

Exhibit No.:	
Issues:	Capital Structure Long-Term Debt Cost
Witness:	Scott W. Rungren
Exhibit Type:	Rebuttal
Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2008-0311
Date:	September 30, 2008

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. WR-2008-0311  
SR-2008-0312**

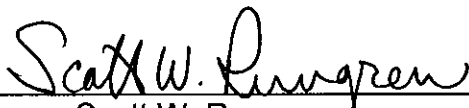
**REBUTTAL TESTIMONY  
OF  
SCOTT W. RUNGREN  
ON BEHALF OF  
MISSOURI-AMERICAN WATER COMPANY**

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

<b>IN THE MATTER OF MISSOURI-AMERICAN )</b>	
<b>WATER COMPANY FOR AUTHORITY TO )</b>	
<b>FILE TARIFFS REFLECTING INCREASED )</b>	<b>CASE NO. WR-2008-0311</b>
<b>RATES FOR WATER AND SEWER )</b>	<b>CASE NO. SR-2008-0312</b>
<b>SERVICE )</b>	

**AFFIDAVIT OF SCOTT W. RUNGREN**

Scott W. Rungren, being first duly sworn, deposes and says that he is the witness who sponsors the accompanying testimony entitled "Rebuttal Testimony of Scott W. Rungren"; that said testimony was prepared by him and/or under his direction and supervision; that if inquires were made as to the facts in said testimony, he would respond as therein set forth; and that the aforesaid testimony is true and correct to the best of his knowledge.

  
\_\_\_\_\_  
Scott W. Rungren

State of Missouri  
County of St. Louis  
SUBSCRIBED and sworn to  
Before me this 2nd day of September 2008.

  
\_\_\_\_\_  
Notary Public

**My commission expires:**

Staci A. Olsen  
Notary Public - Notary Seal  
State of Missouri  
St. Charles County  
Commission # 05519210  
My Commission Expires: March 20, 2009

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**REBUTTAL TESTIMONY  
OF  
SCOTT W. RUNGREN**

**I. INTRODUCTION**

**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

A. My name is Scott W. Rungren and my business address is 727 Craig Road, St. Louis, Missouri, 63141.

**Q. ARE YOU THE SAME SCOTT W. RUNGREN WHO PREVIOUSLY SUBMITTED PREPARED DIRECT TESTIMONY IN THIS PROCEEDING?**

A. Yes, I am.

**II. PURPOSE**

**Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

A. The purpose of my rebuttal testimony is to address, on behalf of Missouri American Water Company (MAWC), the capital structure proposed by the Missouri Public Service Commission Staff (Staff) for determining MAWC's weighted average cost of capital (WACC) in this proceeding. The Staff's capital structure proposal and discussion are contained on pages ten through twelve of the Commission's Staff report entitled "Staff Report – Cost of Service." I also address Staff's methodology for computing MAWC's cost of long-term debt.

1 **III. SUMMARY**

2 **Q. PLEASE BRIEFLY SUMMARIZE YOUR REBUTTAL TESTIMONY.**

3 A. My rebuttal testimony explains why MAWC's capital structure is appropriate for  
4 determining MAWC's overall rate of return on rate base in this proceeding. The  
5 Staff Report incorrectly relies upon the March 31, 2008 consolidated capital  
6 structure ratios of American Water Company (American Water), MAWC's  
7 parent, for determining the overall rate of return on rate base. The reasons  
8 cited by the Staff Report for using American Water's consolidated capital  
9 structure ratios that I address are the following:

- 10 1. MAWC is not a publicly traded company and does not issue its own  
11 common stock.
- 12 2. The debt issued by AWCC is rated based on the consolidated credit  
13 quality of American Water. Thus, the cost of debt MAWC receives from  
14 American Water Capital Corp (AWCC) is based on the consolidated  
15 creditworthiness of American Water.
- 16 3. Investors are not concerned about the capital structure of MAWC when  
17 purchasing the stock of American Water. Rather, they are concerned  
18 about the consolidated capital structure and operations of American  
19 Water (Staff Report, pp. 10-11).

20 I demonstrate that none of these reasons provides any basis for using  
21 American Water's consolidated capital structure for determining MAWC's

overall rate of return on rate base in this proceeding.

