Service Date: April 27, 2016

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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

MOUNTAIN WATER COMPANY'S RESPONSES TO MONTANA PUBLIC SERVICE COMMISSION DATA REQUESTS PSC-011 THROUGH PSC-021

Mountain Water Co., by and through its undersigned counsel, hereby submits to the Montana Public Service Commission these responses to data requests PSC-011 through PSC-021 from the Montana Public Service Commission.

Dated this 27th day of April, 2016.

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By: _____

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PSC-011

Regarding: Investment Valuation
Witness: Bourassa

On page 5 of your direct testimony you refer to employing a proxy group method for determining utility ROEs. Was any proxy group used to value the stock of Western Water Holdings? If so, please provide the proxy group. If not, please explain why.

RESPONSE: Mr. Bourassa has neither valued the membership units of, nor developed an expected ROE for, Western Water Holdings. As a result, he has not determined an appropriate proxy group.

PSC-012

Regarding: Investment Valuation
Witness: Bourassa

When will Mountain Water file a general rate case?

RESPONSE: Mountain Water intends to file a rate case as soon as possible after the completion of the pending condemnation case, and no later than spring or summer of 2017. Mr. Bourassa is not involved in determining when Mountain Water will file a rate case and this response was provided by Mountain Water's President John Kappes.

PSC-013

Regarding: Debt Interest Rate
Witness: Bourassa

On page 4 of your direct testimony you refer to the retirement of a term loan agreement on March 9, 2016. What was the interest rate on that term loan that Liberty retired on March 9, 2016?

RESPONSE: The response to this request was provided by Mountain Water in a confidential filing served on April 22, 2016, titled Mountain Water Company's Notice of Filing Confidential Documents Pursuant to Order to Compel, Order No. 7475g.

PSC-014

Regarding: Investment Valuation
Witness: Bourassa

What information has Mountain Water Co. supplied to Liberty that may have helped Liberty calculate the firm's purchased stock value?

RESPONSE: MWC submitted its objection to this request on April 25, 2016.

PSC-015

Regarding: Investment Valuation
Witness: Bourassa

a. Was any financial metric used to value the stock of Mountain Water or Western Water Holdings?

b. If so, what metric was used? Please provide work papers documenting the metric.

c. If no metric was used, please explain why.

RESPONSE:

a. Mr. Bourassa was not asked to value the stock of Mountain Water or Western Water Holdings, so did not perform such a calculation.

b. See response to a.

c. See response to a.

PSC-016

Regarding: Capital Access
Witness: Bourassa

Will Mountain Water Co. be required to sign any Inter Company Loan Agreements to have access to funds from Liberty?

RESPONSE: Mountain Water does not currently have an intercompany loan agreement in place, but expects to execute one to maintain debt in Mountain Water's capital structure as the Park Water debt is retired. Generally, Liberty does not allow its operating companies to take on debt. The intercompany loans provide the mechanism through which Liberty balances the capital structure of its operating companies while continuing to issue debt at the parent level company level. This response was provided by Bill Killeen.

PSC-017

Regarding: Equity, Debt
Witness: Bourassa (PSC-017(a)); Killeen (PSC-017(b)-(c))

a. Regarding page 4, line 7 of your testimony, please explain from an accounting perspective how an "equity infusion" occurs.

b. On page 4, line 7, please identify the "parent."

c. Regarding page 4, line 7, did the $235 million in Liberty debt simply move from the books of Liberty to its parent as debt, or was the debt actually retired?

RESPONSE:

a. This portion of Mr. Bourassa's testimony refers to information he obtained from Mountain Water's supplemental response to PSC-009. From an accounting perspective, an equity infusion occurs when an affiliated or outside investor provides additional capital into a company in exchange for an equity interest. Outside investors, generally make equity infusions through cash. In the context of affiliated investors, the infusion can take the form of actual cash, or can occur through the shifting of debt or other capital through accounting entries to reflect the change in the affiliate's capital investment in the company. Generally, the investors making the equity investment or infusion receive an increase in their equity stake in the firm equal to the value of the capital infusion.

b. On page 4, lines 5-7 of this testimony, Mr. Bourassa states: "At the time of Acquisition, Liberty borrowed funds totaling $235 million and used $15 million of its own cash. I understand that, recently, Liberty paid this debt out of an equity infusion from its parent." In that testimony, Mr. Bourassa is referring to the fact that the Term Loan Agreement was short term financing for the Acquisition obtained on January 4, 2016. Subsequently, funds from the short term loan were used to complete the Acquisition on January 8, 2016. On March 9, 2016, an intermediate holding company parent of Liberty Utilities Co. assumed the Term Loan Agreement, in turn discharging Liberty Utilities Co. of that debt obligation. That debt obligation is reflected on the consolidated financial statements of APUC. That transaction was undertaken in an effort to maintain the debt/equity structures of its affiliates and maintaining its overall portfolio cash positions. In this instance, the assumption was done to maintain the capital structures of APUC's subsidiaries, including the 55/45 equity-to-debt ratio of Liberty Utilities Co. For ratemaking and accounting purposes, that transaction resulted in an equity infusion on the books of Liberty Utilities Co., having the same effect as if APUC had infused cash into Liberty Utilities Co. to retire the Term Loan Agreement. This response was provided by Bill Killeen.

c. See response to PSC-017(b) above.

