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MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

FINANCIAL ANALYSIS UNIT

SURREBUTTAL TESTIMONY

OF

JEFFREY SMITH

MISSOURI-AMERICAN WATER COMPANY

CASE NO. WR-2017-0285

Jefferson City, Missouri
February 2018

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Q. Please state your name.

A. My name is Jeffrey Smith.

Q. Are you the same Jeffrey Smith who prepared the Rate of Return Section of the Staff's Cost of Service Report ("Staff Report"), and Rebuttal Testimony in this case?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to Ann E. Bulkley's and Scott W. Rungren's rebuttal testimonies. Both witnesses sponsored rate-of-return ("ROR") testimony on behalf of Missouri-American Water Company ("MAWC"). Ms. Bulkley's testimony primarily focused on a fair and reasonable allowed return on common equity ("ROE"). Mr. Rungren's testimony focuses on the appropriate capital structure for purposes of setting MAWC's allowed rate of return.

EXECUTIVE SUMMARY

Q. What are Ms. Bulkley's primary criticisms of your ROR testimony?

A. Ms. Bulkley describes my testimony as "flawed in a number of ways."[1] She believes that the growth projections used in my models are "unrealistically low," stating that I focus "on historical rather than forward-looking market conditions;" that my analysis

[1] Bulkley Rebuttal Testimony, p. 6, ll. 4.

"ignores or discounts" Federal monetary policy tightening; and that my testimony unduly focuses on the most recent ROE authorized by this Commission.[2] Whereas a thoughtful analysis, focused on the reasonableness of model inputs and specifications, may have assisted in clarifying the assumptions underlying the differences in our models, Ms. Bulkley spends the majority of her testimony condemning my outputs, criticizing the use that I make of those outputs to compare the current cost of equity ("COE") to the COE the last time this Commission rendered an allowed ROE decision, and faulting my comparison of differences in the COE between regulated water and electric utilities. The analysis about the reasonableness of model inputs, presented by Ms. Bulkley, makes my comparative methodology more useful. It appears to me that, Ms. Bulkley's single analytic observation is that the projected growth rates used in my models are below the long-term historical growth rate in nominal GDP.

Although Ms. Bulkley acknowledges that "more than ten pages" of my testimony was dedicated to "discussing economic and capital market conditions,"[3] in which I cited many economic research reports, from multiple scholars, at several U.S. Federal Reserve Banks, none of Ms. Bulkley's rebuttal testimony addresses the economic realities of the U.S. as a member of a globalized economy with integrated financial markets. Instead, her argument rests solely on Federal monetary policy and her belief that U.S. Federal Reserve Bank decisions will substantially increase long-term interest rates. Ms. Bulkey would have this Commission believe that changes in monetary policy will affect interest rates in such a manner that the COE will increase to such an extent as to justify a 130 basis point increase in the allowed ROE from the last time this Commission authorized an ROE. Ms. Bulkley also

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[2] *Id.* ll. 5-10.

[3] *Id.* p. 7, ll. 9-10.

expresses several concerns with my recommended capital structure, noting that my recommendation of the consolidated capital structure violates the stand-alone principle.

Q. What are Mr. Rungren's primary criticisms of your ROR testimony?

A. Mr. Rungren focuses on my recommended capital structure. His rebuttal is organized to address what he interprets as my major points of evidence for recommending a consolidated AWK capital structure:

> 1) MAWC does not operate as an independent entity in terms of the procurement of its financing because its capital is raised by American Water Capital Corp ('AWCC'); 2) the debt issued by AWCC is rated based on the consolidated credit quality of American Water; 3) American Water is primarily a regulated water distribution utility, meaning… that the business risks of American Water are similar to that of MAWC; 4) American Water allegedly employs double leverage; 5) all debt issued by AWCC and loaned to MAWC is, in essence… guaranteed by American Water; and, 6) Staff surmises that '[b]ecause MAWC does not issue its own debt… American Water maintains a higher equity ratio at MAWC for the purpose of attempting to achieve a higher revenue requirement in the form of a higher pre-tax rate of return'.[4]

Being that all of MAWC's transactions with AWCC and AWK for debt and equity financing, respectively, are affiliate transactions, and because MAWC has minimal ring-fencing provisions, MAWC has the burden of showing how these affiliate transactions are financially prudent. The fact that MAWC relies almost solely on affiliate debt provided by AWCC shows it is not a "stand-alone entity." MAWC has not provided any evidence to prove why it is necessary to maintain a capital structure that is less cost efficient than its parent company's capital structure. MAWC does not maintain the most cost efficient capital structure because it does not operate as a stand-alone entity; its management is captive to its parent company and receives its financing from its affiliates in the shape and form that its parent company allows.

