

Exhibit No.:

Issue(s):

Witness/Type of Exhibit:

Sponsoring Party:

Case No.:

Return on Equity (ROE)

Murray/Rebuttal

Public Counsel

WR-2023-0344

REBUTTAL TESTIMONY

OF

DAVID MURRAY

Submitted on Behalf of the Office of the Public Counsel

RAYTOWN WATER COMPANY

CASE NO. WR-2023-0344

October 24, 2023

TABLE OF CONTENTS

Testimony	Page
Introduction	1
Rebuttal of Staff Witness Jennings' Recommended ROE	2
Summary and Conclusions	7

REBUTTAL TESTIMONY
OF
DAVID MURRAY
THE RAYTOWN WATER COMPANY
CASE NO. WR-2023-0344

1 **I. INTRODUCTION**

2 **Q. Please state your name and business address.**

3 A. My name is David Murray and my business address is P.O. Box 2230, Jefferson City, Missouri
4 65102.

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

6 A. I am employed by the Missouri Office of the Public Counsel (“OPC”) as a Utility Regulatory
7 Manager.

8 **Q. On whose behalf are you testifying?**

9 A. I am testifying on behalf of the OPC.

10 **Q. Did you file direct testimony in this case?**

11 A. No.

12 **Q. What issue are you addressing in rebuttal testimony?**

13 A. Staff’s recommended return on common equity (“ROE”) for purposes of setting The Raytown
14 Water Company’s (“Raytown”) authorized rate of return (“ROR”) in this case.

15 **Q. What experience, knowledge and education qualify you to address this issue?**

16 A. Please see Schedule DM-R-1 for my qualifications as well as a summary of the cases in
17 which I have sponsored testimony on ROR and other financial issues.

18 **Q. Why are you testifying in rebuttal?**

19 A. I disagree with Staff witness’ Randall Jennings’ estimate of Raytown’s credit risk profile,
20 which forms the basis for his recommended authorized ROE of 10.37%. Mr. Jennings’
21 estimates that Raytown’s credit risk is consistent with a below investment-grade credit
22 rating (*i.e.* junk bond rating). I estimate Raytown’s credit risk profile is consistent with an
23 investment-grade credit rating. Therefore, I believe Raytown’s investment-grade credit risk

1 profile supports a lower authorized ROE than Mr. Jennings' recommends in his direct
2 testimony.

3 **II. REBUTTAL OF STAFF WITNESS JENNINGS' RECOMMENDED ROE**

4 **Q. Can you summarize the basis for Mr. Jennings' recommended ROE of 10.37%?**

5 A. Yes. Mr. Jennings estimated Raytown's ROR by applying Staff's Financial Analysis
6 Department's "Small Utility ROR Methodology."¹ I am familiar with this methodology
7 because I co-authored the whitepaper outlining this methodology with two other previous
8 Financial Analysis Department employees, Shana Griffin and Zephania Marevangepo. The
9 underlying principles of this methodology are guided by Standard & Poor's Global Ratings
10 ("S&P") credit ratings methodology. Based on Mr. Jennings' application of this
11 methodology, he estimated Raytown's credit risk to be consistent with S&P's 'BB' rating,
12 which is below an investment-grade credit rating of 'BBB-' or higher. Mr. Jennings then
13 added a generic equity risk premium of 3.5% to a recent implied 'BB' bond yield of 6.87%
14 to determine his recommended ROE of 10.37%.

15 **Q. How did Mr. Jennings estimate a 'BB' credit rating for Raytown?**

16 A. S&P publishes a table (Schedule DM-R-2) which provides implied credit ratings for a
17 company based on an estimate of a company's business risk profile ("BRP") and financial
18 risk profile ("FRP"). Based on Mr. Jennings' assignment of a BRP of "Strong" and a FRP
19 of "Aggressive," the S&P table indicates a guideline rating of 'BB+'. Apparently, Mr.
20 Jennings rounded the rating to 'BB'.

¹ Jennings Direct Testimony, p. 5, Ins. 5 – 6.

1 **Q. What was Mr. Jennings' basis for assigning Raytown's water utility operations a BRP**
2 **of "Strong"?**

3 A. Mr. Jennings discussed the fact that S&P assigns "Excellent" BRPs for purposes of
4 assigning ratings to larger water utility companies. Mr. Jennings testifies that Raytown's
5 smaller size justifies the assignment of a riskier BRP of "Strong."

