Exhibit No. 207

OPC – Exhibit 207
David Murray
Surrebuttal Testimony
File No. WR-2022-0303

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Issue(s):	Rate of Return (ROR)/ Capital Structure
Witness/Type of Exhibit:	Murray/Surrebuttal
Sponsoring Party:	Public Counsel
Case No.:	WR-2022-0303

SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

Submitted on Behalf of the Office of the Public Counsel

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2022-0303

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Denotes Confidential and Highly Confidential Information that has been redacted

February 8, 2023

PUBLIC

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OF

DAVID MURRAY

MISSOURI AMERICAN WATER COMPANY

FILE NO. WR-2022-0303

Q. What is your name and business address?

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

Q. Are you the same David Murray who filed direct and rebuttal testimony in this case?

A. Yes.

Q. What is the purpose of your testimony?

A. I will respond to the rebuttal testimonies of the following Missouri American Water Company ("MAWC" or the "Company") witnesses: Anne L. Bulkley and J. Cas Swiz. I will also respond to the rebuttal testimony of Staff witness Randall T. Jennings.

Q. Has your review of any of the witnesses' rebuttal testimonies caused you to change any of your positions?

A. No.

Q. What are your main conclusions after reviewing the various parties' rebuttal testimonies as it relates to rate of return ("ROR")?

A. MAWC's views on maintaining a conservative capital structure for ratemaking are at odds with its parent company's, American Water Works Company's ("American Water"), financial strategies. American Water has become more aggressive in its use of leverage (i.e. debt) in its capital structure over the last several years, but MAWC's internally managed capital structure has maintained a common equity ratio above 50%. The discrepancy between American Water's and MAWC's common equity ratios allows

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American Water to earn a significant margin over the cost of capital by inflating MAWC's per books common equity ratio. MAWC's witnesses indicate that if the Commission authorizes a capital structure consistent with American Water's on a consolidated basis, then American Water would make less investment in MAWC because it competes against sister subsidiaries for capital. I requested that MAWC provide specific information as to the specific process/analysis American Water performs to determine whether to provide capital to MAWC as compared to MAWC's sister subsidiaries. Based on the responses I received, it does not appear that American Water has a specific analytical process for making such decisions.[1]

The Company's and Staff's recommended returns on common equity ("ROE") are too high due to their conclusion that recent, and in Ms. Bulkley's case, projected, long-term interest rates are causing higher costs of equity. My analysis of utility stock valuations as compared to changes in long-term interest rates indicate that factors, other than interest rates, continue to support higher utility stock valuation levels. In fact, Ms. Bulkley suggests that the water utility stock valuation levels are currently too high and will decline. Therefore, Ms. Bulkley acknowledges that current water utility stock valuation levels have not declined along with interest rates. Because water utility valuation levels are much higher than those of electric and gas utilities, the Commission should authorize MAWC a lower ROE than the 9.25% the Commission authorized for The Empire District Electric Company ("Empire") in its 2019 rate case, Case No. ER-2019-0374, and the 9.37% the Commission authorized for Spire Missouri Company ("Spire Missouri") in its 2021 rate case, Case No. GR-2021-0108.

Ms. Bulkley's argument about predicted changes to water utility valuation levels is a distraction from what the Commission's key focus should be in this case: setting MAWC's rate of return ("ROR") consistent with current known and measurable capital market conditions. The Commission should recognize the reality of current high water utility stock

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[1] MAWC Responses to OPC Data Request Nos. 3058 (Schedule DM-S-1) and 3059 (Schedule DM-S-2).

valuation levels, and appropriately reflect MAWC's lower cost of common equity through a lower authorized ROE consistent with my 9% recommendation.

Q. Do you have any corrections you need to make to your testimony in this case?

A. Yes. In responding to a data request I received from MAWC, I realized my rebuttal testimony at page 24, lines 18 to 20, was not accurate as stated. I had testified that the stock prices of Ms. Bulkley's proxy group "generally had a positive correlation with increases in long-term bond yields." This language should be deleted and replaced with "only declined slightly."

MAWC'S POSITION: ANNE BULKLEY AND J. CAS SWIZ

Q. Can you summarize Ms. Bulkley's and Mr. Swiz's criticisms of your capital structure recommendation?

A. Yes. Ms. Bulkley and Mr. Swiz claim my recommendation to set MAWC's allowed ROR based on capital structure ratios similar to American Water's capital structure ratios will impair MAWC's credit profile and its ability to attract capital from its parent company, American Water.[2] Ms. Bulkley and Mr. Swiz maintain that MAWC is a stand-alone company with its own financial and operational management. Therefore, they believe MAWC's ratemaking capital structure should be set based on the capital balances shown on MAWC's balance sheet, as well as the cost of the affiliate loans assigned to MAWC. Ms. Bulkley and Mr. Swiz claim that my capital structure position violates the "stand-alone" principle of ratemaking.

[2] Swiz Rebuttal, p. 16, ln. 2 – p. 17, ln. 15 and Bulkley Rebuttal, p. 28, ln. 6 – 31, ln. 5.

Q. Mr. Swiz compares MAWC's situation to that of Spire Missouri when arguing that MAWC's capital structure is appropriate for setting MAWC's ROR.[3] Is Spire Missouri's situation an appropriate comparison for guidance on MAWC's capital structure?

A. No. There are many significant differences between Spire Missouri's circumstances and MAWC's circumstances. As I will explain, MAWC's circumstances are more similar to that of Liberty Utility Company's ("LUCo") Missouri subsidiaries, which I compared and contrasted in Empire's 2019 rate case, Case No. ER-2019-0374, Liberty Utilities (Midstates Natural Gas) Corp. ("Liberty Midstates") case, Case No. GR-2018-0013 and Liberty Utilities (Missouri Water), LLC ("Liberty Water") case, Case No. WR-2018-0170.

Q. What reason did the Commission cite for adopting Spire Missouri's capital structure rather than Spire's consolidated capital structure in Case No. GR-2021-0108?