[4] Rungren Rebuttal Testimony, p. 5, ll. 8-18.

RESPONSE TO MS. BULKLEY'S RATE OF RETURN REBUTTAL TESTIMONY

Q. Can you describe and respond to issues presented in Ms. Bulkley's rebuttal testimony against the methodology you used to derive your COE results and ROE recommendation?

A. Ms. Bulkley has several disagreements with the models I used to estimate the COE and with the methodology I used to arrive at my ROE recommendation. Ms. Bulkley contends I did not rely on any of my COE results to arrive at my ROE recommendation; she disagrees with the specifications of my multi-stage DCF; she does not agree with the differential COE results between the water and electric proxy group apparent in my models; and she does not believe that the KCPL decision is relevant to this proceeding.[5]

First, allow me to clarify and define the research parameters. Ms. Bulkley confuses my COE estimate with my recommended allowed ROE estimate. The COE is a market constructed artifact; while Commission-authorized ROEs are regulatory constructs derived through regulatory processes. The COE, theoretically, is the minimum return investors are willing to accept for their investment in the equity of one company compared to that of other companies. An authorized ROE is an adjudicated return granted to monopoly industries, allowing participants of said industries the opportunity to earn fair and reasonable compensation for their investments. Outside of the regulatory landscape, ROE is a historic accounting assessment looking at a company's balance sheet and income statement to identify the percentage of earning returns attributable to equity financing investment.

Second, I will clarify how I operationalize my research instruments. I use my COE results as a measuring tool used to estimate an unknown position from a known position, to

[5] Bulkley Rebuttal Testimony, p. 25, ll. 13-17.

allow me to derive my recommended ROE. The unknown position in my analysis is the proper ROE to recommend for MAWC. The known position is the authorized ROE in the KCPL rate case. To summarize, I relied on multi-stage DCF models to investigate differences in the COE between the time of the KCPL decision and the current environment, and to identify differences in the COEs between water and the electric utility industries. Comparison of the differences in the current COE from the timeframe KCPL was allowed a 9.5% ROE, and comparison of the differences in the COE between the water utility industry and the electric utility industry led me to recommend a 9.25% ROE for MAWC.

Finally, allow me to describe why the results should be considered. First, Staff has been using the comparative approach since 2014, with the first case being Ameren Missouri, Case No. ER-2014-0258, and the comparative electric proxy group has remained substantively the same, it is the same proxy group with the exception of exclusions of companies going through mergers, acquisitions, or reorganization. Second, the specifications of the models are the same. As long as inputs remain constant, the change from time periods and change among industries is more important than the absolute inputs used in each model. This allows the Commission to set aside arguments about which model inputs are most appropriate because focusing on the absolute value of model's inputs becomes irrelevant and subordinated to focus on the relative changes across time and industries. Third, the ROE that was recently allowed by this Commission to KCPL is a useful benchmark. Although the Commission may look at ROE results around the country, the Commission is accountable to itself, and to the ratepayers and utility companies within its jurisdiction. Finally, the relationship between the COE of water utilities compared to the COE of electric utilities evinced by my models is reaffirmed through the comparison of years of ROE decisions compiled by Regulatory Research Associates showing that average allowed ROEs for water and sewer utilities have consistently been lower than those allowed for electric utilities.

	ROE% Water	ROE% Electric
2012	9.90	10.17
2013	9.73	10.03
2014	9.60	9.91
2015	9.78	9.85
2016	9.68	9.77
2017 [6]	9.56	9.74

Q. How does Ms. Bulkley characterize and critique your multi-stage DCF models?

A. Ms. Bulkley characterizes the results of my multi-stage DCF models as "so low as to be unreasonable" and "not reflective of the cost of equity." She continues by noting that "[n]ot a single regulatory jurisdiction has authorized an ROE as low as the results" of my models."[7] Ms. Bulkley's critique isolates two factors as contributing to unreasonably low results: the dividend yield, and the long-term growth rate.[8] Ms. Bulkley's characterization clearly confuses the COE for regulated utilities and the allowed ROE for said utilities, suggesting that the two are the same when in fact they are not.

