Service Date: June 30, 1987

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

IN THE MATTER of the Application	)	
of MOUNTAIN WATER COMPANY for	)	UTILITY DIVISION
Authority to Increase Rates and Charges for	)	DOCKET NO. 86.9.51
Water Service in the Missoula Montana	)	ORDER NO. 5252b
Service Area.	)	

* * * * *

APPEARANCES

FOR THE APPLICANT:

John Alke, Attorney at Law, Hughes, Kellner, Sullivan & Alke, P.O. Box 1166, Helena, Montana 59624

FOR THE INTERVENORS:

Mary Wright, Staff Attorney, Montana Consumer Counsel, 34 West Sixth Avenue, Helena, Montana 59620

Jim Nugent, City Attorney, Representing City of Missoula, 201 West Spruce, Missoula, Montana 59802

FOR THE COMMISSION:

Robin McHugh, Staff Attorney, 2701 Prospect Avenue, Helena, Montana 59620

BEFORE:

Howard Ellis, Commissioner and Hearing Examiner
Danny Oberg, Commissioner
Tom Monahan. Commissioner

BACKGROUND

1. On September 29, 1986, Mountain Water Company (Applicant or MWC) filed an application with this Commission for authority to increase water rates and charges for its Missoula,

Montana customers on a permanent basis by approximately 26.68%. If granted, this would constitute a revenue increase of approximately $1,083,202.

2. Concurrent with its filing for a permanent increase in rates MWC filed an application for an interim increase in rates of approximately 18.51%, equaling a revenue increase of approximately $751,548 or 69.4% of the proposed permanent increase.

3. On January 13, 1987, the Commission, having considered the merits of the Applicant's interim application, issued Order No. 5252 denying the Applicant's request for interim rate relief.

4. On December 16, 1987, MWC and the Montana Consumer Counsel (MCC) entered into a stipulation that, for purposes of this rate case, a reasonable cost of equity would be 13 percent and a reasonable hypothetical capital structure would be split 50-50 between debt and equity.

5. On January 26, 1987, MWC filed a motion with the Commission requesting that the Commission issue an order adopting the stipulation entered into by the Applicant and MCC. Before the Commission will accept a stipulation disposing of a contested issue in a rate case it requires, 1) that the parties to the stipulation provide sufficient information for the Commission to conclude that the stipulation is reasonable, and 2) that all parties have an opportunity to comment on the stipulation. In this instance the Commission did not find that either the stipulation or MWC's brief in support of its motion to adopt the stipulation provided sufficient information to conclude that the stipulation was reasonable. Further, the Commission wanted to be certain that the City of Missoula and Montana Peoples Action, two parties to this rate case who were not parties to the stipulation, had every opportunity to state their position with respect to the stipulation.

6. On February 19, 1987, following notice to all parties in this Docket, a meeting was held in the Commission offices to discuss the reasonableness of the proposed stipulation. Representatives of MWC, MCC, and the City of Missoula were present at the meeting; Montana Peoples Action was not represented. The purpose of this meeting was to allow the Applicant and the MCC to provide the Commission with additional background information in support of the reasonableness of their stipulation and to receive comments from all parties.

7. On March 5, 1987, the Commission, having considered all of the information presented on the reasonableness of the proposed stipulation, issued Order No. 5252a adopting the stipulation entered into by the Applicant and the MCC. Details on the Applicant's original proposal regarding capital structure and cost of equity as well as the stipulated proposal accepted by the Commission in Order No. 5252a will be discussed later in this order.

8. On April 2-3, 1987, following issuance of proper notice, a hearing was held in the City Council Chambers, City Hall, Missoula, Montana. For the convenience of the consuming public an evening session was held April 2, 1987, at 7:00 p.m. at the same location. The purpose of the public hearing was to consider the merits of the Applicant's proposed water rate adjustments.

9. The year ending December 31, 1985 is the test year in this application. The Commission finds this to be a reasonable period within which to measure the Applicant's utility revenues, expenses and returns for the purpose of determining a fair and reasonable level of rates for water service.

FINDINGS OF FACT

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

Lee Magone, Vice President & General Manager, MWC
Don Cox, Certified Public Accountant.

11. The Montana Consumer Counsel presented the testimony of eighteen public witnesses at the hearing. It also presented the testimony and exhibits of one expert witness: Frank Buckley, Rate Analyst, Montana Consumer Counsel.

The City of Missoula presented the testimony and exhibits of its Fiscal Analyst, Charles Stearns. The City also called to the witness stand Don Gallup, Vice President, Policy, Planning and Rates, Park Water Company. Park Water Company is Mountain Water Company's parent corporation.

CAPITAL STRUCTURE

12. In its application MWC proposed the following capital structure for rate case presentation:

Description	Amount	Ratio
Equity	$5,996,914	66.75%
Debt	$2,987,500	33.25%
	$8,984,414	100.00%

13. As part of the stipulation entered into between the Applicant and the Montana Consumer Counsel, the Applicant agreed to the use of a hypothetical capital structure to determine 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
Equity	$4,492,207	50.00%
Debt	$4,492,207	50.00%
	$8,984,414	100.00%

14. The Commission, for the reasons stated in its Order No. 5252a, found that use of the stipulated capital structure as presented in Finding of Fact No. 13 is reasonable in this instance. The stipulated capital structure will be used to calculate the composite cost of total capital in this Docket.

