Service Date: April 22,1985

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

* * * * *

IN THE MATTER of the Application of	) UTILITY DIVISION
PACIFIC POWER AND LIGHT COMPANY for	)
Authority to Adopt New Rates and	) DOCKET NO. 84.7.38
Charges for Electric Service Furnished	)
in the State of Montana.	) ORDER NO. 5128

APPEARANCES
FOR THE APPLICANT

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FOR THE MONTANA CONSUMER COUNSEL:
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FOR THE COMMISSION:
Opal Winebrenner, Staff Attorney, 2701 Prospect Avenue, Helena, Montana 59620.

BEFORE:
HOWARD L. ELLIS, Commissioner, Presiding
CLYDE JARVIS, Chairman
JOHN B. DRISCOLL, Commissioner
TOM MONAHAN, Commissioner

PART A
BACKGROUND

1. The Pacific Power and Light Company (PP&L, Company or Applicant) is a public utility furnishing electric services to consumers in the State of Montana, and is subject to the regulatory jurisdiction of the Montana Public Service Commission (PSC, Commission).

2. On July 19, 1984, PP&L filed with the Commission its application for authority to increase rates and charges for electric service. That filing was based upon the

premise that Colstrip 3 would be included in rate base in the Commission's Final Order for Docket No. 83.10.71. As a result of the Commission's decision to exclude Colstrip 3 from rate base in Order No. 5028c of Docket No. 83.10.71, PP&L filed a supplement to their original case on August 20, 1984. The revised proposed rates are designed to produce an increase in annual gross operating revenues of $3,904,000, based on a historic test year ended March 31, 1984, adjusted for known and measurable changes. Of this amount, the Company estimates that $1,235,000 can be recovered from the Bonneville Power Administration (BPA), pursuant to the terms of the Company's Residential Purchase and Sale Agreement with BPA, authorized by the Pacific Northwest Electric Power Planning and Conservation Act (Regional Act). Therefore, the proposed tariff schedules are designed to produce a net revenue increase of $2,669,000 or 11.6 percent over the presently effective rates.

3. On August 30, 1984, the Commission issued a Notice of Application and Proposed Procedural Order. On September 17, 1984, the Commission issued a Final Procedural Order.

4. On December 28, 1984, the Commission issued a Notice of Public Hearing in Docket No. 84.7.38.

5. On January 29 through February 1, 1985, pursuant to the Notice of Public Hearing, a hearing was held in the City Council Chambers, Kalispell, Montana.

6. In this proceeding, PP&L did not request interim rate relief.

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

8. Applicant proposes a March 31, 1984, test year adjusted for known and measurable changes, to be used as the test period in this Docket. The March 31, 1984, test period is found by the Commission to be a reasonable period within which to measure Applicant's electric utility revenues, expenses, and returns for the purpose of determining a fair and reasonable level of rates for electric service.

PART B

RATE OF RETURN

Capital Structure

9. Applicant proposed the following capital structure and associated costs (PP&L Exh. 6, RFL, Table 6-6):

Description	Ratio	Cost	Weighted Cost
Long-Term Debt	52.0%	10.39%	5.40%
Preferred Stock	12.0%	10.99%	1.32%
Common Equity	36.0%	16.25%	5.85%

10. MCC proposed the following capital structure and associated costs (MCC Exh. 1, CMS-l):

Description	Ratio	Cost	Weighted Cost
Long-Term Debt	58.2%	9.79%	5.70%
Preferred Stock	11.6%	9.07%	1.05%
Common Equity	30.2%	13.50%	4.08%
	100.0%		10.83%

11. Applicant proposed to utilize its target ratios in the capital structure. The Applicant's target ratios are: 52 percent long-term debt; 12 percent preferred stock; and 36 percent common equity. (PP&L Exh. 5, p.9)

12. Dr. Caroline Smith, who presented expert testimony for the Montana Consumer Counsel, used the end of period capital structure at March 31, 1985. Dr. Smith adjusted the common equity amount to remove the portion invested in businesses other than the electric utility operations. Pursuant to Order No. 4975 Dr. Smith adjusted all of the permanent capital balances to reverse the effects of the -exchange of first mortgage and pollution control bonds for shares of new preferred stock done during 1982. Lastly, Dr. Smith adjusted the capital structure for PP&L's planned redemption of preferred stock. (MCC Exh. 1, p.6)

Debt/Equity Exchange

13. The positions of the parties on the debt/equity exchange are unchanged from Docket No. 83.5.36. MCC recommends that the effect of the exchange be ignored for ratemaking. The Company argues that the exchange be recognized because it more closely approximates the actual capital structure. The Commission finds that the position taken in Order No. 4975 is correct and is accepted in this Docket.

