of capital. The Company's cost of capital is the sum of the cost of its equity financing and the cost of its debt financing. It is the minimum return that a company must earn on its capital to satisfy its shareholders, creditors, and other providers of capital. The cost of common equity is the expected return that investors require on an investment in the utility. Investors expect to earn their required return from receiving dividends and through stock price appreciation; the cost of debt is the interest payments to bondholders and note holders. The weighted average cost of capital ("WACC") represents a company's proportionally weighted average cost of capital from all sources, including common stock, preferred stock, bonds, and other forms of debt. The WACC is equivalent to the rate of return ("ROR") because it expresses, in a single number, the minimum return necessary to satisfy both bondholders and shareholders.

TABLE 1: COMPARATIVE RECOMMENDATIONS OF THE EXPERTS:			
Item	**Company** D'Ascendis[56]	**Staff** Walters[57]	**OPC** Murray[58]
Capital Structure Equity to Debt	68.56 / 31.44	50 / 50	45 / 55
Cost of Debt	6.60	6.60	6.23
Return on Equity Range	11.35 10.85-11.85	9.50 9.2-9.8	9.65 9.1-9.9
Rate of Return	9.86	8.05	7.77

Three well-qualified, expert financial analysts testified in this case. Their recommendations on the three contested Cost of Capital issues are set out above:

Staff's expert witness, Chris Walters, testified that Confluence should be authorized an overall ROR of 8.05%, produced using Mr. Walters' recommended hypothetical capital structure of 50% Equity and 50% Debt; Confluence's embedded Cost of Debt of 6.60%; and Mr. Walters' recommended authorized Return on Common Equity ("ROE") of 9.50% (the midpoint of his range 9.20% to 9.80%). Mr. D'Ascendis' recommendations, skewed by an inflated ROE, result in an inordinately high ROR and should therefore be rejected. Mr. Murray's recommendations, while not per se unreasonable, result in an ROR higher that that recommended by Staff. Since Staff's proposed ROR is sufficient to cover the Company's Cost of Capital, Mr. Murray's recommendations should also be rejected.

56 Ex. 7, D'Ascendis Direct, p. 2, l. 21 through p. 3, l. 5 and Table 1; p. 4, Table 2.

57 Ex. 109, Walters Direct, p. 3, l. 7 through p. 4, l. 8.

58 Ex. 209, Murray Direct, p. 2, ll. 1-16.

Legal Parameters:

As already stated, the Commission's statutory duty is, after due consideration of all relevant factors,[59] to set "just and reasonable" rates.[60] The Commission does so using traditional cost-of-service ratemaking. "Under cost-of-service ratemaking, rates are designed based on a [utility's] cost of providing service including an opportunity for the [utility] to earn a reasonable return on its investment."[61] "[T]he Company and its stockholders have a constitutional right to a fair and reasonable return upon their investment."[62] The United States Supreme Court, in two frequently cited decisions, has established the constitutional parameters that guide the Commission in setting the rate of return.[63] The Court stated, in ***Hope Natural Gas Company***, the later of the two cases:

> 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. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[64]

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[59] ***State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Service Commission,*** 585 S.W.2d 41, 49 (Mo. banc 1979).

[60] Sections 393.130 and 393.140, RSMo. "A just and reasonable rate is fair to both the utility and to its customers, ***St. ex rel. Valley Sewage Co. v. Public Service Commission,*** 515 S.W.2d 845 (Mo. App., K.C.D. 1974), and is no more than is necessary to "keep public utility plants in proper repair for effective public service, [and] . . . to insure to the investors a reasonable return upon funds invested." ***St. ex rel. Washington University et al. v. Public Service Commission,*** 308 Mo. 328, 344-45, 272 S.W. 971, 973 (banc 1925).

[61] FERC, ***Cost-of-Service Rates Manual,*** 1 (1999) [available electronically at www.ferc.gov].

[62] ***State ex rel. Missouri Public Service Co. v. Fraas,*** 627 S.W.2d 882, 886 (Mo. App., W.D. 1981).

[63] ***Federal Power Commission v. Hope Natural Gas Company***, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); ***Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia***, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

[64] ***Hope***, *supra,* 320 U.S. at 603, 64 S.Ct. 288, 88 L.Ed. 345 (citations omitted).

The Court has also stated, "the utility has 'no constitutional rights to profits' such as those 'realized or anticipated in highly profitable enterprises or speculative ventures.'"[65]

In these two decisions, three guiding principles are discerned:

- An adequate return is commensurate to the returns realized from other businesses with similar risks. This is the principle of the commensurate return.
- An adequate return is sufficient to assure confidence in the financial integrity of the utility. This is the principle of financial integrity.
- An adequate return is sufficient to maintain the utility's credit and to enable it to obtain necessary capital. This is the principle of capital attraction.

