

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. WO-2011-0350
Algonquin Water Resources of Missouri, LLC d/b/a Liberty Water
Acquisition of Assets of KMB Utility Corporation

FROM: Roberta Grissum – Auditing Department
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Department
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/s/ Jim Merciel
Case Coordinator

7/19/2011
Date

/s/ Meghan McClowry
Staff Counsel's Office

7/19/2011
Date

SUBJECT: Staff Recommendation Regarding Sale of Utility Assets

DATE: July 19, 2011

PROCEDURAL BACKGROUND

On April 22, 2011, Algonquin Water Resources of Missouri, LLC d/b/a Liberty Water (Liberty) and KMB Utilities Corporation (KMB) (together referred to as “Joint Applicants”) filed a *Joint Application and, if Necessary, Motion for Waiver (Application)*, in which the Joint Applicants seek authority from the Commission to sell and transfer utility assets of KMB to Liberty. As the proposed transaction involves both water and sewer utility assets, the matter was filed as two cases, WO-2011-0350 and SO-2011-0351. Also on April 22, 2011, the Joint Applicants filed a *Motion to Consolidate*, seeking consolidation of the two cases.

On April 22, 2011, the Commission issued its *Notice of Application, Order Directing Filing and Order Directing Notice*, in which, among other things pertaining to sending notice of the case, the Commission set an intervention date of May 13, 2011, and directed the Staff to file its recommendation by May 20, 2011.

On May 17, 2011, the Commission issued its *Order Consolidating Actions*, which consolidated the two cases and established WO-2011-0350 as the primary case. On May 20, 2011, the Staff filed a *Motion for Extension of Time* that requested the Commission grant the Staff leave until July 19, 2011, to file its recommendation, which the Commission granted on the same date in its *Order Extending Time*.

The Joint Applicants stated in their *Application* that they did not believe this would be a contested case, but requested a waiver from the requirement of Commission Rule 4 CSR 240-4.020(2) to provide sixty (60) days notice of filing a case in the event it became a contested case.

This memorandum is intended to Comply with the Commission's orders regarding the filing of a Staff Recommendation. No parties have intervened in this case.

BACKGROUND OF THE JOINT APPLICANTS

Liberty

Liberty is an operating subsidiary involving several corporations, the hierarchy of its Missouri utility operations is as follows:

- Algonquin Power and Utilities Corporation (APUC), a Canadian corporation
- Liberty Utilities Co. (LUC), a Delaware corporation
- Liberty Water Co. (LWC), a Delaware corporation
- Algonquin Water Resources of Missouri, LLC d/b/a Liberty Water (Liberty)

On May 22, 2009, according to records posted by the Missouri Secretary of State's website, Algonquin Water Resources of Missouri, LLC registered the fictitious name, "Liberty Water," which is the name it intends to use when operating utilities in Missouri. However, the Commission's records at present do not reflect the use of that name, as no name change has been filed with the Commission.

Liberty, as Algonquin Water Resources of Missouri, LLC, acquired the assets of a regulated utility, Silverleaf Resorts, Inc., in Case No. WO-2005-0206. Silverleaf Resorts, Inc. provided utility service in three different service areas in which Liberty presently provides service. The three service areas are Holiday Hills Resort in Taney County, Missouri which is a water system, and Timber Creek Resort in Jefferson County, Missouri and Ozark Mountain Resort in Stone County, Missouri, which are water and sewer systems. Each service area has specific, stand-alone rates. All three of these areas consist largely of condominium developments and many or most of the condominium units are either rental units of common ownership, or are "time-share" ownership. There are also some residential and commercial customers. Liberty provides water service to approximately 930 water customers or living units, and sewer service to approximately 385 customers or living units.

