

Service Date: December 11, 1980

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER of the APPLICATION) UTILITY DIVISION
of the BUTTE WATER COMPANY for) DOCKET NO. 6802
authority to increase its rates and) ORDER NO. 4700a
charges for service to its ANACONDA,)
MONTANA, customers.)

APPEARANCES

FOR THE APPLICANT:

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FOR THE INTERVENOR:

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FOR THE COMMISSION STAFF:

Eileen E. Shore, Legal Counsel, 1227 Eleventh Avenue, Helena,
Montana 59601

BEFORE:

JAMES R. SHEA, Commissioner and Hearing Examiner
CLYDE JARVIS, Commissioner
GEORGE TURMAN, Commissioner

FINDINGS OF FACT

A. GENERAL

1. On March 5, 1980, Butte Water Company(Applicant) filed an
application with this Commission for authority to increase
rates and charges for water service to its customers in
Anaconda, Montana. The Applicant requested an average
increase of approximately 69 percent which would result in an
increase of \$125,874 in annual revenues.

2. On April 3, 1980 and July 18, 1980 the Applicant filed requests for interim rate relief both of which were denied by the Commission.

3. On September 5, 1980, pursuant to notice of public hearing, 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.

4. On September 12, 1980, subsequent to the public hearing, the Applicant renewed its request for interim rate relief in the amount of \$82,641. The Applicant requested that the increase be spread to services other than sprinkling since seasonal sprinkling bills had been rendered months earlier.

5. On September 29, 1980, the Commission having considered the testimony taken at the public hearing and the justification submitted by the Applicant issued an order granting the Applicant interim rate relief equal to \$83,229 annually.

6. At the public hearing the Applicant presented the testimony and exhibits of the following five witnesses:

James E. Byrne
C. Wayne Young
Norman R. Walker
Elmer W. Moke
Frank R. Lanou

7. The Montana Consumer Counsel at the public hearing presented the testimony of six public witnesses and the testimony of the following two expert witnesses: Dr. Caroline

Smith Frank E. Buckley

8. The year ending December 31, 1979 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 water service.

B. RATE BASE

9. The Applicant proposed an average original cost depreciated rate base of \$253,818.

10. The Montana Consumer Counsel's witness, Frank Buckley, proposed the following adjustments to the Applicant's rate base:

a. Decreases in depreciation reserve of \$2,773 to reflect decreases associated with additional contributions in aid of construction.

b. Decreases of \$10,374 to reflect the fact that the Applicant has use of accrued property taxes for working capital requirements.

11. The Commission, having examined each of the adjustments proposed in Finding of Fact No. 10 finds those adjustments to be appropriate. The proposed adjustment to working capital is consistent with past Commission rulings relating to accrued property taxes. The remaining adjustments are consistent with accepted accounting principles. Therefore, the Commission finds the rate base to be \$246,217.

Rate of Return

C. CAPITAL STRUCTURE

12. The Applicant proposed the following capital structure for rate case presentation:

Description	Amount (000's)	Ratio
Debt	\$3,000	85.2%
Common Equity	521	14.8%
Total	\$3,521	100.0%

The capital structure proposed by the Applicant was not challenged by any party participating in this proceeding and therefore is accepted by the Commission.

D. COST OF DEBT

13. The debt capital of the Applicant consists of a \$3 million loan from the Crocker National Bank. The cost of debt capital or interest on this loan is set by the prime rate of the Crocker National Bank through March of 1984. The prime rate is the short-term interest rate charged by banks on loans to their best business customers, and therefore the prime rate reflects short-run conditions. Due to the fact that the prime interest rate reflects short-run conditions it may vary greatly. Despite the fact that the interest rate on this loan will vary, the Commission must assign a fixed interest rate to the loan for rate-making purposes.

14. The Applicant's witness, Frank Lanou, recommended a fixed interest rate of 15.25 percent be assigned to the loan as that was the rate being paid by the Applicant on the date his direct testimony was prepared. Lanou affirmed his recommendation of a 15.25 percent interest rate at the time of the public hearing because it closely approximated the actual interest rate incurred by the Applicant during the

period March through July.