The first of these principles requires a comparative process. The return on equity ("ROE") set by the Commission must be about as much as investors would realize from other investments with similar risks.[66] What investments are those? Investments in other public utilities. Every line of business is, by its very nature, subject to a set of unique risks. Consequently, the business entities that face corresponding risks and uncertainties to the utility under consideration are necessarily other utilities engaged in delivering the same service under similar conditions. Therefore, the Commission must look to the returns realized from a proxy group of comparable companies in setting the utility's return on common equity.

The second principle is forward-looking: confidence in a utility's financial integrity refers to the expectation that the utility will continue in business in the future, meeting its

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[65]***Bluefield,*** 262 U.S. at 692-93 (citations omitted).

[66] The rate of return and the return on equity are synonymous for the purposes of ***Hope*** and ***Bluefield*** because the Commission sets the rate of return by setting the return on equity.

obligations as they come due, providing safe and adequate service to its customers, and yielding a fair return to its shareholders.

The third principle refers to the effect of the Commission's decision on the utility's ability to compete in the market place for necessary capital. The requirements imposed by this parameter necessarily vary with economic conditions. For example, the Commission may need to set a higher return on equity in troubled times, when the cost of money is high and general uncertainty causes investors to seek safe investments. If the Commission's decision sustains the company's credit rating and allows the utility to attract capital on reasonable terms, then this parameter is satisfied.

Capital Structure:

Confluence's expert witness, Dylan D'Ascendis, recommends that the Commission use an inflated, equity-heavy capital structure in this case in order to achieve higher rates.[67] Mr. D'Ascendis characterizes this as the Company's "actual capital structure," although in fact it is not.[68] Staff's expert witness, Chris Walters, by contrast, recommends that the Commission adopt a hypothetical capital structure in this case.[69]

"Cost of capital" refers to the financing of a utility's assets. There are two types of financing, debt and equity. The ratio of debt financing to equity financing is reflected in the company's capital structure, in which each component is expressed as a percentage of the whole. Staff prefers the debt-to-equity ratio ("DTE") to be close to 50:50. There are

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[67] Ex. 7, D'Ascendis Direct, p. 15, ll. 8-11.

[68] *Id.*

[69] *Id.,* p. 25, ll. 10-14.

advantages and disadvantages to each type of financing, one of which is that equity is more risky than debt and therefore more costly to the ratepayers.[70]

Traditionally, the Commission has used the company's actual book value capital structure as of the end of the test year for ratemaking, updated to the end of the update period (or true-up). The actual capital structure is the one considered by analysts and investors when assigning a credit rating or making an investment decision. Further, the actual capital structure reflects the decisions management has actually made and the effects of those decisions. However, many utility companies, such as Confluence, are wholly-owned by holding companies. The capital structure of a public utility wholly-owned by a holding company is subject to manipulation in order to inflate the equity ratio in an attempt to obtain a higher rate of return, for example, by a test year infusion of equity. Such wholly-owned utilities' stock is not traded on the market and some no longer issue their own debt, but are financed by the corporate parent or by an affiliate. In the latter case, like Confluence, the utility often has no credit rating.[71]

Mr. D'Ascendis, testified that Confluence's actual capital structure consists of 68.56% equity.[72] However, in response to Staff Data Request 0183, the Company admitted that its actual equity ratio was only 16.19% as of year-end 2022.[73] Furthermore, Confluence's proposed equity ratio significantly exceeds the average equity ratio for Mr.

[70] Debt financing, on the other hand, is more expensive for the company because debt must be serviced with regular payments whereas the company need not distribute dividends.

[71] Ex. 7, D'Ascendis Direct, p. 22, l. 17.

[72] *Id.,* p. 15, ll. 8-11.

[73] Ex. 109, Walters Direct, p. 23, ll. 2-8.

Walters' proxy group, which is 46.3% (including short-term debt) or 46.4% (excluding short-term debt).[74] Confluence's proposed equity ratio of 68.56% (excluding short-term debt) is more than 22 percentage points higher than that of the proxy group's comparable equity ratio and more than 52 percentage points higher than Confluence's actual equity ratio.[75] Mr. Walters testified that "authorized common equity ratios for regulated utilities have generally been in the range of 48.0% to 52.0% over the last several years" and that "Confluence's requested equity ratio exceeds any rational measure and should be adjusted to a more reasonable level."[76] Mr. Walters testified, "[g]iven Confluence's large negative retained earnings balance of approximately $9.5 million at year-end 2022, its unique corporate structure, which relies directly on affiliates for external capital structure and Confluence's size, I believe a hypothetical capital structure is warranted in this case. As such, I recommend the Commission authorize a capital structure with an equity ratio of no more than 50%."[77]

This approach has been approved by Missouri courts:

> What the Missouri Commission has in effect done is to adopt a hypothetical capital structure for ratemaking purposes without regard to the manner in which APL acquired equity ownership of the Company. It appears to be an accepted regulatory practice to disregard the actual book capital structure of a utility when it is deemed to be in the public interest to do so.[78]

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[74] *Id.,* and see Sch. CCW-2.