KMB

According to the Missouri Secretary of State's website, KMB was incorporated in the state of Missouri in 1990. KMB's original owner built his operation by acquiring existing small water or

sewer systems in need of alternative ownership, improved utility management, or both, and consolidating the operations into one company, KMB. KMB's present service areas consist of the following, which result from the identified case in which it acquired the territories:

WM-91-52	<u>High Ridge Manor</u> , Jefferson County (formerly High Ridge Manor Water Co.)
WM-92-122	<u>Crestview Acres</u> , Franklin County (formerly Crestview Acres Water Co.)
WM-92-154	<u>Lakewood Hills</u> , Franklin County (formerly Lakewood Hills Water Co.)
SM-92-264	<u>Cape Rock Village and Tanglewood Estates</u> , sewer system in Cape Girardeau County (formerly SLR Development Co.)
WM-92-310	<u>Scottsdale</u> , Jefferson County (formerly Jefferson County Water Co.)
WM-92-312	<u>Hillside Acres and Sunshine Acres</u> , Franklin County (formerly Progress Unlimited d/b/a Hill-Shine Community Water and Sanitation Co., acquired water system only)
WM-94-21	<u>Warren Woods</u> , Jefferson County (certificate case – acquired water system from a homeowners association that was not under PSC jurisdiction)
WM-2003-0194	<u>Cedar Hill Estates</u> , Jefferson County (formerly Cedar Hill Estates Water Co., Inc.)

KMB serves approximately 548 water customers and 192 sewer customers in the above service areas based upon customer counts used in its most recent rate requests, Case Nos. WR-2010-0345 and SR-2010-0346. Each service area has specific, stand-alone rates.

STAFF'S INVESTIGATION

PLANT, RESERVE and CONTRIBUTIONS IN AID OF CONSTRUCTION (CIAC)

The Auditing Staff has conducted an investigation of KMB's books and records based upon the twelve-months ending May 31, 2011 and has determined total rate base on a consolidated basis in the amount of \$283,958 as of that date. This amount, more specifically explained in the table below, reflects the starting point for the determination of rate base to be used for regulatory purposes in the next rate case. In the chart below, the Auditing Staff has reflected all capital improvements completed on KMB's water and sewer systems since the time of its last rate case. The chart below summarizes the Auditing Staff's calculations based on a review of this pending case, an update of the amount of plant, depreciation reserve and contribution in aid of construction (CIAC) less the accumulated CIAC Amortization Reserve from the last rate case. The results of Auditing Staff's review of accounts are as follows:

Company Operation	Plant	Depreciation Reserve	CIAC Less Accumulated CIAC Amortization	Rate Base
Water System Consolidated	\$644,336	\$431,077	\$7,425	\$205,835
Cape Rock Village Sewer	\$214,616	\$136,493	\$0	\$ 78,123
Total Water and Sewer	\$858,952	\$567,570	\$7,425	\$283,958

Liberty is proposing to acquire the assets for a sale price that is 1.2 times, or 20% over, KMB's rate base, discussed further below.

DEPRECIATION

The Auditing Staff incorporated the depreciation rates approved by the Commission in KMB's most recent rate cases into its rate base calculation for this proceeding. Using these depreciation rates, the Auditing Staff included a level of depreciation reserve for the assets of KMB's water and sewer systems as of May 31, 2011. Depreciation rates are discussed in greater detail below.

CORPORATE ALLOCATIONS

Algonquin Power and Utilities Corporation (APUC), generally, has two types of allocations, labor and non-labor costs. Labor costs are allocated based upon direct charges documented by timesheet reporting. Charges to Liberty include: (1) Executive Salaries allocated from APUC; (2) Treasury Costs allocated from APUC Administration; (3) Corporate Accounting Costs allocated from APUC Administration; (4) Payroll and IT Costs allocated from LUC Administration; (5) Rates & Regulatory Affairs, Accounting, Utility Planning and Customer Service Costs allocated from LUC Administration and (6) Human Resource Costs allocated from LUC Administration. All labor is charged "at cost" and factored up for payroll taxes, health benefits, retirement plans and other insurance. All labor charges specifically attributable to any utility are recorded as a direct charge based upon timesheet reporting. Other charges such as accounting, customer service and billing are allocated based upon customer counts for each utility. Any indirect charges that benefit multiple utilities where it is not practical to use time reporting, are currently allocated based upon customer counts. Non-labor costs incurred by APUC are calculated and totaled into the administration Central Office Cost Pool and then allocated to APUC's subsidiaries. APUC retains 8.33% of all costs and allocates the remainder to its subsidiaries based on their respective shares using individual allocation factors for each cost type.

