Service Date: July 8, 1980

DEPARTMENT OF PUBLIC SERVICE REGULATION
MONTANA PUBLIC SERVICE COMMISSION

In the Matter of the Application of PACIFIC POWER & LIGHT COMPANY, for authority to establish increased rates for electric service.	))))	UTILITY DIVISION DOCKET NO. 6728 ORDER NO 4667

APPEARANCES

FOR THE APPLICANT:

C. Eugene Phillips, Murphy, Robinson, Heckathorn & Phillips, One Main Building, Kalispell, Montana 59901.

Leonard A. Girard, Stoel, Rives, Boley, Fraser and Wyse, 900 S.W. Fifth Avenue, Portland, Oregon 97204.

FOR THE PROTESTANT:

James C. Paine, Montana Consumer Counsel, 34 West Sixth Avenue, Helena, Montana 59601.

FOR THE COMMISSION:

Calvin K. Simshaw, Staff Attorney

BEFORE:

GEORGE TURMAN, Commissioner & Hearing Examiner
CLYDE JARVIS, Commissioner
THOMAS J. SCHNEIDER, Commissioner
JAMES R. SHEA, Commissioner

FINDINGS OF FACT

PART A

General

1. Pacific Power & Light (Applicant) is a public utility furnishing electric service to consumers in the State of Montana.

2. applicant's petition, filed September 26, 1979, requests this Commission's approval of rates and charges for electric utility service which are designed to produce an increase in annual gross operating revenues of $1,587,000, based on an historic test year ending December 31, 1978, adjusted for known and measurable changes.

3. The Montana Consumer Counsel (MCC) has participated in this Docket on behalf of utility customers since the inception of these proceedings.

4. On October 9, 1979, the Commission issued notice of prehearing conference on the application to adopt increased rates for electric service. On November 6, 1979, pursuant to this conference, the Commission issued a procedural order.

5. On January 29, 1980, the Commission issued a supplemental procedural order which set forth that consideration of approval of proposed Schedule 5, Experimental Residential Partial Requirements Service, be joined with and made a part of this Docket.

6. On February 15, 1980, the Commission issued notice of public hearing on the application to adopt increased rates for electric service.

7. On March 11 and 12, 1980, pursuant to the Commission's notice, hearings to receive evidence and allow cross-examination were conducted in Kalispell, Montana.

8. On March 11, 1980, at 7:00 p.m. pursuant to the Commission's notice, a public hearing was held, at which no public witnesses appeared.

9. Initial briefs were due on April 15, 1980. Reply briefs and Proposed Findings of Fact, Conclusions of Law and Order (if desired) were due on April 29, 1980.

10. On April 7, 1980, the Commission granted the request of MCC for an extension of time for the filing of initial briefs. Consequently, all parties were granted to and including April 23, 1980, in which to submit initial briefs and to and including May 7, 1980, in which to submit reply briefs and Proposed Findings of Fact, Conclusions of Law and Order (if desired).

11. Applicant proposes the calendar year 1978, adjusted to reflect known and measurable changes, be used as the test period in this Docket.

12. The 1978 test year is found by the Commission to be a reasonable period within which to measure Applicant's utility revenues, expenses and returns for the purpose of determining a fair and reasonable level of rates for electric service.

CAPITAL STRUCTURE AND ASSOCIATED COSTS

PART B

13. Applicant proposed the following capital structure and associated costs:

Type	Capital Structure	Cost	Weighted Cost
Long-Term Debt	52.4%	7.72%	4.05%
Preferred Stock	9.7	8.45	0.82
Common Equity	34.9	14.50	5.06
Deferred Taxes	3.0	-	-
	100.0%		9.93%

14. MCC proposed the following capital structure and associated costs:

Type	Capital Structure	Cost	Weighted Cost
Long-Term Debt	54.0%	7.72%	4.17%
Preferred Stock	10.0	8.45	0.85
Common Equity	36.0	13.35	4.81
	100.0%		9.83%

15. Summary of capital structure variations between Applicant and MCC:

Long-Term Debt	1.6%
Preferred Stock	0.3
Common Equity	1.1
Total Variation	3.0% *

* This variation is attributable to the inclusion of deferred taxes in the capital structure by the Applicant. MCC does not include deferred taxes in the capital structure. Applicant, however, does not associate any cost to the deferred taxes. These deferred taxes have been treated by

Applicant as an item of "cost free" capital. Applicant contends that, "the use of deferred taxes for investment is no different than the use of the proceeds from issues of debt and equity for investment. All are forms of capital and should be included in the capital structure" (In. Br. pg. 8).

