

SUEZ WATER RHODE ISLAND, INC.
WAKEFIELD, RHODE ISLAND

RATE OF RETURN

REBUTTAL TESTIMONY
OF
HAROLD WALKER, III

JULY 2018

Prepared by:
GANNETT FLEMING
VALUATION AND RATE CONSULTANTS, LLC



Valley Forge, Pennsylvania

**REBUTTAL TESTIMONY
OF
HAROLD WALKER, III
TABLE OF CONTENTS**

| | |
|--|-----------|
| INTRODUCTION..... | 1 |
| SUMMARY | 1 |
| A FAIR RATE OF RETURN | 2 |
| DIVISION’S CAPITAL STRUCTURE..... | 4 |
| RISK FACTORS..... | 6 |
| DIVISION’S RECOMMENDED COST OF DEBT | 12 |
| DIVISION’S RECOMMENDED COST OF EQUITY..... | 13 |
| RESPONSE TO STAFF’S CRITICISM OF MR. WALKER’S TESTIMONY | 25 |

1 **INTRODUCTION AND PURPOSE**

2 **Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.**

3 A. My name is Harold Walker, III. I am employed by Gannett Fleming Valuation and Rate
4 Consultants, LLC as Manager, Financial Studies. My business mailing address is P. O. Box
5 80794, Valley Forge, Pennsylvania 19484.

6 **Q. ARE YOU THE SAME HAROLD WALKER WHO PREVIOUSLY SUBMITTED**
7 **TESTIMONY IN THIS PROCEEDING?**

8 A. Yes.

9 **Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY AT THIS TIME?**

10 A. The purpose of my Rebuttal Testimony is to respond to the Direct Testimony of Matthew I.
11 Kahal on behalf of the Division of Public Utilities and Carriers (“Division”) concerning
12 capital structure, common equity cost rate and overall rate of return for Suez Water Rhode
13 Island, Inc. (“SWRI” or the “Company”). My rebuttal testimony is supported by Exhibit
14 (HW-1R), which is composed of 3 Schedules.

15 **SUMMARY**

16 **Q. WHAT AREAS OF MR. KAHAL’S TESTIMONY DO YOU ADDRESS IN YOUR**
17 **REBUTTAL TESTIMONY?**

18 A. My testimony addresses Mr. Kahal’s recommended:
19 • Recommended capital structure ratios for SWRI;
20 • Risk factors;
21 • Debt cost for SWRI;
22 • Application of the Discounted Cash Flow Model (“DCF”) and Capital Asset Pricing
23 Model (“CAPM”);

- 1 • Common equity cost rate relative to current and recently authorized return rates on
2 common equity various regulatory commissions; and
3 • Common equity cost rate applicable to SWRI.

4 My testimony also addresses Mr. Kahal’s comments on my prepared direct
5 testimony. I respectfully disagree with Mr. Kahal's proposed return on equity of 9.0% and
6 his proposed overall rate of return of 6.98% and I do not believe the Rhode Island Public
7 Utility Commission (“Commission” or “PUC”) should accept Mr. Kahal's proposals.

8 Based upon the results of my entire analysis contained in my Direct Testimony, my
9 recommendation is that the SWRI be permitted an overall rate of return of 7.82% including a
10 recommended common equity cost rate of 10.5%. As a check on the reasonableness of my
11 common equity cost rate recommendation, I reviewed Value Line's projected returns on
12 common equity for comparable utilities which range from 10.5% to 14.0%. The range of the
13 projected returns suggests that my recommendation that SWRI be permitted an opportunity
14 to earn on common equity of 10.5% is reasonable, if not conservative.

15 **A FAIR RATE OF RETURN**

16 **Q. DOES THE RECOMMENDATION OF DIVISION PROVIDE THE COMPANY**
17 **WITH THE OPPORTUNITY TO EARN A FAIR RATE OF RETURN?**

18 A. No. In *Bluefield*¹, a fair rate of return is defined as: (1) equal to the return on investments in
19 other business undertakings with the same level of risks (the comparable earnings standard);
20 (2) sufficient to assure confidence in the financial soundness of a utility (the financial
21 integrity standard); (3) will maintain and support its credit, enabling the utility to raise or

¹*Bluefield Water Works & Improvement Company v. P.S.C. of West Virginia*, 262 U.S. 679 (1923).

1 attract additional capital necessary to provide reliable service (the capital attraction
2 standard).

3 Mr. Kahal's rate of return recommendation is flawed and does not produce a fair rate
4 of return for SWRI. Throughout this rebuttal testimony I highlight the numerous defects
5 contained in his testimony. Mr. Kahal's recommendations show a lack of understanding of
6 the precepts of a fair rate of return, including the comparable earnings standard; capital
7 attraction standard, and the financial integrity standard. Mr. Kahal's testimony implies that
8 SUEZ Water Resources Inc. ("SWR") ownership of SWRI reduces the risk of SWRI
9 providing water service to customers. I do not believe it is reasonable that SWRI should be
10 afforded something less than a fair rate of return because they are owned by a larger
11 company such as SWR.

12 Mr. Kahal's testimony violates the precepts of a fair rate of return, including the
13 comparable earnings standard, the capital attraction standard, and the financial integrity
14 standard. Mr. Kahal's recommendation violates all three-forementioned fair rate of return
15 precepts as demonstrated by his own testimony. SWRI is entitled to a return that will enable
16 it to attract additional capital, not only capital provided by SWR. The credit that enables
17 SWR bonds to be issued is the issuing entity, SWR. A fair rate of return for SWRI is the
18 credit that should enable the SWRI to attract capital regardless of SWR. The risk of SWRI
19 providing service to customers is not mitigated simply because the SWR provides capital or
20 because SWR owns other water utilities. Risk does not change with ownership, and the price
21 or cost of bearing risk is what it is. Mr. Kahal's recommendation offers no incentive to
22 investors to invest in SWRI water assets when higher returns are available from other less

1 risky water assets. Investors will not provide capital and should not be forced to provide
2 capital when higher risk-adjusted returns are available.

3 **DIVISION'S CAPITAL STRUCTURE**

4 **Q. IS IT APPROPRIATE FOR MR. KAHAL TO INCLUDE SHORT-TERM DEBT IN**
5 **HIS RECOMMENDED CAPITAL STRUCTURE?**

6 A. No. It is not appropriate to include short-term debt in SWRI's ratemaking capital structure.
7 Short-term debt is used primarily for interim funding of capital projects, or construction
8 work in progress ("CWIP"). After the CWIP related projects are completed, the short-term
9 debt is replaced by permanent debt or by equity infusion. Since SWRI's CWIP is not part of
10 the Company's rate base claim and since the average monthly balance of CWIP is greater
11 than the average balance of short-term debt, it proves short-term debt is not financing
12 SWRI's rate base claim.

13 Short-term debt is a temporary source of financing for a non-rate base component,
14 CWIP. The temporary nature of short-term debt is evident by the fact that it is repeatedly
15 reduced to a zero balance throughout the year. If short-term debt were a permanent source
16 for financing rate base it's balance would increase or at least stay the same month after
17 month but this is not the case. Accordingly, since short-term debt is a temporary source of
18 financing for the non-rate base component CWIP, its inclusion in the Company's rate
19 making capital structure is not appropriate.