A. The Commission, in supporting its decision not to adopt the use of Spire Inc.'s consolidated capital structure, stated the following in its Report and Order:

> 275. Spire Missouri issues its own long-term debt secured by its own assets.[4]

It is important to emphasize that Spire Missouri issues long-term debt directly to third-party investors on a consistent and continuous basis, with third-party debt investors trading some of this debt in over-the-counter dealer markets. All of Spire Missouri's long-term debt is sold to third-party investors. Unlike MAWC, Spire Missouri does not have affiliate long-term debt financing transactions with its parent company, or a financing subsidiary created for purposes of issuing debt on behalf of the parent and its subsidiaries. Because Spire Missouri continues to sell long-term debt directly to third-party debt investors, it maintains its own public credit rating.

None of the above circumstances apply to MAWC. MAWC has not issued traditional corporate debt to third-party debt investors since the 1990s. Approximately 97% of the

[3] Swiz Rebuttal, p. 9, lines 10-15.
[4] Case No. GR-2021-0108, Amended Report and Order, November 12, 2021, p. 85.

debt shown on MAWC's balance sheet are affiliate notes between MAWC and American Water Capital Corporation ("AWCC"). AWCC is the entity that issues bonds directly to third-party debt investors and then lends these proceeds to American Water and its subsidiaries. Because American Water guarantees these bonds,[5] the terms of the AWCC bonds are based on debt investors' evaluation of American Water's business risk and financial risk (*i.e.* its overall credit quality). Consequently, only American Water needs a credit rating in order to market these third-party bonds. The AWCC bonds are not secured by a lien on MAWC's assets or American Water's equity ownership in MAWC.

Q. What Missouri utility companies have a financing model similar to that of MAWC?

A. Empire, Liberty Midstates, and Liberty Water. LUCo (a holding company for Algonquin Power & Utilities Corp's ownership of its United States' regulated utilities) has consolidated all of the debt financing needs of its regulated utility subsidiaries at the LUCo level, which also uses a financing subsidiary—Liberty Utilities Finance GP1 ("LUF")—to issue bonds directly to third-party debt investors. LUF's credit quality is based on LUCo's credit quality because LUCo guarantees the bonds issued by LUF. Of LUCo's three Missouri utility subsidiaries, only Empire still has legacy third-party debt it had issued prior to LUCo acquiring it. The Commission has determined that LUCo's capital structure is appropriate to set the allowed ROR for all three of its Missouri subsidiaries.[6] To the extent the Commission desires guidance for purposes of setting MAWC's allowed ROR from its own recent decisions on the most appropriate capital structure, its decisions for LUCo's regulated utilities in Missouri are more comparable than its decision in the Spire Missouri case.

[5] American Water Works Company's December 31, 2019, SEC 10-K Filing, p. 63.
[6] Case Nos. ER-2019-0374, GR-2018-0013 and WR-2018-0170.

Q. Are there other issues that illustrate MAWC's circumstance is more similar to the circumstances of Empire, Liberty Water and Liberty Midstates (collectively, "Liberty Missouri Cos.") as compared to Spire Missouri?

A. Yes. MAWC and the Liberty Missouri Cos. are managed by service company employees. American Water Services Company ("AWSC") employees manage all of the affiliate financing transactions completed to achieve certain targeted internal capital structures for MAWC and its sister subsidiaries. The same is true for the Liberty Missouri Cos., which are managed by the Liberty Utility Services Company ("LUSC") employees. These internal capital structures are targeted for ratemaking, not for raising third-party debt capital and/or targeting a cost-efficient capital structure. The only entity that maintains a market-tested, objective capital structure, which appropriately and fairly captures the amount of debt capacity afforded by Missouri's low-risk regulated utility operations, is that of the entity issuing debt directly to third-party debt investors. As I testified in the Liberty Missouri Cos. rate cases, LUSC's and AWSC's objective when setting their internal capital structures is to maintain equity ratio ratios it believes the Commission will allow. Based on my experience in this and other rate cases, this appears to be in the low 50% range.

Q. Ms. Bulkley asserts that if the Commission adopts your recommended more leveraged capital structure, it needs to authorize a much higher ROE, do you agree?

A. No. Ms. Bulkley claims that if MAWC were to target a similar capital structure to American Water's, equity investors would require a higher equity risk premium to be compensated for the financial risk (*i.e.* additional debt in the capital structure) associated with it.[7] If this were true, then American Water's stock would not be trading at the highest P/E ratio among its peers in the water utility industry (approximately 40x versus 30x to 31x). If American Water's investors viewed its more leveraged capital structure as a significant risk factor, then this would cause them to discount American Water's stock to recognize this risk.

[7] Bulkley Rebuttal, p. 37, line 15 – p. 38, line 9.

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Q. Ms. Bulkley suggests that if MAWC's capital structure were managed to a level consistent with American Water's on a consolidated basis, this would "make it difficult to access capital on reasonable terms."[8] What does her position presume?

A. Ms. Bulkley's position presumes that MAWC's business risk is significantly higher than American Water's consolidated business risk.

Q. What information does Ms. Bulkley rely on for purposes of her opinion that MAWC has more business risk than American Water?

A. Ms. Bulkley claims American Water's business is that of being a financing company. She states that American Water is "in the business of providing liquidity and credit management to many water utility operating companies."[9] This is not consistent with investors' perception of the business risk profile associated with purchasing equity in American Water. However, Ms. Bulkley does acknowledge that American Water's business risk is consistent with its ownership of subsidiaries with water utility investments across "more than a dozen regulatory jurisdictions across the U.S."[10] Ms. Bulkley also notes Moody's cited factors regarding American Water's large size and diversity as support for American Water's ability to have a strong investment grade credit rating despite the significant proportion of debt in its capital structure.[11]

Q. Does Ms. Bulkley claim that you agree that MAWC cannot carry the same amount of leverage as American Water and maintain an investment grade credit rating?

A. Yes. Ms. Bulkley testifies as follows:

> Mr. Murray recognizes that American Water benefits from the diversification of utility operations across many jurisdictions, and that the benefits of this lower risk profile are transferred to MAWC customers through the relatively lower financing costs achieved by

[8] *Id.,* p. 29, lines 4-5.
[9] Bulkley Rebuttal, p. 21, lines 1-2.
[10] *Id.,* p. 21, lines 3-7.
[11] *Id.* p. 31, line 19 – p. 32, line 4.