Equity Ratio

14. Dr. Smith, as noted above, made a number of adjustments to the capital structure which result in an equity ratio of 30.2 percent. In Docket No. 83.5.36, Dr. Smith recommended and the Commission accepted an even lower equity ratio of 28.1 percent. While each of the specific adjustments may appear reasonable, the Commission must evaluate the cumulative effect of these changes.

15. Adoption of Dr. Smith's recommendation would result in the Applicant having a lower equity ratio than any utility in the United States (Applicant's opening brief p.20). The Commission finds no reason to set PP&L's equity ratio below that of all other utilities.

16. The reason for the lower than usual equity ratio which Pacific currently has is the write-off of several cancelled nuclear projects (Tr. p.165). The Commission agrees with the Applicant that, on a prospective basis, PP&L should have a capital structure which reflects the electric operations on a stand-alone basis.

17. During the hearing, PSC staff asked Dr. Smith this question about the target capital structure:

Q. Dr. Smith, the target capital structure that PP&L has requested in this docket, do you feel that contains a reasonable equity ratio based on the capital structure of other electric utilities?

A. Yes, in the sense that I think it's perfectly reasonable for PP&L to arrange its financing such that it has that equity ratio on its utility operations. Moreover, once PP&L does have that equity ratio, we should set rates based upon that equity, debt and preferred stock ratio that is in Mr. Lanz' target. My objection to using that though, in this proceeding is that PP&L does not have that high an equity ratio. . ..

(TR. pp.226 & 227)

The Commission agrees with both PP&L and MCC that the target capital structure is a realistic financing goal for the Applicant to achieve. The reasonableness of a 36 percent equity ratio for an electric utility as proposed by PP&L is demonstrated by a review of the record in this Docket. Dr. Smith gave the following evidence:

I'm certainly aware that the industry average is somewhere between 39 and 40 percent (TR. p.154).

PP&L presented a table of nine comparable companies which have an average equity ratio of 38.2 percent tExh. 4, Table 4-3). A second table of seventeen comparable companies reflected an average equity ratio of 40 percent (Exh. 4, Table 4-4). A third table showed an average equity ratio of 41.4 percent for 102 utility companies (Exh. 6, Table 6-2).

18. The Applicant indicated that 3,000,000 shares of common stock will be issued in May or June of this year (Tr. pp.317 & 318). This indicates that Pacific's actual capital structure, excluding investments in subsidiaries, will include at least 34.5 percent common equity during the period rates in this Docket will be in effect (Exh. 28, p.8). Dr. Smith indicated that it is proper to use the capital structure which exists during the time rates are in effect (TR. p.144).

19. After examining all of the evidence in this Docket, the Commission finds that the appropriate equity ratio for PP&L is 34.5 percent. This equity ratio is the level of equity which will actually exist during the time rates are in effect. The Commission did not find any evidence which indicated that PP&L should have the lowest equity ratio for any utility in the United States. The Commission agrees with PP&L that the target capital structure is a reasonable capital structure for an electric utility. The Commission will not utilize the target capital structure until it has actually been achieved. The amount of preferred stock in the capital structure is found to be 12 percent. The remaining portion of the capital structure, long-term debt, is found to be 53.5 percent. Cost of Capital Long-Term Debt

20. The Applicant proposed the use of an estimate of the cost of long-term debt as of March 31, 1985, in the amount of 10.39 percent (Exh. 6, Table 6-6). The cost of long-term debt excluding the debt/equity exchange is 10.05 percent (Exh. 6, Table 6a-3).