20 **Q. MR. KAHAL TESTIFIES THAT YOUR RECOMMENDED COMMON EQUITY**
21 **RATIO OF 54.19% IS AN INCREASE OVER THE COMMISSION APPROVED**
22 **53.31% COMMON EQUITY RATIO THAT WAS THE RESULT OF A**

1 **SETTLEMENT IN THE COMPANY’S LAST RATE CASE. HAVE WATER**
2 **UTILITIES’ COMMON EQUITY RATIOS GENERALLY INCREASED SINCE THE**
3 **COMPANY’S LAST RATE CASE?**

4 A. Yes, common equity ratios of water utilities have generally increased since the Company’s
5 last rate case. Mr. Kahal’s testimony supports the fact that common equity ratios have
6 increased in the water utility industry since 2014. First, in Mr. Kahal’s Exhibit (Schedule
7 MIK-3, page 1) it reveals that his eight company Water Utility Proxy Companies have a
8 common equity ratio of 54.8%. In a similar schedule in his Exhibit in the Company’s last
9 rate case (Docket 4434, Schedule MIK-3, page 1) he revealed the same eight company Water
10 Utility Proxy Companies had a common equity ratio of 52.4%.² Accordingly, Mr. Kahal’s
11 own testimonies prove common equity ratios in the water utility industry have increased
12 about 240-basis since 2014.

13 Second, on page 9 of Mr. Kahal’s testimony he reports the average authorized
14 common equity ratio for water utilities was 49.69% in 2014 and was 54.17% in the first
15 quarter of 2018. Again, Mr. Kahal’s own testimony prove common equity ratios in the water
16 utility industry have increased since 2014. I believe the increase in common equity ratios of
17 water utilities since the Company’s last rate case is reflective of the increased risks they face.

2 A copy of Schedule MIK-3, page 1 from Docket No. 4434 is attached as Schedule 1.

1 **RISK FACTORS**

2 **Q. DO YOU HAVE EVIDENCE SHOWING WATER UTILITIES FACE INCREASED**
3 **RISKS?**

4 A. Yes, I can cite several examples showing water utilities face increased risks. First, on page 8
5 of Mr. Kahal’s testimony he cites a Regulatory Research Associates (“RRA”) article. In the
6 RRA article it states, “the water utility sector faces increasing capital investment needs,
7 driven by increasing environmental standards and aging infrastructure, namely distribution
8 pipes.”³ Second, water utilities’ market’s measure of risk, beta, has increased from 0.70 to
9 0.73 since 2014.⁴ Third, since 2014, the prime lending rate has increased 275-basis point, or
10 over 53%, increasing from 3.25% in 2014 to today’s rate of 5.00%. September 2008 was the
11 last time the prime rate was 5.0%. Third, Moody’s credit rating agency stated the recently
12 signed federal income tax law is “credit negative” for water utilities:

13 Tax reform is credit negative for sector, but impact varies by company . . .
14 The wide-ranging tax legislation passed by the US Congress on December
15 20, 2017 cut the statutory corporate tax rate to 21% from 35%. The
16 legislation was broadly credit positive for corporate cash flows but for
17 regulated investor-owned utilities, which include electric, gas and water
18 utilities, the effect was the opposite. . . The legislation is credit negative for
19 investor-owned utilities. A lower tax rate will reduce the difference between
20 the amount that utilities collect from rate payers to cover taxes and their
21 payments to tax authorities, reducing cash flow. . . Tax reform is neutral for
22 earnings but negative for cash flow. Utilities collect revenue based on book
23 tax but cash tax is much lower. A lower tax rate lowers revenue, while loss of
24 bonus depreciation increases cash tax. . . Cash flow to debt ratio could
25 decline by 150-250 basis points. We estimate that regulated utilities could
26 experience a decline in the ratio of cash flow from operations pre-working

3 Regulatory Research Associates, *Water Advisory Major Rate Case Decision January – December 2017*, (March 26, 2018), Page 2.

4 See Kahal’s Schedule MIK-3, page 1, for 0.73 beta and see Kahal’s Schedule MIK-3, page 1, in Docket No. 4434 for 0.70 beta in 2014, attached as Schedule 1.

1 capital to debt (CFO pre-WC/debt) of 150 bps to 250 bps, assuming no
2 corrective action is taken.⁵

3
4 Finally, regarding the recently signed federal income tax law another credit rating
5 agency, Standard & Poor's, has also recently stated:

6 One of the not-so-apparent implications of the tax reform legislation is that
7 utility credit metrics will likely experience some strain due to the lower
8 customer rates, revenues and cash flows resulting from the corporate tax rate
9 reduction. Utilities can offset the pressure to their credit metrics in several
10 ways. One approach is to reduce capital expenditures, which, while not
11 increasing earnings or cash flow or rates, would conserve funds and
12 counteract the strain on credit metrics. . . Another approach is that utilities
13 can petition regulators for an increase in their authorized equity returns as a
14 means of offsetting the negative credit ramifications of the new tax law. In
15 addition, the companies can increase the equity components of their capital
16 structures which, when approved by regulators, would serve to increase rates,
17 earnings, and cash flow.⁶
18

19 **Q. DO YOU HAVE A RESPONSE TO MR. KAHAL CLAIM ON PAGE 8, “MR.**
20 **WALKER CERTAINLY HAS NOT SHOWN ANY INCREASE IN BUSINESS OR**
21 **FINANCIAL RISK FOR SWRI SINCE 2014”?**

22 A. Yes, I previously cited several examples of increased risk. Further, the Company's last rate
23 case in 2014 was settled and therefore was not a product of the evidence of record decided
24 by an impartial party. Accordingly, there was no finding on SWRI's business or financial
25 risks in the Company's last rate case which makes Mr. Kahal's observation superfluous and
26 misguided.

27 **Q. DID MR. KAHAL UTILIZE THE SAME PROXY GROUP YOU USED TO**
28 **DETERMINE HIS RECOMMENDED RETURN ON COMMON EQUITY?**

5 Moody's Investor Services, *Regulated Utilities - US: Tax Reform is Credit Negative for Sector, But Impact Varies by Company*, January 24, 2018, page 1, attached as Schedule 2.

6 Standard & Poor's, *Financial Focus: Average Utility Equity Ratio Rises Slightly, Possibly from Tax Reform Fallout*, June 20, 2018, Page 1, attached as Schedule 3.

1 A. Yes. Mr. Kahal utilize the same group of eight water utilities that I used.

2 **Q. DID MR. KAHAL PROVIDE ANY ANALYSES QUANTIFYING OR QUALIFYING**
3 **THE RISK OF HIS GROUP AS COMPARED TO SWRI?**

4 A. No. He did not provide any risk assessment of Division’s Proxy Group and he did not
5 provide any risk assessment of SWRI.

6 **Q. DID MR. KAHAL PROVIDE ANY ANALYSES QUANTIFYING OR QUALIFYING**
7 **THE RISK OF SWR AS COMPARED TO SWRI?**

8 A. No. Mr. Kahal referenced an August 8, 2017 Standard & Poor’s credit report for SWR but
9 he did not provide any other risk assessment of SWR and he did not provide any risk
10 assessment of SWRI. According to the information in the Standard & Poor’s credit report
11 utilized by Mr. Kahal, Standard & Poor’s believes SWR risk is mitigated by “Geographic
12 and regulatory diversity” and a “Large customer base.”⁷ Further, regarding SWR Standard
13 & Poor’s states:

14 Our assessment of SWR's business risk profile is based on its mostly lower-
15 risk and rate-regulated water distribution business that serves about 2 million
16 customers across New Jersey, New York, Delaware, Pennsylvania, and
17 Idaho. We view SWR's management of regulatory risk as above average,
18 partially reflecting the extensive use of constructive regulatory mechanisms,
19 including the DSIC rider in New Jersey, Pennsylvania, and Delaware, as well
20 as a revenue decoupling mechanism in New York. Under our base-case
21 scenario, we expect that the company will continue to effectively manage
22 regulatory risk, in part due to the frequency of rate case filings, and will
23 continue to use riders that we collectively view as favorable for the
24 company's credit quality.⁸
25

7 Standard & Poor’s, *RatingsDirect*, Suez Water Resources, Inc., August 18, 2017, page 2.

8 Standard & Poor’s, *RatingsDirect*, Suez Water Resources, Inc., August 18, 2017, page 3.

1 As noted in my direct testimony (page 6, direct testimony) SWRI is a regulated
2 public utility that provides water service to approximately 8,246 (12/31/16) customers who
3 are in their franchise territories in the State of Rhode Island, in a portion of Washington
4 County, including the Town of South Kingstown and the Town of Narragansett. SWR has a
5 more diverse geographic operation than SWRI, which enables SWR to sustain earnings
6 fluctuations caused by abnormal levels of rainfall in one portion of its service territory and
7 since SWR operates in more than one regulatory jurisdiction it enjoys "regulatory
8 diversification" which makes it less susceptible to adverse regulatory developments or
9 eminent domain claims in any single jurisdiction. Further, SWR with a more diverse
10 customer base is less susceptible to downturns associated with regional economic conditions
11 than SWRI.

