8

FILE

BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Ohio	)	
American Water Company to Increase its	)	
Rates for Water and Sewer Service	)	Case No. 11-4161-WS-AIR
Provided to its Entire Service Area.	)	

TESTIMONY
OF
SHAHID MAHMUD
CAPITAL RECOVERY AND FINANCIAL ANALYSIS DIVISION
UTILITIES DEPARTMENT
THE PUBLIC UTILITIES COMMISSION OF OHIO

STAFF EXHIBIT ______

1 Q. Please state your name and business address.

A. My name is Shahid U. Mahmud. My business address is 180 East Broad Street, Columbus, OH 43215.

2. Q. By whom are you employed?

A. I am employed by the Public Utilities Commission of Ohio (PUCO).

3. Q. What is your current position with the Public Utilities Commission of Ohio and what are your duties?

A. My current position is Senior Utility Specialist in the Capital Recovery and Financial Analysis Division of the Utilities Department. My duties include processing: (1) applications to issue securities, (2) applications for certifications of providers of Competitive Retail Electric and Gas Service (3) applications for emergency rate increase, (4) applications to increase rates, (5) applications for transfer of assets, and (6) participating in other inter-divisional reviews and projects.

4. Q. Would you briefly state your educational background and work experience?

A. I have an undergraduate degree in Accounting and a Masters Degree in Business Management from the University of Chittagong, Bangladesh. I have a Masters Degree in Business Administration (International Business) from the Ohio State University, Columbus, Ohio and a Masters Degree in Development Studies (International Affairs) from Ohio University, Athens, Ohio. I have been awarded the professional designation "Certified Rate of Return Analysts" ("CRRA") by the Society of Utility and Regulatory Financial Analysts. This designation is based upon education, experience and the successful completion of a comprehensive written examination.

I was employed by this Commission as a Utility Rate Analyst in the Performance Analysis Division in May 1990 and became a Utility Rate Analyst Coordinator in September 1996. In February 1999, I became a Utility Specialist in the Electricity Division. In December 2008, I became a Senior Utility Specialist in the Capital Recovery and Financial Analysis Division. During the course of my employment with PUCO, I have undergone several training courses and have attended many utility regulatory seminars and conferences.

I primarily review and analyze applications for issuance of securities, certification of competitive retail electric and gas service providers, and transactions related to the transfer of assets.

I assisted in the review, analysis and in the preparation of Staff Comments and Recommendations of the Lakeland Utilities Company's application for an emergency rate increase (Case No. 90-1613-WS-AEM), Akron Thermal, Limited Partnership's application for an emergency rate increase (Case No. 00-2260-HT-AEM), and Southeastern Natural Gas Company's application for an emergency rate increase (Case No. 01-140-GA-AEM). I prepared the Rate of Return section in the Staff Reports for Ohio Cumberland Gas Company (Case No. 10-868-GA-AIR) and, Water and Sewer, LLC. (Case No. 11-4509-ST-AIR) for an increase in their rates and charges.

5. Q. What are your responsibilities in this proceeding?

A. The purpose of my testimony is to address the objections to the rate-of-return to the rate base (ROR) analysis included in the Staff Report docketed in this proceeding on January 31, 2012. Objections to the Staff's ROR were submitted by Ohio American Water Company (the Company or Ohio American), and jointly by the Office of the Ohio Consumers' Counsel (OCC) and the City of Marion (Marion).

6. Q. Ohio American's objections on proxy groups (comparable group) read that the Company has several objections to the Staff's Rate of Return section as regards the proxy group. First, the Staff selected proxy group does not reflect the increased business risk faced by Ohio American relative to its comparable group of water utilities. Second, the proxy group does not reflect the slightly less financial risk of Ohio American. Third, Staff's selection criteria of including water utilities with market capitalization greater than $500 million excludes two water utilities which are closer in the size to Ohio American than the four companies Staff has relied upon and, therefore, closer in business risk. How do you respond?

