Exhibit No. 22

MAWC – Exhibit 22
James S. Merante
Direct Testimony
File No. WR-2022-0303

PUBLIC VERISON
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Exhibit No.:	
Issues:	Capital Structure
Witness:	James S. Merante
Exhibit Type:	Direct
Sponsoring Party:	Missouri-American Water Company
Case No.:	WR-2022-0303
	SR-2022-0304
Date:	July 1, 2022

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. WR-2022-0303
CASE NO. SR-2022-0304

DIRECT TESTIMONY

OF

JAMES S. 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, Inc., 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

July 1, 2022
Dated

DIRECT TESTIMONY
JAMES S. MERANTE

MISSOURI AMERICAN WATER COMPANY
CASE NO.: WR-2022-0303
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DIRECT TESTIMONY
JAMES S. MERANTE

<u>Summary of Direct Testimony</u>

Establishing the appropriate capital structure for ratemaking purposes has important policy implications for the Company. In this case, Missouri-American utilizes a stand-alone capital structure for several reasons. First, Missouri-American's proposal includes the actual capital structure (49.57% debt/50.43% equity) that finances MAWC's rate base and operations in Missouri, adhering to the principle of matching rate base with capital structure based on MAWC's capital investment and financing policies. MAWC's capital structure appropriately reflects its single-state operating risk profile for the State of Missouri, distinct from the Company's parent's capital structure, which finances a diverse group of utilities and non-regulated operations. Second, Missouri-American's capital structure, supported by the financing arrangement with the financing subsidiary of American Water Works Company, Inc. yields significant financial savings for the benefit of MAWC's customers. This cost benefit extends to MAWC's customers via lower rates as a result of the millions of dollars of interest cost savings. I will describe these policy issues in further detail in my Direct Testimony.

DIRECT 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 Direct 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 and support the treasury function for American Water Works Company, Inc. ("American Water" or "AWK") and its subsidiaries. I also serve as the Assistant Treasurer for Missouri-American responsible for supporting MAWC's management and finance teams in the execution of MAWC's financing plans and overall capital structure management.

Q. Have you previously testified before the Missouri Public Service Commission?

A. Yes. I previously filed testimony with the Missouri Public Service Commission (the "Commission") in MAWC's prior base rate proceeding, Case No. WR-2020-0344.

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 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 Direct Testimony in this proceeding?

A. The purpose of my Direct Testimony is to summarize and support Missouri-American's capital structure used to determine the overall rate of return that establishes the revenue requirement requested in this proceeding.

Q. Can you briefly summarize your testimony?

A. Missouri-American maintains a capital structure that supports the continued provision of safe, reliable, and affordable water and wastewater service for the benefit of its customers. In support thereof, I will demonstrate through my Direct Testimony that Missouri-American is a stand-alone business enterprise in all material respects including, but not limited to, its independent state operations, capital investments, management, and corporate governance. MAWC's overall capital structure represents the actual debt and equity capital used to finance its capital investments, which is in line with its peer utilities in Missouri with similar risk profiles. In addition, I will demonstrate that as a subsidiary of the larger American Water enterprise, Missouri-American customers benefit from American Water's size and scale to realize cost savings, the most significant of which includes lower debt costs from the financial services agreement ("FSA") with Missouri-American's affiliate, American Water Capital Corp. ("AWCC"). To date, customers have realized estimated interest cost savings of more than $23 million on MAWC's existing debt issuances and will continue to save millions of dollars through the life of the existing debt and future debt issuances.

Q. Are you sponsoring any Schedules with your Direct Testimony?

A. Yes. I am sponsoring Schedule JSM-1, which summarizes and supports Missouri-American's capital structure for setting rates in this proceeding. I further sponsor Schedule JSM-2, which details the credit spreads for unsecured public bond issuances to credit spreads for unsecured private placement bond issuances for the period 2007-2021.

II. MISSOURI-AMERICAN'S INDEPENDENT BUSINESS

Q. Please explain Missouri-American's operating structure.

A. As detailed further in the Direct Testimony of Company witness Richard Svindland, Missouri-American is a wholly owned regulated utility subsidiary of American Water that was incorporated in the State of Missouri in 1879. Its operations are independent of American Water and its other affiliates, and it is a separate legal entity in all material respects including, but not limited to, maintaining its state specific operations, capital investments, management, and corporate governance.