12 For example, SWR provides water/sewer service in multiple states through 16 water
13 and waste water utilities for about 2 million customers. These wide-ranging operations
14 provide the SWR substantial geographic, economic, regulatory, weather and customer
15 diversification. The SWRI currently provides regulated water service to about 8,246. The
16 concentration of the SWRI's business in southern Rhode Island makes it very susceptible to
17 any adverse development in local regulatory, economic, demographic, competitive and
18 weather conditions.

19 Taken together, this comparison shows that SWRI is exposed to risk that is similar in
20 nature but greater in degree compared with the SWR. This is evident when one considers the
21 size and diversification of SWRI, or lack thereof, as compared to the SWR.

1 **Q. DO YOU BELIEVE IT IS SIGNIFICANT THAT MR. KAHAL DID NOT PROVIDE**
2 **ANY ANALYSES QUANTIFYING OR QUALIFYING THE RISK OF SWRI?**

3 A. Yes. In addition to using a comparison group or proxy group to estimate the cost of equity,
4 comparison companies (proxy companies) are used as a benchmark to satisfy the long-
5 established guideline of providing a utility the opportunity to earn a return equal to that of
6 similar risk enterprises. However, Mr. Kahal did not present any evidence regarding the
7 similarity, or dissimilarity, of risk between Division's Proxy Group and SWRI.

8 On pages 17-29 of my direct testimony I discussed numerous risk analyses of my
9 Comparable Group and SWRI. A risk analysis of SWRI is essential in determining a fair
10 rate of return for SWRI because risk and return counter balance one another. That is, the
11 greater the risk, the higher the required return and vice versa. Therefore, I do not believe the
12 Commission can or should rely upon Mr. Kahal's recommendations since Mr. Kahal did not
13 provide any risk assessment of SWRI relative to Division's Proxy Group.

14 **Q. IS THE COMPANY SIMILAR IN SIZE TO DIVISION'S PROXY GROUP?**

15 A. No. Page 20 of my direct testimony details the large size difference between the SWRI and
16 my Comparable Group. Company size is an indicator of business risk and was in my direct
17 testimony.

18 The large size difference between SWRI and Division's Proxy Group is an indicator
19 of business risk recognized by commissions, credit analysts, and investors. The loss of a
20 large customer will impact a small company much more than a large company because a
21 large customer of a small company usually accounts for a larger percentage of the small
22 company's sales. This risk factor is referred to as "customer concentration."

1 Moreover, Division’s Proxy Group has a more diverse geographic operation than
2 SWRI, and more economic, regulatory and customer diversification than SWRI, which
3 enables Division’s Proxy Group to be less susceptible to downturns associated with regional
4 economic conditions, and less susceptible to adverse regulatory developments or eminent
5 domain claims in any single jurisdiction.

6 The finance literature supports the fact that, as the size of a firm decreases, its risk
7 and, hence, its required return increases. Dr. Thomas Zepp presented research on water
8 utilities that support a small firm effect in the utility industry.⁹ Moreover, Professor Brigham
9 has indicated that smaller firms have higher capital costs than otherwise similar larger
10 firms.¹⁰ Mr. Kahal included information from a credit rating agency, Standard & Poor's.

11 Standard & Poor’s documents that relationship between size and credit rating,

12 Company size and diversification often plays role. While we have no
13 minimum size criterion for any given rating level, company size tends to be
14 significantly correlated to rating levels. This is because larger companies
15 often benefit from economies of scale and/or diversification, translating into
16 a stronger competitive position. Small companies are, almost by definition, -
17 more concentrated in terms of product, number of customers, and geography.
18 To the extent that markets and regional economies change, a broader scope of
19 business affords protection.¹¹ (Underline added.)

20
21 While we have no minimum size criterion for any given rating level, size and
22 ratings do end up being correlated, given that size often provides a measure
23 of diversification, and/or affects competitive positioning.¹² (Underline
24 added.)
25

9 See Zepp (2002), "Utility Stocks and the Size Effect: Revisited", Economics and Finance Quarterly, 43, 578-582.

10 See Fundamentals of Financial Management, 5th Edition, page 623.

11 Standard & Poor's, Corporate Ratings Criteria 2008; pg. 22.

12 Standard & Poor's, Corporate Ratings Criteria 2008; pg. 23.

1 **Q. MR. KAHAL CLAIMS YOU IGNORED “THE DISC PROPOSAL IN THIS CASE**
2 **WHICH WOULD FURTHER REDUCE SWRI’S ALREADY LOW RISK.” IS HE**
3 **CORRECT?**

4 A. No. The Comparable Group or proxy group already use numerous revenue stabilizing
5 mechanisms including a DSIC mechanism. Implementation of the proposed DSIC for SWRI
6 would lessen the risk difference between SWRI and the proxy group, but would not
7 eliminate SWRI’s higher risk. Further, even if SWRI and the Comparable Group both had a
8 DSIC, SWRI’s capital requirements would still be 90% greater than the Comparable
9 Group’s, indicating more risk for SWRI.¹³

10 **DIVISION’S RECOMMENDED COST OF DEBT**

11 **Q. WHAT COST OF LONG-TERM DEBT DID MR. KAHAL RECOMMEND?**

12 A. Mr. Kahal recommended a 4.65% cost of long-term debt, which is the same cost proposed by
13 the Company.

14 **Q. WHAT COST OF SHORT-TERM DEBT DID MR. KAHAL RECOMMEND?**

15 A. Mr. Kahal recommended a 2.65% cost of short-term debt. I do not believe it is appropriate
16 to include short-term debt in the Company’s rate making capital structure ratios. However,
17 if short-term debt is included in the Company’s rate making capital structure ratios, I
18 recommend the cost of short-term debt be based on the latest information and reflect the
19 rapid increases in short-term debt costs which are forecasted to occur in the near term.

13 The Company is forecasted to require 42% of additional capital to finance their construction program while the Comparable Group is projected by Value Line to require 22% of additional capital to finance their construction programs. Accordingly, SWRI’s capital requirements are about 90% greater than the Comparable Group’s through 2019 indicating more risk for SWRI. (See page 27 of my Direct Testimony)

1 **DIVISION’S RECOMMENDED COST OF EQUITY**

2 **Q. MR. KAHAL STATES, “I BELIEVE THAT THE ABOVE TABLE OF ROE**
3 **AWARDS SUPPORTS THE REASONABLENESS OF MY RECOMMENDATION IN**
4 **THIS CASE.” DO YOU AGREE WITH MR. KAHAL THAT THE INFORMATION**
5 **SHOWN IN HIS REFERENCED TABLE ON PAGE 9 OF HIS TESTIMONY**
6 **SUPPORTS HIS RECOMMENDATION?**

7 A. No. None of the authorized ROE’s shown in his table are as low as his 9.0%
8 recommendation. The closet number in his table is the 9.23% average ROE reported by
9 RRA for six companies in the first quarter of 2018. Since the publication of the RRA report
10 used by Mr. Kahal, RRA has reported two additional authorized ROEs of 10.5% for Carolina
11 Water Service and a ROE range of 9.5% to 10.0% for Missouri-American. Accordingly,
12 RRA is currently reporting an average ROE of 9.47% for 2018.

