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Issues:	Capital Structure and Cost of Capital
Witness:	James S. Merante
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Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2020-0344
Date:	January 15, 2021

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2020-0344

REBUTTAL TESTIMONY
REVENUE REQUIREMENT

OF

JAMES MERANTE

ON BEHALF OF

MISSOURI-AMERICAN WATER COMPANY

AFFIDAVIT

I, James S. Merante, under penalty of perjury, and pursuant to Section 509.030, RSMo, state that I am Vice President and Treasurer for American Water Works Company, that the accompanying testimony has been prepared by me or under my direction and supervision; that if inquiries were made as to the facts in said testimony, I would respond as therein set forth; and that the aforesaid testimony is true and correct to the best of my knowledge and belief.

James S. Merante

January 15, 2021

REBUTTAL TESTIMONY
REVENUE REQUIREMENT
JAMES S. MERANTE
MISSOURI-AMERICAN WATER COMPANY
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REBUTTAL TESTIMONY
JAMES S. MERANTE

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is James S. Merante. My business address is One Water Street, Camden, NJ 08102

Q. On whose behalf are you submitting this testimony?

A. I am submitting my testimony on behalf of Missouri-American Water Company, Inc. ("Missouri-American," "MAWC," or the "Company").

Q. By whom are you employed and in what capacity?

A. I am employed by American Water Works Service Company, Inc. ("AWWSC"). My title is Vice President and Treasurer, and I oversee the treasury function for American Water Works Company, Inc. ("American Water" or "AWK") and its subsidiaries.

Q. Did you previously provide direct testimony in this proceeding?

A. No, I did not.

Q. Please summarize your business experience.

A. I was appointed as American Water's Vice President and Treasurer in 2019. Prior to that, I was Vice President, Internal Audit, and served as Divisional Chief Financial Officer for the American Water's Mid-Atlantic Division from 2014 to 2018. Prior to joining American Water, I served in various Executive Finance and Operations roles in the digital media industry and as a CPA in KPMG's audit practice. I am licensed as a Certified Public Accountant in Pennsylvania.

Q. What is the purpose of your rebuttal testimony in this proceeding?

A. I have been advised of the respective recommendations contained in the Cost of Service Report of the Missouri Public Service Commission Staff ("Staff") and, in particular, the section sponsored by Staff witness Seoung Joun Won relating to the authorized return on equity ("ROE") and capital structure, and the Direct Testimony of David Murray on behalf of the Missouri Office of the Public Counsel ("OPC"). My testimony addresses the actions that Missouri-American and its parent would be required to take if the capital structure recommendations of these witnesses were to be adopted by the Commission.

II. CAPITAL STRUCTURE CONSIDERATIONS

Q. What are some of the factors that determine the capital structure of American Water's subsidiaries?

A. American Water and its subsidiaries generally consider several factors when determining the appropriate leverage for each affiliate, including future revenues, future investments, the risk profile for each affiliate, and how comparable companies are financed.

Q. Staff suggests that because American Water Capital Corp. ("AWCC") is the primary source of MAWC's debt financing and AWK is the guarantor of debt issued by AWWC, it is reasonable for the Commission impose the consolidated capital structure of the American Water companies on MAWC for ratemaking purposes.[1] Is this a reasonable position?

[1] Staff Cost of Service Report ("COS Report"), p. 30.

A. No. As Ms. Bulkley explains, there are several options available to a regulator when setting an equity ratio for ratemaking purposes. Where the equity ratio maintained by the utility on a stand-alone basis is comparable to the equity ratio maintained by similarly situated utilities, as it is in the case of Missouri-American, there is no need to manipulate the equity ratio artificially as Staff proposes. The Company currently projects a capital structure composed of 53.00 percent common equity and 47.00 percent long-term debt. This is consistent with the capital structure maintained for the last several years for Missouri-American as shown in the table below:

MAWC Capital Structure (2014- 20)[2]

Year	2014	2015	2016	2017	2018	2019	2020
Equity	51.0%	50.5%	50.2%	52.4%	52.0%	52.4%	53.6%
Long Term Debt	49.0%	49.5%	49.8%	47.6%	48.0%	47.6%	46.4%

Q. Please summarize Staff's comparison of MAWC's risk profile to the overall risk profile of the American Water consolidated companies.

