Service Date: October 7, 1986

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

IN THE MATTER of the Application	)	
of the BUTTE WATER COMPANY for	)	UTILITY DIVISION
Authority to Increase Rates and	)	DOCKET NO. 86.3.8
Charges for Water Service to its	)	ORDER NO. 5195a
Anaconda, Montana Customers.	)	

APPEARANCES

FOR THE APPLICANT:

Edward A. Murphy, Attorney at Law, Central Square Building, 201 West Main, Missoula, Montana 59802.

FOR THE INTERVENORS:

James C. Paine, Montana Consumer Counsel, 34 West 6th Avenue, Helena, Montana 59620.

FOR THE COMMISSION:

Geralyn Driscoll, Staff Attorney, 2701 Prospect Avenue, Helena, Montana 59620.

BEFORE:

John Driscoll, Commissioner and Hearing Examiner

BACKGROUND

1. On March 7, 1986, Butte Water Company (Applicant or BWC) filed an application with this Commission for authority to increase water rates for its Anaconda, Montana customers on a permanent basis by approximately 21.08%. This constitutes an annual revenue increase of approximately $55,651.

2. Concurrent with its filing for a permanent increase in rates, BWC filed an application for an interim increase in rates of 21.08% equaling a revenue increase of approximately $55,651 or 100% of the proposed permanent increase.

3. On April 22, 1986, the Commission, having considered the data filed with the Applicant's interim application, issued Order No. 5195 granting the Applicant interim rate relief in the amount of $22,214 annually.

4. On July 18,1986, after proper notice, a hearing was held in the Deer Lodge County Court House, Anaconda, Montana. The purpose of the public hearing was to consider the merits of the Applicant's proposed water rate adjustment. Pursuant to ARM 38.2.4802(2), all parties stipulated to a final order, rather than a proposed order, being issued in this Docket.

5. On December 18, 1985, Anaconda Minerals Company, BWC's former parent, sold all of BWC's outstanding shares of common stock to Dennis Washington. This sale caused a number of changes in the Applicant’s financial information and those changes are Applicant's being examined for the first time in this Docket.

FINDINGS OF FACT

6. At the public hearing, the Applicant presented the testimony and exhibits of:

James Chelini, President and General Manager, BWC
Don Cox, Certified Public Accountant

C. M. "Skip" Dunfee, Secretary - Treasurer, BWC
Harvey Ravendahl, Superintendent Anaconda Division

7. The Montana Consumer Counsel presented the testimony of one public witness. This public witness expressed concern regarding the magnitude of the proposed revenue increase and the impact this revenue increase would have on the monthly rates.

8. During the public hearing on the Applicant's request to increase rates in its Butte Division, Docket No. 86.3.7, BWC requested that the testimony of its witness, Tim Bartz, be made part of the hearing record in this Docket. None of the parties participating in this proceeding objected to Mr. Bartz’s testimony being included in the record of this Docket.

9. The Montana Consumer Counsel (MCC) requested that Frank Buckley’s testimony in the Butte proceeding, Docket No. 86.3.7 be made part of this Docket. No objections were made. Both witnesses testimony is incorporated in the record of this proceeding.

10. The year ending December 31, 1985, test year was uncontested and is found by the Commission to be a reasonable period to measure the Applicant's utility revenues, expenses and return for the purpose of determining a fair and reasonable level of rates for water service.

Capital Structure

ll. For rate case presentation, the Applicant in its original

application presented the following capital structure in "Data Furnished in Compliance with PSC Minimum Rate Case Requirements, Statement F."

Description	Amount	Ratio
Debt	$2,000,000	51.67%
Equity	$1,870,65	48.33%
TOTAL	$3,870,653	100.00%

12. Subsequent to the filing of the request for increased rates, Dennis Washington, the sole equity investor in BWC, paid off the $2,000,000 debt obligation, increasing his equity interest in BWC by that amount. With the retirement of this debt obligation, the actual capital structure of BWC consists of 100% equity financing.