6 **Q. Do you dispute Mr. Jennings assignment of a "Strong" BRP to Raytown's water utility**
7 **operations?**

8 A. No. However, instead of focusing purely on size, I recognized that unlike the water utility
9 companies rated by S&P, Raytown does not issue debt directly to investors. While size may
10 be a factor in the inability to issue debt directly to investors, it can also be due to other
11 reasons, such as a less creditworthy company. However, Raytown has access to commercial
12 banking facilities so it can procure debt capital through loans, which, in my opinion,
13 supports assigning a "Strong" BRP to Raytown. My assignment of a "Strong" BRP to
14 Raytown is consistent with my assignment of a "Strong" BRP to Confluence Rivers Utility
15 Operating Company in Case No. WR-2023-0006.

16 **Q. What FRP did Mr. Jennings assign to Raytown's water utility operations?**

17 A. He assigned an "Aggressive" FRP to Raytown. Mr. Jennings' "Aggressive" FRP
18 classification was based on his calculation and analysis of Raytown's actual credit metrics
19 for the 2022 calendar year.

20 **Q. Does the intersection of Mr. Jennings' assigned BRP of "Strong" and FRP of**
21 **"Aggressive" imply a 'BB' credit rating based on S&P's benchmark tables?**

22 A. No. As shown in Schedule DM-R-2, the intersection of these classifications indicates a
23 'BB+' credit rating.

1 **Q. Does this one notch rating differential cause a significantly different estimate in the**
2 **cost of capital?**

3 A. Yes. This is primarily a function of Mr. Jennings' opinion that Raytown's credit risk profile
4 is consistent with a non-investment grade credit rating. A difference of one notch in a credit
5 rating is more significant between an investment grade rating category and a non-investment
6 grade rating category. For example, for the nine months ending on September 30, 2023, the
7 average monthly spread between 'A' and 'BBB'-rated bonds was 46 basis points where the
8 average monthly spread between 'BBB' and 'BB'-rated bonds was 115 basis points.
9 Because there are 3 notches between each rating category (e.g. 'BBB', 'BBB-', 'BB+' and
10 'BB'), a one notch rating differential between 'A' and 'BBB' is approximately 15 basis
11 points (46 divided by 3), whereas a one notching rating differential between 'BBB' and
12 'BB' is approximately 38 basis points (115 divided by 3).

13 **Q. How much of an adjustment to the ROE would be warranted based on the one-notch**
14 **higher rating ('BB+') indicated in S&P's tables?**

15 A. A downward adjustment of 42 basis points, which would lower the indicated ROE to 9.95%
16 from 10.37%. I determined this adjustment by subtracting 1/3 of the 125 basis point spread
17 Mr. Jennings calculated for the difference in 'BBB' and 'BB' utility bond yields for the
18 three months ending on May 31, 2023.

19 **Q. Do you agree with Mr. Jennings' assignment of an "Aggressive" FRP to Raytown?**

20 A. No. Mr. Jennings assigned a FRP to Raytown based only on its 2022 credit metrics.
21 Raytown will receive rate relief in this case. Debt investors understand that Raytown's past
22 cash flow profile does not represent the expected cash flow profile subsequent to rate
23 adjustments from this case. Raytown will receive rate relief in this case associated with the
24 investments it made in its system, which are the primary cause of Raytown's increased use
25 of debt in its capital structure. Debt investors anticipate Raytown receiving rate relief,
26 which is one of the primary reasons investors view regulated utility investments as low-risk.

1 Therefore, it is important to consider such anticipated increases in revenues from rate
2 increases in assessing Raytown’s risk profile.

3 **Q. What are Raytown’s projected credit metrics based on Staff and Raytown’s non-**
4 **unanimous stipulation and agreement?**

5 A. Using Staff and Raytown’s stipulated revenue requirement increase of \$1,174,782 and
6 Staff’s rate making income statement, attached to the Non-unanimous Agreement
7 Regarding Disposition of Small Utility Company Revenue Increase Request filed on
8 September 13, 2023,² Raytown’s funds from operations (“FFO”)/debt is expected to be
9 21.67% (*see* Schedule DM-R-3). This FFO/debt ratio is at the high end (*i.e.* less financial
10 risk) of the FFO/debt ratio benchmark for a “Significant” FRP, which is one category higher
11 than the FRP Mr. Jennings assigned to Raytown. Combining a FRP of “Significant” with a
12 “Strong” BRP results in an implied credit rating of ‘BBB’.