ACQUISITION ADJUSTMENT

Liberty has agreed to pay a 20% premium above KMB's rate base. According to Liberty's response to Staff Data Request No. 15, the rate base premium is based upon Liberty's experience and observations of other market deals. Liberty understands that the Staff will not recommend including this premium in rate base for ratemaking purposes. As such, the premium paid for the KMB water and sewer systems will be recorded on the financial books and records of the Company as "goodwill" or "purchase price premium" and will be easily identifiable for General Accepted Accounting Practices (GAAP) and regulatory purposes. The Uniform System of Accounts (USOA) for water and sewer utilities requires the 20% premium over KMB's rate base to be recorded as an acquisition adjustment.

OPERATIONS

Liberty presently utilizes a contract operator for its Timber Creek area, and a different contract operator for its Holiday Hills and Ozark Mountain service areas. Operations are supervised by a Regional Business Manager located in Tyler, Texas, and an Operations Manager located in Dallas, Texas. Initially, Liberty intends to utilize the same water contract operator presently working for KMB in Jefferson and Franklin Counties in Missouri, as well as the same sewer contract operator presently working for KMB operating its Cape Rock sewer system in Cape Girardeau, Missouri. Liberty also intends to initially utilize the same contractors, well drillers and vendors for major items. Any work done by contractors or other vendors will be overseen by the Regional Business Manager. Liberty intends to give its contract operators 24/7 access to both the Regional Business Manager and the Operations Manager in the event such communication is necessary. Based upon Liberty's response to Staff Data Request No. 13, Liberty intends to require its contract operators to submit environmental reporting requirements and lab results to both its Tyler, Texas office and the LWC Environmental Compliance Manager as soon as the information becomes available.

All capital requests made by the contract operators will be submitted to the Tyler, Texas office for approval and subsequent processing. In the event of an emergency, however, an immediate approval process will be in place for issues that threaten regulatory compliance or the capability of Liberty to provide safe and adequate service. It is Liberty's intent to have the Regional Business Manager or the Operations Manager make site visits to the KMB water and sewer systems at least once a quarter, or more often as necessary.

Further, Liberty intends to prepare customer bills and handle accounts from Tyler, Texas, with customer calls for inquiries and emergencies directed by an "800 telephone number" to a call center that is also in Tyler, Texas, which is only operated during business hours. Liberty also presently utilizes a call center located in Avondale, Arizona that operates 24/7 for its existing service areas, and that would be available for after hours calls, overflow telephone traffic and as a backup if other issues affect the Tyler, Texas office.

The Engineering and Management Services Department (EMSD) Staff performed a complete review of the depreciation rates, plant in service, and the accumulated depreciation reserves for KMB in case numbers WR-2010-0345 and SR-2010-0346. The depreciation rates ordered in these cases are still satisfactory to the Staff, and the Staff recommends that Liberty adopt the current ordered depreciation rates of KMB for water and sewer utility assets acquired in this case. Current ordered depreciation rates for KMB are included herein as Attachments 1 and 2 and are incorporated herein by reference.

Liberty must ensure that the acquisition of the KMB assets will have no adverse effect on the level of utility service provided to the customers. EMSD is recommending that Liberty report to the EMSD Staff various performance statistics regarding the corporation call centers located in Tyler, Texas and Avondale, Arizona. The data should be reported on a monthly basis to the EMSD Staff within thirty (30) days after the end of each month. Such information should include at a minimum, but not be limited to:

- Total number of calls received and handled by the Call Center, segregated by calls from Missouri customers.
- Staffing levels for the customer service function and their location.
- Measurements regarding how expediently phones are answered and responses are made to customer calls, and provide explanations of how data is used for calculations.
- Number and percent of estimated meter readings, including numbers specific to Missouri customers.
- Results from the Company's annual customer opinion surveys
- Any major technological advances applied to the call center operations.