13 **Q. MR. KAHAL STATES, “IT IS ALSO NOTABLE THAT THE NEW YORK PUBLIC**
14 **SERVICE COMMISSION IN 2017 APPROVED A 9.0 PERCENT ROE FOR SUEZ**
15 **WATER NEW YORK, SWRI’S UTILITY AFFILIATE.” DO YOU BELIEVE SUEZ**
16 **WATER NEW YORK’S AUTHORIZED ROE IS NOTABLE?**

17 A. No. The SUEZ Water New York authorized ROE was the result of a settlement so other
18 factors besides ROE were consider in reaching the settlement. Further, regarding the SUEZ
19 Water New York decision, RRA stated, “The rate plan, as modified by the New York Public
20 Service Commission, incorporates a 9% ROE, **which is among the lowest ROEs for a**
21 **water company in recent history and notably below the 9.7% average ROE authorized**
22 **for water utilities nationwide in cases decided during 2016**, as calculated by Regulatory

1 Research Associates, an offering of S&P Global Market Intelligence. However, the
 2 authorized ROE is in line with other recent authorizations for electric and gas utilities by the
 3 PSC.”¹⁴

4 **Q. IS THERE OTHER EVIDENCE THAT PROVES MR. KAHAL’S**
 5 **RECOMMENDATION IS NOT REASONABLE FOR SWRI?**

6 A. Yes. Blue Chip Financial Forecast project capital costs rates increasing substantially from
 7 their current levels. Table 1 shows the forecasted increase in interest rates published in the
 8 July 1, 2018 Blue Chip Consensus Forecasts for each quarter through the last quarter of
 9 2019. As shown in Table 1, consensus forecasts show interest rates are expected to increase
 10 between 60-basis points to 110-basis points from current levels depending on the interest
 11 rate instrument.

| <u>Blue Chip Financial Forecasts Long-Range Survey (7/1/18)</u> | | | | | | | |
|---|----------------|---------------------|----------------|----------------|----------------|----------------|----------------|
| | Latest Qtr | Consensus Forecasts | | | | | |
| | 7/1/2018 | (7/1/18) | | | | | |
| | <u>2Q 2018</u> | <u>3Q 2018</u> | <u>4Q 2018</u> | <u>1Q 2019</u> | <u>2Q 2019</u> | <u>3Q 2019</u> | <u>4Q 2019</u> |
| <u>Interest Rates</u> | | | | | | | |
| Prime Rate | 4.8 | 5.0 | 5.2 | 5.4 | 5.6 | 5.8 | 5.9 |
| 3-mo. Treasury Bills | 1.9 | 2.0 | 2.2 | 2.4 | 2.6 | 2.7 | 2.8 |
| 10 Year Notes | 2.9 | 3.1 | 3.2 | 3.3 | 3.4 | 3.4 | 3.5 |
| 30 Year Notes | 3.1 | 3.3 | 3.4 | 3.5 | 3.6 | 3.7 | 3.8 |
| Aaa Corporate Bond Yield | 4.1 | 4.2 | 4.4 | 4.6 | 4.7 | 4.8 | 4.9 |
| Baa Corporate Bond Yield | 4.7 | 5.0 | 5.2 | 5.3 | 5.5 | 5.6 | 5.6 |

12
13
14
15
16
17
18
19
20
Table 1

14 (Bolding added), Regulatory Research Associates, *Regulatory Focus*, (May 30, 2017), page 1.

1 For example, the prime lending rate is projected to increase to 5.9%, or about 110-
2 basis points from recent levels. February 2008 was the last month in which the prime
3 lending rate was at least 5.9%. Further, the yield on the 10-year treasury note is projected to
4 increase to 3.5%, or about 60-basis points from recent levels. February 2011 was the last
5 month in which the yield on the 10-year treasury note rate was at least 3.5%.

6 The competitive disadvantage in which the adoption of Mr. Kahal's recommended
7 ROE of only 9% would place SWRI will be compounded, or magnified, by the projected
8 increase in capital cost rates and may impact SWRI's ability to attract capital when other
9 lower risk investments offering higher returns are available.

10 **Q. YOU PREVIOUSLY TESTIFIED FORECASTERS BELIEVE CAPITAL COSTS**
11 **RATES WILL INCREASE SUBSTANTIALLY FROM THEIR CURRENT LEVELS.**
12 **ARE THERE OTHER FACTORS THAT INDICATE CAPITAL COSTS RATES**
13 **WILL INCREASE MARKEDLY FROM THEIR CURRENT LEVELS?**

14 A. Yes, the Federal Reserve increased interest rates three times in 2017, and two more times in
15 2018, including the most recent change in June 2018. Prior to the new tax law, the Federal
16 Reserve forecasted another three rate increases in 2018 and two in 2019. Additionally, given
17 the markets' positive reaction to the recently enacted changes in tax law, additional rate
18 hikes may be forth coming in reaction the tax law's economic stimulus. The tax law's
19 economic stimulus and rate hikes will put upward pressure on long term interest rates.

20 **Q. HOW DID DIVISION DETERMINE THEIR RECOMMENDED COST OF EQUITY**
21 **FOR THE COMPANY?**

1 A. Mr. Kahal's common equity estimate for SWRI is based on DCF analysis of Division's
2 Proxy Group. As a check on his recommendation, he used a CAPM analysis of Division's
3 Proxy Group. Other utility commissions have recently stated that the methodology that they
4 have been using since the early 1990s are not producing reasonable results. For example, the
5 New York Department of Public Service Staff have acknowledged in recent rate case
6 proceedings that their methodology may not be producing reasonable results under current
7 market conditions.

8 I believe some of the current market conditions may include the Federal Reserve's
9 distortion of the price of risk due (explained at pages 31-32 of my direct testimony), the
10 current artificial interest rate levels and the fact that the market values are substantially
11 above book value as is evidenced by the 3.34-times Market/Book Multiple for Division's
12 Proxy Group.

13 **Q. WHY DO CURRENT MARKET CONDITIONS IMPACT DIVISION'S COST OF**
14 **EQUITY METHODOLOGIES MORE SO CURRENTLY THAN IN PREVIOUS**
15 **PERIODS?**

16 A. The basic proposition of financial theory regarding the economic value of a company is
17 based on market value. That is, a company's value is based on its **market value weighted**
18 **average cost of capital**.¹⁵ The American Society of Appraisers, ASA Business Valuation
19 Standards, 2009, and the National Association of Certified Valuation Analysts, Professional
20 Standards, 2007, use the same definition:
21

¹⁵Other examples, see <http://www.investinganswers.com/financial-dictionary/financial-statement-analysis/weighted-average-cost-capital-wacc-2905>. Also see <http://www.wallstreetmojo.com/weighted-average-cost-capital-wacc/>, or <http://accountingexplained.com/misc/corporate-finance/wacc>.

1 Weighted Average Cost of Capital (WACC). The cost of capital (discount
2 rate) determined by the weighted average, **at market values**, of the cost of
3 all financing sources in the business enterprise's capital structure. (bolding
4 added)

5 Accordingly, the market value derived cost rate reflects the financial risk or leverage
6 associated with **capitalization ratios based on market value**, not book value.

