Service Date: June 22, 2016

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

IN THE MATTER OF the Investigation of the	)	REGULATORY DIVISION
Montana Public Service Commission into	)	
Whether Mountain Water Company's	)	DOCKET NO. D2016.2.15
Rates are Just and Reasonable	)	ORDER NO. 7475i

FINAL ORDER

FOR MOUNTAIN WATER:

Michael Green and D. Wiley Barker, Crowley Fleck PLLP, P.O. Box 797, Helena, MT 59624

FOR THE INTERVENORS:

Montana Consumer Counsel
Robert Nelson and Dennis Lopach, P.O. Box 201703, Helena, MT 59620

The Clark Fork Coalition
Barbara Hall, P.O. Box 7593, Missoula, MT 59801

The City of Missoula
Scott M. Stearns and Natasha Prinzing Jones, Boone Karlberg, P.C., P.O. Box 9199, Missoula, MT 59802

FOR THE COMMISSION:

Will Rosquist, Administrator, Regulatory Division
Scott Fabel, Dagan Lynch and Gary Duncan, Rate Analysts
Justin Kraske, Chief Legal Counsel
Laura Farkas and Jeremiah Langston, Staff Attorneys

BEFORE:

Bob Lake, Commissioner and Presiding Officer
Brad Johnson, Chairman
Travis Kavulla, Vice Chairman
Roger Koopman, Commissioner
Kirk Bushman, Commissioner

PROCEDURAL HISTORY

1. On December 15, 2014, Liberty Utilities Co. ("Liberty"), Liberty WWH, Inc., Western Water Holdings, LLC and Mountain Water Company ("Mountain Water"), collectively known as the Joint Applicants, filed an *Application for Approval of Sale and Transfer of Stock* with the Montana Public Service Commission ("Commission") under Docket D2014.12.99. Approval of this transaction would have allowed Liberty to become the sole owner of Western Water Holdings, which is the sole upstream owner of Park Water Company ("Park Water"). In turn, Park Water is the sole upstream owner of Mountain Water. The Montana Consumer Counsel (MCC), the City of Missoula ("City"), the Clark Fork Coalition (CFC), and the Employees of Mountain Water, were granted intervention in the docket.

2. Over a period of 8 months the Commission endeavored to resolve the discovery and procedural disputes between the parties. Unsatisfied with the Commission's decisions, the City sought judicial review in Montana district court. *See City of Missoula v. Mont. Dept. of Pub. Serv. Regulation*, DV-15-918, Pet. for Judicial Review (Mont. 4th Dist. Ct. Aug. 31, 2015). Despite the Commission's and Mountain Water's motions to dismiss the proceeding, the district court stayed the Commission's proceeding, allowing itself time to examine the merits of the interlocutory appeal. *See City of Missoula v. Mont. Dept. of Pub. Serv. Regulation*, DV-15-918, Minutes and Note of Ruling (Mont. 4th Dist. Ct. Dec. 18, 2015). On January 11, 2016, the Commission was informed through a *Notice of Closing and Withdrawal of Joint Application* that the Joint Applicants had closed on the sale of Park Water to Liberty WWH, which included Mountain Water and two California water utilities. This sale and transfer occurred without Commission approval, in apparent violation of the Commission's implied authority over sales and transfers.

3. On January 13, 2016, the Commission issued a *Notice of Opportunity to Comment* regarding the *Notice of Closing*. On January 27, 2016, the Commission received comments from the MCC, the City, Mountain Water, Liberty, and the CFC. The Commission held a work session on January 29, 2016 to discuss and act on Joint Applicants' *Notice of Closing* and the comments provided by the various parties. At that work session, the Commission voted to initiate a proceeding to inquire into whether Mountain Water's current rates for its Missoula, Montana customers are just and reasonable.

4. On February 3, 2016, the Commission issued a *Notice of Investigation and Intervention Deadline*. On February 10, 2016, the MCC, City, and CFC filed petitions to intervene. On February 19, 2016, Mountain Water filed a *Response to City of Missoula and Clark Fork Coalition Petitions to Intervene*. The Commission issued a *Notice of Staff Action* on February 22, 2016, allowing the parties to reply to Mountain Water's response brief. The City filed its *Reply to Mountain Water's Response to City of Missoula's Motion to Intervene* on February 29, 2016. On March 2, 2016, the Commission issued a *Notice of Staff Action Granting Intervention* to the MCC and on March 10, 2016, issued *Order 7475b*, limiting the City and CFC's intervention in this docket.

5. On February 8, 2016, the Commission issued an *Order to Show Cause* why the Commission should not immediately suspend Mountain Water's upstream dividend payments. *See* Order 7475 (Feb. 8, 2016). On February 22, 2016, Mountain Water filed its *Response to Montana PSC's Order to Show Cause*.

6. On March 8, 2016, the Commission issued *Procedural Order 7475a*. On March 25, 2016, the Commission issued a *Notice of Commission Action* rescheduling the hearing date. On April 6, 2016, Commission staff issued a *Notice of Staff Action* amending various deadlines in *Procedural Order 7475a*.

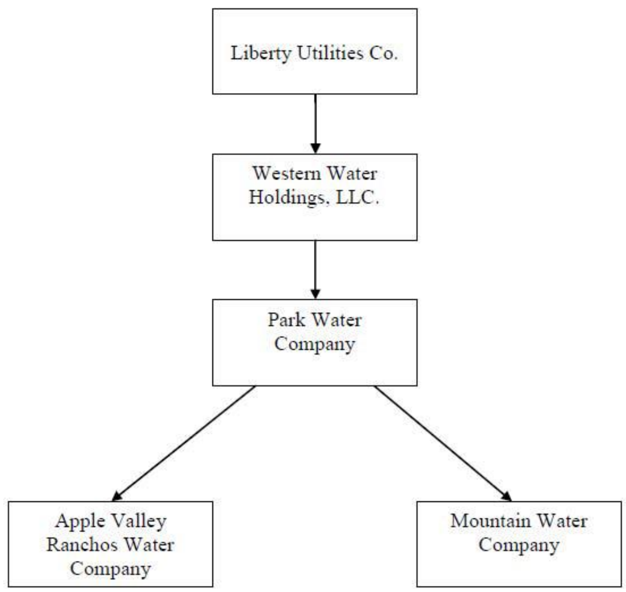
7. On April 13, 2016, the Commission issued a *Notice of Public Hearing*. On April 15, 2016, Mountain Water filed the *Direct Testimony of John Kappes and Thomas J. Bourassa*. On April 15, 2016 the MCC filed the *Direct Testimony and Exhibits of Dr. John W. Wilson*. On April 29, 2016, the MCC, City, Mountain Water, and CFC filed prehearing memoranda.

8. On May 3rd and 4th, 2016, the Commission held a hearing in Missoula, Montana. Following the hearing, on May 6, 2016, the Commission issued a *Notice of Staff Action* establishing the post hearing briefing schedule. On May 17, 2016, the Commission issued a *Notice of Staff Action* extending the post hearing briefing schedule and setting the deadline for the Commission's discussion regarding this matter for May 31, 2016. On May 31, 2016, the Commission held a regularly scheduled work session to take final action in this docket.

FINDINGS OF FACT

9. Liberty, the buyer of Mountain Water, has $1.8 billion in regulated assets. *Joint Appl. for Approval of a Sale and Transfer of Stock* p. 2, Dkt. D2014.12.99 (Dec. 15, 2014).

Liberty is now the upstream owner of Park Water, which, in turn, is the sole upstream owner of Mountain Water. The upstream owner of Liberty is Algonquin Power and Utilities Corporation ("Algonquin"). *See* Pasieka Test. p. 4, Dkt. D2014.12.99 (Mar. 12, 2015). David Pasieka's testimony from Docket D2014.12.99 provides the following chart illustrating the organizational structure under Liberty's ownership:



10. The seller, the Carlyle Group ("Carlyle"), is the former upstream owner of Western Water. The purchase price that Liberty paid for Park Water is $327 million. The purchase price includes financing from a $235 million term credit facility, with a 1.39 percent effective interest rate. Data Response (DR) PSC-009 (Feb. 24, 2016). The credit facility was issued on January 4, 2016, with an expiration date of July 4, 2017. *Id*. In addition, Liberty provided $15 million with cash on hand, and assumed $77 million in Park debt obligations. *Joint Appl.* at 2.

11. On February 3, 2016, the Commission issued *Order 7392q* in Docket D2014.12.99, finding that Mountain Water's current rates for its Missoula, Montana customers may no longer be just and reasonable because they do not reflect the firm's new capital structure and cost of capital. On February 3, 2016, the Commission issued a *Notice of Investigation and Intervention Deadline*, which reiterated the finding in *Order 7392q* and framed the issues of this docket. *See* Notice of Investigation and Intervention Deadline (Feb. 3, 2016).

12. As the language in the *Notice of Investigation* made clear, this docket is narrowly focused, and concerned primarily with Mountain Water's capital structure and the costs of equity and debt. *Id*. Under the terms of the *Notice of Investigation,* this docket required an examination of Mountain Water's capital structure, the cost of debt, and the allowed Return on Equity (ROE). The current Mountain Water approved revenue requirement and rates are based on a specific capital structure, allowed return on equity, and cost of debt, previously approved by this Commission. *See* Order 7251c, Dkt. D2012.7.81 (Nov. 21, 2013). This capital structure is reflected in the chart below:

1. Mountain Water As Approved D2012.7.81			
			Weighted
	Percentage	Cost	Cost
Total Debt	43.88%	8.39%	3.68%
Total Equity	56.12%	9.80%	5.50%
Total Capital	100.00%		9.18%

13. This approved capital structure is the capital structure of Mountain Water's parent company, Park Water. Park Water's capital structure has been imputed to Mountain Water. In response to a data request, Mountain Water stated that the Park capital structure at the closing on January 8, 2016, was 49.64 percent equity and 50.36 percent debt. DR PSC-007 (Feb. 17, 2016). However, no testimony or evidence presented in this docket argues that the approved capital structure should be modified. Therefore, the Commission will utilize the approved capital structure for its deliberations and required calculations in this docket.

14. In the above referenced docket, in consideration of extensive evidence and testimony, the Commission found that a 9.8 percent ROE provided the equity owners of Mountain Water the opportunity to earn a fair return on their investment. The Commission will utilize the approved 9.8 percent ROE for its deliberations and the required calculations in this Order. The 9.8 percent approved ROE is not investor specific. It is assumed that Mountain Water's equity is available to all potential investors at a 9.8 percent return. In fact, when establishing an appropriate ROE, the identity of individual investors, and the financing sources available to those individual investors, are not factors that are considered in the determination of a fair ROE. However, there has been testimony presented in this docket that does focus on an individual equity investor, specifically, current Mountain Water equity owner, Liberty. The MCC recommends that Liberty not be allowed to earn the 9.8 percent ROE, based on the low

cost debt utilized by Liberty for the purchase of Mountain Water. Test. John W. Wilson pp. 13-15 (Apr. 15, 2016). In fact, Dr. John Wilson, an expert witness for the MCC, suggests that Liberty is not entitled to any equity return. Test. Wilson at 18.

15. Mountain Water rejects the proposition that the allowed equity return for the purchaser of common equity of a regulated utility should be based on the source of financing used by the buyer, in this case, the low cost debt financing utilized by Liberty. Test. Thomas J. Bourassa p. 6 (April 15, 2016). The Commission agrees with Mountain Water regarding this matter. Basing the allowed ROE on the source of the equity owner's financing utilized to procure common equity does not comport to any rate making principle of which this Commission is aware. Use of such a methodology by this Commission would engender an unwarranted new and unique focus of investigation by the Commission when examining acquisitions and mergers.

16. The focus of this docket has been on the low cost debt financing utilized by Liberty in its acquisition of Mountain Water. The current rates for Mountain Water customers were approved in Docket D2012.7.81, using a 2011 test year, on November 21, 2013. The rates were based on an 8.39 percent embedded cost of debt imputed from Park Water to Mountain Water. This cost of debt reflected the blended effective interest rate on the outstanding debt of Park Water as of the end of 2011. Test. Leigh Jordan p. 5, Dkt. D2012.7.81 (July 27, 2012). Utility debt costs have continuously decreased since 2011[1]. The Commission finds that the current embedded 8.39 percent cost of debt, upon which Mountain Water's current rates are based, is a legitimate concern.

17. Dr. Wilson explained in his direct testimony that Algonquin financed $160 million of the purchase with 4.13 percent long-term debt. Test. Wilson at 8, fn 4. Subsequently, Mountain Water, in response to a data request, explained that ultimately the transaction was financed with a $235 million credit facility at an effective interest rate of 1.39 percent, rather than the $160 million 30-year debt. DR PSC-009a (Apr. 24, 2016). However, for purposes of his testimony, Dr. Wilson utilized the $160 million, 4.13 percent debt, rather than the $235 million, 1.39 percent debt.

[1] Economic Research, Federal Reserve Bank of St. Louis, Moody's Seasoned Baa Corporate Bond Yield, https://fred.stlouisfed.org/series/BAA (last visited June 16, 2016)

18. Although further references and quotations from Dr. Wilson's testimony utilized in this Order will reflect his use of the $160 million, 4.13 percent debt, the Commission will utilize the $235 million, 1.39 percent debt for its calculations, which is based on more precise information that was filed confidentially with the Commission. In addition, although Dr. Wilson also refers to the financing achieved by Algonquin for the transaction, the Commission in its deliberations views the financing to have been acquired by Liberty. The Commission will continue to consider Liberty as both the buyer of Mountain Water and the procurer of the $235 million, 1.39 percent financing. Regarding the cost of debt utilized in financing the transaction, Dr. Wilson states:

> In view of the financing by APUC to achieve the acquisition of Carlyle's Park Water equity, Mountain Water's current rates are no longer just and reasonable. This is because Algonquin/Liberty achieved a very substantial cost reduction as a result of its acquisition financing and there has been no water utility rate adjustment in Missoula to reflect this cost reduction. This is in contrast to the usual practice in public utility mergers and acquisitions of passing through acquisition-related cost savings to ratepayers, as is generally required and customary under just and reasonable public utility cost-of-service regulation and in accord with the Commission's review procedures to assure that public utility acquisition transactions are in the public interest and produce net benefits and no harms to consumers.

Test. Wilson at 7-8.

19. Dr. Wilson uses the term "cost savings" when referring to the difference between the acquisition debt costs incurred by Liberty versus the current allowed Mountain Water costs of equity and capital, approved by this Commission in Docket D2012.7.81. Dr. Wilson's focus is on the acquisition debt cost, versus the most recent approved ROE for Mountain Water, which is 9.8 percent post-tax, and 16.17 percent pre-tax. Dr. Wilson states as follows:

> APUC has reported that it financed at least $160 million of the $250 million acquisition cost of Carlyle's equity interest in Park Water with debt capital costing 4.13 percent annually for thirty years. Because Carlyle's equity capital currently reflected in Missoula's rates has a Commission authorized and ratepayer-funded cost of more than 16 percent (including income tax allowance), this acquisition-based financing achieved a very large finance cost reduction of approximately $20 million per year for APUC Generally, in utility mergers and acquisitions, any acquisition enabled cost savings are passed through to ratepayers as a necessary condition to gain regulatory approval for the acquisition.

Id.

20. Based on the above analysis, Dr. Wilson presents three possible Mountain Water rate reductions in his testimony. The first option entails implementing a zero percent ROE. Dr. Wilson asserts it is appropriate to conclude that Liberty is not entitled to receive any equity return on its unapproved acquisition and ownership of Mountain Water's equity, and that Mountain Water's rates for its Missoula, Montana customers should be reduced accordingly, resulting in an annual revenue requirement reduction of $3,282,055. *Id*. at 20.

21. The second option Dr. Wilson presents involves assigning a portion of the $20 million Algonquin finance savings to Mountain Water's customers. Dr. Wilson states that in the last rate case, Mountain Water accounted for 31.81 percent of Park Water's consolidated capital. Dr. Wilson then argues that based on the most recent test year, Mountain Water's customers could be assigned 31.81 percent of the $20 million annual finance cost savings, resulting in a savings for Mountain Water customers, and an annual rate reduction for Mountain Water, of $6,127 million. *Id*. at 23.

22. Finally, Dr. Wilson argues that the Commission could "share" acquisition cost savings between Mountain Water ratepayers and Liberty, by replacing the Mountain Water pre-tax 16.17 percent cost of equity from the last rate case with the 4.13 percent Algonquin acquisition cost. This would result in a $2,444,594 Mountain Water annual rate reduction. However, Dr. Wilson states he does not support this option because it would, in effect, award Liberty a partial acquisition adjustment. *Id*. at 25.

23. The Commission finds that Dr. Wilson's first option, which recommends a zero percent ROE, must be rejected because it is based on the proposition that the allowed ROE of a buyer of equity should be based on the source of financing utilized to acquire the equity. Such an approach does not conform to any generally accepted rate making principles. *Supra* ¶ 9.

24. Additionally, the Commission finds that Dr. Wilson's second option also must be rejected. In Docket D2012.7.81, the Commission approved an annual revenue requirement of $18.5 million. Order 7251c, p. 13, Dkt. D2012.7.81 (Nov. 21, 2015). Current rates derive from that prior approved revenue requirement. The $18.5 million revenue requirement consists of $14 million in revenue for operating expenses, depreciation, and taxes, $1.3 million in revenue for interest expense (debt coverage), and $3.2 million in revenue to provide for a 9.8 percent after-tax ROE for equity holders. *See* Attach. A. The $6.127 million rate reduction recommended by Dr. Wilson would mean that the equity holders would have a return of zero. Mountain Water

would be unable to make any interest payments to debt holders, and be unable to cover a portion of its operating expenses. Such a rate reduction would not be just and reasonable because it would not enable Mountain Water to recover legitimate costs of service.

25. Finally, the third option must also be rejected by the Commission. The $2.5 million annual revenue requirement described by Dr. Wilson would, by his own testimony, "…award Liberty/Algonquin with a partial acquisition premium" which Dr. Wilson does not support. Test. Wilson at 25. Given that Dr. Wilson himself does not support this course of action, the Commission rejects this option.

26. While the Commission rejects the revenue requirement reductions espoused by Dr. Wilson, the Commission agrees with Dr. Wilson that the financial benefits of the very low interest rate debt available to Liberty should also be made available to Mountain Water's customers through reduced rates. *Id*. at 7-9.

27. Mountain Water is owned by Park Water. Mountain Water does not issue debt of its own, and, therefore, its actual capital structure is comprised of one hundred percent equity. Under traditional rate of return regulation, a decrease in debt costs because of lower interest rates should be reflected in the overall approved weighted cost of capital for the utility. As discussed above, in order to develop a revenue requirement for Mountain Water, the Commission has in the past imputed the capital structure and embedded cost of debt of Mountain Water's direct parent, Park Water. *See* Test. Jordan at 6, Dkt. D2012.7.81 (July 27, 2012); Order 7251 p. 3, Dkt. D2012.7.81 (Nov. 21, 2013).

28. The following explains the relationship between Mountain Water and Park Water, as utilized by the Commission in *Final Order 7251c*.

> Park provides financial support to its subsidiaries as well as general administrative support in a number of areas… Although Park has outside long-term debt, its subsidiaries do not. Park serves as a common source of necessary debt capital for its subsidiaries, because of its size, it can acquire debt more easily and at more favorable rates than could any of its subsidiaries should they attempt to acquire debt individually. Since Park serves as a de facto borrower for its subsidiaries, and provides its subsidiaries a source of capital through inter-company transactions, there is, in effect, one common capitalization for Park and its subsidiaries. Therefore, the capital structure contained herein is based on a total Park Water consolidated capital structure, and reflects Park's outstanding long-term debt, common stock, and retained earnings.

Test. Jordan at 5-6, Dkt. D2012.7.81 (July 27, 2012).

29. As stated above, the Commission's past practice regarding Mountain Water's debt cost has been to impute the same from Mountain Water's direct parent, Park Water. However, because Mountain Water does not issue its own debt, the Commission believes it has wide latitude in imputing a cost of debt to Mountain Water for traditional revenue requirement rate making purposes. In response to data request PSC-007, Mountain Water stated that Park Water's average cost of debt at closing on January 8, 2016 was 6.039 percent, as opposed to the currently approved 8.39 percent. DR PSC-007c (Feb. 17, 2016). Mountain Water, in that same response, provided the following table showing Park's long-term debt obligations.

Park-Consolidated Total Debt at Close - January 8, 2016

Long-Term Debt

Holder of Obligation	Date of Issue	Date of Maturity	Principal Amt. Authorized	Outstanding Dec. 31, 2013	Rate	Make-Whole Provisions**
Nationwide Life	1995	2025	$ 10,000,000	$ 10,000,000	7.59%	T+50 b.p.
American United	2000	2020	$ 6,000,000	$4,285,716	8.82%	T+50 b.p.
State Life Insurance	2000	2020	$ 500,000	$357,142	8.82%	T+50 b.p.
Pioneer Life	2000	2020	$ 500,000	$357,142	8.82%	T+50 b.p.
Pacific Life	2006	2036	$ 15,000,000	$ 15,000,000	5.99%	T+50 b.p.
American United	2008	2033	$ 8,000,000	$ 8,000,000	7.56%	T+50 b.p.
State Life Insurance	2008	2033	$ 1,500,000	$ 1,500,000	7.56%	T+50 b.p.
Pioneer Mutual	2008	2033	$ 500,000	$ 500,000	7.56%	T+50 b.p.
Pacific Life	2008	2038	$ 7,000,000	$ 7,000,000	7.65%	T+50 b.p.
Pacific Life Annuity	2008	2038	$ 3,000,000	$ 3,000,000	7.65%	T+50 b.p.
American United	2013	2043	$ 5,500,000	$ 5,500,000	4.53%	T+50 b.p.
State Life Insurance	2013	2043	$ 1,000,000	$ 1,000,000	4.53%	T+50 b.p.
Pioneer Mutual	2013	2043	$ 1,000,000	$ 1,000,000	4.53%	T+50 b.p.
Pacific Life	2013	2043	$ 7,500,000	$ 7,500,000	4.53%	T+50 b.p.
Cobank *	2014	2019	$30,000,000	$22,500,000	Var	No
Totals			$97,000,000	$87,500,000		

Short-Term Debt
This consists of outstanding balances in credit lines

Bank of America - Credit Line	$1,650,000
Wells Fargo-Credit Line	$2,200,000
US Bank-Credit Line	$400,000
Total	$4,250,000
Total Debt	$91,750,000

* Only $22.5 million of the CoBank Note has been issued. The interest rate on this debt is variable at Libor + 80 basis points and there is a commitment fee of 0.25% per year on th eunused balance.

** T+50 b.p. indicates that the reinvestment rate in the formula for the make-whole provision is 50 basis points higher than the US Treasury rate for a maturity equivalent to the remaining weighted-average life to maturity of thebonds being redeemed.

30. There were four debt obligations issued by Park Water in the year 2013, with an interest rate of 4.53 percent. There was one issuance in the year 2014 for a variable interest rate obligation. There has not been any refinancing to take advantage of the lower cost of debt since

the year 2014. The table above reflects the Park Water debt obligations under the ownership of Carlyle.

31. The focus of this investigation has been the low cost debt financing utilized by Liberty to acquire Mountain Water. The Commission is very concerned that the current 8.39 percent cost of debt embedded in Mountain Water's current customer rates is higher than required and does not reflect today's debt market conditions. The Commission is also concerned that under Carlyle, there has been no refinancing of higher cost debt since the year 2014. The above table shows Park Water still has outstanding debt obligations from the year 2000 with interest rates approaching 9 percent. Evidence presented in this docket clearly shows that lower cost debt is available to Liberty Utilities and thus Park and Mountain Water. *Supra* ¶ 17; *Infra* ¶ 33. In Liberty's original direct testimony in Docket 2014.12.99, Liberty touted its financial strength and access to capital as follows:

> Q. Please describe what you view as the benefits to Mountain Water's customers of Liberty Utilities' acquisition.
>
> A. Liberty Utilities provides benefits in four key areas: (1) financial compatibility and strength…
>
> Q. Please describe what you mean by "financial compatibility" and "strength."
>
> A. Liberty Utilities couples the strength of ready access to capital markets with an established reputation as a strong utility owner and operator. As a result, Liberty Utilities has access to capital from investors whose expectations are consistent with the operations and investments of a long-term utility. This allows Liberty Utilities to adopt investment and return strategies that are more aligned with the needs of regulated utilities and expectations of utility regulators. Liberty Utilities typically invests more than it takes out in income and more than the depreciation charge. Liberty Utilities has a $200 million credit facility and it spent approximately $178 million in 2014 for capital expenditures with $46 million in depreciation. Our credit facility also gives us access to capital for emergencies or regulatory changes (such as the change in arsenic treatment standards, for example).
>
> Q. Please describe Liberty Utilities' access to capital.
>
> A. In the last four years, Liberty Utilities, its parent and associated affiliates raised over $1.9 billion in equity and debt. Liberty Utilities' parent has been around for 29 years, has been listed on the Toronto Stock Exchange for 18 years, and currently has a strong utility rating, including a BBB designation from Standard & Poor's. Liberty Utilities has a line of credit available to it of approximately $200 million. As of December 2014, only 13% of Liberty Utilities' credit facility had been drawn down.

Test. Pasieka at 10-11 Dkt. D2014.12.99 (Mar. 12, 2015).

32. Further evidence of the availability of lower cost debt financing to Liberty includes the original financing proposal of $160 million long-term debt, with a 4.13 percent interest rate, and the final acquisition financing utilizing a $235 million credit facility at an effective interest rate of 1.39 percent.

33. For purposes of this Order, the Commission finds that a 1.39 percent cost of debt should be utilized in calculating just and reasonable rates for Mountain Water customers. This results in an annual revenue requirement reduction of $1,111,484 million, or an approximately 6 percent reduction. *See* Attach. B.

34. The Commission finds that this reduction results in just and reasonable rates for Mountain Water's customers, as well as a fair and reasonable outcome for Mountain Water. First, Mountain Water customers will see an immediate reduction in their rates based upon Liberty's access to capital and significantly lower cost debt. Regarding Mountain Water, as explained in the above analysis of Dr. Wilson's second option, the current $18.5 million Mountain Water revenue requirement provides for $14 million in revenue to cover operating expenses and taxes and depreciation, as well as $1.3 million to provide for interest payments, and $3.2 million to provide a fair return on equity of 9.8 percent.

35. If the debt attributable to Mountain Water is refinanced at 1.39 percent, interest payments will be reduced to $0.2 million, and there will be no impact on the $3.2 million revenues generating the 9.8 percent ROE. If the debt is not refinanced, then the $3.2 million in revenues for the equity return will be reduced by the $1.1 million rate reduction to $2.1 million, thus reducing the achieved ROE from 9.8 percent to 6.5 percent. It is entirely up to Liberty whether to refinance the Park Water debt attributable to Mountain Water. Accordingly, the opportunity to continue to achieve the allowed 9.8 percent ROE continues to be available to Liberty, if it so chooses.

36. Finally, the Commission is aware that the 1.39 percent interest rate associated with the $235 million credit facility may not be available to Liberty or Park Water when refinancing, due to the short term nature of the 1.39 percent rate, and potential buy out provisions and penalties associated with refinancing. However, the 1.39 percent interest rate is what was provided to the Commission, and is therefore reflected in the available record in this docket.

Mountain Water is free to file a rate case proceeding with this Commission and present evidence regarding what it believes to be an appropriate cost of debt.

37. Regarding rate design, the following exchange took place at the hearing on May 3, 2016, between Commission Staff Attorney Laura Farkas and Dr. Wilson. Hr'g Tr. 59 (May 3, 2016).

> Q. I would like to draw your attention to PSC-029, your Data Response.
> A. Okay, have I that.
> Q. PSC-029.
> A. Yes.
> Q. And in that Data Request you state that you are recommending a bill credit to pass-through the acquisition-enabled cost savings; is that correct?
> A. Yes.
> Q. Is it your position that such a decrease should show up on a customer's bill as a separate line item credit or would you recommend a temporary reduction in rates or something else?
> A. It could be done either way. I think maybe the easiest way to do it is as a line item credit, but I don't feel strongly about how that's done.
> Q. Okay, thank you. And do you have an opinion about how you would apportion rate reductions, including bill credits, between customer rate classes?
> A. I would do it in proportion to revenues.

38. The Commission finds that the $1,111,484 rate reduction should be allocated between Mountain Water’s Metered Rate, Flat Rate, Public Fire Protection, and Private Fire Protection rate classifications based on the percentage of revenues for each rate class as compared to total revenues. The same percentage reduction should apply to each Service Charge and Water Usage rate element within the four rate classes.

CONCLUSIONS OF LAW

39. State law vests the Commission with “full power of supervision, regulation, and control of public utilities.” Mont. Code Ann. § 69-3-102 (2015). Mountain Water is a public utility within the meaning of Mont. Code Ann. § 69-3-101.

40. The Commission has the power to “regulate the mode and manner of all investigations and hearings of public utilities and other parties before it.” *Id*. § 69-3-103(2)(c).

41. Rates must be “reasonable and just, and every unjust and unreasonable charge is prohibited and declared unlawful.” *Id*. § 69-3-201.

42. The Commission may, at any time, "upon its own motion, investigate any of the rates, tolls, charges, rules, practices, and services" of a utility. *Id*. § 69-3-324.

43. The Commission may, "after a full hearing… make by order such changes as may be just and reasonable, the same as if a formal complaint had been made." *Id.*

44. "If, upon such hearing and due investigation, the rates, tolls, charges, schedules, or joint rates are found to be unjust, [or] unreasonable… the commission may fix and order substituted therefor such rates, tolls, charges, or schedules as are just and reasonable." *Id*. § 69-3-330.

45. "What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n.*, 262 U.S. 679, 692 (1923).

46. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. *Id.* at 692-693.`

47. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally. *Id.* at 693.

ORDER

Based upon the foregoing,

IT IS HEREBY ORDERED AS FOLLOWS:

48. Mountain Water's revenue requirement is hereby reduced by $1,111,484 to reflect the imputation of the 1.39 percent interest rate of Liberty's $235 million term credit facility in the calculation of the overall cost of capital of Mountain Water;

49. Mountain Water will implement rates consistent with this Order effective the service date of this Order;

50. Mountain Water must submit tariffs in compliance with this Order within 20 days of the Service Date of this Order.

DONE AND DATED this 31st day of May 2016 by a vote of 4 to 1. Commissioner Bushman dissenting.

ATTACHMENT A

MWC Sources of Revenue Requirement
RR Formula - Total Rev. = E + T + D +(r * RB)

Mountain Water As Approved D2012.7.81

	Percentage	Cost	Weighted Cost
Total Debt	43.88%	8.39%	3.68%
Total Equity	56.12%	9.80%	5.50%
Total Capital	100.00%		9.18%

Revenue Requirement	$18,604	Revenue Requiremnt Coverage	
Op. Expenses	$10,164	Expenses	$10,080
Depreciation	$2,389	Depreciation	$2,389
Taxes	$2,730	Taxes	$1,472
NOI	$3,321	Total E+T+D	$13,941
Rate Base	$36,172	Debt Coverage	$1,331
Return on RB	9.18%	Equity Return	$3,249
			$32,462

Rate Base Required Return Revenue Requirement

	Required NOI	Revenue Requirement
Rate Base	$36,185	
Debt NOI	$1,331	$1,331
Equity NOI	$1,990	$3,249
Total	$3,321	$4,580

ATTACHMENT B

D2016.2.15 -Mountain Water Company Rate Reduction

(Calculates Revenue Requirement for the cost of debt and equity return)

Mountain Water Overall Return as Approved 2012.7.81

	Percentage	Cost	Weighted Cost
Total Debt	43.88%	8.39%	3.68%
Total Equity	56.12%	9.80%	5.50%
Total Capital	100.00%		**9.18%**

	Rate Base	Percentage	Cost	NOI Required	Gross Up	Revenue Required
Debt	$15,878,343	43.88%	8.39%	$1,332,193	NA	$1,332,193
Equity	$20,307,488	56.12%	9.80%	$1,990,134	1.6498	$3,283,323
Total	$36,185,831	100.00%		$3,322,327		$4,615,516

Approved Updated to Reflect 1.39% Cost of Debt.
MWC Response to MCC-01 and MCC-02

	Dollars	Percentage	Cost	Weighted Cost
Total Debt	17,081,761	43.88%	1.39%	0.61%
Total Equity	21,842,823	56.12%	9.80%	5.50%
Total Capital	38,924,584	100.00%		**6.11%**

	Rate Base	Percentage	Cost	NOI Required	Gross Up	Revenue Required
Debt	$15,878,343	43.88%	1.39%	$220,709	NA	$220,709
Equity	$20,307,488	56.12%	9.80%	$1,990,134	1.6498	$3,283,323
Total	$36,185,831	100.00%		$2,210,843		$3,504,032

Decrease in Mountain Water Revenue Requirement **($1,111,484)**

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

BRAD JOHNSON, Chairman

TRAVIS KAVULLA, Vice Chairman

KIRK BUSHMAN, Commissioner (dissenting)

ROGER KOOPMAN, Commissioner

BOB LAKE, Commissioner

ATTEST:

Aleisha Solem
Commission Secretary

(SEAL)

Service Date: June 22, 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 ORDER NO. 7475i

CONCURRING & DISSENTING OPINION OF COMMISSIONER TRAVIS KAVULLA

Liberty Utilities Company (Liberty) has paid a substantial acquisition premium for Park Water, which includes Mountain Water Company. That premium equals more than all of Park's rate base combined.[2] Typically, one would expect that the acquired company's return would not itself be sufficient to make up for the cost of financing the acquisition premium in the first years after such an acquisition. Instead, a buyer would expect commodity sales growth and incremental capital investment to grow a regulated utility's earnings over time in order to make up the premium. In this transaction, however, the 2.87 percent weighted average cost of capital (WACC) at the acquisition level is so low relative to the 9.1 percent WACC used for ratemaking purposes that, notwithstanding the large acquisition premium, there is a substantial savings between the profit that Park would be poised to make and how much it is actually costing Liberty to own Park.

The cost of financing the acquisition is the product of the $327 million sale price, including the assumption of $77 million of Park debt, multiplied by the WACC of the instruments that financed the transaction. The acquisition WACC is comprised of a $235 million Term Loan Agreement at a 1.39 percent effective interest rate; $77 million in Park debt made up of several issues, with an average rate of 6.039%; and $15 million in cash that Liberty used to finance the transaction. Liberty is entirely made up of regulated utility subsidiaries, and it is reasonable to use 9.8 percent, which is Mountain's authorized annual return on equity, as an

[2] The $327 million acquisition price, less $161 million in rate base, equals a $166 million acquisition premium.

appropriate measure for the cost of this equity. This results in a total acquisition WACC of 2.87 percent.

Weighted Cost of Purchase Price ($327 Million)
Cred. Fac. 1.39%, Assumed Debt 6.039%, Equity 9.8%

Cap Structure	Percentage	Purchase Price (Millions)	Cost	Weighted Cost
Credit Facility - Debt	71.87%	$235	1.390%	0.999%
Outstanding Park Debt	23.55%	$77	6.039%	1.422%
Liberty Cash - Equity	4.59%	$15	9.800%	0.450%
Total Purchase Price		$327		2.870%

If one applies this to the overall purchase price, the required return to cover the capital cost is about $9,387,000. Assuming that the small portion which is equity investment will be subject to income taxation at the U.S. corporate tax rate, this would add another approximately $1 million in return.

Purchase Price Revenue Requirement Using 2.87% WACC						
Cap Structure	Percentage	Purchase Price Price (Thousands)	Cost	Required NOI (Thousands)	Gross Up	Revenue Requirement (Millions)
Credit Facilty - Debt	71.87%	$235,000	1.390%	$3,267	NA	$3,267
Outstanding Park Debt	23.55%	$77,000	6.039%	$4,650	NA	$4,650
Liberty Cash - Equity	4.59%	$15,000	9.800%	$1,470	1.6498	$2,425
Total Purchase Price		$327,000	2.870%	$9,387		$10,342

Meanwhile, Park has rate base of $161 million, which is the measure of direct capital investment, less depreciation, upon which regulated utilities are conventionally allowed to earn a return. The WACCs approved by the California and Montana commissions, meanwhile, are 9.07% and 9.19%, respectively. Ex. MWC-1, p. 17. When applied against the amount of rate base allocable to each jurisdiction, this produces an authorized return of about $14,645,000. The portion of this return attributable to the 56.8 percent of the rate base that was funded by equity investment, and not debt, is additionally subject to income taxation, which adds another approximately $6 million to the annual revenue requirement factored into consumer rates.

Park Water Rate Base ($161 million Bourassa Transcript Page 219)						
				NOI	Rev. Req.	Revenue
Total Park	Rate Base	Percentage	Cost	Required	Gross Up	Requirement
Debt	$69,548	43.20%	8.18%	$5,690	NA	$5,690
Equity	$91,452	56.80%	9.79%	$8,955	1.6498	$14,774
Total	$161,000	100.00%		$14,645		$20,464
Weighted CC	$0		9.10%			

The bottom line of this analysis is that it costs Liberty roughly $10 million less to own the Park assets by dint of their financing than Park's assets command in regulated revenue for the purpose of paying for the owner's "cost of capital." Effectively, the acquirer has used extreme low-cost debt to acquire downstream equity, and expects that the additional rents obtained through regulation should compensate the acquirer regardless of its actual costs.

Mountain counsels that it is conceptually inappropriate to assign a parent's cost of capital to a subsidiary. "For example, assume an investor inherited the stock of utility company [sic] or received the stock as a gift. If we accept the argument that how the investor acquired the stock determines the allowed rate of return, the allowed return on equity would be zero since the investor got the stock for free." Ex. MWC-1, p. 6. This argumentation is irrelevant. Here, the debate really is about the effects of the cost of debt, not equity. Arguments that an upstream parent's cost of debt should not be considered in ratemaking for a subsidiary are unpersuasive, especially because Mountain has never opposed the practice of taking Park's cost of debt and imputing it to Mountain, which issues no debt and is 100 percent equity, for the purpose of creating rates. *Supra* ¶¶ 10, 21-24.

Similarly, Liberty, Park's new parent, generally does not permit operating companies like Mountain and Park to hold their own debt. DR PSC-016 (April 27, 2016) All of it is held at the parent company level, and Park's own long-term debt will be retired or replaced over time. Regulators in other jurisdictions use the cost of Park-issued debt in order to set rates for its subsidiary operating companies, apparently without objection from Liberty or those operating companies. DR PSC-007d (Feb. 17, 2016). In light of this, for ratemaking purposes, Liberty has through its acquisition taken the place of Park as the appropriate entity to use in order to measure the cost of debt.

Where I differ with the Order is in regard to the fact that it simply takes the cost of Liberty's debt and imagines that Mountain's debt cost is now that debt cost. This is conceptually inappropriate and a drastic oversimplification of what has happened in the financing of this acquisition. It is undisputed that Liberty did acquire, and will have to pay for, $77 million in outstanding debt from Park, and the assumption that upstream debt would simply displace downstream debt at the upstream borrowing rate ignores the make-whole penalties that are standard in long-term utility debt issues. Hr'g Tr. 190:16-194:9 (May 3, 2016).

The central problem of this docket is that Liberty is making through an artificially inflated regulated return much more than is actually necessary to pay for the financing and ownership of the water utility in question. An adjustment needs to recognize not only the lower cost of debt of the Term Agreement and the pre-existing $77 million in Park debt, but also the sheer amount of leverage--$312 million of a $327 million purchase price—which is at the heart of this transaction.[3] To do so is simple. One needs only take the current regulated returns of Park, deduct from them Liberty's cost of owning those assets, and then distribute the savings pro rata to Mountain as a proportion of Park.[4]

Net Operating Income and Revenue Requirement Impacts

	Park	Pur. Price	Difference	MWC Percentage	MWC
NOI Requirement	$14,645	$9,387	($5,259)	22.48%	($1,182)
Rev. Requirement	$20,464	$10,342	($10,123)	22.48%	($2,276)

In sum, the reduction in rates for Mountain should amount to an annualized figure of about $2,276,000, or double what the Order requires. Only this calculation would ensure that any acquisition-related financial savings are preserved for customers, which is particularly important in this context, where Liberty has not gone through any Commission process to determine that their ownership will provide net benefits, or even the same standard of service, that Mountain customers existed under the previous ownership. As such, at least in this circumstance and until

[3] Mountain now contends that the $235 million Term Loan Agreement is now equity on the books of Liberty, because Algonquin or one of the many intermediary corporate vehicles above Liberty has assumed it, and thus "invested" that amount of equity into Liberty, even though the underlying instrument is still the same Term Loan Agreement at a 1.39 percent interest rate. *Tr.* at 136:11-139:21. This argument, if taken seriously, would allow endless gaming; and it is the same argument the Commission rejects each time it refuses to set rates based on a 100 percent equity ratio for Mountain, even though that is what is recorded on that company's books.

[4] The 22.48 percent Mountain allocator and the information on Park's rate base originate in the *Joint Appl. of Park Water Company (U314W) and Apple Valley Ranchos Water Company (U346W) for Authority to Establish an Authorized Cost of Capital for 2013-2015, Appl. 12-05-001* (Cal. Pub. Util. Comm'n May 30, 2013).

a full general rate case can be entertained, it is appropriate to allocate those benefits to Mountain's consumers.

Therefore, I respectfully CONCUR IN PART AND DISSENT IN PART with the Order.

Travis Kavulla, Vice Chairman