Q. Can you describe Missouri-American's state-specific operations and overall capital investment plan?

A. As stated further in the Direct Testimony of Company witness Mr. Svindland, Missouri-American provides water service to approximately 475,000 customers and wastewater service to approximately 18,000 customers in several counties throughout the State of Missouri. As explained further in the Direct Testimony of Company witness Jeffrey Kaiser, MAWC's water systems consist of more than 6,800 miles of main, as well as hydrants, distribution storage tanks, water treatment plants, wells and pump stations. Missouri-American's wastewater system facilities include over 270 miles of collection mains, lift stations, and wastewater treatment plants.

Moreover, as detailed further in the Direct Testimony of Company witness Brian LaGrand, MAWC's water and wastewater investments in Missouri contribute to a total rate base in excess of $2.3 billion through the proposed test period in this case.

Q. Can you describe how Missouri-American manages its operations in Missouri.

A. As further detailed in the Direct Testimony of Company witness Mr. Svindland, Missouri-American maintains an independent executive management team, led by the President of Missouri-American, who is the principal executive officer and is responsible for the supervision of all business and affairs of MAWC. Specifically, MAWC's President, Mr. Svindland, is responsible for developing and overseeing the achievement of MAWC's business performance, developing and executing on MAWC's capital plan, as well as implementing business practices and procedures to achieve MAWC's overall business objectives.

As further detailed in his Direct Testimony, Mr. Svindland describes his responsibility in overseeing MAWC's management team in Missouri including the Vice President of Operations (Mr. Kaiser), the Vice President of Engineering (Ms. Losli), the Director of Rates and Regulatory (Mr. LaGrand), as well as others in governmental affairs, external affairs, and communications. Mr. Svindland also has direct responsibility for MAWC's financial performance, which is supported by the Director of Finance for MAWC, Andie Cokel. The oversight of the financial performance includes setting the capital structure based on the capital investment and operating requirements of MAWC.

Q. Can you briefly summarize the collective State specific operations and responsibilities of the MAWC management team?

A. Yes. The collective State operations and responsibilities of the Missouri-American management team include, but are not limited to, the following:

- Management and responsibility for field services, production, maintenance, water quality, environmental compliance and safety related to the Company's water and wastewater operations across the State;
- Purchasing and materials management for State supplier services agreements, including bid solicitations, contract administration, ordering and inventory management;
- Oversight and management of the planning, design and construction of water and wastewater systems;
- Responsibility for the Company's capital program and maintaining compliance with State and Federal requirements;
- Coordinating the procurement of all project design and construction services in the State and providing comprehensive MAWC system planning;
- Responsibility for the labor negotiations, hiring and retaining of critical personnel in the State that oversee and maintain MAWC's operations, including more than 726 existing employees at the time of this filing;
- Preparing all rate change applications consistent with MAWC management policies, guidelines and Missouri Commission regulatory requirements;
- Executing on the implementation of rate orders (including development of the revised tariffs), responding to Commission inquiries, and providing support for financial analyses (including preparation of all applicable Commission regulatory filings);
- Responsibility for the financial performance of MAWC, including the development of the independent operating capital and financing plans; and
- Responsibility for payment of all State and local taxes, including income taxes, and

annual property taxes for all real property and facilities maintained in Missouri.

Q. In your opinion, does Missouri-American operate independently from an overall corporate governance perspective?

A. Yes. As detailed in the Direct Testimony of Mr. Svindland, and pursuant to its Articles of Incorporation, as Amended and Restated effective December 2013, Missouri-American's business and affairs are managed under the direction of an independent Board of Directors ("BOD"). The MAWC BOD is comprised solely of MAWC officers and outside directors who are, as required under MAWC's corporate By-Laws, independently appointed and approved by MAWC's BOD. By way of resolution approved by a majority of directors, MAWC's BOD duties include, among others, authorizing the Company to enter into certain contracts; altering, amending or repealing the By-Laws; approving all debt issuances of the Company (such as the SRF funding that closed in March 2022, as described below); and approving all dividend payments. In addition, the BOD annually elects the officers of the Company including the President, Vice President, Treasurer and Secretary.

