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APPLICATION OF RIO CONCHO
AVIATION, INC. FOR A RATE/TARIFF
CHANGE

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BEFORE THE STATE OFFICE

OF

ADMINISTRATIVE HEARINGS



DIRECT TESTIMONY OF
ANDREW C. NOVAK
WATER UTILITY REGULATION DIVISION
PUBLIC UTILITY COMMISSION OF TEXAS

September 9, 2016

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1 **I. PROFESSIONAL QUALIFICATIONS**
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3 **Q. Please state your name and business address for the record.**

4 A. Andrew C. Novak, Public Utility Commission of Texas, 1701 N. Congress Avenue, Austin,
5 Texas.

6 **Q. Please provide a brief educational and professional background**

7 A. I am currently employed by the Public Utility Commission of Texas (PUC or Commission).
8 I have been employed by the Commission since October 1, 2015 as a Financial Analyst.
9 Prior to my employment with the Commission, I was employed by WIIN Consulting from
10 May 2015 to September 2015. I hold a Bachelor of Business Administration degree with a
11 major in Finance from the University of Houston. My previous testimonies are listed on
12 Attachment AN-5.

13 **Q. Please describe your current job responsibilities at the PUC.**

14 A. My responsibilities include reviewing and processing contested and uncontested rate
15 change applications; sale, transfer, and merger applications (STMs); applications to obtain
16 or amend certificates of convenience and necessity (CCNs), and rate appeals filed with the
17 PUC. For contested applications, my responsibilities include testifying as an expert
18 witness on accounting and financial matters in rate cases, financial and managerial aspects
19 of CCNs and STMs, and participating in the overall examination, review, and analysis of
20 such applications.
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II. PURPOSE OF TESTIMONY

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3 Q. What is the purpose of your testimony in this proceeding?

4 A. The purpose of my testimony is to present a recommendation regarding the rate of return
5 for Rio Concho Aviation, Inc. (Rio Concho).

6 Q. Please explain the scope of your participation in the present proceeding.

7 A. I have reviewed the filed application of Rio Concho, regarding rate of return, including the
8 capital structure, the cost of long term debt, the cost of common equity, and the overall fair
9 rate of return.

III. RATE OF RETURN

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12 Q. Please define the term "rate of return."

13 A. Rate of return generally is the amount of revenue an investment generates (in the form of
14 net income), usually expressed as a percentage of the amount of capital invested over a
15 given period of time. Rate of return is one of the components of the revenue requirement
16 formula.

17 **Q. What is the revenue requirement formula?**

18 A. The revenue requirement formula used in base rate cases is as follows:

19 $RR=E+D+T+(RB \times ROR)$

20 Where:

21 RR – Revenue requirement

22 E - Operating Expense

23. D- Depreciation Expense

24 T= Taxes

25 RB= Rate Base

26 ROR= Overall Rate of Return

1 In the above formula, the rate of return is expressed as a percentage. The calculation of that
2 rate is independent of the determination of the appropriate rate base value for ratemaking
3 purposes. As such, the appropriate total dollar return is dependent upon the proper
4 computation of the rate of return and the proper valuation of Rio Concho's rate base.

5 **Q. What is defined as fair and reasonable rate of return?**

6 A. The general framework for setting a fair and reasonable rate of return is based on two
7 decisions of the U.S. Supreme Court: *Bluefield Water Works & Improvement Company v.*
8 *Public Service Commission of West Virginia (1923)*,¹ and *Federal Power Commission v.*
9 *Hope Natural Gas Company (1944)*.² These cases set the following principles that are
10 generally recognized by regulators in establishing a fair and reasonable rate of return:

- 11 1) A utility is entitled to a return similar to that being earned by other enterprises with
12 corresponding risks and uncertainties, but not as high as those earned by highly
13 profitable or speculative ventures;
 - 14 2) A utility is entitled to a return level reasonably sufficient to assure financial
15 soundness;
 - 16 3) A utility is entitled to a return sufficient to maintain and support its credit and raise
17 necessary capital;
 - 18 4) A fair return can change (increase or decrease) along with economic conditions and
19 capital markets.
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¹ *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm. of W. Va.*, 262 U.S. 679 (1923).

