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						
		Purchase				
		Price		Required		Revenue
		Price		NOI		Requirement
Cap Structure	Percentage	(Thousands)	Cost	(Thousands)	Gross Up	(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)

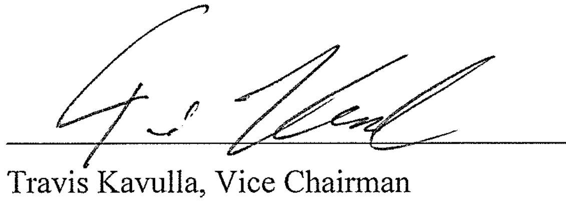
In sum, the reduction in rates for Mountain should amount to an annualized figure of about $2,276,000, or double what the Order requires. Only this calculation would ensure that any acquisition-related financial savings are preserved for customers, which is particularly important in this context, where 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