COST OF EQUITY

15. The Applicant originally requested that the Commission authorize a 13.5% return on equity. As part or the stipulation between the Applicant and the MCC, the Applicant agreed to reduce its requested return on equity from 13.5% to 13.0%.

16. The stipulated return on equity was not a contested issue during the public hearing in this Docket. As indicated by the Findings of Fact in Order No. 5252a, the stipulated return on equity is within the range of the returns recently authorized by this Commission for other utilities under its jurisdiction. The 13.0% return on equity stipulated to by the Applicant and the MCC will be used in this order for purposes of determining MWC composite cost of total capital.

FINDINGS OF FACT 12 THROUGH 16 ARE PRESENTED FOR INFORMATION PURPOSES ONLY. THE APPLICANT'S CAPITAL STRUCTURE AND COST OF EQUITY WERE THE SUBJECT OF A SEPARATE COMMISSION ORDER.

COST OF DEBT

17. The debt capital of the Applicant consists of a $2,987,500 note issued by Park Water Company to Montana Power Company. This debt is an obligation of Park Water Company rather than it subsidiary, MWC, but the note has been properly assigned to the Applicant for ratemaking purposes.

18. The cost of debt, or interest, on this note is variable, the present cost being 9.25% and the cost at maturity being 10.0%. The cost of debt presented by the Applicant was not challenged by any party participating in this proceeding and is accepted by the Commission.

CAPITAL STRUCTURE AND COMPOSITE COST OF TOTAL CAPITAL

19. The Commission finds the following capital structure and composite cost of total capital to be reasonable:

Description	Amount	Ratio	Cost	Weighted Cost
Equity	$4,492,207	50.0%	13.00%	6.500%
Debt	$4,492,207	50.0%	9.25%	4.625%
	$8,984,414	100.0%		
Composite Cost of Total Capital				11.125%

RATE BASE

20. In its original application MWC proposed an average original cost depreciated rate base of $9,743,657. At the public hearing the Applicant submitted a revised Exhibit No. DC-1 that reflects a reduction of its claimed original cost depreciated rate base. The Applicant's reduced rate base of $9,599,520 results from adjustments that were proposed by either the MCC or the

Commission staff and accepted by MWC. These adjustments include, but are not limited to, a reduced level of post test year plant additions, an increase in land not used and useful, exclusion of "old" main office computer from rate base and a reduction in main office transportation equipment.

21. Even though the Applicant accepted certain proposed adjustments to its claimed rate base, all issues were not resolved and rate base remained a contested issue in this case. The Applicant in its revised rate base included $540,957 in post test year plant additions. The inclusion of these post test year plant additions in rate base is opposed by the MCC.

22. The MCC's expert witness, Frank Buckley, in his prefiled testimony advocated that the Commission should disallow the Applicant's proposal to include post test year plant additions in its rate base. Mr. Buckley's rationale is succinctly stated in the following response to a question in his prefiled testimony:

> Q. Are you satisfied that there is an appropriate match between the Company's proposed test year plant, expenses and revenues?
>
> A. No. Response to MCC-11 indicates that such an attempt in my opinion would not result in "known and measurable changes." It shows that these adjustments are best estimates and should be rejected.

23. At the hearing Mr. Buckley expanded on his opinion that the Company's proposal to include post test year plant additions should be disallowed. On cross-examination he was asked the following question and gave the following response:

> Q. And what are those additional appropriate adjustments that you request?
>
> A. "...I think it would be appropriate also to reflect 1986 investment levels supplied by the rate payer. Sir, those would be additional dollars in the depreciation reserve anywhere from a range of 280 to 300,000; additional dollars in advance for construction, approximately 56,000; additional dollars in contributions in aid of construction, approximately 21,000; additional dollars in division deferred taxes in the range of 167,000. I believe if those adjustments were made, we would come close to having an appropriate "rate base match", if you will. (Tr. pg. 171)

The MCC's expert witness admitted that the Company attempted to match post test year plant additions with revenues and expenses associated therewith, but he reasoned that the Applicant did not make an appropriate match between the Company's proposed test year plant, expenses and

revenues. He contended that MWC made adjustments that reflect only one side of the plant investment equation, that being investor supplied, which results in an increase in rate base, and ignored post test year plant investment supplied by the ratepayer which would be a reduction to rate base.

24. MWC, through its expert witness, Don Cox, gave the following reasons why the Commission should allow the inclusion of post test year plant additions in rate base: 1) The Commission has allowed inclusion of post test year plant additions in other dockets, specifically Mountain Water Company, Docket No. 84.9.59, and Montana Power Company, Docket No. 83.9.67; 2) lf post test year plant additions are not allowed "the Company is being required to provide these facilities for public service without being permitted to recover the cost of the facilities" (Don Cox Rebuttal Testimony, pg. 10); and 3) The Company has made a good faith estimate of the cost savings generated by the main replacement program.

25. Mr. Cox referred in his rebuttal testimony to decisions where the Commission allowed the inclusion of post test year plant additions in the rate base calculation. As previously mentioned these cases relate to Montana Power Company and Mountain Water Company. In reference to the Commission's allowance of Colstrip (3) in rate base Mr. Cox states: "...in PSC Docket 83.9.67, the Colstrip generating station did not come on line until ten months after the close of the historic test year used in that case, but because of the obvious impact that event had on the cost of service, it was accepted as a known and measurable change." (Don Cox, rebuttal testimony pg. 9)

Regarding the Commission's allowance of post test year plant additions in MWC's last rate case, Mr. Cox, on cross-examination, admitted that the monetary magnitude of the improvements was significantly above the level under consideration in this Docket: approximately $1.2 million vs. $540,000. Mr. Cox also acknowledged the fact that a substantial portion of the post test year plant additions in the prior case were associated with the development of new wells as a source of supply. He further admitted that the need for the development of these wells was occasioned by the Applicant's loss of the Rattlesnake as a source of supply.

