Service Date: February 23, 1988

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 Authority to Increase Rates and Charges for Water Service to its Anaconda, Montana Customers.	)))))	UTILITY DIVISION DOCKET NO. 87.6.31 ORDER NO. 5332

APPEARANCES

FOR THE APPLICANT:

James Robischon, Attorney at Law, Murphy, Robinson, Heckathorn & Phillips P.O. Box 759, Kalispell, Montana 59903

FOR THE INTERVENORS:

Mary Wright, Staff Attorney, Montana Consumer Counsel, 34 West 6th Avenue, Helena, Montana 59620

FOR THE COMMISSION:

Geralyn Driscoll, Staff Attorney, 2701 Prospect Avenue, Helena, Montana 59620-2601

Ron Woods, Rate Analyst, 2701 Prospect Avenue, Helena, Montana 59620-2601

BEFORE:

JOHN DRISCOLL, Commissioner & Hearing Examiner

BACKGROUND

1. On June 17, 1987, 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 52.3 percent. This constitutes an annual revenue increase of approximately $167,996.

2. Concurrent with its filing for a permanent increase in rates, BWC filed an application for an interim increase in rates of 20.3 percent equalling a revenue increase of approximately $65,097 or 38 percent of the proposed permanent increase.

3. On October 28, 1987 after proper notice, a hearing was held in the Metcalf Senior Citizens Center, 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.

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

James Chelini, President and General Manager, BWC
Don Cox, Certified Public Accountant
Mike Patterson, Vice President and Operations Manager, BWC

5. The Montana Consumer Counsel (MCC) presented the testimony of one expert witness, Frank Buckley, Rate Analyst, Montana Consumer Counsel, and four public witnesses.

6. As provided in ARM 38.2.4802(2), the parties stipulated to a final order being issued in this docket.

FINDINGS OF FACT

7. The test year ending December 31, 1986, was uncontested and is found by the Commission to be a reasonable period with-in 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.

CAPITAL STRUCTURE

8. At the time of filing for rate relief in this docket the Applicant's actual capital structure consisted of 100 percent equity. For rate case presentation, BWC presented the following hypothetical capital structure in "Data Furnished in Compliance with PSC Minimum Rate Case Requirements, Statement F."

Description	Amount	Ratio
Debt	$1,845,926	50.0%
Equity	$1,845,926	50.0%
TOTAL	$3,691,852	100.0%

9. This hypothetical capital structure was originally presented to the Commission as part of a stipulation between the Applicant and the Montana Consumer Counsel, in Docket No. 86.3.7. In that docket the Applicant and the MCC agreed to a 50/50 debt-

equity ratio because in their opinion that is reasonable and compares favorably with that of other regulated utilities.

10. The utility industry is capital intensive and leverage is widely used to finance large plant additions. A debt to equity ratio of 50/50 as proposed by the Applicant is not an atypi cal ratio in the utility industry, and was not challenged by any party participating in this proceeding.

11. The Commission finds that the hypothetical capital structure proposed by the Applicant is reasonable in this Docket.

COST OF DEBT

12. 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.

13. Absent contractual obligations that would establish the cost of debt, the Commission must determine a reasonable cost based on reliable information that fairly reflects BWC's cost of attracting this type of capital.

14. The Applicant's witnesses testified that the 11.50 percent cost of debt assumed in this filing was based on interest

rates currently available at area banks for long-term, fixed rate commercial loans. This cost of debt is a .25 percent reduction in debt cost from that authorized by the Commission in BWC's last general rate order. It was an uncontested issue. The Commission finds the cost of debt proposed by the Applicant to be reasonable in this Docket.

COST OF EQUITY

15. The return on equity of 13.0 percent proposed by the Applicant 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 requested return on equity of 13.0 percent is accepted by the Commission.

CAPITAL STRUCTURE AND WEIGHTED COST OF TOTAL CAPITAL

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

Description	Amount	Ratio	Cost	Weighted Cost
Debt	$1,845,926	50.0%	11.50%	5.75%
Equity	1,845,926	50.0%	13.00%	6.50%
	$3,691,852	100.00%		12.25%

OPERATING REVENUES

17. The test period operating revenues are an uncontested issue in this case. The Applicant utilized the 12 months ended December 31, 1986, to determine the test period revenues under the rates that became effective October 15, 1986. Total test year revenues of $320,999, as calculated by the Applicant, are accepted by the Commission.

OPERATION AND MAINTENANCE EXPENSE

18. On October 9, 1987, BWC, through its expert witness Don Cox, filed revised financial exhibits that proposed total test period operation and maintenance expenses of $428,684. This includes pro forma adjustments increasing expenses by $167,379.