A. Staff suggests that American Water's consolidated company is primarily a water distribution company and concludes the business risks are similar to MAWC. Staff also makes assertions that while the consolidated company has greater leverage due to the diversity of its business operations, its financial risk is comparable to MAWC.[3]

[2] MAWC's equity and long-term debt ratios for 2014-2019 are as reported on the MAWC PSC Annual Reports. The 2020 MAWC equity and long-term debt ratios are current estimates be updated in the Company's true up filing.
[3] COS Report, p. 30.

Q. Do you agree with Staff's assertion that MAWC's business risk is similar to the overall business risk of the American Water consolidated companies?

A. No, I do not. To the extent a company's business risk refers to the company's ability to generate sufficient revenue and cash flows to cover its operational expenses and debt service requirements, it is worth noting that Missouri-American has not collected the revenues authorized by this Commission in eight of the last 10 calendar years. (Roach DT, Table GPR-11). In contrast, just as American Water consolidated is advantaged from a credit rating perspective by the diversification of financial and regulatory risk across many regulatory jurisdictions, it is also advantaged from the geographic and regulatory diversification of business risk across many jurisdictions; and it is further advantaged from the low risk, less capital intensive, and cash flow positive Market-Based Businesses included in the consolidated companies' capital structure.

AWK has extensive regulated and market-based business operations with consolidated operating revenues of approximately $3.6 billion, operating cash flows of approximately $1.4 billion, and total assets of approximately $23 billion for 2019. American Water's regulated utilities serve 3.4 million water and wastewater customers in 16 states. American Water's market-based operations had operating revenues of $539 million in 2019, accounting for approximately 15 percent of the consolidated companies' total operations. MAWC is only one of the 16 regulated operating utilities, contributing only 10.5 percent of total regulated operating revenue.[4] These are significant differences in business risk between MAWC and the consolidated group of companies, which in turn, support different levels of financial risk and capital

[4] SEC Form 10-K, December 31, 2019, p. 4.

structures. As Ms. Bulkley notes, the financial rating agencies have recognized that the business, geographical and regulatory diversity of American Water supports higher bond ratings than would be suggested by AWK's current financial leverage.

Q. Please respond to Staff's assertion that MAWC's financial risk is comparable to the overall financial risk of the American Water consolidated companies.

A. A company's financial risk is defined by the degree of financial leverage or debt burden it carries (i.e., its capital structure). While Staff acknowledges that the consolidated company has greater leverage than MAWC, due to the diversity of its business operations, its financial risk conclusions seem to simply ignore those differences. The difference in the actual capital structures of the American Water consolidated group and MAWC (39%/61% equity/long-term debt vs. 53%/47% equity/long-term debt) is based in part on differences in business risks between the American Water consolidated group and MAWC. It is our belief the significant and justifiable differences in financial risk between the American Water consolidated group and MAWC should not simply be ignored or disregarded for ratemaking purposes and does not support an imputation of the American Water consolidated capital structure on MAWC for ratemaking purposes.

Q. What would be the likely consequences of the Commission imputing the consolidated capital structure of the American Water companies on MAWC for ratemaking purposes?

A. As I will explain below, the use of the American Water consolidated capital structure for ratemaking will: 1) create an incentive for MAWC to increase the dividend to AWK to align its actual capital structure with the ratemaking capital structure; 2) weaken MAWC's credit metrics and therefore, limit the ability for MAWC to attract capital from outside sources; 3) create a disincentive to invest discretionary capital in the state of Missouri; and 4) not result in the lowest cost option for ratepayers in the long run.

Q. What is the source of the equity component of MAWC's capital structure?

A. The equity in MAWC is provided through a combination of equity investments by AWK and through retained earnings from Missouri-American utility operations. Each year that MAWC generates positive net income, the equity generated by the operating subsidiary that is retained in the Company increases. MAWC may also secure additional equity through investments from its parent company, AWK, as additional paid-in-capital.