[75] *Id.*, p. 24, ll. 8-11.

[76] *Id.,* p. 24, ll. 12-15.

[77] *Id.,* p. 25, ll. 10-14.

[78] ***State ex rel. Associated Nat. Gas Co. v. Pub. Serv. Comm'n of Missouri,*** 706 S.W.2d 870, 878 (Mo. App., W.D. 1985).

The court went on to identify two situations in which the use of a hypothetical capital structure for ratemaking is appropriate. First, the situation where "the utility's actual debt-equity ratio is deemed inefficient and unreasonable because it contains too much equity and not enough debt, necessitating an inflated rate of return."[79] Second, when the utility is part of a holding company system and the utility's book capital structure and capital costs are not be a true reflection of the system's capital costs with respect to a particular operating company.[80] The present case is an example of the first situation identified by the court.

In summary, Staff urges the Commission to adopt the hypothetical, ratemaking capital structure proposed by Mr. Walters. At a DTE of 50:50, Mr. Walters' proposal is fair to both the Company and the ratepayers. Just as the ratepayers should not have to reimburse Confluence for income tax that it has not paid, and will never pay, so they should not be required to pay the cost of non-existent equity financing.

Cost of Debt:

Debt financing is borrowed money that the Company is obligated to pay back, with interest, to its creditors. The cost of debt is the average interest rate required by the various debt instruments. Since the amount is fixed and is readily ascertainable, the cost of debt is said to be "embedded." Confluence's embedded cost of debt is 6.60% as Staff and the Company agree.[81]

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[79] *Id.*

[80] *Id.,* at pp. 878-879.

[81] Ex. 7, D'Ascendis Direct, p. 3, l. 1; Ex. 109, Walters Direct, p. 4, ll. 7-8.

Although the cost of debt is embedded, and thus theoretically readily ascertainable, it is nonetheless a frequently contested issue. For one thing, there are multiple ways that the embedded cost of debt can be computed.[82] In the present case, OPC's expert witness, David Murray, has reduced the embedded rate on Confluence's refinancing from CoBank to reflect an anticipated patronage credit of 42 basis points.[83] Mr. D'Ascendis, not surprisingly, considers Murray's adjustment to be inappropriate.[84] Mr. Murray responds that the anticipated credit is material due to its quantity and if not applied to reduce the cost of debt, then it should be tracked on a cumulative basis, with carrying costs based on the 6.6% interest rate.[85] The balance of accumulated patronage credits should then be applied as a rate base offset in future rate cases or as a direct offset to the allowed ROR.[86] Staff notes that the use of Mr. Murray's cost of debt with Staff's capital structure and ROE would result in a ***lower*** ROR for Confluence.

Return on Common Equity:

The cost of equity is unobservable and must be estimated through the application of various models that rely on market data. This is a matter of expert judgment. The three experts that testified in this case applied a series of widely-recognized and accepted

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[82] David C. Parcell, ***The Cost of Capital – A Practitioner's Guide,*** SURFA (1997), p. 5-1.

[83] Ex. 209, Murray Direct, p. 2, ll. 13-14; Ex. 211, Murray Surrebuttal, p. 11, ll. 8-13, p. 13, ll. 9-11; Ex. 8, D'Ascendis Rebuttal, p. 47, ll. 13-15.

[84] Ex. 211, Murray Surrebuttal, p. 13, ll. 1-4, 9-11.

[85] *Id.,* p. 13, ll. 14-19.

[86] *Id.*

analytical methods[87] to proxy groups of regulated public utilities[88] to estimate the cost of equity ("COE"),[89] which is the minimum return required by investors from the Company's stock.[90] The experts discuss cost of equity (COE) and return on equity (ROE). Staff, and Mr. Murray, regard COE and ROE as two separate things, the former being a market-driven value and the latter a value set by a governmental regulatory commission, such as the P.S.C.[91] Mr. D'Ascendis does not.[92]

The experts' results:

TABLE 2: COMPARATIVE ANALYTICAL RESULTS:			
Method	**D'Ascendis[93]**	**Walters[94]**	**Murray[95]**
DCF	9.73	9.20	6.02-7.50
RP	11.84	9.80	8.25-8.55
CAPM	12.00	9.40	8.00-8.25
Non-Price Regulated Proxy Group	11.97	--	--

