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MISSOURI PUBLIC SERVICE COMMISSION
FINANCIAL AND BUSINESS ANALYSIS DIVISION
FINANCIAL ANALYSIS DEPARTMENT

DIRECT TESTIMONY
OF
RANDALL T. JENNINGS

THE RAYTOWN WATER COMPANY

CASE NO. WR-2023-0344

Jefferson City, Missouri
October 2023

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1 A. In this testimony, Staff presents evidence and provides a recommendation
2 regarding the appropriate ROR to be used in establishing the water service rates of The Raytown
3 Water Company (“RWC”).

4 Staff’s analyses and conclusions are supported by the data presented in the attached
5 Confidential Schedule RTJ-d2. Staff’s workpapers will be provided to the parties at the time of the
6 filing of this Direct Testimony. Staff will make any additional source documents of specific
7 interest available upon the request of any party to this case or the Commission.

8 **I. EXECUTIVE SUMMARY**

9 Q. Please provide a summary of your methodology and findings concerning the ROR
10 that should be utilized in setting rates for RWC’s water utility operations in this proceeding.

11 A. Staff estimated the market-based cost of common equity (“COE”) for RWC using
12 its small utility rate case method that is based on the Standard and Poors (“S&P”) Credit Ratings
13 guide¹ and the Bond Yield Plus Risk Premium² method. The S&P Credit Ratings guide provides
14 parameters for estimating credit ratings. Credit ratings are in turn used to estimate debt cost. The
15 Bond Yield Plus Risk Premium method simply adds a premium, known as the equity risk premium
16 (“ERP”), to the estimated debt cost to come up with a return on equity (“ROE”). ROE is then
17 combined with debt cost to arrive at an estimated ROR.

18 Q. Please summarize the result of your analysis and recommended ROR.

19 A. For the current rate case, Staff recommends that the Commission set RWC’s
20 authorized ROE at 10.37%. Staff’s recommended authorized ROE is based on RWC’s estimated

¹ S&P RatingsDirect, May27, 2009, “Criteria Methodology: Business Risk/Financial Risk Matrix Expanded”.

² Brigham, E. F., Shome, D. K., & Vinson, S. R. (1985). The risk premium approach to measuring a utility's cost of equity. Financial Management, 33-45.

1 credit rating, the difference between United States Corporation Index averages, Public Utility
2 Bond Yield averages and an estimated risk premium. Staff's recommendation of a 10.37%
3 authorized ROE would fairly compensate RWC for its current market COE.

4 Staff also recommends that the Commission use RWC's actual capital structure of 47.20%
5 common equity, 14.82% preferred stock, and 37.97% long-term debt as of December 31, 2022, for
6 purposes of setting RWC's ROR in this proceeding.³ Consistent with Staff's capital structure
7 recommendation, Staff also recommends at this time that the Commission use RWC's cost of debt
8 value of 3.75%, resulting in the overall ROR of 6.80%.⁴

9 Q. Please explain how your direct testimony is organized.

10 A. Staff's testimony is organized into five sections. First, Staff discusses the applicable
11 regulatory principles concerning cost of capital and ROR analysis that supports the just and
12 reasonable rates for RWC's water utility services. Second, Staff presents the corporate analysis of
13 RWC's business profile and credit ratings. Third, Staff explains its cost of capital and ROR
14 analysis using RWC's capital structure. Fourth, Staff concludes with a presentation of Staff's
15 recommended ROE, cost of debt, and capital structure for calculating RWC's allowed ROR for
16 ratemaking purposes.

17 **II. REGULATORY PRINCIPLES**

18 Q. Please describe the regulatory principles that guide the determination of a just and
19 reasonable ROR for a regulated utility.

20 A. The determination of a fair ROR is guided by principles of economic and financial
21 theory, as well as by certain minimum Constitutional standards. Investor-owned public utilities,

³ Confidential Schedule RTJ-d2, Jennings' Direct Testimony.

⁴ Ibid.

1 such as RWC, are private property that the state may not confiscate without appropriate
2 compensation. The United States Supreme Court has described the minimum characteristics of a
3 Constitutionally-acceptable ROR in two frequently-cited cases: *Bluefield Waterworks &*
4 *Improvement Co. v. Public Service Commission of West Virginia* and *Federal Power*
5 *Commission v. Hope Natural Gas Co.*⁵

6 From these two decisions, Staff derives and applies the following principles to guide it in
7 recommending a just and reasonable ROR:

- 8 1. A return consistent with returns on investments of comparable risk;
- 9 2. A return that allows the utility to attract capital on reasonable terms; and
- 10 3. A return sufficient to assure confidence in the utility's financial integrity.