CAPITAL STRUCTURE

16. Applicant proposed to utilize its objective or target ratios in the capital structure, adjusted to reflect the addition of deferred taxes amounting to 3 percent of the capital structure. The Applicant's objective ratios are: 54 percent long-term debt, 10 percent preferred stock and 36 percent common equity (Exh. 11, p. 12).

17. MCC accepted the Applicant's objective or target ratios, and utilized this capital structure in determining the cost of capital. MCC use of the Applicant's optimal capital structure is found to be reasonable by the Commission (Exh. A, p. 13, Exhibit Section).

18. MCC does not include deferred taxes in the capital structure. This is consistent previous Commission decisions to disallow deferred taxes in rate base (Exh. B, p. 6).

COST OF DEBT

19. The cost of debt capital is not a controverted issue in this case. The cost of long-term debt capital is based on the embedded cost at April 30, 1979, and has been determined to be 7.72% by the Applicant and MCC. This cost is acceptable to the Commission (Exh. A, p. 13, Exhibit Section and Exh. 2, Table 2-12).

COST OF PREFERRED

20. The cost of preferred stock is not a controverted issue in this case. The cost of preferred stock is based on the embedded cost of preferred shares outstanding at April 30, 1979, and has been determined to be 8.45% by the Applicant and MCC. This cost is acceptable to the Commission (Exh. A, p. 13, Exhibit Section and Exh. 2, Table 2-12).

COST OF COMMON EQUITY

21. Applicant uses the following methodologies in arriving at a return on equity of 14.5%:

a. Application of the Pacific Model (Applicant's Mathematical Model) to the Applicant's financial data. The Model yielded a range of return on equity of 13.47 - 14.55%.

1. The dividend payout ratio was estimated to be approximately 75 percent, based on the average historical payout ratio for the Applicant over the eleven-year period 1968 through 1978 (Exh. 11, p. 8)

2. Annual growth in common equity capital was estimated to be 10 percent. This estimation was derived by reviewing data on growth in net utility plant for the years 1962 through 1978, as growth in net utility plant is a good indicator of growth in common equity capital (Exh. 11, p. 9).

3. Future dividend growth rate was estimated to be 4.4 percent. This estimation was made after reviewing data on the compound growth in the Applicant's dividends per share over 12 different periods, each ending in 1978 (Exh. 11, p. 11).

4. An estimate of the dividend yield was developed by reviewing the Applicant's historical dividend yields, Moody's 24 utility composite historical dividend yields and a historical series of 91 day treasury bill bids. The Applicant's dividend yield was estimated to be 9.42%.

b. The Pacific Model's reliability was tested on seven Companies which the Applicant feels have investment opportunities similar to that of the Applicant. The selected Companies had March 31,1973 through March 31, 1979 compound growth in dividends per share plus March 31, 1979 dividend yield between 13.3 percent and 14.3 percent. The average return granted to these seven Companies was determined to be 13.61 percent, which is within the range of returns produced by the Pacific Model, 13.47% - 14.55%.

22. MCC uses the following methodologies in arriving at a return on equity of 13.35%.

a. Application of discounted cash flow (DCF) techniques to Applicant's financial data. The DCF Methodology yielded a range of return on equity of 12.85% - 13.85%.

1. Dividend yield was estimated at 9.65 percent after determining the average yield of Applicant's common stock over a 26 week period, June 11 - December 3, 1979 (Exh. A, p. 19).

2. Regression analysis was used to measure historical growth rates. The historical growth rates were measured in 5-, 10-, and 15-year periods, for the years 1964 through 1979. Witness Rettenmayer also analyzed the internal growth of book value per share from retained earnings for the years 1962 through 1979. The expected dividend growth rate was determined to be 3.7 percent (Exh. A, pp. 15-18).

3. An allowance of 3.5 percent for issuance costs and market pressure was recommended following an empirical study of new stock issues from 1975 through the first half of 1979 (Exh. A, p. 30).

b. Application of the HOPE comparability standard, which specifies that the return on equity should by commensurate with returns on investments in other enterprises having corresponding risks, to a comparison group. The comparison group was comprised of eleven utilities meeting the following criteria:

(1) Common stock is traded on the New York Stock Exchange.