PSC-018

Regarding: Equity, Debt
Witness: Bourassa

a. Please see page 5, lines 12-18. You argue that determining the cost of equity must be consistent with the Hope and Bluefield cases, which make clear that the relevant considerations in determining the cost of capital for a company are the alternatives available to investor and the risks and return available to those alternatives. Please explain how Liberty/Park Water uses the criteria propounded in the Hope and Bluefield cases when it decides whether to invest in Mountain Water's equity.

b. Please see page 5, lines 20-23. Please explain how Liberty/Park Water analyzes the risks of Mountain Water as compared to other investments before investing in the equity of Mountain Water.

RESPONSE:

a. Mr. Bourassa's testimony on page 5 is a generalized description of the standards applied to regulatory rate making based on the precedence set in *Hope* and *Bluefield.* Those cases are the universally accepted seminal recitation of the legal standard for setting a reasonable rate of return in the context of a regulated industry. As such, they set out the requirements for the Commission in setting just and reasonable rates, and not Liberty's decisions about whether or not to invest additional equity in Mountain Water. Mountain Water's obligations as a regulated utility do not leave Liberty entirely free to decide whether to invest or not. Instead, the level of equity capital in Mountain Water will be driven by the ongoing capital needs required to meet Mountain Water's obligation to serve and the Commission's expectation about an acceptable capital structure and allowed rates of return. Put simply, *Hope* and *Bluefield* describe how the Commission determines the value and allowable return on investment, and not whether or how a company decides to invest, because those decisions are based on utility needs and expectations, rather than market opportunities.

b. As a holding company owning exclusively regulated utility companies, Liberty analyzes its ongoing equity investments (including the accrual of retained earnings) largely based on regulatory obligations and regulator expectations. Investment at Mountain Water will be driven primarily by system and customer needs, and the Commission's expectations. That said, purely discretionary decisions regarding investment priorities will be driven by Liberty's expectations of achieving the most favorable returns on its investments, and risk of achieving expected returns.

PSC-019

Regarding: Double Leverage, debt risk
Witness: Bourassa

a. Please provide additional information regarding footnotes 6, 7 & 8. The information contained in the cite is not adequate to reference the information.

b. The Montana Supreme Court (*Mountain States Tel. & Tel. Co. v. Dep't of Pub. Serv. Regulation*, 191 Mont. 331, 624 P.2d 481 (1981)) in 1981 affirmed a District Court decision that concurred with the use of the double leverage concept by the Commission. Please comment why the Commission should not rely on that decision in deciding whether to consider the use of double leverage in deciding the overall cost of capital for Mountain Water.

c. Regarding page 13, lines 1-6, please provide any cites to state commission or court cases supporting the statement that "[s]ome proponents of DL attempt to address this by assigning a different equity cost rate to retained earnings." In addition, please provide a numerical example of how this concept is applied.

d. On page 13, line 11, please numerically define "significant."

e. Please see page 14, lines 13-22. Please explain how the statement "the cost of debt and equity depend on the return investors expect to receive on investments of comparable risk" applies in a case where the subsidiary does not have publicly traded stock and the only investor is the parent company. That is, does the parent actually perform an analysis of investments with comparable risk? If so, please provide any such analysis.

RESPONSE:

a. Footnotes 6, 7, & 8 all refer to pages of the 2006 version of Roger Morin's *New Regulatory Finance* book, the full cite for which is provided at Footnote 4.

b. As an initial matter, the assumptions underlying the application in that case do not exist in this case. For example, the MCC testimony in that matter indicated that AT&T and Mountain Bell had the same ROE. While it is impossible to tell from the information publicly available what assumptions that conclusion rested on, that testimony does not exist in this case. There is no evidence to suggest that Mountain Water has a similar risk profile to Liberty or APUC, so use of their WACC would be an inappropriate proxy for a just and reasonable return for Mountain Water.

Additionally, as indicated in Mr. Bourassa's testimony, double leveraging has fallen out of favor since that decision. The Supreme Court noted several regulatory decisions supporting application of double leverage in the *Mountain Bell* case. However, since that time most of those jurisdictions have abandoned double leveraging.

c. Mr. Bourassa does not have specific citations. Mr. Bourassa relied on Dr. Roger Morin's discussion in his book, New Regulatory Finance, at pages 525-526 which he provided a citation to on page 13. Treating retained earnings differently in a double leverage approach is also discussed in a presentation by Enrique Bacalao ("Double Leverage: A Seductively Dangerous Notion," 45th Financial Forum, Society of Utility and Regulatory Financial Analysts, April 18, 2013).