[87] "I used several models based on financial theory to estimate Confluence's cost of common equity. These models are: (1) a constant growth Discounted Cash Flow ("DCF") model using consensus analysts' growth rate projections; (2) a constant growth DCF using sustainable growth rate estimates; (3) a multi-stage growth DCF model; (4) a Risk Premium model; and (5) a Capital Asset Pricing Model ("CAPM")." Ex. 109, Walters Direct, p. 22, ll. 8-12. Mr. D'Ascendis used "the DCF model, a RP model that he calls the Predictive Risk Premium Model™ ("PRPM"), a bond yield plus risk premium model, as well as the traditional and empirical forms of the CAPM." Ex. 119, Walters Rebuttal, p. 2, ll. 19-21; Ex. 7, D'Ascendis Direct, p. 20, ll. 9-22. Mr. Murray used a multi-stage DCF and a CAPM and applied various tests of reasonableness, including the bond-yield-plus-risk-premium method. Ex. 209, Murray Direct, p. 34, ll. 20-23.

[88] Mr. D'Ascendis also used a non-regulated proxy group.

[89] COE can also be determined from the results of a company's operations over a period of time.

[90] Ex. 109, Walters Direct, p. 21, ll. 3-5; Ex. 7, D'Ascendis Direct, p. 20, ll. 2-8; Ex. 209, Murray Direct, p. 35, ll. 2-7. Staff notes that Mr. D'Ascendis also applied two upward adjustments or "adders" that are not widely-recognized or accepted.

[91] Ex. 209, Murray Direct, p. 20, ll. 10-21.

[92] Ex. 8, D'Ascendis Rebuttal, p. 43, ll. 18-23.

[93] Ex. 119, Walters Rebuttal, p. 2, l. 17 to p. 4, l. 5; esp. Table CCW-1.

[94] Ex. 8, D'Ascendis Rebuttal, p. 2, l. 15; Ex. 109, Walters Direct, p, 52, l. 4 to p. 53, l. 3, esp. Table CCW-12.

[95] Ex. 8, D'Ascendis Rebuttal, p. 42, 3-12; p. 49, ll. 15-16; p. 50, ll. 21-22; p. 52, ll. 2-3.

Result Range	10.86 10-36—11.36	9.50 9.20—9.80	9.00 8.60-9.25
Business Risk Adder	+1.00	--	--
Financial Risk Adder	-0.51	--	--
Company-specific Premium	--	--	+0.65
Recommendation Range	11.35 10.85—11.85	9.50 9.20—9.80	9.65 9.25—9.90

Criticisms of Mr. D'Ascendis' Methodology:

Mr. Walters testified, "Mr. D'Ascendis' estimated market ROE of 11.35% for Confluence is significantly overstated for several reasons[.]"[96] Mr. Murray testified, "the end-results caused by [Mr. D'Ascendis'] risk premium assumptions are not consistent with reasonable capital market expectations."[97] Mr. Murray also explained, "COE estimates using standard/typical risk premium estimates currently cause inflated COE estimates in the current higher long-term interest rate environment."[98]

1. Discounted Cash Flow (DCF):

Mr. D'Ascendis performed a traditional, constant growth DCF analysis.[99] In this analysis, the current dividend yield of a security is added to a growth rate to produce the current value of all income the security will produce in perpetuity. Mr. D'Ascendis used an average growth rate of 7.28%, which, with his other inputs, produced results in the range

[96] Ex. 119, Walters Rebuttal, p. 2, ll. 14-15.

[97] Ex. 210, Murray Rebuttal, p. 10, ll. 18-19.

[98] *Id.,* p. 9, ll. 24-26.

[99] Ex. 119, Walters Rebuttal, p. 9, l. 14.

5.08% to 14.28%, average of 9.28%.[100] He then excluded the lowest result – 5.08% -- and produced a revised average result of 10.17%.[101] Finally, he averaged 9.28% and 10.17% to reach his final DCF result of 9.73%.[102] Mr. Walters testified that "Mr. D'Ascendis biases his DCF results upward by removing only the low-end outlier when a DCF result of 14.28% is clearly a high-end outlier."[103] Mr. Walters explained that the proper way to account for such outliers is to measure the median of all the results, which would produce a result of 9.28%.[104] He could have also considered the "truncated mean" by removing both the high-end and low-end outliers; the truncated mean, after removing the 5.08% and 14.28% outliers, is 9.08%.[105] The midpoint of the 9.28% and 9.08% results is 9.18%, which is consistent with the DCF results Mr. Walters recommended in his direct testimony.[106]

Mr. Walters also criticized the inflated growth rate used by Mr. D'Ascendis, which Staff addresses below.[107]

2. Risk Premium:

In this analysis, an equity risk premium is added to a risk-free rate. Mr. D'Ascendis first estimated a risk premium return of 11.84%, being the midpoint of the range described by his Predictive Risk Premium Model (PRPM™) (12.20%) and his adjusted total market

[100] *Id.,* ll. 16-19.