15. The Montana Consumer Counsel's (MCC) witness, Dr. Caroline Smith, recommended a fixed interest rate of 11 percent be assigned to the loan. Dr. Smith predicated her recommendation on a three year historical study of the prime interest rate which indicates that the average for the three year period was 11 percent. Dr. Smith noted that, during the past three years "the range [of the prime interest rate] has been large (6.25 to 20 percent), and the unusually high prime rates of the recent past began in 1979, as lenders became more and more concerned about the high short-term inflation rates as well as - possible controls which the Federal Reserve might impose. " (MCC-A-8)

16. The Commission accepts Dr. Smith's recommendation, Mr. Lanou's recommendation seems to rest primarily on the prime rate in effect at the time he wrote his testimony (February, 1980) and on the fact that the average prime rate or the period between February and the time he filed his rebuttal testimony (July, 1980), closely approximated his original recommendation. (Tr. 336) As indicated by Dr. Smith's Exhibit CMS-2, this period included extraordinarily high interest rates when compared to the recent past. Use of such short-term data is inappropriate for ratemaking purposes, where the Commission is required to establish an estimate of what prime rates will be over a period of time in the future. By contrast, Dr. Smith correctly notes of her own recommendation, ". . .if the prime rate behaves over the next three years as it has for the past three years, the Company will, on average, face an interest expense of 11 percent. " (Exhibit MCC-A-9) The Commission must rely to some extent to past experience in predicting the future.

17. In rebuttal, Mr. Lanou argues that "we are now facing inflationary expectations that are so high that the prime rate will remain much higher than in the average of the 1970's." (Tr. 330-331) That argument is unpersuasive in view of the fact that Dr. Smith's three-year average includes prime rates in effect during periods of very high inflation.

18. An examination of the events surrounding the Company's decision to take out the Crocker loan and at the time it choose to do so further supports the Commission's decision to accept the more conservative prime rate estimate recommended in this case.

a. According to the Company's counsel, James A. Robischon, the Company decided to seek refinancing to fulfill its "promise" to the Commission in an earlier rate case to finance its construction program "through the issuance of long-term debt securities. " (Tr. 462) This "promise" did not come at the urging or by order of the Commission. Even had such a "promise" not been made, the Company would have sought outside financing to replace the former arrangement of the parent company, the Anaconda Company, funding such projects. (Tr. 454)

b. The proceeds of the Crocker loan were used to pay accounts receivable and a demand note held by the Anaconda Company. (Byrne-Direct Testimony-4) Nothing in the record indicates that the Anaconda Company incurred financing costs for those projects which are comparable to the prime rate which was or will be in affect over a period of time in the future.

c. The Anaconda Company advanced funds to the Butte Water Company during a period which includes the period used by Dr. Smith in formulating her recommendation.

d. The Company had anticipated instituting its refinancing program following the last increase (1977) but did not do so for two reasons: (1) The Company believed it necessary to see what its "experience under the new increase would be"; (2) The merger of the Anaconda Company and the Atlantic Richfield Company introduced complexities to the corporate situation, including a diversion of attention of Anaconda officials from the problems of the Butte Water Company. (Byrne-Direct Testimony-4,5)

e. Had the Company proceeded with its plan to refinance its debt in the form and at the time originally contemplated, it could have done so at rates substantially less than those in effect in 1980, even if refinancing had been effected by a loan at prime interest rates. (CMS-2)

f. The decision to pursue refinancing through short-term debt in the form of a loan at prime interest rates, rather than through conventional long-term financing at substantially lower rates, was largely the result the time at which refinancing was secured. (Lanou-Direct Testimony-40)

g. According to the Company's witness, contrary to the Company's decision " [i]t is uncommon for the entire debt to take this form [short-term debt]." (Lanou-Direct Testimony-40)

h. Although long-term debt financing was unavailable at the time the Company sought refinancing, the Company did not consider the possibility of postponing the refinancing program until economic conditions were more favorable:

Q. Was there any consideration of problems you faced in trying to secure that financing during what Mr. Lanou and other witnesses have described as very difficult economic

conditions as far as high interest rates, difficult conditions for securing long-term financing for any kind of company, even one which was healthier than the Butte Water Company, did you consider holding on for a year or six months or anything of that sort?

A. No. I pursued it doggedly and as quickly as I could because I wanted to get back and make this rate-case application, and I knew that one of the considerations was to clear up the financing.

(Tr. 454. 455)

i. Refinancing for the Company was available only with the backing of the parent companies, either the Anaconda Company or the Atlantic Richfield Company (Lanou-Direct Testimony-42), and the Crocker loan is, in fact, guaranteed by the Anaconda Company. (Tr. 466) The Company could have secured financing with the assistance of the parents at lower than prime interest rates:

Q. Isn't it possible that in the development of a capital structure more nearly that of a utility, i. e., going to the market for debt, isn't it possible that the Anaconda Company or ARCO could have gone to the marketplace for long-term debt and then simply passed that through at that rate, thereby compensating themselves through the Butte Water Company? In other words, couldn't you have issued 10 percent long-term debt security and then had that flowed through to the Butte Water Company?