Q. What incentives would be created for MAWC from the use of the consolidated capital structure for ratemaking purposes?

A. Requiring the use of the consolidated capital structure for ratemaking purposes creates the incentive to match the actual capital structure with the ratemaking capital structure because to do otherwise would render it virtually impossible for the Company to achieve the ROE authorized by the Commission. In this circumstance, the MAWC actual capital structure is composed of 53 percent equity and 47 percent debt, whereas the equity ratios proposed by Staff and OPC, are based on the consolidated capital structure are 39.18 percent and 41.10 percent equity, respectively. Therefore, if rates were set using either of those lower equity ratios, it would be rational to reduce the MAWC equity ratio to the lower amount by increasing dividends to the parent company or foregoing equity infusions into MAWC, or both, in order to achieve the lower authorized ratemaking capital structure.

Q. Would the imputation for ratemaking of the consolidated capital structure affect ongoing investment in MAWC?

A. Yes, it would. While American Water will always ensure that MAWC has the funds available to continue to invest in order to provide safe and reliable service, that is not the same funding level that best serves the long-term interest of customers. Discretionary investment in MAWC will likely be reduced. Discretionary capital is capital that is invested above and beyond the capital that is needed to maintain safe and reliable service. As discussed by Company witness Deborah Dewey, since the Company's last rate case, the Company has or plans to invest nearly $950 million in its water and wastewater facilities through May 2022, including the replacement, operation, maintenance, and rehabilitation of assets s that can reduce operating costs or further improve efficiencies going forward to the benefit of present and future customers.[5] The increased level of investment in the State has tremendous statewide impacts including jobs, spending on goods and services, enhanced system reliability and improved customer service, all of which may be diminished if discretionary capital is withdrawn from the State.[6]

Q. How does the use of the consolidated capital structure affect MAWC's access to capital other than through AWCC?

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[5] Dewey RT, p. 10.

[6] Dewey RT, p. 11. See also, A Water Research Foundation report indicates every $1million spent on water and wastewater projects supports the creation of approximately 15 jobs across the economy. http://thevalueofwater.org/sites/default/files/Economic%20Impact%20of%20Investing%20in%20Water%20Infrastructure_VOW_FINAL_pages.pdf

A. Under the agreement with AWCC, MAWC is free to seek financing elsewhere if it can obtain better terms than offered by AWCC. Although, in practical terms, AWCC has generally been the lowest cost source of capital, this provision is an important protection for MAWC and its customers. If, however, MAWC found itself in a position where it was advantageous to seek capital from a source other than AWCC, imposing the consolidated capital structure on MAWC would result in weaker credit metrics that will likely limit MAWC's options for access to capital from sources other than AWCC.

Q. Is MAWC's capital structure consistent with industry norms and therefore, reasonable for ratemaking purposes?

A. Yes, it is for several reasons. First, Company witness Brian LaGrand's testimony demonstrates that the Company's capital structure is reflective of the way the Company has been operated and, as I indicated, the equity ratio has been consistently above 50% since 2014.[7] Furthermore, Ms. Bulkley examined the capital structures of the operating companies of the proxy group use to determine the Company's ROE as well as the capital structures that have recently been authorized for natural gas and water utilities. She concluded that in each case, the Company's proposal is within the established range of actual equity ratios established by the utility operating companies held by the proxy group.[8] In contrast, Staff and OPC's proposed equity ratios are appreciably lower than the equity ratios of the proxy companies. Ms. Bulkley further demonstrated that the majority of the recently authorized equity ratios for natural gas and water utilities are in the range of 50-55 percent.[9] MAWC's proposed equity ratio of 53 percent

[7] LaGrand DT, pp. 12-19.
[8] Bulkley DT, pp. 80-89.
[9] Bulkley RT, pp 8–9.

is, therefore, well within the range of authorized equity ratios for companies of comparable risk. In contrast, the Staff and OPC's proposed equity ratios are below every authorized equity ratio over this time period. Consequently, it should be clear that the capital structure used to finance Missouri-American's operations is in line with similar utility companies and is, therefore, reasonable and in the best interest of the Company and its customers.

III. CONSEQUENCES OF IMPUTING AN UNREASONABLY LOW EQUITY RATIO

Q. What would be the consequences if the Commission were to adopt an equity ratio in the roughly 40% range recommended by Staff and the OPC?