19. At the hearing Don Cox corrected the revised test period operation and maintenance expenses submitted to the Commission on October 9, 1987. The corrections proposed by Mr. Cox produced a net decrease of $4,293 in the revised operation and maintenance resulting in pro forma adjustments increasing expenses by a total of $163,086. These corrections were not challenged by any party participating in this proceeding. Any Commission adjustments to the Applicant's operation and maintenance expense are to the pro forma increase amount of $163,086.

20. The Consumer Counsel's expert witness, Frank Buckley, proposed a number of adjustments to the Applicant's test period operation and maintenance expenses. Some of the adjustments proposed by Mr. Buckley were accepted by the Applicant and are incorporated in Mr. Cox's corrections. The Commission will address only those issues which remain contested.

The following items are the issues that remain as contested between the Applicant and the MCC:

1) Senate Bill No. 28 expenses
2) Pension Expense

21. The Montana Legislature passed Senate Bill No. 28 during its 1987 legislative session. For purposes of discussion in this order the term SB 28 will be used. SB 28 is as codified as 69-4-511, MCA. SB 28 changes the responsibility for maintenance and repair of water service lines. Prior to the October 1, 1987, effective date of SB 28, the responsibility for repair and maintenance of the entire water service line from the water main to the premises of the consumer was the consumer's obligation. On October 1, 1987, it became the responsibility of the private water service provider to maintain and repair the portion of the water service line from the company's water main to the consumer's property line.

22. In testimony both the MCC and BWC acknowledged that BWC will incur additional expenses as a result of the legislated change in repair and maintenance responsibility. The only area of disagreement surrounding SB 28 is the ratemaking treatment during the first year. Both the MCC and BWC concede that the Applicant has no historical data regarding expenses associated with the repair and maintenance of water service lines.

The Applicant has proposed that the costs associated with repair and maintenance that will now be BWC's responsibility be recovered as a current operating expense of the utility. Based upon contractor information bids the Applicant in its financial data has provided a cost estimate of the expense that will be incurred in discharging this obligation.

The MCC proposed that the first year of additional expenses associated with SB 28 be capitalized. Succeeding year's costs would be reflected as an operating expense using the first year as an estimate. The first year's capitalized expense would be recovered through amortization over a reasonable time frame.

23. SB 28 imposes an additional expense on private water service providers that in the Commission's view is properly recoverable from ratepayers. For a pro forma adjustment increasing or decreasing expenses to be included in rates, it must meet the

criteria of ARM 38.5.106 that it is a known and measurable change becoming effective within 12 months of the close of the test period. The statutory revision requiring private water service providers to repair and maintain service lines is a known change affecting a privately owned water utility. The question is whether this change in financial responsibility is measurable.

24. The MCC contends that the Commission should deny BWC's request to recover as an operating cost expenses associated with SB 28. The MCC opposes BWC'S original estimate of $49,648, and subsequent revision, for recovery of SB 28 on the grounds that the adjustment does not meet the requirements contained in Commission Rule 38.5.106, which states in part "...no adjustments will be permitted unless based on changes in facilities, operations or costs which are known with certainty and measurable with reasonable accuracy at the time of filing." The MCC contends that the Applicant's proposed SB 28 adjustment was not measurable with reasonable accuracy at the time of filing. To support this position the MCC points to the testimony of the Applicant's witnesses that the reported cost is based on estimates provided by contractors who have done the maintenance on the part of the service line that is now the Applicant's responsibility. MCC also points out that there was a substantial reduction in the overall

cost estimate between the original application and the late-filed exhibits.

25. The Commission agrees with the MCC that the Applicant's original cost estimate of additional expenses to be incurred because of SB 28 did not meet the requirement of measurable with reasonable accuracy. But the revised estimate provided in the late-filed exhibit does satisfy this test. The Applicant's assumptions made in development of its original estimate were fully explored during the course of this proceeding and it was shown that the original adjustment was erroneous. In its late-filed exhibit BWC corrected the errors in its SB 28 adjustment for maintenance.

26. The Applicant estimates that it will incur additional expenses in the amount of $34,968 in discharging its statutory obligation to maintain and repair service lines from the main to property line of the consumer. The Commission will allow recovery of this amount subject to the true-up described in the following finding. In its original application BWC determined that the additional service line maintenance requirement would cost the company $49,648 and this is the amount included in its pro forma operation and maintenance expense increase. Since the Commission is recognizing the adjusted figure provided in late-filed exhibits,

the Applicant's pro forma operation and maintenance expense should be reduced by $14,680.