26. It is true that the Commission, on occasion, has allowed the inclusion of post test year plant additions in the rate base calculation. But as noted by the MCC's expert witness, Frank Buckley, the Commission has also disallowed the inclusion of post test year plant additions in the calculation. Mr. Buckley referred to Commission Dockets 83.8.58 and 85.7.26 assigned to rate cases of Montana-Dakota Utilities Co. and Great Falls Gas Co., respectively. In those two Dockets the companies proposed the inclusion of post test year plant additions in rate base and the Commission denied the proposal. In both cases the denial was predicated on the company's failure to make any substantial adjustments to the revenues and expenses in an effort to match them with the proposed rate base.

27. Mr. Cox further alleges that if the Commission does not allow the inclusion of post test year plant additions in rate base MWC is being required to provide facilities for public service without receiving compensation. During cross-examination by the Commission staff Mr. Cox was asked a series of questions regarding the nature of the post test year plant additions under consideration in this Docket and their effect on the operating statement of the Applicant. Mr. Cox indicated that the post test year plant additions under consideration in this Docket were "on going" in nature, meaning that the Commission could typically expect to see a continuation of capital expenditures of the dollar magnitude included in this filing. Mr. Cox was also asked if the post test year plant additions would result in a savings in operation and maintenance expense for MWC and whether this savings would represent a compensation to MWC if the Commission decided that it was inappropriate to include adjustments associated with post test year plant. The witness responded that the Applicant would realize savings in operation and maintenance expense and that if the Commission chose not to reflect any adjustments regarding post test year plant additions that this savings in operation and maintenance expense would represent a compensation to MWC on this investment. The witness's admission that a Commission decision disallowing inclusion of post test year plant adjustments would result in the Applicant realizing compensation for these additions, negates his statement that the Applicant would be required to provide facilities without being allowed to recover costs.

28. The third item relied upon by the Applicant to support the reasonableness of its proposal to include post test year plant additions in the rate base calculation is the fact that MWC has made a good faith effort to estimate the cost savings associated with the additions. This is where the Applicant's proposal diverges from previous presentations where companies have requested the inclusion of "on going" capital maintenance in rate base. The Commission's previous denials regarding post test year plant additions generally centered around the failure of the utility to make appropriate adjustments to its revenues and expenses associated with the post test year additions. In this Docket the applicant has made an attempt to match revenues and expenses with the post test year additions by adjusting electrical expense, repairs expense and depreciation expense. The MCC questioned whether or not these were the only adjustments that were required for the Applicant to properly reflect the impact of these additions on its operating statement. The MCC during its cross-examination of Mr. Cox elicited testimony that possibly there should be an adjustment increasing revenues, to reflect additional revenues from fire hydrant charges.

29. The Commission finds a stronger case is made for denial of the Applicant's proposal to include post test year additions in its rate base. The Commission concurs with the MCC's position that the Applicant has not made all the necessary adjustments that would provide for an appropriate matching of revenues, expenses and rate base. The Applicant attempted to make an appropriate match, but the Applicant's analysis is flawed because it does not recognize the ratepayer provided investment for 1986. Furthermore, if the Applicant made all the adjustments necessary to provide for an appropriate matching this would carry it into the realm of a future test year which is not the test year concept endorsed by this Commission.

The Applicant, in part, relied upon two prior Commission decisions that allowed the inclusion of post test year plant additions in the rate base calculation to argue that it is appropriate to include post test year additions in this application. Those decisions should not be understood to reflect a Commission policy allowing the inclusion of "on going" capital maintenance as post test Year Plant additions. In the two Dockets where the Commission authorized the inclusion of post test year additions the level of capital expenditure was significantly above normal and a Commission failure to allow recognition of those additions in rate base would have resulted in substantial

financial harm being inflicted on the utility. The plant additions recognized in those orders were not "on going" capital maintenance, they were substantial capital expenditures incurred by the utilities to insure that an adequate water and electrical supply was available to their customers.

30. In light of the above the Commission finds that the Applicant's request to include $540,957 in post test year plant additions in its calculation of rate base should be denied. Since it is the Commission's finding that the Applicant's proposal to include post test year plant additions should be denied, it is necessary for the Commission to reflect an adjustment decreasing the Applicant's reserve for depreciation by $12,976. Disallowance of the post test year plant additions and the adjustment to the depreciation reserve results in a net reduction in the Applicant's rate base of $527,981.

31. During the test year the Applicant installed a new computer system at its main offices in Downey, California. The Applicant indicated that the new computer system was installed because the old computer was outdated and inadequate for the Applicant's needs. The need for installation of a new computer system was substantiated in a study conducted by Arthur Young and Company. Arthur Young and Company in its study outlined three alternatives for a new computer configuration, none of which was adopted in its entirety by the Applicant.

32. The Applicant, in response to a data request and through the testimony of its expert witness, Don Cox, indicated that the new computer system is currently operating at approximately 60% capacity. The Applicant further indicated that it did not expect the new programs to be fully implemented until late 1988.

