STATE OF IOWA

BEFORE THE IOWA UTILITIES BOARD

IN RE:	:	**DOCKET NO. RPU-09-________**
	:	
IOWA-AMERICAN WATER COMPANY	:	**RPU-2009-0004**
APPLICATION FOR REVISION OF RATES	:	

DIRECT TESTIMONY OF SCOTT W. RUNGREN

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS?

A. My name is Scott W. Rungren. My business address is 727 Craig Road, St. Louis, Missouri 63141.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by American Water Works Service Company ("Service Company") as a Financial Analyst III. The Service Company is a subsidiary of American Water Works Company, Inc. ("American Water") that provides various services to American Water's utility subsidiaries. In this proceeding I am testifying on behalf of Iowa-American Water Company ("IAWC" or "the Company").

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND.

A. In May of 1983, I received a Bachelor of Science degree in Business Administration with a major in Energy Management from Eastern Illinois

University. In May of 1986, I received a Master of Business Administration degree with a specialization in Finance from Northern Illinois University.

Q. PLEASE SUMMARIZE YOUR EMPLOYMENT EXPERIENCE.

A. From 1986 to 1999 I was employed by the Illinois Commerce Commission ("Commission"). I held various positions while employed there. I joined the Finance Department in 1987, and was promoted to Senior Financial Analyst in 1989. In 1993 I transferred to what was then called the Energy Programs Division, returning to the Finance Department in 1995, again as a Senior Financial Analyst. I remained in the Finance Department until my departure from the Commission in February of 1999. In March of 1999 I began employment with Cinergy Corp., working in the Retail Commodity Services group focusing on their Real Time Pricing program. In 2001 I began performing long-run generation planning studies for Cinergy's Kentucky and Indiana service areas. In May of 2007 I joined the Service Company as a Senior Financial Analyst. My present duties consist primarily of assisting with the preparation of financing and other rate-related filings for American Water's Central States.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my direct testimony is to present the capital structure that I recommend be used for computing Iowa-American's weighted average cost of capital ("WACC") in this proceeding. The Company's WACC is used as the overall rate of return on rate base and reflects the cost of common equity recommendation presented in the Direct Testimony of IAWC witness Ms. Pauline Ahern. I also present the Company's costs of long-term debt and preferred stock.

Q. WHICH EXHIBIT ARE YOU SPONSORING IN THIS PROCEEDING?

A. I am sponsoring Exhibit __ [SWR-1], Schedules 1 through 3. This Exhibit is described below.

Q. WAS THE INFORMATION CONTAINED IN EXHIBIT __ [SWR-1] OBTAINED OR DERIVED FROM THE BOOKS AND RECORDS OF THE COMPANY?

A. Yes, the information contained in Exhibit __ [SWR-1] was obtained from the books and records of Iowa-American for the twelve months ended December 31, 2008, and from the Company's financing projection included in its 2009 Annual Business Plan.

Q. PLEASE DESCRIBE EXHIBIT __ [SWR-1].

A. Exhibit __ [SRW-1] consists of three schedules. Schedule 1 shows the cost of capital summary, which includes the total capitalization and overall cost of capital. Schedule 2 shows the pro forma cost of long-term debt, and Schedule 3 shows the pro forma cost of preferred stock.

Q. WHAT TEST YEAR IS THE COMPANY PROPOSING IN THIS PROCEEDING?

A. The Company is proposing use of the calendar year ended December 31, 2008 as the test year.

Q. PLEASE DESCRIBE THE CAPITAL STRUCTURE YOU RECOMMEND FOR IOWA-AMERICAN IN THIS PROCEEDING.

A. Consistent with prior practice, I recommend the use of the Company's historical thirteen-month average capital structure as of December 31, 2008, with pro forma adjustments to reflect the $3,000,000 long-term debt issuance on February 4, 2009, the $[redacted] long-term debt issuance planned for [redacted], and the $[redacted] of additional paid-in capital planned for [redacted]. These financings are included in the Company's 2009 Business Plan. As shown on Exhibit __ [SRW-1], Schedule 1, this capital structure is as follows:

Long-term Debt	[redacted]%
Common Equity	[redacted]%
	100.00%

Q. WHAT GOALS DOES THE COMPANY SEEK TO ACHIEVE WITH ITS CAPITAL STRUCTURE?

A. The Company's goals are to minimize the overall cost of capital and to maintain financial ratios that allow the Company to attract new capital on reasonable terms. The Company also seeks to maintain flexibility to issue various types of securities (e.g., tax-exempt debt, long-term taxable debt, preferred or common equity) under varying market conditions.