21. Dr. Caroline Smith proposed an adjusted cost of long-term debt in the amount of 9.79 percent (MCC Exh. 1, CMS-3 p.2 of 3).

22. Mr. Lanz, a witness for PP&L in his rebuttal testimony revised the cost rates for several bond issues which have variable rates. The revised rates are: Adjustable Rate First Series Mortgage Bonds 15.7 percent; Eurodollar Variable rate Bonds 10.7 percent; Pollution Control Revenue Bonds due 2011, 7.7 percent and Pollution Control Revenue Bonds due 2014, 6.1 percent. Using those revised rates, Dr. Smith calculated the cost of long-term debt to be 9.94 percent (MCC Reply Brief Attachment "A"). The Company has indicated that 9.94 is the appropriate cost of debt. The Commission finds that the cost of debt in this Docket is 9.94 percent, which was agreed to by the parties.

Preferred Stock

23. The cost of preferred stock is not a contested issue in this case. Pacific and MCC agree that the Applicant's embedded cost of preferred stock excluding the effects of the debt/equity exchange, is 9.07 percent. This cost of preferred stock is accepted by the Commission.

Common Equity

Applicant

24. Dr. Vander Weide, President of Utility Financial Services, provided expert testimony on the cost of equity for the Applicant. According to Dr. Vander Weide, there were two primary economic principles which were relevant to his appraisal of PP&L's cost of capital. The first, relating to the demand for -~capital, states that a firm should continue to invest in plant and equipment only so long as the return on its investment is greater than or equal to its cost of capital for that project. The

second principle, relating to the supply of capital, states that rational investors are maximizing their total return on capital only if the returns they receive on investments of comparable risk are equal (Exh. 3, p.4).

25. In his direct testimony, Dr. Vander Weide indicates that broad economic conditions in the capital markets have a direct bearing on a firm's cost of capital. He goes on to note that today's high capital rates are due to recent high levels of inflation. Although the C.P.I. rose only 6.1 percent in 1982 and 3.2 percent in 1983, Dr. Vander Weide does not believe it reflects investors' long-run inflation expectations. His reasoning is that there is uncertainty associated with the Federal deficit.

26. Dr. Vander Weide used two methods to determine the appropriate return on equity for PP&L. The two methods he employed are the Discounted Cash Flow (DCF) and the Risk Premium method. The DCF method assumes that the current market price of the firm's stock is equal to the discounted value of all expected future dividends. The Risk Premium method equates investors' current expectations to the historical record of comparable returns on stock and bond investments (Exh. 3, p.23).

27. Instead of using the traditional DCF analysis which assumes a constant dividend growth rate, annual dividend payments, and no selling costs, Dr. Vander Weide used a quarterly
version of the DCF Model. In addition, all of his DCF calculations include a 5% allowance for flotation costs and market pressure (Exh. 3, p.25).

28. Dr. Vander Weide used market data for two groups of electric companies in deriving his DCF estimate. The first group was made up of nine electric companies with similar split bond ratings (Exh. 4, Table 4-3). The second group consisted of seventeen utilities with 1) single A bond ratings from both Moody's and S&P, and 2) no significant nuclear construction program (Exh. 4, Table 4-4).

29. For his estimate of the expected growth rate, Dr. Vander Weide used analyst forecasts of earnings growth as published in the Institutional Brokers Estimate

System (IBES). For firms not covered by IBES, he used Value Line forecasts (Exh. 3, p.27). The Commission questions whether the IBES was available to all investors, given its cost.

30. Based on his DCF analysis, Dr. Vander Weide concluded that for utilities with similar business risk characteristics as PP&L, the cost of equity is in the range of 17-17.5% (Exh. 3, p.30). However, PP&L is not requesting 17 to 17.5 percent on equity. Mr. Watson of PP&L explained in his direct testimony:

I have reduced the return on common stock equity
request from the 17 to 17.5 percent range sponsored by
Dr. Vander Weide to 16.25 percent assuming the
reasonable and conservative target capital structure
recommended by Dr. Vander Weide and Mr. Lanz is adopted
(Exh. 1, p.2)

31. Based on his Risk Premium analysis, Dr. Vander Weide concluded that investors will-require an equity return of at least 3.5-5.5 percentage points above the expected yield on PP&L's long-term debt issues. By adding a 3.5-5.5 percentage points risk premium to a 14 percent projected yield on PP&L's debt issues, he obtained an expected return on equity of 17.5-19.5 percent.

