| | |
|---|---|
| Exhibit No.: | |
| Issues: | Capital Structure, Long-Term Debt Financing, and Overall Rate of Return |
| Witness: | Scott W. Rungren |
| Exhibit Type: | Rebuttal-Revenue Requirement |
| Sponsoring Party: | Missouri-American Water Company |
| Case No.: | WR-2017-0285<br>SR-2017-0286 |
| Date: | January 17, 2018 |

**MISSOURI PUBLIC SERVICE COMMISSION**

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

# REBUTTAL TESTIMONY
# REVENUE REQUIREMENT

**OF**

**SCOTT W. RUNGREN**

**ON BEHALF OF**

**MISSOURI-AMERICAN WATER COMPANY**

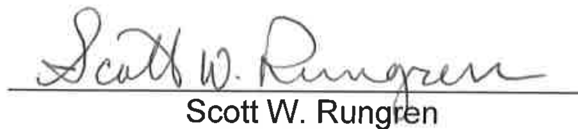
**BEFORE THE PUBLIC SERVICE COMMISSION**

**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**<br>**CASE NO. SR-2017-0286** |

## 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 Revenue Requirement of Scott W. Rungren"; that said testimony was prepared by him and/or under his direction and supervision; that if inquiries 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 12th day of January 2018.**

**Notary Public**

**My commission expires:**

MARY BETH HERCULES
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires April 26, 2020
Commission # 96546828

**REBUTTAL TESTIMONY**
**REVENUE REQUIREMENT**
**SCOTT W. RUNGREN**
**MISSOURI-AMERICAN WATER COMPANY**
**CASE NO. WR-2017-0285**
**CASE NO. SR-2017-0286**

## TABLE OF CONTENTS


I. Introduction .......... 1

II. Overview .......... 3

III. MAWC's 2017 Long-Term Debt Financing .......... 3

IV. Capital Structure Ratios .......... 4

A. Staff's Proposed Capital Structure .......... 4

B. MAWC's Capital Structure .......... 16

V. Summary .......... 23

**REBUTTAL TESTIMONY**
**REVENUE REQUIREMENT**

**SCOTT W. RUNGREN**

1 **I. INTRODUCTION**

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

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

5 **Q. Are you the same Scott W. Rungren who previously submitted direct testimony in**
6 **this proceeding?**

7 A. Yes, I am.

8 **Q. What is the purpose of your revenue requirement rebuttal testimony in this**
9 **proceeding?**

10 A. The purpose of my revenue requirement rebuttal testimony is to address, on behalf of
11 Missouri American Water Company ("MAWC" or the "Company"), the capital
12 structure proposed by the Staff ("Staff") of the Missouri Public Service Commission
13 ("Commission") for determining MAWC's Weighted Average Cost of Capital
14 ("WACC") in this proceeding. The capital structure proposal of the Staff and
15 discussion are contained on pages 33 to 35 of the Staff report entitled "Staff Report –
16 Revenue Requirement Cost of Service" ("Staff Report"). I also address Staff's
17 methodology for computing MAWC's costs of long-term debt, preferred stock, and
18 short-term debt. Company witness Bulkley, in her testimony, will also address some
19 of Staff's capital structure proposals and claims. It is noteworthy, in this regard, that

1 the remaining rate of return witness in this case, OPC witness Michael P. Gorman, does
2 not take issue with the capital structure proposed by the Company.

3 **II. OVERVIEW**

4 **Q. Please provide a brief overview of your rebuttal testimony.**
5 A. The Staff Report incorrectly relies upon June 30, 2017 consolidated capital structure
6 ratios of American Water Works Company, Inc. ("American Water") for determining
7 the Company's WACC. (Staff Report, p. 35). My rebuttal testimony explains
8 MAWC's long-term debt issuances since the filing of its direct case in this proceeding
9 and explains why MAWC's actual capital structure is appropriate for determining
10 MAWC's WACC, or overall rate of return on rate base.

11 **Q. Is the Commission required to choose any particular capital structure?**
12 A. No. The Commission may choose the Company's actual capital structure, the capital
13 structure of American Water, or a hypothetical capital structure. As the Missouri Court
14 of Appeals for the Southern District noted: "The complexities inherent in a rate of
15 return determination necessarily require that the Commission be granted considerable
16 discretion." *State ex rel. Missouri Off. of Pub. Counsel v Pub. Serv. Com'n of State*, 293
17 SW3d 63, 84 (Mo Ct App 2009).