Ms. Bulkley says that dividend yields are at historically low levels because of market conditions, which she says "cannot be expected to be maintained in perpetuity."[9] Ms. Bulkley

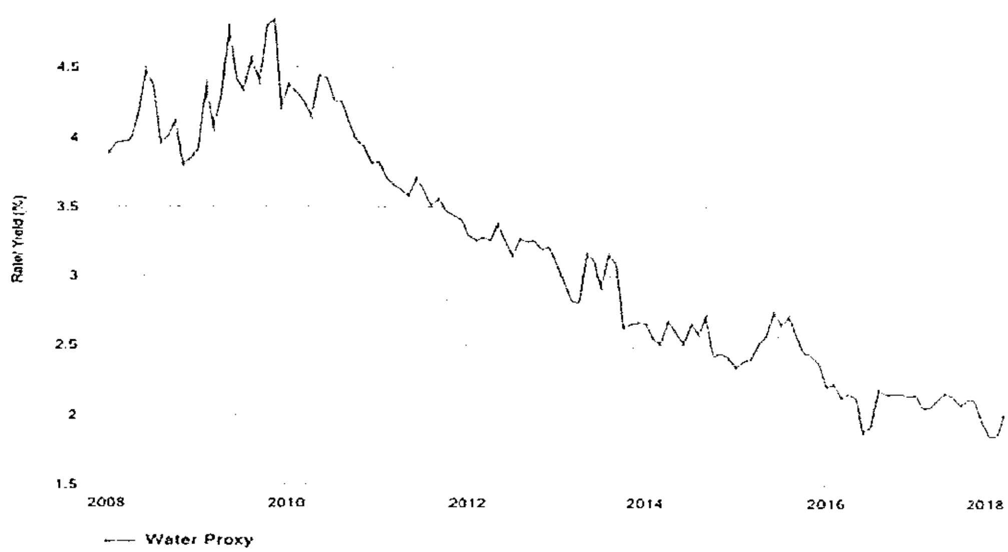
[6] RRA preliminary estimates as of January 18, 2018.

[7] Buckley Rebuttal Testimony. p. 27, ll. 6 - 8.

[8] *Id.* p. 28, ll. 11.

[9] *Id.* ll. 13- 14.

thinks these "anomalous market conditions" lead to model results that are distorted and unreliable. My testimonies have shown that market conditions have not changed significantly since fall 2016. Ms. Bulkley's continued gravitation back towards her argument of "anomalous market conditions" begs the question as to how long she believes market conditions must persist before they are freed from the pull of these "anomalous market conditions." Ms. Bulkley attempts to use several cases, dating back to 2012, where other Commissions' opinions about anomalous or unsustainable market conditions led them to believe that DCF model results were unreliable. She would have this Commission do the same. I caution against falling into this line of reasoning because as the chart below depicts, dividend yields have been in a downward drift nearly 10-years, as long as the average business cycle, indicative of something more than an anomalous event.[10]



Ms. Bulkley disagrees with my long-term growth rates because she believes they are too low. She notes that they "are approximately 130 basis points below the long-term historical growth

[10] SNL Financial.

rate in nominal GDP."[11] However, my growth rates are in line with consensus nominal GDP projections. It is curious that Ms. Bulkley's point of contention pivots away from her pursuit of projected figures towards historic figures. Perhaps it is because using historic nominal GDP growth would lead to a higher COE result.

Q. How does Ms. Bulkley characterize and critique your constant growth DCF?

A. Ms. Bulkley characterizes my constant growth DCF results of 6.14 – 7.14 as "not indicative of the cost of equity that has been authorized for any utility over the last six years."[12] Her critique asserts that my constant growth DCF analysis did not consider the ROE results for each company in the proxy group,[13] that I did not consider the fact that utility dividend yields are at historically low levels, and that I did not provide analysis to demonstrate that my growth rates were reasonable.[14] Again, Ms. Bulkley confuses differences in the COE and authorized ROEs. Her assumption that my constant growth DCF did not consider the COE results for each company in the proxy group is unfounded because she herself observed my COE results for each company in the proxy group and made no adjustment.

Ms. Bulkley's belief that I did not consider historically low levels of dividend yields is dispelled in my point estimate recommendation for an allowed ROE of 9.25%, 25 basis points lower than the last authorized ROE by this Commission. Dividend yields at historically low levels means that they are at lower levels than when this Commission rendered its decision on the allowed ROE for KCPL. It also means that AWK could raise

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[11] Buckley Rebuttal Testimony, p. 29, ll. 10.

[12] *Id.* p. 34, ll. 9 – 10.

[13] *Id.* ll. 11 – 12.

[14] *Id.* p. 35, ll. 12 – 18.

significant amounts of equity capital at historically low costs by issuing shares at their current historically high prices. This historically low COE environment is exactly what led me to recommend a lower ROE than that authorized when dividend yields were at higher levels during the KCPL rate case.

