

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois-American Water Company :
: **Docket No. 07-0507**
Proposed general increase in water rates. :

Corrected Direct Testimony of

Michael Gorman

On Behalf of

Illinois Industrial Water Consumers

March 25, 2008
Project 8888



BRUBAKER & ASSOCIATES, INC.
ST. LOUIS, MO 63141-2000

13 Q WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS
14 PROCEEDING?

15 A I will provide an overview of IIRC's recommendations in this proceeding. I will also
16 respond to the Company's proposed return on equity of 11.25%, as sponsored by
17 Illinois-American witness Pauline Ahern.

18 Q PLEASE SUMMARIZE IIRC'S OVERALL RECOMMENDATIONS IN THIS
19 PROCEEDING.

20 A IIRC is sponsoring three witnesses in this proceeding: James Collins, Brian Janous,
21 and me. Mr. Collins' testimony addresses two issues. First, he will propose an
22 adjustment to Illinois-American's new depreciation rate proposal. Second, Mr. Collins
23 comments on the Company's proposed method for allocating the revenue deficiency
24 among customers and the adjustment of retail rates. Mr. Janous's testimony
25 recommends a fair return on common equity.

26 Q PLEASE SUMMARIZE YOUR RESPONSE TO ILLINOIS-AMERICAN WITNESS
27 PAULINE AHERN'S PROPOSED RETURN ON EQUITY OF 11.25%.

28 A Ms. Ahern's proposed return on equity of 11.25% is unreasonable and should be
29 rejected. Ms. Ahern overstates her estimated return on equity for Illinois-American by
30 the inclusion of an inappropriate 10 basis point small company risk premium, and her
31 DCF and CAPM studies overstate a reasonable estimate for Illinois-American's return
32 on equity.

33 Her DCF return estimates are based on growth rates that are too high to be
34 reasonable estimates of long-term sustainable growth. By overstating the long-term
35 sustainable growth rate, Ms. Ahern has overstated her DCF return for Illinois-

36 American making it unreasonable and inaccurate. Further, her CAPM study is based
37 on a market risk premium which is unreasonably high. Ms. Ahern's market risk
38 premium is based on a DCF return on the market which again is based on an
39 unreasonably and unsustainably high growth rate. By use of a market DCF return
40 that is overstated, her market risk premium is overstated, which in turn causes her
41 CAPM return estimate to be overstated and unreasonable.

42 Proper adjustments to Ms. Ahern's DCF studies and CAPM study, show that
43 Illinois-American's return on equity is in the range of 9.1% to 10.5%, which supports
44 Mr. Janous's proposal in this case.

45 **Q IS MR. COLLINS' PROPOSED ADJUSTMENT TO ILLINOIS-AMERICAN'S**
46 **DEPRECIATION RATES REASONABLE?**

47 **A** Yes. Mr. Collins is proposing adjustments to certain plant accounts' net salvage
48 component of depreciation rates. As outlined in his testimony, Mr. Collins
49 demonstrates that the Company's proposed net salvage component of overall
50 depreciation rates for certain major plant accounts is excessive. Mr. Collins
51 demonstrates that the net salvage component of depreciation rates proposed by
52 Company witnesses will result in annual revenue receipts for net salvage costs that
53 significantly exceed the inflation-adjusted actual net salvage expense Illinois-
54 American has incurred over the last ten years.

55 Further, Mr. Collins demonstrates that Illinois-American's proposed net
56 salvage components of overall depreciation rates significantly exceed the net salvage
57 component of depreciation rates proposed by or implemented for American Water
58 Company operating utility affiliates in several other jurisdictions. Hence, Illinois-

59 American's proposed net salvage components of overall depreciation rates should be
60 adjusted to be reasonably comparable to those American Water Company affiliates.

61 Mr. Collins' proposed depreciation rate adjustments will lower the claimed
62 revenue deficiency while still providing Illinois-American adequate cash recovery of its
63 net salvage cost and will result in depreciation rates that are just and reasonable.