13. As part of a stipulation entered into between the Applicant and the MCC, the Applicant agreed to the use of a hypothetical capital structure in determining its composite cost of total capital. The Applicant and the MCC agreed to the use of a 50/50 debt equity ratio for purposes of calculating the following capital structure:

Description	Amount	Ratio
Debt	$1,935,327	50.00%
Equity	$1,935,327	50.00%
TOTAL	$3,870,654	100.00%

14. The Applicant and the MCC are of the opinion that the above

capital structure is reasonable and compares favorably with that of other regulated utilities.

15. The utility industry is capital intensive and leverage is widely used to finance large plant additions. A debt equity ratio of 50/50, as proposed by the Applicant and the MCC in their stipulation, is not an atypical ratio in the utility industry. The Commission finds that use of the stipulated capital structure proposed by the Applicant and the MCC is reasonable in this Docket.

Cost of Debt

16. The Commission has accepted a hypothetical capital structure in this Docket that assumes a debt component in the Applicant's capital structure; in actuality there is no debt and no contractual obligations have been entered into that would establish an actual cost of debt for the Applicant. Absent contractual obligations that would establish a cost of debt, the Commission must determine a reasonable cost based on reliable information that fairly reflects BWC's type of capital.

17. In this Docket, the Applicant submitted a hypothetical loan request to various banks in Butte. Two banks indicated the interest rates they would charge to loan BWC money. The banks stated that a loan in the amount of $2,000,000 having a term of seven years would have an interest rate of between 10 to 12 Percent depending on whether the debt instrument carried a fixed BWC or variable rate of interest. The bank letters stated that if

the debt instrument were fixed rate financing, then the debt cost would range from 11.5 to 12.0 percent.

18. In their stipulation regarding capital structure and cost of capital, the Applicant and the MCC failed to specifically state their agreed upon cost of debt but, using the information contained in the stipulation, it can be determined that the cost of debt is 11.75%. The stipulated debt cost is the mid-range of the fixed rate financing available from local lending institutions on a loan of $2,000,000 having a term of seven years.

19. As previously indicated, the debt component accepted by the Commission in this Docket is $1,935,327. This magnitude of debt is comparable to the hypothetical loan request amount described in the bank letters wherein the lending institutions indicated a fixed rate cost of between 11.5 and 12.0 percent. The Commission, in this instance, finds it reasonable to accept the stipulated cost of debt, 11.75 percent, since it represents the mid-range of fixed rate financing available from local lending institutions.

Cost of Equity

20. The Applicant originally requested that the Commission authorize a 14.75% return on equity. As part of the stipulation between the Applicant and the MCC, the Applicant agreed to reduce its requested return on equity from 14.75% to 13.01.

21. The stipulated return on equity was not a contested issue in this Docket and is within the range of the returns recently

authorized by the Commission for other utilities under its jurisdiction. Therefore, the stipulated return on equity of 13.0% is accepted by the Commission.

Capital Structure and Weighted Cost of Total Capital

22. Applying Findings of Fact contained herein, the Commission finds the following capital structure and weighted cost of total capital to be reasonable:

Description	Amount	Ratio	Cost	Weighted Cost
Debt	$1,935,327	50.0%	11.75%	5.88%
Equity	$1,935,327	50.0%	13.00%	6.50%
	$3,870,654	100.0%		12.38%

Operating Revenues

23. The test period operating revenues are an uncontested issue in this case. The Applicant utilized the 12 months ended December 31, 1985, to determine the test period revenues under the rates that became effective January 1, 1985, adjusted for the phasing in of charges to consumers previously receiving free water service. Total test year revenues of $264,003, as calculated by the Applicant, are accepted by the Commission.

Operation and Maintenance Expense

24. In its responses to PSC staff data requests, the Applicant proposed total test period operation and maintenance expenses of $264,260. The test period operation and maintenance expense proposed by the Applicant includes proforma adjustments

increasing expenses by $30,951.