32. In his rebuttal testimony, Dr. Vander Weide raised five points: (1) the proper implementation of the DCF model when dividends are paid quarterly; (2) the use of historical growth rates versus analysts' forecasts in estimating the growth rates expected by investors; (3) that Dr. Smith's correlation and regression methodology is incorrect and her results are unreasonable; (4) the reasonableness of Dr. Smith's comparable earnings approach and (5) Dr. Smith's incorrect analysis of his testimony (Exh. 26, pp.1 & 2).

33. Mr. Hannigan, an employee of the Applicant, presented rebuttal testimony which related to the issue of the cost of equity. The purpose of his testimony was to evaluate the statistical portion of Dr. Smith's estimation of Pacific Power and Light's cost of common equity capital and to demonstrate an alternative and more accurate approach to the statistical estimation of investor dividend growth expectations (Exh. 30, p.2).

34. Mr. Hannigan was asked in his rebuttal testimony to summarize the errors he found made by Dr. Smith:

The first error deals with Dr. Smith's incorrect use of correlation analysis to estimate expected growth rates of dividends. The second error occurs in Dr. Smith's use of an equation with the statistical problem of multicollinearity. The third error in her approach deals with Dr. Smith's attribution of all explanatory power in her model to factors which explain only part of the total variation (Exh. 30, p.2).

35. Mr. Hannigan did not agree with Dr. Smith's conclusion regarding investor dividend growth expectations. In his view an expected dividend growth rate of at least 4.7 percent per year should be adopted for Pacific Power and Light Company (Exh. 30, p.23).

MCC

36. Dr. Smith provided expert testimony on the cost of equity, representing the MCC. Dr. Smith used two methods to determine the appropriate return on equity for PP&L. The two methods she employed are the Discounted Cash Flow (DCF) and the Comparable Earnings method. Dr. Smith used a traditional discounted cash flow model, modified to account for intra-industry risk differences (MCC Exh. 1, pp.15 & 16). Comparable earnings of similar companies are evaluated to provide a test of the reasonableness of the estimate of the cost of equity.

37. In her DCF study, Dr. Smith used 86 electric and combination electric and gas utility companies which are traded on the New York Stock Exchange. Nine companies were excluded from her study due to price behavior or failure to pay dividends. The pricing period beginning in August of 1983 through September 1984 was used as the time period for evaluation (MCC Exh. 1, Appendix B, p.2).

38. At page 3 of Appendix B, Dr. Smith indicates how dividend yields were calculated:

The current dividend yield (D1/PO) for each company was calculated by dividing the current annual dividend by the stock's market price. The dividend used is the indicated rate published in the October 1984 issue of Standard and Poor's Stock

Guide. The price used is the average of the high and low prices for the six months from April through September 1984. Dividend yields were calculated for each company in the industry, including PP&L. The average dividend yield for the 86 companies is 11.50 percent. PP&L's dividend yield is 10.20 percent. 39. Dr. Smith estimated dividend growth by examining growth rates in dividends, earnings and book value over a ten year period. The growth indicators for industry are 2.0 percent, 2.4 percent and 4.6 percent. Dr. Smith derived an equity cost range of 13.9 to 14.9 percent for industry. For PP&L, her calculated growth indicators are .9 percent, 1.6 percent and 3.8 percent. She concluded:
My estimate of the long-term dividend growth investors expect for PP&L is in the range of 2.8 to 3.8 percent (MCC Exh. 1, pp.32 & 33). 40. Adding Dr. Smith's growth estimate to her dividend yield produces a range in the cost of equity of 13.0 to 14.0 percent. Her recommendation is that the Commission allow a 13.5 percent equity return (MCC Exh. 1, p.5).