27. The MCC is correct that the exact amount of expenses cannot be quantified at this time and BWC is correct that the utility should be able to recover these expense. To balance these interests the Commission requires BWC to keep an account showing the expenses actually incurred to implement SB 28. This account will be reviewed by the Commission staff and MCC to determine the accuracy of expenses. At the end of one year from the date of this order the actual expense will be compared to the expense and rates adjusted prospectively to adjust for actual expenses incurred.

28. There is a second type of service line maintenance for which the Applicant will be responsible, that maintenance being the thawing of frozen water service lines. The Applicant in its filing has indicated that it anticipates its expenses to increase by $9,021 as a result of its assumption of this responsibility. The $9,021 expense for the Anaconda division was determined through use of contractor estimates received for the Butte division multiplied by the percentage of Anaconda customers to Butte customers ($37,250 x (3,199 - 13,209) = $9,021).

The following discussion appears in the Butte Division rate order for Docket No. 87.6.30, regarding the calculation of thawing expense:

> An examination of the underlying work papers developing this increased cost indicates that the Applicant used "average" number of service line freeze ups per winter and worst case scenario of freeze ups, to develop a $37,250 annual expense (see response to MCC data request no. 10). In the Commission's view the Applicant's calculation which represents an averaging of costs, developed for an "average" number of freeze ups and worst case number of freeze ups, is wrong.
>
> If the 120 frozen service lines alluded to in the Applicant's data response is the "average" then this is the arithmetic mean of frozen service lines experienced on the system and, therefore, would take into consideration the high and low number of freeze ups experienced. Based on the preceding the Commission finds that the Applicant's cost for maintaining frozen service lines should be established by the cost developed for the 120 "average" number of frozen services experienced on the system. The information submitted by the Applicant indicates that it will cost $11,200 annually to thaw 120 frozen service lines. The Commission finds that the Applicant's proforma expenses should be reduced by $26,050.

29. Since the thawing expense calculated for the Anaconda division represents a percentage of the expense developed for the Butte Division, and the Commission has found the Butte Division expense to be lower than originally filed it naturally follows that an adjustment to the Anaconda division expense is appropriate. The Commission found the appropriate expense level for the Butte division to be $11,200, applying the previously stated customer

ratio to the $11,200 expense develops an expense of $2,712 for the Anaconda division. The Commission finds that the Applicant's pro forma expenses should be reduced by $6,309.

30. The second issue contested by the MCC is BWC's proposal to increase pension expense to accumulate an unfunded past service liability over a three year period. The MCC does not contest the amount of the unfunded service liability to be accumulated. Its proposal allows BWC to accumulate the full amount of the unfunded service liability, over an eight year period, the maximum allowable time frame for funding, rather than the three year period proposed by the Applicant. The MCC's primary reason for proposing accumulation over an eight period, as opposed to the three year period, is to lessen the rate shock that will experienced by ratepayers.

31. The information elicited from the Applicant's witnesses indicates that the ratepayers, who are responsible for funding the unfunded past service liability of the pension plan, run the risk of having additional costs placed on them by an elongated term for funding of this liability. The following three factors could significantly increase the amount of the unfunded service liability of the pension plan; 1) legislative action 2) declines in interest rates and, 3) the retirement of an employee covered by the plan.

The effects the three factors could have on the amount of unfunded service liability that ultimately will be payable by subscribers are impossible to quantify, but certainly are germane considerations in determining the appropriate period for accumulation of the funds.

32. The issue of the proper accumulation period for the unfunded service liability is subjective; both the MCC and the Applicant have presented periods that in their opinion are reasonable. The Commission believes that the rationale presented by the Applicant in support of its shorter accumulation period considers factors that could increase the ratepayers exposure to increased liability through extension of the accumulation period to the maximum allowable term. The Commission finds that the Applicant's proposal to accumulate the unfunded service liability over a three year period is reasonable.

33. It should be noted that an adjustment that would decrease BWC's recoverable expenses was discussed during the hearing but could not be considered for because it is beyond the allowable adjustment period. Renegotiated union employee contracts took effect January 1, 1988. Based on information provided by the Applicant, the new contracts entered into by the Applicant and the Unions reduced the overall compensation received by these employees, by approximately $98,000 annually.

34. Based on the preceding Findings of Fact pro forma operation and maintenance expenses are found to be $403,402, recognizing total pro forma adjustments increasing expenses by $142,097.

DEPRECIATION EXPENSE

35. The test period depreciation expense is not a contested issue in this Docket. The Applicant proposed depreciation expense of $9,858, which is accepted by the Commission.