25. The MCC proposed one adjustment that increased the Applicant's proforma operation and maintenance expenses. The MCC's expert witness proposed an adjustment increasing the Applicant's rate case expense for the Anaconda Division by $23,660.
In pre-filed testimony, Mr. Buckley stated that he believed that rate case expense should be allocated between the Butte and Anaconda Divisions using a 50/50 allocation until such time as BWC demonstrates another allocation factor is more appropriate.

26. During direct examination, Mr. Cox, BWC's expert witness, stated that he reviewed BWC's accounting firm's billings for preparation of the Butte and Anaconda Division rate cases. This review indicated that of 90 percent the hours worked to prepare the rate cases were attributable to Butte and 10 percent attributable to Anaconda.

27 The Commission finds, based upon 'he testimony of Mr. Cox, that the rate case expense should be allocated between BWC's Butte and Anaconda divisions on a 90/10 basis. Using the 90/10 allocation factor the proforma expenses of the Applicant would be increased by $1,260.

28. At the hearing, the Applicant reduced its proforma wage expense increase by $25. The Applicant's Exhibit No.1 reflects a lower cost of living adjustment (COLA) than that originally calculated. The lower COLA for BWC wage earners, as calculated by the Applicant, reduces wage expense for the Anaconda Division by

$25 annually. The Commission finds the $25 reduction to be appropriate and accepts the adjustment.

29. On August 18, 1986, pursuant to ARM 38.2.4805, BWC filed an "application for rehearing" asking the Commission to reopen the proceeding for the purpose of taking additional evidence. All parties to this proceeding were served with a copy of the application, and the 10 day period for the filing of comments in opposition to the application passed with no comments being filed.

30. In its application for rehearing, BWC stated that at the date of the hearing it "had no basis upon which to speculate as to the size" of any increase in liability insurance premiums. The following quotes from BWC's "application for rehearing" state why it had no knowledge regarding the magnitude of any increase in premiums and BWC's reasons for asserting that this increase should be considered subsequent to the close of the hearing in this Docket:

> When the company was owned by Anaconda Minerals Division of ARCO, it was self-insured. Following its sale the present owner provided insurance through United States Fidelity and Guaranty Company. After obtaining the insurance, representatives of the carrier conducted a thorough review of the company's operations for underwriting purposes. That review was not completed until June 30, 1986, and the bill for the premium was not delivered until August 7, 1986.

The increase is $66,521.00 which is a significant increase. It is essential for the company to obtain liability coverage, otherwise a Judgement against the company could totally destroy the company's net worth. Such a result could trigger a Chapter 11 Bankruptcy. The expense is a normal and necessary operating

expense which is routinely compensated in rate making.

31. The Commission finds that BWC's application for rehearing establishes that conditions have so changed as to require the reopening of this proceeding to take additional evidence. Additional evidence is limited to the issue of the increase in liability insurance expense.

32. The Applicant stated in a letter to the Commission that its application to reopen the proceeding was not a request to increase the annual revenues above the level requested in its original application. The Applicant wrote "It is the company's desire that the requested adjustment on the insurance premium be considered in lieu of other adjustments either stipulated to between the company and the Consumer Counsel or otherwise made by the Commission in its decision." Since there was no modification to the Applicant's requested annual increase in revenue beyond that which had already been noticed, no further public notice was issued.

33. The Applicant in the application for rehearing states that the amount of liability expense included in the test year totals $25,535. The premium received by the Applicant on August 7, 1986, totaled $91,056; therefore, the Applicant has experienced an annual increase in this expense totaling $66,521.

34. The Applicant proposes that the $66,521 increase in liability expense be allocated between its Butte and Anaconda Divisions because the increase represents a company total. The Applicant

proposes that the increase amount be allocated based upon the proportion of plant in the two divisions. Using this allocation 6.25% of the increase is attributed to the Anaconda Division representing an annual expense increase of $4,158.

35. Based on the preceding Findings of Fact, the Commission finds the Applicant's request to include the increase in liability insurance as a proforma adjustment increasing its operating expenses to be reasonable. The Commission further finds that the proforma expenses of the Anaconda Division should be increased by $4,158, as calculated by the Applicant.

