Exhibit No.:	
Issues:	Ability to attract funding
Witness:	Cheryl D. Norton
Exhibit Type:	Surrebuttal
Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2017-0285 SR-2017-0286
Date:	February 9, 2018

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2017-0285
CASE NO. SR-2017-0286

SURREBUTTAL TESTIMONY

OF

CHERYL D. NORTON

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

IN THE MATTER OF MISSOURI-AMERICAN WATER COMPANY FOR AUTHORITY TO FILE TARIFFS REFLECTING INCREASED RATES FOR WATER AND SEWER SERVICE	)))))	CASE NO. WR-2017-0285 CASE NO. SR-2017-0286

AFFIDAVIT OF CHERYL D. NORTON

Cheryl D. Norton, being first duly sworn, deposes and says that she is the witness who sponsors the accompanying testimony entitled "Surrebuttal Testimony of Cheryl D. Norton"; that said testimony was prepared by her and/or under her direction and supervision; that if inquiries were made as to the facts in said testimony, she would respond as therein set forth; and that the aforesaid testimony is true and correct to the best of her knowledge.

Cheryl D. Norton

Cheryl D. Norton

State of Missouri
County of St. Louis
SUBSCRIBED and sworn to
Before me this 7th day of February 2018.

Mary Beth Hercules

Notary Public

My commission expires:

MARY BETH HERCULES
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires April 28, 2020
Commission # 96546828

SURREBUTTAL TESTIMONY
CHERYL D. NORTON
MISSOURI-AMERICAN WATER COMPANY
CASE NO. WR-2017-0285
CASE NO. SR-2017-0286

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SURREBUTTAL TESTIMONY

CHERYL D. NORTON

I. INTRODUCTION

Q. Please state your name business address and position.

A. My name is Cheryl D. Norton, and my business address is 727 Craig Road, St. Louis, MO, 63141. I am the President of Missouri-American Water Company ("Missouri-American", "MAWC" or the "Company").

Q. Have you previously submitted testimony in this proceeding?

A. Yes, I previously submitted Direct Testimony.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to underscore how the ratemaking adjustments and policies advocated by the parties in this case adversely impact the Company's ability to achieve funding levels that best serve the long-term interests of its customers. As explained in the testimony of Company witness Jenkins, under Missouri's traditional ratemaking approach, Missouri-American is facing persistent revenue shortfalls from declining use per customer and the need to rebuild legacy infrastructure.

Q. Have the Company proposals attempted to address these issues?

A. Yes. Mr. Jenkins further explains how the Company's alternative ratemaking proposals (revenue stabilization mechanism ("RSM") and future test year) are intended to, and will, efficiently and effectively address those concerns. The RSM provides the Company a realistic opportunity to collect its authorized revenue requirement, and the future test year properly recognizes the expense levels and plant that will be serving Missouri-American's customers when the new rates take effect.

Q. Are there other issues that will have a significant impact on this circumstance?

A. Yes. I will also explain the likely consequences if the Commission adopts a return on equity ("ROE") that is on the order of the ROEs recommended by the Staff of the Commission ("Staff") or the Office of the Public Counsel ("OPC"). As MAWC witness Bulkley explains in her rebuttal testimony, those ROE recommendations are lower than all but four that any commission has authorized in recent history and are out of touch with ROEs found reasonable for other American Water operating utilities and with ROEs generally across the country. Furthermore, when the low ROEs are combined with Staff's recommendation to impose an equity ratio of just 43.99%, the result would directly and adversely impact the Company's ability to secure discretionary funding levels that best serve the long-term interests of our customers.

II. MAWC's ABILITY TO ATTRACT FUNDING

Q. Are you aware of the net result of Staff's ROE recommendation?

A. Yes, in her rebuttal testimony, Ms. Bulkley explained that Staff witness Smith's recommended equity ratio of 43.99 percent, in combination with his recommended ROE of 9.25 percent, would provide an overall equity cost rate of 4.07 percent. She noted that this is lower than all but four of the equity cost rates approved in the approximately 90 rate case decisions reported by Regulatory Research Associates for water utilities since 2012. Moreover, Ms. Bulkley's Chart 5 demonstrates that Mr. Smith's recommended equity ratio and ROE would provide MAWC a return well below the vast majority of authorized equity cost rates for water utilities since 2012.

Q. Have you asked MAWC witness Bulkley to perform a similar calculation for OPC and Missouri Industrial Energy Consumers ("MIEC") witness Gorman's overall equity cost rate?

A. Yes, Ms. Bulkley calculated Mr. Gorman's equity cost rate to be 4.50%.

Q. How do these equity cost rates stack up against the equity cost rates that are in place for your sister utility companies in the American Water system?