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> AWCC than could otherwise be obtained if MAWC were to seek financing on a stand-alone basis.[12]

Q. Is Ms. Bulkley's summary of your testimony accurate?

A. No. Ms. Bulkley cites page 45 of my direct testimony. I discuss American Water's business risk profile on page 45, lines 17-25, of my direct testimony. My testimony emphasizes that American Water's high debt capacity is enabled by its low-risk regulated water utility subsidiaries, which include MAWC. I *did not* testify that the benefits of American Water's lower risk profile are transferred to MAWC through lower financing costs than MAWC could otherwise obtain on its own. On the contrary, I testify that American Water is attempting to charge MAWC a higher ROR than is justified by its low-risk regulated water utility assets.

Q. How?

A. Through the request for a higher than necessary common equity ratio. Additionally, I found that the weighted cost of the debt (3.78%) AWCC charges American Water is cheaper than the weighted cost of the debt (4.47%) AWCC charges MAWC.[13]

Q. Mr. Swiz claims that the Commission should adopt MAWC's per books capital structure because the relevant consideration is not the source of the funds, but the risk associated with the use of funds.[14] Do you agree with Mr. Swiz that the risk associated with the use of funds should drive the determination of a fair rate of return for MAWC?

A. Yes.

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[12] *Id.*, p. 32, lines 8-12.
[13] Murray Rebuttal, p. 14, lines 13-27.
[14] Swiz Rebuttal, p. 5, lines 8 – 10.

Q. Do you agree that this principle supports the use of MAWC's per books capital structure?

A. No. MAWC's capital structure is managed based on an internal policy to target a capital structure for ratemaking, not the risk of the use of the funds. In fact, Mr. Swiz confirmed that American Water does not analyze the business risk of its subsidiaries or analyze their credit metrics for purposes of determining the type or terms of capital it invests in them.[15] This type of analysis is fundamental to determining an optimal targeted capital structure, which balances the cost of capital against financial stability.

Q. How do debt investors in AWCC determine their required returns on the AWCC debt they purchase?

A. The cost of this debt is based on the business risk inherent in American Water's regulated water utility operations and the financial risk (*i.e.* use of debt) underlying American Water's capital structure. Consequently, a true match of the costs charged to MAWC captures the risk of the actual capital structure, which is American Water's consolidated capital structure, to which the third-party debt investors are exposed.

Q. Mr. Swiz also seems to attempt to legitimize MAWCs capital structure by noting that MAWC's debt is not guaranteed by American Water.[16] Would American Water guaranteeing MAWC's debt have a legitimate purpose for MAWC's debt investor?

A. No. MAWC borrows from AWCC, which is wholly-owned by American Water. These are affiliate loans. Being that American Water wholly-owns MAWC and AWCC, an American Water guarantee has no economic consequence because no third-party has an investment interest in the equity or debt.

[15] MAWC response to OPC Data Request Nos. 3058 and 3059.
[16] Swiz Rebuttal, p. 10, lines 18-22.

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Q. Is it clear that MAWC would have a much lower credit rating if it had a capital structure consistent with that of American Water?

A. No. First, although MAWC has obtained *** ***

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Q. In which jurisdictions do these other water utility companies operate?

A. A majority of their operations are in California, New Jersey, Pennsylvania and Connecticut.

Q. Does S&P assign a stronger (i.e. better) regulatory advantage category to these other jurisdictions?

A. Only Pennsylvania. Otherwise the other jurisdictions are assigned a weaker (i.e. worse) regulatory advantage categories than Missouri.

Q. Are any of these companies similar in size to MAWC on a stand-alone basis?

A. Yes. In fact, many are smaller.

Q. How did you measure the size of MAWC compared to the comparable companies?

A. Based on the book value of assets as of June 30, 2022.

Q. What was the book value of MAWC's assets as of June 30, 2022?

A. $3.197 billion.[17]

Q. What is the book value of the assets at June 30, 2022, for the comparable water utility companies used by each ROR witness in this case?

A. The book values of the assets are as follows:

- American States Water Company: $1.950 billion;
- California Water Services Group: $3.683 billion;
- Essential Utilities: $15.046 billion;

[17] MAWC Balance Sheet at June 30, 2022.

- Middlesex Water Company: $1.038 billion;
- SJW Group: $3.541 billion; and
- The York Water Company: $0.487 billion.

Q. Do any of these companies have limited jurisdictional diversity?

A. Yes. American States Water Company, California Water Services Group and SJW Group are all concentrated in the western part of the United States, with a majority of their operations in California. Middlesex's water utility operations are predominately in New Jersey and Delaware. York Water Company's water utility operations are solely in Pennsylvania.

Q. Are any of these smaller and less geographically diverse companies as aggressive as American Water in their use of financial leverage (i.e. debt) in their capital structures?

A. Yes. SJW Group's capital structure has similar leverage to that of American Water. SJW Group has a similar common equity ratio at approximately 40% (see Schedule DM-R-3 attached to my rebuttal testimony).

Q. How do SJW Group's funds for operations ("FFO")/debt ratios compare to American Water's FFO/debt ratios?

A. SJW Group's FFO/debt ratios have been below 10% the last couple of years and are only expected to be in the 10-11% range over the next couple of years. This compares to American Water's FFO/debt ratios of around 13% the last couple of years and expectations of 12-13% over the next couple of years.

Q. Does SJW Group have lower and more volatile earned ROEs than MAWC?

A. Yes.

Q. What is SJW Group's S&P issuer credit rating?

A. 'A-'.

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Q. How does this compare to American Water's S&P issuer credit rating?

A. American Water's S&P issuer credit rating is one-notch higher at 'A'.

Q. Did you estimate MAWC's FFO/debt ratios in your direct testimony?

A. Yes. I indicated that MAWC's FFO/debt ratios have been in the range of 19.1% to 20.3% since 2019.

Q. How did your calculations of MAWC's FFO/debt ratios compare to those determined by S&P for purposes of determining the * ____________________**

A. ____ ____ __________

Q. ____ __________

A. ____ ____ ____ ____ ***

Q. How do MAWC's assets as of June 30, 2022 compare to Missouri's other large utilities?

A. The book values of assets were as follows:

- Ameren Missouri: $19.401 billion;
- Evergy Metro: $9.184 billion;
- Evergy Missouri West: $4.520 billion; and
- Spire Missouri: $5.034 billion.