(2) Common stock has a beta coefficient of .70, according to Value Line (same as Applicant).

(3) Common stock has a safety rank of 1, according to Value Line.

The comparison group yielded a range of return on equity of 12.20% - 15.25%, with a group mean of 14.1%, and the estimate for the Applicant of 12.9% (Exh. A, pp. 23-25).

C. Review of the Solamon Brother's stock research reports data on electric utilities for 13 Companies rated BAA/BBB, 7 Companies rated A/BBB or BAA/A and for 100 electric utilities of all ratings. For these groups, on the average, the required rate of return is above 12.5% (Exh. A, pp. 21-22).

23. The Commission accepts the methodology sponsored by MCC as fundamentally sound. MCC relies primarily on a discounted cash flow (DCF) analysis to determine the cost of equity. Witness Rettenmayer applied the DCF techniques to the Applicant's data and to a comparison group of electric utility Companies. The application of the DCF techniques to Comparison Companies serves as a check on the Applicant's specific results.

The Comparison Group Companies were selected by MCC by using comparable beta coefficients, a measure of market price variability, and comparable safety ranks (Exh. A, p. 23).

Data used in witness Rettenmayer's DCF calculations was the most currently available information at the time the testimony was completed in December, 1979. The twenty-six week time frame used by MCC is reasonable and acceptable to the Commission.

MCC witness Rettenmayer examined dividend growth, and considered earnings and book growth in his analysis. He included 1979 data in his analysis (Exh. A, pp. 1-7 of schedules). MCC utilized regression analysis to measure historical growth rates. Applicant's witness Lanz examined only dividend growth, and studied data through 1978 (Exh. 2, Table 2-8). MCC concluded that the estimates of future growth most reasonably assumed by investors lies between 3.2 and 4.2 percent, with the lower end of this range a more reasonable estimation (Exh. A, p. 18). The use of the most current data available is preferable for decision making, and the Commission finds the estimation made by MCC to be reasonable.

RATE OF RETURN

24. Based on the findings for long-term debt, preferred stock and common equity, the following capital structure and costs are determined appropriate:

Type	Capital Structure	Cost	Weighted Cost

Long-Term Debt	54.0%	7.72%	4.17%
Preferred Stock	10.0	8.45	0.85
Common Equity	36.0	13.35	4.81
	100.0%		9.83%

RATE BASE

PART C

25. The following rate base proposals were submitted. The final column is the rate base approved by the Commission.

1978 TEST YEAR
(000)

Average Rate Base	Applicant Rate Base	Adj. by Consumer Counsel	Consumer Counsel Rate Base	Approved Rate Base
Net Plant in Service	44,236		44,236	44,236
Plant Held for Future Use	118	(105)	13	13
Utility Plant Acquisition Adjustment	2	(2)		
Nuclear Fuel	16		16	16
Customer Advances for Construction	(205)		(205)	(205)
Materials & Supplies	673		673	673
Working Capital	458	(458)		
Misc. Electric Surveys	614	(351)	263	263
Customer Contributed Capital	______	(1,357)	(1,375)	(1,357)
Total	45,912	2,273	43,639	43,639

PLANT HELD FOR FUTURE USE

26. Included in Applicant's rate base was $118,000 of plant held for future use. MCC proposes an adjustment to remove $105,000 of this amount as the property is not expected to be placed in service before 1990. The Company has agreed not to contest this issue for the purposes of this case. The Commission finds the amount of $13,000 to be the proper amount of plant held for future use included in rate base.

ACQUISITION ADJUSTMENT

27. Applicant's proposed rate base has an acquisition adjustment in the amount of $9,000. The rate base proposed by MCC eliminates this amount. Mr. Hess states that in his opinion Montana law prevents including amounts which exceed original cost in rate base (TR. p. 253, lines 5-9). The removal of this acquisition adjustment by MCC is consistent with past Commission action. The Commission finds that the $2,000 acquisition adjustment should be eliminated.

WORKING CAPITAL

28. Applicant's rate base contains a working cash requirement of $458,000. The MCC rate base does not include an allowance for working cash.

The Applicant's working capital adjustment was derived through a study done by the Company which showed a 47 day lag between the mid-point of the billing period and receipt of payments.

The Company goes on to assert that investors are supplying working capital at 12 1/2% or a lag in revenues of 45 days (Exh. 13, p. 12, lines 17-24).