18 **III. MAWC'S 2017 LONG-TERM DEBT FINANCING**

19 **Q. Has MAWC issued long-term debt since the filing of its direct case in this**
20 **proceeding?**
21 A. Yes, it has. The Company has issued two long-term promissory notes. The first was
22 issued on August 22, 2017, in the amount of $70,000,000. This note has a thirty-year

1 term and was issued at a rate of 3.75%. The second note was issued on September 13,
2 2017 in the amount of $12,646,633. This note has a ten-year term and was issued at a
3 rate of 2.95%. Both notes were issued through American Water's financing subsidiary,
4 AWCC. A portion of the $70,000,000 note, $51,871,000, was used to fund the
5 retirement of six notes that matured in October 2017. The remaining portion,
6 $18,129,000, replaced short-term debt that was used to temporarily fund capital
7 expenditures. With respect to the second note, $11,000,000 of the total was used to
8 refund a portion of the Company's $20,000,000 note issued at a coupon rate of 3.4%
9 and a maturity date of December 21, 2021. The portion of the refunded note,
10 $11,000,000, represents 55% of the total amount of $20,000,000. The remaining
11 portion of the new note, $1,646,633, was used to fund a make-whole premium the
12 Company paid to call and redeem the $11,000,000. These new long-term debt issues,
13 and their impact on the capital structure, the overall cost of long-term debt, and the
14 WACC, will be reflected in the Company's upcoming True Up filing on January 31,
15 2018.

16 **IV. <u>CAPITAL STRUCTURE RATIOS</u>**

17 **A. Staff's Proposed Capital Structure**

18 **Q. The Staff Report – Cost of Service (p. 33) recommends that the Commission adopt**
19 **American Water's consolidated capital structure component ratios for the**
20 **purpose of determining MAWC'S overall rate of return on rate base in this**
21 **proceeding. Do you agree with the Staff's recommendation?**

1 A. No, I do not. There are a number of compelling reasons why the Commission should
2 not set rates for MAWC in this proceeding based upon American Water's consolidated
3 capital structure ratios.

4 **Q. What reasons does Staff offer for its recommendation?**

5 A. Staff calculated this equity ratio using American Water's Form 10-Q for the quarter
6 period ended June 30, 2017 to recommend the use of a consolidated equity ratio of just
7 43.99%. The Staff Report claims the following as reasons for using American Water's
8 consolidated capital structure ratios: 1) MAWC does not operate as an independent
9 entity in terms of the procurement of its financing because its capital is raised by
10 American Water Capital Corp. ("AWCC"); 2) the debt issued by AWCC is rated based
11 on the consolidated credit quality of American Water; 3) American Water is primarily
12 a regulated water distribution utility, meaning, in Staff's view, that the business risks
13 of American Water are similar to that of MAWC; 4) American Water allegedly
14 employs double leverage; 5) all debt issued by AWCC and loaned to MAWC is, in
15 essence, according to the Staff Report, guaranteed by American Water; and, 6) Staff
16 surmises that "[b]ecause MAWC does not issue its own debt, Staff believes American
17 Water maintains a higher equity ratio at MAWC for the purpose of attempting to
18 achieve a higher revenue requirement in the form of a higher pre-tax rate of return.
19 (Staff Report, pp. 33-35). I will demonstrate that none of these reasons Staff offered
20 provides any justification for using American Water's consolidated capital structure for
21 determining MAWC's overall rate of return on rate base (i.e., WACC) in this
22 proceeding.

1 **Q. The first reason presented in the Staff Report as a basis for using American**
2 **Water's consolidated capital structure is that "MAWC is not operating as an**
3 **independent entity, at least when considering MAWC'S procurement of financing**
4 **and the cost of that financing" (Staff Report, p. 25). Please respond.**

5 A. The Staff Report (p. 33) notes that MAWC has a Financial Services Agreement
6 ("FSA") with AWCC, which provides MAWC with short-term borrowing and cash
7 management services. In fact, AWCC is also MAWC's typical source for long-term
8 debt; however, MAWC is not required to finance through AWCC and will choose the
9 least-cost debt financing option available at the time. Indeed, Staff concedes that
10 "MAWC has accessed the capital markets directly in the past by issuing tax-advantaged
11 bonds through the State Environmental Improvement and Energy Resources
12 Authority" (*id.*), confirming my statement that MAWC is not required to raise capital
13 through AWCC if more advantageous financing sources are available. Moreover, the
14 financial services provided to MAWC by AWCC and noted in the Staff Report are not
15 a basis for the Commission to use American Water's consolidated capital structure for
16 setting rates. The financial services made available by the FSA do have an impact on
17 MAWC's cost of short-term debt and, potentially, cost of long-term debt, but they have
18 nothing whatever to do with the sources and proportions of capital used to finance
19 MAWC's rate base. Thus, the point being raised by Staff may be correct in the context
20 of MAWC's *cost* of capital, but has no bearing on the determination of the appropriate
21 capital structure to use for ratemaking purposes. It does not follow that because there
22 is a financial relationship between AWCC and MAWC that American Water's
23 consolidated capital structure ratios should be used in place of MAWC's capital
24 structure ratios for computing the WACC.