7 As shown in Table 2, there is a large difference in the market capitalization ratios and
8 the book capitalization for Division's Proxy Group. This difference in market values and
9 book values results in debt/equity ratios based on **market value of 22%/78%** (debt/equity)
10 verses 45%/55% (debt/equity) based on book value for Division's Proxy Group shown on
11 Table 2.

| | Recent Book Value Capitalization Ratios (12/31/17) | Recent Market Value Capitalization Ratios |
|-------------------------------|--|--|
| <u>Divisions' Proxy Group</u> | | |
| Long Term Debt | 45.1 % | 21.6 % |
| Preferred Stock | 0.1 | 0.1 |
| Common Equity | <u>54.8</u> | <u>78.3</u> |
| Total | <u>100.0 %</u> | <u>100.0 %</u> |

22 **Table 2**

1 The larger the difference between market values and book values the less reliable the
2 models' results are because **the models provide an estimate of the cost of capital of**
3 **market value**, not book value.

4 **Q. HAVE MARKET CONDITIONS CHANGED DURING THE PERIODS REVIEWED**
5 **BY MR. KAHAL?**

6 A. Yes. Table 3 illustrates the change in the Division' Proxy Group **market value**, or
7 Enterprise Value, over the last 72 months as measured by its multiple of investor provided
8 capital, or book value (i.e., Total Enterprise Value ÷ Total Book Value). Where the
9 Enterprise Value includes the market value of common equity plus minority interest,
10 preferred stock, and total debt net of cash and cash equivalents. The market value of
11 common equity is the product of multiplying the closing stock price by the number of
12 common shares outstanding. The Enterprise Value provides an indication of the market's
13 value of the entire business. The "Valuation Metric" of Enterprise Value multiple of
14 investor provided capital, or book value ("market multiples") for Division's Proxy Group
15 was calculated as of April 30, 2018 and for each of the prior 72 months based on the
16 financial data available at that date.¹⁶

16 An ending date of April 30, 2018 was used to match, or coincide with the ending time, or month, used by Mr. Kahal in his cost of capital analysis.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22

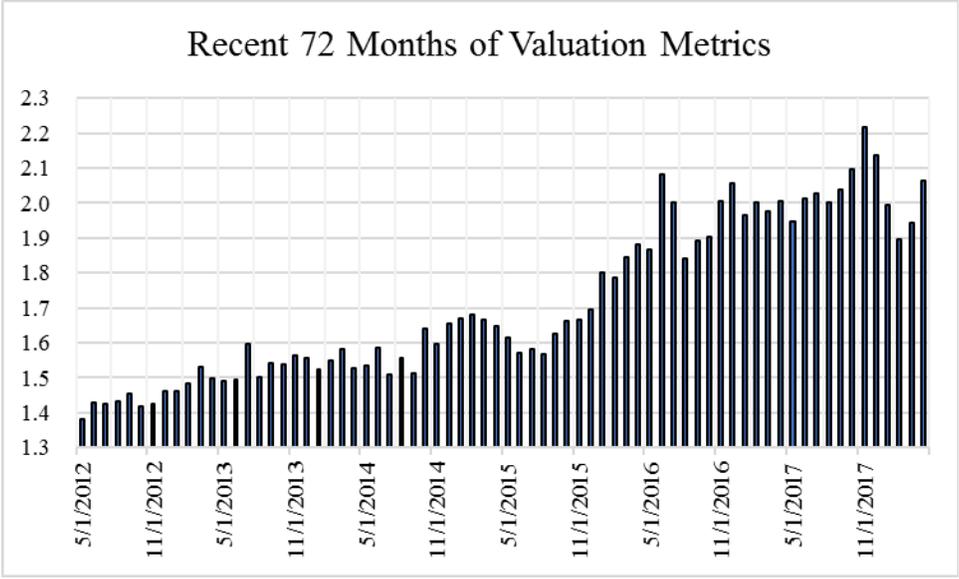


Table 3

The change in the Division’s Proxy Group’s markets multiples of investor provided capital, or book value, shown in Table 3, shows the **change in market valuation** over the last 72 months. As shown in Table 3, the Division’s Proxy Group’s valuation multiples at April 30, 2018 are 37% higher than 2014’s lowest levels and 25% higher than 2014’s highest levels and 30% higher than 2013’s lowest levels and 23% higher than the 2013’s highest levels. The Division’s Proxy Group’s April 30, 2018 valuation multiples are 32% higher than 2012’s lowest levels and 28% above the 2012’s highest levels.

Measurable capital cost rates have fluctuated and some of the changes can be attributed to the Federal Reserve's distortion of the price of risk due (explained at pages 31-32 of my direct testimony) which have produced the current artificial interest rate levels and attributed to the high market values. The known and measurable cost of capital for a public utility has not varied much between 2012 to date as is evidenced by the average yield of 4.1% on A rated public utility bonds and 2.2% on 10-Year Treasury notes during this period

1 (shown on Mr. Kahal's Schedule MIK-2). These average yields are **below** the April 2018
2 yields of 4.2% and 2.9% shown on Mr. Kahal's Schedule MIK-2 for A rated public utility
3 bonds and 10-Year Treasury notes. Further, the prime lending rate averaged 3.5% during
4 this 72-month period and was 4.8% in April 2018.

5 **Q. ARE YOU SAYING MR. KAHAL'S METHODOLOGY AND RECOMMENDATION**
6 **IS FLAWED BECAUSE HE ONLY USED ONE MODEL TO DETERMINE THE**
7 **COST OF EQUITY FOR THE COMPANY?**

8 A. Yes, Mr. Kahal's primary reliance on only one model or methodology is especially
9 troublesome given the large difference between market value and book values. There is no
10 single method (model) suitable for estimating the cost rate for common equity. While a
11 single investor may rely solely upon one model in evaluating investment opportunities, other
12 investors rely on different models. Most sophisticated investors who use an equity valuation
13 model rely on many models in evaluating their common equity investment alternatives.
14 Therefore, the average price of an equity security reflects the results of the application of
15 many equity models used by investors in determining their investment decisions.

16 The application of any single model to estimate common equity cost rates is not
17 appropriate because the security price for which the equity cost rate is being estimated
18 reflects the application of many models used in the valuation of the investment. That is, the
19 price of any security reflects the collective application of many models. Accordingly, if only
20 one model is used to estimate common equity cost rates, that cost rate will most likely be
21 different from the collective market's cost rates because the collective valuation in the
22 market reflects more than one method.

1 Noted financial texts, investor organizations and professional societies all endorse the
2 use of more than one valuation method. "We endorse the dividend discount model,
3 particularly when used for establishing companies with consistent earnings power and when
4 used along with other valuation models. It is our view that, in any case, an investor should
5 employ more than one model."¹⁷ (Emphasis added.) The American Association of
6 Individual Investors state, "No one area of investment is suitable for all investors and no
7 single method of evaluating investment opportunities has been proven successful all of the
8 time."¹⁸

9 In their study guide, the National Society of Rate of Return Analysts state, "No cost
10 of equity model or other concept is recommended or emphasized, nor is any procedure for
11 employing any model recommended . . . it remains important to recognize that alternative
12 methods exist and have merit in cost of capital estimation. To this end, analysts should be
13 knowledgeable of a broad spectrum of cost of capital techniques and issues."¹⁹

14 Several different models should be employed to measure accurately the market-
15 required cost of equity reflected in the price of stock and variation between market values
16 and book values must be considered and reflected as well.

¹⁷Sidney Cottle, Roger F. Murray and Frank E. Block, Graham and Dodd's Securities Analysis 5th Edition, McGraw-Hill, Inc., 1988, p. 568.

¹⁸Editorial Policy, AAII Journal, American Association of Individual Investors, Volume 18, No. 1, January 1996, p. 1.

¹⁹David C. Parcell, The Cost of Capital - A Practitioners Guide, National Society of Rate of Return Analysts, 1995 Edition.