Witness Hess noted that there is no mention of the average lag between the time services are rendered to the Company and the Company's payment of its bills for such services (Exh. B, p. 5, lines 6-9).

As in Docket No. 6517 the Applicant has attempted to show the need for a working capital allowance based on the lag of receipt of customer payments. Examining only half of the information needed to assess working capital is not a sound method of evaluation. Either a lead-lag study or an analysis of accounts payable should be performed to demonstrate the need for a working capital allowance.

Since the Applicant does not consider both sources and uses of funds, the Commission rejects the working capital segment in the rate base.

MISC. ELECTRIC SURVEYS

29. The proposed rate base of the Applicant had $614,000 related to miscellaneous electric surveys. MCC proposed to eliminate the entire amount from rate base. During the hearing Mr. Hess agreed that $263,000 in this category was properly included in rate base. The Company has agreed not to contest this issue for the purposes of this case. The Commission finds the amount of $263,000 to be the proper amount of miscellaneous electric surveys included in rate base.

CUSTOMER CONTRIBUTED CAPITAL

30. The Applicant proposed including deferred taxes at zero cost in the cost of capital and including these customer contributed funds in rate base. MCC proposes to eliminate the deferrals from rate base. The Commission consistent with prior decisions finds the elimination of deferred taxes from rate base to be correct. The amount of the deduction is $1,357,000.

REVENUE AND EXPENSES

PART D

31. The following income and expense proposals were submitted. The final column contains the revenue and expense amounts approved by the Commission:

1978 TEST YEAR

(000)

	Applicant		Consumer Counsel	Approved

	Revenue and Expenses	Adj. by Consumer Counsel	Revenue and Expenses	Revenues and Expenses
Operating Revenues	13,045		13,045	13,045
Operating and Maintenance Expense	6,634	(52)	6,582	6,582
Depreciation and Amortization	1,493		1,493	1,493
Taxes Other than Federal Income	1,029	(21)	1,008	1,008
Federal Income Tax	335	(243)	92	197
Deferred Income Tax	57		57	57
Income Tax Deferred in Prior Years	(85)		(85)	(85)
Investment Tax Credits Deferred	211	105	316	211
Investment Tax Credits Restored	(30)	(286)	(316)	(30)
Total Deductions	9,644	(497)	9,147	9,433
Net Operating Revenues	3,401		3,898	3,612

OPERATING EXPENSES

32. Included in Applicant's revenue deductions are operating expenses in the amount of $6,634,000. MCC proposes adjustments which reduce these expenses by $52,000. The adjustments include: A reduction of the profit on the sale of coal from the Bridger coal subsidiary of $43,000; the elimination of institutional advertising $5,000; and the elimination of $4,000 of research expense.

MCC witness Hess calculated a return on mining investment at Bridger of 24% excluding CWIP. It is also noted that the coal mining facilities at Centralia and Dave Johnston are included by the Applicant in rate base. Therefore limiting the return on Bridger coal purchases to the 13.35 return on common equity proposed by Dr. Rettenmayer is consistent with Applicant's treatment of coal costs at Centralia and Dave Johnston (Exh. B, p. 8, lines 1-9).

The Applicant contends that the price paid by the Company for Bridger coal should be accepted as it is less than the fair market price of the coal. A number of other coal sales for other Companies in 1978 was presented to show the comparability of various coal sources. The Applicant agreed that the price of Bridger coal would increase each year due to an inflation factor in the coal contract (TR. p. 107, lines 10-12).

The Commission is persuaded that to allow a return on Bridger coal equal to the return allowed for common equity is the most reasonable of the proposals. The use of inflation factors has been consistently rejected by this Commission. Allowing inflation factors adds to the inflationary spiral.

The elimination of institutional advertising is proper as this expense is not allowed for rate making purposes by the Commission. Future growth in sales is not allowed as a justification for increased expenses relating to EEI dues. Reduction of operating expense by $52,000 is accepted by the Commission.

TAXES OTHER THAN FEDERAL INCOME

33. For the reasons noted in Finding of Fact No. 32 the Commission accepts the adjustments to taxes other than federal income. The reduction of $21,000 leaves approved taxes in this category of $1,008,000.

FEDERAL INCOME TAX

34. MCC proposes to make a pro forma interest expense adjustment to decrease federal income taxes in the amount of $160,000. MCC also proposed adjustments to increase federal income tax in the amounts of $18,000 for Bridger Coal and $4,000 for advertising and research. The Commission has utilized this adjustment in the past and finds it to be appropriate in this Docket. The approved amount of federal income tax expense is $197,000.