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Q. What S&P ratings are assigned to the debt of each of Missouri's large regulated utilities?

A. Ameren Missouri's first mortgage bonds are rated 'A'; Evergy Missouri West's unsecured debt is rated 'A-'; Evergy Metro's first mortgage bonds are rated 'A+'; and Spire Missouri's first mortgage bonds are rated 'A'.

Q. Why are you providing information on the amount of assets and credit ratings for Missouri's other utilities?

A. Because Ms. Bulkley and Mr. Swiz claim that MAWC is charged a lower cost of debt because of its ability to access financing through AWCC. As demonstrated, Spire Missouri's and Evergy Missouri West's assets are not that much larger than MAWC's assets. ** ____

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____ ** All of Missouri's other large regulated utilities have an embedded cost of long-term debt of 4% or less as compared to MAWC's 4.5% cost of debt.

Q. Ms. Bulkley indicates that American Water can carry more leverage than its subsidiaries due to the fact that it is the largest water utility holding company diversified across many different regulatory jurisdictions.[19] Do you agree with her assertions?

A. I agree that having operations in several jurisdictions diversifies risks, but it certainly does not justify an approximate 10% difference in American Water's common equity ratio compared to that which it requests be used to determine MAWC's ROR. As I have explained, rating agencies typically have less stringent financial ratio benchmarks for regulated water utilities, whether stand-alone or part of a holding company, as compared to most regulated electric and some gas utilities, such as Spire Missouri. This explains why

[18] Murray Rebuttal, p. 10, lines 1-10.
[19] Bulkley Rebuttal, p. 31, line 15 – p. 32, l. 4.

even water utility companies that have FFO/debt ratios in the 10% to 12% range still have at least an 'A-' credit rating.

Q. Ms. Bulkley expresses concern that if the Commission were to adopt a more leveraged capital structure to set the ROR for MAWC, this would weaken MAWC's credit metrics and "could limit MAWC's options for access to capital from sources other than AWCC."[20] What information does she rely on to support her position?

A. Ms. Bulkley identifies Moody's 2019 downgrade of American Water's credit rating from 'A3' to 'Baa1' due to its steadily declining financial risk profile. As Ms. Bulkley identifies, at the time Moody's downgraded American Water's credit rating, its FFO/debt ratio had declined to 16% in 2016 from around 18% in 2014. Although American Water's FFO/debt ratios have declined to around 13% in recent years, Moody's has not downgraded American Water's credit rating further. However, Moody's cited the following "credit challenges" in its 2019 report as it relates to American Water's creditworthiness:

- Primarily debt-funded free cash flow deficits increasing leverage
- Declining financial metrics
- Over $2.0 billion of annual capex and up to 10% dividend growth assumed through 2026
- $1.5 billion of asset sales proceeds used to offset future equity issuance, but not repay debt[21]

Moody's further indicated the following about American Water's ratings outlook:

> American Water's stable outlook incorporates our view that financial metrics will decline over the next few years (e.g., FFO to net debt and retained cash flow (RCF) to debt between 12-13% and 8-9%, respectively), but remain above our downgrade thresholds.

Consequently, I agree with Ms. Bulkley that Moody's continues to express concern about American Water's more aggressive use of debt.

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[20] Bulkley Rebuttal, p. 29, lines 7-10.
[21] Ryan Wobbrock, et. al, "American Water Works Company, Inc.: Update to credit analysis," November 4, 2021.

Q. If the Commission adopted your recommended ratemaking capital structure and ROE, what is your estimate of the impact on MAWC's FFO/debt ratio?

A. The revenue requirement difference attributed to my recommended capital structure and ROE compared to MAWC's view of its implied ROE and capital structure from the 2020 rate case is approximately $23 million/year. The pro forma impact of the reduction to FFO and increase to MAWC's debt ratio would reduce its FFO/debt ratio by approximately 4% to 4.5%. Applying this reduction to *** ____ ____ ____________________

Q. ____ ____________________________

A. ____ ____ ____ ____________________ ***

Q. Is it MAWC's position that it is an independent company that should be viewed on a stand-alone basis without consideration for American Water's financial policies?

A. Yes. This is MAWC's position, but the facts and circumstances prove that MAWC's position is wrong. The cost of debt assigned to MAWC is based on American Water's risk profile, which includes its use of leverage. Ms. Bulkley uses American Water's declining FFO/debt ratios to bolster her position that if the Commission should adopt a capital structure consistent with American Water's, this will constrain MAWC's ability to access financing outside of American Water. However, if this is a concern for MAWC (a company that does not currently directly procure capital through the corporate debt markets), then it should be American Water's concern (the company that directly procures capital through corporate debt markets for its subsidiaries).

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If a more conservatively managed capital structure is important for capital attraction, then this needs to occur at American Water. However, anytime OPC has requested American Water-level financial information from MAWC, such as information related to American Water's anticipated common equity issuances of up to $2 billion through 2026, MAWC has objected and refused to provide such information. While refusing to provide American Water information may be consistent with MAWC's stated position of independence, MAWC's stated position is at issue in this case. In fact, as compared to Ameren Missouri, Spire Missouri, Evergy Metro and Evergy Missouri West, MAWC's financing is even less independent from the parent company, yet each of these other Missouri utility companies provided OPC access to parent company information and documents. This allowed OPC to investigate the operating utility company's claims of being independent by comparing the substance of the operating company's Board of Director ("BOD") meetings to that of the parent company's BOD meetings. Even with the Missouri utility subsidiaries that issue their own debt to third-parties, OPC discovered that the subsidiary BOD minutes and materials lacked much substance.

Q. What is MAWC's support for its position that it is a financially and operationally independent entity?

A. Mr. Swiz continues to emphasize that MAWC is a stand-alone business because it has independent state operations, capital investments, and corporate governance.[23] He also testifies that MAWC's management team is responsible for development of independent operating capital and financing plans.[24]

Q. Does Mr. Swiz testify about the analysis MAWC performs for purposes of establishing a targeted capital structure for MAWC?