For a numerical example of how retained earnings would be treated differently, consider the following example computation of the WACC for a parent company and a wholly owned subsidiary as shown in Table 1.

Table 1

Subsidiary and Parent Company Cost of Capital

	% Weight	Cost	Weighted Cost
Subsidiary			
Debt	50%	6.00%	3.00%
Equity – Common Stock	25%	10.00%	2.50%
Equity – Retained Earnings	25%	10.00%	2.50%
Return			8.00%
Parent Company			
Debt	60%	6.00%	3.60%
Equity	40%	10.00%	4.00%
Return			7.60%

Under the double leverage approach, the subsidiary's WACC would be computed as set forth in Table 2.

Table 2

Subsidiary Cost of Capital: Double Leverage Approach

	% Weight	Cost	Weighted Cost
Debt - Subsidiary	50%	6.00%	3.00%
Equity – Common Stock Subsidiary	25%	7.60%	1.90%
Equity – Retained Earnings Subsidiary	25%	10.00%	2.50%
Return			7.40%

As shown, there are two different cost rates for equity; 7.6% (the WACC of the parent) for common stock and 10.0% for retained earnings. Both are considered common equity but there are two cost rates, which does not make sense.

d. Mr. Bourassa considers debt ratios above 40 percent for relatively small water utilities as significant. While the debt ratio of the large publicly traded water utilities are in the range about 42% to 52%, and on average about 46%[1], smaller water utilities

[1] *See* AUS Utility Reports dated April 2016 for AWR, WTR, CWT, CTWS, MSEX, and YORW)

have greater business risk which would imply that a lower debt ratio is more appropriate. In other words, smaller firms would find it prudent to offset higher business risks related to being small by reducing financial risk with a lower debt ratio.

e. Mr. Bourassa's statement universally applies no matter the type of ownership. The cost of capital is a function of the investment, not the investor. Stated another way, the opportunity cost of capital depends on its use to which that capital is put. *See* Pratt, Shannon P., Grabowski, Roger J. *Cost of Capital: Applications and Examples*, Fifth Edition. Hoboken, New Jersey, John Wiley and Sons, 2014, p. 5.

Yes, the parent company analyzes the risks of all potential investments. Expenditure budgets are prepared at the local utility level and submitted to Liberty. If funds are insufficient for all expenditures, there is a ranking process which involves assessing the individual project risks and returns, as Mr. Bourassa noted in his testimony. For larger project, additional information is provided, including the project rationale and economic analysis. Capital is then allocated pursuant to this analysis, which will, of course, include an analysis of allowed and expected rates of return. The second paragraph of this response to e. was provided by Bill Killeen.

PSC-020

Regarding: Hypothetical Capital Structure
Witness: Bourassa

a. Please see page 16, footnote 15. Please define "optimum." Is there a range of debt to equity ratios that is considered optimum, and if so what is that range?

b. Page 14, line 20. In a rate case, one method for grossing up for taxes the Commission determined increase or decrease in Net Operating Income (NOI) to the actual required increase or decrease in revenues is through the use of a Gross Up Factor/ Revenue Multiplier/Tax Factor (all of these have the same meaning in the context of this question.) The required change in NOI is then multiplied by the gross up factor. For example, if it is found that an increase in NOI of $10,000 is required to earn the overall allowed rate of return, this would be multiplied by the gross up factor, say 1.64, which would then yield a required increase in revenues of $16,400. Please explain the use of a pre-tax equity return for the gross up for taxes versus the use of a gross up factor in the estimated required revenue reductions. Do the two methods produce the same required revenue reduction? Please illustrate this by providing a numerical comparison.

RESPONSE:

a. Theoretically, an optimum capital structure is one in which the weighted average cost of capital is at its minimum. That is, the cost advantage of debt is exactly offset by the increase in the cost of equity. However, as Dr. Morin states

> Financial theory provides limited guidance on what a company's capital structure should be precisely... Capital structure decisions depend critically on each company's own situation and the level of business risk as well. The higher the business risk, the lower the debt ratio.

As a practical matter, the effect of the capital structure on total weighted cost of capital is likely to be minor over the range of capital structures usually found in the utility industry.[2]

Following Dr. Morin's statements, Mr. Bourassa believes that a debt ratio in the range of the large publicly traded water utilities (42% to 52%) serves as a starting point for the range appropriate debt ratio for relatively small water utilities. However, Mr. Bourassa believes that small water utilities have greater business risk than the large publicly traded water utilities, which would imply a lower debt ratio than indicated by the large publicly traded utilities.

b. The use of a pre-tax equity return assumes income taxes are not used in the determination of the test year operating income and operating income deficiency

[2] *See* Morin, p. 470

(required operating income less test year operating income) whereas use of an after-tax return assumes income taxes are included in the determination of the test year operating income and revenue deficiency. A gross-revenue conversion factor is used to account for the additional income taxes associated with the increase in revenues. Both approaches result in the same required increase in revenues to achieve the required after-tax operating income.