The growth rates used in DCF models are always major points of contention in cost of capital proceedings. Multi-stage DCF models are often used to reflect the projected change in growth rates from near term to the more distant future. Ms. Bulkley, however, did not provide a multi-stage DCF analysis of her own.

Q. What issues does Ms. Bulkley present against your CAPM analysis?

A. Ms. Bulkley believes that the risk-free rate and the market risk premium I use in my CAPM are too low, not forward looking, and do not take into account investor expectations. As I described in my rebuttal testimony, current risk-free rates incorporate investor expectations of future economic conditions.[15] Ms. Bulkley has provided no evidence to support her position that projected interest rates are needed, as the risk-free rate in the CAPM, to incorporate investors' expectations.

Ms. Bulkley says that my market risk premium "fails to consider the inverse relationship between interest rates and the market risk premium. That is, as interest rates decrease, the market risk premium increases."[16] However, her insistence to use higher projected interest rates does not align with the higher projected market risk premium she uses in her CAPM; her CAPM model's use of higher interest rates combined with higher market risk premiums is evidence of an infirm model. Furthermore, Table 6 of her rebuttal

[15] Smith Rebuttal Testimony, pp. 23 – 24.

[16] Bulkley Rebuttal Testimony, p. 48, ll. 5 – 7.

testimony,[17] depicting historic market risk premiums, seesaws between decreasing and increasing market risk premiums during a time period when interest rates were continually falling, contradicting her statements of the relationship between interest rates and market risk premiums.

Q. What issues does Ms. Bulkley present against your "Rule of Thumb" analysis?

A. Similar to the objectivity expressed against my CAPM analysis, Ms. Bulkley's critique of my rule of thumb analysis revolves around my selection of a risk premium estimate, which she characterizes as my lack of consideration of the rising interest rate environment and what she perceives as a market risk premium derived from "markets as a whole [which] does not appear to provide any adjustment for the return requirements of different industries."[18] I addressed the first two points of Ms. Bulkley's critique above in my CAPM response. In arriving at her third point, Ms. Bulkley ignored two clear pieces of evidence: first, market risk premiums are in fact derived from markets, hence the word "market"; second, I specifically state that my selection of risk premium considers "that regulated utilities are on the low end of the risk spectrum of the general U.S. market."[19]

RESPONSE TO CAPITAL STRUCTURE ISSUES

MS. BULKLEY

Q. Which MAWC witnesses sponsored testimony on the appropriate capital structure to use for setting MAWC's allowed ROR?

A. Ms. Bulkley and Mr. Rungren. I will first respond to Ms. Bulkley's testimony on capital structure and then I will reply to Mr. Rungren's testimony.

[17] *Id.* p. 38.

[18] *Id.* p. 50, ll. 18 – 20.

[19] Staff Cost of Service Report, p. 44, ll. 24 – 25.

Q. Ms. Bulkley claims that your capital structure recommendation fails to consider the stand-alone principle. Do you agree?

A. No. Analysis I provided in Staff's Cost of Service Report[20] and in my rebuttal testimony[21] shows why the stand-alone principle is not applicable to MAWC from a practical standpoint. Apart from practical issues already described, the stand-alone principle is not applicable from a theoretical stand-point because the relationship between MAWC and AWK violates a fundamental tenet of the stand-alone principle. In his book, *New Regulatory Finance,* Roger A. Morin, PhD, discusses the stand-alone principle by stating that:

> ... [u]tility companies are not homogeneous in risk. One can think of a utility company as a portfolio, or bundle, of assets, with each asset within the company carrying a different degree of risk. For example, monopolistic services differ in risk from competitive services; capacity expansion projects are riskier than routine maintenance projects; residential services differ in risk from commercial-industrial services; power generation differs in risk from electricity transmission or distribution. Viewing these divisional investments on a stand-alone basis just like any other corporate investment, the higher the risk of that investment, the higher the cost of capital.[22]

When discussing the reasoning for assessing divisional investments using the stand-alone principle, Dr. Morin describes its virtue, "[t]he stand-alone principle of economics is essential if efficient allocation of capital resources is to be promoted and cross-subsidies avoided."[23]

Therefore, according to Dr. Morin, the stand-alone principle promotes efficient allocation of capital, and avoids cross-subsidies. Both Company witnesses' testimonies unwittingly provide evidence that MAWC's higher equity ratio, compared to that of AWK, is cross subsidizing AWK's other operations. First, Ms. Bulkley says that "it is not

[20] *Id.* p. 33, ll. 12 – 23.

[21] Smith Rebuttal Testimony, p. 9, ll. 16 – 22, and p. 10, ll. 1 – 2.

[22] Morin R.A., *New Regulatory Finance*, Public Utilities Reports, 2006, p. 215.

[23] *Id.*

appropriate to use the parent company capital structure of American Water as the ratemaking capital structure for MAWC because the additional debt on American Water's balance sheet is being used to fund acquisitions of other water companies."[24] Second, Mr. Rungren states, "[i]f Staff had inquired as to why the equity ratio decreased for American Water while remaining stable for MAWC, Staff would have been informed that the level of acquisitions of troubled water companies in other jurisdictions exceeded the level of such activity in Missouri."[25]

What these witnesses failed to consider is a point candidly described by Dr. Morin, "common sense and financial theory assert that risk-averse investors require higher returns from higher risk investments."[26] Therefore, more acquisitions of water companies, especially troubled water companies, by AWK, compared to MAWC, would expose it to greater risk. Investors required higher returns for these higher risk investments, would lead to a higher equity ratio because the equity portion of the capital structure is that which requires the higher return. Given Company witness' testimonies, it appears that AWK's lower equity ratio is a consequence of MAWC's cross-subsidies, rendering the stand-alone principle inapplicable.

Q. Do you agree with Ms. Bulkley's belief that the Company should be awarded a 135 basis point adjustment to the COE if the Commission accepts Staff's recommendation to use AWK's consolidated capital structure?

A. No. What Ms. Bulkley fails to recall is that AWK was a member of the proxy group used to estimate the COE and that AWK's individual cost of equity was

[24] Bulkley Rebuttal Testimony, p. 46, ll. 16 – 19.

[25] Rungren Rebuttal Testimony, pp. 10 – 11, ll. 24 – 1.

[26] Morin R.A., *New Regulatory Finance,* Public Utilities Reports, 2006, p. 216.

only 4 basis points above the proxy group's average COE, nowhere near the 135 basis points Ms. Bulkley presumes reasonable.

Q. Do you share Ms. Bulkley's belief that MAWC's actual capital structure is reasonable compared to capital structures adopted by regulators for electric, natural gas, and water utilities?

A. No. Although ratios in MAWC's capital structure may be similar to other regulated electric, natural gas, and water utilities, absent adequate ring fencing provisions to ensure that MAWC is being managed as a separate entity, given the nature of MAWC's and AWK's relationship and their relationships with other operating subsidiaries under the aegis of "American Water", the reasonableness of MAWC's capital structure is highly suspect. Ms. Bulkley's note that "all American Water subsidiaries are managed to a 50 percent equity ratio, and American Water focuses on maintaining a strong financial profile for subsidiaries so that they could go to market if necessary"[27] implies significant coupling and collusion among the entities.

Furthermore, when the Company was asked to provide the minutes for American Water's Finance Committee meetings, which, according to AWK's proxy statement, is responsible for "capital structure, including new issuances, purchases or redemptions of debt and equity securities," and approving "issuances of debt by American Water and its subsidiaries and related guarantees and support obligations,"[28] the company objected.[29]

Proxy statements showing AWK orchestrating its operating companies' financing, statements made by MAWC witnesses, and a deviation from the underpinning tenet of

[27] Bulkley Rebuttal, pp. 46 – 47, ll. 20 – 2.

[28] American Water, 2017 Proxy Statement, p. 8.

[29] Company response to Staff Data Request No. 0183.

the stand-alone principle highlight why the use of MAWC's operating capital structure is unreasonable.

Q. Is Ms. Bulkley's assessment of how your capital structure recommendation would be interpreted by Moody's credit rating agency valid?

A. No. Ms. Bulkley suggestion that my recommendation would be reflective of a "Ba" rating from Moody's is invalid because Ms. Bulkley fails to see the obvious: my capital structure recommendation is to use the consolidated capital structure of AWK; Moody's rating for AWK is A3, several tiers higher than her observation.

Q. Do you agree with Ms. Bulkley's characterization that your recommended equity ratio, in conjunction with your recommended ROE do not meet the requirements of Hope and Bluefield?

A. No. Ms. Bulkley looks at an average of ROEs and equity ratios over the past 6 years,[30] but fails to take into account that ROEs and equity ratios have been trending down, and that recent market to book ratios have met and exceeded their long term averages, nearing historical highs. This means that investors have been more than willing to make investments in the company's equity, given its assets and their expected returns, in light of decreasing return trends.