11 Embodied in these three principles is the economic theory of the opportunity cost
12 of investment. The opportunity cost of investment is the return that investors forego in
13 order to invest in similar risk investment opportunities that vary depending on market and
14 business conditions.

15 Methodologies of financial analysis have advanced greatly since the *Bluefield* and *Hope*
16 decisions. Additionally, today's utilities compete for capital in a global market rather than a local
17 market. The principle of commensurate return is based on the concept of risk. Financial theory
18 holds that the return an investor may expect is reflective of the degree of risk inherent in the
19 investment; risk being a measure of the likelihood that an investment will not perform as expected
20 by that investor. Any line of business carries with it its own risks, and it follows, therefore, that

⁵ *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923); *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944).

1 the return RWC's shareholders may expect is equal to that required by shareholders of comparable-
2 risk utility companies.

3 Q. How does Staff estimate a just and reasonable authorized ROE regarding
4 commensurate return and comparable-risk?

5 A. Staff employed its Small Utility ROR Methodology for its authorized ROE
6 estimation. COE is a market-determined, minimum return that investors are willing to accept for
7 their investment in a company, compared to returns on other available investments. Using market
8 data, COE can be directly estimated. An authorized ROE, on the other hand, is a
9 Commission-determined return granted to monopoly industries, allowing them the opportunity to
10 earn just and reasonable compensation for their investments in the rate base. Stock market data
11 cannot directly determine an authorized ROE. However, Staff can estimate a just and reasonable
12 authorized ROE anticipated by the financial market by using rates of return on investments having
13 similar risks. Therefore, Staff's recommendation of an authorized ROE, based on a COE derived
14 from the comparison of similar investments, is consistent with the principles set forth in *Bluefield*
15 and *Hope*.

16 **III. CORPORATE ANALYSIS**

17 Q. Please provide the corporate profile of RWC.

18 A. RWC provides water services to residential and commercial customers in Missouri.
19 As of December 31, 2022, RWC provides water service to 6,541 metered service connections, all
20 in Missouri.⁶

21 Q. How was RWC's approximate credit rating determined?

⁶ Staff's Data Request No. 0092.

1 A. RWC does not have a public credit rating. Because RWC’s credit rating is not
2 publicly available, Staff utilized the S&P Credit Ratings guide to approximate RWC’s credit rating
3 using its parameters for estimating credit ratings.

4 To estimate credit ratings using the S&P Credit Ratings guide, Staff examined the financial
5 risk profile (“FRP”) and business risk profile (“BRP”) of RWC. To examine the FRP and BRP of
6 a small utility, Staff analyzes financial statements and ratios. Staff also reviewed RWC’s 2019
7 through 2022 Annual Reports that are filed with the Commission.

8 Q. What is RWC’s Business Risk Profile (“BRP”)?

9 A. According to a November 27, 2007 S&P Credit Ratings publication, regulated
10 utilities and holding companies that are utility-focused virtually always fall in the upper range
11 (“Excellent” or “Strong”) of business risk profile. In addition, all water utilities currently rated by
12 S&P are assigned a BRP of “Excellent”, owed to their regulated revenues. RWC is smaller than
13 other major regulated water utilities rated by S&P. In Staff’s reasonable judgement, a BRP of
14 “Strong”, one notch lower than the “Excellent” assigned to water utilities by S&P Credit Ratings,
15 is appropriate for RWC.

16 Q. What is RWC’s Financial Risk Profile (“FRP”)?

17 A. For FRP, RWC showed net operating incomes for 2021 and 2022 after showing net
18 losses in 2019 and 2020. While net incomes indicate the company is operating in a sustainable
19 manner, and considered by itself would indicate a minimal financial risk, as of December 31, 2022
20 the company’s Debt to Earnings before Interest, Taxes, Depreciation, and Amortization
21 (“EBITDA”) and Funds From Operations (“FFO”) to Debt ratios (5.74x and 10.89% respectively)
22 both remain high and reveals that the company is still considered “Highly Leveraged.” RWC’s
23 Debt to Capital ratio is 37.97% which would be considered “Intermediate.” The combination of

1 these factors leads Staff, in its reasonable judgment, to believe an FRP of “Aggressive” is
2 appropriate for this rate case.⁷

3 Q. What was RWC’s BRP and FRP in its previous rate case, WR-2020-0264?

4 A. RWC’s previous rate case, WR-2020-0264, resulted with a BRP between “Strong”
5 and “Satisfactory” and an FRP of “Minimal.” A factor leading to this included RWC having a
6 debt to capital ratio of less than 5% compared to its 37.97% as of December 31, 2022.