36. Proforma operation and maintenance expenses under present rates are found to be $269,653 recognizing total proforma adjustments increasing expenses by $36,344.

Depreciation Expense

37. The test period depreciation expense is not a contested issue in this Docket. The Applicant proposed depreciation expense of $9,534 which is accepted by the Commission.

Taxes Other Than Income

38. The Applicant proposed an expense for "Taxes Other Than Income" of $20,653. Included in "Taxes Other Than Income is $261 for Montana Consumer Counsel tax calculated at the rate of $1.00 per $1,000 of gross revenue. Subsequent to the filing of the Applicant's rate request, the Montana Department of Revenue

determined that the Montana Consumer Counsel Tax rate should be decreased from $1.00 per $1,000 of gross revenue to $.30 per $1,000 of gross revenue.

39. Applying the new tax rate to the $264,003 operating revenues recognized by the Commission results in a Montana Consumer Counsel tax liability of $79. Since the Applicant has a decreased tax liability for Montana Consumer Counsel tax, "Taxes Other Than Income" should be reduced by $182. The Commission finds "Taxes Other Than Income" to be $20,741.

Rate Base

40. The Applicant proposed an average original cost depreciated rate base of $139,020. In his prefiled testimony, the Montana Consumer Counsel's witness, Frank Buckley, proposed two adjustments decreasing the Applicant's average original cost depreciated rate base. The adjustments proposed by the MCC's witness are a reduction in the Applicant's cash working capital and reflection of accumulated deferred federal income taxes.

41. In his prefiled testimony and on direct examination, MCC's witness testified that BWC used an incorrect rate in determining the cash working capital requirement for unmetered consumers paying 15 days after service is provided. He contended that the correct rate for determining the cash working capital for this category of consumers was 4.2% not the 12.5% used by the Applicant. On cross-examination, the Applicant did not challenge the contention that 4.2% was the correct rate for unmetered consumers paying 15 days after service is provided.

42. The Commission, based upon the direct testimony of the MCC's

witness and the Applicant's apparent acceptance of the rate, finds 4.2% to be the appropriate rate for determining cash working capital for unmetered consumers paying 15 days after service is provided.

43. On cross-examination, the Commission staff asked Mr. Buckley why he had proposed an adjustment to the rate determining the cash working capital requirement for unmetered consumers paying 15 days after service is provided and not for metered consumers paying 15 days after service is provided. Mr. Buckley indicated that not proposing the adjustment for metered consumers was an oversight and that the same rationale used in determining the rate for unmetered consumers would be appropriate for the metered consumers.

44. The Commission has already found the 4.2% rate appropriate for
determining the cash working capital requirement for unmetered consumers paying 15 days after service is provided.

It must also find that the 4.2% rate is appropriate for metered consumers because the same rationale applies to both customer categories.

45. Based on the preceding Findings of Fact, the Commission finds that the Applicant's cash working capital allowance should be reduced by $8,586.

46. The second adjustment proposed by the MCC's witness, which

reduced rate base, was the inclusion of Accumulated Deferred Federal Income Taxes in the rate base calculation. In his prefiled testimony, Mr. Buckley states "Since these monies are non-investor supplied, they should be treated as cost-free and used to reduce rate base." The Applicant agreed with Mr. Buckley that these monies were non-investor supplied and should be used to reduce rate base.

47. Since the monies in question were ratepayer provided, the Commission finds that the Applicant's rate base should be reduced by the average projected amount $2,298.

48. When comparing the Applicant's Exhibit No. 1 rate base calculation to the calculation of the rate base in the responses to PSC data requests, the Commission noted that the Applicant had used two different figures for Unrestored Investment Tax Credits (UITC) in its calculations. In its Exhibit 1, the Applicant reflects $10,023 of UITC, and in responses to data requests, the Applicant reflects $8,155 of UITC. The original cost depreciated rate base valuation proposed by the Applicant of $139,020 uses the $8,155 figure in the calculation.