[101] *Id.,* ll. 19-20.

[102] *Id.,* l. 21.

[103] *Id.,* p. 10, ll. 9-10.

[104] *Id.,* ll. 10-12.

[105] *Id.,* ll. 12-14.

[106] *Id.,* ll. 14-15.

[107] *Id.,* p. 10, l. 16 through p. 11, l. 21.

approach risk premium (11.48%).[108] First, Mr. D'Ascendis derived a proxy group average equity risk premium, using the PRPM™, of 10.25%.[109] He then added his estimate of the risk-free rate of 3.96%.[110] Mr. D'Ascendis then excluded the two high-end outliers, American Water Works (19.87%) and Essential Utilities (16.29%), resulting in a proxy group average equity risk premium of 8.32%, which, added to the risk-free rate of 3.96%, produced a proxy group mean ROE estimate of 12.28% and a median of 12.12%, which average to 12.20%.[111] Mr. Walters pointed out that this methodology yielded an unreasonable result. Mr. D'Ascendis' PRPM™-derived risk premium study adjusted result of 12.28% exceeds the highest average authorized ROEs for electric, gas, and water utilities since 2006, which was 10.52% for electric utilities in 2008.[112] Natural gas utilities have not had an average authorized ROE of 12.28% or higher since 1991.[113] This result is simply excessive.

Second, Mr. D'Ascendis' calculated an adjusted total market risk premium, based on a projected utility bond yield of 5.74% and an average equity risk premium of 5.74%, which, added together, result in an indicated ROE of 11.48%.[114] The projected 5.74% risk premium used by Mr. D'Ascendis is itself the average of the results of two separate risk

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108 *Id.,* p. 11, ll. 24-26.

109 *Id.,* p. 12, ll. 2-3.

110 *Id.,* ll. 3-4.

111 *Id.,* ll. 4-8.

112 *Id.,* p. 13, ll. 12-17, and Table CCW-1 on p. 14.

113 *Id.,* ll. 17-20 and see Ex. 109, Walters Direct, Table CCW-10.

114 *Id.,* ll. 10-12.

premium studies, 6.77% and 4.70%.[115] The first of these, 6.77%, is the adjusted average of the results of six estimates of equity risk premiums: three based on the Ibbotson data, including an equity risk premium (6.13%), a regression risk premium (7.02%), and a PRPM™ method risk premium (9.79%); an equity risk premium estimate based on Value Line Summary and Index Data (11.16%); a S&P 500 DCF-derived equity risk premium using Value Line data (11.17%); and a S&P 500 DCF-derived equity risk premium using Bloomberg data (6.81%).[116] The average of these six risk premium estimates of 8.68% was then adjusted by his proxy group average *beta* of 0.78, to produce the estimate of 6.77%.[117] The second term, 4.70%, is the average of five separate risk premium estimates: a historical equity risk premium of the S&P Utility Index of 4.28%; a regression-derived risk premium of 5.01 %; a PRPM™-derived risk premium of 5.51%; a forecasted equity risk premium of the total returns of the S&P Utility Index from Value Line of 4.75%; and a forecasted equity risk premium of the total returns of the S&P Utility Index of 4.75% from Bloomberg.[118] The average of these five risk premiums is 4.70%.[119]

Mr. Walters also criticized Mr. D'Ascendis' second risk premium result, 11.48%, as unreasonable.[120] Mr. Walters points out that natural gas utilities have not had an average authorized ROE of 11.48% or higher since 1998.[121] Mr. Walters explained that both

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[115] *Id.,* ll. 13-14.

[116] Ex. 7, D'Ascendis Direct Sch. DWD-4, p. 8.

[117] Ex. 119, Walters Rebuttal, p. 12, ll. 15-24.

[118] *Id.,* p. 13, ll. 1-9.

[119] *Id.,* l. 10.

[120] *Id.,* ll. 21-24.