<u>MR. RUNGREN</u>

Q. Mr. Rungren asserts that the integration of AWK's and its subsidiaries financial services through AWCC, and the fact that AWCC's credit rating is based on the consolidated operations of AWK have no bearing on MAWC's capital structure and are not valid reasons to use American Water's consolidated capital structure. Do you agree?

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[30] Bulkley Rebuttal Testimony, p. 51, Table 12.

A. No. Approximately 96% of MAWC's financing is received by affiliate loans from AWCC and AWCC's credit rating is based on AWK's financials, indicating that MAWC's capital structure is of no consequence to credit rating agencies and that AWK does not have to manage it in the most efficient and cost effective manner.

Mr. Rungren states that AWCC is "MAWC's typical source for long-term debt; however, MAWC is not required to finance through AWCC and will choose the least-cost debt financing option available at the time."[31] To confirm his statement that "MAWC is not required to raise capital through AWCC if more advantageous financing sources are available,"[32] Mr. Rungren repeats an observation made by Staff, "MAWC has accessed the capital markets directly in the past by issuing tax advantaged bonds through the State Environmental Improvement and Energy Resources Authority."[33] What Mr. Rungren fails to convey is that MAWC has not accessed Environmental Improvement and Energy Resource Authority bonds since AWK became a publicly traded utility again in 2008.

Furthermore, with regard to Mr. Rungren's statement about MAWC raising capital outside of AWCC if more advantageous financing is available, MAWC cannot prove that it has sought financing through financial markets, apart from AWCC. In response to Staff Data Request No. 0271, asking the Company to provide indicative pricing information supplied to it by investment banks from which MAWC solicited financing, MAWC could not provide a single indicative pricing tear sheet. The closed loop financing relationship MAWC has with AWK and its affiliates shows that MAWC's capital structure is not managed in the most efficient manner, that inefficiencies in its capital allocation are detrimental to Missouri

[31] Rungren Rebuttal Testimony, p. 6, ll. 7 – 9.

[32] *Id.* ll. 12 – 13.

[33] *Id.* ll. 9 – 12.

ratepayers, and that these detriments to Missouri ratepayers confer undue advantages to MAWC's lone shareholder, AWK.

Q. Can you respond to Mr. Rungren's contentions to the third reason presented in the Staff report for using American Water's consolidated capital structure?

A. Mr. Rungren's statements confuse Staff's position. He characterizes another of Staff's justifications for using the consolidated capital structure as being such that, Staff believes "because American Water is primarily a regulated water distribution utility, the business and financial risks of American Water are similar to that of Missouri-American."[34] The subtle but significant difference is that, if the business and financial risks of American Water were similar to that of Missouri-American we would not need to deliberate capital structure issues. Staff makes the point that because the business risks of the two companies are similar, their financial risk should also be similar; however, they are not, leading Staff to conclude that Missouri-American's capital structure is being managed for ratemaking rather than for maintaining debt capacity and flexibility.

Mr. Rungren dismisses Staff's assertion that AWK and MAWC have similar levels of business risk by stating that "Staff has offered no specific evidence showing that American Water and MAWC have similar levels of business risk."[35] To buttress his position that the two companies' business risks are different and justify his position that AWK faces less business risk, Mr. Rungren states, "American Water primarily owns fifteen regulated water utilities which, due to this diversification, faces less business risk than does MAWC."[36] It is important to note that, in AWK's position, diversification is a double-edged sword.

[34] *Id.* p. 8, ll. 20 – 22.

[35] *Id.* p. 9, ll. 9 – 10.

[36] *Id.* ll. 16 – 17.

The risk reductions AWK experiences by having operations in multiple jurisdictions are offset by the nonregulated operations constituting approximately 15% of its assets.[37] AWK's program of acquisitions of troubled water and sewer utilities increases its business risk more.

Staff acknowledges Mr. Rungren's remarks on business risk and note that they help to clarify an important point, again, so succinctly described by Dr. Morin: "[i]nvestors recognize that different subsidiaries are exposed to different risks, as evidence by the different bond ratings and cost rates of operating subsidiaries."[38] MAWC's lack of a credit rating makes assessing its business risk futile because its cost rates are all reflective of AWK's. The lack of verified risk measures, however, does not vindicate the use of MAWC's costs structure and costs; to the contrary, the lack of market tested data for MAWC makes using AWK's cost structure and costs financially prudent.