Commission Analysis

41. The Commission began its analysis with the evidence of statistical problems in Dr. Smith's DCF model as testified to by Mr. Hannigan. The first point he made was that Dr. Smith incorrectly used correlation analysis to estimate expected growth rates of dividends. Dr. Smith and Mr. Hannigan are in agreement that there is a difference between correlation and causation.

Q. In the statistical sense, there's a difference between correlation and causation; isn't there? Statistics never really demonstrate that one thing is causing another; it really just shows the two phenomenon are associated in time?

A. That's right. That's where Mr. Hannigan's rebuttal had some sense to it, I thought. It is true that a correlation analysis will never ever demonstrate any kind of causation at all. All a correlation analysis does is tell us whether or not there is a relationship (Tr. p.194A). Dr. Smith explained that causation is demonstrated by a hypothesis which is tested by statistical analysis, and which must have sound logical or theoretical support.

Dr. Smith explained why historical data is appropriate to estimate investor expectations:

first of all, their [sic] factual data. The historical data we have are growth rates utilities have been able to achieve. The second reason the historical data are logical candidates is because those growth rates are available to all participants in the market. There's rot a single buyer and seller of electric utilities that does not have ten years, at least, worth of historical data available to him. That's not true of other kinds of data.

The third important reason that I can make the connection between historical growth rates and expected growth rate is that the historical growth data are believable. There are various reasons for this. One is that historical growth data cover a very wide range of events of things that have happened to electric utilities in the past. Those things have had effects on earnings dividends and book value, and although those same exact things may not happen in the future,
those same kinds of effects will tend to persist over time (Tr. pp.194A & 195).

42. The second problem Mr. Hannigan had with Dr. Smith's work was that multicollinearity existed. Mr. Hannigan described the problem at page 10 of his rebuttal testimony:

Multicollinearity exists when two or more "independent" variables (such as book value per share and earnings per share in Dr. Smith's model) are highly correlated with each other in a multiple regression equation. When this happens the ordinary least squares statistical techniques used by Dr. Smith cannot separate out the individual influences of the hypothesized independent variable on the dependent variable (i.e., dividend yield), since the hypothesized independent variables are in fact statistically dependent upon one another. A statistical test of her regression equation shows that one can be 95 percent sure the equation is multicollinear (see Appendix SRH-2), indicating that the estimated regression coefficients do not measure the importance of each explanatory variable. Therefore, using these coefficients to weight the relative importance is incorrect. Dr. Smith did not agree with Mr. Hannigan that her model is flawed because of multicollinearity:

My model does not have serious multicollinearity. The two variables that he's talking about are those in my second model, the model of two best growth rates or two most important growth rates, and the correlation coefficient between the independent variable which are six year book value and two year earnings growth rates is .28. That's not serious multicollinearity.

Serious multicollinearity exists when you have a correlation coefficient or value of R between two independent variables of at least .5 or higher. That's the point at which I would consider multicollinearity a problem, and I've seen references in some statistic books to be concerned about multicollinearity when the R value is .9 or higher (Tr. pp.254 & 255).

43. The third point raised by Mr. Hannigan is that the model used by Dr. Smith explains only 44% of the variability in dividend yields. Dr. Smith indicated that her model has unexplained variability due to the risk term. Her detailed discussion of risk is found in her Appendix B.

44. After reviewing the arguments presented by Mr. Hannigan and the rebuttal arguments offered by Dr. Smith, the Commission does not agree with the Applicant that Dr. Smith's analysis is invalid due to statistical errors. With respect to multicollinearity, the Commission does not feel that the Applicant met its burden of proof in showing that a factor of .28 is a serious problem. Beyond the absolute degree of multicollinearity, Dr. Smith explained to the Commission's satisfaction that a certain level of multicollinearity in her model is expected (Tr. p.256). The Commission finds that Dr. Smith used reasonable judgement in developing her hypothesis that historic growth rates provide a sound basis to estimate future dividend growth. Mr. Hannigan's testimony taken as a whole, while interesting, did not give the Commission sufficient reason to reject Dr. Smith's analysis.

