MEMORANDUM

TO:COMMISSIONER HANSEN

COMMISSIONER NELSON

COMMISSIONER SMITH

FROM:SCOTT WOODBURY

DATE:JUNE 3, 1998

RE:CASE NO. UWI-W-97-6

CAPITAL STRUCTURE

United Water Idaho Inc.’s common stock is not traded.  It is wholly-owned by United Water Works (UWW; formerly General Waterworks Corp.), which is wholly-owned by United Water Resources Inc.  Tr. p. 252.  The actual capital structure of UWI is 100% equity.  Tr. p. 288.  The interest expense is allocated to UWI.

One of the issues in this proceeding is the capital structure that should be adopted for the regulated United Water Idaho Inc.  Testimony on this issue was presented by Frank J. Hanley (AUS Consultants) for the Company and Terri Carlock for Commission Staff.  Also submitted were post-hearing briefs.  The following schedule sets forth the related recommendations of each:

|  |  |  |
| --- | --- | --- |
|  | CAPITAL  STRUCTURE |  |
| COMPONENT | RATIO (UWI) | RATIO (STAFF) |
| Long-term debt | 54.98% | 52.0% |
| Minority Interest (Preferred Stock) | 0.14% | 8.0% |
| Common Stock | 44.88% | 40.0% |
| TOTAL | 100.00% | 100.00% |

Reference UWI Exhibit 13, Schedule 8; Staff Exhibit 101, Schedule 17.

United Water employs the actual June 30, 1997 consolidated capital structure of United Water Works (UWW).  Tr. p. 248.  The Company represents that this is appropriate because of the following:

1.UWW provides all of the external capital required by United Water;

2.No equity capital has been injected into UWW by its parent United Water Resources (UWR) since the April 1994 merger and thus UWW is not financially dependent on UWR;

3.UWR provides no financial guarantees, pledges, or any of its assets to any lender for the benefit of UWW;

4.No capital of UWR other than UWW could be used to finance United Water’s rate base; [prohibition disputed by Staff]

5.UWW capital structure ratios are reasonable vis-à-vis a proxy group of five water companies represented as generally similar in risk to United Water;

6.UWW capital structure ratios are consistent with those required by Standard and Poor’s (S&P) for a water utility to maintain an A bond rating with an “average” business position, i.e., the business position of UWW.  (S&P’s total debt to total capital criterion for a water company in an average business position to obtain an “A” bond rating is 52% implying, the Company states, a total equity ratio of 48%.  Tr. p. 301.)

Tr. p. 248.

In BOI-W-93-3, the Company’s last general rate case, the Commission adopted a hypothetical rate structure for Boise Water Company (United Water’s predecessor).  Reference Order No. 25640.  [The Company notes that at the time of the Commission’s Order in BOI-W-93-3 there existed uncertainty regarding the corporate relationships and resulting capital structure as indicated by the following Commission language:  “Because the common equity ratio of GWC is expected to be 40% for 1994 and because United’s common equity is expected to approximate 40% in the near term, we find that to be a reasonable equity ratio.”  Tr. pp. 288-290.]  Commission Staff in this case rejects the Company’s UWW capital structure and recommends continued use of the hypothetical capital structure approved in BOI-W-93-3.  Tr. p. 479.  Staff contends that its proposal is consistent with the Value Line water industry (Tr. pp. 462, 479) and S&P financial benchmark (Tr. p. 485) for a total debt to total capital ratio to maintain the S&P bond rating.  Staff states that the stock is traded at the United Water Resource level with United Water Resource controlling the pay out ratio, and thus the retained earnings and common equity ratio for United Water Works.  Tr. pp. 492-493; 499-503.  This control, Staff contends, has the potential to skew the capital structure ratios lending further support for the use of the hypothetical capital structure for rate making purposes.  Tr. pp. 495, 496.

The Company citing legal and regulatory principles suggests that use of a hypothetical capital structure is only appropriate if the actual capital structure (UWW) is “clearly unsound or extravagantly conservative.”  Tr. p. 272.  In support of the reasonableness of its position, the Company cites a recent Pennsylvania Commission case that found that for a sister subsidiary of UWW, United Water Pennsylvania, Inc., it was reasonable and appropriate to use UWW’s capital structure.  Tr. pp. 752-753.  With only two exceptions (UWI’s BOI-W-93-3 and a case involving United Water Delaware now on appeal to the Supreme Court of Delaware) in recent history, the Company states that the subsidiaries of UWW and the former General Waterworks Corp. have been consistently regulated in their rate cases, both before and after the merger, on a basis of UWW’s capital structure.  UWI Brief.

It is to be noted the UWR’s consolidated capital structure consists of 55.20% long-term debt, 8.51% preferred stock and 36.29% common equity.  Exhibit 13, Schedule 3.  The hypothetical debt ratio of 52% proposed by Staff, is less than the current debt ratio for UWR of 52.5% and the water utility industry average of 56.5%.  The 52% debt ratio is also the same as the ratio stated for an “A” rated utility as set forth in Standard & Poor’s Financial Benchmarks.  Exhibit No. 101, Schedule 15 also reflects these comparisons.  (UWW’s debt is rated “A” by S&P and UWR’s credit rating is “A-.”  Tr. p. 297.)  The 8% minority interest in the hypothetical capital structure is consistent with the 8.5% preferred stock held by UWR.

United Water does not directly raise funds in the market.  The debt funds are issued at the United Water Works level and the equity funds are retained through earnings or raised at the United Water Resources level [disputed by Company].  Therefore, the actual capital structure shown on the books of United Water Idaho, Staff contends, has been provided by and supported by one of the parent entities.  The UWI capital structure, Staff states, should be double leveraged to reflect this relationship.  Rather than double leverage, however, Staff contends that a hypothetical capital structure is more appropriate.  Tr. pp. 461, 462.  The Company states that Staff’s hypothetical capital structure is essentially the same as utilizing double leveraging.  This is disputed by Staff (Staff Brief), which presents but does not recommend an example of a double leveraged capital structure for UWI.  Staff Brief Exhibit A (objected to by Company).

The average capital structure ratios for the two proxy groups are depicted on Exhibit 13, Schedule 3, page 2.  They are for the proxy group of five water companies, 52.19% long-term debt,  1.88% preferred stock, 45.93% common equity capital; and for the proxy group of six Value Line water companies, 55.15% long-term debt, 2.58% preferred stock, and 42.27% common equity capital.  Tr. p. 760.  The Value Line water industry average capital structure consists of 39.5% in 1997 and is projected to be 40% in 1998.  Exhibit 101, Schedule 15.

The Company represents that its primary proxy group of five water companies (Exhibit 12, Schedule 5) is a better and more meaningful proxy than the group of six Value Line water companies.  Exhibit 12, Schedule 6, used by the Company as check and relied upon by Staff.  Tr. pp. 280-283.  The Value Line check group of six is dismissed by United Water as irrelevant in this case because the companies are much larger than United Water and geographically diverse.  Tr. pp. 756, 282.  Excluding the purported nonrepresentative American Water Works and United Water Resources, Inc. (which make up over three-fourths of the total capitalization of the group, Tr. p. 481), the 9/30/97 average capital structure for the remaining companies in the Value Line group would be 53.92% long-term debit, 0.94% preferred stock, and 45.14% common equity.  Tr. p. 760.  Compare Brief page 5 and Exhibit 13, Schedule 2 - average equity ratio 44.2%; excluding AWW and UWR 47.4%.

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