1 **Q. DO YOU BELIEVE DIVISION'S MARKET VALUE DCF RECOMMENDATION IS**
2 **BELOW THE ZONE OF REASONABLENESS?**

3 A. Yes. Mr. Kahal improperly relied upon growth rates that he calculated. He subjectively
4 ignored the investor influencing growth rates of security analysts and instead, calculated his
5 own growth rates. Mr. Kahal relied upon internal growth rates. Internal growth measures
6 growth in book value, not stock price. Growth in book value is meaningless given today's
7 relatively **high market value** multiples and therefore, internal growth is not a good proxy
8 for investors' growth expectations.

9 **Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING DIVISION'S DCF**
10 **MODEL SHOWN ON SCHEDULE MIK-4?**

11 A. Yes. Division's sustainable growth rate of 6.8% ("sv+br" on Schedule MIK-4, page 5) is
12 calculated using Value Line's projected return on equity. According to Mr. Kahal's
13 workpapers, Value Line's projected return on equity, or ROE, for Division's Proxy Group
14 ranges from 10.5% to 14.0% and averages 12.5%. Value Line's average projected ROE of
15 12.5% is 350-basis points higher than Mr. Kahal's recommended ROE of 9.0% and
16 highlights the inadequacy of Mr. Kahal's recommendation.

17 Even if Mr. Kahal's judgments concerning future growth were superior to the
18 analysts' forecasts, there still would be no justification for using Mr. Kahal's unique growth
19 rate in a DCF formula because investors that price stocks are totally unaware of Mr. Kahal's
20 analysis (even if hypothetically it were better). Instead, investors rely upon analysts'
21 forecasts, which are widely available to and used by investors.

1 **Q. PLEASE EXPLAIN DIVISION’S RECOMMENDED GROWTH RATE RANGE OF**
2 **6.5% TO 7.0% SHOWN ON SCHEDULE MIK-4, PAGE 1.**

3 A. Yes. The growth rate range of 6.5% to 7.0% shown Schedule MIK-4 page 1 is footnoted to
4 Schedule MIK-4, pages 3 and 5. On Schedule MIK-4 page 3 the average forecasted earnings
5 growth is shown to range from 6.5% to 7.5% and averages 6.9%. On Schedule MIK-4 page
6 5 the sustainable growth rate is 6.8% (“sv+br” on Schedule MIK-4, page 5). Therefore, Mr.
7 Kahal’s growth rate range is 6.5% to 7.5% if based on absolute ranges and 6.8% to 6.9% if
8 based on growth rate methodology (earning growth forecasts and sustainable growth), not
9 the growth range he shows on Schedule MIK-4 page 1.

10 **Q. MR. KAHAL USED A CAPM AS A CHECK ON HIS RECOMMENDATION. DO**
11 **YOU AGREE WITH DIVISION’S CAPM METHODOLOGY?**

12 A. No. The three input variables in Mr. Kahal’s CAPM are the risk-free rate, the beta of
13 Division’s Proxy Group, and the market risk premium. The areas of disagreement I have
14 with Mr. Kahal’s CAPM relate to his risk-free rate and his market risk premium. The first
15 area of disagreement I have with Mr. Kahal’s CAPM is his risk-free rate is based on his use
16 of only historical yields not projected yields. Mr. Kahal’s risk-free rate of 3.1% is a six
17 month historical average of the 30-year Treasury bond yields. The Blue Chip Financial
18 Forecast that were discussed regarding Table 1 shows projected capital costs rates increasing
19 substantially from their current levels. Had Mr. Kahal used the more appropriate projected
20 30-year Treasury bond yield his risk-free rate would have been 3.8% based on the interest
21 rate forecast for the fourth quarter of 2019 shown in Table 1, not 3.1%. As shown in Table

1 1, consensus forecasts show interest rates on 30-year Treasury bonds are expected to
2 increase 70 basis points from current levels.

3 Another area disagreement I have with Mr. Kahal's CAPM is his market risk
4 premium of 5.0% to 8.0% which is based on a 2005 finance textbook by Brealey, Myers and
5 Allen (Principles of Corporate Finance, 8th edition). On page 154 of that text book the
6 authors state, "Brealey, Myers, and Allen have no official position on the issue, but we
7 believe that a range of 5% to 8% is reasonable for the risk premium in the United States."
8 They reached their opinion in a different interest rate environment than currently exists. As
9 shown in my Direct Testimony (pages 52-53) there is a negative relationship between
10 interest rate levels and the resulting risk premium. That is, when interest rates are high, risk
11 premiums are lower and vice versa. On Schedule MIK-5, the low end of Mr. Kahal's market
12 risk premium of 5.0%, based on Brealey, Myers, and Allen, indicates a cost of equity of
13 6.8%. This 6.8% equity cost rate determination proves the unreliability Mr. Kahal's CAPM
14 and suggest the 5.0% risk premium was based on a much higher interest rate environment. I
15 believe Mr. Kahal should have used the most noted asset return studies and resultant risk
16 premium studies that are published, by Ibbotson Associates. The Ibbotson Associates
17 market risk premium are documented in my direct testimony.

18 The last area disagreement I have with Mr. Kahal's CAPM is he did not reflect the
19 required CAPM size premium. The size premium reflects the risks associated with
20 Division's Proxy Group's small size and its impact on the determination of their beta. This
21 adjustment is necessary because beta (systematic risk) does not capture or reflect the
22 Division's Proxy Group's small size. According to Brealey, Myers, and Allen, "the

1 relationship among stock returns and firm size and book-to-market ratio has been well
2 documented.”²⁰ Brealey, Myers, and Allen also state, on page 202, that “between 1926 and
3 2008 the difference between the annual returns on small and large capitalization stocks
4 averaged 3.6%” which should be included in Mr. Kahal’s CAPM.

5 **Q. HOW WOULD DIVISION’S CAPM RESULTS CHANGE IF DIVISION USED BLUE**
6 **CHIP FINANCIAL FORECAST’S PROJECTED INTEREST RATES SHOWN IN**
7 **TABLE 1?**

8 A. The upper end of Mr. Kahal’s CAPM model of 8.9% would be 9.6% for Division’s Proxy
9 Group and the lower end would become 7.5%. Since Mr. Kahal placed greater weight on the
10 upper end of his CAPM range, I believe his CAPM would be 9.6%.²¹

11 **RESPONSE TO DIVISION’S CRITICISM OF MR. WALKER’S TESTIMONY**

12 **Q. MR. KAHAL CLAIMS YOUR RECOMMENDED 10.50% COST OF EQUITY FOR**
13 **SWRI IS EXCESSIVE. BESIDES THE RESULTS OF THE MODELS YOU**
14 **EMPLOYED, IS THERE OTHER EVIDENCE WHICH SUPPORTS THE**
15 **REASONABLENESS OF YOUR RECOMMENDATION?**

16 A. Yes. My recommendation reflects the results of the models I used, my overall risk
17 assessment of SWRI, my understanding of capital markets and my broad experiences. A
18 review of a recent RRA publication informs me that RRA is currently reporting on 17 water
19 and wastewater utility rate cases proceedings involving rate change requests of \$0.5 million

20 Brealey, Myers and Allen, Principles of Corporate Finance, 10th edition, page 198.

21 Mr. Kahal’s testimony at page 7, “In addition, the CAPM produces a range of 6.8 to 8.9 percent, although I tend to place greater weight on the upper end of this range.”

1 or greater for major investor-owned and privately held water utilities that are currently in
2 progress. The average reported requested return on equity is 10.51%.

