BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Middlefork Water Company for an Order Initiating an Investigation to Ascertain the Value of the Company's Property Devoted to the Public Service	))))	Case No. WO-2007-0266

MIDDLEFORK WATER COMPANY'S RESPONSE TO
STAFF'S RECOMMENDATION AND EXPLANATION

Middlefork Water Company ("Middlefork" or "Company") hereby responds to the recommendation and the subsequent explanation of that recommendation that were filed by the Staff of the Missouri Public Service Commission ("Staff") on November 20, 2007, and December 21, 2007, respectively. In those two filings, Staff recommends that approximately eighty-five percent of Middlefork's net Plant in Service be categorized as Contributions in Aid of Construction ("CIAC") for regulatory and ratemaking purposes. But Staff's recommendation is both factually and legally wrong and should be rejected for several reasons. First and foremost, the Company's utility plant does not satisfy any of the requirements, or exhibit any of the characteristics, of CIAC as that account is defined in the Uniform System of Accounts for Class A and B Water Companies ("USOA").[1] In addition, Staff's recommendation ignores three key principals or conventions that for almost a century have governed how regulators have viewed and have treated debt-financed plant for accounting and ratemaking purposes: 1) that plant financed by debt capital is no less an investment by the utility than plant financed by equity capital; b) that a utility's debt service costs routinely are included in its cost of service for ratemaking purposes and, thereby, are recovered from customers through

[1] Rule 4 CSR 240-50.030(1) adopts the Uniform System of Accounts for Class A and B and Class C and D Water Companies, as issued by the National Association of Regulatory Utility Commissioners in 1973, and as revised in 1976, and prescribes their use for all regulated water companies in Missouri.

rates; and c) the recovery of debt service costs through customer rates does not convert debt-financed utility investment into CIAC.

Although the determination of how Middlefork's plant investment should be valued and categorized will have no immediate impact on rates, whatever decision is reached in this case likely will affect the Company's decisions regarding future investment. As noted in its application, Middlefork needs to make additional investment in its plant facilities to improve service to existing customers and to bring its system into compliance with state and federal mandates, including the "Surface Water Treatment Rules" adopted by the Missouri Department of Natural Resources. In addition, the Company hopes to participate in the MDNR-sponsored Northwest Missouri Water Partnership, which is a long-term planning process that will produce a plan to interconnect viable water supplies in a twelve-county region in Northwest Missouri. If the Missouri Public Service Commission ("Commission") rejects Staff's recommendation in this case, and, instead, applies traditional regulatory principles that will allow Middlefork to include all of its debt-financed, plant investment in rate base, then additional investments necessary to upgrade and expand the Company's existing water supply system – utilizing both equity and debt capital – will be both attractive, from a business standpoint, and financially viable. Conversely, if the Commission adopts Staff's recommendation to categorize debt-financed plant as CIAC, then Middlefork will need to reconsider possible expansion of its system to help meet the need for water outside its service area. The Company also will be forced to re-examine its options for financing necessary system upgrades to determine which of those options are financially viable.

1. *Middlefork Water Company – A Brief History*

In its March 31, 1992, order in Case No. WA-92-65, the Commission granted Middlefork a certificate of convenience and necessity to own and operate a water supply system and to provide service as a public utility. In addition, the Commission authorized the Company to issue and sell up to $2 million in tax-exempt bonds issued by the State Environmental Improvement and Energy Resources Authority.[2] Ultimately, the Company issued EIERA bonds and invested the proceeds it received from the sale of those bonds, as well as equity capital raised from Middlefork's shareholders, to construct the plant and facilities it uses to provide water service to customers.

From its inception and continuing to today, the Company has had but two customers: the cities of Grant City and Stanberry, Missouri. Each of these cities buys water from Middlefork at wholesale and then resells the water to retail customers through municipal water systems that are operated independently by each city. As recited in the Commission's order granting the Company its certificate,[3] prior to Middlefork's formation both Grant City and Stanberry were receiving service through wells that "have proven to be of questionable reliability" and from treatment plants that are "outmoded and in need of renovation or replacement." Middlefork was formed to remedy the historical shortcomings of the two municipal water systems, and the voters of each city responded to the remedy the Company offered by overwhelmingly approving propositions obligating the cities to enter into 20-year water service contracts with Middlefork, provided, of course, that the Company was able to obtain from the Commission the operating authority required by law.

In granting the Company's application for a certificate, the Commission noted several circumstances that made Middlefork's situation highly unusual, if not unique. For example, the Company proposed to finance its construction of the water supply and

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[2] The State Environmental Improvement and Energy Resources Authority is a state agency authorized by law to issue bonds and/or notes for the purpose of making loans to any private person, firm, or municipal corporation to acquire, construct, and operate water and/or sewer treatment facilities, with the objective that the state-issued securities will reduce the costs of those facilities and the rates charged to customers that are served thereby. For purposes of this response, Middlefork's loan from the State Environmental Improvement and Energy Resources Authority will be referred to as the "EIERA loan."