45. Turning to Dr. Vander Weide's DCF analysis, the Commission evaluates first the alternative quarterly DCF method. Dr. Vander Weide did not use the traditional DCF model because it underestimates the cost of equity by failing to properly account for the fact that dividends are generally paid quarterly rather than annually...(Exh. 3, p.24). MCC argues that to utilize a quarterly DCF model produces a higher cost of equity than is necessary. The Commission agrees

with the MCC on this point. There is every reason to believe that investors reinvest their dividends on a timely basis. To grant a higher return on equity to reflect quarterly dividend payments, on top of the reinvestment of those dividends, would place an unfair burden on ratepayers.

46. Dr. Vander Weide reflected a 5 percent increase to the cost of equity to cover issuance expenses and market pressure. This adjustment is designed to recover all past issuance expenses incurred by the Applicant. There are two reasons why this adjustment is not acceptable to the Commission. First, the 5 percent increase is an estimate which fails to meet the requirement of being a known and measurable change. Second, any past issuance expense has no bearing on the test year before the Commission. As the Applicant is aware, there is a prohibition against adjustments which constitute retroactive ratemaking. In future rate cases, the Commission will consider expensing actual, current issuance expenses if such an adjustment is proposed.

47. The Commission, as it has in the past, finds that the appropriate method to determine the cost of equity is the DCF method. The alternative methods presented by the parties are not accepted by the Commission in this Docket.

48. Both MCC and the Applicant used a DCF model to determine the cost of equity in this proceeding. In each model there are elements which are based upon the judgement of the expert presenting the model. Two major differences stand out in comparing the DCF models in this Docket: !1) MCC used 86 companies for analysis, and, in contrast, PP&L used 26 companies; (2) Dr. Smith used historical growth rates to estimate growth while Dr. Vander Weide used analyst's forecasts. With respect to the number of companies studied, the Commission finds that the MCC approach is preferable because in evaluating a large number of companies, factors which are unique to a particular firm or firms are minimized. With respect to the second difference, the Commission does not agree with PP&L that analysts' forecasts are superior to the historical data used by Dr. Smith. Historic data is known and is readily available to investors. Projections made by analysts, by definition, are simply estimates of the future. The Commission finds the approach used by MCC preferable to that of the Company in this Docket.

49. In arriving at the cost of equity for PP&L, the Commission closely examined Dr. Smith's Table B-9. The Commission is concerned with the position Dr. Smith has taken on PP&L's risk relative to the risk of the industry as a whole. As a result of this concern, the Commission finds it necessary to make an upward adjustment to the growth estimate recommended by Dr. Smith. The Commission selects the all growth rates growth estimate on Table B-9 of 3.8 percent. When combined with a dividend yield of 10.2 percent, the approved cost of equity for PP&L is found to be 14.0 percent.

50. A return on equity of 14.0 percent places PP&L in the lower part of the industry cost of equity as calculated by Dr. Smith. The Commission finds that the return on equity found in this Docket is reasonable when the approved capital structure is considered. The increased equity ratio approved in this Docket will result in reduced financial risk to PP&L.

51. The Commission notes with interest that the Applicant requested a cost of equity of 15.75 percent in Wyoming in a case being contested at the same time as this Docket (MCC Reply Brief p.1) .

Rate Of Return

52. Based on the findings for long-term debt, preferred stock, and common equity in this proceeding, the following capital structure and costs resulting in an 11.24 percent overall rate of return are determined appropriate:

Description	Ratio	Cost	Weighted Cost
Long-Term Debt	53.5%		9.94% 5.32%
Preferred Stock	12.0	9.07	1.09
Common Equity	34.5	14.00	4.83
	100.0%		11.24%

PART C

RATE BASE, REVENUES, EXPENSES, AND REVENUE REQUIREMENT

53. Consistent with previous Commission decisions, both PP&L and MCC proposed an average rate base for the twelve months ended March 31, 1984,

adjusted to include certain known and measurable changes. One of the primary considerations of the Commission in rate base decisions has always been proper matching of test year income with the plant that produced that income. The Commission, therefore, finds an average rate base for the twelve months ended March 31, 1984, adjusted for certain known and measurable changes, to be appropriate in this proceeding.

