DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA
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IN THE MATTER OF the Investigation of the Montana Public Service Commission into whether Mountain Water Company's rates are Just and Reasonable.	)))))	REGULATORY DIVISION DOCKET NO. D2016.2.15

DIRECT TESTIMONY

OF

JOHN KAPPES

ON BEHALF OF

MOUNTAIN WATER COMPANY

April 15, 2016

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I. INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is John Kappes. My business address is 1345 W. Broadway, Missoula, Montana.

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

A. I am the President of Mountain Water Company ("Mountain Water").

Q. **PLEASE BRIEFLY DESCRIBE YOUR EDUCATIONAL EXPERIENCE, PROFESSIONAL BACKGROUND, AND PREVIOUS EXPERIENCE TESTIFYING BEFORE THE MONTANA PUBLIC SERVICE COMMISSION ("COMMISSION").**

A. I graduated May of 1994 from the University of Montana with a Bachelor of Science Degree in Business, with an emphasis in accounting. I passed the Certified Public Accountant exam November 1994, and received my CPA license for the state of Montana April of 1997. In April of 1995, I attended the NARUC Utility Rate Seminar co-sponsored by Florida State University.

I have worked for Mountain Water since November 14, 1990 in different departments, including Customer Service and Accounting and have been in my current position as President since January 2012. I worked as the Coordinator of Rates from 1994 until 2001. I was involved in the preparation of the general rate applications for the Missoula Division, Docket No. 94.7.26, and for the Superior Division, Docket No. 94.10.46. I prepared and was a witness in three generate rate applications for Missoula Division, Docket Nos. D96.4.61, D98.5.104, and D2000.7.112, as well as the Superior Division general rate application, Docket No. D96.6.97. I oversaw the preparation of and was a witness for the general rate applications for the Missoula Division in Docket Nos. D2002.5.60, D2005.4.49, D2008.9.119, D2010.4.41, and D2012.7.81. I was also a witness in the proceeding involving the sale and transfer of stock in Park Water Company ("Park Water"), Docket No. D2011.1.8, and the most recent proceeding involving Liberty's acquisition of Western Water Holdings, LLC, Docket No. D2104.12.99.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. I am testifying on behalf of Mountain Water.

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will provide information regarding Mountain Water's cost of capital, the impact of lower debt rates, and to compare Mountain Water's current costs to the costs considered in the last rate case.

Q. IS THERE ANY REASON THAT THE CURRENT RATES OF MOUNTAIN WATER SHOULD NOT BE DEEMED JUST AND REASONABLE?

A. No. The current rates we are charging are based on our operating costs and average capital for a test year 2011, as approved by the Montana Public Service Commission. Those rates went into effect January 21, 2013. They have been adjusted as necessary to meet the requirements of our power tracker tariffs and SRF tracker tariffs. Those adjustments have also been reviewed by the PSC per the requirements of those tariffs. Since that filing we have invested capital, which has increased our rate base, and we have had inflationary pressures on our operating costs, which are not offset by trackers or otherwise accounted in our current rates.

We have been able to substantially offset those upward cost pressures through new borrowing to support the capital investments made since the 2011 test year that has lowered our embedded debt rate and some overall efficiency in our operations. However, our investments, combined with the increase in ongoing operating costs, have more than offset the efficiencies we have achieved and the lower blended debt rates Park Water has been able to obtain.

We have not prepared a general rate application, but will be doing so as soon we free up resources from the ongoing condemnation litigation. That general rate application will identify the extent to which we may need to have a rate increase and also include an update to our ongoing main improvement program.

III. IMPACT OF LIBERTY ACQUISITION

Q. DID THE SALE TO LIBERTY CAUSE THE RATES MOUNTAIN WATER CHARGES TO BE UNJUST OR UNREASONABLE?

A. No. Mountain Water is still owned by its parent company Park Water, now known as Liberty Utilities (Park Water). Our cost of capital savings came under the Carlyle ownership, and is based on the consolidated capital of Park Water. The sale of Western Water to Liberty has no effect on Mountain's actual cost of capital.

Q. SHOULD LIBERTY'S CAPITAL COSTS BE PUSHED DOWN TO MOUNTAIN WATER?

A. No. This is similar to the argument the MCC made in the last rate case (D2012.7.81) about Carlyle's ownership. The PSC agreed with Mountain Water its cost of capital is based on the capital structure of its parent company, Park Water, and is not based on its further upstream owner. More specifically, Mountain Water's debt component is based on its actual consolidated debt at the Park Water level. The PSC was taken to District Court on their decision by the MCC, and the District Court confirmed the PSC's decision.

