COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

ELECTRONIC APPLICATION OF	)	
BLUEGRASS WATER UTILITY	)	
OPERATING COMPANY, LLC FOR AN	)	**Case No. 2022-00432**
ADJUSTMENT OF SEWAGE RATES	)	

REBUTTAL TESTIMONY

OF

DYLAN W. D'ASCENDIS

ON BEHALF OF

BLUEGRASS WATER UTILITY OPERATING COMPANY, LLC

FILED: **August 11, 2023**

REBUTTAL TESTIMONY

OF

DYLAN W. D'ASCENDIS

TABLE OF CONTENTS

Page

REBUTTAL TESTIMONY

OF

DYLAN W. D'ASCENDIS

I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Dylan W. D'Ascendis. I am employed by ScottMadden, Inc. as Partner. My business address is 3000 Atrium Way, Suite 200, Mount Laurel, NJ 08054.

Q. Are you the same Dylan W. D'Ascendis who provided Direct Testimony in this matter?

A. Yes.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your Rebuttal Testimony in this proceeding?

A. The purpose of my Rebuttal Testimony is to respond to the direct and supplemental testimonies of Mr. David Dittemore, who testifies on behalf of the Office of the Attorney General ("AG"), as it relates to Bluegrass Water Utility Operating Company, LLC's ("Bluegrass Water" or the "Company") ratemaking capital structure and requested return on common equity ("ROE") on its Kentucky jurisdictional rate base.

III. SUMMARY

Q. Please summarize the key issues that you address in your Rebuttal Testimony.

A. My Rebuttal Testimony responds to Mr. Dittemore's recommended capital structure and ROE applicable to Bluegrass Water's jurisdictional rate base. Specifically, Mr. Dittemore's recommended capital structure is flawed because it is not representative of a regulated sewer utility. The assumptions that he makes to derive his recommended capital structure are not supported in his evidence, and the reasoning he uses to reject my recommended capital structure (i.e., alleged double leverage) is flawed.

Concerning Mr. Dittemore's recommended ROE, his acceptance of the result of the Company's last authorized ROE ignores the fact that ROEs change with capital markets and that the implied direction of the cost of capital has increased since Bluegrass Water's last rate case.

Q. Have you prepared schedules in support of your Rebuttal Testimony?

A. No, I have not.

IV. <u>CAPITAL STRUCTURE</u>

Q. Please summarize Mr. Dittemore's position as it relates to the Company's capital structure.

A. Mr. Dittemore does not support the Company's proposed equity ratio, which consists of 38.84% long-term debt and 61.16% common equity. Instead, in his direct testimony, Mr. Dittemore recommends a capital structure that consists of 72.31% long-term debt and 27.69% common equity.[1] In his supplemental testimony, Mr. Dittemore proposes an alternative capital structure composed of 84.79% debt[2] and 15.21% common equity based upon capitalization balances provided in response to discovery request PSC 1-27.[3] I do not know which capital structure Mr. Dittemore is currently recommending the Commission accept in this proceeding.

---

1 Dittemore Direct Testimony, at 29.

2 Comprised of Notes Payable and Long-Term Liabilities Payable to Associated Companies. Both have debt cost rates of 6.80%.

3 Dittemore Supplemental Testimony, at 7; Exhibit SDND-2.

Mr. Dittemore's departure from my position, which is the actual capital structure of Bluegrass Water, is because he disagrees with the classification of contributed capital by the Company's parent as 100% equity.[4] Mr. Dittemore seems to be concerned about the source (e.g., debt or equity) of the contributed capital and believes that the source of the capital infused into Bluegrass Water "matters a great deal."[5]

Q. Do you have any general comments regarding Mr. Dittemore's recommended capital structure?

A. Yes, I do. Mr. Dittemore's recommended capital structure consisting of 72.31% long-term debt and 27.69% common equity, and his proposed alternative capital structure, which consists of 84.79% long-term debt and 15.21% common equity, are not capital structures that are representative of regulated water companies. As discussed in my Direct Testimony,[6] in fiscal year 2021, the range of equity ratios maintained by the Utility Proxy Group was from 40.31% to 62.44%. Expected equity ratios for the Utility Proxy Group for the years 2025 to 2027 range from 40.00% to 62.50%. Mr. Dittemore's recommended capital structures contain significantly more leverage than what is currently, and expected to be, maintained by the Utility Proxy Group, and therefore, contain significantly more risk. Conversely, the Company's requested common equity ratio of 61.16% falls at the high end of the range of equity ratios set by the Utility Proxy Group.