3 **Q. ON PAGE 39 MR. KAHAL STATES, “INSTEAD, HE SHOULD HAVE RELIED**
4 **UPON THE 6.5 PERCENT GROWTH RATE FROM THE FOUR AUTHORITATIVE**
5 **SOURCES AND THAT SPECIFICALLY APPLICABLE TO HIS OWN SELECTED**
6 **PROXY GROUP” REGARDING YOUR 7.2% GROWTH RATE USED IN YOUR**
7 **DCF. IS MR. KAHAL’S TESTIMONY CORRECT?**

8 A. No. First, Mr. Kahal’s growth rate range is 6.5% to 7.0% shown Schedule MIK-4 page 1.
9 However, his average forecasted earnings growth is shown to range from 6.5% to 7.5% and
10 averages 6.9%. On Schedule MIK-4 page 5 the sustainable growth rate is 6.8% (“sv+br” on
11 Schedule MIK-4, page 5). Therefore, Mr. Kahal’s growth rate range is 6.5% to 7.5%, which
12 encompasses my recommendation of 7.2%. Further, as stated in my direct testimony, the
13 published historical earnings growth rates for the Water Group averages 8.9%, which
14 suggest my 7.2% growth selection is reasonable if not conservative.

15 **Q. ON PAGE 39 MR. KAHAL CLAIMS, “THE PROPOSED LEVERAGE**
16 **ADJUSTMENT HAS NOTHING TO DO WITH THE ACTUAL COST OF EQUITY.”**
17 **IS MR. KAHAL CORRECT IN HIS ASSERTION?**

18 A. No. I explain the reason this adjustment should be used in my direct testimony. Further,
19 financial theory concludes capital structure and firm value are related. Since capital
20 structure and firm value are related, a leverage adjustment (Hamada adjustment) is required
21 when a cost of common equity model is based on market value and if its results are then
22 applied to book value. As explained previously, the market value derived cost rate reflects

1 the financial risk or leverage associated with **capitalization ratios based on market value**,
2 not book value. The authors Brealey, Myers and Allen relied upon by Mr. Kahal provide a
3 similar definition of the cost of capital being based on market capitalization, not book value,

4
5 The values of debt and equity add up to overall firm value ($D + E = V$) and
6 firm value V equals asset value. **These figures are all market values, not**
7 **book (accounting) values.** The market value of equity is often much larger
8 than the book value, so the market debt ratio D/V is often much lower than a
9 debt ratio computed from the book balance sheet.²²

10 The work of Modigliani and Miller concludes that the market value of any firm is
11 independent of its capital structure and this is precisely the reason why the leverage
12 adjustment (Hamada adjustment) is appropriate. The only way for the market value of a firm
13 to remain independent of its capital structure is if the capital cost rates change to offset
14 changes in the capitals structure. If the capital cost rates do not change to offset changes in
15 the capitals structure then the value of the firm will change. Clearly a leverage adjustment
16 (Hamada adjustment) is required when a cost of common equity model is based on market
17 value and if its results are then applied to book value because the capitals structure is
18 changed from market value capitalization to book value capitalization.

19 Referring to Table 2, the Division's Proxy Group's cost of capital is based on
20 debt/equity ratios based on **market value of 22%/78%** (debt/equity). Therefore, Mr.
21 Kahal's equity cost rate of 9.0% reflects a 78.3% equity ratio. That is not just my opinion
22 but it is a corner stone of financial theory. Mr. Kahal determined of 9.0% cost rate that
23 reflects a 78.3% equity ratio and yet he recommends his 9.0% cost of equity be applied to a
24 53.9% equity ratio based on book value. Even if a 9.0% cost of equity were appropriate for a

22 (Bolding added) Brealey, Myers and Allen, Principles of Corporate Finance, 10th edition, page 216.

1 78.3% equity ratio, it cannot simultaneously be appropriate for a 53.9% equity ratio without
2 violation Modigliani and Miller's precept.

3 **Q. DO YOU HAVE ANY RESPONSE TO DIVISION'S TESTIMONY REGARDING**
4 **"SIZE ADJUSTMENT" IN THE CAPM?**

5 A. Yes. Investors prefer liquidity to lack of liquidity. Accordingly, a share in a business is
6 worth more if it is easily marketable or, conversely, worth less if it is not. Privately held
7 water utilities such as SWRI are worth less than publicly traded water utilities. Further,
8 publicly traded water utilities are not as marketable as the large companies which comprise
9 the S&P 500. The size premium used in the CAPM accounts for some of these differences.

10 **Q. IS THE USE OF THE SIZE PREMIUM WIDELY ACCEPTED BY THE ACADEMIC**
11 **COMMUNITY AND THE FINANCIAL COMMUNITY?**

12 A. Yes. Since size is a recognized and meaningful element of risk, it is appropriate to reflect
13 that risk in a company's cost of equity. Credit rating agencies recognize that size impacts
14 credit rating. Valuation professionals and courts recognize the use of a size premium.

15 As stated previously, the authors Brealey, Myers and Allen relied upon by Mr. Kahal,
16 discuss the "firm size" and the size premium. In a 2002 article by T. M. Zepp he explains
17 that size premium does exist and presented research on water utilities that support a small
18 firm effect.²³ Additional support for the use of the size premium for utilities is also found
19 in a 1995 article by M. Annin.²⁴

20 **Q. ON PAGE 42 MR. KAHAL STATES HIS OPINION THAT A "SWRI SPECIFIC**
21 **RISK FACTOR IS ALSO INAPPROPRIATE BECAUSE SWRI IS SIMPLY NOT**

23 See Zepp (2002), "Utility stocks and the size effect: revisited", Economics and Finance Quarterly, 43, 578-582.

24 See Annin (1995), "Equity and the Small Stock Effect", Public Utilities Fortnightly, October 15, 1995, at 42-43.

1 **RISKIER THAN THE PROXY COMPANIES.” DID MR. KAHAL PROVIDE ANY**
2 **EVIDENCE SUPPORTING THIS OPINION?**

3 A. No. He did not provide any risk assessment of Division’s Proxy Group and he did not
4 provide any risk assessment of SWRI. On pages 17-29 of my direct testimony I discussed
5 numerous risk analyses of my Comparable Group and SWRI. I do not believe the
6 Commission can or should rely upon Mr. Kahal’s recommendations since Mr. Kahal did not
7 provide any risk assessment of SWRI relative to Division’s Proxy Group.

8 **Q. ON PAGE 43 MR. KAHAL STATES, “MR. WALKER IS ACCURATE IN**
9 **OBSERVING THAT VALUE LINE PROJECTS THAT THE EARNED RETURN ON**
10 **COMMON EQUITY FOR THE EIGHT PROXY WATER UTILITY COMPANIES**
11 **WILL INCREASE TO 10.5 TO 14.0 PERCENT OVER THE NEXT FIVE YEARS.”**
12 **HE THEN STATES HIS BELIEF THAT THE EARNED RETURNS, OR**
13 **“ACCOUNTING ROEs,” HAVE LITTLE TO DO WITH THE ROE TO BE**
14 **DETERMINED IN THIS CASE. DO YOU AGREE WITH MR. KAHAL OPINION?**

15 A. No, not really. I agree there is a distinction between a market return and an accounting
16 return. The ROE that the Commission will determined in this case will become SWRI’s
17 accounting ROE benchmark by which underearning and over-earning will be measured. If
18 the Division’s Proxy Group is earning an accounting return of 10.5% to 14.0% while SWRI
19 earns only 9.0%, it places SWRI at a complete disadvantage in the competition to attract
20 capital. According, Value Lines projected ROE are a useful measure.