A. Ms. Bulkley advised me that the median equity cost rate approved by regulators for the regulated water utilities in the American Water system is 4.88%. Therefore, the rates of return and equity ratios recommended by Messrs. Smith and Gorman, respectively, would be lower than the median cost rate allowed for other American Water companies by regulators. Moreover, because of the very low equity ratio recommended by Mr. Smith, even though his ROE is 25 basis points higher than Mr. Gorman's, his equity cost rate would place MAWC at the very bottom among the American Water regulated utilities.

Q. Are there other factors that exacerbate the low equity cost rates recommended by the witnesses for Staff and OPC?

A. Yes, most definitely. As Mr. Jenkins has testified, the Company has been chronically unable to achieve its allowed rate of return due, in large part, to Missouri's traditional regulatory policies. The use of the historical test year and the adoption of sales forecasts that seem rarely to be realized have, among other policies, resulted in our inability to achieve the revenue requirement determined by the Commission. If this were to continue with the rejection of our future test year and revenue stabilization mechanism, the effects of the low equity cost rate would be compounded by the knowledge that we would be unlikely even to achieve that substandard cost rate.

Q. What would the consequences be if the Commission approved such low equity cost rates for MAWC, especially one that places MAWC at the bottom of allowed equity cost rates?

A. American Water owns the common stock of regulated water and wastewater utilities in 14 jurisdictions, including Missouri. A ROE that is so significantly below the returns available to other American Water subsidiaries, as well as other utilities generally, would directly and adversely impact the Company's ability to secure discretionary funding. While American Water always ensures that each of its water and wastewater utilities is afforded funding to provide safe, adequate, and reliable service, investment funding is not limitless. American Water is competing with other companies and industries in the marketplace for capital, and American Water's subsidiaries are competing within the American Water system for discretionary allocations of American Water's investment and financing capacity.

Discretionary allocations within American Water can be influenced by a company's capital requirements, as well as by market conditions and available funds. Like any rational investor, American Water considers what return it can earn when considering investment opportunities. All other things being equal, American Water, again, like any investor, generally favors higher-return investments over lower ones, provided the investment risks are comparable. If Staff's or OPC/MIEC's recommendations – compounded by Staff's low equity ratio - were adopted, the Company would have the lowest authorized equity cost rate of any of American Water's regulated subsidiaries—by a very wide margin. As a consequence, American Water would have much less incentive to allocate discretionary funding to MAWC than to its other regulated subsidiaries.

Q. So is the concern about attracting money from investors, or what is best for customers?

A. Both, this is about aligning customer and shareholder interests. We have a multi-decade-long investment need that is funded up-front by shareholders and lenders and recovered from customers over a 40 plus-year time frame. American Water is acutely aware that utility statutes and regulatory schemes vary from state to state; regulatory commissions have different policies, administrative procedures, and precedents; and these differences affect American Water's investment decisions. Investors have choices. The choices investors make must necessarily consider the returns available on invested capital. When investors have an incentive to invest, they will, and when they do not, they won't. Imposing extraordinarily low shareholder returns may have the temporary effect of lowering rates, but that practice ultimately imposes long-term costs that cannot be measured in dollars alone. Discouraging discretionary funding that serves the long-term interests of customers, in the name of "protecting" those customers, ultimately harms the constituency the policy is meant to help. It is well-recognized that a reasonable ROE and equity ratio is necessary to align both customer and investor interests. This results in a stronger and more reliable water system for both current and future customers, reduces the need for general rate cases, lessens the occurrence of customer "rate shock," supports the maintenance and improvement of essential infrastructure, ensures safety and reliability, and allows for more efficient, streamlined regulation.

Q. What is your role in securing capital for MAWC?

A. Part of my job involves making the case to American Water for investment in Missouri. Every affiliate employs someone in a capacity comparable to mine, and part of that person's job is to make the case for investment in their respective state. Because the collective need for capital inevitably exceeds the resources available from American Water, the various states are effectively competitors. This type of competition is healthy because it forces the utilities to identify and develop projects that produce the greatest benefits at the least cost. But it is competition nonetheless, and the utility's authorized ROE is a factor that definitely influences capital investment decisions.

Q. Are you suggesting that American Water will cut-off investment to MAWC if the Commission adopts equity cost rate recommendations that place it among the worst performing in the American Water system?

A. I am not saying that at all. As I said previously, the Company will fulfill its duty to provide safe, adequate, and reliable service. MAWC continues to make the necessary investments in developing and maintaining adequate sources of supply, treatment, pumping, transmission and distribution facilities, as well as to comply with applicable environmental laws and regulations (Safe Drinking Water Act, the Clean Water Act, etc.).

Q. Where does the Commission's approach make a difference?

A. The manner in which a utility complies with regulatory standards is generally a matter of management's business judgment— for example, whether capital investment now is more cost effective over the long term than annual maintenance expenditures. Good business practice dictates that the utility invest in its system at a level that is more than the bare-minimum acceptable regulatory standards, but less than a level that suggests a rate base with unnecessary facilities. Between these extremes lies a vast range of acceptable business judgment.