---

4 Dittemore Supplemental Testimony, at 26.
5 Dittemore Supplemental Testimony, at 27.
6 D'Ascendis Direct Testimony, at 16.

Q. Is a hypothetical capital structure appropriate in this proceeding?

A. No, it is not. The factors typically considered relative to the use of a regulated subsidiary's actual or expected capital structure, or a hypothetical capital structure, are provided by David C. Parcell in The Cost of Capital – A Practitioner's Guide ("CRRA Guide"), prepared for the Society of Utility and Regulatory Financial Analysts ("SURFA"), and provided as the study guide to candidates for SURFA's Certified Rate of Return Certification Examination. The CRRA Guide notes that there are circumstances where a hypothetical capital structure is used in favor of an actual or expected capital structure. These circumstances are:

(i) The utility's capital structure is deemed to be substantially different from the typical or "proper" capital structure; or

(ii) The utility is funded as part of a diversified organization whose overall capital structure reflects its diversified nature rather than its utility operations only.[7]

Phillips echoes the CRRA Guide when he states:

> Debt ratios began to rise in the late 1960s and early 1970s, and the financial condition of the public utility sector began to deteriorate. It became the common practice to use actual or expected capitalizations; actual where a historic test year is used, expected when a projected or future test year is used.[83] (footnote omitted)
>
> The objective, in short, shifted from minimization of the short-term cost of capital to protection of a utility's ability "to raise capital at all times." This objective requires that a public utility make every effort to keep indebtedness at a prudent and conservative level."[84] (footnote omitted)

[7] David C. Parcell, The Cost of Capital – A Practitioner's Guide, Prepared for the Society of Utility and Regulatory Financial Analysts, 2020 Edition, p. 47.

> *A hypothetical capital structure is used only where a utility's actual capitalization is clearly out of line with those of other utilities in its industry or where a utility is diversified.*[85] (footnote omitted) (italics added)[8]

In the case of Bluegrass Water, circumstance (i) is not applicable because Bluegrass Water's capital structure is within the range set by typical or "proper" capital structures of comparable water utilities. Circumstance (ii) is also not applicable because Bluegrass Water operates solely as a water and sewer utility.

Q. Why is it important for Bluegrass Water's actual capital structure, consisting of 38.84% long-term debt and 61.16% common equity, be authorized in this proceeding?

A. In order to provide safe, reliable, and affordable service to its customers, Bluegrass Water must meet the needs and serve the interests of its various stakeholders, including customers, shareholders, and bondholders. The interests of these stakeholder groups are aligned with maintaining a healthy balance sheet and a supportive regulatory environment, so that the Company has access to capital on reasonable terms in order to make necessary investments.

Safe and reliable service cannot be maintained at a reasonable cost if utilities do not have the financial flexibility and strength to access the competitive markets on reasonable terms. The authorization of a capital structure other than the Company's actual capital structure will weaken the financial condition of the Kentucky operations and adversely impact the Company's ability to address expenses and investment, to the detriment of customers and shareholders. Safe and reliable service for customers cannot

[8] Charles F. Phillips, Jr., The Regulation of Public Utilities – Theory and Practice, 1993, Public Utility Reports, Inc., Arlington, VA, at 391.

be sustained over the long term if the interests of shareholders and bondholders are minimized such that the public interest is not optimized.

Q. Mr. Dittemore's recommended and alternative capital structures allocate the Company's residual capital between common equity and debt instead of allocating it entirely to common equity. Does Mr. Dittemore provide any evidence from the academic literature or regulatory precedent supporting his decision to divide the Company's residual capital between debt and equity?

A. No, he does not. Mr. Dittemore simply says since he has not been able to ascertain the source of the Company's equity financing, he was going to allocate the residual capital into equity and debt.[9]

Q. Does the source of funds used to finance the equity of Bluegrass Water matter when determining the appropriate capital structure for the Company?

A. No, it does not. Regulation determines the return for each company it regulates on a stand-alone basis and would not incorporate or consider that company's ownership structure, as it is not subject to the Commission's jurisdiction.

From an external investor's perspective, the combined company must provide a return reflecting the risks of the company's constituent parts. Investors therefore value combined entities on a sum-of-the-parts basis, expecting each operating segment to provide its appropriate risk-adjusted return. That practical financial principle is consistent with the regulatory principle of treating utilities as stand-alone entities. From both perspectives, it

---

[9] Dittmore Direct Testimony, at 26, 29.

is the utility's operating risk that defines the capital structure and cost of capital, not investors' sources of funds.