Q. Please explain how Missouri-American finances its operations.

A. Through the MAWC management and finance teams, including the Company President and Director of Finance, MAWC develops financing plans to support its Missouri-American operating and capital plans. These plans, like all the other subsidiary utility financing and capital plans, are then incorporated into and make up the overall financing/capital plans of AWK. It is my understanding that Missouri-American's financing plans consider MAWC's cash flows and liquidity needs in order to maintain a capital structure (established by MAWC) and an overall cost of capital that is consistent with its business risk profile. MAWC's business risk profile is further discussed in the

Direct Testimony of Company witness Ann Bulkley.

Q. Does MAWC provide or receive guarantees on indebtedness from AWK or any of its affiliated subsidiaries?

A. No. MAWC is solely responsible for the debt that it directly issues and for its repayment obligations under its FSA with AWCC. MAWC does not guarantee the debt of AWK or any of its affiliated subsidiaries, including AWCC. Additionally, neither AWK nor any of its affiliate subsidiaries guarantee the debt issued directly by MAWC. Rather, AWK maintains a credit support agreement with AWCC that supports its strong credit ratings and, as discussed below, its ability to effectively access the public bond markets at a lower cost than MAWC could achieve in the private placement bond market.

Q. Do you regard MAWC as financially independent and distinct from American Water?

A. Yes. As previously discussed, the debt included in MAWC's actual capital structure is solely the obligation of MAWC. MAWC sets its capital structure based on the funding needs and associated operating and financial risks of managing its rate base and operations. MAWC's annual budgets are based on its distinctive operating environment and risk profile. AWCC is simply the conduit for MAWC to achieve its capital financing objectives. Through its economies of scale and portfolio diversity, as explained below, AWCC offers MAWC the opportunity to issue debt at a lower overall cost for the benefit of its customers. The MAWC management team also presents its capital structure and financing plan, including the applicable debt financing sourced through AWCC, to the MAWC BOD for its review and approval. In addition, MAWC is responsible for paying all taxes and dividends from the earnings generated solely by the Company, which further supports its independence from AWK.

Q. What role do you play regarding MAWC's debt financing?

A. My responsibilities are focused on supporting MAWC's management and finance teams in the execution of its financing plans, including MAWC's access to the lowest cost financing.

III. MISSOURI-AMERICAN'S CAPITAL STRUCTURE IS THE APPROPRIATE CAPITAL STRUCTURE FOR SETTING RATES

Q. What capital structure is Missouri-American proposing in this case?

A. Missouri-American is proposing to use its capital structure that finances MAWC's rate base and operations for setting rates in this case. The capital structure reflected in this case is the actual capital in place to support MAWC's rate base at the time rates will be in effect. MAWC's capital structure is 49.57% Debt and 50.43% Equity for the test year (including true-up period) based on the amount of long-term debt ("LTD") and equity expected at test year-end, December 31, 2022, as adjusted through May 2023. Schedule JSM-1 supports this capital structure.

Q. Please describe Schedule JSM-1.

A. Schedule JSM-1 shows MAWC's capital structure and the calculation of the overall weighted cost of capital along with the cost rates, capital structure ratios and the weighted cost for each capital component. The overall rate of return that MAWC has included in this case is 7.53% based on the cost rates of 4.50% for LTD and 10.50% for Equity, as well as the capital structure ratios of 49.57% for LTD and 50.43% for Equity. The 10.50% cost of common equity is recommended and supported by MAWC witness Ann Bulkley.

Q. How was the embedded cost of LTD calculated?

A. For each LTD issuance, the total annual cost, which consists of annual interest and amortization of the issuance expense and discount, is divided by the total carrying value (less the applicable unamortized issuance cost/discount) to arrive at the overall embedded cost rate for LTD.

Q. How does Missouri-American obtain debt capital?

A. MAWC currently has $23.5 million of first mortgage bonds and a State Revolving Fund loan of $10.7 million that was issued by MAWC. MAWC obtains the remainder of its debt financing needs from AWCC. Missouri-American's use of AWCC to raise debt capital was approved by the Commission, in part, because it is an efficient and cost-effective way to raise capital.[1] The FSA between MAWC and AWCC does not prohibit or restrict MAWC from borrowing from other parties or obtaining financial services from other parties whenever and on whatever terms it deems appropriate, but to date, this arrangement has resulted in the lowest cost debt for MAWC's customers. From time to time, MAWC may have the opportunity to finance certain projects through special low-cost governmental programs. Other than those instances, AWCC is used because it is the lowest cost option to finance MAWC operations.