[3] See *Order Granting Certificate of Convenience and Necessity and Approving Financing*, issued March 31, 1992, in Case No. WA-92-65, at pp. 1-2.

treatment facilities with investment capital consisting of 89.74% debt and 10.26% equity. Initially, the unusually high percentage of debt in Middlefork's proposed capitalization was a source of concern to Staff; however, two mitigating factors allayed these concerns sufficiently to allow Staff to achieve a "comfort level" that ultimately allowed it to recommend approval of the Company's proposal. These factors were: 1) "take-or-pay" water supply agreements that Middlefork would enter into with each of the cities it proposed to serve, and 2) letters that expressed the cities' approval of the Company's proposed capitalization and also their willingness to pay rates that covered both Middlefork's operating expenses as well as the debt service costs on its EIERA bonds. Staff found additional comfort in the fact that the take-or-pay provisions of the proposed water supply agreements were expected to allow the capital markets to value the Company's debt securities like municipal bonds – even though those securities would be issued by a private company and would be secured by a private company's assets and revenues.[4] As the Commission noted in its order, valuing Middlefork's debt securities like municipal bonds likely would result in a lower cost of debt to the Company and, ultimately, lower rates to its customers.

The ordered provisions at pages 5-7 of the Commission's order granting Middlefork's application for a certificate address several of the special circumstances regarding that application that were described in the preceding paragraph. Certain of those provisions, which may be relevant to the issues presented for decision in this case, state as follows:

> 2. That Middlefork Water Company is authorized hereby to issue and sell up to Two Million Dollars ($2,000,000) in aggregate principal of tax-exempt State Environmental Improvement and Energy Resources Authority (EIERA) Bonds at a rate not to Exceed eight (8) percent for a

[4] The term sheet for Middlefork's EIERA loan, which was designated as Attachment A to the Commission's order, states that the Company will be required to provide as security for the loan: i) a first mortgage on Middlefork's assets, and ii) a pledge of revenues from the take or pay contacts the Company negotiated with each of the cities to be served.

term of twenty (20) years and under the financing terms and conditions as set out in Attachment A and incorporated herein by reference.

3. That the issuance of these EIERA bonds and proceeds realized therefrom shall be used for the purposes specified herein and no other except to pay out of the gross proceeds from the sale of these EIERA bonds the reasonable expenses incurred in connection with the issuance and sale thereof.

4. That Middlefork Water Company be authorized hereby to execute and deliver a first mortgage on its utility assets as well as a pledge of the revenues from the contracts between Middlefork Water Company and its water customers.

. . .

10. That Middlefork Water Company be directed hereby to revise tariffs reflecting the surcharge and rates at any time a contract for water service is proposed for another wholesale customer.

2. *Middlefork's Plant Does Not Qualify as CIAC Under the Definition of That Account in the USOA*

Account balances for Plant in Service that qualify as CIAC are booked in Account 271 of the USOA, which is defined, in relevant part, as follows:

271. Contributions in Aid of Construction

A. This account shall include:

(1) Any amount or item of money, services or property received by a utility, from any person or governmental agency, any portion of which is provided at no cost to the utility, which represents an addition or transfer to the capital of the utility, and which is utilized to offset the acquisition, improvement or construction costs of the utility's property, facilities, or equipment used to provide utility services to the public.

Reduced to its basics, this definition requires that in order for plant assets to properly be categorized as CIAC they must satisfy two criteria: 1) they must be in the form of money, services, or assets that are provided to a utility by a third party; and 2) the money, services, or assets must be cost-free to the utility. Any utility asset that fails to satisfy *both* of those criteria cannot, by definition, legitimately be categorized as CIAC.

As the Commission is well aware, it is quite common for a significant portion of the Plant in Service of small water or sewer utilities to be categorized as CIAC. That is true because the plant used by such utilities to serve their customers comes into being as follows: A developer builds water and sewer facilities as part of a subdivision and then recovers all or part of the costs of that infrastructure through the sale of lots or houses. In exchange for a commitment from the utility to provide service to the homes served by the contributed infrastructure, the developer then contributes that infrastructure to either an existing utility or to one set up by the developer itself. The infrastructure assets acquired by a utility in this fashion are CIAC because the they came from the developer, a third party, and the utility acquired the assets at no cost.