21 **Q. ON PAGE 45 MR. KAHAL STATES HIS BELIEF THAT “A ROE RISK**
22 **ADJUSTMENT FOR SWRI’S ASSERTED SMALL SIZE WOULD BE INCORRECT**

1 **AS IT IGNORES THE COMPANY’S STATUS AS A COMPONENT OF THE MUCH**
2 **LARGER SWR. THIS CORPORATE ORGANIZATION ARRANGEMENT**
3 **ELIMINATES THIS ASSERTED RISK.” DID MR. KAHAL PROVIDE ANY**
4 **EVIDENCE SUPPORTING THIS VIEW?**

5 A. No, he did not provide any support for his stated view. The authors Brealey, Myers and
6 Allen relied upon by Mr. Kahal, hold a view that is opposite to Mr. Kahal’s opinion, “the
7 true cost of capital depends on project risk, not on the company undertaking the project.”²⁵
8 From Brealey, Myers and Allen view, SWRI is the “project risk” and SWR would be “the
9 company undertaking the project.”

10 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

11 A. Yes.

25 Brealey, Myers and Allen, Principles of Corporate Finance, 10th edition, page 215.

SUEZ WATER RHODE ISLAND, INC.
WAKEFIELD, RHODE ISLAND

RATE OF RETURN

EXHIBIT

TO ACCOMPANY THE
REBUTTAL TESTIMONY

JULY 2018

Prepared by:
GANNETT FLEMING
VALUATION AND RATE CONSULTANTS, LLC



Valley Forge, Pennsylvania

RIPUC Docket No. 4434
 Schedule MIK-3
 Page 1 of 1

UNITED WATER RHODE ISLAND, INC.

List of the Water Utility Proxy Companies

| | | | | 2013 Common Equity Ratio* |
|--------------------------|--------------------------|-------------------------------|-------------|------------------------------------|
| <u>Company</u> | <u>Safety Rating</u> | <u>Financial Strength</u> | <u>Beta</u> | <u>Ratio*</u> |
| 1. American States Water | 2 | A | 0.70 | 57.0% |
| 2. Aqua American | 2 | B++ | 0.60 | 50.0 |
| 3. American Water Works | 3 | B + | 0.65 | 46.0 |
| 4. California Water | 3 | B++ | 0.65 | 58.0 |
| 5. Connecticut Water | 3 | B+ | 0.75 | 50.5 |
| 6. Middlesex Water | 2 | B++ | 0.70 | 57.0 |
| 7. SJW Corporation | 3 | B+ | 0.85 | 45.5 |
| 8. York Water | <u>2</u> | <u>B+</u> | <u>0.70</u> | <u>55.0</u> |
| Average | 2.5 | -- | 0.70 | 52.4% |

* The common equity ratio excludes short-term debt (and current maturities of long-term debt). Actual 2013 equity ratio including short-term debt and current maturities averages 49.6 percent.

Source: *Value Line Investment Survey*, October 18, 2013.

MOODY'S

INVESTORS SERVICE

SECTOR COMMENT

24 January 2018

Rate this Research >>

Contacts

Toby Shea +1.212.553.1779
 VP-Sr Credit Officer
 toby.shea@moodys.com

Ryan Wobbrock +1.212.553.7104
 VP-Senior Analyst
 ryan.wobbrock@moodys.com

Nana Hamilton +1.212.553.9440
 AVP-Analyst
 nana.hamilton@moodys.com

Natividad Martel, CFA +1.212.553.4561
 VP-Senior Analyst
 natividad.martel@moodys.com

Robert Petrosino, CFA +1.212.553.1946
 VP-Senior Analyst
 robert.petrosino@moodys.com

Laura Schumacher +1.212.553.3853
 VP-Sr Credit Officer
 laura.schumacher@moodys.com

Graham Taylor +44.20.7772.5206
 VP-Sr Credit Officer
 graham.taylor@moodys.com

Michael Haggarty +1.212.553.7172
 Associate Managing Director
 michael.haggarty@moodys.com

Jim Hempstead +1.212.553.4318
 MD-Utilities
 james.hempstead@moodys.com

CLIENT SERVICES

| | |
|--------------|-----------------|
| Americas | 1 212-553-1653 |
| Asia Pacific | 852-3551-3077 |
| Japan | 81-3-5408-4100 |
| EMEA | 44-20-7772-5454 |

Regulated Utilities - US

Tax reform is credit negative for sector, but impact varies by company

The wide-ranging tax legislation passed by the US Congress on December 20, 2017 cut the statutory corporate tax rate to 21% from 35%. The legislation was broadly credit positive for corporate cash flows but for regulated investor-owned utilities, which include electric, gas and water utilities, the effect was the opposite.

- » **The legislation is credit negative for investor-owned utilities.** A lower tax rate will reduce the difference between the amount that utilities collect from rate payers to cover taxes and their payments to tax authorities, reducing cash flow.
- » **Tax reform is neutral for earnings but negative for cash flow.** Utilities collect revenue based on book tax but cash tax is much lower. A lower tax rate lowers revenue, while loss of bonus depreciation increases cash tax.
- » **Cash flow to debt ratio could decline by 150-250 basis points.** We estimate that regulated utilities could experience a decline in the ratio of cash flow from operations pre-working capital to debt (CFO pre-WC/debt) of 150 bps to 250 bps, assuming no corrective action is taken.
- » **Utilities with weaker than expected financials are most affected.** The potential for lower cash flows hurts the credit profile of numerous regulated utilities that already have weakening financial projections. Major holding companies affected include American Electric Power Company (AEP, Baa1 stable), Consolidated Edison, Inc. (ConEd A3 negative), Dominion Energy (Dominion, Baa2 negative), Duke Energy Corporation (Duke, Baa1 negative), Entergy Corporation (Entergy, Baa2 negative) and The Southern Company (Southern, Baa2 negative).
- » **Most utilities are still well positioned within their credit profiles.** The vast majority of utilities and their holding companies are well positioned within their credit profiles thanks to supportive regulatory relationships and a capital structure balanced between both debt and equity.

S&P Global

FINANCIAL FOCUS

Average utility equity ratio rises slightly, possibly from tax reform fallout

Tuesday, June 26, 2018 12:47 PM ET

By Dennis Sperduto

Some provisions of the tax reform legislation that was enacted in December 2017 have relatively obvious financial implications for utilities. For instance, rate regulated utilities will, with very few exceptions, be required to lower customer rates to account for the reduced tax expense due to the decline in the corporate tax rate to 21% from 35%. In addition, the corporate tax rate reduction will require utilities to recalculate their deferred income tax balances at the new lower rate, which will lead to the companies having reduced deferred income tax balances.

One of the not-so-apparent implications of the tax reform legislation is that utility credit metrics will likely experience some strain due to the lower customer rates, revenues and cash flows resulting from the corporate tax rate reduction. Utilities can offset the pressure to their credit metrics in several ways. One approach is to reduce capital expenditures, which, while not increasing earnings or cash flow or rates, would conserve funds and counteract the strain on credit metrics. However, data contained in a RRA Financial Focus report that was published on April 20, Utility Capital Expenditures Update, indicates that a pullback in utility CapEx plans has not occurred.

Another approach is that utilities can petition regulators for an increase in their authorized equity returns as a means of offsetting the negative credit ramifications of the new tax law. In addition, the companies can increase the equity components of their capital structures which, when approved by regulators, would serve to increase rates, earnings, and cash flow.

This article examines capital structure data contained in a June 20 Financial Focus Quality Measures report for 83 utility operating companies. The data indicates that the average equity component of capital increased slightly for this group of companies, from 50.1% at year-end 2017 to 50.3% at the conclusion of 2018's first quarter. We note that the three months covered by the Quality Measures report that have elapsed since the new tax law became effective on Jan. 1, represent a short time frame in which to evaluate whether any significant trend has emerged. However, as the data indicates, a trend, albeit a slight one, may have commenced in the first quarter of 2018. We expect this nascent trend toward increased equity ratios to garner at least modest momentum in the remainder of 2018, given the anticipated pressure on utility credit metrics.



<<< Read the full report >>>