A. Ohio American's objection on comparable companies concerning the size of the Company and its recommendation for an adjustment range of 0.22% (negative 22 basis points) of financial risk adjustment, a 0.12% (positive 12 basis points) floatation cost adjustment, and a 0.60% (positive 60 basis points) of business risk adjustment should be made to reflect the financial and business risk differential between the Company and the proxy group is erroneous. Ohio American has no publicly traded stock, and it depends on its parent, American Water Works Company, for its equity funding. American Water Works Company is a large publicly traded company which meets the selection criteria for Staff's comparable group. It would be inaccurate to characterize Ohio American as a stand alone small company when it is actually part of the corporate structure of the American Water

Works Company, which serves approximately 15 million customers in more than 30 U.S. States, as well of parts of Canada. [1]

The adjustments proposed by Ohio American are unnecessary because the Company receives its equity funding at a low cost from its parent American Water Works Company whose cost of equity is the cost of equity to Ohio American. Staff's selection of the proxy group with market capitalization over $500 million consists of four companies while Ohio American listed two other companies in the proxy group whose market capitalization is below $500 million. The Staff's selection of the proxy group is consistent with the ROR determination in the most recent rate case proceeding of the Company (Case No. 09-391-WS-AIR) where the Commission adopted the Staff's position on the selection of the proxy group.

7. Q. Ohio American's first objection on "Capital Asset Pricing Model" (CAPM) states that, "Staff utilized a historical yield on US Treasury Bonds as the risk-free rate instead of the more appropriate forecasted rate". Ohio American's fourth objection on "Capital Asset Pricing Model" states that, "Staff incorrectly utilized only the historical market equity risk premium without also evaluating a prospective market equity risk premium". Please explain the Staff's response to these objections?

A. The Staff will not predict economic conditions for the rate period when formulating its Capital Asset Pricing Model (CAPM) recommendation. Staff believes that growth rates occur in a manner independent of the preceding growth rate. Short term forecasts involve arbitrarily selective guesses as to which conditions that have occurred before will be prevalent in the near-term. Staff cannot predict the future and, thus, incorporates parameters that reflect broad general conditions in its analysis.

8. Q. Ohio American's "Capital Asset Pricing Model" second objection, states, that "Staff inappropriately averaged the historical yield on 10-year U.S. Treasury bonds with the historical yield on 30-year U.S. Treasury bonds." What is your response to Ohio American's concern?

A. Staff's average of the historical yield on 10-year U.S. Treasury bonds with the historical yield on 30-year U.S. Treasury bonds accommodates the use of Ibbotson data to calculate a market to risk free rate spread for CAPM.

---

[1] http://amwater.com/About-Us/Corporate-Information/company-history.html

Staff uses Ibbotson's data for long term government bonds and for large company stock for its spread. Ibbotson's 2011 SBBI Valuation Yearbook states that long term government bonds are those with an approximate twenty year maturity (on pages 22 and 200). In the CAPM calculation, the yield and the spread should be consistent with respect to maturity.

9. Q. Ohio American's "Capital Asset Pricing Model" Objection 5, states, "Staff did not include an empirical CAPM analysis to reflect the fact that the empirical Security Market Line ("SML") described by the CAPM is not as steeply sloped as the predicted SML." How does Staff address this issue?

A. The Staff used of Value Line betas, which vary less with risk and compensate for these shortcomings.

10. Q. Ohio American's Objection to Staff's use of Discounted Cash Flow ("DCF") method on the ground that that such method is flawed on the following respects: 1) Staff's exclusive use of the non-constant version of the DCF; 2) Staff's inappropriate reliance on historical growth in the Gross National Product (GNP); 3) Staff's implicit rejection of the constant growth DCF results; and 4) Staff's use of erroneous date in its DCF analysis. How does Staff address these issues?