A. Those funds?

Q. Yes.

A. Yes, we could have done that. I think the way we've gone is a cleaner way for the Butte Water Company and for the ratepayers.

Q. Wouldn't that have been a more attractive interest rate than a floating prime rate?

A. Possibly it would have, yes, if the ARCO --yes, sir. (Tr. 464, 465)

19. In summary, for strictly corporate reasons which did not reflect any particular benefit to the company's customers, the Company choose an unusual financing mechanism, using expensive short-term debt (the Crocker loan) instead of a long-term debt which is normally used for capital programs and which was available through the parents, and it did so at a time when the cost of short-term debt was very high.

The expenses which are now being financed with the Crocker loan were incurred over a period of time (1976-1980) when financing costs, even at prime rates, were much lower than they are today. Had the Company pursued financing of these expenses in a more conventional fashion as it had originally planned, with long-term debt at the time the expenses were being incurred, its ratepayers would not be subject to the current prime rates.

Although the Commission does not find that the Company's decision to secure the Crocker loan was imprudent, based on this record, the record does clearly show that that decision resulted in the most expensive alternative reasonably available. It must be further noted that the loan was secured to pay off amounts the Company owed its parent, the Anaconda Company, which had for a long period of time provided financing to the water utility. In view of these facts it is

appropriate that the Commission reject the premium interest rate recommended by Mr. Lanou and accept Dr. Smith's recommendation of 11 percent, which nonetheless is higher than what ratepayers would have been subject to had conventional financing been secured. The Commission has serious doubts as to whether use of a loan at prime interest rates should be used in the kind of situation presented here; however, because the record does not reveal what the cost of long-term debt would have been for the refinancing program, testimony based on the actual loan is accepted.

E. COST OF EQUITY

20. The Applicant's witness Lanou advocated a return on equity of 15.25 percent. The witness predicated his recommendation on the fact that the average water utility as entitled to an equity return in the range of 13.5 percent to 14.0 percent and due to additional risk inherent in Butte Water Company stock, its return should be higher than the average.

21. The Commission rejects Applicant's assertion that investment in Butte Water Company stock is riskier than that of any other water utility.

22. The Commission accepts the assertion that the average return on equity for water utilities is in the range of 13.5 percent and 14.0 percent.

23. MCC's witness Smith concluded that a reasonable return on common equity to the ultimate equity investors of Butte Water Company is 13.9 percent.

24. Dr. Smith reduced her return allowance from 13.9 percent

to 12.3 percent through the use of triple leveraging. The triple leveraging mechanism was employed because Butte Water Company is a third tier subsidiary in a vertically pyramided corporate structure, with Butte Water Company being wholly owned by Anaconda Company and Anaconda in turn wholly owned by ARCO.

25. In ratemaking cases, it is the Commission's responsibility to determine a fair rate of return for a public utility. It is incumbent upon the Commission to set rates at a level which returns to the utility its cost of attracting capital (debt and equity). The common equity of Butte Water Company (BWC) does not represent funds acquired in the open market: Funds are acquired from the parent companies (AC & ARCO). Since the funds are acquired from BWC's parents, BWC's cost of acquiring funds from its parents should be equal to the parent's cost of acquiring those funds to invest in BWC. Therefore, the Commission accepts Dr. Smith's use of triple leveraging to determine the Applicant's cost of common equity.

26. An 11.19 percent rate of return allowance for the Applicant will yield a 13.9 percent return to the ultimate equity investors, calculated as follows:

Capital Structure and Composite Cost
of Total Capital

	Amount (000's)	Ratio	Cost Rate	Weighted Cost
Debt	\$3,000	85.2%	11.00	9.37%
Common Equity	521	14.8%	12.30	1.82%
Total	\$3,521	100.0%		
Composite Cost of Total Capital				11.19%

27. The Commission accepts test period operating revenue of \$181,994.

Operating Expenses

28. The Applicant proposed total test period operating revenue deductions of \$258,097.

29. MCC's witness Buckley proposed the following adjustments to the Applicant's proposed test period operating revenue deductions:

a. Reduced increase in wages by \$2,206 to reflect Applicant's late filed Exhibit 13 revised September 12, 1980.

b. Reduced salaries by \$6,870 to reflect overstatement by Applicant as shown in response to MCC data request D.

c. Reduced personnel reductions and economies by \$1,772 to reflect 10 year amortization of this one-time expense.

d. Reduced additional rate case expense by \$7,133 to reflect appropriate three year amortization of expense.

e. Disallowed pro forma federal income taxes since availability and usage of operating loss carry-forwards, unused investment tax credits and current investment tax credits would offset any alleged tax liabilities.