1 **Q. The second reason presented in the Staff Report for using American Water's**
2 **consolidated capital structure is that "debt issued by AWCC is rated by credit**
3 **rating agencies based on the consolidated credit quality of American Water",**
4 **which impacts the cost of debt that MAWC obtains through AWCC (Staff Report,**
5 **p. 25). Please respond.**
6 A. The cost of debt issued by AWCC does reflect the credit quality of American Water
7 consolidated. This has no relationship, however, to the sources of capital that comprise
8 MAWC's capital structure. The cost of debt to AWCC only impacts MAWC's cost of
9 borrowing through AWCC, which is already quite advantageous. Since the manner in
10 which AWCC debt is rated by rating agencies has no bearing on MAWC's capital
11 structure, Staff's point is irrelevant to determining the appropriate capital structure to
12 use for computing MAWC's WACC. MAWC is a separate legal entity, responsible
13 for making its own decisions regarding its financing sources and the composition of its
14 capital structure. MAWC does not issue Notes to AWCC unless it can determine, based
15 on market conditions applicable at the time, that such issuance will result in the lowest
16 overall cost to MAWC when compared to securities of comparable type, maturity, and
17 terms that MAWC could issue to third parties. Thus, the cost of AWCC's debt will
18 determine whether MAWC uses AWCC as a source of debt financing, but the cost will
19 not impact the amount of debt in MAWC's capital structure.

20 **Q. How much of MAWC'S existing long-term debt capital was raised through**
21 **sources other than AWCC?**
22 A. As of November 30, 2017, approximately 4.00% of MAWC's long-term debt came
23 from sources other than AWCC. This percentage has declined since MAWC's last rate
24 case due to the refunding on December 19, 2016, of $57.48 million of tax-exempt bonds

1 the Company issued through the Missouri State Environmental Improvement and
2 Energy Resources Authority ("EIERA") on December 21, 2006. These bonds were
3 replaced with a new issuance through AWCC at a lower interest rate which, of course,
4 directly benefits our customers by reducing our debt cost. Although the proportion of
5 debt in the Company's long-term debt portfolio that was issued directly to investors
6 has declined since the last rate case, MAWC still considers that financing avenue when
7 formulating its debt financing plan. In fact, in its recent financing application filed
8 with the Commission and approved in Case No. WF-2017-0349, the Company
9 requested authority to pursue tax-advantaged debt financing options, such as funding
10 through the Water Pollution Control Program administered by the Missouri Department
11 of Natural Resources, which would occur outside of the AWCC arrangement. The
12 Company also requested authority to obtain funding from the Missouri State Revolving
13 Fund administered by the U.S. Environmental Protection Agency and the State of
14 Missouri, and may also consider obtaining funding from the Environmental
15 Improvement and Energy Resources Authority ("EIERA"). Again, funding from any
16 of these options would be obtained directly by MAWC and not through AWCC. This
17 illustrates, again, that MAWC does not obtain capital solely from AWCC and that the
18 Company will seek to obtain the most cost advantageous funding sources available.

19 **Q. The third reason presented in the Staff Report for using American Water's**
20 **consolidated capital structure is that because American Water is primarily a**
21 **regulated water distribution utility, the business and financial risks of American**
22 **Water are similar to that of Missouri-American (Staff Report, p. 34). Do you**
23 **agree with Staff's reasoning?**

1 A. No, I do not. The Staff Report (p. 34) claims that "American Water is primarily a
2 regulated water distribution utility." It is more accurate to say that American Water is
3 a holding company that owns, among other entities, the stock of fifteen operating water
4 utilities. Because it believes that American Water consolidated and MAWC have
5 similar levels of business risk, Staff argues that they should be expected to have similar
6 levels of financial risk. And further, Staff contends that, because their business and
7 financial risks are similar, American Water and MAWC should be expected to have
8 similar capital structures. This argument makes an unwarranted and unjustified
9 assumption regarding the risk profile of two separate entities. Staff has offered no
10 specific evidence showing that American Water and MAWC have similar levels of
11 business risk and that they should, therefore, have similar financial risk. Two firms
12 that exist within the same industry do not necessarily possess the same business risk
13 profile, and thus, should not necessarily be expected to have the same capital structure
14 and cost of capital. These determinations are firm-specific, as should be the capital
15 structure and resulting weighted average cost of capital. As noted above and alluded
16 to by Staff, American Water primarily owns fifteen regulated water utilities which, due
17 to this diversification, faces less business risk than does MAWC. Thus, rather than
18 simply assuming that American Water and MAWC have a similar level of business
19 risk, and then arguing that they should be expected to have the same level of financial
20 risk to justify use of American Water's consolidated capital structure, it is more
21 reasonable and prudent to use MAWC's capital structure, which represents the capital
22 mix that actually finances MAWC's jurisdictional rate base. It is the risks facing
23 MAWC and their impact on the management of MAWC's capital structure that are
24 relevant to MAWC's ratepayers, not the risk profile of American Water consolidated.