#### **IV. CAPITAL STRUCTURE RATIOS**

##### **A. MOPSC'S PROPOSED CAPITAL STRUCTURE**

**Q. THE MISSOURI PUBLIC SERVICE COMMISSION (MOPSC) STAFF REPORT – COST OF SERVICE (STAFF REPORT) RECOMMENDED THAT THE MOPSC ADOPT AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE COMPONENT RATIOS FOR THE PURPOSE OF DETERMINING MAWC'S OVERALL RATE OF RETURN ON RATE BASE IN THIS PROCEEDING. DO YOU AGREE WITH THE STAFF'S RECOMMENDATION?**

**A.** No, I do not. The MoPSC should not set rates for MAWC in this proceeding based upon American Water's consolidated capital structure ratios. Rather, the MoPSC should adopt MAWC's capital structure at the true-up date of September 30, 2008. As shown on Schedule SWR-1, page 1, attached to my direct testimony in this proceeding, the pro forma capital structure consists of 51.99% long-term debt, 0.36% preferred stock, and 47.65% common equity. That schedule will be updated with actual September 30, 2008 MAWC capital component balances when the Company files its true-up in October.

1   **Q.       DOES MAWC'S PRO FORMA CAPITAL STRUCTURE CONTAIN ANY**  
2   **SHORT-TERM DEBT?**

3   A.       No, it does not. At the time the Company filed its direct case in this proceeding  
4           MAWC's pro-forma September 30, 2008 short-term debt balance was projected  
5           to be zero, as shown on Schedule SWR-1, page 2, attached to my direct  
6           testimony.

7  
8   **Q.       DOES STAFF'S RECOMMENDED AMERICAN WATER CONSOLIDATED**  
9   **CAPITAL STRUCTURE CONTAIN SHORT-TERM DEBT?**

10 A.       Yes, it does. The Staff included the balance of short-term debt from American  
11           Water's consolidated March 31, 2008 balance sheet, adjusted for the  
12           outstanding balance of Construction Work in Progress (CWIP). Specifically,  
13           the consolidated short-term debt balance was \$368,137,000, from which the  
14           MAWC CWIP amount of \$49,622,488 was subtracted, resulting in a short-term  
15           debt balance of \$318,514,512 in Staff's consolidated capital structure (Staff  
16           Report, Schedule 8). Staff used the MAWC CWIP balance, rather than  
17           American Water's consolidated CWIP balance, because MAWC was not able to  
18           provide the consolidated CWIP balance to Staff prior to the filing of its direct  
19           case. However, subsequent to the filing of Staff's direct case, the Company  
20           provided a revised response to Staff Data Request S0161, which has been  
21           designated "Highly Confidential." This revised data response contains



1 American Water's consolidated CWIP balance, which should be subtracted  
2 from American Water's consolidated short-term debt balance to arrive at an  
3 accurate balance of short-term debt to include in American Water's  
4 consolidated capital structure, assuming that capital structure is used for  
5 ratemaking purposes.

6  
7 **Q. PLEASE EXPLAIN THE METHODOLOGY THE COMPANY WILL USE FOR**  
8 **COMPUTING THE CORRECT BALANCE OF SHORT-TERM DEBT TO**  
9 **INCLUDE IN ITS CAPITAL STRUCTURE FOR THE TRUE-UP FILING IN**  
10 **OCTOBER.**

11 A. When the Company files its true-up in October, which will include MAWC's  
12 actual capital structure as of September 30, 2008, the outstanding short-term  
13 debt balance at that time will be reduced by MAWC's outstanding CWIP  
14 balance. For ratemaking purposes, the short-term debt balance should be  
15 reduced by the amount of CWIP outstanding at the same point in time.

16  
17 **Q. WHY IS MAWC'S PROJECTED SEPTEMBER 30, 2008 CAPITAL**  
18 **STRUCTURE APPROPRIATE FOR RATEMAKING PURPOSES?**

19 A. The Company's projected September 30, 2008 capital structure is appropriate

1 for ratemaking purposes for three reasons; 1) MAWC is a separate corporate  
2 entity that issues its own debt and common stock and, therefore, has an  
3 independently determined capital structure, 2) MAWC's stand-alone capital  
4 structure represents the actual capital financing MAWC's jurisdictional rate  
5 base, to which the overall rate of return set in this proceeding will be applied;  
6 and 3) MAWC's stand-alone capital structure is consistent with the capital  
7 structure ratios maintained, on average, by other water companies.

8  
9 **Q. PLEASE EXPLAIN HOW MAWC MANAGES ITS CAPITAL STRUCTURE**  
10 **AND MAKES FINANCING DECISIONS INDEPENDENTLY OF ITS PARENT,**  
11 **AMERICAN WATER.**

12 A. In conjunction with all of its financing requirements, MAWC considers the  
13 appropriate mix of debt, preferred stock and common equity appropriate for its  
14 capital structure. This decision is made independently of its parent's target  
15 capital structure. Thus, the decision of whether to issue equity or debt, and the  
16 type of debt, is made based on MAWC's target capital structure and capital  
17 market conditions at the time the security is to be issued. In addition, MAWC  
18 adheres to a policy of obtaining the most favorable financing terms possible.  
19 For example, MAWC will not issue Notes to American Water's financing  
20 subsidiary, AWCC, unless it can determine, based on market conditions  
21 applicable at the time, that such issuance will result in the lowest overall cost

1 available to MAWC when compared to securities of comparable type, maturity,  
2 and terms.