Q. WHY DO YOU RECOMMEND THIS CAPITAL STRUCTURE?

A. The recommended capital structure, which was developed using average capital component balances over the period beginning January 1, 2008 and ending December 31, 2008, is consistent with IAWC's chosen test year in this proceeding. It is also consistent with IAWC's proposed use of thirteen-month average balances for rate base items. In addition, because this proceeding will determine rates for future service, it is reasonable for the capital structure components to reflect the pro forma adjustments to long-term debt and paid-in capital noted above. The proposed capital structure is also consistent with the Company's target capitalization.

Q. IS YOUR RECOMMENDED CAPITAL STRUCTURE REASONABLE FOR RATEMAKING PURPOSES?

A. Yes, it is.

Q. HOW DID YOU DETERMINE THAT CAPITAL STRUCTURE IS REASONABLE?

A. To determine whether IAWC's historical thirteen-month average capital structure ending December 31, 2008, with pro forma adjustments, is reasonable for ratemaking purposes, I examined the average common equity ratios of the two proxy groups of utility companies discussed in the Direct Testimony of IAWC witness Pauline Ahern. Specifically, I compared IAWC's common equity ratio in my proposed capital structure to that of Ms. Ahern's six AUS Utility Reports water companies and to her group of ten AUS Utility Reports natural gas distribution companies. These utilities and their corresponding financial data are shown on

Schedules 4 and 5, respectively, of Exhibit __ [PMA-1], attached to the Direct Testimony of Ms. Ahern. For the year ended 2007, the average common equity ratio of Ms. Ahern's six AUS Utility Reports water companies was 50.63%. For the same period, the average common equity ratio of Ms. Ahern's ten AUS Utility Reports natural gas distribution companies was 53.98%. Thus, IAWC's equity ratio of [redacted]% is [redacted] than the average common equity ratio of both Ms. Ahern's six AUS Utility Reports water companies and her ten AUS Utility Reports natural gas distribution companies.

To further check the reasonableness of my proposed capital structure, I also considered projected equity ratios from Value Line Investment Survey[1]. Value Line estimates that the composite common equity ratio for the water utility industry will be 48.0% in 2008, 49.0% in 2009, 50.0% in 2010, and 50.0% over the 2012-2014 time period. Thus, IAWC's thirteen month average equity ratio for the period ending December 31, 2008, with the pro forma paid-in capital adjustment previously noted, is also reasonable when compared to Value Line's projected common equity ratios for the water utility industry.

Based on these comparisons, I concluded that IAWC's thirteen-month average capital structure ending December 31, 2008, with pro forma adjustments, is reasonable for computing the Company's WACC in this proceeding. The WACC is used, of course, as the authorized overall rate of return on rate base.

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1 Value Line Investment Survey, April 24, 2009, p. 1793.

Q. PLEASE EXPLAIN THE ADJUSTMENT YOU MADE TO IAWC'S COMMON EQUITY BALANCE.

A. Starting with the Company's thirteen-month average common equity balance for the year ended December 31, 2008, I made an adjustment to reflect the infusion of $[redacted] million of common equity planned for [redacted]. The actual amount of the infusion, which could differ from the planned amount, will be known prior to the close of the record in this case. I will update my testimony, including a recalculation of the Company's WACC, to reflect the actual amount of the infusion after it has occurred. This update will also include capturing the change to the retained earnings balance.

Q. WHAT COST RATE DID YOU ASSIGN TO THE COMPANY'S COMMON EQUITY COMPONENT?

A. To compute the Company's WACC I used the cost of common equity developed by Ms. Pauline Ahern, the Company's consultant on this issue. Ms. Ahern has concluded that the Company's cost of common equity is 12.20%.