1 Further, a logical extension of Staff's position suggests that the capital structure of any
2 water utility could be used as a proxy for MAWC's capital structure, including that of
3 any of the firms in Staff's comparable group, all of which (with the exception of
4 American Water) have a higher equity ratio than that of MAWC.

5 **Q. On this same point, Staff claimed that "[B]ecause it is the Parent Company's**
6 **consolidated operations that drive the cost of debt capital and equity capital, the**
7 **parent company's capital structure is the capital structure that will be analyzed**
8 **by investors when determining the required rate of return for debt issued by**
9 **AWCC and equity issued by American Water." (Staff Report, p. 34). Please**
10 **respond to Staff's assertion.**

11 A. The above statement has nothing to do with determining the appropriate capital
12 structure to use in this proceeding. The cost of debt issued by AWCC is indeed a
13 function of American Water's consolidated operations, as is American Water's cost of
14 common equity. MAWC's capital structure, however, is not impacted by these costs.
15 The only financial impact of American Water's consolidated operations on MAWC is
16 related to MAWC's costs of short-term and long-term debt, to the extent MAWC issues
17 long-term debt through AWCC. Therefore, Staff's point on this topic is simply not
18 relevant to the determination of an appropriate capital structure for MAWC. For
19 example, Staff's schedule 5-2 shows that, while MAWC's equity ratio for the last five
20 years (2012-2016) has remained steady at approximately 50%, the equity ratio of
21 American Water consolidated declined to 45.17% in 2016 and declined further to
22 slightly below 44%, as of June 2017 (as calculated by Staff). If Staff had inquired as
23 to why the equity ratio decreased for American Water while remaining stable for
24 MAWC, Staff would have been informed that the level of acquisitions of troubled water

1 companies in other jurisdictions exceeded the level of such activity in Missouri.
2 Because such acquisitions are made with debt until the utility company's next general
3 rate case, the level of debt increased on the consolidated level. This increased level of
4 debt, however, had little or no relation to the composition of MAWC's capital structure.
5 Consequently, the level of equity at MAWC remained relatively constant over the last
6 five years and is, therefore, more representative of the proper level of equity for MAWC
7 operations.

8 **Q. The fourth reason presented in the Staff Report for use of American Water's**
9 **consolidated capital structure is that Amerian Water employs double leverage, a**
10 **situation in which Amerian Water supposedly uses proceeds received from debt**
11 **financings to infuse equity into its subsidiaries (Staff Report, p. 34). Please**
12 **respond to that assertion.**

13 A. The Staff Report does not explain the relevance of double leverage to MAWC's capital
14 structure, and why this is a basis to use American Water's consolidated capital
15 structure. Under the double leverage approach, the operating subsidiary company's
16 equity capital is traced to its source, namely the parent's debt and equity capital. The
17 cost of equity to the operating subsidiary is then the overall weighted average cost of
18 capital to the parent, since the equity capital is said to have been raised by the parent
19 through a mixture of debt and equity. Of course, in order to be consistent with the
20 double leverage philosophy and take it to its logical conclusion, the debt and equity
21 capital invested in the subsidiary should also be traced to its ultimate source, namely
22 the shareholders and bondholders of the parent company (e.g. mutual funds, pension
23 funds, individual investors, etc.) just as the subsidiary's source of equity capital is
24 traced to its parent company. This would be inappropriate because, as I discuss below,

1 the rate of return required on an investment has nothing to do with the cost of the funds

2 used by the investor to make that investment.

3 What is most disturbing about Staff's argument is that the double leverage approach

4 has been all but abandoned in regulatory arenas in view of its serious conceptual and

5 practical limitations and violations of basic notions of finance, economics, and fairness.

6 To the best of my knowledge, only Iowa and Tennessee have relied on this approach

7 in the recent past; however, the Iowa Utilities Board rejected this adjustment in Iowa-

8 American Water's most recent rate case.

9 **Q. You noted that the Iowa Utilities Board recently rejected a double leverage**

10 **adjustment. Is their rejection of it relevant to this case?**

11 A. Yes, it is. The Iowa Board's discussion of this issue is highly relevant to Staff's claim

12 in this case:

13 The Board finds the arguments against the application of double
14 leverage for Iowa-American to be persuasive and will no longer apply
15 the adjustment to Iowa-American. Iowa is one of perhaps only two
16 states that still apply the adjustment and application of the adjustment
17 could place Iowa-American at a competitive disadvantage with respect
18 to capital investment by its parent, American Water Works, if higher
19 earnings may be earned by utility subsidiaries in states where there is no
20 double leverage adjustment. In particular, the Board believes the
21 evidence and arguments regarding how retained earnings are not
22 traceable to the parent and the negative impact the additional debt has
23 on Iowa-American's financial risk demonstrates the conceptual
24 problems with the double leverage adjustment cited by Iowa-American.
25
26 This does not mean that the Board is not concerned with the potential
27 abuses that double leverage was designed to prevent, such as artificially
28 inflating the common equity return by increasing the amount of debt at
29 the parent level and by decreasing the amount of debt at the subsidiary.
30 However, if manipulation is evident in future rate cases, the Board may
31 address this issue in the same manner as other jurisdictions by imposing
32 a hypothetical capital structure on the utility, if necessary. OCA
33 acknowledges that other states use this instead of double leverage and
34 that a hypothetical capital structure can help to address the concerns

> arising from a parent-subsidiary relationship. (Tr. at 298). OCA also acknowledges that no evidence of manipulation is present in this case. (Tr. at 308-309). By using a different tool to prevent abuses of debt manipulation, parent companies with subsidiaries operating in Iowa may look more favorable to investors as an appropriate place to invest additional capital and improve the terms and conditions of attracting capital.

*In Re: Iowa-Am. Water Co.*, 336 PUR4th 335 (Feb. 27, 2017). It appears here that Staff is recommending that the Commission employ a "stealth" double leverage approach by using American Water's capital structure. I find that inappropriate.

**Q. Why do you find Staff's approach inappropriate?**

A. The flaws associated with the double leverage approach are well known. For example, they are thoroughly discussed in Chapter 19 of Dr. Roger Morin's book, The New Regulatory Finance. The chapter shows that the double leverage approach has serious conceptual and practical limitations and is not consistent with basic financial theory and the notion of fairness. In short, the double leverage argument violates the core notion that an investment's required return depends on its particular risks and not on its funding source. Cost of capital has to do with the use of funds and not with the source of funds, and the same is true for the appropriate capital structure. The appropriate return on any investment and capital structure are dictated by the risk of that investment and not by the manner in which that investment is financed. Regardless of who makes the investment, e.g., a member of the public or American Water makes an investment, the proper return and capital structure for that investment must be reflective of that investment's risk, irrespective of the source of funding. I believe that the double leverage approach has no place in regulatory practice and should be discarded, as has been done in almost all jurisdictions. I also note that applying additional debt leverage, thereby imputing a common equity ratio that is substantially lower than MAWC's 50%

1 common equity ratio, and far lower than the average equity ratio of 54.71% (as of
2 December 31, 2016) for the water utility proxy group, is not only unfair and
3 unreasonable, but is also untimely in light of the Company's significant planned
4 construction program. The Company's need to tap capital markets and attract funds on
5 reasonable terms occurs at the crucial point when the Company's ambitious capital
6 expenditure program will require external financing and an increased dependence on
7 capital markets. This is no time to weaken the Company's balance sheet to a level far
8 inferior to that of its industry peers.

9 **Q. The fifth reason presented in the Staff Report for use of American Water's**
10 **consolidated capital structure is that in Staff's view "it appears that all debt issued**
11 **by AWCC and loaned to MAWC is essentially guaranteed by American Water."**
12 **The Staff Report goes on to say that "[T]he subsidiary's use of debt financing that**
13 **is backed by the parent, supports the Staff's recommendation to use American**
14 **Water's consolidated capital structure" (Staff Report, pp. 34). Is this relevant to**
15 **determination of the appropriate capital structure for MAWC?**

16 A. No, it is not. American Water has not guaranteed any debt issued by MAWC through
17 AWCC. The Support Agreement does not relieve MAWC of its financial obligation
18 associated with debt issued through AWCC. The Support Agreement, in essence,
19 affords the financial backing and credit risk of American Water to AWCC, as signified
20 by bond rating agencies typically assigning the same rating to AWCC as they do to
21 American Water. The extent to which risk associated with debt issued by MAWC
22 through AWCC is mitigated by the Support Agreement between American Water and
23 AWCC will be reflected in a lower interest rate to MAWC, which is then reflected in

1 the Company's WACC, but has no bearing on determining the appropriate capital
2 structure to use for ratemaking purposes.

3 **Q. Staff raises as a sixth issue its suspicion that American Water is maintaining a**
4 **higher equity ratio at MAWC in order to boost earnings. Is this a reasonable**
5 **assertion?**

6 A. No, it is not. Staff claims (Staff Report, p. 35) that:

> 7 Based on the information shown in Schedules 5-1 and 5-2, it appears
> 8 that American Water has targeted a common equity ratio of
> 9 approximately 44% to 47%. American Water appears to prefer a
> 10 common equity ratio of 47% to 50% for its MAWC operations. Because
> 11 MAWC does not issue its own debt, Staff believes American Water
> 12 maintains a higher equity ratio at MAWC for the purpose of attempting
> 13 to achieve a higher revenue requirement in the form of a higher pre-tax
> 14 rate of return.