The Applicant testified that the new computer system is not being utilized to capacity but has included the full cost of the new computer system in its main office rate base. The statutes under which this Commission operates, specifically 69-3-109, has a used and useful clause relating to the Commission's authority in ascertaining property value. It is the Commission's position that of am asset is not fully used and useful in the provision of service to consumers then an adjustment, which reflects only that portion which is used and useful, is appropriate.

33. On cross-examination Mr. Cox stated the following with respect to the used and usefulness of the new computer system:

> "80 percent of the real storage is considered full capacity on a computer. If you get over 80 percent, your response time is greatly reduced. Your chances of losing data greatly increase." (Tr. pg. 114)

The Commission for purposes of calculating the adjusted value of the computer system in this Docket, will use the 80 percent figure as representing full utilization. Since 80 percent represents full utilization and 60 percent is the current utilization the Commission finds that 75 percent of the original cost of the new computer system should be reflected in this Docket.

34. The new computer system installed at the Downey main office cost $307,329. To determine the appropriate amount to be included in MWC's rate base, it is necessary to make two calculations. First, it is necessary to multiply the original cost of $307,329 by 75% to determine the allowable main office rate base amount for this docket. Then it is necessary to multiply that product (230,496) by the weighted average from the four factor allocation, 28.67%, to determine the MWC allowed rate base amount of $66,083.

35. The revised rate base of MWC includes an asset cost for the new computer system in the amount of $88,111. The Commission has calculated, based on the used and useful test, that the appropriate amount to be included in rate base is $66,083. Based on the preceding the Commission finds that the Applicant's original cost depreciated rate base should be reduced by $22,028.

36. Based on the above, the Commission finds the Applicant's original cost depreciated rate base to be (9,599,520-(527,981 + 22,028)=9,049,511).

OPERATING REVENUES

37. The Applicant in its Exhibit B proposed test period operating revenues of $4,002,993. The test period operating revenues as calculated by the Applicant were not a contested issue in this Docket and are accepted by the Commission.

38. There was discussion on the record relative to Applicant's failure to normalize metered revenues, but in this application the Commission has determined that it is inappropriate to normalize metered revenues. The Commission's decision not to normalize revenues stems from the fact that only one half of the procedure could be calculated with any degree of accuracy. When you

normalize it is necessary to normalize both revenues and expenses in an application. In this instance the Commission could have calculated the normalized revenue but due to the Applicant's conversion to a 100% ground water source of supply, in 1983-84, there was not sufficient historical data available to normalize expenses.

39. Mr. Cox during cross-examination stated the following when asked questions regarding normalization of metered revenues:

A. "...Really a true normalization for the water system such as Mountain Water Company's would be too complex. We thought it better to use the actual results of the year, which we do know with certainty."
(Tr. pg. 99)

Q. Is it, your opinion, better to calculate an average consumption figure for consumers rather than an actual use?

A. "I think the most accurate data you have is the actual usage."

The Commission generally has not required water utilities to produce a complete normalization study. The Commission has chosen to use averages to eliminate distortions in revenues and expenses occasioned by variations in consumption, rather than requiring the production of an expensive normalization study. If it is the opinion of the Applicant that the simplified procedure of using averages does not meet its needs, then it should by all means prepare a normalization study; because once sufficient data is available, both revenues and expenses will again be subject to normalization by the Commission.

OPERATING EXPENSES

40. The Applicant in its revised Exhibit B, proposed total test period operation and maintenance expenses of $2,376,913. The test period operation and maintenance expense proposed by the Applicant includes proforma adjustments increasing expenses by $230,247. The revised expenses presented by the Applicant reflects some of the adjustments proposed by intervenors in this Docket. Only those items of expense that remain a contested issue will be addressed in this section.

41. The City of Missoula, through its witness Charles Stearns, essentially advocated that the Commission recognize none of the increases in operation and maintenance expense proposed by

the Applicant in this filing. This is demonstrated by the following quote from Mr. Stearns' prefiled direct testimony:

> "The proposed adjustment would be that the entire rate application be denied and if any additional profitability is needed, that it be achieved by reducing expenditures rather than increasing revenues." (pages 7 and 10).

In the Commission's view, the City's testimony raises a number of thought provoking questions regarding the reasonableness of certain expenses (salary levels, main office administrative and general expense, main office data processing expense) incurred by the Applicant, but the testimony fails to develop substantial evidence supporting the position that those expenses should be denied. The statutes and case law that dictate the Commission's ratemaking authority do not allow for denial of expenses incurred by a utility, unless there is a clear showing that those expenses are unjust and unreasonable (some of the expense items questioned by the City will be discussed in the miscellaneous section of this order).

42. The MCC's proposed adjustments to the Applicant's test period operation and maintenance expense which remain unresolved are:

1) Two year amortization of abandonment expenses associated with fuel storage tanks.
2) Reduction in main office expense allocated to MWC.
3) Land lease expense.
4) Expense savings associated with MWC's main replacement program.
5) Third year of a three year amortization of expenses ordered by this Commission in the last Docket.

43. The first adjustment proposed by the MCC is the disallowance of a proposed two year amortization of an abandonment expense for removal of underground fuel storage tanks. In his prefiled direct testimony Mr. Buckley stated that he "..could not find the adjustment to the plant accounts, but the Company did propose a $3,000 test year abandonment expense." In the Applicant's revised exhibits the test year abandonment cost was adjusted to reflect the actual total cost of abandonment, $2,896, but no adjustment to the plant accounts had been made to reflect the abandonment of the asset.