² *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944).

IV. RECOMMENDATIONS

Q. Please summarize Rio Concho's rate of return claim in the case.

A. Based on Rio Concho's submitted rate tariff change application, Rio Concho requested the following rate of return:

Capital	Cost Rate	Ratio	Weighted Cost Rate
DEBT	3.90%	19.86%	0.77%
EQUITY	12.49%	80.14%	10.01%
TOTAL		100.00%	10.78%

Q. Please summarize staff's recommended rate of return in this case.

A. Staff recommends the following rate of return for Rio Concho:

Capital	Cost Rate	Capital Structure	Weighted Cost Rate
DEBT	5.03%	50.00%	2.52%
EQUITY	8.48%	50.00%	4.24%
TOTAL		100.00%	6.76%

Q. What is Staff's recommended cost of debt?

A. Staff recommends using a cost of debt of 5.03%.

Q. What is the basis for Staff's recommendation?

A. As recommended in Debi Loockerman's testimony, Rio Concho's long term debt should be disallowed. In accordance with Ms. Loockerman's recommendation, a hypothetical cost

1 of debt of 5.03% was used to calculate the weighted cost of debt. As shown in Exhibit AN-
2 4, the 5.03% was calculated by finding the average interest rate for Baa utility bonds for
3 every month over the test year used for this application. The Mergent Bond Record was
4 used in order to calculate the above mentioned hypothetical interest rate.

5 **Q. What is Staff's recommended rate of return on equity?**

6 A. Staff recommends that Rio Concho's rate of return on equity be set to 8.48%.

7 **Q. What is the basis for Staff's recommendation?**

8 A. I calculated the 8.48% return on equity using the Discounted Cash Flow (DCF) Method.
9 The DCF analysis employed a spot dividend yield, a 52-week dividend yield and earnings
10 growth forecasts, as shown in Exhibits AN-1, AN-2, AN-3. The data for the components
11 of the DCF analysis were taken from a group of water utilities, or proxy group, which act
12 as a standard for setting a utility's overall rate of return.

13 **Q. Please Explain your DCF Analysis.**

14 A. My analysis employs the standard discrete DCF model as portrayed in the following
15 formula: $k = D_1 / P_0 + g$

16 Where:

17 k = Cost of equity

18 D_1 = Dividend expected during the year

19 P_0 = Current price of the stock

20 g = Expected growth rate of dividends

21 **Q. Why did you use a proxy group?**

22 A. A proxy group is typically utilized since the use of data exclusively from one company
23 may be less reliable than using a proxy group. The lower reliability occurs because the data

1 for one company may be subject to events which can cause short-term anomalies in the
2 marketplace. A proxy group cost of equity also provides the subject utility with the
3 opportunity to earn a return equal to that of similar risk enterprises.

4 **Q. What proxy group did you use in your analysis?**

5 A. I used the following water utilities: American States Water Company, American Water
6 Works, Aqua America, California Water Service Group, Connecticut Water Service,
7 Middlesex Water, SJW Corporation, and York Water. Collectively, these utilities make up
8 the Value Line Investment Survey water proxy group.

9 **Q. Did you use the proxy group at any other point in your analysis? Please explain.**

10 A. Yes. A hypothetical capital structure was used due to the fact that Rio Concho's current
11 capital structure, of approximately 80% equity and 20% debt, is not in line with the average
12 for water utilities. According to the Value Line Investment Survey water proxy group,
13 which provides insight on how the average water utility is run, a water company's optimal
14 capital structure runs at 50% common equity and 50% long term debt.