Another common source of CIAC – one that is utilized not only by water and sewer utilities but also by electric, gas, and telecommunications utilities – are line extension or connection charges, which are collected from customers to defray, in whole or in part, the extraordinary costs that a utility will incur to extend service to one or more customers at a remote location. In this scenario the utility receives no assets but, instead, receives cash, which it then uses to construct assets. However, those assets are still properly classified as CIAC because the cash used to construct the assets came from a third party and was provided at no cost to the utility.

Regulators, including the Commission, long have recognized that CIAC should be treated differently for ratemaking purposes than plant that is acquired or built with the utility's own funds.

> Ratemaking treatment for contributions in aid of construction is a different situation, because no obligation exists for the utility either to repay any funds received or to reimburse parties donating physical property. The general rule is that any such contributions should be excluded from the rate base, since the related plant investment has not been financed by the utility and customers should not therefore be required to pay a return on the plant.

Hahne, Robert L. & Gregory E. Aliff, *Accounting for Public Utilities*, 4-32 (1989). However, as the preceding passage makes clear, plant is not CIAC if it is constructed with funds where an obligation exists for a utility to repay those funds. Thus, plant constructed with debt capital that a utility is required to repay is not CIAC.

None of the Company's Plant in Service that is the subject of Staff's recommendation satisfies either of the criteria that are required by the USOA's definition of CIAC. All of Middlefork's plant was built using funds provided by the Company itself; no third party contributed any of the Company's plant or any of the funds used to build that plant. Instead, Middlefork, itself, constructed 100 percent of its plant and raised the capital it used to construct that plant from two sources: equity, which was provided by the Company's shareholders, and debt, which the Company raised through the sale of EIERA bonds. And the funds that the Company invested in its plant were far from cost-free: the EIERA bonds, which Middlefork is contractually obligated to repay in full, carry an interest rate of eight percent per annum, while the Company's shareholders have the expectation that they will earn a fair return on their equity investment.

Yet, despite these facts, Staff argues in support of its recommendations that the debt used to finance the construction of the majority of Middlefork's plant was not provided by the Company but was, instead, provided by its customers.

> Middlefork is the obligor on the EIERA bonds, but all of the payments of both principal and interest are paid by the cities. In essence, Middlefork acts much like a guarantor of the loans. That is, the payments are actually made by the cities . . ..[5]

Staff goes on to argue that "[t]he payments that the cities make under the Surcharge may be likened to the payments of connection charges that developers or customers make . . .."[6]

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[5] *Staff's Explanation of the Factual and Legal Bases for Its Recommendation that Plant in Service Be Classified as Contributions in Aid of Construction*, at p.5

[6] *Id.* at p. 6.

Staff's analysis both distorts and misapplies the USOA's definition of CIAC because Middlefork's plant does not satisfy even one – much less both – of the criteria that are required by that definition. It is nonsense for Staff to argue that Middlefork's customers, through their payment of cost of service-based water rates, have contributed either plant or capital to the Company. And it is equally ridiculous to suggest that the portion of Middlefork's plant investment that was financed by the proceeds of the EIERA bonds – for which the Company, alone, is contractually obligated to tens of thousands of dollars annually in principal and interest – was cost free to the utility.

In addition, Staff's argument that Middlefork is nothing more than a guarantor of the obligations created by its debt securities is wrong because it ignores several material and irrefutable facts to the contrary:

- the EIERA bonds are issued in Middlefork's name alone;
- as a matter of contract and securities law, the Company is the sole obligor under those bonds and not merely a guarantor;
- Middlefork is solely responsible for the repayment of all principal and interest due on the bonds;
- the property and other assets that have been pledged as security for the bonds belong to the Company and its shareholders and to no one else; and
- in the event of default, the holders of the EIERA bonds will look to Middlefork, alone, to satisfy any and all claims that result from such default.[7]

Middlefork's ability to recover its debt service costs through rates does not change the terms of its bond indenture in any way or transfer the Company's obligations under that indenture to the customers who pay those rates. As far as its bondholders are concerned, Middlefork the sole obligor of the EIERA bonds, not a mere guarantor. Moreover, Staff's argument is further weakened by the fact that, as the tenth ordered

[7] Staff's argument also is internally inconsistent because though Staff contends that the customers, and not the Company, supplied the debt capital used to construct the water service facilities, Staff acknowledges, at page 5 of its explanatory pleading, that "in the event that the cities failed to make payments as required, then Middlefork would still be obligated to make the payments."

provision of the Commission's final order in Case No. WA-92-65 makes clear, Middlefork will be required to adjust the debt service costs it collects from the cities of Grant City and Stanberry if the Company adds more customers in the future. So, the cities' relationship to Middlefork is that of customers paying rates, not that of investors providing capital. And the fact that the cities pay the Company's capital costs as part of their utility rates makes them no different than any other customer of any other debt-financed utility operating in Missouri.