Q. Do Mr. Rungren's statements about double leverage reconcile with your own?

A. Mr. Rungren says that "[t]he staff report does not explain the relevance of double leverage to MAWC's capital structure, and why this is a basis to use American Water's consolidated capital structure."[39] He also notes that [t]he 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."[40] Staff did not pursue any of the approaches Dr. Morin described in Chapter 19, "Double Leverage."[41] As such, Mr. Rungren's assessment of Staff's use of double leverage is

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[37] Standard & Poor's Rating Services, Ratings Direct, Research update: American Water Works Co. Inc. And Subsidiaries Ratings Raised To 'A' From 'A-' On Improved Financial Measures, May 7, 2015.

[38] Morin R.A., *New Regulatory Finance,* Public Utilities Reports, 2006, p. 525.

[39] Rungren Rebuttal Testimony, p. 11, ll. 13 – 19.

[40] *Id.*, p. 13, ll. 13 – 15.

[41] Morin R.A., *New Regulatory Finance,* Public Utilities Reports, 2006, p. 519.

simply wrong; none of the approaches were the basis for Staff's use of AWK's consolidated capital structure. Chapter 19, Double Leverage, of Dr. Morin's book describes multiple approaches to double leverage: the Stand-Alone Approach, the Double Leverage Approach, the Modified Double Leverage Approach, and the Consolidated Approach.

Staff described why the Stand-Alone Approach is not an appropriate approach when responding to Ms. Bulkley's capital structure testimony. It is clear that Staff did not use the Double Leverage Approach or the Modified Double Leverage Approach because Staff did not make any adjustments to the COE. Staff did not use the consolidated approach because, assuming that AWK was willing to provide the required information on all of its subsidiaries allowing Staff to complete the required calculations, Staff would encounter the same issues with regard to the subsidiaries not having market tested costs and cost structures.

Although several of the approaches to account for double leverage have weaknesses, double leverage still exists in monopoly environments, realized by the numerous approaches devised to measure and correct it. Staff's concern that AWK may be siphoning the debt capacity of MAWC, resulting in cross subsidies and a less efficient capital structure belies the relevance of double leverage to MAWC's capital structure. The facts that MAWC has relied on AWK or AWCC for almost all its financing needs since AWCC was created, and that there is a lack of ring-fencing provisions to protect MAWC from AWK makes it appear MAWC is captive to AWK, and is the basis for Staffs continued use of American Water's consolidated capital structure.

Q. Mr. Rungren indicates that American Water does not guarantee debt issued by MAWC. Is there any purpose for American Water to guarantee MAWC's promissory notes to AWCC?

A. No. This is akin to a parent loaning his/her child money and then telling the child I will guarantee the debt you owe me. There is no purpose. MAWC does not issue debt to third-parties. AWCC issues debt to third-parties. The third-parties are only concerned about AWK guaranteeing the AWCC debt since AWCC is only a financing subsidiary.

Q. Regardless, how do rating agencies view the support agreement AWK provides to AWCC?

A. When describing the relationship between AWK and AWCC Moody's describes the support agreement structure as being "similar to a guarantee for rating purposes."[42]

Q. Mr. Rungren maintains that MAWC is an autonomous entity with respect to the issuance of equity and debt and the management of its capital structure. Do you agree that MAWC is autonomous?

A. No. It is not clear to Staff why MAWC appears to have targeted a common equity ratio, evident by its historical capital structure, between 47% - 50%, while American Water appears to have targeted a common equity ratio of around 44% - 47%. AWCC is issuing consolidated debt issuances to third-parties based on American Water's guarantees, not individual subsidiary guarantees. Therefore, there are no consequential effects of MAWC's capital structure other than for ratemaking purposes.

Q. Can you demonstrate how American Water makes MAWC's capital structure more costly to Missouri ratepayers than it needs to be?

A. Yes. In October 2017 MAWC received an additional $64 million as a common equity infusion in the form of paid-in capital from AWK. This perpetuates the

[42] Moody's Investor Service, Credit Opinion, American Water Works Company, Inc., August 10, 2016.

current relationship the companies' share, where AWK limits the debt capacity of MAWC. There is no reason why MAWC should not receive the $64 million in additional capital in the form of a loan from AWCC.

Q. If MAWC was loaned this capital directly from AWCC, how much would Missouri ratepayers have to pay for this capital?

A. Missouri ratepayers would have to pay $3,161,600 ($64,000,000 x 4.94%) for this capital.[43]

Q. If the Commission accepts that this capital should be treated as equity, how much will Missouri ratepayers have to pay for this capital?