13 Although S&P assigns the most weight to the FFO/debt ratio, I also determined Raytown’s
14 pro forma Debt/EBITDA (earnings before interest, taxes, depreciation and amortization)
15 and FFO/interest coverage ratios. Raytown’s pro forma Debt/EBITDA ratio of 3.63x is also
16 consistent with the benchmarks for a ‘BBB’ credit rating. Raytown’s pro forma
17 FFO/interest coverage ratio of 6.78x is consistent with a credit rating in the range of ‘BBB+’
18 to ‘A-’.

19 **Q. If the generic 3.5% equity risk premium is added to a ‘BBB’ bond yield, what is the**
20 **implied COE?**

21 A. 9.12%.

² [Docket Sheet - WR-2023-0344 - Item 10 - EFIS \(mo.gov\)](#)

1 **Q. What is the revenue requirement impact of a 9.12% ROE compared to Staff's**
2 **recommended 10.37% ROE?**

3 A. It reduces Raytown's annual revenue requirement by \$70,413.80.

4 **Q. How would this lower revenue requirement impact Raytown's pro forma FFO/debt**
5 **ratio?**

6 A. It would lower Raytown's FFO/debt ratio to 20.19%, which is still consistent with a FRP of
7 "Significant" and a 'BBB' rating.

8 **Q. What if the Commission authorized a 9.9% ROE, which is the same as it intends to**
9 **authorize Confluence?**

10 A. Raytown's pro forma FFO/debt ratio would be approximately 21.11%, which is still
11 consistent with a 'BBB' rating.

12 **Q. What do you conclude from your analysis?**

13 A. Raytown should be authorized an ROE in the range of 9.12% to 9.9%.

14 **Q. What is your point recommended ROE?**

15 A. I recommend Raytown be authorized a 9.12% ROE because this is consistent with
16 Raytown's investment grade credit risk profile of at least a 'BBB' credit rating.

17 **Q. What other information supports your position that Raytown's credit risk profile is**
18 **consistent with an investment grade credit rating?**

19 A. Raytown's loan from the State of Missouri's Environmental Improvement and Energy
20 Resource Authority ("EI ERA") is an amortizing loan. Consequently, the principal balance
21 of this loan will decline over time. At December 31, 2022, the outstanding balance on
22 Raytown's EI ERA loan was \$5 million. However, Raytown retired \$235,000 of principal
23 on March 1, 2023, leaving a balance of \$4,765,000 at that date. As shown in Schedule DM-
24 R-4, Raytown's loan balance will decline by another \$175,000 on March 1, 2024 with an
25 increasingly declining balance through the next twenty years. Unless Raytown issues more

1 debt in subsequent periods, its credit metrics will continue to improve over time. This
2 further supports Raytown being viewed as having a credit profile consistent with a solid
3 investment grade credit rating.

4 **Q. Has Raytown already pre-funded anticipated near-term debt service obligations?**

5 A. Yes. According to the minutes of Raytown's August 10, 2022 Board of Directors meeting,
6 because the proceeds from the EIARA bond issuance cannot be used to directly fund the
7 construction of a new garage for Raytown's vehicles, it decided to use \$291,145.67 of the
8 bond proceeds to pre-fund interest payments on the debt through March 2024. This cash
9 available to service the debt should also be deducted from the loan balance for purposes of
10 assessing Raytown's credit quality.

11 **Q. What impact would these considerations have on Raytown's FFO/debt ratios?**

12 A. They would improve because these amounts would be deducted from debt, causing higher
13 FFO/debt ratios.

14 **III. SUMMARY AND CONCLUSIONS**

15 **Q. Can you summarize your rebuttal testimony?**

16 A. Yes. I disagree with Mr. Jennings' opinion that Raytown's credit risk profile is consistent with
17 a junk bond rating. His credit metric assessment does not consider the fact that Raytown's
18 rates will be increased to reflect its investment in its system. Reflecting an expectation of a
19 reasonable increase in rates from this rate case will cause Raytown's cash flows as compared
20 to its debt to be consistent with an investment grade credit rating. Therefore, Staff's
21 recommended 3.5% equity risk premium should be added to the average 'BBB' bond yield of
22 5.62% to set a fair and reasonable ROE of 9.12% to set Raytown's revenue requirement in this
23 case.

24 **Q. Does this conclude your testimony?**

25 A. Yes.

**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 DAVID MURRAY

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

David Murray, of lawful age and being first duly sworn, deposes and states:

1. My name is David Murray. I am a Utility Regulatory Manager for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.



David Murray
Utility Regulatory Manager

Subscribed and sworn to me this 24th day of October 2023.



My Commission expires August 8, 2027.



Tiffany Hildebrand
Notary Public