Staff's attempt to analogize the Company's plant investment to line extension or connection charges also misses the mark. As described earlier, connection charges are assessed to fund the construction of utility plant necessary to provide service to customers. Middlefork, on the other hand, built its plant first and funded the construction of that plant with capital the Company, itself, raised. Only afterwards did the Company collect anything from its customers; and what it collected then were cost of service-based rates for water service, not connection charges.

Finally, as will be discussed more fully later in the next section of this response, Staff's recommendation is contrary to well-established legal precedent and regulatory practice dating back almost a century. Throughout that period, courts and regulators – including the Commission – consistently have recognized that the funds that utilities invest in plant come from two sources, equity and debt, and that debt-financed plant is investment and not CIAC. Courts and regulators also have recognized that debt service costs are a legitimate part of any utility's cost of service, and that the recovery of those costs through rates does not convert bona fide utility investment into CIAC.

3. *Staff's Recommendation Is Contrary to Well-Established Legal Rules and Regulatory Conventions That Govern How Debt-Financed Investment Should Be Treated for Regulatory Purposes*

Utilities have always used a combination of equity and debt to provide the capital they require to construct, improve, extend, and maintain the plant and facilities required to provide service to customers. They do this because it makes good financial sense to do so, and it makes good financial sense because debt capital is less costly than equity. Indeed, it could be argued that because debt capital costs less than equity regulators often prefer debt to equity. That certainly is one explanation for why regulatory commissions use debt-rich, hypothetical capital structures for ratemaking purposes in circumstances where the regulators believe a utility's actual capital structure contains more equity than is optimal.

Because the use of debt as a source of investment capital is both commonplace and prudent, regulators consistently have recognized that debt service costs – the principal and interest that utilities must pay to their debt holders – are a legitimate cost of service that should be collected from customers through rates. Professor Roger Morin acknowledges this fact in his respected and widely cited text *Utilities' Cost of Capital*:

> [T]he inclusion of the embedded cost of debt and preferred cost in the overall cost of capital assures that the actual costs associated with the current amounts of outstanding [debt] are taken into account in the computation of revenue requirements . . ..[8]

The Commission routinely adheres to this regulatory norm, and Middlefork is unaware of any rate case decision for a Missouri utility in which the Commission did not include the utility's embedded debt costs as part of the cost of service used to set customer rates.

The courts also have recognized that utilities rely on both debt and equity for the investment capital needed to finance their operations, and have held that utilities have a constitutional right to rates that cover the costs of both sources of capital. As Justice Douglas observed in the United States Supreme Court's decision in *FPC v. Hope Nat. Gas. Co.*, 320 U.S. 591 (1944):

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. *These include service on debt and dividends on stock.*"

[8] Morin, Roger A., *Utilities' Cost of Capital*, p.24 (1984).

Id. at 603 (emphasis added). Courts also have consistently held that customers do not acquire any property interest in a utility's assets through the payment of lawful, cost of service-based rates for utility service. *See Straube v. Bowling Green Gas Co.*, 360 Mo. 132, 227 S.W.2d 666, 671 (1950).

Because both regulators and the courts long have accepted that debt is a legitimate and widely-utilized source of investment capital for utilities, and also that debt service costs are a legitimate part of the costs that should be recovered through rates, Staff's recommendation becomes even harder to understand. If the debt-based investments of other Missouri utilities are not transformed into CIAC when those utilities collect their debt service costs from customers through rates, why should a different fate befall Middlefork? Staff's recommendation provides no clue to the answer to that question; indeed, for good reason, Staff steers clear of that question altogether. But it is a question that the Commission cannot avoid in resolving the issues in this case. The right is obvious: there is no reason to treat Middlefork differently, because debt-financed investment can never legitimately be classified as CIAC. And the fact that Middlefork, like all other utilities, recovers its debt service costs from its customers through the rates they pay for service does not change that answer one bit.

4. *Conclusion*

Because Middlefork's plant does not satisfy the definition of CIAC in the USOA, and because there is no reasonable basis – in fact, law, regulatory policy, or otherwise – to treat the Company's debt-financed plant investment any differently than similarly financed plant investments are treated for other Missouri utilities, Staff's recommendation must be rejected. Plant that is built using capital raised by the utility itself, regardless of whether that capital comes from debt or from equity, is investment, not CIAC. Middlefork constructed its plant from scratch, using capital that the Company raised through the sale of equity to its shareholders and through the sale of EIERA bonds. Therefore, the net value of all of Middlefork's debt-financed plant should be recognized as investment by the utility and, accordingly, should be included in a rate base for accounting, ratemaking, and other regulatory purposes.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on the 11th day of January, 2008, a true and correct copy of the above and foregoing document was delivered by first class mail, electronic mail, or hand delivery to the following:

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