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

A. The equity in MAWC results from the retained earnings from Missouri-American utility operations and any additional equity needs come from equity contributions from its parent, American Water.

Q. How does MAWC's proposed capital structure compare to its actual historical capital structure?

A. MAWC's filing includes a capital structure composed of 50.43% Equity and 49.57% LTD. This is comparable to the capital structure maintained for the last decade for Missouri-

[1] MAWC's financing program, which was the subject of the Application in Case No. WF-2002-1096 was approved by the Commission in Order Approving Financing dated August 30, 2002.

American as shown in Table JSM-1 below:

Table JSM-1

	Average 2012 - 2021	Proposed in This Case
LT Debt %	48.4%	49.57%
Equity %	51.6%	50.43%

Q. Is MAWC's capital structure consistent with industry norms?

A. Yes. MAWC's capital structure is reflective of the way MAWC has been operated and financed, including maintaining a consistent equity ratio above 50% since 2012 (see Table JSM-1 above). Furthermore, MAWC witness Ms. Bulkley examined the capital structures of the operating companies of a proxy group (defined in Ms. Bulkley's testimony) used to determine MAWC's return on equity ("ROE"), as well as the capital structures that have recently been authorized for MAWC's peer utilities with similar risk profiles. Ms. Bulkley concluded that in each case, MAWC's proposal is within the established range of actual equity ratios of the utility operating companies held by the proxy group. Ms. Bulkley further demonstrated that the mean equity ratio that has recently been authorized for natural gas and water utilities is approximately 51.0%, which is generally consistent with the equity ratio proposed by MAWC of 50.43%. Therefore, MAWC's proposed equity ratio is well within the range of authorized equity ratios for companies of comparable risk and comparable ROEs.

IV. SAVINGS TO DATE IN EXCESS OF $30 MILLION DIRECTLY BENEFITTING MAWC CUSTOMERS

Q. Is Missouri-American able to obtain financing through AWCC to invest in its systems at a lower cost than if Missouri-American were to issue its own stand-alone debt?

A. Yes, AWCC can secure lower interest rates than MAWC due to its ability to access the public bond market versus MAWC accessing the private placement bond market. AWCC can execute large bond issuances that are typically in the size of $1 billion or more annually. AWCC's issuance sizes are index eligible, *i.e.*, greater than $300 million, which allows AWCC to access a broader investor base for its bonds. Additionally, AWCC's strong credit ratings and strong brand support broader access and demand for AWCC bonds in the public market than MAWC could achieve in the private placement market. MAWC would pay a premium on its bond issuances in the private placement market due to its smaller issuance sizes (not Index Eligible), and premiums required by investors due to the illiquidity of this market, which limits investor's ability to actively trade bonds. Therefore, AWCC can more cost effectively raise debt capital on an on-going basis in the public bond market compared to MAWC raising debt capital in the private placement bond market. Additionally, AWCC achieves economies of scale by spreading debt issuance costs across all of its 13 regulated subsidiaries rather than MAWC incurring issuance costs for stand-alone debt financing.

Q. How have you quantified the cost savings realized by Missouri-American's customers because of this favorable financing model?

A. Since MAWC's initial long-term debt offering with AWCC in 2007, MAWC customers have realized estimated savings of $30 million through the end of 2021, including interest expense, issuance cost and administrative cost savings, as detailed in Table JSM-2. Customers would have paid higher debt costs than that offered through AWCC if not for MAWC's favorable financing model. Moreover, through the remaining term of the currently outstanding debt, MAWC customers will save an additional $87 million in total costs, for a combined savings of $117 million related to currently issued debt.