A. If Ms. Bulkley's recommended ROE is allowed; $11,218,729 ($64,000,000 x 10.8% x 1.62308), and if Staff's recommended ROE is allowed; $9,608,634 ($64,000,000 x 9.25% x 1.62308).[44]

Q. How do you summarize the witnesses' responses to your capital structure recommendation?

A. Both witnesses justification for using MAWC's capital structure rely on the stand-alone principle, asserting that Staff has not taken it into consideration. Evidence provided shows that the stand-alone principle is not applicable in practice, or in theory. In asserting their claim that the stand-alone principle should be applied to MAWC, the Company has not provided evidence that sufficient ring-fencing attributes exist to assure that MAWC is indeed operating as a stand-alone entity.

[43] 4.94% is the company's average long-term debt cost.
[44] 1.62308 is the tax factor.

CAPITAL MARKETS UPDATE

Q. Do recent capital market events support the Commission maintaining its view that a similar allowed ROE of 9.5% would still be fair and reasonable for KCP&L, and that a similar allowed ROE would be fair and reasonable for a water and sewer utility?

A. Yes. Although the COE for the electric proxy group appears to have increased modestly, since Staff presented it Cost of Service Report, apparent differences in the COE between water utilities and electric utilities still justify a similar ROE for water utilities.

Q. What has happened to water and electric utility P/E ratios and dividend yields since you prepared the ROR Section of the Staff Report in this case?

A. Average dividend yields for January, for the water proxy group, have come down to 1.99% from 2.06% during the time frame used in Staff's report, indicating that the COE for the water utility proxy group has remained relatively stable. Similarly, price to earnings ratios ("P/E") for the water utility group remained fairly consistent for the two time periods at 28.4x and 28.1x, respectively. Unlike the water utility proxy group, the electric utility proxy group has seen a sell off, indicated by changes in PE ratios for the two time periods of 33.78x and 19.8x, respectively.[45] However, the majority of the precipitant decline is caused by one of the companies in the electric proxy group, American Electric Power ("AEP").[46] Removing AEP, the P/E ratios for the two time periods were 21.4x and 20.4x, respectively. As such, dividend yields have increased from 3.04% to 3.34%, respectively,

[45] Ratios related to the time period of the Cost of Service Report may appear different than those in the Report because Staff no longer has the same access to water industry data through S&P Capital. For this analysis Staff relied on SNL Financial.

[46] SNL uses market weighted indexing and AEP has a substantial weight in the proxy group. AEP experienced nonrecurring financial artifacts that drove its P/E ratio down significantly, and with it the P/E ratio of the proxy group.

including AEP, and from 2.93% to 3.22%, respectively, excluding AEP, indicating that the COE for the electric utility group has increased modestly.

Q. How have American Water's bonds traded since you prepared the ROR Section of the Staff Report in this case?

A. Average yields for the month of January for the two AWK bonds referenced in Staff's Cost of Service Report were similar to their yields quoted in the Cost of service report: 3.83% and 3.72% compared to 3.82% and 3.79%, respectively. This indicates that although short-term interest rates increased, their effects on AWK's long-term utility bonds have been negligible.

SUMMARY AND CONCLUSIONS

Q. Please summarize the conclusions of your surrebuttal testimony.

A. Ms. Bulkley and I have a fundamental disagreement about the probable level of the COE. She believes the water utility industry has a COE above 10%, whereas I think it is 7% or lower. However, I believe an allowed ROE of 9.25% is reasonable when considering the Commission's recent allowed ROE for KCP&L.

Ms. Bulkley and Mr. Rungren argue that MAWC is managed financially as a stand-alone entity and therefore, its capital structure should be used for purposes of setting MAWC's allowed ROR. The relationship between MAWC and AWK violates a fundamental tenet of the stand-alone principle, rendering it inapplicable to MAWC. MAWC does not issue its own debt, and therefore, it does not have a separate credit rating.

There is no reason for American Water to carry debt at the holding company level because that debt can simply be loaned directly to the subsidiaries so all subsidiaries maintain a capital structure consistent with American Water's targeted consolidated capital structure.

This is the only market-tested capital structure that is managed to achieve the lowest possible capital costs. There is insufficient evidence showing MAWC is safeguarded to ensure the stand-alone principle: the promotion of the efficient allocation of capital, and the avoidance of cross-subsidies.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri-American Water Company's Request for Authority to Implement General Rate Increase for Water and Sewer Service Provided in Missouri Service Areas	)))))	Case No. WR-2017-0285

AFFIDAVIT OF JEFFREY SMITH

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

COMES NOW JEFFREY SMITH and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing Surrebuttal Testimony; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

JEFFREY SMITH

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 8th day of February, 2018.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2020
Commission Number: 12412070

Notary Public