44. The Applicant has failed to make all of the appropriate ratemaking adjustments that would permit the Commission to allow recovery of the abandonment expense. Before the Commission could allow MWC to recover the cost of abandonment of the fuel storage tank the Applicant would have to make all the necessary adjustments to it plant accounts to reflect removal of this asset from its rate base. If the Commission were to allow the Applicant to recover abandonment expense, without the adjustments to the plant accounts, MWC would be receiving a double compensation. The ratepayer would be paying a return on the depreciated value of the asset, which is no longer used and useful, as well as compensating the Applicant for the cost of removal.

45. The Commission finds that the Applicant's request to amortize, in rates, the expense of abandoning the underground fuel storage tank over a two year period should be denied. The Commission further finds, that the Applicant's test year operation and maintenance expense should be reduced by $1,448, the annual amount to be recovered through rates.

46. The MCC proposed a number of adjustments to the Applicant's "Interdepartmental Transactions". These transactions represent the Applicant's effort to fairly allocate the main office expense and rate base of Park Water Company to its operating divisions. The proposed adjustments include, 1) an averaging of the four-factor allocation over a six year period, 2) disallowance of the allocated salary expense of a post test year employee, and 3) a five year amortization period for the undepreciated value of the old computer.

47. The first adjustment proposed by the MCC is the use of a six year averaging procedure to determine the appropriate allocation factors. It is contended that use of an averaging procedure would tend to levelize any possible distortions which could affect the allocation procedure. Mr. Buckley states in his prefiled testimony that "...a large construction program or large capital expenditure in any one division for any one year..." or "The addition or deletion of additional utilities would cause the factors to change with no real addition or deletion of the cost-causation relationships utilities or divisions."

48. The Applicant contends that the MCC's proposed averaging procedure would "...turn the main office allocation into an entirely fictional number which would not be reflective of the test year operations..." MWC further contends that acquisition or condemnation which would affect the

number of utilities owned by Park Water, as well as the allocation factors, take years to process. Therefore, the Applicant maintains that use of the actual relationships from the test year, between the water systems owned by Park Water, is the best estimate of an appropriate allocation.

49. In his prefiled direct testimony Mr. Buckley prepared a table showing the allocation factors for each of the years 1981 through 1986. The Commission's examination of this table indicates that there exists a certain degree of volatility in the factors used to allocate main office expenses. If allocation factors are volatile, meaning that they are subject to variation from year to year, then it is not uncommon for the allocation procedure to include an averaging process to minimize the effect of these variations.

50. In 1983, the last year the Pomona system was reflected in the four factor allocation, MWC absorbed 24.13% of the main office expenses. In 1984, the year following the loss of the Pomona system, MWC's share of the main office expenses increased to an overall percentage of 29.09%. Clearly the loss of the Pomona system resulted in a substantial increase in MWC's allocated main office percentage. This substantial change in the overall percentage, in a one year period, tends to support the MCC's contention that volatility exists within the allocation procedure and warrants the averaging of the factors over a number of years.

51. As stated in the previous finding the Commission is of the opinion that the four-factor allocation procedure should be averaged over a period of years, but it is not going to make such an adjustment in this Docket. There are two reasons why the Commission is going to decline such an adjustment in this proceeding: 1) Park Water Company's operations are multi jurisdictional, and 2) The Commission has unresolved questions relative to the validity of the allocation procedure used in determining main office expenses attributable to the operating divisions (further discussion of these concerns will appear in the Miscellaneous Section of this order).

52. The four-factor allocation procedure used by Park Water Company to assign main office expense to its various operating divisions is a procedure developed and adopted by the Public Utilities Commission of California. Park Water Company operates water utilities in two jurisdictions, California and Montana. If the Montana Commission makes a unilateral adjustment to the allocation procedure adopted for use by the California Commission, without first placing the

utility on notice that the allocation procedure needs to be examined and possibly modified, this Commission guarantees that the utility will not fully recover its main office expenses.

Generally when a utility is subject to multiple regulatory jurisdictions, this Commission has been involved, or at a minimum concurred, in the development of an allocation procedure that has been adopted and found reasonable for use in all jurisdictions. The Commission at this point is unwilling to modify the allocation procedure without giving the Applicant an opportunity to resolve problems that could arise from the two regulatory agencies adopting different allocation procedures.

53. The second proposed adjustment to "Interdepartmental Transactions" is disallowance of the allocated salary expense of a post test year employee. In March, 1986, Park Water Company hired a professional engineer whom it is training as a replacement for Mr. Don Gallup, who is contemplating retirement in July, 1987. The testimony in this Docket indicates that the additional employee hired at the main office is an employee in training and that the Applicant will ultimately be compensated for this salary through the retirement of Mr. Gallup. There was no clear showing that the additional employee's work produced any benefit to the MWC operation.

54. Based on the preceding the Commission finds that the Applicant's request to include the salary of a post test year employee should be denied. The Commission further finds that the Applicant's test period operation and maintenance expense should be reduce by $13,797, the amount of the allocated salary expense.

55. The last adjustment to "Interdepartmental Transactions" proposed by Mr. Buckley was to increase the term of the amortization period for the old computer system. Amortization periods, in general, are subjective in nature, the Applicant has proposed a three year amortization period and the MCC has chosen a five year period. The MCC has tied its amortization period to the projected useful life of the new computer system and the Applicant has tied its amortization period to the original estimated useful life of the old system. Both amortization periods have merit, therefore the Commission's selection is purely arbitrary. The Commission finds the period proposed by the Applicant to be acceptable.

