Service Date: November 14, 2013

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

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IN THE MATTER OF the Application of Mountain Water Company for Authority to Increase Rates and Charges for Water Service to its Missoula, Montana, Customers	))))	REGULATORY DIVISION DOCKET NO. D2012.7.81 ORDER NO. 7251c

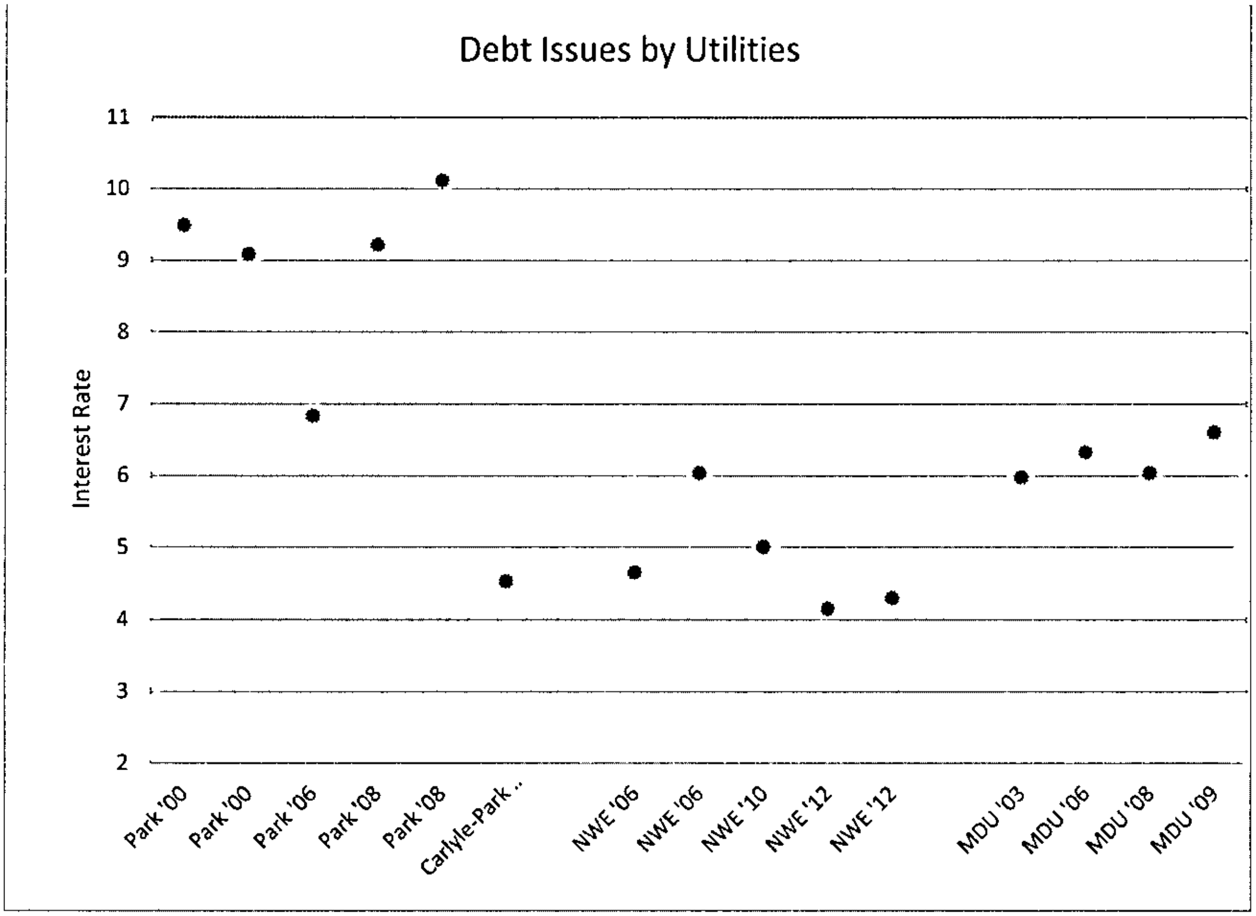
DISSENTING OPINION OF COMMISSIONER TRAVIS KAVULLA

Mountain Water last filed a rate case in 2010 and, since that time, its cost of capital has declined dramatically. The evidence of this trend is the precipitous drop in the utility's borrowing costs. In 2008, Park Water—Mountain's parent—issued several notes with effective rates of 9.22 and 10.12 percent. See *Application*, Sched. F, 38.5.147 Debt Capita. This year, Park issued debt at a cost of 4.53 percent. Tr., p. 162.

In the past, Park borrowed at a premium over other utilities' debt costs, and that premium was substantial—often several full percentage points, or hundreds of basis points. Tr., pp. 296, 324. That is no longer true. NorthWestern Energy's 2012 issuances commanded interest rates of 4.15 and 4.3 percent, only slightly below Mountain's 2013 cost of debt.