64 IWC testimony shows its adjustments are reasonable, and will support Illinois-
65 American's financial integrity.

66 **Q PLEASE SUMMARIZE MR. JANOUS'S TESTIMONY IN THIS PROCEEDING.**

67 A Mr. Janous employs methodologies relied on by this Commission to estimate the
68 current market cost of equity for a regulated utility company with similar investment
69 risk as Illinois-American. Mr. Janous relies on several well proven models including:
70 the constant growth and two-stage growth DCF models, with quarterly compounding,
71 and the Capital Asset Pricing Model (CAPM).

72 **Q DID MR. JANOUS DEMONSTRATE THAT HIS PROPOSED RETURN ON EQUITY**
73 **OF 9.9% WILL SUPPORT ILLINOIS-AMERICAN'S FINANCIAL INTEGRITY?**

74 A Yes. Mr. Janous demonstrated that a return on equity of 9.9%, along with
75 depreciation expense adjustment proposed by IWC witness Mr. Collins, will produce
76 Funds From Operations (FFO) coverages of debt interest expense and total debt
77 expense, at a level that will meet the credit metrics necessary to support American
78 Water Capital Corporation's "A-" bond rating which underlies Illinois-American's cost
79 of service, financial integrity and credit rating for the Illinois jurisdiction. This is a clear
80 indication that IWC's proposed return on equity and depreciation expense
81 adjustment not only produce reasonable estimates of Illinois-American's current cost

82 of equity and the salvage cost of utility plant, but also produce cash flow coverages
83 that will support Illinois-American's financial integrity and access to capital.

84 **Response to Company Witness**
85 **Pauline Ahern's Return on Equity Testimony**

86 **Q WHAT RETURN ON COMMON EQUITY IS ILLINOIS-AMERICAN PROPOSING**
87 **FOR THIS PROCEEDING?**

88 A Illinois-American's proposed return on equity is supported by its witness Ms. Pauline
89 Ahern. She recommends a return on equity for Illinois-American of 11.25%.

90 **Q PLEASE DESCRIBE MS. AHERN'S METHODOLOGY SUPPORTING HER**
91 **RETURN ON COMMON EQUITY.**

92 A Ms. Ahern estimates the appropriate return on equity for Illinois-American based on
93 the Discounted Cash Flow (DCF) model, and the Capital Asset Pricing Model
94 (CAPM), applied to two proxy groups. The first proxy group consists of eight water
95 utilities. The second proxy group consists of 13 utility holding companies.

96 **Q IS MS. AHERN'S ESTIMATED RETURN ON EQUITY FOR ILLINOIS-AMERICAN**
97 **REASONABLE?**

98 A Ms. Ahern's recommended return on equity of 11.25% for Illinois-American is
99 excessive and unreasonable for a low-risk regulated water utility company. The
100 unreasonableness of Ms. Ahern's recommendation is evident from a detailed
101 assessment of the rate of return models supporting her recommendation in this
102 proceeding. Such evaluations clearly show that the fair return on equity for Illinois-

103 American in this proceeding is less than 10%, and indeed, clearly show that Mr.
104 Janous's recommended return on equity for Illinois-American of 9.9% is reasonable.

105 **Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH MS. AHERN'S ANALYSES.**

106 A I have three major issues with Ms. Ahern's analyses. First, Ms. Ahern's DCF analysis
107 is based on growth rates that are excessive and cannot be sustained in the long run.
108 Second, Ms. Ahern's market risk premium estimate used in her CAPM is overstated
109 and inflates her CAPM return. Finally, Ms. Ahern's business risk ("size-premium")
110 adjustment of 10 basis points is without merit and should be rejected.

111 As set forth below, use of more reasonable market-based data in Ms. Ahern's
112 analysis and excluding her size-premium return on equity add-on, shows that Illinois-
113 American's current cost of common equity is around 10.0%.