A. Yes. On page 15, line 12 through page 16, line 1 of Mr. Swiz's rebuttal testimony he describes what seems to be a fairly detailed analyses and planning process for purposes of

[23] Swiz Rebuttal, p. 4, lines 19-21.
[24] Merante Direct, p. 7, lines 21-22.

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determining a fair and reasonable balance of common equity and debt in its capital structure.

Q. Have you reviewed the 2022 budget MAWC management provided to MAWC's BOD for approval?

A. Yes. Please see the attached Schedule DM-S-4 for MAWC's 2022 budget.

Q. Did MAWC hold a BOD meeting to discuss the 2022 Budget before it was approved?

A. No.

Q. Did MAWC's management provide presentations to the MAWC BOD to prove that procuring debt financing from AWCC was the most economical and prudent option?

A. No.

Q. Did MAWC's management provide a capital structure analysis to the MAWC BOD to illustrate that MAWC's budgeted capital structure would achieve certain credit metrics to allow for a lower cost of capital while maintaining a stable credit rating?

A. No.

Q. Is this the type of substance you would expect for an "independent" company?

A. Yes.

Q. Is it likely that presentations to American Water's BOD contain this type of substance?

A. Yes.

Q. Whose interests do MAWC's BODs represent?

A. American Water's shareholder's interests as it wholly-owns MAWC.

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Q. Have any of the members of MAWC's BOD also held other positions with the American Water family of companies?

A. Yes. Three of the five members of MAWC's BODs have held positions with other companies within the American Water family of companies.

Q. Have you discovered anything in the MAWC BOD materials and meeting minutes which would lead you to believe that MAWC's BODs is acting solely in the best interests of MAWC and its ratepayers?

A. No.

RESPONSE TO BULKLEY REBUTTAL TESTIMONY ON ROE

Q. Can you summarize Ms. Bulkley's criticisms of your recommended ROE?

A. Yes. Ms. Bulkley claims that my interpretation of the impact of market conditions on MAWC's cost of equity ("COE") in this case are inconsistent with my interpretation in MAWC's 2020 rate case, Case Number WR-2020-0344. She indicates that I have changed my explanation for American Water's high P/E ratios from low long-term interest rates in the 2020 rate case to high demand for its stock in the current market environment because of American Water's favorable environment, social and governance ("ESG") ratings rather than interest rates. Ms. Bulkley claims that my inconsistency in interpreting market conditions is due to personal bias for a desired outcome.[25] Although I will address her criticisms in more detail later in my testimony, I am simply reporting the market's valuation of American Water's stock. I am not manipulating American Water's stock price, or predicting what it might be in the future as Ms. Bulkley suggests is appropriate in setting a fair and reasonable ROE in this case. I am simply comparing American Water's stock price to its projected earnings. American Water's P/E ratios continue to be extremely high. Because long-term interest rates increased significantly in 2022, then obviously long-term rates are not the explanatory variable they had been in the past for utility stocks. Consequently, my analysis and research is an attempt to understand and explain the factors

[25] Bulkley Rebuttal, p. 18, line 12 – p. 19, line 2.

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causing American Water's stock price to continue to be highly valued. This pure market data supports, at least on a conceptual basis, that MAWC's cost of equity is lower, whether it is due to macro factors, stock demand and/or lower business risks.

Q. Ms. Bulkley claims that you placed no weight on your COE analysis for purposes of your recommended allowed ROE.[26] Is she correct?

A. No. I recognize that my allowed ROE recommendation is not at parity with my COE estimate, but this does not mean I did not rely on my COE estimates in determining a reasonable recommended allowed ROE. COE analysis using complex methods, such as discounted cash flows ("DCF"), Capital Asset Pricing Models ("CAPM") and risk premium methods, can result in a wide range of COE estimates due to various assumptions (industry growth rates and equity risk premiums). However, there are simple, straightforward reasonableness tests (standard risk premium added to a company's own bond yield) and corroborating practical information (stock analysts' utility cost of equity assumptions) that can assist in determining the reasonableness of COE estimates. Ms. Bulkley believes allowed ROEs are the proper barometer to test the reasonableness of COE estimates. If utility investors followed Ms. Bulkley's advice, utility stocks would be wildly overpriced. They are not. I am not attempting to use methods and assumptions to target a desired allowed ROE. I am providing a reasonable, objective and logical analysis to provide the Commission information on utility companies' current cost of capital. I have observed and recognized that investors expect allowed ROEs to be higher than the COE. In fact, as I will discuss later, Ms. Bulkley actually cites to investor communications that confirm such views.

Consequently, my COE estimate of around 6% to 6.5% supports MAWC being authorized a lower ROE than the 9.25% ROE the Commission authorized Empire in Case No. ER-2019-0374 and the 9.37% the Commission authorized Spire Missouri in Case No. GR-2021-0108.

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[26] *Id.*, p. 5, lines 9-16.

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Q. Ms. Bulkley claims your authorized ROE recommendation is "mismatched" because it is applied to a more leveraged capital structure than that which is consistent with the proxy companies' capital structures.[27] Does she accurately represent your approach?

A. No. I included American Water in my proxy group COE analysis. My COE estimate for American Water is consistent with the COE estimates for the other water utility companies in my proxy group. Therefore, if anything, my approach of analyzing American Water's specific financial fundamentals as compared to its stock price, is superior to Ms. Bulkley's approach of applying an ROE she derived from not only other water utility companies with different capital structures, but also other gas and electric companies with different operating risks.

Q. What other mismatch is inherent in Ms. Bulkley's assessment of the cost of common equity as it relates to capital structure?

A. Ms. Bulkley analyzed capital market data of publicly-traded holding companies that own regulated operating utilities. Therefore, her cost of equity estimates are based on the business and financial risk of the holding companies, not the individual operating utilities. As I show on Schedule DM-S-5, seven of Ms. Bulkley's thirteen proxy companies have equity ratios generally below 45% with three of these companies having equity ratios below 40%, which is even more leveraged than American Water's capital structure.