[121] *Id.,* and see Ex. 109, Walters Direct, Table CCW-10.

of Mr. D'Ascendis' risk premium results, which depend on his PRPM™ method, should be discarded because they violate the weak form of the efficient market hypothesis.[122] The PPRM™ model is based solely on trends in equity prices, volatility of those historical prices, and historical investor behavior – a technical analysis.[123] The weak form of the efficient market hypothesis holds that current prices reflect all historical price and volume information such that technical analysis cannot be used to predict future market movements, because all information contained in past prices is already reflected in the current price.[124] Mr. Murray also criticized Mr. D'Ascendis' reliance on the PPRM™ method, saying, "the fact that this model produces individual results that vary by almost 100% for a proxy group of relatively homogenous regulated water utility companies should have caused Mr. D'Ascendis to question the reliability of this method."[125]

3. Capital Asset Pricing Model (CAPM):

Mr. D'Ascendis also performed two CAPM analyses, a traditional CAPM and an Empirical CAPM. The CAPM is similar to the Risk Premium in that a market risk premium is added to a risk-free rate; it differs in that the market risk premium is adjusted by multiplication by a factor *beta* that represents the degree to which the subject security is more or less risky than the market as a whole.[126] Mr. D'Ascendis relied on a proxy group *beta* of 0.78, which was the average of the mean and median *beta* published by

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[122] *Id.,* p. 14, l. 3, through p. 15, l. 24.

[123] *Id.,* p. 14, ll. 3-6.

[124] *Id.,* p. 14, l. 10 through p. 15, l. 2.

[125] Ex. 210, Murray Rebuttal, p. 11, ll. 14-16.

[126] *Id.,* p. 10, ll. 6-14.

Bloomberg and Value Line for his proxy companies; a market risk premium of 9.98%; and a projected risk-free rate of 3.96% to produce a traditional CAPM estimate of 11.71% and an Empirical CAPM ("ECAPM") estimate of 12.27%.[127] Mr. Walters criticized Mr. D'Ascendis' CAPM analyses: first, his market risk premium of 9.98% is excessive and unreliable due to the unsustainable growth rates he used to develop his market return; second, more recent projections of the risk-free rate are about 20 basis points lower than the figure he used; finally, his market risk premium estimates are flawed in the same way as his risk premium results due to his reliance on the PRPM™ methodology.[128] As to Mr. D'Ascendis' ECAPM, Mr. Walters testified: "here is simply no legitimate basis to use an adjusted *beta* within an ECAPM because it unjustifiably alters the security market line and materially inflates a CAPM return for a company with a *beta* less than one (1)."[129] For this reason, Mr. Walters urged the Commission to discard Mr. D'Ascendis' ECAPM result.

4. Non-Regulated Companies Analysis:

Mr. D'Ascendis also applied the same analytical methods to a non-regulated proxy group of 27 companies, chosen based solely on whether they had *betas* within two standard deviations of the *beta* of his utility proxy group.[130] The average of his mean and median market-based studies on his non-price regulated companies using this methodology

[127] Ex. 119, Walters Rebuttal, p. 16, ll. 11-15.

[128] *Id.,* ll. 17-22.

[129] *Id.,* p. 21, l. 13, through p. 22, l. 1.

[130] *Id.,* p. 22, ll. 6-11.

produced an estimated ROE of 11.97%.[131] The results of these analyses are flawed in the same way as are the results of his analyses of his regulated utility proxy group.[132]

5. Manipulated Inputs:

Each of the experts, in rebuttal testimony, criticized the methods and results of the others. It is important to understand that, while the experts all use variants of the same analytical methods, the data inputs are different, leading to significantly different results. These differences mean thousands or millions of dollars for the Company and significantly higher or lower rates for ratepayers. Each of the three analytical methods used by the experts contains at least one term that is selected through the exercise of expert professional judgment and thus is subject to purposeful manipulation in order to achieve a higher or lower result. Let's compare those inputs:

TABLE 3: COMPARATIVE ANALYTICAL INPUTS:			
Input	**D'Ascendis[133]**	**Walters[134]**	**Murray[135]**
DCF: Growth Rate	7.28	6.72, 6.41 5.99, 5.60 4.00	3.75-4.25, 4.00
RP: Equity Risk Premium	8.32, 5.74	5.93	3.00-4.00
CAPM: Market Risk Premium	9.98	6.00-8.01	6.00, 4.95-6.38

Mr. D'Ascendis performed a Constant Growth DCF using a growth rate of 7.28. This figure is higher than any of the growth rates used by either Mr. Walters or Mr. Murray. It is

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[131] *Id.*

[132] *Id.,* ll. 14-21.

[133] *Id.*, p. 9, ll.14-16; p. 12, ll. 2-8 and 10-12.

[134] Ex. 109, Walters Direct, p. 31, ll. 1-2; p. 33, ll. 4-5; p. 37, l. 8 to p. 38, l. 6.