49. To determine which figure to use in calculating the Applicant's original cost depreciated rate base, the Commission examined the rate base calculation contained in the Applicant's Exhibit No. 2 (prefiled testimony and exhibits of Don Cox). For purposes of calculating rate base in Exhibit 2, Mr. Cox used $10,023 of UITC. Since $10,023 of UITC appears twice in separate calculations, the Commission will assume it to be the correct figure. Since the Applicant used the $8,155 figure in calculating a rate base of $139,020 and the appropriate number appears to be

$10,023, the Commission finds that the Applicant's rate base should be reduced by $1,868 to reflect the increased level of UITC.

50. Based on the preceding Findings of Fact, the Commission finds the Applicant's original cost depreciated rate base should be $126,268.

Income Taxes

51. The income tax issue in this Docket is how should the net operating losses (NOLs) that could be available to reduce taxable income be treated for ratemaking purposes. In prior Orders, specifically, Butte Water Company, Order No. 4699a, Dock et No. 6801 and Mountain Water Company, Order No. 5139a & 5139b, Docket No. 84.9.59, the Commission found that NOLs should be used to compute income tax expense allowed for ratemaking purposes. In Order 5139a, the Commission noted that City of Helena v Montana Department of Public Service Regulation, Mont. , 634 P.2d 192 (1981) prohibits the Commission from setting rates that allow a utility to recover past operating losses. By ignoring the NOLs in its ratemaking review, the Commission allows the investor indirect recovery of utility operating losses. In Order No. 5139a, the Commission found "that the net operating loss carry forwards available to offset the income tax obligation should be recognized in calculating the Applicant's income tax liability." Order 5139a, page 11, FoF 32. BWC argues that the Commission should deviate from its past ratemaking treatment of NOLs, but this Commission disagrees.

52. BWC incurred tax net operating losses during the period 1974

through 1985 totaling $3,376,243 (late-filed exhibit No.3). Applicant's rationale for ignoring the NOLs in calculating the tax expense is: one, the NOLs were caused, in part, by interest on intercompany borrowings; two, the losses did not actually result in a tax benefit to ARCO because of intercompany elimination's required by the Internal Revenue Service; and, three, ARCO used all of BWC's NOLs to offset income tax liabilities of profitable enterprises on a consolidated return. Therefore, no NOL's are actually available to offset income tax expense of BWC (see Applicant's Brief Pages 8-10).

53. The Commission does not find any of these arguments persuasive reasons for deviating from its prior orders. From 1974 through 1981, BWC sustained total net operating losses of $2,257,802. These losses were neither caused by interest on BWC inter-company borrowings nor eliminated on the consolidated tax returns; interest payments to ARCO did not start until 1982. Any interest expense during this time frame (74-81) was paid to a third party lender, Crocker National Bank (see response to staff data request No.20). Since the interest expense was paid to a third party during this time, no inter-company elimination occurred and a contention that the equity investor received no tax benefit from the net operating loss would be incorrect.

54. The Commission has seriously Considered Applicant's contention that NOLs should be ignored in calculating income tax expense for ratemaking purposes because no NOLs available to reduce taxable income. However, no NOLs are available to BWC for tax reporting purposes because ARCO elected to use BWC's net operating losses to offset taxable income of other profitable

enterprises. BWC, as well as the BWC ratepayer, would have benefited from these NOLs if they were available. Nothing prevented BWC from retaining the NOLs. It would be inequitable to the ratepayer to deny it the benefit of a tax savings that BWC could have retained but chose not to.

55. Viewed on a "stand alone" basis, BWC generated NOLs that could be used to reduce taxable income. Since BWC has not used the NOLs, in the Commission's view, they are still available for ratemaking purposes and should be used to determine BWC's tax expense for ratemaking purposes. Any tax benefit accruing to a regulated utility must remain with the utility until such time as it can be used by the utility. To do otherwise would wrongfully disallow the ratepayer from realizing the effects of such tax benefits.

56. Dennis Washington, the sole equity investor, acquired 100% of the outstanding shares of BWC stock from ARCO on December 18, 1985. The Applicant in its brief argued:

> ...If the net operating losses that are not present are nevertheless used to reduce that expense, it will be to the detriment of an investor whose management practices did not generate the net operating losses.