15 First, Staff has not provided any evidence that American Water has targeted a
16 consolidated equity ratio of 44% to 47%. American Water's consolidated equity ratio
17 is the product of rolling up all of the capitalization data related to each of the
18 Company's business entities, both regulated and unregulated, and is not managed to a
19 specific target. Further, Staff apparently loses sight of the fact that, if MAWC's rates
20 are based on the American Water consolidated equity ratio of 43.99% that Staff views
21 as appropriate for MAWC, but MAWC actually continues to maintain an equity ratio
22 of approximately 50%, then MAWC could not possibly earn the rate of return on equity
23 set by the Commission on the lower equity ratio. Indeed, the only means by which the
24 Company could achieve its authorized rate of return would be to make dividend
25 payments of sufficient size up to the parent that would result in lowering MAWC's
26 retained earnings balance to align its actual equity ratio with that imputed in the
27 ratemaking process. Of course, MAWC *could* do this but it would not be a particularly

1 constructive step, especially in light of the Company's significant ongoing construction
2 program. "Hollowing out" MAWC's equity ratio to the lower level recommended by
3 Staff would only serve to weaken the Company's financial condition, which is
4 discussed in the rebuttal testimony of Ms. Bulkley. Again, this is not a constructive
5 avenue when the Company is facing considerable construction expenditures for the
6 foreseeable future. In addition, Staff's view that American Water "appears to prefer"
7 an equity ratio of 47% to 50% for its MAWC operations is not supported with any
8 evidence. As explained in more detail in the next section, MAWC manages its
9 capitalization, and does so in the manner it finds appropriate based on its business risk
10 profile, market conditions, and accepted industry standards.

11 **B. MAWC's Actual Capital Structure**

12 **Q. Please explain how MAWC manages its capital structure and makes financing**
13 **decisions.**
14 A. In conjunction with all of its financing requirements, MAWC considers the appropriate
15 mix of debt, preferred stock and common equity appropriate for its capital structure.
16 This decision is made independently of its parent's financing and capital structure
17 decisions. Thus, MAWC's determination of whether to issue equity or debt, and the
18 type of debt, is made by MAWC based on its capital structure objectives and on capital
19 market conditions at the time the security is to be issued.

20 In addition, MAWC adheres to a policy of obtaining the most favorable financing terms
21 possible. The Financial Services Agreement ("FSA") between MAWC and AWCC
22 does not preclude MAWC from issuing debt to non-affiliated entities. Paragraph 7 of
23 the FSA, which addresses the issue of non-exclusivity, specifically states:

1 "Nothing in this Agreement prohibits or restricts the Company from borrowing from
2 third parties, or obtaining services described in this Agreement from third parties,
3 whenever and on whatever terms it deems appropriate."

4 Thus, MAWC will not issue Notes to American Water's financing subsidiary, AWCC,
5 unless it can determine, based on market conditions applicable at the time, that such
6 issuance will result in the lowest overall cost available to MAWC when compared to
7 securities of comparable type, maturity, and terms. As I show below, MAWC has from
8 time to time raised capital from entities other than AWCC. With respect to equity
9 capital, there is no requirement that MAWC receive its equity in whole, or in part, from
10 its parent; however, the Company foresees the continuation of American Water as the
11 sole source of its equity funding.

12 The above discussion illustrates that MAWC has autonomy with respect to the issuance
13 of both its debt and equity securities and, thus, the management of its capital structure.

14 **Q. You noted that use of MAWC'S capital structure, rather than American Water's**
15 **consolidated capital structure, is appropriate because MAWC'S stand-alone**
16 **capital structure represents the actual capital that finances MAWC'S**
17 **jurisdictional rate base. Why is the actual capital financing MAWC'S**
18 **jurisdictional rate base relevant and appropriate for ratemaking purposes?**

19 A. Using MAWC's actual capitalization is relevant and appropriate for ratemaking
20 purposes because it represents the actual dollars that are financing MAWC's
21 jurisdictional rate base to which the rate of return authorized in this proceeding will be
22 applied. In contrast, the consolidated American Water capital structure proposed by
23 the Staff contains capital that was not used to finance MAWC's jurisdictional rate base.

1 For example, it includes the long-term debt capital of American Water's other operating
2 water subsidiaries, in addition to MAWC, which finances the jurisdictional rate bases
3 of those subsidiaries.