[135] Ex. 209, Murray Direct, p. 37, l. 20 to p. 38, l. 2; p. 41, ll. 7-14; p. 42, lll. 18-22. Mr. Murray's "rule of thumb" check on reasonableness is a variety of risk premium analysis.

also 82% higher than the growth rate projected for the U.S. economy, which is inappropriate for a growth rate that in theory will continue forever.[136] As Mr. Walters testified, "An average growth rate of 7.28%, assumed to last in perpetuity, defies the economic and financial literature of which I am aware."[137] Mr. Murray, also critical of Mr. D'Ascendis' DCF growth rate, testified that he had never seen a "DCF analysis in the investment community which assumes company's cash flows (e.g. DPS) will grow in perpetuity at the same rate as equity analysts' consensus 5-year CAGR in EPS."[138] Mr. D'Ascendis' equity risk premiums are higher than those used by Mr. Murray and one of them is higher than that used by Mr. Walters. Mr. D'Ascendis' market risk premium is higher than those used by either Mr. Walters or Mr. Murray. Mr. D'Ascendis also used an inappropriately high risk-free rate.[139] Mr. D'Ascendis' ROE recommendation is high because he used inflated inputs in his analyses. Consequently, the Commission should not rely on Mr. D'Ascendis manipulated results.

The Adders:

Mr. D'Ascendis proposes an unreasonable 100-basis point adder "to reflect his belief that Confluence has greater risk relative to that of his proxy group companies, due to its market capitalization size."[140] As an initial matter, according to financial theory, the market does not compensate investors for taking on risks that can be diversified away. Thus,

[136] Ex. 119, Walters Rebuttal, p. 10, ll. 4-6 and l. 16 to p. 11, l. 21.

[137] *Id.,* p. 11, ll. 2-3.

[138] Ex. 210, Murray Rebuttal, p. 22, ll. 19-22. "DPS" is dividend per share; "CAGR" is compound annual growth rate; "EPS" is earnings per share.

[139] Ex. 119, Walters Rebuttal, p. 16, l. 19-20.

[140] *Id.,* p. 6, ll. 1-3.

investors are only compensated for taking on systematic, or non-diversifiable risks.[141] This alone makes Mr. D'Ascendis's proposed business risk adjustment for size irrelevant. Furthermore, Mr. Walters noted, "There are several fundamental errors and flaws in Mr. D'Ascendis' quantitative estimate and logic."[142] First, Confluence is not publicly traded and its actual market capitalization is unknown.[143] Second, a small-size adder is not warranted because Confluence is owned by a large parent company that operates in eleven states and provides capital to Confluence.[144] Finally, while size premiums are present in industrial companies, they are not present in utility companies nor are they appropriate to include in valuing utilities.[145] Mr. Walters' conclusion is "[t]he size adjustment, as proposed by Mr. D'Ascendis, is not appropriate and should be denied."[146]

Mr. D'Ascendis also estimated a negative financial risk adjustment to account for the difference in financial risk between Confluence and the proxy group companies given Confluence's exorbitant requested equity ratio of 68.56%.[147] Based on the results of his two methods of estimation, Mr. D'Ascendis applied a downward adjustment of 0.51%.[148] Mr. Walters testified, "Mr. D'Ascendis' analysis is severely flawed and significantly understates the difference in financial risk between the proxy companies and

[141] Ex. 109, Walters Direct, p. 48.

[142] *Id.,* ll. 3-4.

[143] *Id.,* ll. 4-7.

[144] *Id.,* ll. 8-10.

[145] *Id.,* ll. 12-13.

[146] *Id.,* ll. 14-15.

[147] *Id.,* ll. 18-21.

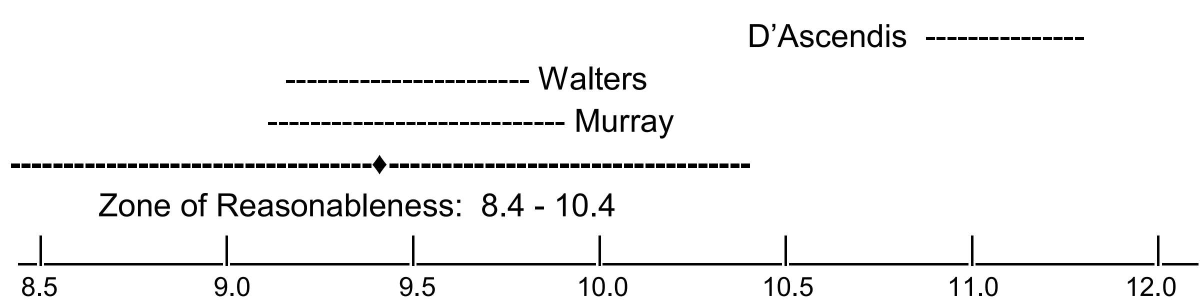
[148] *Id.*

Confluence."[149] The correct figure, calculated using D'Ascendis' methods, is a downward adjustment of 1.63%.[150]