56. As part of its proposal to include post test year plant additions in rate base the Applicant made adjustments decreasing operation and maintenance expense. These adjustments were

made in an effort to reflect expense savings that would occur if the new plant were included in rate base.

57. In the rate base section of this order the Commission found that the Applicant's request to include post test year plant additions should be denied. Since the Commission has denied the Applicant's proposal to include the post test year plant additions, it is necessary to adjust the operation and maintenance expense adjustments. The following expense decreases are associated with post test year additions and should be reversed:

1)	Electrical Expense	-	$13,325
2)	Repairs Expense	-	$15,960
3)	Lease Expense	-	$ 500
	Total		$29,785

58. Because the Applicant's post test year plant additions have been denied in this Docket, the Commission finds that the Applicant's test period operation and maintenance should be increased by $29,785.

59. The last adjustment proposed by Mr. Buckley is a $14,000 increase in the Applicant's operation and maintenance expense. This proposed expense adjustment flows from a three year amortization of $42,000 in expenses, ordered by this Commission in MWC, Docket No. 84.9.59, Order No.5139a. Mr. Buckley asserts that there is approximately one year remaining of the three year amortization period ordered by the Commission. Mr. Buckley has indicated in his testimony that it is his belief that an amortization is prospective from the date that rates recognizing an amortization are implemented.

60. The Applicant, through the testimony of its expert witness has indicated that it is MWC's position that the amortization period for this item of expense has expired. Since it was MWC's belief that the amortization period had expired Mr. Cox did not include recovery of the $14,000 in the operation and maintenance expense of the Applicant.

61. The Commission concurs with the position taken by the MCC and finds that the Applicant's operation and maintenance expense should be increased by $14,000. The Commission will fully develop its rationale for finding that it is appropriate to include this amortization in the Applicant's operation and maintenance expense in the Income Tax section of this order.

62. The last issue to be addressed regarding the Applicant's operation and maintenance expense is the cost of living adjustment (cola) provided employees. Substantial public testimony was received by the Commission relative to the economic conditions existing in the Missoula area. This public testimony portrayed a community that is experiencing severe economic hardships in at least two of its most important enterprises, wood products and the University of Montana. The consumers pointed to the fact that salaries and wages in these two very essential enterprises were either being frozen or reduced, and questioned why the employees of MWC were receiving a cola increasing wages and salaries at the expense of ratepayers.

The consumers, who through rates will bear the additional salary and wage expense, have asked a valid question regarding why the employees of MWC should receive an increase in wages through a cola adjustment. As portrayed by consumers the economic conditions in Missoula, which is MWC's principal service area, certainly would not appear to support the granting of a cola to employees. The Commission is of the opinion that a utility, exercising its option to grant increased wages, should examine the economic conditions existing in its service area before deciding to authorize increased salary and wages. The wage and salary schedule provided the Commission also indicates the' the average compensation of a MWC employee, while comparable with other private utility operations, is above the average compensation received by a Montana worker. The Commission finds, based on the testimony of the consuming public, that the Missoula area is suffering from a depressed economy and the Applicant's proposal to include a cola in its operation and maintenance expense should be denied.

63. Based on the preceding Finding of Fact, the Commission finds that the Applicant's test period operation and maintenance expense should be reduced by $40,056 the amount of the cola included in this application (See Exhibit B, pgs. 157.3, 160.7 and 160.8).

64. Based on the Findings of Fact in this order section the Commission finds the Applicant's test period operation and maintenance expenses under present rates to be $2,365,397, recognizing total proforma adjustments increasing expenses by $218,731.

DEPRECIATION EXPENSE

65. The Applicant proposed test period depreciation expense totaling $337,105. The Commission's denial of the Applicant's proposal to include post test year plant additions necessitates the removal of the current depreciation expense associated with those assets. Schedule 165.3 of Exhibit B shows that the Applicant has included $12,976 of depreciation expense for post test year additions. The Commission finds, that with removal of the depreciation expense associated with the post test year additions, the Applicant's depreciation expense is $324,129.

TAXES OTHER THAN INCOME

66. The Applicant proposed a total test period expense for taxes other than income of $333,553. Here again, it is necessary to make an adjustment reducing the proposed expense to reflect the Commission's decision to disallow post test year plant additions. At page 173.1 of Exhibit B the Applicant reflects an increase in property taxes of $11,213 associated with the post test year plant additions, this expense increase is denied. The Commission finds MWC taxes other than income to be $322,340.

INCOME TAXES

67. There were two major areas of controversy surrounding the income taxes in this Docket. The areas of controversy were, 1) The Tax Reform Act of 1986, and 2) The appropriate ratemaking treatment to be afforded the amortization of net operating loss carryforwards (NOL) ordered by this Commission in MWC Docket No. 84.9.59, Order Nos. 5139a and 5139b.

68. On November 24, 1986, this Commission initiated Docket No. 86.11.62 in response to the passage of the Tax Reform Act of 1986 (TRA) by the United States Congress. The TRA contained significant changes affecting the calculation of the income tax liability for regulated public utilities. The main impetus for initiating the tax Docket was to insure that the rates and charges of the public utilities remained just and reasonable following the passage of the TRA

69. The Applicant during the course of this proceeding attempted to draw an analogy between post test year plant additions and the TRA. The Applicant contended that if the Commission

decided to deny the inclusion of post test year plant additions in this Docket then equity dictated that it also ignore the effects of the TRA, because both items represented post test year adjustments.