4 MAWC's rate base is financed in a manner that reflects MAWC's capital structure
5 ratios, not American Water's consolidated capital structure ratios. That is, MAWC's
6 rate base is financed by the capital components that comprise MAWC's capital
7 structure, in the ratio of each capital component's proportion to total capital. It is this
8 capital structure that should be used to determine the weighted cost of each of the
9 individual capital components, because the sum of these weighted component costs is
10 the overall cost of capital. It is this overall cost of capital that represents the rate of
11 return MAWC needs to earn on its rate base to satisfy the contractual obligations to,
12 and the return requirements of, its investors. Using the consolidated capital structure
13 of American Water will not ensure that MAWC is provided the proper level of funding
14 to service its various forms of capital.

15 **Q. Why is MAWC'S pro forma thirteen-month average capital structure ending May**
16 **31, 2019 more appropriate for ratemaking purposes?**

17 A. The Commission should adopt MAWC's pro forma thirteen-month average capital
18 structure for the period ending May 31, 2019. The Company's projected thirteen-
19 month average capital structure ending May 31, 2019 is more appropriate for
20 ratemaking purposes for four reasons; 1) MAWC is a separate corporate entity that
21 issues its own debt and common stock and, therefore, has an independently determined
22 capital structure, 2) MAWC's stand-alone capital structure represents the actual capital
23 financing MAWC's jurisdictional rate base, to which the overall rate of return set in

1 this proceeding will be applied, 3) the thirteen-month period ending May 31, 2019 more
2 closely matches the time when the rates set in this case will go into effect; and 4)
3 MAWC's stand-alone capital structure is consistent with the capital structure ratios
4 maintained, on average, by other water companies. In fact, all of the rate of return
5 witnesses in this case use proxy groups to some degree in their respective analyses, and
6 the Company's proposed equity ratio approximates, but is lower than, the average of
7 each of the proxy groups employed.

8 **Q. How do the Company's proposed pro forma capital structure ratios compare with**
9 **those maintained by other water companies?**

10 A. The Company's pro forma capital structure ratios for the thirteen-month average ending
11 May 31, 2019 are consistent with those maintained, on average, by the eight water
12 companies in Staff's comparable water utility group, as shown on Schedule 10 attached
13 to the Staff Report. Staff accepted company's witness Ann E. Bulkley's proxy group,
14 and used the same proxy group to complete its ROE analysis (Staff Report, p. 36).
15 These are also the same eight companies I assessed in my Direct Testimony when
16 discussing the reasonableness of MAWC's proposed capital structure, because these
17 companies also comprise Company-witness Bulkley's proxy group (see Rungren DT,
18 pp. 5-6). Thus, for purposes of evaluating a proper capital structure for MAWC, Ms.
19 Bulkley's proxy group and the Staff's comparable water utility group are identical. As
20 I noted in my Direct Testimony, the average equity ratio of this comparable water utility
21 group was 54.71% as of December 31, 2016. Thus, the equity ratio of MAWC's
22 proposed capital structure, 51.03%, is lower than that of the average equity ratio of the
23 water sample used by both Ms. Bulkley and Staff in their respective cost of equity
24 analyses.

1 I also noted in my Direct Testimony, page 6, that the equity ratio of MAWC's proposed
2 capital structure is lower than Value Line's projected equity ratios for these eight water
3 companies. That conclusion was based on Value Line reports published on April 14,
4 2017. For this rebuttal testimony I have reviewed the most recent Value Line
5 Investment Survey reports published on October 13, 2017. The results are almost
6 identical to those based on the April 14, 2017 reports. Value Line projects an average
7 common equity ratio for the eight water utilities of 54.7% in 2017, 53.9% in 2018, and
8 53.8% over the 2020-2022 period. Again, MAWC's proposed common equity ratio of
9 51.03% is lower than each of these projections. OPC witness Gorman also used proxy
10 groups to determine his recommended cost of equity. His water proxy group has an
11 average common equity ratio of 52.2% from S&P and 54.7% (excluding short-term
12 debt) from Value Line for 2016 (Gorman, p. 17). Mr. Gorman's gas proxy group has
13 an average common equity ratio of 48.9% from S&P and 53.1% (excluding short-term
14 debt) from Value Line in 2016. *Id.* These comparisons further confirm my opinion of
15 the reasonableness of MAWC's proposed capital structure. Again, both Staff witness
16 Smith and OPC witness Gorman used proxy groups when making their cost of equity
17 recommendations for MAWC.

18 Because MAWC's proposed capital structure is consistent with those maintained, on
19 average, by (1) the eight water companies in MAWC's and Staff's comparable water
20 group, (2) with Staff witness Smith's electric proxy group and (3) OPC witness
21 Gorman's gas proxy group, the use of MAWC's proposed capital structure is
22 reasonable for ratemaking purposes in this proceeding. Ms. Bulkley explains this in
23 more detail in her rebuttal testimony. In any event, the fact that MAWC is financed
24 using capital in similar proportions to that of all the proxy groups used in this case is a

1 compelling reason for a finding that MAWC's proposed capital structure is appropriate
2 for ratemaking purposes because it is the way that water utilities – indeed electric and
3 gas utilities, too – are actually capitalized.