114 **Q PLEASE SUMMARIZE MS. AHERN'S RESULTS.**

115 A Ms. Ahern's results are summarized in the table below.

TABLE 1			
<u>Summary of Ms. Ahern's ROE Estimate</u>			
<u>Model</u>	<u>Water Group</u>	<u>13-Utility Group</u>	<u>Adjusted Results</u>
	(1)	(2)	(3)
DCF	11.45%	10.34%	9.10%
CAPM	11.07%	11.76%	10.50%
Business Risk Adjustment	0.10%	0.10%	Reject
Adjusted ROE Range	11.35%	11.15%	
ROE	11.25%		9.80%

Source: Ahern Direct, Table 2 at 6-7.

116 Q DO YOU HAVE ANY COMMENTS CONCERNING MS. AHERN'S USE OF TWO
117 PROXY GROUPS?

118 A Yes. A proxy group should reasonably reflect the investment risk of the underlying
119 utility company, otherwise the estimated return on equity from a proxy group will not
120 be appropriate. This is significant because Ms. Ahern's 13-utility holding company
121 proxy group is not reasonably risk comparable to Illinois-American. Specifically,
122 Ms. Ahern acknowledges that a utility bond rating reasonably captures the total
123 investment risk (both business and financial) of the underlying utility company.
124 However, Ms. Ahern's 13-utility proxy group's average bond rating is "BBB+" which is
125 somewhat more risky than Illinois-American. While the difference in bond rating is not
126 that significant, what is notable is the large difference in operating risk of the holding
127 companies relative to Illinois-American.

128 Standard & Poor's has made an independent assessment of the operating risk
129 of Illinois-American's affiliate, American Water Capital Corporation – its debt issuance
130 service affiliate. S&P's business profile score for American Water Capital Corporation
131 which reasonably approximates that for Illinois-American, is '2' on a scale of '1' lowest
132 risk to '10' highest risk. In comparison, the average business profile score of
133 Ms. Ahern's 13-utility group is '4.1'. This '4.1' indicates significantly higher operating
134 risk for her proxy group compared to Illinois-American's relatively low operating risk.
135 In comparison, Ms. Ahern's eight water utility sample has a bond rating and S&P
136 business profile score which are reasonably comparable to that of Illinois-American
137 (Ms. Ahern's Schedule 12.03, page 1).

138 Q PLEASE DESCRIBE MS. AHERN'S DCF ANALYSIS.

139 A Ms. Ahern estimates a DCF return for each company within her two comparable
140 groups, based on the quarterly version of the constant DCF model. Ms. Ahern
141 applied two quarterly DCF analyses based on the formulas discussed on page 24 of
142 her direct testimony.

143 Ms. Ahern's DCF cash flows for her Water proxy group and 13-utility group,
144 were 11.38% and 10.72%, respectively. These DCF returns are based on proxy
145 group average growth rates of 8.23% and 6.80%, respectively.

146 Q PLEASE SUMMARIZE THE ISSUES YOU HAVE WITH MS. AHERN'S DCF
147 ANALYSIS.

148 A Ms. Ahern's analysts' projected growth rate estimates are not reasonable estimates of
149 sustainable long-term growth. The quarterly constant growth version of the DCF
150 model, which Ms. Ahern is relying on, requires a growth rate that is sustainable
151 indefinitely. The growth rates relied on by Ms. Ahern in her Water proxy group and
152 13-utility proxy group of 8.23% and 6.80%, respectively, are too high to be
153 reasonable estimates of long-term sustainable growth.

154 By using growth rates which exceed reasonable estimates of long-term
155 sustainable growth, Ms. Ahern's constant growth DCF return estimates are
156 overstated.

157 Q WHY DO YOU BELIEVE MS. AHERN'S DCF GROWTH RATES ARE NOT
158 REASONABLE ESTIMATES FOR LONG-TERM SUSTAINABLE GROWTH AS
159 REQUIRED BY THE CONSTANT GROWTH DCF MODEL?