Table JSM-2

$ millions	Interest Expense	Issuance Costs	Admin Costs	Total Costs
Savings through December 31, 2021	$23	$2	$5	$30
Additional Savings through Maturity	$70	$6	$11	$87
Total Savings	**$93**	**$8**	**$16**	**$117**

Q. Please explain the savings realized from lower interest expense.

A. As previously discussed, by having broad access to investors in the public bond market due to its large issuances and strong credit ratings, AWCC can issue bonds at a lower interest rate than MAWC. It is estimated that the interest rate for AWCC issuances in the public bond market are 37 basis points (bps) lower than what the interest rate would be for MAWC issuances in the private placement bond market, on average. The 37 bps savings was applied to MAWC's debt issuances through AWCC since its first issuance in 2007 through 2021 that totaled approximately $1.1 billion, which yields an interest savings of approximately $23 million. Additionally, by applying the same methodology, additional interest savings of $70 million will be realized over the remaining maturity of the debt outstanding as of December 31, 2021, for a total interest savings of $93 million. (Table JSM-2).

Q. Please explain how you derived the 37 bps differential.

A. The 37 bps used to calculate the interest savings was derived by comparing credit spreads for unsecured public bond issuances to credit spreads for unsecured private placement bond issuances using credit spread indexes, i.e., the Bloomberg Public Utility "A-rated" Index and the US Private Placement "NAIC-1" Rated Index, for the period 2007-2021 (represents the period since MAWC's first issuance through AWCC in 2007). The analysis shows that private placement bond issuance credit spreads have averaged 37 bps higher than public bond issuances for the period 2007-2021. See Schedule JSM-2 attached hereto.[2]

Q. Please explain the impact of economic conditions and capital markets volatility on credit spreads.

A. During periods of economic downturn and capital markets volatility, credit spreads increase due to increased investor uncertainty and increased credit risk. This can be seen in the credit spread analysis in Schedule JSM-2 that compares public market spreads versus private market spreads in the last economic downturn in 2008-2009**.** During this time, private placement spreads were as much as 180 bps higher than public market spreads. Therefore, MAWC could expect to pay significant premiums to access the private placement market during times of economic uncertainty.

Q. Does your interest savings analysis consider that MAWC could issue secured versus unsecured debt?

A. Yes. While MAWC could realize some pricing benefit by issuing secured versus unsecured debt, this benefit would not be sufficient to offset the higher premiums MAWC would pay by issuing in the private placement market. Additionally, secured debt is considered less optimal to unsecured debt considering a company is subject to its assets being encumbered and is generally subject to more restrictive debt covenants that provide less financial and operational flexibility for the company.

Q As MAWC continues to borrow from AWCC in the future, will there be ongoing future savings to customers?

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[2] **____ ____.**

A. Yes. MAWC can reasonably expect to issue at least $200 million of long-term debt annually on a going forward basis based on its capital investment plan. If MAWC continues to utilize AWCC for future financings, the savings on future issues can be expected to materialize as outlined above on currently issued debt.

Q. Please explain how MAWC's access to debt financing could be limited in the private placement market.

A. Considering MAWC's long-term capital program, MAWC needs consistent and broad access to debt capital on a timely basis. As previously discussed, MAWC would have reduced access to investor distribution of its bonds in the private placement market due to its small issuance sizes and due to the illiquid nature of the private placement bond market, *i.e.*, bonds cannot be actively traded. The reduced investor demand would limit MAWC's ability to attract debt capital to effectively support the timing and size of its financing needs and, as previously discussed, it would be at a higher cost. Additionally, during times of economic uncertainty and capital markets volatility, access to debt capital in the private placement market could be severely limited or inaccessible due to investor concerns about the ability to actively trade bonds. MAWC's risk to sufficiently access the debt markets is significantly reduced by accessing the public bond market through AWCC.

Q. Are you aware of any reason why Missouri-American should pursue an alternative financing approach for meeting its investment and operation needs?

A. No. The FSA between Missouri-American and AWCC is non-exclusive, *i.e.*, it specifically provides that nothing prohibits nor restricts MAWC from borrowing from third parties whenever and on whatever terms it deems appropriate. Therefore, Missouri-American can secure stand-alone debt financing and has as noted above; however, as demonstrated above, AWCC routinely offers the lowest cost debt and broadest access to debt capital for Missouri-American and its customers.