I note that these common equity ratios include each company's use of short-term debt, which is a financial risk factor utility equity investors consider when determining their required return on equity for investment in the holding company's equity. Short-term debt not only adds leverage to the balance sheet, but it subjects the company to refinancing risk, which causes greater uncertainty in the equity investors' expected return. I note these issues because Ms. Bulkley derived her ROE estimates by analyzing the cost of equity of the holding companies and then applied her ROE estimates to her derivation of less leveraged operating subsidiary capital structures. Therefore, she is guilty of her own

[27] *Id.*, p. 34, line 1 through page 35, line 22.

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accusation of mismatching, while I apply my ROE estimates to a capital structure similar to that which investors actually consider in determining their required market return on equity.

Q. Does Ms. Bulkley appear to accept that water utility companies currently have a lower COE due to high valuation levels?

A. Yes. Ms. Bulkley acknowledges that water utility stocks are currently trading at valuation levels that are well above historical averages.[28] However, as I discussed in my rebuttal testimony, instead of providing her estimate of the water utility industry's current COE, Ms. Bulkley apparently believes she has the ability to predict the water utility industry's future COE. For example, she states the following:

> …he [Mr. Murray] has failed to account for the fact that equity analysts view water utility stock prices as overvalued and are expecting their stock prices to decline. As water utility stock prices decline going forward, in the case of Mr. Murray's multi-stage DCF, the amount needed to be paid by an investor to capture the benefit of future dividends declines, thereby increasing the cost of equity.[29]

Ms. Bulkley supports her predictions by citing to various equity analysts' recommendations to either hold or even sell water utility stocks due to current high valuations. She even cites that water utility stocks are currently *expensively* priced.[30]

Q. If a security is *expensive* to an investor, what does this mean for the issuer of the security?

A. It is cheap to procure capital, which is synonymous with a low cost of capital. In fact, as I illustrated in various charts in my direct testimony, American Water likely has the lowest cost of equity of any company in the entire utility industry. American Water's low cost of equity is a function of its ownership of low-risk regulated water utility subsidiaries, which includes MAWC.

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[28] *Id.,* p. 17, lines 6-7.
[29] Bulkley Rebuttal, p. 55, lines 11-15.
[30] *Id.*, p. 57, lines 5-8.

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Q. Ms. Bulkley claims that the mere fact that your cost of equity estimates are below typical authorized ROEs proves that your cost of equity estimates are not reliable.[31] Does Ms. Bulkley quote investor information that corroborates your position that authorized ROEs are higher than utility companies' cost of equity?

A. Yes. On page 56, lines 14-17 of her rebuttal testimony, Ms. Bulkley provides the following Morningstar information regarding its outlook for American Water's stock:

> Morningstar currently rates American Water as 2 out of 5 stars and that its stock price is overvalued, but Morningstar states it is confident that American Water's "**returns on invested capital will remain at a healthy spread over its cost of capital for the foreseeable future"** (emphasis added)[32]

Because Morningstar's audience are investors, they are forthright about the widely accepted view in the investment community—utilities earn more than their cost of capital, which is due to the fact that they are typically authorized returns at a significant spread over their cost of capital. In my experience, the only time in which investors thought allowed returns were not at a "healthy spread" over the cost of capital was at the height of the financial crisis in early 2009.

Q. Despite Ms. Bulkley's view that water utility stock prices will decline in the future, does she maintain that investors expect water utilities to grow faster now compared to their expected growth in early 2021?

A. Yes. In rebutting Mr. Jennings's testimony, Ms. Bulkley indicates that the average projected growth rates for water utilities have increased compared to 2021.[33]

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[31] *Id.* p. 4, lines 20-23.
[32] Andrew Bischof, "American Water's Regulated Water Growth Should Top Most Electric Utilities," Morningstar Investor, November 8, 2022.
[33] *Id.,* p. 16, lines 5-8.

Q. Does this demonstrate the fact that the utility business model is almost recession proof?

A. Yes. Despite general concerns about a potential recession due to the Fed's aggressive monetary policy tightening, apparently utility companies are confident in continuing their growth in investment because otherwise their expected earnings growth rates would decline. Again, these types of factors explain why utility stock valuation levels have not declined much along with the increases in long-term bond yields. Under normal competitive conditions, companies expect their profitability and growth to decrease, but not so for utility companies. In fact, they use current market conditions as support to request a higher ROE.

Q. Does your recommended allowed ROE allow for a significant spread over the COE?

A. Yes. My allowed ROE recommendation allows for a 275 basis point margin over my COE estimate. As I explained in my direct testimony, some utility investors have indicated that they expect the allowed ROE-to-COE spread to average approximately 225 basis points over the long-term.[34]

Q. Ms. Bulkley claims that your fairly stable ROE recommendations of 9% to 9.25% in cases since December 1, 2019, disregards changing capital market conditions over the same period.[35] Do you agree?

A. No. I consider my recommended authorized ROEs as quite reasonable and measured. Ms. Bulkley is correct that this period included significant capital market changes, such as a decade-long secular decline in long-term bond yields, which caused utility P/E ratios to hit all-time highs in February 2020. While utility stock valuation levels in February 2020 implied that the utility industry's COE was as low as in the 5% range, I recommended the Commission reduce its previous authorized ROEs of around 9.5% to 9.25%. While a 9% ROE at that time would certainly have been justified, a 9.25% ROE was more incremental and measured. Fortunately, the Commission did reduce both Empire's and Spire

[34] Murray Direct, p. 19, line 26 – p. 20, l. 2.
[35] Bulkley Rebuttal, p. 48, l. 4 – 49, l. 7.

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Missouri's authorized ROEs. Because equity capital market conditions tightened slightly for the electric and gas utility subsectors (I estimate their cost of equity is about 100 basis points higher than for water utilities), I have recently recommended Spire Missouri's and Ameren Missouri's authorized ROEs be set at 9.25% in Case Nos. GR-2022-0179 and ER-2022-0337, respectively, but as recognized by Ms. Bulkley herself, water utility stock valuation levels, especially for American Water, are at incredibly high levels. This justifies setting MAWC's ROE lower and also applying the ROE to a more leveraged capital structure.

Q. Ms. Bulkley testifies that it is unnecessary to apply a multi-stage DCF method to the utility industry because it is a mature industry with relatively stable growth over time. She indicates that use of a constant-growth DCF is consistent with the views of equity analysts.[36] Did Ms. Bulkley provide any practical examples to support her testimony?