160 A The growth rate estimates used to derive the return on equity for Illinois-American
161 range from 6.8% to 8.2%. I conclude that these growth rates are not rational
162 estimates of long-term sustainable growth for several reasons. First, the GDP growth
163 represents the maximum growth rate of the U.S. economy, which serves as a ceiling,
164 or high-end, sustainable growth rate for a utility over an indefinite period of time. The
165 five- and ten-year consensus analysts' projected GDP growth rate, based on the *Blue*
166 *Chip Economic Indicators*, is 5.0%. Ms. Ahern's DCF estimates are based on growth
167 rates that exceed the consensus economists' projected GDP growth rate by 180-320
168 basis points.

169 A water utility's long-term sustainable growth cannot exceed the projected
170 GDP growth on an indefinite basis because the water utility would become an
171 increasingly large percentage of total U.S. GDP. This is not a rational expectation
172 because a utility's growth is tied to the growth of its utility plant investment. Utility
173 plant investments are made to meet the demands of its service area economy.
174 Utilities operate to provide service to the service area economy. It is not reasonable
175 to expect a utility will become the primary economic engine of the underlying service
176 area economy. As such, a maximum rational growth rate expectation for a utility
177 company over an indefinite period of time is the expected growth of U.S. GDP.

178 Second, the historical growth rate of Ms. Ahern's Water group and 13-utility
179 group has trailed that of the growth rate of the overall GDP, and has been much more
180 aligned with inflation growth over the last five and ten years. This is shown on my
181 IWC Exhibit 1.1. Hence, it is not reasonable or rational to expect that the growth rate

182 of these companies could not only increase, over an indefinite period of time, to a
183 level that exceeds the inflation included in the GDP, the real growth to the GDP, but
184 also grow at a premium to the GDP growth. This is particularly problematic because
185 the historical growth of these companies has been lower than the nominal GDP, and
186 in fact much more in line with historical inflation.

187 The drastic change in growth over the next three to five years relative to the
188 last 10 years is a reasonable expectation for the next three- to five-year period, but is
189 not a reasonable estimate of long-term sustainable growth.

190 **Q CAN THE DATA RELIED ON BY MS. AHERN BE USED IN THE DCF ANALYSIS**
191 **TO PRODUCE A MORE REASONABLE DCF RETURN ON EQUITY ESTIMATE**
192 **FOR HER PROXY GROUPS?**

193 A Yes. That can be done by reflecting a two-stage growth DCF model. The initial stage
194 of growth reflects the abnormally high growth expectations for utilities that coincide
195 with exceptionally large capital expenditure programs, followed by a period where
196 growth will subside to a more reasonable estimate of long-term sustainable growth.

197 **Q HAVE YOU REPLICATED MS. AHERN'S MODEL TO REFLECT A TWO-STAGE**
198 **DCF GROWTH OUTLOOK?**

199 A Yes. I have replicated Ms. Ahern's Schedule 12.07 by applying the two-stage DCF
200 model, which consists of two growth rate periods. The short-term growth rate period
201 includes the first five years. For this period, I used Ms. Ahern's analysts' projected
202 growth rate estimates. The long-term growth rate period starts in year six and
203 continues through perpetuity. For this period, I applied the consensus projected GDP

204 growth rate of 5.0%. I also used Ms. Ahern's stock prices and dividends as shown on
205 her Schedule 12.07.

206 Applying the two-stage DCF model reduces Ms. Ahern's Water and 13-utility
207 comparable group return estimates from 11.5% and 10.3% to 8.5% and 9.0%,
208 respectively. To these annual DCF return estimates, I applied the quarterly formula
209 shown on my IWC Exhibit 1.2, which produces a DCF return on equity of 8.8% for
210 Ms. Ahern's Water group and 9.3% for her 13-utility group. This indicates a DCF
211 return for Illinois-American in the range of 8.8% to 9.3%, with a midpoint of 9.1%.