V. <u>CONCLUSION</u>

Q. Please briefly summarize your findings.

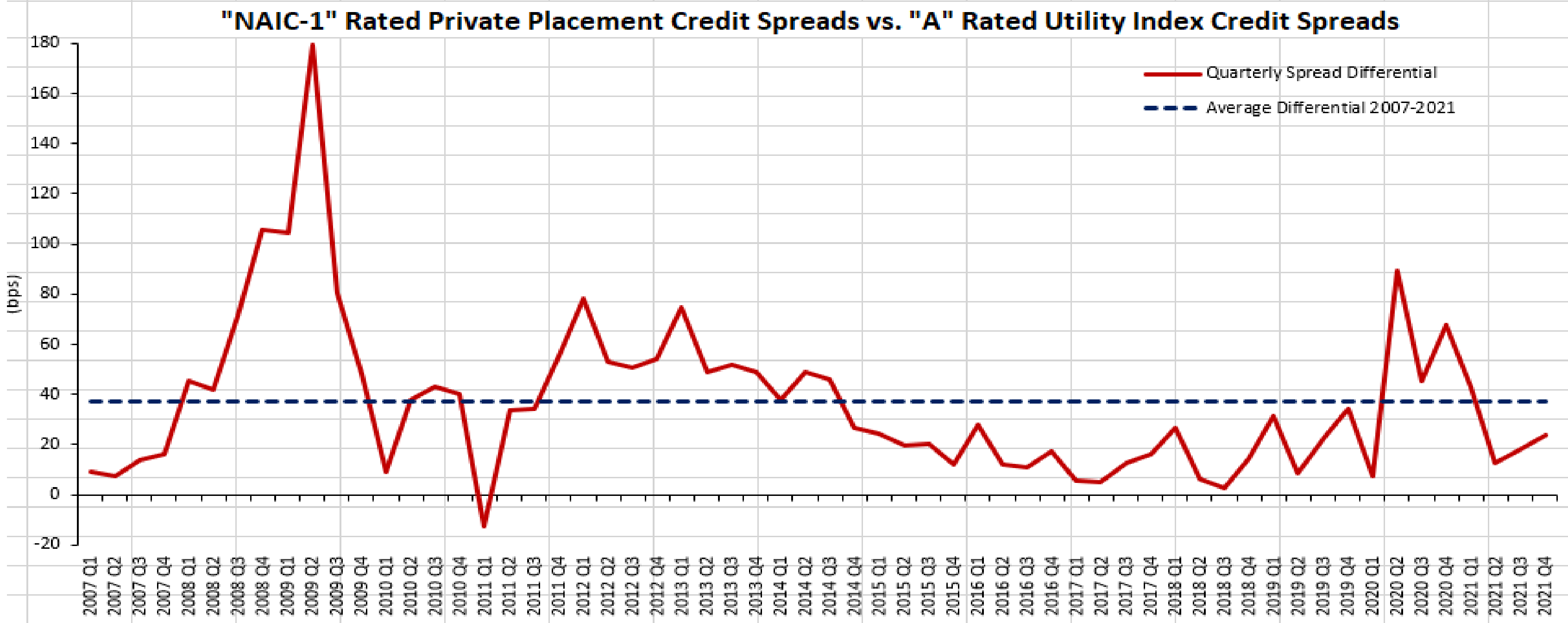
A. MAWC's capital structure represents how Missouri-American finances its independent operations and capital investments, and therefore is the appropriate capital structure to be used for rate making purposes. MAWC's capital structure includes the actual costs incurred for both debt and equity financing based on the risk factors relevant to MAWC and is in line with its peer utilities in Missouri with similar risk profiles. As further stated above, Missouri-American's customers have and will continue to benefit from the independence of Missouri-American as a stand-alone business entity as well as its affiliation within the larger American Water enterprise, including the significant debt financing costs savings on currently outstanding debt issued through MAWC's financing arrangement with AWCC. These cumulative savings and millions more in future savings will continue to inure to the benefit of customers for so long as this financing arrangement remains in place.

Q. Does that conclude your Direct Testimony?

A. Yes, it does.

Missouri-American Water Company
Weighted Average Cost of Capital
Pro Forma for the Twelve Months Ended May 31, 2023
Case No. WR-2022-0303
Case No. SR-2022-0304

Class of Capital	Amount	Percent of Total	Cost Rate	Weighted Cost of Capital
Long-Term Debt	1,212,112,648	49.57%	4.50%	2.23%
Common Equity	1,233,175,990	50.43%	10.50%	5.30%
Total Capitalization	$2,445,288,638	100.00%		7.53%



Source: Bloomberg LP and Wells Fargo Securities