Q. PLEASE EXPLAIN THE PRO FORMA ADJUSTMENTS YOU MADE TO IAWC'S LONG-TERM DEBT BALANCE.

A. I started with the Company's thirteen-month average long-term debt schedule for the year ended December 31, 2008 and made adjustments to reflect the following: 1) the $3 million long-term debt issuance that occurred on February 4, 2009, and 2) the $[redacted] million long-term debt issuance planned for [redacted].

Q. PLEASE DESCRIBE THE NEW LONG-TERM DEBT THE COMPANY ISSUED IN FEBRUARY 2009.

A. The Company issued $3 million of long-term debt on February 4, 2009. The Company has included this debt issue in the embedded cost of debt calculation at the actual annual coupon rate of 8.25%. In addition, the Company proposes to amortize and recover the expected $108,724 of debt issuance costs over the thirty-year life (i.e., 358 months) of this new issuance.

Q. PLEASE DESCRIBE THE LONG-TERM DEBT THE COMPANY PLANS TO ISSUE IN [redacted].

A. The Company plans to issue $[redacted] million of long-term debt in [redacted] for the purpose of financing utility property that will be placed in service and to pay down short-term bank debt that is expected to build up through the normal course of business. This debt obligation is projected to have an interest rate of [redacted]% with a [redacted]-year term to maturity. The Company has estimated that debt issuance costs will total $[redacted] which, consistent with the February 2009 issuance, the Company proposes to amortize and recover over the [redacted]-year term. While the principal amount, interest rate, and issuance costs have been estimated at this time, the actual terms of this financing should be available prior to the close of the record in this case. I will update my testimony, including a recalculation of the Company's WACC, to reflect the actual principal amount, interest rate, and issuance costs after the debt has been issued.

Q. WHAT IS IAWC'S COST OF LONG-TERM DEBT?

A. IAWC's pro forma cost of long-term debt is [redacted]% for the test year ended December 31, 2008. The computation of this cost is shown on Exhibit __ [SWR-1], Schedule 2.

Q. WHAT IS IAWC'S COST OF PREFERRED STOCK?

A. As shown on Exhibit ___ [SWR-1], Schedule 3, IAWC does not have any preferred stock.

Q. WHAT IS THE OVERALL WACC THE COMPANY IS PROPOSING IN THIS PROCEEDING?

A. The overall WACC is calculated by summing the component costs of the capital structure, with each component weighted by its respective proportion to total capitalization. Based on the test year capital component balances, pro forma adjustments, and component costs I have described, IAWC's WACC is [redacted]%, as shown on Exhibit __ [SWR -1], Schedule 1.

Q. WHY DID THE COMPANY NOT APPLY DOUBLE LEVERAGE TO COMPUTE THE WEIGHTED COST OF EQUITY, CONSISTENT WITH PRIOR BOARD ORDERS?

A. The Company believes that it is not appropriate to use the double-leverage methodology to calculate the weighted cost of equity. First, the Company does not believe that the double-leverage methodology is consistent with the long-accepted finance principle that expected return is a function of the relative risk borne by investors. IAWC's parent, American Water, bears all of the risk of its investment in IAWC's common equity, regardless of American Water's source of funds. These risks include, but are not limited to, subordination to all other forms of capital in the event of liquidation, and a much higher risk of loss of the principal invested in the Company. Since the true cost of common equity is the risk-adjusted opportunity cost to investors, the investors' source of funds is irrelevant. Second, the Company does not believe that the double-leverage methodology would be used consistently. For example, if the Company was owned by individual investors rather than by American Water, use of the double-leverage methodology would require the Board to take into account each individual investor's method for funding his or her investment in the Company to determine IAWC's weighted cost of equity. Such an approach would not be practical. Alternatively, the Board could ignore the double-leverage methodology in such an instance. However, doing so would give individual investors the opportunity to earn a higher return than American Water on an investment in IAWC. The opportunity to earn a higher return on its investment in IAWC solely due to the form of ownership (i.e. individual investors in contrast to a parent corporation) illustrates the arbitrary and inherently unfair nature of the double leverage approach. The argument against a double leverage adjustment to the weighted cost of equity is addressed in greater detail in Ms. Ahern's Direct Testimony.

Q. DOES THIS CONCLUDE YOUR PREPARED DIRECT TESTIMONY?

A. Yes, it does.