15 **Q. Does your recommendation run contrary to the method Rio Concho used in order to**
16 **calculate Rio Concho's return on equity?**

17 A. Yes.

18 **Q. Please explain how.**

19 A. According to page 22 of the direct testimony of Randy Manus, Rio Concho used, "the
20 formula for determining the Rate of Return as described in the Class B/C Rate Application
21 instructions, page 10 the first paragraph." Barbie Brunson supports the methodology Mr.
22 Manus used in page 28 of her direct testimony. While the application instructions do outline

1 a method for developing a reasonable return on equity, the instructions also state, "this
2 method will be presumed reasonable if no other party provides opposing testimony." As
3 evidenced by the filing of this testimony and the upcoming hearing on the merits, the
4 presumption of the reasonableness of Rio Concho's return on equity has been lost.

5 **Q. What overall rate of return are you recommending?**

6 A. I recommend using 6.76% as the overall rate of return, as stated in the above table.

7 **Q. Does this conclude your pre-filed testimony?**

8 A. Yes, however, I reserve the right to supplement this testimony during the course of the
9 hearing as new information is presented.

Expected Market Cost Rate of Equity
 Using Data for the Barometer Group of Eight Water Companies
 5 Year Forecasted Growth Rates

<u>Time Period</u>		Adjusted Dividend Yield(1) (1)	Growth Rate (2)	Expected Rate of Return (3=1+2)
(1)	52 Week Average Ending: July 26, 2016	2.51%	6.15%	8.66%
(2)	Spot Price Ending: July 26, 2016	<u>2.16%</u>	<u>6.15%</u>	<u>8.31%</u>
(3)	Average:	<u>2.34%</u>	<u>6.15%</u>	<u>8.48%</u>

Sources: Value Line July 26, 2016
 Barrons July 26, 2016

Dividend Yields of Eight Company Peer Group

	Average	American States Water Co	American Water Works	Aqua America	California Water Service Group	Connecticut Water Service	Middlesex Water	SJW Corp	York Water
Symbol		AWR	AWK	WTR	CWT	CTWS	MSEX	SJW	YORW
Div		0.97	1.57	0.80	0.71	1.20	0.84	0.85	0.66
52 wk low		35.80	50.16	24.45	19.55	33.15	22.12	27.54	19.89
52 wk high		47.24	85.24	35.83	35.62	56.62	44.11	39.48	33.40
Spot Price		43.46	81.6	34.03	32.91	51.94	41.43	39.37	31.28
Spot Div Yield	2.16%	2.23	1.92	2.35	2.18	2.31	2.03	2.16	2.11
52 wk Div Yield	2.51%	2.34	2.32	2.65	2.57	2.67	2.54	2.54	2.49
Average	<u>2.34%</u>								
Source	Barrons	July 26, 2016							
Value Line	July 26, 2016								

Five Year Growth Estimate Forecast for Eight Company Barometer Group

<u>Company</u>	<u>Symbol</u>	Yahoo	Clear Station	Morning star	Value Line	Average
American States Water Co	AWR	3.85%	3.80%	n/a	6.00%	4.55%
American Water Works	AWK	7.27%	7.20%	6.50%	8.00%	7.24%
Aqua America	WTR	6.05%	6.30%	n/a	7.00%	6.45%
California Water Service Group	CWT	9.05%	9.10%	n/a	7.50%	8.55%
Connecticut Water Service	CTWS	6.00%	6.00%	N/A	4.00%	5.33%
Middlesex Water	MSEX	2.70%	N/A	N/A	5.00%	3.85%
SJW Corp.	SJW	14.00%	N/A	n/a	1.50%	7.75%
York Water	YORW	4.90%	N/A	N/A	6.00%	5.45%
						6.15%

Source:

Internet

July 26, 2016

BAA Bond Rating for Rio Concho test year

AN-4

2015

December	5.55
January	5.57
February	5.47
March	5.42
April	5.23
May	5.22
June	5.13
July	4.91
August	4.51
September	4.51
October	4.44
November	4.39

Testimonies Prepared by Andrew Novak

AN-5

Date	Organization	Docket No.	Description
7/8/2016	Public Utility Commission of Texas	45248	Ratepayers Appeal of the Decision by the City to Change Rates
7/11/2016	Public Utility Commission of Texas	45506	Complaint of Regina Lee Against C&R Water Supply