

Exhibit No.:
Witness: Brian A. Janous
Type of Exhibit: Rebuttal Testimony
Issue: Cost of Capital
Sponsoring Parties: Missouri Industrial Energy Consumers
Case No.: WR-2008-0311

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of Missouri-American Water)	
Company's Request for Authority to Implement)	
a General Rate Increase for Water and Sewer)	Case No. WR-2008-0311
Service Provided in Missouri Service Areas)	

Surrebuttal Testimony and Schedule of

Brian A. Janous

On Behalf of

Missouri Industrial Energy Consumers

October 16, 2008
Project 8980



BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water
Company's Request for Authority to Implement
a General Rate Increase for Water and Sewer
Service Provided in Missouri Service Areas

Case No. WR-2008-0311

STATE OF MISSOURI


COUNTY OF ST. LOUIS

SS

Affidavit of Brian A. Janous

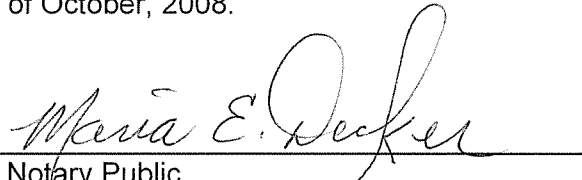
Brian A. Janous, being first duly sworn, on his oath states:

1. My name is Brian A. Janous. I am a consultant with Brubaker & Associates, Inc., having its principal place of business at 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017. We have been retained by the Missouri Industrial Energy Consumers in this proceeding on their behalf.
2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony and schedule, which were prepared in written form for introduction into evidence in Missouri Public Service Commission Case No. WR-2008-0311.
3. I hereby swear and affirm that the testimony and schedule are true and correct and that they show the matters and things that they purport to show.


Brian A. Janous

Subscribed and sworn to before me this 16th day of October, 2008.




Notary Public

**In the Matter of Missouri-American Water
Company's Request for Authority to Implement
a General Rate Increase for Water and Sewer
Service Provided in Missouri Service Areas**

Surrebuttal Testimony of Brian A. Janous

8 A The purpose of my surrebuttal testimony is to respond to the issues raised in
9 Missouri-American witness Pauline Ahern's rebuttal testimony.

BRUBAKER & ASSOCIATES, INC.

1 **Q PLEASE RESPOND TO MS. AHERN’S CLAIM ON PAGE 18 OF HER REBUTTAL**
2 **TESTIMONY INDICATING THAT YOUR CONCERNS REGARDING THE HIGH**
3 **GROWTH RATE ESTIMATES FOR THE COMPARABLE WATER GROUP ARE**
4 **CONTRADICTED BY YOUR OWN TESTIMONY.**

5 A Ms. Ahern’s claim has no merit. Not only do I support the claim made in my
6 testimony that the DCF model should be based upon analysts’ projected growth
7 estimates, the DCF model used in my testimony was, in fact, based on analysts’
8 projected growth rates. My disagreement with Ms. Ahern is not whether analysts’
9 projected growth rates are the proper input into the DCF model, but rather whether
10 current projected growth rates accurately reflect the growth rates for water utilities in
11 perpetuity as required by the constant growth DCF model. As I presented in both my
12 direct and rebuttal testimony, current analyst 3- to 5-year projected growth rates are
13 not a reasonable proxy for long-term sustainable growth and a rational investor would
14 reach this conclusion. Rather, a proper application of the DCF model in this case
15 would reflect more appropriate long-term sustainable growth rates as I have done in
16 my three-stage DCF analysis.

17 **Q DOES THE USE OF EITHER A TWO- OR THREE-STAGE DCF MODEL EQUATE**
18 **TO A REJECTION OF “THE EMPIRICAL EVIDENCE OF THE PROVEN**
19 **RELIABILITY OF ANALYST’S FORECAST OF EPS” AS MS. AHERN CLAIMS ON**
20 **PAGE 20 OF HER REBUTTAL TESTIMONY?**

21 A Absolutely not. Once again, the question is not whether analyst projected growth
22 rates are the appropriate input into a DCF model. The question is which DCF model
23 most accurately reflects a rational investor’s expectation regarding future sustainable
24 long-term growth rates for water utilities. In this case, a single-stage DCF model is

1 simply not adequate to reflect rational investors' long-term expectations while still
2 reflecting very high growth over the next 3 to 5 years.

3 **Q PLEASE RESPOND TO MS. AHERN'S CLAIM ON PAGE 24 OF HER REBUTTAL**
4 **TESTIMONY THAT "THERE IS NO EMPIRICAL EVIDENCE THAT THE SECOND**
5 **OR EVEN THIRD STAGE OF ANY COMPANY, ESPECIALLY THE RELATIVELY**
6 **STABLE UTILITY COMPANIES, WOULD GROW AT THE AVERAGE OF THE U.S.**
7 **ECONOMY."**

8 A Ms. Ahern's claim is demonstrably false. Schedule BAJ-1 demonstrates that
9 electricity use, and hence, electric utility growth, has actually lagged the GDP growth
10 historically. There is no reason to believe that water utilities' growth rates would
11 follow a different pattern. Water company earnings follow plant growth, which follows
12 customer demand, which follows economic growth. Consequently, using projected
13 GDP growth as the long-term sustainable growth rate for water utilities is actually a
14 conservative estimate for the sustainable growth of these companies.