212 **Q PLEASE DESCRIBE MS. AHERN'S CAPITAL ASSET PRICING MODEL.**

213 A Ms. Ahern applied the traditional Capital Asset Pricing Model (CAPM) to her Water
214 and 13-utility comparable groups to estimate the cost of equity for Illinois-American.
215 The traditional CAPM as discussed at pages 28-34 of her direct testimony, produces
216 a CAPM return on equity of 11.16% for her Water comparable group and 12.22% for
217 her 13-utility comparable group.

218 **Q PLEASE DESCRIBE THE ISSUES YOU HAVE WITH MS. AHERN'S CAPM**
219 **ANALYSIS.**

220 A The issue I have with Ms. Ahern's CAPM analysis is that her market risk premium of
221 8.13% is significantly overstated.

222 **Q HOW DID MS. AHERN DEVELOP HER MARKET RISK PREMIUM ESTIMATE?**

223 A As discussed at page 31 of her direct testimony, Ms. Ahern estimated a weighted
224 average market return of 13.46% by conducting a quarterly compounded DCF
225 analyses of the companies included in the S&P 500 as of July 13, 2007. She used

226 the data provided by Zacks and excluded non-dividend paying stocks and companies
227 for which Zacks does not provide long-term EPS growth estimates.

228 Then, Ms. Ahern subtracted her estimated risk-free rate of 5.33% from the
229 market return of 13.46%, which produced a market risk premium of 8.13%.

230 **Q WHY DO YOU BELIEVE MS. AHERN'S ESTIMATED RETURN ON THE MARKET**
231 **RISK PREMIUM OF 8.13% IS NOT REASONABLE?**

232 A Ms. Ahern's estimated market risk premium of 8.13% is based on a DCF return on the
233 market of 13.46%. Since the S&P market index Ms. Ahern relied on currently is
234 paying a dividend yield of less than 2%, Ms. Ahern's DCF return on the market
235 implies a long-term sustainable growth rate in the market of 12.5%. This growth rate
236 is unreasonable, and produces an excessive return on the market. By relying on an
237 excessive return on the market, Ms. Ahern's analysis produces a market risk premium
238 of 8.13% that is unreasonable. The growth rate of the market at this level is
239 unreasonable for at least two reasons.

240 First, the historical growth on the S&P 500 over the period 1926 through 2006
241 has been 7.9%.¹ Hence, it is unreasonable to expect that the forward-looking long-
242 term sustainable growth on the market will be 12.5%, when it has been less than 8%
243 historically. Second, as noted above, while the market growth can exceed that of the
244 overall U.S. GDP over some period of time, it is not rational to expect that that growth
245 rate can be sustained indefinitely. Ms. Ahern's constant growth DCF return on the

¹ SBBI 2007 Yearbook at 119.

246 market reflects such an expectation, and therefore overstates a reasonable DCF
247 return estimate for the marketplace.

248 **Q IS THERE OTHER DATA THAT SUGGESTS THE EXPECTED RETURN ON THE**
249 **MARKET PORTFOLIO IS SIGNIFICANTLY LESS THAN THE 13.46% RETURN**
250 **ESTIMATED BY MS. AHERN?**

251 A Yes. For example, *The Value Line Investment Survey* is currently projecting a three-
252 to five-year capital appreciation for the 1,700 stocks it follows to be 50%, and the
253 corresponding dividend yield for this stock portfolio to be 1.9%. This indicates a DCF
254 return of 12.6%.² *Value Line* projections indicate a market risk premium of
255 approximately 7.80% using the most recent 30-year Treasury bond yield projection as
256 the risk-free rate, 4.80%.

257 Second, Ibbotson Associates estimates a historical total return on equity
258 securities above the achieved return on Treasury bonds to be 6.5% for the period
259 1926 through 2006.³ This 6.5% equity risk premium is the actual historical market
260 risk premium earned on market investments (12.3%) relative to the returns earned on
261 long-term Treasury bond investments (5.8%).