Liberty Water Company (LWC) is in the process of installing an interactive voice response (IVR) unit to its call centers that serve Missouri customers. Once the implementation of these systems has been completed, Liberty and EMSD Staff will meet to determine the appropriate indicators to be provided in the reporting.

FINANCING ISSUES

Liberty attached balance sheet and income statement information to its Application (Appendix D1 and Appendix D2) for its current Missouri water utility assets and the assets proposed to be acquired, pursuant to 4 CSR 240-3.605 (1)(E). Although these financial statements provide financial data on the combined properties, they are not insightful for purposes of assessing the financial impact of the proposed acquisition on the financial condition of the entity which will ultimately issue capital on behalf of Liberty and any of its Missouri utility assets. According to Liberty's responses to staff data requests, Liberty will finance the acquisition of the KMB properties with internal cash. Based on the final amended financial statements attached to the Application, Liberty does not have enough cash on hand to finance the KMB acquisition.

Consequently, it appears that Liberty intends to receive cash from its parent company, LWC, which may in turn receive this cash from LUC, which may in turn receive this cash from APUC. Relative to the size of APUC, this is a very small transaction and will have minimal impact on APUC's financial condition.

Liberty has also indicated in responses to Staff data requests that to the extent KMB needs capital to finance its operations, it most likely would rely on at least LWC for such financing. On December 22, 2010, LWC issued \$50 million of 10-year unsecured debt million at a coupon of 5.6%. Staff is not aware of any ratings assigned to this debt. KMB's ability to receive financing through direct debt issuances by LWC or any other upstream parent company should allow for ongoing access to capital at reasonable costs.

According to Liberty's responses to Staff data requests, none of the companies that hold APUC's regulated utility assets are rated by any rating agencies. However, APUC's nonregulated subsidiary, Algonquin Power Company (APCO) is a power generation and development company. S&P's latest credit rating, February 14, 2011, on APCO is "BBB-" with a stable outlook. This reflects the company's "satisfactory" business risk profile and its "significant" financial risk profile.

Based on Staff's review of APUC's current financial condition and recent debt issuances, it does not appear that APUC's higher risk, non-regulated operations have yet impaired the ability of APUC's regulated subsidiaries to issue debt at reasonable costs. However, the Commission has no authority over the non-regulated operations of APUC. Consequently, as the Commission is aware from experience with the failure of Aquila, Inc.'s non-regulated operations, absent legal and structural separation, the risk of non-regulated operation failures impacts the ability of the regulated operations' ability to raise capital at reasonable costs. Although Staff has this concern, Staff recognizes that on a stand-alone basis KMB does not currently issue its own debt. Consequently, at least in the near term, KMB's access to reasonably priced capital should improve. Although Staff is not proposing any conditions in this case to ensure that APUC's regulated utilities are protected from possible impairment from APUC's non-regulated operations, Staff may propose conditions in future applications in which APUC is proposing to acquire Missouri regulated utility assets in order to ensure continued access to reasonably priced capital.

STAFF'S FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

The Staff believes that the transfer of utility assets from KMB to Liberty is not detrimental to the public interest, and thus recommends approval of the requested transfer of assets.

Liberty stated in the *Application* that it intends to adopt existing rates and rules of KMB. Therefore, the Staff recommends that Liberty file adoption notices for KMB's tariffs, two (2)

water and one (1) sewer, and since the adoption notices likely will be filed as 30-day tariff sheets after closing of the transfer of assets, the Staff also recommends that Liberty be granted authority to exercise the rates and rules in the KMB tariffs on an interim basis until the adoption notices take effect. In addition, Liberty's existing tariffs applicable to its existing service areas presently apply to "All Missouri Service Areas" but those tariffs should not apply to KMB service areas. The Staff further recommends that Liberty file appropriate paperwork for a name change, pursuant to Commission Rule 4 CSR 240-2.060(5). This filing should include Liberty's adoption notices for Liberty's existing tariffs, limiting those tariffs to only the presently existing service areas, and as a means for the Commission to recognize the use of the fictitious name "Liberty Water."