15 **Q PLEASE RESPOND TO THE STATEMENT ON PAGE 25 OF MS. AHERN'S**
16 **REBUTTAL TESTIMONY INDICATING THAT THE RESULTS OF YOUR**
17 **TWO- AND THREE-STAGE DCF ANALYSES ARE "WOEFULLY INADEQUATE**
18 **RELATIVE TO RECENT AUTHORIZED ROEs FOR ELECTRIC AND GAS**
19 **UTILITIES AGAINST WHICH MAWC MUST COMPETE FOR CAPITAL IN THE**
20 **CAPITAL MARKET."**

21 A On page 25 of Ms. Ahern's rebuttal testimony, she compares my two- and three-stage
22 DCF results of 8.73% and 9.02%, for my water group, and 9.20% and 9.30% for my
23 gas group, to a range of recently authorized ROEs of 9.1% and 12.12% as shown on

1 Schedule PMA-18. She indicates that since my results are near or below the low end
2 of this range they should be rejected.

3 **Q IS MS. AHERN'S ARGUMENT REASONABLE?**

4 A No. I should note that I did not use my two-stage DCF result in the determination of
5 my recommended ROE for Missouri-American, but rather I relied solely on my three-
6 stage DCF in addition to my risk premium and CAPM analyses in order to derive my
7 recommendation. The average of my three-stage DCF result of 9.16% is within the
8 range of 9.1% to 12.12% indicated by Ms. Ahern. Further, I find Ms. Ahern's
9 comments here perplexing in light of her insistence in her direct testimony upon the
10 use of all models available for estimating cost of common equity. In fact, she states
11 on page 24 of her direct testimony, "it is clear that investors are or should be aware of
12 all the models available for use in determining a common equity cost rate. The EMH
13 [Efficient Market Hypothesis] requires the assumption that, collectively, investors
14 consider them all." She goes on to state on page 32 of her testimony, "multiple costs
15 of common equity models should be relied upon when estimating investors'
16 expectations." It appears as though Ms. Ahern is willing to rely upon multiple models
17 unless the results fall toward the low end of her desired range.

18 Her rejection of my three-stage DCF model on these grounds is particularly
19 odd in light of her reliance on a comparable earnings model that returns an average
20 result of 14.07% (Ahern Direct Testimony, page 62), which is 195 basis points higher
21 than the high end of her range. Yet, she would reject my three-stage DCF result
22 because it falls only six basis points within the low end of the range. Ms. Ahern's
23 argument here is clearly results-based and should be ignored.

1 **Q PLEASE RESPOND TO MS. AHERN'S OBJECTIONS TO YOUR USE OF THE**
2 **EQUITY MARKET GROWTH FOR THE YEARS 1986 THROUGH 2008 IN THE**
3 **DETERMINATION OF YOUR EQUITY RISK PREMIUM.**

4 A Ms. Ahern argues that my selection of this period is arbitrary since I selected it based
5 upon the rationale that during this period utility common stock has traded at a
6 premium to book value. Ms. Ahern's argument, that is, that there is no relationship
7 between market-to-book ratios and earned rates of return on common equity, is
8 beside the point. The issue is whether regulatory authorized returns on equity have
9 supported a utility's ability to attract capital. I would certainly agree with Ms. Ahern
10 that common stocks of public utilities are influenced by numerous factors which are
11 outside of the influence of regulators, however, the burden is still on regulators to
12 authorize ROE's that are sufficient to support the utility's ability to attract capital
13 through the issuance of common stock without diluting existing shares.

14 **Q WHAT PARTICULAR CONCERNS DOES MS. AHERN RAISE REGARDING YOUR**
15 **CAPM ANALYSIS?**

16 A First, Ms. Ahern objects to my use of total return on treasury securities as opposed to
17 income returns as an appropriate measure of the risk-free rate. Although there is no
18 perfect proxy for a risk-free rate, the relevant comparison in establishing a market risk
19 premium is the premium that equity investors demand for holding equity securities, as
20 opposed to holding treasury securities. A rational investor will consider the total
21 return on treasury securities, not simply income return, when determining what
22 premium is necessary to encourage investment in equity securities.