3  
4 **Q. YOU NOTED THAT USE OF MAWC'S CAPITAL STRUCTURE, RATHER**  
5 **THAN AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE, IS**  
6 **APPROPRIATE BECAUSE MAWC'S STAND-ALONE CAPITAL**  
7 **STRUCTURE REPRESENTS THE ACTUAL CAPITAL THAT FINANCES**  
8 **MAWC'S JURISDICTIONAL RATE BASE. WHY IS THE ACTUAL CAPITAL**  
9 **FINANCING MAWC'S JURISDICTIONAL RATE BASE RELEVANT AND**  
10 **APPROPRIATE FOR RATEMAKING PURPOSES?**

11 A. It is relevant and appropriate for ratemaking purposes because it represents the  
12 actual dollars that are financing MAWC's jurisdictional rate base to which the  
13 rate of return authorized in this proceeding will be applied. In contrast, the  
14 consolidated American Water capital structure proposed by the MoPSC Staff  
15 contains capital that was not used to finance MAWC's jurisdictional rate base.  
16 For example, it includes the long-term debt capital of American Water's other  
17 operating water subsidiaries, in addition to MAWC, which finances the  
18 jurisdictional rate bases of those subsidiaries.

19 MAWC's rate base is financed in a manner that reflects MAWC's capital  
20 structure ratios, not American Water's consolidated capital structure ratios.  
21 That is, MAWC's rate base is financed by the capital components that comprise

MAWC's capital structure, in the ratio of each capital component's proportion to total capital. It is this capital structure that should be used to determine the weighted cost of each of the individual capital components, because the sum of these weighted component costs is the overall cost of capital. And it is this overall cost of capital that represents the rate of return MAWC needs to earn on its rate base to satisfy the contractual obligations to, and the return requirements of, its investors.

**Q. DOES THE STAFF REPORT INCLUDE ANY ERRORS WITH RESPECT TO THE CALCULATION OF MAWC'S EMBEDDED COST OF LONG-TERM DEBT?**

A. Yes, in addition to improperly using American Water's consolidated capital structure, Staff chose to calculate the embedded cost of long-term debt for MAWC by using American Water's consolidated total annual long-term debt costs and carrying value (Staff Report, Schedule 9). This methodology results in a long-term debt cost of 6.00%, rather than the correct cost of 6.17%, as shown on Schedule SWR-1, page 2 of 5, attached to my direct testimony. Clearly, the computation of MAWC's embedded cost of long-term should be performed using MAWC's long-term debt schedule. Using inputs that are applicable for calculating American Water's consolidated cost of long-term debt rather than MAWC's is entirely inappropriate and cannot be expected to provide

MAWC the ability to meet the contractual obligations it has to its bondholders. Thus, the methodology Staff used to compute MAWC's embedded cost of long-term debt should be rejected by the MoPSC.

**Q. WILL THE USE OF AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE, RATHER THAN MAWC'S CAPITAL STRUCTURE, RESULT IN AN OVERALL RETURN ON RATE BASE THAT IS NOT REASONABLE FOR RATEMAKING PURPOSES?**

A. Using American Water's consolidated capital structure will produce an overall rate of return on rate base that may not reflect MAWC's cost of capital. Thus, the overall rate of return authorized by the MoPSC could be higher or lower than that needed to satisfy the return requirements of MAWC's investors. If that were to occur, then the overall authorized rate of return will not be reasonable from a regulatory standpoint.

**Q. SHOULD THE MOPSC BE CONCERNED WITH DETERMINING A REASONABLE COST OF CAPITAL FOR MAWC?**

A. Yes, it should. Although a primary objective of regulation is to minimize the cost of reliable service to ratepayers, it should also allow public utilities the opportunity to earn a fair and reasonable rate of return. When a public utility is

1 authorized a rate of return equal to a reasonable cost of capital, the interests of  
2 ratepayers and investors are properly balanced. If the authorized rate of return  
3 is greater than a reasonable cost of capital, ratepayers are burdened with  
4 excessive rates. Conversely, if the authorized rate of return is less than a  
5 reasonable cost of capital, the utility may be unable to raise capital at a  
6 reasonable cost and ultimately may be unable to raise sufficient capital to meet  
7 demands for service. Therefore, the interests of ratepayers and investors are  
8 best served when a utility's allowed rate of return is set equal to a reasonable  
9 overall cost of capital.

