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

OPENING BRIEF OF THE MONTANA CONSUMER COUNSEL

The Commission issued its Notice of Investigation in this proceeding on February 3, 2016, for the purpose of determining whether the rates of Mountain Water Co. (Mountain) are just and reasonable following the acquisition of Western Water Holdings by Liberty Utilities. That acquisition was closed without the authorization of the Montana Public Service Commission (PSC or Commission) when Liberty paid $250 million for the Carlyle Group's equity interest plus the assumption of $77 million in Park Water debt.

Unfortunately, the Commission, the Montana Consumer Counsel (MCC) and the City of Missoula, together with Carlyle and Liberty Utilities (Liberty), had devoted hundreds of hours in the effort to determine whether Liberty would be a fit operator of the Mountain system and to assess how Missoula customers would be impacted by the transaction. Due to Liberty's decision to terminate the case and complete the transaction, that effort was all wasted. The question still lingers whether Liberty can be a fit operator. Given its incredibly complex corporate structure, its opaque financial statements, and its unfortunate propensity to avoid data requests, Liberty has done very little to persuade the Commission of its intention to do anything other than resist regulation which is conducted on a routine basis with other companies.

The present case tests the Commission's willingness to hold Liberty to a traditional cost-based model of regulation. Under Sec. 69-3-201, MCA, Mountain's rates must be "reasonable and just, and every unjust and unreasonable charge is prohibited and declared unlawful." As noted in the case of American Paper Institute, Inc. v. American Electric Power Service Corp., 461 U.S. 402, 414 (1983), the terms "just and reasonable" are "frequently associated with cost-of-service ratemaking." Further, under the traditional Commission cost of service approach that employs a rate base/rate of return model of ratemaking, recognition of an "acquisition adjustment" (the excess of purchase price over book value) is prohibited in virtually all cases ("the value may not exceed the original cost of the property"). Sec. 69-3-109, MCA.

Montana law does not permit the Commission to recognize an acquisition adjustment in rates, unless such an adjustment is determined to be in the public interest. Liberty apparently believes it can avoid that issue altogether by substituting extremely low cost debt for the equity capital and equity returns that are built into the existing rate structure. In this approach, the rate base does not change. Rates do not change. But, because the real capital costs have been drastically reduced, Liberty can justify to itself the vastly inflated value it has paid Carlyle for Western Water Holdings, consisting of Park Water Co. and including the Missoula Mountain Water system.

Under these circumstances, Mountain's customers are being unfairly treated, and Mountain's rates ceased to be just and reasonable on January 8, 2016, the date of the unauthorized closing of the sale. The question now is what this Commission will do to rectify this unfortunate situation.

This Opening Brief will summarize the testimony of Dr. John W. Wilson and will address the testimonies of the Mountain and Liberty witnesses. It will discuss the extensive control exercised over Mountain by Liberty and its parent, Algonquin Power & Utilities Corp. (APUC). That control extends to the capital structure of its subsidiaries, which can change daily, almost as if by the whim of those at the top of the corporate pyramid. Dr. Wilson advocates an approach that recognizes real costs in rates despite Liberty's continuing financial machinations.

The Commission should review the record, as well as its statutory powers and the precedents of the Montana Supreme Court concerning ratemaking, and order a rate reduction for Missoula customers that demonstrates this Commission's adherence to traditional ratemaking principles supporting regulation in Montana that is meaningful and effective. It is also important that the Commission put others on notice that this attempted recovery of a surreptitious acquisition premium will not go undetected nor be tolerated.

Finally, the Commission should remove the protected status of Liberty's financing documents as supplied in data requests MCC-001 and MCC-002 and order Liberty to make public the costs and terms of its acquisition financing. Liberty is now doing business as a regulated entity in a state in which transparency is highly valued. Public utility financing rates should not be hidden and secret, particularly when those costs are the very basis by which APUC/Liberty is attempting to recover the large premium over book cost that it opted to pay to Carlyle. An acquisition premium by any other name is still an acquisition premium.

I. Dr. Wilson's Recommendations

Dr. John Wilson, testifying on behalf of MCC, explained the background of the Mountain Water sale to Liberty/Algonquin. He referred to the substantial "cost reduction" achieved by Liberty made possible by the current extremely low interest rates available to corporate borrowers. These low rates allowed Liberty to finance at least $160 million of the $250 million acquisition cost (plus assumed debt of $77 million) at an initial rate (as reported to the SEC on March 16, 2016) of 4.13% (although Liberty reported in a response to a data request that this loan was replaced the next day with substantially cheaper debt, the exact interest rate on which remains secret). MCC-1, p. 8.

Dr. Wilson's term "cost reduction" refers to the substantially lower cost of financing the Mountain Water rate base with Liberty's new debt rates. Liberty opted to finance both that rate base and a huge acquisition adjustment, but the acquisition adjustment is irrelevant for ratemaking purposes. Compared to the costs embedded in Mountain's current rates, the reduction is very significant. Dr. Wilson estimated a savings for Missoula customers of $6.127 million per year, and suggested that amount could be flowed through to Missoula customers. Exhibit MCC-1, p. 23.[1]

One option Dr. Wilson recommends is elimination of Mountain's equity return and the accompanying income tax loading until such time as the Commission approves the Algonquin/Liberty acquisition. Exhibit MCC-1, p. 19. This approach would require the companies to either re-commit to completion of the acquisition/fitness proceeding, or to negotiate a resolution of the issues raised in that Docket.

[1] While the real debt rate, as compared to the 4.13% reported to the SEC, is currently treated as confidential by order of the PSC, Liberty's Director of Regulatory Operations, William Killeen, confirmed that the secret rate is close to 2%, "possibly even lower". Tran, p. 150. At 2%, the cost reduction is $7,211,089.

Dr. Wilson also discussed the possibility of “sharing” the cost reduction between Liberty and Missoula ratepayers, but did not favor that approach since it would effectively provide Liberty/Algonquin with a partial acquisition premium. MCC-1, p. 25.

As the Commission knows, Liberty argues that customers are indifferent to its financial maneuvers because their rates haven’t changed. But Mountain’s costs have changed dramatically, and failure to reflect that cost reduction in rates would be to tolerate a continuing overpayment to Mountain’s new owners. Moreover, accepting Liberty’s argument, and condoning such an approach, would encourage utilities to forego debt cost reductions in the hope that a future sale would allow potential savings to be captured in sale premiums. As discussed below, this Commission is fully within its powers to reflect that cost reduction in rates as a result of this proceeding and to encourage such behavior as a matter of sound public policy.

II. The Mountain/Liberty/Algonquin Position

Mountain and its new holding company owner (generally referred to as Liberty) strongly resist the notion that Mountain’s rates have become unreasonable because of the massive reduction of the cost of the debt that finances Mountain’s rate base. Mr. Bourassa addressed the acquisition premium paid at the Western Water Co. level as follows:

> “..the rate bases approved in Park Water and MWC most recent rate cases was about $161 million upon which an allowed return would be determined in a rate case. The difference between the adopted rate bases of $161 million and the $327 million purchase price is about $166 million.
>
> (emphasis added) Exhibit MWC-4, p. 17.

It’s worth pausing to think about what Mr. Bourassa emphasized in this statement. Liberty paid a premium of $166 million for the three water companies comprising Park Water. A reasonable person must wonder where the money will come from to support that very significant investment when rate base cannot exceed original cost less depreciation. Mr. Bourassa had an answer (of sorts).

> Liberty is a long-term investor; and over time, with the growth in earnings on its rate base, based on its rate base, it will over time earn its—they expect to earn their authorized return on their investment. Tran., p. 245.

In arguing that his client was an extraordinarily patient investor, Mr. Bourassa chose to ignore the substantial difference between Liberty’s borrowing cost and the cost in Mountain’s rates that indeed permits current recovery of, and a much quicker recovery at that, of the $166 million premium (if rates are not reduced to reflect costs). The replacement of Mountain’s equity with inexpensive

Liberty debt creates a rate vs. cost differential that does not require a great deal of patience in order to realize significant profits.[2]

Liberty apparently entered this transaction with the assumption that its rate vs. cost differential would go unquestioned. But the differences are simply too great to ignore. As Dr. Wilson emphasized, Liberty's investment in excess of original cost depreciated is "…purely a matter that they have to resolve without dipping into the consumer pocket." Tran., p. 69.

III. Legal Basis for MCC Recommendation

Two primary arguments support the MCC's contention that it is appropriate for the Commission to immediately reflect the reduction in Mountain's costs in rates, given that this change flows directly from a sale and transfer of the utility. The first has to do with the magnitude of the change in Mountain's capital costs. The second has to do with Montana legal precedent that it is appropriate to reflect holding company costs in an operating company's rates when the holding company's financing decisions have a substantial impact on the costs that the operating company seeks to recover from customers.

The first of these issues implicates "single-issue" ratemaking. Mr. Bourassa asserts that changing rates to reflect Mountain's new capital cost would be single

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[2] Mr. Bourassa also presented a confusing rebuttal exhibit (MWC-5) in an apparent effort to obfuscate the impact of Dr. Wilson's recommendation. In maintaining that Dr. Wilson had stated that Carlyle had been earning on $250 million of equity, Mr. Bourassa was simply incorrect and his calculations that flowed from that number are meaningless.

issue ratemaking. Exhibit MWC-4, pp. 2-3. Much of Mr. Kappes' testimony discusses Mountain's overall cost structure. He explains in Exhibit MWC-1 that, since its last rate case, Mountain's total debt has increased but its debt cost has been reduced (page 4); property taxes have increased (page 5); and rate base has increased (page 6). Mr. Kappes expects Mountain will file a rate case when the more pressing matter of the City of Missoula's condemnation case has been resolved. (page 3).

What these arguments ignore is that Mountain's new financing costs are a fraction of what they were just a few short years ago, and that these cost changes occurred in the context of a sale and transfer. MCC generally agrees, and has agreed consistently for years, that the best way to determine public utility rates is by looking at the full cost of service and capturing the investment, revenue and expense changes that have occurred since the prior rate proceeding. But this case is unique because it involves both the issue of transfer of ownership and acquisition-enabled savings of a very significant magnitude. These circumstances make a compelling case for an exception, and Montana law allows that exception. In Montana Consumer Counsel, Geoffrey L. Brazier v. Public Service Commission of Montana, 541 P. 2d 770 (1975), the PSC had approved a single issue rate increase for Montana Power Co. to reflect the increased cost of natural gas imported from Canada. The MCC appealed, arguing that the PSC lacked the authority to conduct a "mini hearing" and that Montana statutes required a "full scale hearing and examination of all revenue and expense accounts of the Company…" 541 P.2d, 773. The Court rejected that contention.

> Under such circumstances, the rate of return and annual net earnings were not germane to the Company's application, and a full scale hearing into the factors affecting the rate of return and general rate structure of the Company was beyond the scope of the inquiry before the Commission. The Commission was correct in refusing to expand the hearing into a full scale examination of factors affecting the general rate structure of the Company and the rate of return under the circumstances of the instant case. 541 P. 2d, 774.

Mountain Water can file a general rate case whenever it wants. Until it does, the PSC is fully within its powers to examine the very significant capital cost reduction that Liberty's purchase has produced, and which could have been examined in the transfer case but for the conduct of Liberty/Algonquin and Carlyle.

The second area of legal dispute involves Liberty's challenge to Dr. Wilson's recommendation that the holding company capital cost be considered in setting rates at the operating company level. In attempting to defend Liberty's right to retain the savings, Mr. Bourassa makes the unsurprising assertion that "it does not matter the source of funds Liberty or APUC may have used to acquire the equity of MWC…" Exhibit MWC-4, p. 16. As with the "single issue" ratemaking argument, the Montana Supreme Court has affirmed the PSC's right to look at the manner in which a holding company finances its operating company.

In Mountain States Telephone and Telegraph Co. v. Dept. of Public Service Regulation, 624 P.2d 481 (1981), the Court considered the utility's appeal of the District Court's approval of the PSC's use of a "double leverage" adjustment. The Court reviewed the PSC's examination of the way in which AT&T used debt at the holding company level as a means of reducing the cost of its equity at the operating company level. 624 P.2d, 483. The Supreme Court affirmed the PSC, finding that it "acted reasonably and within the bounds of the law." 624 P.2d, 486. The Court noted that "This capital structure was determined by the management of the two companies, not by the rate order of the PSC. *Id*.

Here, the acquisition of Western Water was accomplished by Liberty/Algonquin at the very low costs obtained by those companies that are available in today's financial markets, and Carlyle's equity capital was replaced by debt at a fraction of the cost established by this Commission in its 2013 rate order. To fail to reflect that debt cost in the rates of Mountain customers would result in Liberty recovering the acquisition premium it has steadfastly testified that it has no intent of seeking.

IV. Removal of Trade Secret Status of Data Request Responses to MCC-001 and MCC-002

At hearing, MCC made a motion under Sec. 38.2.5030 (1) (a), Admin. Rules Mont., to redetermine the trade secret status of two responses to data requests which included the terms of the debt instruments that Liberty used to secure funding for the Mountain transaction. Tran., p. 205. The Commission had approved that status in Order No. 7475c on April 7, 2016, as this matter was making its halting steps toward hearing.

The basis for Liberty's assertion of confidentiality is contained in Mr. Killeen's affidavit supporting the motion for protection of material responsive to these data requests that was filed on March 17, 2016. The essence of Liberty's justification for protection is that "both the Term Loan Agreement and the Note Purchase Agreement are governed by confidentiality provisions." Killeen Affidavit, para. 15, p.3.

MCC submits that the mere act of designating documents as confidential does not establish a basis for trade secret designation. Liberty/Algonquin may prefer confidentiality to public disclosure, but that preference is a business practice and is not sufficient to justify secrecy.

Further, Mr. Killeen argued at paragraph 17 of his Affidavit that:

> The Confidential Information derives independent economic value from its secrecy, and Liberty Utilities derives economic value from its secrecy. Liberty Utilities is able to acquire extensive access to capital on behalf of its subsidiaries based in part on its ability to maintain the confidentiality of its financial affairs.

Again, Mr. Killeen offers a bare conclusion in place of material demonstrating the validity of his assertion. The Commission has no basis to conclude that access to capital on the part of Liberty/Algonquin would be impaired if the protected status were removed.

V. Conclusion

Following months of consideration, the Commission is currently left with far more questions than answers about the Liberty/Algonquin structure and the acquisition of Mountain Water. It seems inevitable that future proceedings involving Liberty and Algonquin will be needed to resolve the numerous issues regarding the involvement of those companies in Mountain's affairs. Those issues are already apparent.

Mr. Kappes' testimony was reviewed and approved by Liberty's Vice President of strategy, Mr. Peter Eichler. Tran., p. 169. Mr. Killeen, Liberty's Director of Regulatory Operations, will sign off on Mountain's decisions involving the filing of rate cases. Tran., p. 113. Mountain's budget, which is at the heart of its operation and is fundamental to the quality of service that the company will provide its Missoula customers, will be submitted to Mr. Kappes' supervisor, Mr. Gerald Tremblay. Mr. Tremblay is Liberty's VP of operations.

For now, and pending resolution of the condemnation issue, the Commission should reflect the actual cost of the acquisition debt in Mountain's rates and enforce Montana law denying a public utility the recovery in rates of an acquisition premium.

Respectfully submitted this 16th day of May, 2016.

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