7 Q. Based upon the S&P Credit Ratings guide matrix⁸, what is RWC’s current
8 approximate credit rating?

9 A. With a BRP and FRP of “Strong” and “Aggressive,” respectively, for RWC, the
10 S&P Credit Ratings guide matrix indicates a credit rating of ‘BB’.⁹

11 **IV. RETURN ON EQUITY**

12 Q. How was ROE calculated?

13 A. In order to arrive at Staff’s recommended ROE, Staff examined the three-month
14 average yield on “BB” rated corporate bonds¹⁰ and “BBB” rated corporate bonds.¹¹ The three-
15 month averages (March – May of 2023) were 6.86% and 5.61% respectively with a difference of
16 125 basis points between the two investment ratings.

⁷ According to a September 18, 2012 S&P guide (Methodology: Business Risk/Financial Risk Matrix Expanded), Table 2, utilities with a ratio of Debt to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) of less than 1.5 is typically “Minimal” and a Funds From Operations (FFO) to Total Debt (Debt) ratio of greater than 60% typically have an FRP of “Minimal.” RWC’s ratios for year ending 2022 were Debt/EBITDA = 5.74 and FFO/Debt = 10.89%.

⁸ S&P Ratings Direct, Methodology: Business Risk/Financial Risk Matrix Expanded, Table 1, September 18, 2012.

⁹ Ibid.

¹⁰ ICE BofA BB US High Yield Index Effective Yield (BAMLH0A1HYBBEY) | FRED | St. Louis Fed (stlouisfed.org); <https://fred.stlouisfed.org/series/BAMLH0A1HYBBEY#0>

¹¹ ICE BofA BBB US Corporate Index Effective Yield (BAMLC0A4CBBBEY) | FRED | St. Louis Fed (stlouisfed.org); <https://fred.stlouisfed.org/series/BAMLC0A4CBBBEY#0>

1 The “Mergent Bond Record” indicated an average “Baa” Public Utility bond yield of
2 5.62% over the same time frame.¹² Adding the difference between the two investment ratings
3 (125 basis points) to this Public Utility bond yield average gives a total of 6.87%.

4 Because small water and sewer companies typically don’t issue debt that is actively traded,
5 Staff must rely on its estimate of RWC’s credit rating and then determine a recent average cost of
6 utility debt for this rating based on data Staff obtains. Staff also applies a “standard” risk premium
7 to this reasonable estimate of the current cost of debt to arrive at an estimated cost of equity. Staff
8 then adds the “standard” risk premium (3% to 4%) to this current cost of debt to estimate the cost
9 of common equity.

10 Q. What is Staff’s recommended ROE?

11 A. Staff used a risk premium of 3.5% added to the previous 6.87% to give an estimated
12 ROE of 10.37%.

13 **V. CAPITAL STRUCTURE**

14 Q. What is Staff’s recommended capital structure for RWC in this proceeding?

15 A. Staff recommends using RWC’s actual capital structure as of December 31, 2022,
16 composed of 47.20% common equity, 14.82% preferred stock, and 37.97% long-term debt. The
17 actual capital structure most accurately represents the proper ratemaking structure and reflects the
18 composition upon which debt and equity financing will be based.

19 **VI. COST OF CAPITAL**

20 Q. What is RWC’s cost of Preferred Equity?

¹² June 2023 Mergent Bond Record, page 22.

1 A. On November 4, 2020, RWC requested permission to issue Preferred Stock in file
2 WF-2021-0131. The application states that:

3 A brief description of the securities Applicant desires to issue is as follows:
4 up to Five Hundred (500) Preferred stock shares with a par value of Ten
5 Thousand Dollars (\$10,000) each, in a principal sum not to exceed Five
6 Million Dollars (\$5,000,000) bearing an interest rate not to exceed the prime
7 rate per annum as reported each January 1 in the Wall Street Journal. The
8 interest rate shall be adjusted on an annual basis based on the rate reported
9 each year. All dividends will be paid quarterly, and principal payments to
10 begin once all projects are useful and in service and earning a rate of return
11 through a rate case filing (anticipated to be within five (5) years from the
12 date of issuance.

