

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
File No. WF-2024-0135, Liberty Utilities (Missouri Water), LLC

FROM: Kelli McKinley, Financial Analyst, Financial Analysis Department,
Financial and Business Analysis Division

/s/ Seoung Joun Won, PhD, 12/21/2023
Financial Analysis Department / Date

SUBJECT: Staff Recommendation Concerning the Application of Liberty Utilities (Missouri Water), LLC (“Liberty Water,” “Company,” or “Applicant”), for authority to issue, in one or more issuances, up to \$30,000,000 in fixed rate long-term debt (“New Long-Term Debt” or the “Loan”) to Liberty Utilities, Co. (“LUCo”).

DATE: December 21, 2023

FINDING OF FACTS:

1. (a) **Type of Issue:** Long-term (not to exceed 30 years) unsecured debt in one or more issuances through 2025.
- (b) **Amount:** Up to \$30,000,000 (\$30 Million).
- (c) **Rate:** The New Long-Term Debt is anticipated to bear a fixed interest rate not to exceed 8%.
- (d) **Other Provisions:** Liberty seeks approval to issue the long-term debt in one or more issuances through 2025.¹
2. **Proposed Date of Transaction:** Liberty will issue a portion of the long-term debt shortly after receiving approval from the Commission with the remaining portion of the long-term debt to be issued in 2024.²
3. (a) **Statement of Purpose of the Issue:** Liberty seeks the long-term debt to repay outstanding money pool borrowings of approximately \$30 million incurred for the acquisition of the Bolivar water and wastewater systems and prior year capital expenditures as well as to fund future capital expenditures of approximately \$35 million.³

¹ Paragraph 9, The Application.

² Paragraph 7, The Application and Liberty Water’s response to Staff Data Request No. 0007.

³ Paragraph 6, The Application.

(b) From a financial perspective, does Staff deem this Statement of Purpose of the Issue reasonable?

Yes, with conditions imposed.

4. Copies of executed instruments defining terms of the proposed securities:

No instruments have been executed, but the general terms and conditions of the indebtedness were detailed in the Company's Appendix 2.

5. Certified copy of resolution of the directors of applicant, or other legal documents authorizing the issuance of the securities reviewed:

Yes.

6. Pro-forma Balance Sheet and Income Statement reviewed:

Yes.

7. Capital expenditure schedule reviewed:

Yes.

8. Journal entries required to be filed by Liberty Water to allow for the Fee Schedule to be applied:

Liberty Water indicates that they cannot determine what portion of such debt securities, if any, are or will be subject to the fee schedule set forth in RSMo. Section 386.300.2 at this time.⁴ Liberty further indicated that the Applicant will submit a verified report to the Commission, documenting the issuance and the applicability and measure of fees under RSMo. Section 386.300.2 when individual debt securities are issued.⁵

9. Recommendation of the Staff:

Conditional Approval recommended (see Comments and Recommended Conditions below).

⁴ Paragraph 16, The Application.

⁵ Ibid.

COMMENTS:

Liberty Water is a Missouri limited liability company with its principal office located at 602 Joplin Street, Joplin, MO 64801. Liberty Water is owned by Liberty Utilities (sub) Corp., an indirect subsidiary of LUCo. Applicant is qualified to conduct business as a public utility in the State of Missouri subject to the jurisdiction of the Commission as provided by law. Liberty Water is engaged, generally, in the business of furnishing water and sewer services, currently providing water service to approximately 11,450 connections and sewer service to approximately 4,778 connections in its Missouri service area.

On October 13, 2023, Liberty Water filed an Application with the Commission requesting approval for authority to issue up to \$30 million of unsecured long-term affiliate indebtedness (the “Notes”) through LUCo. Approval is requested through 2025 for one or more issuances to be split as follows: \$12 million in long-term debt shortly after receiving commission approval (\$17 million in capital contributions from LUCo in conjunction with this issuance). Up to \$18 million in long-term debt to be issued in 2024 and 2025 (\$19 million in capital contributions from LUCo in conjunction with this issuance).⁶

The Note will not be secured by a mortgage, lien, or encumbrance on Liberty Water’s properties in the State of Missouri.⁷ The long-term borrowings will be evidenced by a Promissory Note, payable to LUCo, attached as Appendix 2 to the Company’s Application. Liberty Water states in paragraph 10 of their application that:

Any issuances of Notes will not be priced until after receipt of Commission approval. As of September 29, 2023, a 10-year Note would have an all-in interest rate of approximately 6.5% before issuance costs and a 30-year Note approximately 7%. Future rates for an issuance of Notes are subject to change based on changes in the U.S. credit markets.