Contrary to those basic principles, Mr. Dittemore's double leverage argument assumes the required return depends on the source of financing, not on the risks of the underlying utility operations. The position that a company would have different cost rates depending on how its investors fund their equity investments violates the widely acknowledged economic "law of one price," which states that in an efficient market, identical assets would have the same value. In other words, two utilities, identical in all respects but for their form of ownership, should have the same common equity cost rates.

Moreover, if the common equity of a subsidiary were held by both the parent and an external investor, the equity held by the parent would have one required return, and the equity held by outside investors would have another. To the extent the required returns differ, so would the value of the equity. But in an efficient market, identical assets must have the same price (value). If not, the difference quickly would be arbitraged away. As Morin noted in Modern Regulatory Finance:

> Carrying the double leverage standard to its logical conclusion leads to even more unreasonable prescriptions. If the common shares of a subsidiary were held by both the parent and by individual investors, the equity contributed by the parent would have one cost under the double leverage computation while the equity contributed by the public would have another.[10]

The double leverage argument also requires every affiliate within the corporate family to have the same cost of capital, regardless of differences in risk. Morin further noted:

10 Roger A. Morin, Modern Regulatory Finance, (PUR Books, 2021), at 581 ("Morin").

> Just as individual investors require different returns from different assets in managing their personal affairs, why should regulation cause parent companies making investment decisions on behalf of their shareholders to act any differently? A parent company normally invests money in many operating companies of varying sizes and varying risks. These operating subsidiaries pay different rates for the use of investor capital, such as long-term debt capital, because investors recognize the differences in capital structure, risk, and prospects between the subsidiaries. Yet, the double leverage calculation would assign the same return to each activity, based on the parent's cost of capital. Investors recognize that different subsidiaries are exposed to different risks, as evidenced by the different bond ratings and cost rates of operating subsidiaries. The same argument carries over to common equity. If the cost rate for debt is different because the risk is different, the cost rate for common equity is also different, and the double leverage adjustment shouldn't obscure this fact.[11]

Longstanding academic literature has thoroughly discussed the flaws associated with the double leverage approach. For example:

1. Pettway and Jordan (1983), and Beranek and Miles (1988) point out the flaws in the double leverage argument, particularly the excess return argument, and also demonstrate that the "stand-alone" method is the superior approach.[12]
2. Rozeff (1983) discusses the ratepayer cross-subsidies of one subsidiary by another when employing double leverage.[13]
3. Lerner (1973) concludes that the returns granted to equity investors must be based on the risks to which the investors' capital is exposed and not the investors' source of funds.[14]

---

[11] Morin, at 582.

[12] Richard H. Pettway and Bradford D. Jordan, *Diversification, Double Leverage, and the Cost of Capital,* The Journal of Financial Research, Vol. VI, No. 4, Winter 1983; William Beranek and James A. Miles, *The Excess Return Argument and Double Leverage,* The Financial Review, Vo. 23, No. 2, May 1988.

[13] Michael S. Rozeff, *Modified Double Leverage – A New Approach*, Public Utilities Fortnightly, March 31, 1983.

[14] Eugene M. Lerner, *What are the Real Double Leverage Problems?* Public Utilities Fortnightly, June 7, 1973.

Basic finance texts reach the same conclusions. In Principles of Corporate Finance, 8th edition, Brealey, Myers, and Allen state:

> In principle, each project should be evaluated at its own opportunity cost of capital; the true cost of capital depends on the use to which the capital is put. If we wish to estimate the cost of capital for a particular project, it is *project risk* that counts.[15]

Likewise, in Modern Corporate Finance, 1st edition, Shapiro states:

> Each project has its own required return, reflecting three basic elements: (1) the real or inflation-adjusted risk-free interest rate; (2) an inflation premium approximately equal to the amount of expected inflation; and (3) a premium for risk. The first two cost elements are shared by all projects and reflect the time value of money, whereas the third component varies according to the risks borne by investors in the different projects. For a project to be acceptable to the firm's shareholders, its return must be sufficient to compensate them for all three cost components. This minimum or required return is the project's cost of capital and is sometimes referred to as a **hurdle rate**.
>
> The preceding paragraph bears a crucial message: the cost of capital for a project depends on the riskiness of the assets being financed, not on the identity of the firm undertaking the project. Simply put, the notion of double leverage runs counter to both financial and regulatory principles.[16]

Lastly, double leverage arguments have been rejected by several regulatory commissions, including the Maryland Public Service Commission:

> We reject People's Counsel's proposed capital structure [reflecting a double leverage adjustment] because it suffers from numerous flaws. First, it assumes that the rate of return depends on the source of capital rather than the risks faced by the capital.[17]

---

[15] Richard A. Brealey, Steward C. Meyers, Franklin Allen, Principles of Corporate Finance, McGraw-Hill Irwin, 8th Ed., 2006, at 234.