70. The effects the TRA would have on the rates and charges of a public utility were the subject of a separate proceeding. The Applicant chose to have the effects on rates and charges addressed in its pending rate application. The following is a Commission staff data request and the Applicant's response to that request:

> Q. The Commission currently has outstanding an order to show cause why utility company rates should not be adjusted to reflect the provisions of the new Federal Tax Act. Does MWC plan on incorporating its answer to that order to show cause into this rate increase application? If not, please provide an explanation.
>
> A. The Company intends to include the effects of the Tax Reform Act of 1986 in this rate increase application

The Applicant made a voluntary decision to include the effects of the TRA in this Docket, therefore, it is improper for the Applicant to argue that it is beyond the scope of the test year and should be excluded. The Commission finds that in calculating the income tax liability it is appropriate to incorporate the findings from this Commission's Order No. 5236c into this proceeding.

71. The second item of controversy regarding income taxes in this Docket, is the ratemaking treatment to be afforded the three year amortization of a NOL, ordered by this Commission in MWC's last general rate proceeding. The MCC and the City of Missoula contend that the amortization period does not expire until July 21, 1988. The MCC and the City reason that the amortization period did not begin for ratemaking purposes until July 22, 1985, the effective date of the rates recognizing the amortization of the NOL.

72. The Applicant contends that the amortization period expired December 31, 1985. The December 31, 1985 date advocated by the Applicant is the stated date for expiration contained in this Commission's Order 5139b. This expiration date recognizes the amortization period commencing with the test year from the prior proceeding, 1983.

73. To determine the appropriate date on which the ordered NOL amortization should expire it is necessary to discuss the amortization concept. Generally, in ratemaking, there are two reasons why an item is amortized in rates over a period of years. The first reason is to allow the

utility an opportunity to recover the cost of an item from the ratepayer. The second reason is that a utility may have derived a financial benefit that under ratemaking theory should be flowed through to the ratepayer.

When an amortization is ordered, for the purpose of the utility recovering a cost or flowing through a benefit to the ratepayer, the revenue requirement of the utility is either increased or decreased, depending on whether the amortization is a recovery of a cost or a flow through of a benefit. In general, the reason an item is amortized is because the item either benefits future periods or the dollar magnitude of the item under consideration is so substantial that it would have a significant impact on the revenue requirement of either increasing or decreasing rates for a short period, thus providing the wrong price signal to consumers.

This Commission, for purposes of establishing rates uses a historic test year adjusted for known and measurable changes occurring within 12 months of the close of that test year. This means that the Commission for ratemaking purposes is examining costs retrospectively and establishing rates for future periods based on those adjusted costs. When the historic test period contains an item that in the opinion of the Commission warrants amortization, recovery or flow through of the item is prospective, because until the rates recognizing the amortization have been approved and placed in effect, the item to be amortized has not been part of the Applicant's revenue requirement.

If this Commission did not reflect amortizations as a prospective adjustment, affecting the utility's revenue requirement, its ratemaking practices would be punitive. If amortizations were not reflected on a prospective basis the utility or the ratepayer would be unduly penalized. Commission refusal of prospective recognition of amortizations would result in the utility being denied the opportunity to fully recover costs that appropriately should be borne by the ratepayer, or the ratepayer would be denied the full flow through of a benefit the utility has derived and is properly assignable to the ratepayer.

74. In this application the Applicant has requested that a number of items be afforded amortization. Two such items are the write-off of the old computer, total main office expense $118,346, amortization period 3 years, and a Management Information Study, total main office expense $172,119, amortization period 5 years. To demonstrate the punitive impact of not reflecting

amortizations prospectively, the Commission will examine the Applicant's cost recovery if amortizations were to start with the test year. If the Commission accepts the Applicant's position that the first year of an amortization begins with the test year, which in this Docket is 1985, then the Commission for the above stated expenses would only allow the Applicant to recover: $39,449 of its $118,346 computer expense, because it would be in the third year of its three year amortization, and $103,271 of its $172,119 management expense, because it would be in the third year of a five year amortization (the Commission recognizes that MWC is only responsible for an allocated share of the above expenses). The above examples clearly show that if the Commission does not reflect an amortization prospectively, from the effective date of the rates recognizing that amortization, then it is being punitive

75. The Commission admits that in its Order No. 5139b it made a misstatement of fact when it stated that the amortization period for the NOL would expire on December 31, 1985. This misstatement was inadvertent and should have been caught by the Commission, its staff, or one of the parties participating in that proceeding. The Commission finds that the Applicant's assertion that the misstatement of dates alters the appropriate treatment that should be afforded the ordered NOL amortization is unjustified. If the Commission were to accept the Applicant's position and uniformly apply the amortization principle that all amortizations start with the test year to all proposed amortizations of the Applicant, then all equity would be removed from the amortization concept. Equity would be removed because uniform application of the principle supported by the Applicant adhering to the stated dates would insure that the utility and the ratepayer would never realize the full benefit from an ordered amortization.

76. Based on the preceding Findings of Fact regarding the amortization of the NOL ordered by the Commission in the last Docket, the Commission finds that the Applicant will have $310,983 in NOL available to offset income tax obligations when rates flowing from this order are implemented. The Applicant in the recent past has been averaging a rate change approximately every two years. Therefore, the Commission finds that it is acceptable to modify the original amortization schedule and allow the Applicant to amortize the remaining available NOL balance over a two year

period. Modification of the amortization period will result in the Applicant utilizing $155,492 per year to offset its calculated income tax obligation.