INVESTMENT TAX CREDITS

35. Applicant's expenses in this proceeding included $30,000 of investment tax credits flowed through to ratepayers. MCC makes use of a three year period (1976 through 1978) to yield a short-term average. This would increase the amount of investment tax credits flowed through to ratepayers to $316,000 (Exh. B, p. 13, lines 21-24).

In the past the Applicant has amortized investment tax credits to income over 5-year periods for those related to mass property additions and over 10-year periods for those related to major additions. The Applicant now proposes to restore investment tax credits on an eight year basis or 12.5% per year (Exh. 13, p. 15, lines 14-16).

The adjustment made by MCC is premised on the concept that short-term averaging is not being achieved using the Applicant's method of modified flow-through. As a result the test year is increased to the average of the three year period (1976-1978). To concentrate the benefits generated by plant having a life measured in decades in a three year period is not a sound matching of revenue and expense. Future ratepayers should receive some of the benefits created by the addition of assets which generate investment tax credits. The Commission accepts the 8 year restoration proposed by the Applicant as the method that provides sound matching of investment tax credits to present and future ratepayers. The amount of tax credits to be flowed through is found to be $30,000.

REVENUE REQUIREMENT

PART E

36. The Commission finds that the additional annual revenue required in Applicant's Montana electric operations is $1,350,000 as follows:

Approved Rate Base	43,639	
Approved Rate of Return	9.83%	
Recommended Return		$4,290
Adjusted Test Year Return		3,612
		$ 678

	% of Revenue	
Revenue Deficiency	100.00	$1,350
Operating Revenue Deductions		
Uncollectibles	.224	3
MCC Tax	.060	1
State Taxable Income	99.716	1,346
State Tax at 6.75%	6.731	91
Federal Taxable Income	92.985	1,255
Federal Income Tax at 46%	42.773	577
Net Operating Income	50.212	$ 678

RATE STRUCTURE

PART F

37. All matters pertaining to electric rate design, which determines the relative increase applicable to each customer and customer class, will come before the Commission at a hearing to be scheduled at a later date. Until such time as rate design matters are completed in the phase II hearing rates will be set on a uniform cents per kilowatt hour basis.

CONCLUSIONS OF LAW

1. The Applicant, Pacific Power and Light Company, is a "public utility" within the meaning of Montana law, Section 69-3-101, MCA.

2. The Commission properly exercises jurisdiction over the Applicant's rates and operations pursuant to Sections 69-3-102, and 69-3-302, MCA.

3. The Commission's action in denying Applicant's proposed acquisition adjustment (Finding of Fact No. 27) is proper in light of Section 69-3-109, MCA, as interpreted by Montana Power Company v. Public Service Commission, 36 St. Rptr. 312 (1979) which provides that items in rate base "may not exceed the original cost or the property."

4. The rate of return allowed in this Order meets the constitutional requirement that a public utility's return must be "commensurate with the returns on investments in other enterprises having corresponding risks sufficient to insure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 603 (1944).

5. The rate structure approved herein which is interim in nature pending the hearing and decision in phase II of this Docket is just, reasonable and not unjustly discriminatory.

ORDER

THE MONTANA PUBLIC SERVICE COMMISSION ORDERS THAT:

1. Pacific Power & Light Company shall file rate schedules which reflect an annual revenue increase of $1,350,000 for Montana electric service, based on the test period ending December 31, 1978.

2. The increased electric revenues authorized herein shall be distributed to Applicant's classes of service on a uniform cents per kilowatt-hour basis.

3. Applicant shall file revised schedules incorporating the changes in its rate schedules and service regulations approved herein. The schedules shall become effective for service rendered after approval of said schedules.

4. All motions and objections not ruled upon at the hearing are denied.

DONE IN OPEN SESSION at a meeting of the Montana Public Service Commission held July 7, 1980, by a vote of 4-0.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

CLYDE JARVIS, Commissioner

THOMAS J. SCHNEIDER, Commissioner

JAMES R. SHEA, Commissioner

GEORGE TURMAN, Commissioner

ATTEST:

Madeline L. Cottrill
Commission Secretary

(SEAL)

NOTE: You May be entitled to judicial review of this Order. Judicial review may be obtained by filing within thirty (30) days from the service of this Order a petition for review pursuant to Section 2-4-702 MCA.