262 Using this information would imply a market return estimate in the range of
263 7.8% to 6.5%. The average of these market risk premiums is 7.2%.

² $(1.50)^{1/4} - 1 + 1.9\%$.

³ SBBI Valuation Edition 2007 Yearbook at 28.

264 **Q HOW WOULD MS. AHERN'S CAPM ANALYSIS CHANGE CORRECTING FOR**
265 **THE FLAWS DISCUSSED ABOVE?**

266 A Using Ms. Ahern's average beta of 0.72 for her Water comparable group and 0.85 for
267 her 13-utility group, and the most recent 30-year T-bond yield projection of 4.80% as
268 the risk-free rate and a market risk premium of 7.20% will result in a CAPM return of
269 10.0% (4.8% + 0.72 x 7.20%) for her Water group and 10.9% (4.8% + 0.85 x 7.20%)
270 for her 13-utility group. Averaging these results will produce a CAPM return on equity
271 for Illinois-American of 10.5%.

272 **Q DOES MS. AHERN PROPOSE ANY ADJUSTMENTS IN MAKING HER RETURN**
273 **ON EQUITY RECOMMENDATIONS?**

274 A Yes. She proposes a small company business risk adder of 10 basis points.

275 **Q PLEASE EXPLAIN HOW MS. AHERN DEVELOPS HER BUSINESS RISK**
276 **ADJUSTMENT .**

277 A Ms. Ahern compares the average size of the companies included in her two
278 comparable groups and she concludes that based on market capitalization the Water
279 and the 13-utility comparable groups are 1.3 and 21.2 times greater than Illinois-
280 American, respectively. Because it is smaller, Ms. Ahern concludes Illinois-American
281 has greater operating risk, and therefore, proposes an equity return add-on "small-
282 size" adjustment in the range of 0.21% to 1.97%, respectively. (Ahern Direct at 14
283 and 36). To be conservative, she concludes that the appropriate business risk or
284 small-size equity return add-on for Illinois-American is 10 basis points.

285 **Q IS MS. AHERN'S PROPOSED SIZE PREMIUM ADJUSTMENT REASONABLE?**

286 A No. Small company risk is part of a company's total investment risk. By selecting
287 companies with similar risk to Illinois-American, the proxy group can be used to
288 estimate a fair return to compensate investors with Illinois-American's total investment
289 risk, including those risks related to its size.

290 **Q DID MS. AHERN IN HER TESTIMONY RECOGNIZE THAT A COMPANY'S TOTAL**
291 **BUSINESS AND FINANCIAL RISK, OR TOTAL INVESTMENT RISK, IS**
292 **REFLECTED IN A UTILITY'S BOND RATING?**

293 A Yes. At page 17 of Ms. Ahern's testimony, she states:

294 Similar bond ratings/issue credit ratings reflect similar combined
295 business and financial risks, i.e., total risk. Although the specific
296 business or financial risks may differ between companies, the same
297 bond rating indicates that the combined risks are similar as the bond
298 rating process reflects acknowledgment of all diversifiable business
299 and financial risks in order to assess credit quality or credit risk.
300 (Emphasis added).

301 Hence, a bond rating reflects all operating risk of the enterprise including the
302 risk associated with the size of the operation. Therefore, it is not appropriate to
303 include a return on equity add-on to Illinois-American's authorized return on equity if
304 the proxy group used to estimate that return on equity is a reasonable risk proxy to
305 Illinois-American.

306 In this case, this is particularly important since her 13-utility group is more
307 risky than Illinois-American, not less risky as implied by her small company return on
308 equity add-on. Ms. Ahern's Water proxy group has a comparable bond rating, and as
309 such, it is a comparable risk proxy to Illinois-American.