The Tables below reflect numerical examples using both approaches.

Table 1
Approach 1 - Using Pre-Tax Return

Rate Base	$	10,000,000
TY Operating Income Before Income Taxes	$	1,503,000
Required ROR pre-tax		16.37%
Required Operating Income Before Tax	$	1,636,600
Operating Income Deficiency Before Tax	$	133,600
Tax Rate		N/A
Gross Revenue Conversion Factor		N/A
Required Increase in Revenues	$	133,600

Table 2
Approach 2 - Using After-Tax Return

Rate Base	$	10,000,000
TY Operating Income After Income Taxes	$	900,000
Required ROR after-tax		9.80%
Required Operating Income After-Tax	$	980,000
Operating Income Deficiency	$	80,000
Tax Rate (assumed)		40.00%
Gross Revenue Conversion Factor		1.67
Required Increase in Revenues	$	133,600

PSC-021

Regarding: Cost of Capital, financial comparisons
Witness: Kappes

a. Page 3 of 6, line 23. Does Mountain Water issue common stock? If so, how many shares are outstanding and what is the price of each share? Are these shares publicly traded? If not, please explain the ownership of the shares and how the investment in those shares is financed.

b. Page 4, line 15. Please provide the most recent Park Water/Mountain Water capital structure.

c. Page 5, line 10. Please explain the statement that Mountain Water's current return on equity was calculated using a different equity percentage. Different from what?

d. Page 5, lines 18-26. When would the equity percentage of Park Water/Mountain Water's capital structure be expected to increase? Is this accomplished by an equity infusion from Park or Liberty or Algonquin?

e. Page 6, lines 5-8. Please explain the difference between Gross Revenues and net Revenues. Please provide a comparison between 2015 and 2011 of both gross and net revenues.

RESPONSE:

a. Yes. 50,000 shares, for a total book value of $6,940,578. These shares are not publicly traded. 100% of the shares are owned by Liberty Park Water, the same Company that owned the shares prior to the Liberty transaction. The investment is financed through Park Water's equity structure. The stock of Mountain Water is part of the collateral for Park Water's debt.

b. Mountain Water does not have debt so it is 100% equity. Park Water's equity to debt ratio was set on December 31, 2015 at 49.64% equity and 50.63% debt.

c. The rate of return in the current rates is based on Park Water's 2012 capital structure. Park Water's current capital structure is different, see b.

d. The equity percentage is expected to increase closer to its historical 55% equity, 45% debt over time. The timing will depend on the rate of capital expenditures. Currently we expect that to be accomplished through increases to retained earnings from Mountain Water's earnings which has been the case under Carlyle ownership and is required by the Commission's Order. However, Liberty has indicated it is open to

making additional investment if required to meet Mountain Water's ongoing capital needs.

e. Net revenues, as used in the testimony, are operating revenues after all operating expenses, depreciation, taxes and normalized income taxes have been deducted.

The testimony at Lines 5-8 compares our 2011 test year revenue requirement with our 2016 budget. The 2016 budget numbers for expenses and revenues would be different than an actual test-year 2015 rate application following the PSC Minimum Rate Case Filing, for such items as annualization of expenses and normalization of revenues, with average test-year customer counts.

Our current rates are based on the 2011 test year, with net revenues of $3,320,234 and gross revenues of $18,518,497. This compares to our 2016 budgeted net revenues of $3,074,431 and gross revenues of $18,531,328.

Comparison of actual 2011 with 2015 as specifically requested is difficult given the condemnation legal costs and their effect on income taxes. As a result, from the PSC annual report numbers, actual income taxes were excluded from the net revenues, and normalized income tax numbers were used instead.

For 2011, net revenues were $2,694,856 and gross revenues were $17,490,119. For 2015, net revenues were $4,198,533 and gross revenues were $19,092,815. The difference between the 2015 actual revenues and the 2016 budgeted revenues, is that the 2015 actual revenues exceeded normal revenues by approximately $500,000, due to a warmer-than-average irrigation season. By contrast, budgeted revenues, including 2016, are based on average-usage patterns. Property taxes increased by nearly $300,000, depreciation increased by $100,000, and other operating expenses increased by approximately $200,000.

CERTIFICATE OF SERVICE

I hereby certify that on April 27, 2016, the foregoing Responses to Data Requests PSC 011 through PSC 021 were served via electronic and U.S. mail on:

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