A. No. Consequently, I requested Ms. Bulkley provide practical examples of equity analysts that actually determine a fair price to pay for a utility stock by using the constant-growth DCF using the assumptions she suggests. She could not provide an example. She indicated her testimony is based on her twenty years of experience reviewing equity analyst earnings per share ("EPS") growth rate forecasts (see Schedule DM-S-6). She apparently believes reviewing EPS forecasts, and not the equity analysts' more detailed analysis provided in their reports, as sufficient to support her testimony.

Q. What have you observed in your experience of reviewing the analysis performed by the equity analysts that provide EPS growth forecasts?

A. They typically value utility stocks using two primary methods: a projected P/E multiple based on estimated earnings two-to-three years from the current year and a multi-stage dividend discount model ("DDM") analysis (synonymous with DCF in the utility ratemaking setting). I have specifically reviewed multi-stage DDM analyses performed by Wells Fargo, Evercore ISI and U.S. Capital Advisors. In fact, I attached an example of U.S. Capital Advisors multi-stage DCF in my Direct Testimony (*see* Schedule DM-D-5).

[36] *Id.,* p. 60, lines 1-8.

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Contrary to Ms. Bulkley's assumption, in my twenty years of experience I have *never* seen an equity analyst determine the value of a utility stock consistent with Ms. Bulkley's assumptions. Investors do not naively assume a utility's dividend will grow at a constant rate in perpetuity at the same rate as analysts' projected 5-year compound annual growth rate ("CAGR") in EPS. My experience in reviewing such reports indicates that equity analysts use the projected EPS growth rate to assess if a particular company's P/E ratio should trade at a premium or discount to its peers (e.g. top quartile growth deserves a higher P/E ratio).

Q. Did you review all of the recent equity research reports recently published on American Water?

A. No. Despite MAWC providing this equity research in the 2020 rate case, in this case MAWC has not provided OPC access to this research.[37]

Q. Could these reports contradict theories proffered by cost of capital witnesses such as Ms. Bulkley and contribute to MAWC's lack of cooperation in providing these reports?

A. Certainly.

Q. Ms. Bulkley also claims that the 6% market risk premium American Water used for its goodwill impairment analysis in November 2019 should not be used to assess the reasonableness of the various CAPM analyses in this case.[38] Why?

A. She indicates that these assumptions, which are used to certify to investors that the fair value of its assets are no less than that reported on its balance sheet, are not meaningful because they are not forward-looking. She also states that because this information is from 2019, it is outdated and no longer relevant.

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[37] OPC Data Request No. 3001.
[38] *Id.,* p. 71, line 3 through p. 73, line 8.

Q. Did you request American Water's more recent goodwill impairment assessments, which are completed annually in November?

A. Yes, but MAWC has refused to provide this information.

Q. If American Water had estimated that its cost of capital had increased significantly due to significant changes in capital market conditions, would this be a material factor that should be addressed in subsequent goodwill impairment reports?

A. Yes.

Q. Are you concerned about American Water's resistance to provide these documents as well?

A. Yes. Again, this type of information is used to attest to the accuracy and reliability of the value assigned to American Water's regulated water utility assets. If the cost of capital has increased as much as Ms. Bulkley suggests, this should be of concern to American Water because it may impact the estimated fair value of its regulated water utility assets.

Q. Ms. Bulkley shows annual stock market returns for the 13-year period 2009 to 2021 to support her high market risk premium estimates.[39] If you used the 13-year period ending in 2008, what would this information imply about market risk premium estimates starting in 2009 when the S&P 500 had just declined by 37% in 2008?

A. The arithmetic average annual S&P 500 market returns for the period 1996 to 2008 was 7.05%. The arithmetic average annual long-term United States Treasury ("UST") bond returns over this same period was 8.98%. Based on Ms. Bulkley's logic of using a recent 13-year total return to estimate a market risk premium, this would imply that investors' market risk premium was a negative 1.93% over UST bonds at the beginning of 2009. These arbitrary periods should not be used to justify an implied market risk premium. It is widely understood that during periods when the S&P 500 is trading at high valuation levels, the required returns going forward are lower, and when the S&P 500 is trading at lower

[39] *Id.*, p. 71, lines 1-2.

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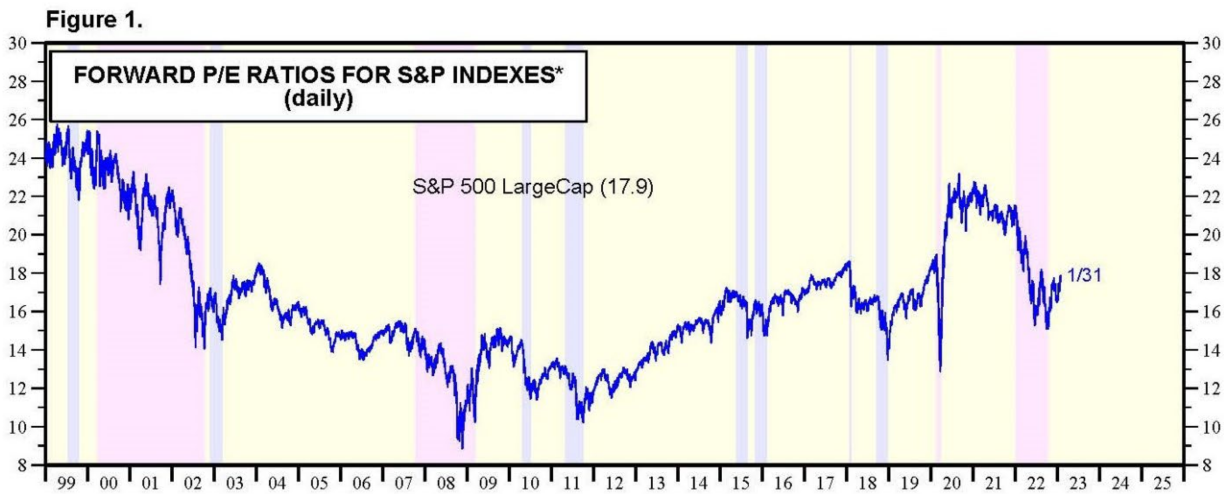
levels, the required returns going forward are higher. See the following chart which shows the valuation levels of the S&P 500 over the last couple of decades:



Q. Does Ms. Bulkley recognize that using select historical periods may cause counter-intuitive indications of investors' implied market risk premiums?