4 **Q. What capital structure assumption underlies MAWC witness Bulkley's**
5 **recommended return on MAWC's common equity capital?**

6 A. Ms. Bulkley's recommended return on common equity for the Company is predicated
7 on the adoption of a test year capital structure consisting of approximately 50%
8 common equity, consistent with the equity ratio maintained by MAWC, and projected
9 for the test year in this case.

10 **Q. Why should MAWC's capital structure be used for ratemaking purposes?**

11 A. MAWC's capital structure is reflective of the capital actually used to finance the
12 Company's rate base assets and, moreover, is an appropriate capital structure because
13 it is consistent with the capital structure ratios of the proxy groups employed by all of
14 the rate of return witnesses in this case. MAWC's stand-alone capital structure is,
15 therefore, the most appropriate capital structure to use for setting MAWC's rates.

16 **Q. How will the use of American Water's consolidated capital structure, rather than**
17 **MAWC'S capital structure, affect the overall return on rate base that is**
18 **reasonable for ratemaking purposes?**

19 A. Using American Water's consolidated capital structure will produce an overall rate of
20 return on rate base that will not reflect MAWC's cost of capital. Thus, the overall rate
21 of return authorized by the Commission will be lower than that needed to satisfy the
22 return requirements of MAWC's investors. If that were to occur, then the overall
23 authorized rate of return would not be reasonable from a regulatory standpoint.

1 **Q. Does the Staff Report include any errors with respect to the calculation of**
2 **MAWC's embededded cost of long-term debt?**
3 A. Yes, in addition to improperly using American Water's consolidated capital structure,
4 Staff chose to calculate the embedded cost of long-term debt for MAWC by using
5 American Water's consolidated total annual long-term debt costs and carrying value
6 (Staff Report, Schedule 7). This methodology results in a long-term debt cost of 5.35%,
7 rather than the correct cost of 5.24% for the test year, as shown on Schedule SWR-1,
8 page 7 of 14, attached to my direct testimony. Clearly, the computation of MAWC's
9 embedded cost of long-term debt should be performed using MAWC's long-term debt
10 schedule, which represents its actual contractual commitments to bond holders. Using
11 inputs that are applicable for calculating American Water's consolidated cost of long-
12 term debt rather than MAWC's is entirely inappropriate and cannot be expected to
13 provide MAWC the ability to meet the contractual obligations it has to its bondholders.
14 Thus, the methodology Staff used to compute MAWC's embedded cost of long-term
15 debt should be rejected by the Commission.

16 **Q. Does the Staff Report include any errors with respect to the calculation of**
17 **MAWC's embedded cost of preferred stock?**
18 A. Yes, the Staff used the same methodology for computing the cost of preferred stock as
19 it did for computing the cost of long-term debt. That is, Staff improperly used
20 American Water's consolidated capital structure and calculated the embedded cost of
21 preferred stock for MAWC by using American Water's consolidated total annual
22 preferred stock costs and carrying value (Staff Report, Schedule 8). This methodology
23 results in a preferred stock cost of 8.67%, rather than the correct cost of 9.70%, as
24 shown on Schedule SWR-1, page 10 of 14, attached to my direct testimony. Thus,

1 Staff's methodology and cost of preferred stock should be rejected by the Commission
2 for the same reasons noted above in the discussion of the cost of long-term debt.

3 **Q. Does the Staff Report include any errors with respect to the calculation of the cost**
4 **of short-term debt?**

5 A. Yes, the Staff used the balance of short-term debt in American Water's consolidated
6 capital structure rather than calculating MAWC's balance of short-term debt. The
7 balance of short-term debt, if any, in MAWC's capital structure should be based on
8 MAWC's short-term debt balance, not that of American Water consolidated. In
9 addition, Staff's short-term debt cost of 0.99% is based on the average cost of the
10 twelve months ended June 30, 2017 (Staff Report, page 36). However, Staff should
11 have used more recent data to derive its cost recommendation since short-term rates
12 have changed significantly in recent months. For example, MAWC's actual costs of
13 short-term debt were 1.274% in June, 2017, and 1.527% in December, 2017. In
14 addition, although there is no short-term debt in the Company's test year capital
15 structure for the thirteen-month average period ending May 31, 2019, the Company's
16 projected short-term rate for that period is 2.00%, as shown on Schedule SWR-1, page
17 4 of 14, attached to my direct testimony. Thus, Staff's methodology and cost of short-
18 term debt should be rejected by the Commission.

19 **V. <u>SUMMARY</u>**

20 **Q. Does this conclude your revenue requirement rebuttal testimony?**

21 A. Yes, it does.