The Commission disagrees with the above quote from the Applicant's brief which asserts that the Commission's ratemaking practice of reflecting NOLs will harm the current equity investor. The Commission's practice of reflecting NOLs as an offset to income taxes in ratemaking is a matter of public record and has been used in previous decisions relating specifically to BWC. The time for a prospective equity investor to consider the

Commission's ratemaking treatment of various items when acquiring an equity interest in a regulated utility, is prior to the acquisition of the equity interest. The cost of acquiring the equity interest should reflect ratemaking treatments that work to the benefit or detriment of the prospective investor. If, in the purchase price, the prospective equity investor fails to recognize a ratemaking treatment that is detrimental to the equity holder, any harm that befalls the equity investor is not the fault of regulation, but the failure of the investor to exercise the reasonable business practice of investigating before investing.

57. The Commission, based on Findings of Fact in this section, finds that the Applicant for ratemaking purposes has sufficient NOLs available to offset any income tax obligation.

58. Based upon the preceding Findings of Fact, the Commission finds BWC's test period operating income to be ($35,925) calculated as follows:

Operating Revenue	$264,003
Operating Deductions	299,928
Operating Income	($35,925)

REVENUE REQUIREMENT

Rate Base	$ 126,268
Rate of Return	12.38%
Return Requirement	$ 15,632
Adjusted Balance Available for Return	(35,925)
Return Deficiency	51,557

Revenue Deficiency	51,573
MCC Tax at .003%	16
Income Available for Return	$ 51,557

59. In order to produce a return of 12.38% on the Applicant's average original cost depreciated rate base, the Applicant will require additional annual revenues in the amount of $51,573 from its Anaconda, Montana, water utility.

Rate Design

60. The Applicant proposes to continue the current water rate structure and generate the increased revenue determined appropriate in this order by increasing rates and charges for all water services on a uniform percentage basis. The rate design proposed by the Applicant appears to equitably spread the increase among the various customer categories. Therefore, the Commission accepts the Applicant's proposed rate design in this Docket .

Rules

61. The Applicant has proposed implementation and modification of certain rules of practice for the water utility. The Commission has reviewed the proposed rules and they appear to be in substantial conformance with this Commission's "General Rules for Privately-Owned Water Utilities." The Commission finds the rules of practice filed by the Applicant with its application should be approved.

CONCLUSIONS OF LAW

1. The Applicant, Butte Water Company, is a public utility as defined in Section 69-3-101, MCA. The Montana Public Service Commission properly exercises jurisdiction over Applicant's rates and service pursuant to Section 69-3-102, MCA.

2. The Commission has provided adequate public notice and an opportunity to be heard as required by Section 69-3-303, MCA, and Title 2, Chapter 4, MCA.

3. The rates and rate structure approved in this order are just and reasonable. Sections 69-3-201, and 69-3-330, MCA.

ORDER

NOW, THEREFORE, IT IS ORDERED THAT:

1. Butte Water Company shall file rate schedules which reflect an increase in annual revenues of $51,573 for its Anaconda, Montana service area. The increased revenues shall be generated by increasing rates and charges to all customer classifications on a uniform percentage basis.

2. The rates approved herein shall not become effective until approved by the Commission.

3. The revenues approved herein are in lieu of, and not in addition to, those approved in Order No. 5195.

4. The special rules proposed by Butte Water Company for its Anaconda service area are approved.

5. DONE IN OPEN SESSION at Helena, Montana, this 6th day of October, 1986, by a 3 - 0 vote.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

_____
JOHN B. DRISCOLL, Commissioner

_____
HOWARD L. ELLIS, Commissioner

_____
TOM MONAHAN, Commissioner

ATTEST:

Ann Purcell
Acting Secretary

(SEAL)

NOTE: Any interested party may request the Commission to reconsider this decision. A motion to reconsider must be filed within ten (lO) days. See 38.2.4806, ARM.