10  
11 **Q. HOW DO THE COMPANY'S PRO FORMA CAPITAL STRUCTURE RATIOS**  
12 **AT SEPTEMBER 30, 2008 COMPARE WITH THOSE MAINTAINED BY**  
13 **OTHER WATER COMPANIES?**

14 **A.** The Company's pro forma September 30, 2008 capital structure ratios are  
15 consistent with those maintained, on average, by the four water companies in  
16 Staff's comparable group, as shown on Schedule 18 attached to the Staff  
17 Report. Specifically, the common equity ratios, based upon total capital,  
18 including short-term debt, of Staff's four water companies averaged 51.08% for  
19 the year 2007, ranging from 44.60% to 56.60%. Also, as noted on pages 3-4 of  
20 my direct testimony in this proceeding, I compared MAWC's pro forma  
21 September 30, 2008 equity ratio to that of Ms. Pauline Ahern's six AUS Utility

1 Reports water companies and to her group of four Value Line (Standard  
2 Edition) water companies. My analysis showed that MAWC's pro-forma  
3 September 30, 2008 equity ratio of 47.65% is within one standard deviation of  
4 the average common equity ratio of both Ms. Ahern's six AUS Utility Reports  
5 water companies and to her group of four Value Line (Standard Edition) water  
6 companies.

7 I also noted in my direct testimony, page 4, that I analyzed projected equity  
8 ratios from Value Line Investment Survey. I found that MAWC's pro-forma  
9 September 30, 2008 equity ratio is relatively close to Value Line's projected  
10 water utility industry common equity ratios of 52.0% in 2007, 51.0% in 2008,  
11 and 50.0% over the 2010-2012 time period. Thus, MAWC's ratemaking  
12 common equity ratio at September 30, 2008 of 47.81% is similar to the average  
13 equity ratios of Staff's comparable group of water utilities and both of Ms.  
14 Ahern's proxy groups. Since MAWC's pro forma September 30, 2008 capital  
15 structure ratios are consistent with those maintained, on average, by the four  
16 water companies in Staff's comparable group, and both of Ms. Ahern's proxy  
17 groups, MAWC's proposed capital structure is reasonable for ratemaking  
18 purposes in this proceeding.

19 **B. MOPSC STAFF REPORT**

20 **Q. THE FIRST REASON PRESENTED IN THE STAFF REPORT FOR USE OF**  
21 **AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT**

1           **“MAWC IS NOT A PUBLICLY TRADED COMPANY AND DOES NOT ISSUE**  
2           **ITS OWN COMMON STOCK” (STAFF REPORT, P. 10). PLEASE**  
3           **RESPOND.**

4    A.       The fact that MAWC does not have publicly-traded common stock does not in  
5           any way justify use of American Water’s consolidated capital structure ratios in  
6           place of MAWC’s capital structure ratios for ratemaking purposes. The fact that  
7           a company’s common stock is not publicly traded does not in any way suggest  
8           that its capital structure is unreasonable, especially when that capital structure  
9           is market-based, as is MAWC’s. Staff provides no basis for the relevance of  
10          this point and, thus, it should be disregarded.

11  
12   Q.       **THE SECOND REASON PRESENTED IN THE STAFF REPORT FOR USE**  
13           **OF AMERICAN WATER’S CONSOLIDATED CAPITAL STRUCTURE IS**  
14           **THAT “DEBT ISSUED BY AWCC IS RATED BASED ON THE**  
15           **CONSOLIDATED CREDIT QUALITY OF AMERICAN WATER”, WHICH**  
16           **IMPACTS THE COST OF DEBT THAT MAWC OBTAINS THROUGH AWCC**  
17           **(STAFF REPORT, P. 10). PLEASE RESPOND.**

18   A.       While it is true that the cost of debt issued by AWCC will reflect the credit  
19           quality of American Water consolidated, this has no relation to the sources of  
20           capital that comprise MAWC’s capital structure. The cost of debt to AWCC will  
21           only impact MAWC’s cost of borrowing through AWCC. Since this has no



1 bearing on MAWC's capital structure, this point is irrelevant to determining  
2 MAWC's capital structure for the purpose of ratemaking. MAWC is a separate  
3 legal entity, responsible for making its own decisions regarding its financing  
4 sources and the composition of its capital structure. As noted previously,  
5 MAWC does not issue Notes to AWCC unless it can determine, based on  
6 market conditions applicable at the time, that such issuance will result in the  
7 lowest overall cost available to MAWC when compared to securities of  
8 comparable type, maturity, and terms. Thus, the cost of AWCC's debt will  
9 determine whether MAWC uses that as a source of debt financing, but the cost  
10 will not impact the amount of debt in MAWC's capital structure.