23 Ms. Ahern also argues that my calculation of the average real market return
24 from 1926 to 2007 is mathematically incorrect. In addition, she claims that it is not

1 appropriate to add a forecasted inflation rate to this average real market return. First
2 of all, the average real market return of 9.0% that I used in my analysis came from the
3 same source that Ms. Ahern cited in her rejection of my figure. Page 120 of the
4 Ibbotson SBBI – 2008 Classic Yearbook – Market Results for Stocks, Bonds, Bills
5 and Inflation¹ indicates that the arithmetic mean real market return for the years 1926
6 to 2007 is, in fact, 9.0%. On the issue of using inflation projections along with
7 historical market returns, I simply disagree with Ms. Ahern that investors would not
8 consider current inflation projections in conjunction with historical real market returns
9 in assessing a risk prospective premium. Rational investors would consider all
10 relevant information, both historical and prospective, when evaluating investment
11 alternatives.

12 **Q PLEASE RESPOND TO MS. AHERN'S COMMENTS ON PAGE 32 THROUGH 33**
13 **OF HER REBUTTAL TESTIMONY REGARDING THE LEVEL OF WATER**
14 **COMPANY BETAS.**

15 **A** As I demonstrated on Schedule BAJ-11 in my direct testimony, water company stock
16 performance as of late has resulted in relatively high betas when compared to
17 historical levels. This is significant because the current betas near 1.0, which would
18 place the risk of water companies on par with that of the overall economy, are just not
19 a reasonable expectation for water company betas going forward. However, for the
20 sake of conservatism, I did use the current beta estimate in developing my ROE
21 recommendation.

¹Ibbotson SBBI – 2008 Classic Yearbook – Market Results for Stocks, Bonds, Bills and Inflation 1926 – 2007, Morningstar, Inc., Chicago, 2008, p. 120.

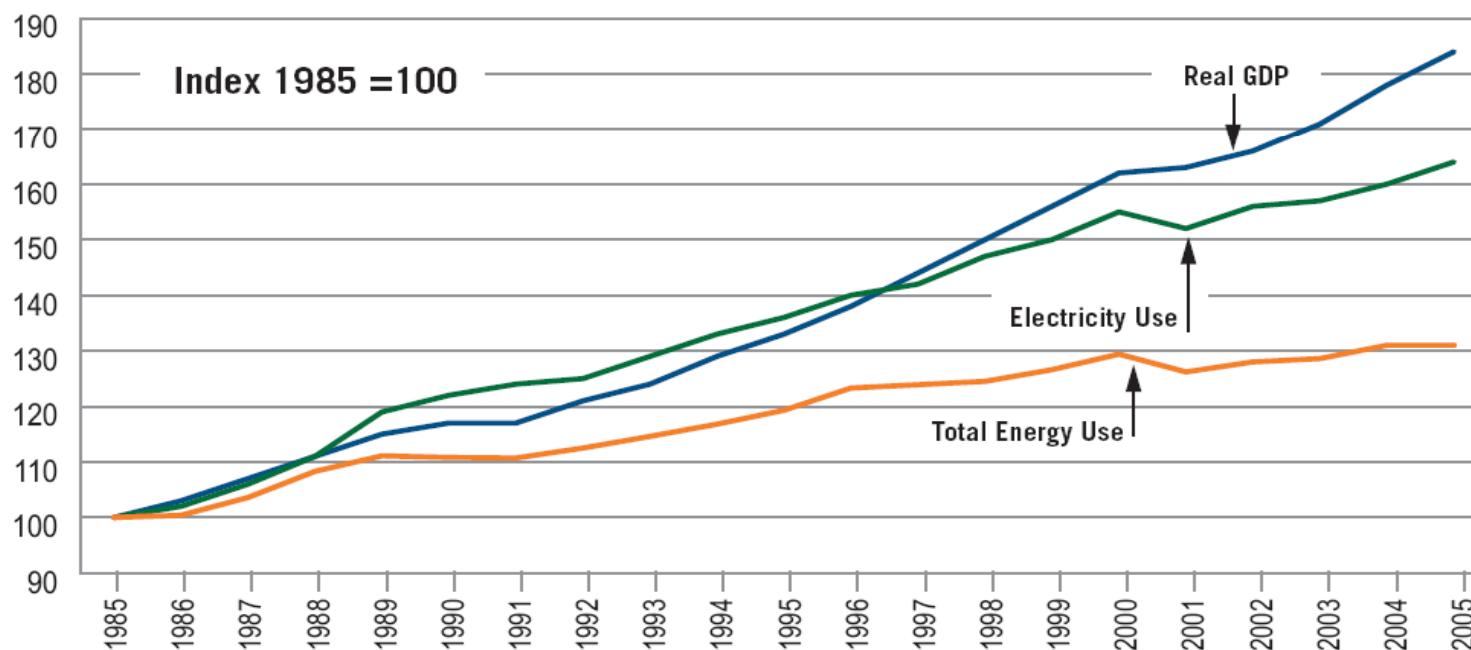
1 **Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

2 **A Yes.**

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Missouri-American Water Company

U.S. Economic Growth Is Linked To Electricity Growth



1985 represents the base year. Graph depicts increases or decreases from the base year.

Source: U.S. Department of Energy, Energy Information Administration (EIA).

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