310 Q **HOW WOULD A COMPANY'S SIZE IMPACT ITS RISK?**

311 A A company's size would impact its operating risk in the following ways:

- 312 1. Small companies typically have less ability to attract qualified management.
- 313 2. Small companies usually do not have the economies of scale to minimize
314 operating expenses by spreading expertise over a larger customer base and
315 buying materials and supplies in larger quantities.
- 316 3. Small companies do not have the geographic diversification to mitigate sales
317 variations caused by weather and local economic cycles.

318 Q **CAN ONE SELECT A COMPARABLE GROUP THAT ENCAPSULATED ILLINOIS-**
319 **AMERICAN'S SMALL COMPANY RISK IN ESTIMATING A FAIR RETURN FOR**
320 **ILLINOIS-AMERICAN IN THIS CASE?**

321 A Yes. These small company risk factors certainly are considered by credit rating
322 analysts and security analysts in assessing a utility's investment risk and valuation.
323 Hence, when selecting a group of comparable risk companies, if one relies on a group
324 of companies with bond ratings that are comparable to the proxy company and
325 business profile scores in particular, that reasonably compare to the utility's business
326 profile score, then the proxy group itself would reflect these risk factors.

327 As such, it is unreasonable and would be redundant to add a size premium to
328 a proxy group return if that proxy group already reasonably captures Illinois-
329 American's total investment risk. For example, Illinois-American's small company risk
330 can be offset by differences in other risk elements. As such, focusing on a single
331 aspect of investment risk, rather than reviewing proxy groups on the basis of total
332 investment risk, is inappropriate and produces unreasonable results.

333 Since Mr. Janous's proxy group and Ms. Ahern's proxy group reasonably
334 emulate an investment grade bond rating, with a higher than average (i.e., lower than
335 average risk) integrated water utility business profile score, the proxy group

336 reasonably captures Illinois-American's small size risk and all other risk factors. As
337 such, there is no need to add a size premium to the return on equity estimated from
338 this proxy group.

339 **Q ARE THERE OTHER FLAWS IN MS. AHERN'S PROPOSED SMALL COMPANY**
340 **RETURN ON EQUITY RISK PREMIUM?**

341 A Yes. Ms. Ahern appears to ignore the fact that Illinois-American is a wholly owned
342 subsidiary of American Water Company. American Water Company in turn is owned
343 by RWE, an international company. Illinois-American's small company risk is
344 significantly mitigated by its corporate structure. Specifically, American Water has a
345 subsidiary, American Water Capital Corporation, which provides capital on behalf of
346 all subsidiaries including Illinois-American. This affiliate, American Water Capital
347 Corporation, increases Illinois-American's access to capital.

348 Also, American Water Company has service companies that provide
349 executive, engineering, treasury, legal and accounting expertise to Illinois-American,
350 which provides it a greater breadth of management experience than small companies
351 could typically support on their own. Hence, being incorporated within American
352 Water Company's structure mitigates to a large extent Illinois-American's small
353 company risk.

354 As such, Illinois-American's access to capital through its parent company and
355 access to management expertise through its parent company and regulated service
356 territory, significantly mitigates if not completely eliminates any small company risk for
357 this affiliate.

358 Further, all the cost properly allocated to Illinois-American from affiliated
359 companies are passed on to retail customers. Hence, retail customers should receive
360 the benefit of the parent company's structure because they are supporting its cost.

361 For these reasons, a small company equity return add-on is wholly
362 inappropriate, is not based on competent, credible evidence, and should be rejected.

363 **Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

364 **A** Yes, it does.

Qualifications of Michael Gorman

1 **Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A Michael Gorman. My business mailing address is P. O. Box 412000, 1215 Fern
3 Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000.

4 **Q PLEASE STATE YOUR OCCUPATION.**

5 A I am a consultant in the field of public utility regulation and a principal with Brubaker &
6 Associates, Inc., energy, economic and regulatory consultants.

7 **Q PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK
8 EXPERIENCE.**

9 A In 1983 I received a Bachelors of Science Degree in Electrical Engineering from
10 Southern Illinois University, and in 1986, I received a Masters Degree in Business
11 Administration with a concentration in Finance from the University of Illinois at
12 Springfield. I have also completed several graduate level economics courses.