A. Yes. Just a few pages earlier in in her rebuttal testimony, Ms. Bulkley explains the counter-intuitive conclusions one could make using historical earned market returns to estimate implied required market returns.[40] This logic is equally applicable when market returns have been unexpectedly higher or lower than investors expect over the long-term.

Q. Ms. Bulkley testifies that the Commission authorized Spire Missouri a 54.25% common equity ratio in Case No. GR-2021-0108.[41] Is she correct?

A. No. The Commission's authorized common equity ratio in Case No. GR-2021-0108 was 49.86%.[42]

[40] *Id.*, p. 66, line 5 – p. 67, line 10.
[41] *Id.*, p. 42, lines 18-20.
[42] Case No. GR-2021-0108, Staff Accounting Schedules, Commission Amended Report & Order, December 13, 2021 (EFIS Item No. 456).

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Q. What do you conclude after considering Ms. Bulkley's criticisms of your testimony?

A. Ms. Bulkley freely admits that water utility stocks are trading at high valuation levels. She also acknowledges that expected growth for the utility industry is relatively stable over long periods. If expected growth rates for utilities are fairly stable, then the primary factor impacting investors' assessment of a fair price to pay for utility stocks is their required return on equity (i.e. the cost of equity). The primary consideration should not be whether water utilities current higher valuation levels are due to the level of long-term interest rates, higher demand due to ESG considerations, lower business risk, defensive characteristics in light of recessionary fears, the ability to pass higher inflationary costs through to ratepayers and/or any other investor considerations. Rather, the primary consideration in setting a fair and reasonable ROE based on consideration of the COE is whether utility stock prices are higher because investors are willing to accept a lower return based on current business, interest rate, and/or economic conditions. The answer to this consideration is yes. This should be reflected in a lower authorized ROE for MAWC.

RANDALL T. JENNINGS

Q. What are Mr. Jennings' criticisms of your direct testimony and what is your response?

A. Mr. Jennings testifies that my recommended ROE of 9% is inconsistent with my findings that MAWC's COE has increased slightly since the 2020 rate case. As Mr. Jennings correctly notes, I recommended a 9.25% ROE in the 2020 rate case. However, the mid-point of my estimated COE range of 6% to 6.5% in this case is 25 basis points higher than the mid-point of my COE range of 5.5% to 6.5% in the 2020 rate case. My narrower range in this case is due to my concern that methodologies that rely more heavily on long-term bond yields are not as reliable in the current capital market environment. As I showed in several charts in my Direct Testimony, for the period since the onset of Covid-19, utility stocks' P/E ratios have not exhibited their typical strong negative correlation to changes in long-term bond yields. Additionally, my comparison of the valuation levels of water utility stocks to the valuation levels of regulated electric and natural gas utility companies' stocks supports my position that water utility companies' costs of capital are lower than that of electric and gas utility companies. The resiliency of the water utility industry's P/E ratios in light of increasing long-term bond yields should be considered in determining whether Missouri's water utility companies should be awarded an ROE different from that of Missouri's gas and electric utility companies. Consequently, I decided a 9% ROE is reasonable, which is below the ROEs the Commission authorized Empire and Spire Missouri.

Q. Mr. Jennings cites to your response to Staff Data Request No. 0279. Did you make a mistake in your response to this data request?

A. Yes. In my response, I indicated that my American Water-specific multi-stage DCF cost of equity estimate in this case is 20 basis points higher than my estimate in the 2020 rate case. I incorrectly compared my 6.04% estimate using a 3.5% perpetual growth rate in the 2020 rate case to my 6.24% COE estimate using a 4% perpetual growth rate in this rate case. If I had properly compared my company-specific multi-stage DCF COE estimates using a 4% perpetual growth rate in both cases, my COE estimate for American Water is essentially the same in both cases (approximately 6.25%).[43]

SUMMARY AND CONCLUSIONS

Q. Can you summarize the main points of your surrebuttal testimony?

A. Yes. MAWC witnesses claim that American Water is able to carry more leverage than MAWC because of its diversified holdings of several low-risk regulated water and sewer companies. I claim that American Water can carry more leverage because of its high quality, low-risk regulated water and sewer utility subsidiaries, which include MAWC. MAWC's witnesses' arguments are based on hypothetical scenarios of MAWC being a stand-alone company. My recommendation is based on the reality that MAWC is not a stand-alone company, but rather a company being charged debt costs based on the risk profile of its pure-play water and sewer parent company, American Water. The more

[43] Murray Direct, Schedule DM-D-2 and Case No. WR-2020-0344, Murray Direct, Schedule DM-D-2

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leveraged capital structure supporting MAWC's low-risk assets is that of American Water's consolidated capital structure. My recommendation matches the debt costs charged to MAWC with the capital structure in which American Water's debt investors invest.

Utility commissions in other states have not resisted American Water's financial strategy of targeting equity-rich capital structures at its subsidiaries to allow for higher cash flows to support even more debt at the holding company. Therefore, American Water has been increasing the delta between its actual consolidated common equity ratio and those it requests regulators approve for ratemaking. There is no objective evidence that demonstrates American Water's business risk has declined for any reason other than it owns high-quality, low-risk regulated water and sewer utility assets, which includes MAWC.

Water utility stock valuation levels support a lower cost of capital environment. American Water trades at the highest P/E ratio of all of it peers. Ms. Bulkley's attempt to speculate as to the direction of utility capital markets should be dismissed. MAWC's authorized ROE should be set below that which the Commission authorized Missouri's gas and electric utility companies.

Q. Does this conclude your testimony?

A. Yes.

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of	)	
Missouri-American Water Company's	)	
Request for Authority to Implement	)	Case No. WR-2022-0303
General Rate Increase for Water and Sewer	)	
Service Provided in Missouri Service Areas	)	

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 surrebuttal 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 8th day of February 2023.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

TIFFANY HILDEBRAND
My Commission Expires
August 8, 2023
Cole County
Commission #15637121

Tiffany Hildebrand
Notary Public

My Commission expires August 8, 2023.