11  
12 **Q. HOW MUCH OF MAWC'S EXISTING LONG TERM DEBT CAPITAL WAS**  
13 **RAISED THROUGH SOURCES OTHER THAN AWCC?**

14 A. Referring to page 3 of Schedule SWR-1 attached to my Direct Testimony, as of  
15 the pro forma date of September 30, 2008, MAWC will have approximately  
16 \$386 million of long-term debt outstanding. Of that amount, approximately  
17 \$213 million, or 55.2%, will have come from sources other than AWCC. This  
18 includes \$57.48 million of tax-exempt bonds the company issued on December  
19 21, 2006, using the Missouri State Environmental Improvement and Energy  
20 Resources Authority ("EI ERA") as a conduit.

1 **Q. THE THIRD REASON PRESENTED IN THE STAFF REPORT FOR USE OF**  
2 **AMERICAN WATER'S CONSOLIDATED CAPITAL STRUCTURE IS THAT**  
3 **"INVESTORS ARE NOT CONCERNED ABOUT THE CAPITAL STRUCTURE**  
4 **OF MAWC WHEN PURCHASING THE STOCK OF AMERICAN WATER"**  
5 **(STAFF REPORT, PP. 10-11). WHAT IS YOUR RESPONSE?**

6 A. Whether or not investors are concerned about the capital structure of MAWC  
7 when considering the purchase of American Water stock is irrelevant to  
8 MAWC's management of its capital structure. The price investors are willing to  
9 pay for American Water stock has no connection to any decisions MAWC must  
10 make with respect to its capital structure. Staff has not explained the relevance  
11 of this statement and, therefore, this point should be disregarded.

12  
13 **Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY WITH RESPECT TO**  
14 **THE ISSUE OF THE APPROPRIATE CAPITAL STRUCTURE TO USE FOR**  
15 **DETERMINING MAWC'S OVERALL RATE OF RETURN ON RATE BASE.**

16 A. I have demonstrated the erroneous assumptions underlying Staff's  
17 recommendation in this proceeding to use American Water's consolidated  
18 capital structure, rather than MAWC's capital structure, by noting that:

- 19 • MAWC manages its capital structure and makes financing decisions  
20 independently from its parent, American Water.

- 1                   • Using American Water's consolidated capital structure will result in  
2                   capital component ratios that produce an overall rate of return on  
3                   rate base that may be higher or lower than that needed to satisfy the  
4                   return requirements of, and the contractual obligations to, MAWC's  
5                   investors.
  
- 6                   • Using MAWC's pro forma September 30, 2008 capital structure will  
7                   produce an overall rate of return on rate base that will allow the  
8                   Company to satisfy the requirements of its investors.
  
- 9                   • MAWC's pro forma September 30, 2008 capitalization is consistent  
10                  with that of the proxy water company groups used by both Staff and  
11                  Company witness Pauline Ahern in this proceeding.
  
- 12                 • Staff's point that MAWC does not have publicly traded common  
13                 stock is not a valid reason for using American Water's consolidated  
14                 capital structure ratios.
  
- 15                 • Staff's argument that debt issued by AWCC is rated based on the  
16                 credit quality of American Water has no bearing whatever on  
17                 determining the appropriate capital structure for MAWC.
  
- 18                 • Staff's point that investors are not concerned about the capital  
19                 structure of MAWC when purchasing the stock of American Water is  
20                 irrelevant to MAWC's management of its capital structure.

1 Therefore, Staff's proposal to use American Water's consolidated capital  
2 structure ratios should be rejected by the MoPSC for the purpose of setting  
3 rates in this proceeding. I have demonstrated that the MoPSC should adopt  
4 MAWC's actual capital structure as of the true-up date of September 30, 2008.

5  
6 **Q. HAVE YOU PROVIDED ANY OTHER RECOMMENDATIONS IN YOUR**  
7 **REBUTTAL TESTIMONY?**

8 A. Yes, I have. I recommended that MAWC's cost of long-term debt be calculated  
9 using MAWC's debt schedule, and not American Water's consolidated debt  
10 schedule, as was inappropriately done by Staff. Also, I pointed out that the  
11 correct balance of short-term debt to include in MAWC's capital structure  
12 should be reduced by the outstanding CWIP balance at that time.

13  
14 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

15 A. Yes, it does.