The Staff recommends that the Commission prescribe, and Liberty adopt, the most recent depreciation rates approved by the Commission for the KMB water and sewer systems in Case Nos. WR-2010-0345 and SR-2010-0346, until such time as new depreciation rates may be set in a future rate case proceeding.

The Staff recommends that Liberty be required to adopt the individual plant in service, depreciation reserve and CIAC balances utilized by the Auditing Staff for purposes of determining the appropriate rate base in this proceeding as a starting point for plant in service, depreciation reserve and contributions in aid of construction (CIAC) for the KMB water and sewer systems recorded in the books and records of Liberty. Further, the Staff recommends that Liberty be required to maintain and retain proper plant in service, depreciation reserve and CIAC records on a going forward basis for these assets. The Auditing Staff will meet with the Company to explain in detail how to maintain these types of records, if necessary.

In any future rate increase request, the Staff recommends that Liberty be required to file for all of its regulated water and sewer systems in Missouri concurrently, to ensure that costs are correctly assigned and that appropriate rates are established for all customers in the state. Staff puts Liberty on notice that the filing of any future rate case may require Staff to seek additional time to account for the additional service areas Liberty seeks to acquire in Missouri, now and in the future before the next rate case is filed.

OTHER MATTERS

Both Liberty and KMB have filed annual reports, as shown on the Commission's EFIS records through the calendar year 2010. Liberty is current on annual assessment amounts through the fiscal year 2012, and KMB is current and has paid through the first quarter of fiscal year 2012, as posted by the Commission's Administration Division on its intranet site. Liberty has another case pending before the Commission, WO-2011-0328, involving its proposed acquisition of the water utility assets of Noel Water Co., Inc. Commission approval as requested in the subject

case will have no direct impact upon that case, nor will Commission approval of the subject case have any direct impact upon that case.

There are no issues with the Missouri Department of Natural Resources (DNR) with respect to KMB's water systems. Although KMB is in compliance with the DNR discharge permit with respect to the sewage treatment facility, the discharge permit requires a plan to implement a program to address stormwater inflow and infiltration into the collection system, to reduce or eliminate overflows from manholes and from a pumping facility. As part of the KMB sewer rate case, SR-2010-0346, the Audit Staff amortized the cost of an engineering study on this matter to be performed by Strickland Engineering that was not to exceed \$10,000 over a three-year period in KMB's cost of service. Actual work on this, and reporting to DNR, remains to be accomplished. Since the DNR discharge permit and the responsibility to implement this program will be transferred to Liberty upon approval and after the close of the sale, Liberty intends to hire Strickland Engineering to perform this engineering study, in accordance with the ratemaking treatment afforded to KMB in its most recent rate case, and in compliance with the DNR discharge permit requirements.

SUMMARY

The Staff recommends the Commission issue an order that:

1. Approves Joint Applicant's request to sell and to transfer KMB's utility assets to Liberty;
2. Requires KMB to turn over all plant records, operations records, and expense records to Liberty upon closing of the assets, and require Liberty to adopt the individual plant in service, depreciation reserve and CIAC balances utilized by the Audit Staff for purposes of determining the appropriate rate base in this proceeding as a starting point for plant in service, depreciation reserve and contributions in aid of construction (CIAC) for the KMB water and sewer systems recorded in the books and records of Liberty, and that Liberty be required to maintain and retain proper plant in service, depreciation reserve and CIAC records on a going forward basis. The Audit Staff will meet with Liberty to explain in detail how to maintain these types of records, if necessary;
3. Requires Liberty, in any future rate increase request, file concurrently for all its Missouri regulated water and sewer systems, as discussed above.
4. Requires Liberty to use the schedule of depreciation rates set out in Attachments 1 and 2 to this Memorandum that were prescribed by the Commission and used by

KMB, from the date of the transfer forward, until changed by further order of the Commission.