[16] Alan C. Shapiro, Modern Corporate Finance, Wiley, 1st Ed., 1990, at 276.

[17] Maryland Public Service Commission, Order No. 81517, Case No. 9092, In the Matter of the Application of Potomac Electric Power Company for Authority to Revise its Rate and Charges for Electric Service and for Certain Rate Design Changes, July 19, 2007, at 73. [Clarification added]

In view of all of the above, the Commission should dismiss Mr. Dittemore's double leverage arguments.

V. RETURN ON COMMON EQUITY

Q. Please summarize Mr. Dittemore's position regarding Bluegrass Water's ROE.

A. Mr. Dittemore recommends an ROE of 9.90%[18], the ROE adopted by the Commission in the Company's last rate proceeding in Case No. 2020-00290.

Q. Has Mr. Dittemore completed an independent ROE analysis in support of his proposed ROE?

A. No, he has not. Mr. Dittemore states, "I simply used the ROE adopted by the Commission in the prior proceedings for illustration purposes."[19]

Q. Do you agree with Mr. Dittemore's use of the authorized return for the Company in its last rate case as his recommendation in this case?

A. No, I do not. While authorized ROEs may be reasonable benchmarks of acceptable ROEs, they do not reflect the current cost of common equity. The reason why historical authorized returns do not reflect the investor-required return is because authorized ROEs are a lagging indicator of investor-required returns; i.e., authorized ROEs are based on market data presented in an evidentiary record, which spans a period before the decision, sometimes lasting over a year in some cases. Simply put, historical authorized returns do not completely reflect the investor required return because the economic conditions in the past are not representative of economic conditions now.

---

[18] Mr. Dittemore Direct Testimony at 29, line 19.

[19] Mr. Dittemore Direct Testimony at 30, lines 4-5.

Q. Have you compared your indicated model results from this proceeding with those in the Company's last proceeding?

A. Yes, I have. Table 1 below compares the model results from the Company's previous proceeding and those filed in my Direct Testimony in this proceeding.

Table 1: Cost of Common Equity Model Results from Company's Last Rate Case and the Current Proceeding

	2020 Filing[20]	Present Filing	Difference
Discounted Cash Flow Model	9.07%	9.16%	+0.09%
Risk Premium Model	10.88%	12.09%	+1.21%
Capital Asset Pricing Model	10.96%	11.58%	+0.62%
Market Models Applied to Comparable Risk, Non-Price Regulated Companies	10.71%	11.40%	+0.69%

As can be gleaned from Table 1, the indicated ROEs derived by all of my cost of common equity models have increased since the Company's last proceeding. While the Commission's authorized ROE in the last case was below my recommendation, the increase across each of the individual models should serve as a directional indicator of the ROE as compared to the Company's last proceeding.

VI. CONCLUSION

Q. Should any or all of the arguments made by Mr. Dittemore persuade the Commission to approve a capital structure other than the actual capital structure of the Company?

A. No, they should not. An approved capital structure other than the Company's actual capital structure may result in a misrepresentation of their cost of capital.

[20] KY PSC Case No. 2020-00290, DT Exh. DD-1, Schedule DWD-1, page 1.

Q. Should any or all of the arguments made by Mr. Dittemore persuade the Commission to lower the ROE it approves for Bluegrass Water below your recommendation?

A. No, they should not. An overall weighted average cost of capital of 9.77%, which includes a cost of common equity of 11.65% is both reasonable and conservative. It will provide Bluegrass Water with sufficient earnings to enable it to attract necessary new capital efficiently and at a reasonable cost.

Q. Does this conclude your Rebuttal Testimony?

A. Yes, it does.

ELECTRONIC APPLICATION OF BLUEGRASS WATER UTILITY OPERATING COMPANY, LLC FOR ADJUSTMENT OF SEWAGE RATES
CASE NO. 2022-00432

VERIFICATION

I, Dylan W. D'Ascendis, verify, state, and affirm that I prepared or supervised the preparation of the Rebuttal Testimony filed with this verification, and that Rebuttal Testimony is true and accurate to the best of my knowledge, information, and belief formed after a reasonable inquiry.

____
Dylan W. D'Ascendis

STATE OF NEW JERSEY)
) ss:
COUNTY OF BURLINGTON)

SUBSCRIBED AND SWORN TO before me on this the 9th day of August, 2023.

My commission expires: 12/14/25

____
Notary Public

JOSEPH M NICHOLSON
Notary Public - State of New Jersey
My Commission Expires Dec 14, 2025