A. The Staff has used the non-constant version of DCF growth result and has also used the historical growth in the GNP as measures of growth as such measures has been accepted by the Commission in previous base rate cases (Case Numbers: 06-433-WS-AIR and 07-1112-WS-AIR). This is consistent with the most recent rate case proceeding of the Company in Case No. 09-391-WS-AIR, where the Commission adopted the Staff position on the stated growth measures used. In regards to the allegation of erroneous data in Staff's DCF analysis, the Staff has updated the data from January 1, 2011 to December 31, 2011 and analyzed those to include the adjusted closing price of the stocks of the proxy group for dividends and for the stock splits of one particular company in the proxy group.

11. Q. OCC and Marion's Objection 5 states, "The OCC and Marion object to the PUCO Staff's inappropriate increase of the cost of equity by allowing an adjustment for flotation or equity issuance costs even though OAW provided no proof that the Company incurred any flotation costs and OAW

did not provide proof of the magnitude of flotation costs the Company will incur in the reasonably near future. Consumers should not have to pay for such costs that OAW will not necessarily incur." How does Staff address this issue?

A. It should be noted that Staff adjusts for issuance costs and not flotation costs. Staff assumes no prospective issuances by the company. And Staff's adjustment is generic; it is based on issuance costs to the utility industry as a whole.

The issue is not relevant if the Company or its parent or affiliates have plans to issue new equity. Staff makes its equity issuance adjustment to support the portion of the embedded balance of equity that was raised from equity issuance and not generated internally. The Staff's adjustment is merely structured to support this balance on an annual basis. The Staff has no intention on reflecting issuance costs as annual operating expense in the revenue requirement.

OCC and Marion misconstrue Staff's issuance adjustment as including flotation costs. Staffs adjustment in no way reflects flotation costs, if such a term is meant to refer to dilution or price pressure. Staff's adjustment reflects only properly included issuance cost.

12. Q. The OCC and Marion objection states "The OCC and Marion object to the PUCO Staff's utilization in its Capital Asset Pricing Model of a risk premium inappropriately based on the spread of arithmetic mean total returns between large companies stocks and long-term government bonds, thereby artificially increasing the common equity cost that consumers will pay. The use of the arithmetic mean of annual returns inflated the estimated cost of equity because it unrealistically assumed that the relevant horizon was only one year, even though investors were expected to hold their stocks for longer term horizons." Why does the Staff disagree with this approach?

A. Use of Capital Asset Pricing Model (CAPM) spread based on the geometric mean, as advocated by OCC and Marion, would be misapplied. The Staff correctly uses an arithmetic mean instead. Ibbotson, on pages 56-57 of 2011 SBBI Valuation Yearbook, states that because the CAPM is an additive model, the arithmetic mean is more appropriate than the geometric mean in the DCF approach, and "the geometric average is more appropriate for reporting past performance...". The CAPM estimates current cost of equity. It does not report past performance.

13. Q. Does this conclude your testimony?

A. Yes, it does.

PROOF OF SERVICE

I hereby certify that a true copy of the foregoing Testimony, submitted on behalf of the Staff of the Public Utilities Commission of Ohio, was served by regular U.S. mail, postage prepaid, or hand-delivered, upon the following parties of record, this 19th day of March, 2012.

Devin D. Parram
Assistant Attorney General

Parties of Record:

City of Marion, Ohio

Mark D. Russell
Law Director – City of Marion, Ohio
233 West Center Street
Marion, Ohio 43302
law@marionohio.org

Office of Ohio's Consumer's Council

Mellissa R. Yost
Kyle L. Kern
Assistant Consumers' Counsel
10 West Broad Street, Suite 1800
Columbus, Ohio 43215-3485
yost@occ.state.oh.us
kern@occ.state.oh.us

Perry Township, Franklin County, Ohio

Peter N. Griggs
Loveland & Brosius, LLC
50 West Broad St., Suite 3300
Columbus, Ohio 43215
pgriggs@lblaw.net

Ohio American Water Company

Mark A. Whitt
Melissa L. Thompson
Whitt Sturtevant LLP
PNC Plaza, Suite 2020
155 East Broad Street
Columbus, Ohio 43215
whitt@whitt-sturtevant.com
thompson@ whitt-sturtevant.com