Staff applies the “not detrimental to the public interest” standard to financing applications. In reviewing requests for long-term financing authority, Staff analyzes the requested amount as it relates to the stated uses to ensure that the amount requested is reasonable and generally supports long-term capital investment. Staff also analyzes the pro forma impact the requested financing may have on the company’s credit metrics, which may include the estimated impact on the parent company’s credit metrics if the subject company’s rating is influenced by the parent company’s financial risk.

⁶ Paragraph 7, The Application.

⁷ Paragraph 12, The Application.

Staff typically recommends the Commission include a condition that approval of the financing is not considered approval of the terms and conditions of the financing transaction for ratemaking purposes.⁸

Concurrent with the issuance of the Notes, Liberty Water intends to pay LUCo, its parent company, a placement fee equal to 80 basis points of the principal amount of the Note.⁹ Liberty Water states that the placement fee “covers actual expenses (agents, rating agencies, etc.) that Liberty Utilities Co. (‘LUCO’) will incur on the issuance of long-term debt externally.”¹⁰ Liberty Water further states that “[t]his fee will be incurred and paid by Liberty at the time of each debt issuance. In Liberty’s financial statements it will be recorded as a deferred financing cost and amortized over the term of the new debt issuances. The fee paid by Liberty to LUCo will eliminate upon consolidation in LUCo’s consolidated financial statements.”¹¹ Liberty Water indicated that LUCo will incur financing costs on all external debt issuances, but this fee has yet to be incurred and they are not seeking ratemaking treatment for this fee at this time.¹²

Liberty Water states in their application that,

[c]oncurrent with the issuance of the Notes, Liberty will pay to LUCo a placement fee equal to 80 basis points of the principal amount of the Notes. At this time, however, Liberty is not requesting approval of the payment of this fee for ratemaking purposes. Liberty agrees that approval of the requested financing may be conditioned on the Commission reserving the right to consider the ratemaking treatment to be afforded the financing transactions and their impact on cost of capital in a subsequent rate case.¹³

Liberty Water additionally states that they are requesting the Commission authorize them to,

Incur, pay, and amortize the debt issuance expense of 80 basis points of the principal amount of the Notes and/or similar expenses related thereto over the life thereof.¹⁴

Staff recognizes “placement fees” or other transactional costs are inherently part of obtaining debt financing. These fees and costs are a part of an Applicant’s total debt costs, and the impact thereof is determined during a subsequent general rate case when calculating the cost of debt; not during a finance case. Staff also recognizes that this specific finance application is to obtain

⁸ See “Recommended Condition” number 1 of this memorandum.

⁹ Paragraph 11, The Application and Liberty Water’s response to Data Request No. 0017.

¹⁰ Liberty Water’s response to Data Request No. 0017.

¹¹ Ibid.

¹² Ibid.

¹³ Paragraph 11, The Application.

¹⁴ Page 4, Request B, The Application.

long-term debt from the Applicant’s parent company in order to pay existing outstanding debts to the same parent company. Because of these facts, Staff does not find the “placement fee” of 80 basis points reasonable.

Staff has verified that Liberty Water’s projected capital expenditure plan supports the need for the \$30 million long-term debt. Liberty Water's 2024 total projected capital expenditures total just over ** [REDACTED] **, equating to roughly ** [REDACTED] ** of expenditures per month.¹⁵ Liberty Water currently projects that it needs ** [REDACTED] ** for the period 2024 to 2028.¹⁶ Though the amount of the loan appears out of line with Liberty Water’s projected capital expenditures through 2028, they indicate in the application that:

In conjunction with capital contributions from LUCo, Liberty will repay outstanding money pool borrowings of approximately \$30 million incurred for the acquisition of the Bolivar water and wastewater systems and prior year capital expenditures and fund future capital expenditures of approximately \$35 million.¹⁷

The pro forma impact of Liberty Water’s proposed debt financing on Liberty Water’s balance sheet as of June 30, 2023, is as follows:¹⁸

Liberty Water (in Thousands)

| | | <u>As June 30, 2023</u> | | | | <u>Pro Forma</u> | | | | | | |
|-----------------|----|-------------------------|----|----|------------|------------------|----|------------|----|----|------------|----|
| Total Equity | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** |
| Total Debt | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** |
| Long-Term Debt | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** |
| Short-Term Debt | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** |
| Total | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** | ** | [REDACTED] | ** |

¹⁵ Appendix 1, The Application.

¹⁶ Ibid.

¹⁷ Paragraph 6, The Application.

¹⁸ Summary, Staff’s Workpaper.