There are a number of reasons for the two trends we are witnessing here: the decline in borrowing costs of the applicant, and the erasure of the differential between the applicant's and other utilities' borrowing costs. In explaining the former, it is obvious that the cost of capital, economy-wide, has declined. Much of this is the product of the easy-money policies of the Federal Reserve. Treasury note yields are near an all-time low, and the cost of capital in debt and equity to private firms follows those trends. *See*, generally, the discussion of the Capital Asset Pricing Model in Ex. MCC-1, Ex. MW-9.

The erasure of the differential between Mountain's and other utilities' borrowing costs, meanwhile, suggests that the decline is not simply related to economy-wide factors; it likely has something to do with the firm itself. What would have driven this turn? There is only one



significant thing that has happened in the recent life of the Mountain Water Company: the sale in late 2011 of its insular, family-owned parent company, Park, to the multi-national conglomerate, the Carlyle Group.

Efforts to explain away as irrelevant the upstream ownership of Park/Mountain should inevitably fall flat in this proceeding in the face of the only hard evidence of cost of capital: that post-Carlyle, the utility has been able to attract capital at an interest rate which is half of that in the *status quo ante*. This, of course, was the very benefit that was promised to consumers by the Carlyle acquisition—a large firm with abundant access to its own capital, with a concomitant positive effect on the confidence of outside investors, making the firm able to withstand events that might sink a family company. Since borrowing costs are a direct pass-through to ratepayers, the consuming public benefits from this advantage (as they would from being served by anyone with ready access to low-cost capital).

In spite of this, the Order holds that "not much has changed for Mountain as a result of the Carlyle acquisition" and argues that Park is "still a closely held company and has limited access to capital as opposed to publicly traded companies." Ord., ¶ 35. This is a bizarre contention. Carlyle *is* publicly traded and even before it went public, it had numerous, well-heeled investors. Its balance sheet records $33 billion in assets.[1] This is not a mom-and-pop business. The financial community understands this, and treats it accordingly through a lower cost of debt. It is unfortunate that, in this monopoly setting, the job of establishing what to pay equity owners (as opposed to debt holders) rests with a government agency, which, through this Order, fails to acknowledge the basic economic reality of the situation. In so doing, the Commission diminishes through regulatory fiat a substantial advantage to ratepayers from Carlyle's ownership: its low cost of capital.

Establishing a Reasonable Rate of Return for Mountain Water

With this background in mind, the Commission has established a 9.8 authorized return on equity paid on the capital investments that make up Mountain Water's rate base, down from the previously authorized 10.0 percent. In other words, although borrowing costs demonstrably reduced by about half, the return on equity is supposed to have reduced by only two percent.

The Order announces that return on equity is an art, and not a science, in its declaration that the selection of a particular number depends on "regulatory priorities [and] objectives." Ord., ¶ 26. However, the Order fails to articulate what those are, and how they exist in relation to the actual steps taken in making the calculations in ¶¶ 28-32. Instead, the Order's reasoning is an amalgam of averages between the low and high figures offered by the witnesses of the Montana Consumer Counsel and Mountain Water, respectively. A philosophical commitment to averages is not, or at least should not be, a regulatory objective. It encourages the perpetuation of a trend where witnesses present in testimony unrealistically high and low numbers, not wanting to give away bargaining chips in advance of the expected settlement in the middle. I disagree, therefore, with the premise of the calculations made for the two Discount Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) equations.

The Order also contradicts itself on two important questions. The Commission "finds more merit" in the use of a forward dividend, which is represented in DCF equations as D_1, but when it actually comes time to crunch the numbers, the Order uses D_0. Ord., ¶ 30. This is a math problem. Either one agrees with the use of a particular variable in this equation, or not.

[1] http://finance.yahoo.com/q/bs?s=CG+Balance+Sheet&annual (accessed Nov. 13, 2013).

In a similar but even more significant contradiction of itself, the Commission opines on the purportedly small size of the firm—see the discussion of this matter above—but when it comes time to adopt Mountain Water's proposed 80 basis point adder to the return on equity, which represents the risk of this kind of small firm in excess of the proxy group of publicly traded companies, the Commission declines to do so. It makes this decision without affording any explanation whatsoever, which directly contradicts what the Commission has otherwise said on the matter. Ord., ¶ 30. Parties, then, are left to wonder whether or not the Commission really believes the part of the Order that says that Mountain Water is a small firm, in light of the Order's unwillingness to mathematically account for this finding.

Rather than describing with clarity the steps taken to arrive at a 9.8 percent return on equity, the Order's discussion of the matter is characterized by hemming and hawing that leaves the reader justifiably confused. The Commission makes findings, but refuses to implement them in the math problems that are at the heart of a return on equity determination. Inasmuch as there is not a "rational connection between the facts found and the choices made," the Order is arbitrary. *Burlington Truck Lines v. United States*, 371 U.S. 156, 168, 83 S.Ct. 239, 245-246 (1962).