5. Requires Liberty to begin reporting call center information to the EMSD Staff, as described herein;
6. Requires Liberty to notify the Commission within five (5) business days after the assets have been transferred;
7. Requires Liberty to, within five (5) business days after closing, file tariff adoption notice sheets, adopting the two (2) water tariffs and one (1) sewer tariff currently in effect for KMB, with 30-day notice, and authorize Liberty to use the rates and rules of KMB's tariff on an interim basis until the effective date of such tariff adoption notices;
8. Requires Liberty, any time before five (5) days after closing, to file tariff adoption notice sheets, with 30-day notice, for its existing water tariff and sewer tariff to update its operating name, and limiting the applicability of those tariffs to the Timber Creek, Holiday Hills, and Ozark Mountain service areas, and further, requires Liberty to use its company name or file appropriate documentation with the Commission which would allow it to use its chosen fictitious name and to take all steps necessary to ensure that the name is consistently used in all communications with its Missouri customers including billing, and filings with the Missouri Public Service Commission, including certificates, tariffs and annual reports;
9. After receipt of such notice on closing in No. 6, above, cancels the Certificates of Convenience and Necessity for KMB, and grants Certificates of Convenience and Necessity to Liberty for water service and sewer service, as appropriate, in the current KMB service areas;
10. Makes no finding that would preclude the Commission from making any determination on any matter in any future rate proceeding;
11. Requires the Applicants, if closing on the assets has not occurred with thirty (30) days after the effective date of an Order from the Commission approving this transfer of assets, to file a status report with the Commission thirty (30) days after the effective date of the Order, and at the end of each subsequent thirty (30) day period until closing and the transfer of assets is complete; and, alternatively, if the transfer is not expected to be completed requires the Applicants to file a pleading with the Commission stating such;

12. Requires Liberty to record the value, identified above, as the amounts of plant, depreciation reserve and contributions in aid of construction, as of May 31, 2011.

Attachments: 1. Depreciation Accrual Rates – Water Utility Plant
 2. Depreciation Accrual Rates – Sewer Utility Plant

WO-2011-0350
SCHEDULE of DEPRECIATION RATES
WATER Class C
(This Schedule was Filed in Case No. WR-2010-0345)

USOA

ACCOUNT NUMBER	ACCOUNT DESCRIPTION	DEPRECIATION RATE	AVERAGE SERVICE LIFE (YEARS)	NET SALVAGE
Source of Supply				
314	Wells & Springs	2.0%	50	0%
Pumping Plant				
321	Structures & Improvements	2.5%	40	0%
325	Electric Pumping Equipment	5.0%	20	0%
328	Other Pumping Equipment	4.0%	25	0%
WaterTreatment Plant				
332	Water Treatment Equipment	2.9%	35	0%
Transmission and Distribution				
342	Distribution Reservoirs & Standpipes	2.5%	40	0%
343	Transmission & Distribution Mains	2.0%	50	0%
345	Customer Services	2.5%	40	0%
346	Customer Meters	10.0%	10	0%
347	Customer Meter Pits & Installation	2.5%	40	0%
348	Hydrants	2.0%	50	0%
General Plant				
391.1	Office Electronic & Computer Equip.	1.0%	5	0%
392	Transportation Equipment	7.0%	7	9%
394	Tools, Shop, Garage Equipment	5.0%	20	0%
397	Communication Equipment	6.7%	15	0%

WO-2011-0350
SCHEDULE of DEPRECIATION RATES
SEWER CLASS C
(This Schedule was Filed in Case No. SR-2010-0346)

ACCOUNT NUMBER	ACCOUNT DESCRIPTION	DEPRECIATION RATE	AVERAGE SERVICE LIFE (YEARS)	NET SALVAGE
Land and Structures				
Collection Plant				
352.2	Collection Sewers (Gravity)	2.0%	50	0%
Pumping Plant				
363	Electric Pumping Equipment	3.0%	10	0%
Treatment and Disposal				
372	Oxidation Lagoons	4.0%	25	0%
373	Treatment & Disposal Facilities	4.5%	20	0%
General Plant				
391.1	Office Computer & Electronic Equip.	1.0%	5	0%
392	Transportation Equipment	7.0%	7	9%
393	Other General Equipment (tools, shop equip., backhoes, trenchers, etc.)	5.0%	13	13%