Q. How does this work in practice?

A. When an investor is confronted with the choice of investing in Missouri at 4.07% equity cost rate or, for example, nearby Iowa or Illinois, at a 5.00% and 4.88% equity cost rates, respectively, the disparity in available returns will necessarily steer the allocation of discretionary capital in a way that requires MAWC to manage operations toward the "bare minimum" end of the acceptable range. By doing so, capital is freed-up for jurisdictions with higher equity cost rates to operate toward the other end of the range. The equity cost rate that Staff is recommending would put MAWC in a subordinate position, resulting in capital funding at a level necessary to maintain only adequate service, and certainly not optimal service. And it would surely put me at a distinct competitive disadvantage against my colleagues as we vie for investment by American Water.

Q. Have you quantified the range of what would be considered a "bare minimum"

level of capital investment versus a level that begins to suggest imprudence?

A. I have not, and I do not believe anyone else can, either. There are simply too many variables to consider in deciding whether a utility is spending too much or too little. These judgments are typically made in hindsight based on whether the decision was reasonable, given what was known, or should have been known, at the time the decision was made. My point is not to establish that there is a definite, quantifiable figure for what is "too much" or "too little." I am simply trying to stress the point that authorized ROEs, equity ratios, and the resultant equity cost rates have a very real influence in how capital allocation decisions are made in the real world. And it is my firm belief that Staff's ROE and equity ratio recommendation in this case ignores that reality, as does Mr. Gorman's extremely low 9.0% equity cost recommendation.

Q. What type of capital projects would be at risk if the Commission authorized a 4.07 percent equity cost rate resulting from a low equity ratio?

A. I cannot provide a line-by-line description of every planned project and how it would be affected. What I can say is that investment decisions would have to be re-evaluated. The internal competition for capital with affiliates is difficult enough without being saddled with the lowest equity cost rate in the American water system, which would simply render the Company uncompetitive in relation to its affiliates.

Q. You have discussed the internal competition for capital MAWC faces with respect to its affiliates. Does the Company also face external competition?

A. We do. One of our growth strategies is system acquisitions. There are many water and sewer systems scattered throughout the state, many of which are in dire straits, both financially and operationally. The acquisition of these systems is usually viewed as a "win-win," due to the ability of the acquiring companies to invest in these systems and turn them around. If an investor has an opportunity to fund a competitor and earn a higher equity cost rate than ours, that investor will most likely invest in the more attractive option – in this case, our competitor. Similarly, with an equity cost rate that is substandard, it is unlikely that I could recommend MAWC should make any additional investment to acquire troubled water or sewer systems in Missouri.

Q. **Would a 4.07 equity cost rate attract the level of capital investment needed to address the aging infrastructure replacement issue discussed by MAWC witness Bruce Aiton?**

A. Not likely. As with most other water utilities, Mr. Aiton shows just how much the need to replace aging infrastructure outpaces our available resources. This is a national issue, and mustering the $1.7 trillion in investment needed to address the issue is no small feat, even in the best of times. I cannot imagine a scenario where MAWC would be able to attract the capital necessary to boost its rate of infrastructure replacement to the level that will be needed, when utilities with the same need can offer returns and equity cost rates far superior to those that MAWC can offer.

Q. **If the Company cuts back capital investment to a level supported by a 4.07 equity cost rate, who would be harmed?**

A. Everyone: the Company, American Water, customers, and the Missouri economy. The Company currently invests between $90 and $180 million annually in system improvements and infrastructure. We've directly invested $1.2 billion in capital between 2007 and 2017 in the State of Missouri. For example, over 142 miles of new water mains have been installed in the last three years. This level of investment in Missouri has tremendous statewide impacts including jobs, spending on goods and services, system reliability and improved customer service. In conjunction with our investment, we are highly focused on safety, diversity and the customer experience. The Company's occupational recordable injury rate was 72% better than the industry average as reported by the Bureau of Labor Statistics for 2017 and continues to positively trend. Just under 43 percent of the people we hired in 2017 are diverse. The Company increased its certified diverse sourceable spend over eight times from 2013 to 2017 increasing from 3.82% ($3.8M) to 32.18% ($54.4M). The Company ranked in the top third in customer satisfaction among water companies in the Midwest in the inaugural 2016 - 2017 J.D. Power Water Study and has reduced customer complaints at the PSC by over 20% since 2014. Could the Company have spent less? Perhaps. Would it have achieved these milestones if it had? Absolutely not. The Commission is being asked to authorize an equity cost rate that is the lowest in our system. Such a decision would have regrettable consequences, starting with the unraveling of the benefits achieved through investment that got the Company to where it is today.

Q. **What do you want the Commission to do?**

A. I obviously want the Commission to adopt the Company's ROE recommendation, but I am not submitting this testimony to either attack or defend any witness's methods or recommendation. I simply want the Commission to understand the very real consequences of adopting a ROE and equity ratio that together are so out of step with reality and returns awarded in other jurisdictions

Q. Does this conclude your Surrebuttal Testimony?

A. Yes, it does.