30. The Commission accepts each of the proposed adjustments outlined in Finding of Fact No. 29. The Commission finds that the premises utilized by the MCC to make each of the adjustments is supported by the record in this Docket. Therefore, the Commission finds the following:

Butte Water Company - Anaconda Division

	Company Pro forma (Present Rate)	MCC Adjustments	Adjusted
Operating Revenues	\$ 181,994	\$ -0-	\$ 181,994
Operating Revenue Deductions			
Operating & Maintenance Expense	230,919	(17,981)	212,938
Depreciation	9,913	(2,773)	7,140
Taxes Other Than Federal Income	17,265	-0-	17,265
Income Taxes (Federal)	-0-	-0-	-0-
Total Deductions	\$ 258,097	\$(20,754)	237,343
Operating Income or Return (55,349)	(76,103)	20,754	
Average Rate Base			
Net Plant in Service	221,852	2,773	224,625
Materials and Supplies	3,101	-0-	3,101
Cash	28,865	(10,374)	18,491
Total Rate Base	253,818	7,601	246,217
Rate of Return	(29.98%)		(22.48%)

Revenue Requirement

31. In order to produce a return of 11.19 percent on the Applicant's average original cost depreciated rate base, the Applicant will require additional annual revenues in the amount of \$83,229 from its Anaconda, Montana water utility.

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

Butte Water Company - Anaconda Division

	Company Pro forma (Present Rate)	MCC Adjustments	Adjusted	Proposed Increase	Earnings With Rate Increase
Operating Revenues	\$ 181,994	\$ -0-	\$ 181,994	\$83,229	\$ 265,223
Operating Revenue Deductions					
Operating & Maintenance Expense	230,919	(17,981)	212,938		212,938
Depreciation	9,913	(2,773)	7,140		7,140
Taxes Other Than Federal Income	17,265	-0-	17,265	328	17,593
Income Taxes (Federal)	-0-	-0-	-0-		-0-
Total Deductions	\$ 258,097	\$(20,754)	237,343	328	237,671
Operating Income or Return	(76,103)	20,754	(55,349)	82,901	28,552
Average Rate Base					
Net Plant in Service	221,852	2,773	224,625		
Materials and Supplies	3,101	-0-	3,101		
Cash	28,865	(10,374)	18,491		
Total Rate Base	253,818	7,601	246,217		246,217
Rate of Return	(29.98%)		(22.48%)		11.19%

CONCLUSION OF LAW

1. The Montana Public Service Commission properly exercises jurisdiction over the parties and subject matter in this proceeding.

2. The Commission afforded all parties interested in this proceeding proper notice-and an opportunity to participate.

3. The rates approved herein are reasonable, just and proper.

ORDER

NOW THEREFORE, at a session of the Montana Public Service Commission, Department of Public Service Regulation, held in its offices at 1227 11th Avenue, Helena, Montana 59601, on the 8th day of December, 1980, there being present a quorum of Commissioners, there came regularly before the Commission for final action the matters and things in Docket No. 6801, and the Commission being fully advised in the premises;

IT IS ORDERED by the Commission that Butte Water Company shall file rate schedules which reflect an increase in annual revenues of \$83,229 for its Anaconda, Montana water service.

IT IS FURTHER ORDERED that the water revenues authorized herein shall be distributed among Applicant's classes of service on a uniform percentage basis.

IT IS FURTHER ORDERED that a full, true and correct copy of this order be sent forthwith by first class United States mail to the Applicant and to all other appearances herein.

IT IS FURTHER ORDERED that the rates will be effective for

water service rendered on and after December 8, 1980.

THE FOREGOING ORDER was adopted by the Department of Public Service Regulation of the State of Montana, Public Service Commission, IN OPEN SESSION at Helena, Montana, this 8th day of December, 1980, by a vote of 2-1.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

CLYDE JARVIS, Commissioner

GEORGE TURMAN, Commissioner

JAMES R. SHEA, Commissioner
Voting to Dissent)

NOTE: You may be entitled to judicial review of the final decision in this matter. If no Motion for Reconsideration is filed, judicial review may be obtained by filing a petition for review within thirty (30) days from the service of this order. If a Motion for Reconsideration is filed, a Commission order is final for purpose of appeal upon the entry of a ruling on that motion, or upon the passage of ten (10) days following the filing of that motion. cf. the Montana Administrative Procedure Act, esp. Sec. 2-4-702, MCA; and Commission Rules of Practice and Procedure, esp . 38.2. 4806, ARM.