TAXES OTHER THAN INCOME

36. The Applicant proposed an expense for "Taxes Other Than Income" at present rates of $18,765. The Applicant reduced "Taxes Other Than Income" by $2,364 to reflect a reduced property tax liability resulting from its removal of land not used and useful. The Commission in the rate base section of this order did not remove these lands from rate base, therefore this adjustment reducing property taxes must be reversed. The Commission finds "Taxes Other Than Income" to be $21,129.

RATE BASE

37. The Applicant proposed an average original cost depreciated rate base of $133,720.

38. The Applicant proposed two adjustments reducing rate base that the MCC opposed. The Applicant contends that it has approximately 4,805 acres of land worth $23,445 included in rate base that is no longer used and useful in the provision of service to consumers. Since in the opinion of the Applicant this land is no longer used and useful it proposes to remove $23,445 from rate base, thus relieving the ratepayers of the burden of supporting these properties. BWC used original cost as the value of the property to be removed from rate base.

39. The MCC disagrees with the Applicant's proposal to remove these properties from rate base at the calculated original cost. The MCC's expert witness, Frank Buckley, made the follow ing statements in his prefiled testimony regarding the Applicant's proposed removal of this property from rate base:

> I do not believe this is the most appropriate treatment. It would allow for the future possibility of sale of such properties at a possible gain without the ratepayer receiving any benefit, although they bore the financial and economic burden of supporting these properties.
>
> In Docket No. 86.3.7, I testified why I felt any gain resulting from these types of sales belong to the ratepayer. That philosophy was adopted by the Commission.
>
> The best or most appropriate treatment would be to remove these properties now at their current fair market value, thus relieving the ratepayer of financial and economic and

> crediting them with the gain. This cannot be done at this time, because the Company indicates it does know the current market value.
>
> An alternative to that approach is to remove the properties from rate base at their estimated original cost, then allow BWC to capitalize carrying costs on such properties equal to the allowed rate of return along with an property taxes and any other expenses which can be directly identified with such properties. These total sums would then be used in the calculation of any gains from any subsequent sales, thereby protecting the current and future interests of both the stockholder and ratepayer.

40. The issue of removing these properties from rate base is not just a simple determination that the property is no longer used and useful in the provision of service. There is also a need to consider what value is to be assigned to the property being removed. Removal of these properties from rate base at fair market value as proposed by the MCC would insure that the ratepayer receives the benefit of the gain. Removal of the properties from rate base at original cost as proposed by the Applicant flows the gain to the equity investor. In Order No. 5194a the Commission determined that the gain on the sale of similar property should benefit the ratepayer, but the Commission also stated in that Order that there is no hard and fast rule to determine who should benefit from the gain, equity investor or ratepayer.

There was no significant discussion regarding which party should receive the benefits, therefore, at this time the Commission is unable to establish the value at which these properties should be removed.

41. The record in this Docket, regarding the used and useful aspects of the land to be removed from rate base, did not detail the assumptions made by the Applicant in determining that the property was no longer used and useful. Absent full particulars surrounding the Applicant's recent determination that property it has held for many years is suddenly no longer used and useful, the Commission is unable to make an informed decision regarding the appropriateness of this proposal.

42. The Applicant in the testimony of one its witnesses, and in its opening brief, stated that if the Commission determined that the Applicant's proposal to remove property from rate base as presented was unacceptable, the property should be considered used and useful and its request withdrawn. The Commission, given the lack of details surrounding this adjustment, accepts the Applicant's request that the proposed rate base adjustment removing properties be withdrawn. Based on the preceding the Commission finds that the Applicant's rate base should be increased by $23,445.

43. The Applicant contends that the Commission erred in its Order Nos. 5194a and 5194b when it did not recognize a reduction in BWC's rate base for deferred federal income taxes. The Applicant in this Docket proposes to reduce its rate base by $3,995, the amount of the deferred income taxes.

The MCC opposes this adjustment on the grounds that the Commission in the previously referenced orders made no provision for income taxes and, therefore the adjustment should be disallowed. For reasons that will be discussed in the income tax section of this order the Commission finds that the adjustment reducing rate base by $3,995 should be accepted.

44. Based upon the preceding Findings of Fact, the Commission finds the Applicant's original cost depreciated rate base should be $157,165.

INCOME TAXES

45. The income tax issues, with the exception of deferred federal income tax expense, are the same as those presented by BWC in Docket No. 86.3.7. The Commission issued Order Nos. 5194a and 5194b disposing of all matters in that Docket. The Applicant presented no new arguments for Commission consideration of the income tax issue. The Commission reaffirms its find ings in the previously cited orders, regarding the income tax treatment to be

afforded BWC, and finds that the Applicant's request to recover income tax expense should be denied.