The "Zone Of Reasonableness":

The ROE is a "headline" number with significant effects and ramifications. Utility regulatory commissions take great care with their ROE decisions. Over the past twenty years, this Commission has, from time-to-time, used a benchmarking process in evaluating expert ROE recommendations via an analytical tool referred to as the "Zone of Reasonableness." "The zone of reasonableness test deems a return on equity presumptively reasonable if it is within a percentage point of the national average for similar utilities."[151] The appellate courts have welcomed its use and have upheld it in the strongest terms, for example, "this Court has expressly held that '[t]he United States' Supreme Court has instructed the judiciary not to interfere when the commission's rate is within the zone of reasonableness.'"[152] The testimony in this case is that the national average is 9.4%.[153] The Zone of Reasonableness, therefore, extends from 8.4 to 10.4. Let's compare the expert recommendations in this case to the Zone of Reasonableness:

TABLE 4: ZONE OF REASONABLENESS:



341 (Mo. App., W.D. 2010).

[153] Tr. vol. 10, p. 88, l. 24.

Table 4 shows graphically that Mr. D'Ascendis' entire recommended range is outside the Zone of Reasonableness, while those of Mr. Walters and Mr. Murray are within it. In the past, the Commission has summarily discarded recommendations that are outside of the Zone of Reasonableness.[154] The Zone of Reasonableness analysis corroborates the testimony of Mr. Walters and Mr. Murray that the Company's recommendation is simply too high. Table 4 makes plain the inflated nature of Mr. D'Ascendis' proposed ROE range. "Evaluation of expert testimony is left to the Commission which 'may adopt or reject any or all of any witnesses' [sic] testimony.'"[155] "It is not the theory or methodology, but the impact of the rate order which counts."[156] The impact of a rate order founded upon Mr. D'Ascendis' inflated recommendation would be neither fair nor reasonable. The Zone Of Reasonableness is "the zone between the lowest rate not confiscatory and the highest rate fair to the public."[157] The Company's ROE recommendation is emphatically not fair to the public and should be rejected.

Cost of Capital Conclusion:

Based on the evidence adduced, the Commission should adopt the recommendations of Staff's expert witness, Chris Walters, and authorize for the Company an overall ROR of 8.05%, based on a hypothetical capital structure of 50% Equity and 50%

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[154] ***In the Matter of Kansas City Power & Light Co.,*** Case No. ER-2006-0314, ***Report and Order,*** issued December 21, 2006; pp. 21-2: "Because the return on equity recommended by DOE falls outside of the "zone of reasonableness", the Commission will discard it and find that it merits no further discussion."

[155] ***State ex rel. Associated Natural Gas v. Pub. Serv. Comm'n,*** 37 S.W.3d 287, 294 (*quoting* ***State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm'n,*** 706 S.W.2d 870, 880 (Mo.App.1985)).

[156] ***In the Matter of KCP&L v. Pub. Serv. Comm'n***, 509 S.W.3d 757, 765 (Mo. App., W.D. 2016) (internal quotation omitted).

[157] ***In re New Jersey Power & Light Co. v. State,*** 89 A.2d 26, 44 (N.J. 1952).

Debt; Confluence's embedded Cost of Debt of 6.60%; and an authorized ROE of 9.50%, the midpoint of a reasonable range from 9.20% to 9.80%.

Kevin A. Thompson

5. Advanced Meter Infrastructure Investments:
Should the Commission disallow any costs related to AMI meter investments?

Staff takes no position on this issue.

6. Operations, Maintenance, and Oversight:
With respect to operations, maintenance, and oversight—

d. Should the Commission order a disallowance related to Confluence's contract-based business model, and if so, how much?

Staff did not take a position on this issue. However, Curtis Gateley, Manager of Staff's Water, Sewer and Steam Department, testified that cutting funding for current contracts is not in the best interest of customers.[158] Therefore, Staff opposes the proposed disallowance because, if granted, it would likely impair the quality of service delivered by Confluence to its customers.

Conclusion:

On account of all the foregoing, the Commission should resolve each disputed issue as recommended by the Staff; and grant such other and further relief as the Commission deems just in the circumstances.

[158] Ex. 126, Gateley Surrebuttal, p. 11, ll. 3-4.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served, either electronically or by hand delivery or by First Class United States Mail, postage prepaid, on this **8th day of September, 2023,** to the parties of record as set out on the official Service List maintained by the Data Center of the Missouri Public Service Commission for this case.

/s/ Kevin A. Thompson