The above capital structure ratios imply positive changes in capital structure wherein the Total Equity increases by ** [REDACTED] ** while the Total Debt decreases by the same amount as a result of this transaction. Liberty Water indicated that approximately ** [REDACTED] ** of the requested long-term debt and coinciding capital contributions is to repay approximately the same amount in intercompany borrowings as of December 31, 2022 while the remaining portion will go to support their capital expenditures from 2023 through 2026.¹⁹

Liberty Water indicated that the pro forma impact Liberty Water’s proposed debt financing on their financial ratios as of June 30, 2023, is as follows:²⁰

| | <u>As June 30, 2023</u> | | | <u>Pro Forma</u> | | |
|-------------------------|-------------------------|------------|-------------------------------------|------------------|------------|-------------------------------------|
| | | | <u>Financial Risk</u> ²¹ | | | <u>Financial Risk</u> ²¹ |
| FFO/Debt (%) | ** | [REDACTED] | ** Significant | ** | [REDACTED] | ** Highly Leveraged |
| Debt/EBITDA (x) | ** | [REDACTED] | ** Modest | ** | [REDACTED] | ** Highly Leveraged |
| Debt/Capital (%) | ** | [REDACTED] | ** Highly Leveraged | ** | [REDACTED] | ** Significant |

The Funds from Operations to Total Debt (“FFO/Debt”) for Liberty Water shows the ratio decreasing and Total Debt to Earnings Before Interest, Taxes, Depreciation, and Amortization (“Debt/EBITDA”) shows an increase in the pro forma. These are largely due to the transaction simply reclassifying short-term borrowings to long-term borrowings. The Debt to Capital ratio decreases, which is considered better for the company as it typically indicates less risk to shareholders. Although Staff finds that this transaction will impact Liberty Water’s financial risk profile, Staff finds that the overall impact to them is neutral.

Liberty Water additionally states that,

The additional indebtedness of \$30 million and capital contributions of \$35 million as submitted in the financing application will allow the Company to repay short-term borrowings and fund future capital expenditures with a desired capital structure of approximately 49% debt and 51% equity. Short-term borrowings are subject to floating interest rates and should not be used to permanently finance long-term assets, such as net utility plant, since the assets by definition are recovered through rates over

¹⁹ Liberty Water’s response to Data Request No. 0005.1.

²⁰ Ibid.

²¹ S&P Financial Benchmarks from “Methodology: Business Risk/Financial Risk Matrix Expanded”, www.standardandpoors.com/ratingsdirect, published September 18, 2012.

a long period of time. The refinancing of the Company's short-term debt balances with new long-term debt appropriately matches the longer-term assets and their recovery and reduces the Company's and ultimately the customer's financial risk. The benefit of long-term fixed rate debt financing is that the interest rate is fixed and predictable versus a daily variability over long periods of time.²²

Staff finds that the Application is not detrimental to the public interest.

RECOMMENDED CONDITIONS:

Staff recommends that, the Commission approve Liberty Water's Application in this case as the transaction is not detrimental to the public interest. Staff recommends that Commission approval be subject to the following conditions:

1. That nothing in the Commission's order shall be considered a finding by the Commission of the value of this transaction for rate making purposes, specifically including, but not limited to, the placement fee (if authorized), and that the Commission reserves the right to consider the rate making treatment to be afforded the financing transaction and its impact on cost of capital, in any later rate proceeding;
2. That the Company shall file with the Commission within thirty (30) days of issuance of any financing authorized pursuant to a Commission order in this proceeding, a report including the amount of indebtedness issued, date of issuance, interest rate (initial rate if variable), maturity date, redemption schedules or special terms, if any, use of proceeds, estimated expenses, and loan or indenture agreement concerning each issuance. In addition, the Company shall also provide the analysis, to include but not be limited to, indicative pricing information provided by investment banks it performed to determine that the terms for the debt it decided to issue were the most reasonable at the time;
3. That the Company shall file with the Commission, through its electronic filing and information system ("EFIS") any information concerning communication with credit rating agencies concerning any such issuance if there is any;

²² Liberty Water's response to Staff Data Request No. 0012.

4. That the Company shall file with the Commission as a non-case related submission in EFIS under “Resources” - “Non-Case Related Query” - “Ordered Submission” any credit rating agency reports published on Liberty Water’s or LUCo’s corporate credit quality or the credit quality of its securities;
5. That Liberty Water be required to file a five-year capitalization expenditure schedule in future finance cases;
6. That, to the extent that any non-regulated investments made by the Company or LUCo and affiliated companies may potentially impact the Company’s credit quality and resulting credit ratings, the Company shall notify Staff of such possibility and provide a status report to the Commission;
7. That the Commission’s grant of authority shall expire three years from the effective date of the order in this proceeding;
8. That the Commission not approve a specific “placement fee” in this finance case, and that any ratemaking treatment involving a “placement fee” or the amortization thereof shall be determined in future rate proceedings.