46. The Applicant has requested that the Commission reflect deferred federal income tax expense that result from accelerated depreciation used for income tax purposes. The Applicant contends that the Commission's failure to include deferred income tax expense jeopardizes the utility's use of accelerated depreciation for tax purposes. The Applicant believes that failure to recognize the deferred taxes represents a flow through of benefits arising from use of the accelerated depreciation, in violation of the normalization principles, and this will cause the Internal Revenue Service (IRS) to disallow use of accelerated depreciation for BWC.

The Applicant also asserts that the deferred income tax expense would not be offset by net operating loss carryforwards (NOLS). In his rebuttal testimony Don Cox emphasized the fact that the deferred taxes will have an affect on the Applicant 15 to 20 years from now, long after the NOLS have expired.

47. The MCC does not share BWC's opinion that deferred taxes must be considered by the Commission in order to protect BWC's ability to use accelerated depreciation for tax purposes. The MCC asserts that the Commission's disallowance of tax expense in the approved cost of service negates the Applicant's argument regarding

violation of normalization principles and possible disallowance of accelerated depreciation by the IRS.

48. The Commission disagrees with the MCC's position regarding disallowance of deferred federal tax expense. The Commission is persuaded by the assertions of the Applicant that a violation of the normalization principle occurs by not recognizing the expense. The Commission for purposes of this order will give consideration to deferred federal income tax expense in the amount of $7,990.

49. Based upon the Findings of Fact contained herein, the Commission finds BWC's test period operating income (loss) to be ($121,380) calculated as follows:

Operating Revenue	$320,999
Operating Deductions	$442,379
Operating Income	$(121,380)

REVENUE REQUIREMENT

Rate Base	$157,165
Rate of Return	12.25%
Return Requirement	$ 19,253
Adjusted Balance Available for Return	(121,380)
Return Deficiency	140,633
Revenue Deficiency	141,153
MCC-PSC Tax at .0037%	520
Income Available for Return	$ 140,633

50. In order to produce a return of 12.25 percent on the Applicant's average original cost depreciated rate base, the Applicant will require additional annual revenues in the amount of $141,153 from its Anaconda, Montana, water utility.

RATE DESIGN

51. The Applicant prepared a cost of service study for this proceeding and based upon information contained in that study developed its proposed rate design. The information contained in the cost of service study indicates that three customer classes should receive a reduction in rates those being metered service hydrant, and fire lines. The Applicant in its proposed rate design does not propose a rate reduction for these customer classes. The Applicant proposes that rates for these customer classes remain at the current level, with the excess revenue from these customer classes being applied to the cost of service for flat customers, reducing the overall cost of providing service to this class.

52. The Commission agrees with the above proposal of the Applicant regarding construction of its proposed rate design. Information elicited during the course of this proceeding indicated that BWC would be filing annual rate increases with this Commission

for sometime to come. A proposal by the Applicant, at this time, to decrease rates for metered consumers, hydrants and fire lines, would provide these customer classifications with a false price signal when it is known that subsequent rate filings will result in increased rates for these customer classes.

RULES

53. ARM 38.5.2503(6)(b) states:

> The utility shall make provisions in its tariff for the extension of service mains through special rules to be approved by the commission.

In this Docket BWC proposed a rule on main extensions and a rule on multiple service connections on a single service line. These rules were reviewed by the MCC and Commission staff. Staff proposed some modifications to the rules that were acceptable to BWC. The rules to be adopted pursuant to ARM 38.5.2503(6)(b) are included as an attachment to this order. The rules filed in compliance with this order should be filed by BWC as special rules S-19 through S-21.

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 the 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 $141,153 for its Anaconda, Montana service area. The increased revenues shall be generated by increasing rates and charges as provided herein.

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

3. The Applicant is authorized to implement rules as provided herein.

DONE IN OPEN SESSION at Helena, Montana this 22nd day of February, 1988, by a vote of 4 - 0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

_____
CLYDE JARVIS, Chairman

_____
JOHN B. DRISCOLL, Commissioner

_____
HOWARD L. ELLIS, Commissioner

_____
TOM MONAHAN, Commissioner

_____
DANNY OBERG, Commissioner

ATTEST:

Ann Purcell
Acting Secretary

(SEAL)

NOTE: Any interested party may request that the Commission reconsider this decision. A motion to reconsider must be filed within ten (10) days. See 38.2.4806, ARM.