In my view, a reasonable return on equity could have been calculated by doing the following:

- Siding with Mountain Water that D_1 is the appropriate variable to measure dividends in the calculation ROE = D/P + g.
- Discounting Mountain Water witness Thomas Zepp's introduction of new source material in rebuttal testimony, partly as a sanction for the company's failure to present in its direct testimony any evidence supporting its return on equity claim. This eliminates also the problematic source-swapping that Dr. Zepp engages in when a company's growth forecast as reported by a certain source is negative.
- Agreeing with Mountain Water to eliminate Artesian Water from the proxy group because it is thinly traded.
- Excluding the high and low outliers (San Jose Water, whose estimated cost of equity is a whopping 17.3 percent and Middlesex Water, which is 6.8 percent) from the proxy group calculations, which prevents a significant skewing effect. Ex. MW-9, Exhibit TZ-1, p. 2 (showing the estimated cost of equity of the proxy group, after the dividend adjustment for D_1). Dr. Zepp himself questions the inclusion of a "really wild, high number." Tr., 254.
- Decline to award a small-size premium, since Mountain Water is not really a small firm and because small-size premia are already captured in the returns earned even by seemingly large companies, since they typically include many smaller subsidiaries,

which have a return on equity established separately by regulatory commissions across the United States. Tr., p. 246.

- Using the CAPM result as a check on the DCF result, since CAPM in the current economy gives a better market insight into the cost of capital in a period when interest rates are very low.

Taking those steps results in an authorized return on equity of approximately 9.2 percent according the dominant DCF model. Other DCF models could be run to create an average, which might trend slightly higher. These results are within the range of CAPM calculated by the witnesses in this proceeding.

			(1)	(2)	(3)	(4)	
	DCF Results Based on Projected Earnings Growth						
	Value Line Water Utilities						
		Company	**Average Dividend Yield**	**Forecasted Growth**	**Expected Div Yield (D1/PO)**	**D/P + g**	
1	AWR	American States	3 3%	4 0%	3 43%	7.4%	
2	WTR	Aqua America	2 8%	7 3%	2 93%	10 2%	
3	CWT	California Water	3 5%	5 0%	3 68%	8 7%	
4	CTWS	Connecticut Water Service	3 2%	6 1%	3 40%	9 5%	
5	MSEX	Middlesex Water	4 0%	2 7%	4 11%	6 8%	exclude (outlier)
6	SJW	SJW Corporation	2 9%	14 0%	3 31%	17 3%	exclude (outlier)
7	AWK	American Water	2 7%	8 2%	2 93%	11 1%	
8	YORW	York Water Co	3 1%	4 9%	3 25%	8 2%	
		Average				**9.2%**	
	Source						
		(1) From Exhibit__(JW-1), Page 1					
		(2) From Yahoo Finance, December 11, 2012					

Management and Labor Expense

Finally, one item in Mountain Water's expenses that did not receive the attention it should have in this proceeding is the utility's labor expense. Mountain Water pays its employees well, and presumably in some part does so because cost recovery of its labor expenses are all but guaranteed. Indeed, a last-minute pay increase in December 2012—just as the period for known and measurable expenses to be reflected in rates was about to elapse—seems designed for this very purpose. Tr., pp. 347-50. In 2011, Mountain employees received a 3.9 raise. In 2012, they received a 2.2 percent raise. Tr., pp. 45-47. This happens in a familiar cycle, with raises tied to the consumer price index. However, it deserves mentioning that there is little evidence that such raises—more than 6 percent over two years, not including other bonuses awarded to employees—are widely replicated in other water utilities in the state. Mountain Water and its customers deserve a qualified workforce, and it would be premature to judge whether the policy of awarding raises systematically is reasonable or unreasonable, but it is something the Commission should take time to hear more about in future rate cases.

Also, Mountain Water's executive salaries should be reviewed with the same healthy measure of skepticism. The company's general manager is paid a salary of [redacted], while the manager of financial services makes [redacted], and the manager of risk and legal services [redacted]. DR PSC-031 (deemed proprietary). These salaries seem high by comparison to what other comparably sized water utility employees in Montana earn. The Commission, in my view, has a special duty to review the reasonableness of rate recovery of these expenses in light of the fact that Mountain Water has continually refused to publicly disclose them—even though Park, its parent, discloses its salaries to the California Public Utilities Commission.

Conclusion

I generally agree with the Commission's other minor adjustments to the Mountain Water revenue requirement (although I question whether ratepayers should be obligated to pay for the company's booth at the fair, which seems more branding exercise than educational opportunity). However, the main issue in this proceeding is return on equity, and on this count I believe the Commission has not only arrived at an excessively high rate of return for Mountain, but has arrived there using a flawed logic.

For these reasons, I dissent with respect to ¶¶ 26-36, 50, and 54 of the Order.

Travis Kavulla, Commissioner (dissenting)