77. The Commission having incorporated the findings from its Order No. 5236c into this proceeding did not have sufficient information available in this filing to calculate the income tax obligation of the Applicant. Therefore, the Commission provided the Applicant with the necessary information from this order and requested that the Applicant calculate its income tax obligation and provide the Commission with the pertinent work papers.

REVENUE REQUIREMENT

78. Based on the Findings of Fact contained herein, the Commission finds that in order to produce a rate of return of 11.125% on MWC's average original cost depreciated rate base, the Applicant will require additional annual revenues in the amount of $317,029 from its Missoula, Montana water utility.

79. Applicant's accepted test year proforma operating revenues, expenses and rate of return are summarized as follows:

MOUNTAIN WATER COMPANY - MISSOULA DIVISION

Computation of Net Income - Test Year 1985

	Present Rates (Company)	Adjustment	Test Year	To Produce 11.125% Rate of Return	Accepted by the Commission
Operating Revenues	$4,002,993		$4,002,993	$317,029	$4,320,022
Deductions:					
O&M Expense	$2,376,913	(11,516)	$2,365,397	$ 3,179 (1)	$2,368,576
Depreciation	337,105	(12,976)	324,129		324,129
Taxes Other Than Income	333,553	(11,213)	322,340	1,046	323,386
Income Taxes	282,184		292,194	14,986	297,173
Net Income	$ 673,238		$ 708,942		$1,006,758
Rate Base	$9,599,520	(550,009)	$9,049,511		$9,049,511
Return on Rate Base	7.01%		7.83%		11.125%

(1) Applicant's bad debt expense is a function of revenues

RATE DESIGN

80. The Applicant's proposed rate design was not challenged by any party participating in this proceeding. The Commission's examination of the rate structure indicates that the Applicant has attempted to equitably distribute the cost of providing service to the various customer classifications and it is, therefore, accepted.

MODIFICATION OF RULES

81. The Applicant proposed amendments to the Special Terms and Condition section of its tariff. The Applicant has proposed that the Commission authorize the implementation of the following two special rules:

> In a situation where more than one user is being provided with water from a single service line, with a single shut off device controlling the water flow, and if any one or more of the water users either will not sign up for service or will not pay for service, the responsibility for payment of the future water charges must be assumed by the property owner until such time as the piping configuration has been modified to provide an individual shut off valve for each water user in order to prevent the service from being disconnected for non sign or non payment.
>
> If service has been disconnected for non payment, a $30.00 reconnection fee will be charged prior to reconnection of service.

82. During the course of this proceeding the reasonableness of allowing implementation of the above rules was examined. Based on the testimony in this Docket the Commission is sufficiently convinced that implementation of the proposed rules is reasonable. The Commission, however, does want consumers fully informed of the rule changes, and the Applicant will notify in writing every property owner having multiple service connections on a single service, that ultimately

he may become responsible for payment of future water rents. A copy of the written notification and a statement that all involved property owners have been notified will be served on the Commission prior to the Commission allowing enforcement of the rule. Also the Commission wants the Applicant to inform every consumer in its termination notification, for non-payment, that the $30.00 charge will be assessed

MISCELLANEOUS

83. The four factor allocation procedure used by the Applicant, and approved for use by the California Public Utilities Commission, to allocate main office expenses to the various operating divisions of Park Water is an area of concern for this Commission. Based on the testimony received during this proceeding this Commission is not convinced that the procedure equitably distributes costs between the divisions. Two of the components of the four factor allocation, net plant and operating expenses, are of most concern to the Commission. The testimony in this Docket indicates that these two items could increase significantly, increasing the amount of main office expenses allocated to an operating division, without an actual increase in the main office expense occurring for that operating division.

This Commission is of the opinion that the allocation procedure currently being used by the applicant warrants an in depth review and possible modification. The Commission makes this statement because an increase in an allocation factor may result in increased expenses being assigned a division without an actual increase occurring. The Commission feels that a review of the reasonableness of the allocation procedure should be entered into between the Applicant, the Commission, and other parties to this proceeding and will initiate a discussion some time in the near future.

84. As a late-filed exhibit the Applicant provided the Commission with an employee count for its main office for the years 1981 through 1986. This employee count reveals that the Applicant has reduced the overall number of employees on its payroll from 35 in 1981, to 24 in 1986. The majority of this reduction has occurred in the Applicant's non-professional staff. In 1981

Park Water had 13 profession/management employees while in 1986 the Applicant had 11 people employed in this capacity.

The Applicant since 1981 has experienced a reduction in the number of its operating divisions and has decentralized its operations. These two actions have not reduced significantly the number of professional/management employees employed at the Downey main office. It seems to the Commission that a reduction in the number of operating divisions and decentralization should significantly reduce the number of profession/management employees needed in the main office. The Commission in the Applicant's next rate proceeding will be investigating the staffing pattern of the main office.

CONCLUSIONS OF LAW

1. The Applicant, Mountain 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. Mountain Water Company shall file rate schedules which reflect an increase in annual revenues of $317,029 for its Missoula, Montana service areas. The increased revenues shall be generated by increasing rates and charges to all customer classifications as provided herein.

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

3. The rules approved herein shall be implemented as provided in Finding of Fact No. 82

4. DONE IN OPEN SESSION at Helena, Montana, this 29th day of June, 1987, by a 3 - 0 vote.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

_____
HOWARD L. ELLIS, Commissioner

_____
TOM MONAHAN, Commissioner

_____
DANNY OBERG, 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 (10) days. See 38.2.4806, ARM.