13 In August of 1983, I accepted an analyst position with the Illinois Commerce
14 Commission (ICC). In this position, I performed a variety of analyses for both formal
15 and informal investigations before the ICC, including: marginal cost of energy, central
16 dispatch, avoided cost of energy, annual system production costs, and working
17 capital. In October of 1986, I was promoted to the position of Senior Analyst. In this
18 position, I assumed the additional responsibilities of technical leader on projects, and
19 my areas of responsibility were expanded to include utility financial modeling and
20 financial analyses.

21 In 1987, I was promoted to Director of the Financial Analysis Department. In
22 this position, I was responsible for all financial analyses conducted by the staff.
23 Among other things, I conducted analyses and sponsored testimony before the ICC
24 on rate of return, financial integrity, financial modeling and related issues. I also
25 supervised the development of all Staff analyses and testimony on these same
26 issues. In addition, I supervised the Staff's review and recommendations to the
27 Commission concerning utility plans to issue debt and equity securities.

28 In August of 1989, I accepted a position with Merrill-Lynch as a financial
29 consultant. After receiving all required securities licenses, I worked with individual
30 investors and small businesses in evaluating and selecting investments suitable to
31 their requirements.

32 In September of 1990, I accepted a position with Drazen-Brubaker &
33 Associates, Inc. In April 1995 the firm of Brubaker & Associates, Inc. (BAI) was
34 formed. It includes most of the former DBA principals and Staff. Since 1990, I have
35 performed various analyses and sponsored testimony on cost of capital, cost/benefits
36 of utility mergers and acquisitions, utility reorganizations, level of operating expenses
37 and rate base, cost of service studies, and analyses relating industrial jobs and
38 economic development. I also participated in a study used to revise the financial
39 policy for the municipal utility in Kansas City, Kansas.

40 At BAI, I also have extensive experience working with large energy users to
41 distribute and critically evaluate responses to requests for proposals (RFPs) for
42 electric, steam, and gas energy supply from competitive energy suppliers. These
43 analyses include the evaluation of gas supply and delivery charges, cogeneration
44 and/or combined cycle unit feasibility studies, and the evaluation of third-party

45 asset/supply management agreements. I have also analyzed commodity pricing
46 indices and forward pricing methods for third party supply agreements, and have also
47 conducted regional electric market price forecasts.

48 In addition to our main office in St. Louis, the firm also has branch offices in
49 Phoenix, Arizona and Corpus Christi, Texas.

50 **Q HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?**

51 A Yes. I have sponsored testimony on cost of capital, revenue requirements, cost of
52 service and other issues before the regulatory commissions in Arizona, California,
53 Delaware, Georgia, Illinois, Indiana, Iowa, Louisiana, Michigan, Missouri, New
54 Mexico, New Jersey, Oklahoma, Oregon, Tennessee, Texas, Utah, Vermont,
55 Washington, West Virginia, Wisconsin, Wyoming, and before the provincial regulatory
56 boards in Alberta and Nova Scotia, Canada. I have also sponsored testimony before
57 the Board of Public Utilities in Kansas City, Kansas; presented rate setting position
58 reports to the regulatory board of the municipal utility in Austin, Texas, and Salt River
59 Project, Arizona, on behalf of industrial customers; and negotiated rate disputes for
60 industrial customers of the Municipal Electric Authority of Georgia in the LaGrange,
61 Georgia district.

62 **Q PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR**
63 **ORGANIZATIONS TO WHICH YOU BELONG.**

64 A I earned the designation of Chartered Financial Analyst (CFA) from the Association
65 for Investment Management and Research (AIMR). The CFA charter was awarded
66 after successfully completing three examinations which covered the subject areas of

67 financial accounting, economics, fixed income and equity valuation and professional
68 and ethical conduct. I am a member of AIMR's Financial Analyst Society.

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