A. If the Company were imputed an equity ratio in the range recommended by Staff and OPC for ratemaking purposes, it would be virtually impossible for Missouri-American to have any opportunity to achieve its authorized return of equity without swiftly and significantly reducing its current equity ratio to the lower amount authorized in rates.

Q. Why would that be the case?

A. It is a simple result of math. Assume that Missouri-American was authorized an ROE of 10% on equity but it was applied to a 40% equity ratio instead of the 53% equity ratio that the Company projects. A 10% ROE applied to a 53% equity ratio would produce a weighted equity return of 5.30%. If the same equity return is applied to an equity ratio of only 40%, the weighted equity return is only 4.0%. Unless the Company reduces its actual equity ratio accordingly, an authorized weighted ROE of 4.0% based on a 10% ROE and 40% equity ratio, when applied to an actual 53% equity ratio will fall 130 basis points short on a weighted result. Stated differently, a weighted ROE of

4.0% applied to a 53% equity ratio would produce an ROE of just 7.54%; not the 10% authorized. Clearly, under that scenario, the Company would have no reasonable opportunity to earn its authorized return unless it reduced its equity ratio to align with the 40% equity ratio authorized for ratemaking.

Q. How might Missouri-American reduce its equity ratio from the current 53% to a hypothetical 40% equity ratio?

A. The Company could issue dividends to its parent out of the retained earnings account and the parent would restrict or perhaps forgo equity infusions into Missouri-American to align the Company's equity ratio to the equity ratio authorized for ratemaking.

Q. What would this process entail?

A. Throughout 2020, American Water invested $140M of equity in MAWC, plans to invest another $35M of equity in March 2021, and $18M equity in March 2022. Consequently, Missouri-American and American Water would take steps to rebalance Missouri-American's capital structure as swiftly as practicable to align with the capital structure used in rates. Until that lower equity ratio is achieved, the Company would have almost no chance of earning its authorized ROE.

Q. What would be an immediate adverse consequence of the capital structure recommendations of Staff and OPC were adopted?

A. Ms. Dewey explains that Missouri-American is in competition for discretionary capital with its sister utilities in the American Water system.[10] If the Company were unable

[10] Dewey RT, p. 9.

to achieve its authorized ROE, there would be no reason to invest discretionary capital in Missouri. Furthermore, the parent would be in a position of trying to withdraw equity capital from Missouri in order to align the equity ratio with the low equity ratio used to set rates. Thus, the parent would be withdrawing equity from Missouri; not investing it.

Q. Please explain further the potential challenges that the imputation of such a low equity ratio would create for Missouri-American.

A. There are several. If Missouri-American's capital structure were rebalanced to align with the approved regulated capital structure of roughly 40% equity, this will result in increased leverage, and financial risk for Missouri-American versus its regulated utility affiliates. If it were determined that the burdens imposed were unfairly imposing costs on other affiliates, a determination could be made that Missouri-American would have to raise capital on its own. This would lead ultimately to higher debt costs including transactions costs for separate financings (i.e. credit rating agency fees, legal, audit, securities registration fees, costs for additional treasury resources dedicated to Missouri financings and other costs attendant to a separate financing). Such a capital structure could also limit MAWC's access to capital in the form of private placements and bank loans. If MAWC were forced to seek financing on its own, it may need to become a SEC registrant for public offerings, with the associated costs, administration, and risks including capital market risk. This separation also could limit access to AWCC's liquidity resources and the loss of the consolidated company's credit support through AWCC. All of the above resulting increased financing costs would be passed on to customers.

Q. Would there be other adverse consequences of reducing the equity ratio?

A. Yes. The lower equity ratio would introduce more financial risk to Missouri-American. This would both weaken Missouri-American's credit metrics and increase the Company's borrowing costs if it chose to seek financing from other than AWCC.

Q. Do you have an overall recommendation?

A. Yes. The capital structure recommendations of Staff and OPC will have short- and long-term consequences that are not in the interest of the Company, its customers or the State of Missouri. The Commission should be cautious about trading a short-term revenue reduction through the capital structure ratio for the long-term good of all stakeholders.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.