13 On January 27, 2021, the Public Service Commission issued its order granting permission for
14 RWC to issue the preferred stock as described.

15 On January 1, 2022, the prime rate was 3.25%.¹³ Due to the test year being January 1,
16 2022 through December 31, 2022, this was the cost of Preferred Equity used for Staff's
17 calculations.

18 Q. What is RWC's cost of long-term debt?

19 A. RWC filed an Annual Report for 2022 listing a single long-term debt of an
20 Environmental Improvement and Energy Resources Authority ("EIERA") Bond authorized in file
21 WF-2021-0427 for Five Million Dollars (\$5,000,000) with a fixed interest rate of 3.75%.

22 **VII. CONCLUSION**

23 Q. What is Staff's conclusion?

¹³ Bank Prime Loan Rate (DPRIME) | FRED | St. Louis Fed (stlouisfed.org); <https://fred.stlouisfed.org/series/DPRIME>

Direct Testimony of
Randall T. Jennings

1 A. Staff's recommended ROE of 10.37% for RWC, an embedded cost of debt of
2 3.75%, and a cost of preferred stock of 3.25% applied to a capital structure of 37.97% long-term
3 debt, 14.82% Preferred Stock and 47.20% common equity, results in an allowed ROR of 6.80%.¹⁴

4 Q. Does this conclude your direct testimony?

5 A. Yes, it does.

¹⁴ Confidential Schedule RTJ-d2, Jennings' Direct Testimony.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

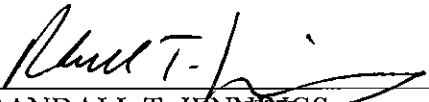
In the Matter of the Application of a Rate)
Increase of Raytown Water Company) Case No. WR-2023-0344

AFFIDAVIT OF RANDALL T. JENNINGS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW RANDALL T. JENNINGS and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing *Direct Testimony of Randall T. Jennings*; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

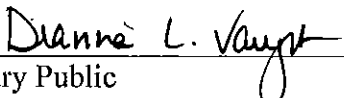


RANDALL T. JENNINGS

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 6th day of October 2023.

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| DIANNA L. VAUGHT Notary Public - Notary Seal State of Missouri Commissioned for Cole County My Commission Expires: July 18, 2027 Commission Number: 15207377 |
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Notary Public

Randall Jennings

Present Position:

I am a Senior Utility Regulatory Auditor in the Financial Analysis Department of the Financial and Business Analysis Division of the Missouri Public Service Commission. I have been employed by the Missouri Public Service Commission Since October 2021.

Educational Background and Work Experience:

I earned a Bachelor of Science degree in Business Administration from Drury University in Springfield, MO. I was previously employed as a Regulatory Auditor and Supervisor with the Missouri Division of Professional Registration for 11 years and prior to that as an Investigator for the Missouri Attorney General for 8 years.

Case Participation:

| <u>Company Name</u> | <u>Case Number</u> | <u>Case Type / Type of Testimony</u> | <u>Utility Type</u> |
|---------------------------------------------------------------|------------------------------|-----------------------------------------------------------------------|---------------------|
| The Raytown Water Company | WF-2021-0427 | Finance – Staff Memorandum | Water |
| Evergy Missouri West, Inc. | EF-2022-0103 | Finance – Staff Memorandum | Electric |
| Summit Natural Gas of Missouri, Inc. | GR-2022-0122 | Tariff Revision – Rebuttal & Surrebuttal Testimony | Gas |
| Missouri American Water Company | WF-2022-0161 | Finance – Staff Memorandum | Water |
| Union Electric Company d/b/a Ameren Missouri | EF-2022-0164 | Finance – Staff Memorandum Financing Compliance – Staff Memorandum | Electric |
| Spire Missouri Inc. | GF-2022-0169 | Finance – Staff Memorandum | Gas |
| Summit Natural Gas of Missouri, Inc. | GF-2022-0216 | Finance – Staff Memorandum | Gas |
| S.K. & M. Water and Sewer Company | SR-2022-0239 WR-2022-0240 | Rate Case – Staff Memorandum | Water |
| Argyle Estates Water Supply | WR-2022-0345 | Rate Case – Staff Memorandum | Water |
| Missouri American Water Company | WR-2022-0303 | Rate Case – Direct, Rebuttal & Surrebuttal Testimony | Water |
| Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty | GF-2023-0280 | Finance – Staff Memorandum | Gas |
| | | | |

SCHEDULE RTJ-d2

HAS BEEN DEEMED

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IN ITS ENTIRETY