The debt from Park Water is collateralized by Mountain Water's stock, while any debt at the Liberty level is not.

IV. CHANGES AT MOUNTAIN WATER

Q. CAN YOU DESCRIBE THE CHANGES IN MOUNTAIN WATER'S DEBT SINCE THE LAST RATE CASE?

A. Mountain Water has not had long term debt since it paid off the original note to Montana Power Company. Mountain Water's capital has come from its parent company, Park Water. For Montana rate making purposes, Mountain Water has traditionally been allocated a portion of Park Water's debt. Since the last Mountain Water rate case, Park Water has taken out additional long term debt on terms more favorable than the debt it held at the time of the last Mountain Water rate case. Through this borrowing, Park Water has increased its total debt and lowered its blended debt rate.

Q. IN A RATE CASE, WHAT IMPACT WOULD YOU EXPECT THE CHANGES IN PARK WATER'S DEBT TO HAVE ON MOUNTAIN WATER'S ALLOWED RATE OF RETURN?

A. Based on my experience with the Commission's rate setting, the debt component of Mountain Water's capital structure would likely be increased, while the debt rate would be lowered.

Q. HAS MOUNTAIN WATER CONSIDERED THE IMPACT OF THAT CHANGE IN DEBT ON ITS ALLOWED RATE OF RETURN?

A. Yes. We regularly review costs and our allowed returns to determine the need for a rate case. We recognize that the changes in Park Water's debt would likely result in some reduction in Mountain Water's allowed rate of return in a future rate case, but believe the current rates remain just and reasonable, because those potential reductions are more than offset by increased investment and increased operating expenses.

Q. SHOULD THE COST OF CAPITAL SAVINGS THAT MAY RESULT FROM CHANGES IN PARK WATER'S DEBT BE PASSED ON TO THE WATER CUSTOMERS IN A SINGLE-ISSUE RATE ADJUSTMENT? IF NOT, WHY?

A. No. The water customers are already benefitting from those changes. As I've stated we have not had to have a general rate increase since our 2011 test year rate application, largely because of our recognition of this change in the implied cost of capital. Those savings are offsetting other cost increases. For example, our property taxes alone have increased more than $500,000, which almost completely offsets those cost of capital savings. In addition our overall rate base has increased due to our capital investments since the 2011 test year. A one item rate adjustment would ignore other offsetting rate considerations and would create unjust and unreasonable tariffs.

Also it would be difficult to determine the exact rate of return given that Mountain Water's current return on equity was calculated using a different equity percentage. Therefore it would take a full review of what Mountain Water's actual rate of return should be under its current equity ratio.

Q. WHAT CAUSED THE DECREASE IN THE COST OF CAPITAL SINCE 2011?

A. There are two components to the change in those costs. First, Park Water was able to get lower cost debt that is helping to reduce our overall cost of debt. Second, our equity tends to range from 50% to 56%. Our equity level for our 2011 test year was 56%, while currently it is closer to 50%.

Q. WHAT IS THE REASONING FOR THE LOWER EQUITY RATIOS THAT PARK'S NEW EQUITY TARGET?

A. No. This is a timing issue. The current level is considered to be a low point, and is not considered to be a typical level for Park Water. Over time as Park Water takes on its debt, it is done in amounts that make economic sense, which then reduces overall equity until capital is reinvested back into the operating systems. Park and Mountain Water will continue to try and have a consolidated equity ratio greater than 50% and closer to 55% to provide the best balance of equity and debt to provide the lowest overall cost of debt and equity. However there will continue to be fluctuations over time.

Q. CAN YOU DESCRIBE MOUNTAIN WATER'S INVESTMENT AND CHANGES IN EXPENSES THAT SHOULD BE CONSIDERED TO DETERMINE WHETHER MOUNTAIN WATER'S RATES ARE CURRENTLY JUST AND REASONABLE?

A. Our net revenues have remained similar to 2011, as growth in customer counts has been offset by changes in use patterns. Since our 2011 test year, our overall rate base, net of depreciation has increased by $3,700,000, which is over a 10% increase to rate base. Our net expenses for operations, depreciation, and property taxes, have increased $370,000.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes.