

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. 7475j

**ORDER ON RECONSIDERATION**

**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 3<sup>rd</sup> and 4<sup>th</sup>, 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.

9. On June 22, 2016, the Commission issued *Final Order No. 7475i* reducing Mountain Water's revenue requirement 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. The Commission also ordered that Mountain Water implement rates consistent with its order and submit tariffs in compliance with the order within 20 days of the service date.

10. On July 5, 2016, the MCC filed a *Motion to Reconsider Order No. 7475i with Integrated Brief* ("Motion"). On July 26, 2016, the Commission held a regularly scheduled work session to discuss and act on the MCC's Motion.

#### Analysis of MCC's Motion

11. The MCC in its Motion argues that the Commission erred with Finding of Fact Nos. 14, 15 and 23. The MCC does not actually make any suggested changes to Finding of Fact No. 14 in its Motion. The argument appears to be presented simply to assert that the Commission erred in its analysis in that particular finding. Since the MCC did not request any change and the Commission does not find a modification necessary, Finding of Fact 14 will remain the same.

12. The MCC next argues that Finding of Fact Nos. 15 and 23 should be stricken or modified. The MCC argues that Finding of Fact No. 15 is of particular concern in that it fails to recognize a principle of Montana law that may be important in future ratemaking decisions. In particular the MCC focuses on the underlined section of Finding 15 below:

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.

13. The MCC argues that the approach described in this Finding, known as double leverage, is neither new nor unique and was determined to be a warranted focus of the Commission by the Montana Supreme Court. In the case of *Mtn. States Telephone & Telegraph Co. v. Dept. of Pub. Serv. Reg.*, the Montana Supreme Court reviewed a Commission rate determination in which the capital structure of a Montana public utility, Mountain Bell, was financed in part by the debt-funded investment of a parent company.

14. Most utilities are financed by a mix of debt and equity. The Montana Supreme Court identified this reality as “leverage # 1”. *Mtn. States Telephone & Telegraph Co. v. Dept. of Pub. Serv. Reg.*, 624 P. 2d 481, 483 (1981). The Court then discussed a second level of leverage, the debt financing used by AT&T to partly finance its equity investment in Mountain Bell. The Commission held that the return on equity should be reduced to take account of the reduced cost of equity to Mountain Bell’s shareholder that resulted from that debt financing, “the second or ‘double leverage.’” *Id.*

15. In summarizing the arguments against the Commission’s adjustment, the Montana Supreme Court noted that “Mountain Bell argues that the principle on which the ‘double leverage’ adjustment is based is that the source of funds determines its costs...” *Id.* at 485. The Court rejected that objection and approved the Commission’s double leverage adjustment, stating that, “[i]t would appear that the PSC applied the “double leverage” adjustment in order to protect Montana ratepayers from paying excessive utility rates.” *Id.* at 486.

16. The import of the Mountain States decision, which has not been reversed by the Montana Supreme Court, is that the source of funding of a Montana public utility’s equity investment is a valid ratemaking consideration by the Commission. Finding of Fact No. 14 is inaccurate when it states that “Basing 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.”

17. While Mountain Water Co.’s witness argued that double leverage has largely disappeared from modern regulation (Exhibit No. MWC-4, p. 8), it seems more likely that the actual practice of financing operating companies with debt incurred at the holding company level

has itself gone out of vogue because of regulatory resistance to and treatment of this financing practice. One of the more influential texts on public utility ratemaking also acknowledges the regulatory precedents for considering sources of financing and recognizes the rationale in the Mountain States decision. The latest version of Professor Bonbright's text discusses this issue as follows:

Double leverage advocates are quick to point out that the parent really is not just another investor...It is a fact that the parent is the only possible investor (in a practical sense), and the subsidiary's only source of external equity financing. The subsidiary cannot go to the equity market with a stock issue to raise equity capital...Bonbright, Danielsen and Kamerschen, *Principles of Public Utility Rates*, 2nd, Arlington VA: Public Utilities Reports, Inc. (1988), p. 310.

18. The MCC argues that Finding of Fact No. 15, therefore, inaccurately portrays regulatory precedent and is inconsistent with governing Montana law.

#### **FINDINGS OF FACT**

19. The Supreme Court decision referenced by the MCC states as follows: "The evidence presented by the PSC established to the satisfaction of the district judge that the "double leverage" adjustment was based on substantial evidence. The District Court found that the double leverage adjustment simply established the true cost of that portion of Mountain Bell's equity (common stock) attributable to AT&T financing (88.55%). The PSC established 9.80% as the true cost by weighing the three associated costs making up AT&T's capital structure—debt, preferred stock and common stock." *Mtn. States Telephone & Telegraph Co. v. Dept. of Pub. Serv. Reg.*, 624 P. 2d 481. The following table is from the Supreme Court Decision.

<b>Mountain Bell Weighted Cost of Capital (WCC)</b>			
			Weighted
<u>Type of Capital</u>	<u>Percent</u>	<u>Cost</u>	<u>Cost</u>
Debt	44.65%	7.26%	3.24%
Common Stock	55.35%	11.25%	6.23%
	100.00%		9.47%
<b>AT&amp;T Weighted Cost of Capital (WCC)</b>			
			Weighted
<u>Type of Capital</u>	<u>Percent</u>	<u>Cost</u>	<u>Cost</u>
Debt	23.10%	6.47%	1.49%
Preferred Stock	8.00%	7.82%	0.63%
Common Stock	68.80%	11.25%	7.74%
	99.90%		9.86%
<b>Mountain Bell WWC Using AT&amp;T WCC for the Cost of the Equity Owned by AT&amp;T (Mountain Bell WWC using "double leverage")</b>			
			Weighted
<u>Type of Capital</u>	<u>Percent</u>	<u>Cost</u>	<u>Cost</u>
Debt	44.65%	7.26%	3.24%
*Equity Supplied by AT&T (88.55% X 55.35)	49.01%	9.86%	4.83%
Equity Supplied by Minority Stockholders	6.34%	11.25%	0.71%
	100.00%		8.79%
* AT&T Owned 88.35% of the common stock of Mountain Bell			

20. In its decision the Supreme Court upheld a District Court decision supporting the use of “double leverage” by the Commission in establishing the cost of equity for Mountain Bell. In that decision, the Commission used the overall weighted cost of capital (weighted cost of debt plus the weighted cost of preferred and common equity) from AT&T (Mountain bell’s parent) as the cost of equity for Mountain Bell. (See above where the AT&T WCC of 9.86% was used as the cost of AT&T Equity for Mountain Bell.).

21. The methodology used by the MCC in this docket was not the double leverage methodology approved by the Supreme Court. Dr. Wilson stated in his testimony 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.

Test. Dr. John W. Wilson 8-9 (April 15, 2016).

22. Dr. Wilson utilized the \$20 million “cost savings” in his Option 2 preferred rate reduction of \$6.127 million for Mountain Water. Thus, Dr. Wilson used the 4.13% interest rate of one particular financing instrument as the cost of equity for Park Water. Dr. Wilson did not

utilize the “double leverage” methodology upheld in the Supreme Court Order of utilizing the overall weighted cost of capital as the equity cost for Park.

23. One of the primary issues with the MCC testimony raised by the Commission in Order No.7475i was the substitution of the interest rate associated with one particular financing instrument for the cost of equity of Mountain Water. The order does not reference “double leverage” because the MCC did not recommend the use of “double leverage” as upheld by the Montana Supreme Court. However, the Commission does recognize that that Supreme Court decision is precedential regarding imputing the cost of a subsidiaries equity from the weighted cost of capital of the parent. The following statement is from Finding 15:

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.

The statement was intended to assert that the use of the interest rate associated with one debt instrument Liberty as the cost of equity of Mountain Water did not comport to any ratemaking principle of which the Commission is aware. However, the Commission would agree that the statement, taken on a stand-alone basis, may be too broad.

### CONCLUSIONS OF LAW

24. 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.

25. 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).

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

27. 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.

28. 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.*

29. “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.

30. “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).

31. “Within ten days after an order or decision has been made by the commission, any party may apply for reconsideration in respect to any matter determined therein... If, after such motion for reconsideration is filed, the commission is of the opinion that the original order or decision is in any respect unjust or unwarranted, or should be changed, the commission may abrogate, change or modify the same. Mont. Admin. R. 38.2.4806 (2016).

## ORDER

Based upon the foregoing,

IT IS HEREBY ORDERED AS FOLLOWS:

32. Finding of Fact No. 15 is modified as follows:

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 equity return of the purchaser on the interest rate associated with one debt instrument of that equity owner 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.

33. Finding of Fact No. 23 is modified as follows:

The Commission finds that Dr. Wilson’s first option, which recommends that Mountain Water’s rates for consumers in Missoula be reduced by eliminating the equity return component of rate base, must be rejected. Dr. Wilson assigns the MWC weighted cost of capital from the last rate case of 3.68% to the entire rate base effectively treating the total rate base as debt with no equity component. Such an approach does not comport to any rate making principles of which the Commission is aware.

DONE AND DATED this 26<sup>th</sup> day of July 2016 by a vote of 3 to 2. Commissioners Lake and Bushman dissenting.

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 (dissenting)

ATTEST:

  
Aleisha Solem  
Commission Secretary

(SEAL)