54. Ms. Robyn A. Warsinske and Mr. Stephen E. Pearson of PP&L sponsored exhibits and testimony which detailed the cost of service and average rate base amounts which support the proposed revenue increase of $3,441,000, prior to the proposed elasticity adjustment of $463,000, as requested by the Applicant and based on an overall rate of return of 12.57%. Mr. Pearson concluded that, based on the test period ending March 31, 1984, the Company would require additional revenues of $3,904,000, including an elasticity adjustment, in order to earn an overall return of 12.57 percent.

55. Mr. David E. Peterson, a witness for MCC, presented testimony and exhibits on the cost of service and the proper rate base. Mr. Peterson urged the use of an average rate base for the twelve months ended March 31, 1984, as was also proposed by the Company, adjusted for certain known and measurable changes. He prepared a series of schedules and presented related testimony which culminates with the change in revenues required to produce the 10.83 percent rate of return recommended by MCC witness Dr. Caroline Smith. Mr. Peterson concluded that, based on the proposed average test year, the Company requires additional permanent revenues of $25,000.

56. During the course of the hearing, the Company and MCC negotiated a Stipulation which served to settle most of the issues in this Docket. This give-and-take arrangement, as
discussed in detail in subsequent Findings, eliminates the necessity of an in-depth discussion of those issues subject to the terms of the Stipulation. As stated in the Stipulation:

Pacific objects to the adjustments proposed by the Consumer Counsel, but has agreed to accept certain of the Consumer Counsel's adjustments for purposes of this proceeding. The Consumer Counsel likewise objects to aspects of the Company's application,- but as a condition of a partial settlement has agreed to accept the Company's position on certain of the contested issues. (Stipulation, p.1) Based on Dr. Smith's proposed cost of equity and overall cost of capital, the Stipulation calls for a revenue increase for PP&L in the amount of $398,000. Colstrip 3 57. In his rebuttal testimony, Steinberg a witness for PP&L, presented an updated and revised loads and resources study as of November 1984. In his direct testimony, Steinberg relied upon a loads and resources study as of March 1984. In the updated study, Pacific's peak resource capability is lower bv 176.3 MW. The November, 1984 plan is different from the March, 1984 plan in the following respects: (1) a 70 MW reduction in Colstrip peak capability in the 1985-86 operating year, due to a 9 month delay in the planned commercial operation date of Colstrip Unit 4 from July, 1985 to April, 1986; (2) a 26.1 MW increase in Company-owned hydro peak capability, due to changes in the Regional Hydro System Regulation Studies performed annually by the Pacific Northwest Power Pool under the provisions of the Pacific Northwest Coordination Agreement; (3) a 109.3 MW decrease in peak capability from Mid-Columbia Resources, due primarily to the recognition of a system operating constraint; (4) a 21.3 MW reduction in QF purchases, due primarily to a change in PP&L's planning assumptions. The March 1984 plan reflected those purchases from QF's actually under contract, plus power from agreements expected to be consummated during the planning horizon. The QF purchases contained in the revised plan reflect power only from QF's currently under contract; (5) a 60 MW increase in Pacific's allocated reserve requirement is due to the use of the most recent regulation study, which is prepared and used by the Power Pool for reserve determinations (Exh. 34, pp.2, 3, 6, 7).

58. In addition to these peak loads and resources changes, several adjustments were made to energy loads and resources in the new plan: (1) a 7 average MW reduction in Mid-Columbia energy production capability, due to the combined effects of the revised regulation studies and the increased withdrawal of power by the Eugene Water and Electric Board under the provisions of the power sales agreement; (2) a 14.3 average MW reduction in QF energy availability, due to the change in planning assumptions regarding QF power "previously discussed); (3) a

27.0 average MW reduction in Colstrip energy production capability due to the Colstrip Unit 4 construction delay (previously discussed); (4) a 31.5 average MW net reduction in the energy capability of the Company's other coal-fired generating plants, due to the combined effects of revised thermal power plant availability data and revised planned maintenance schedules; (5) a 6 average MW increase in energy deliveries to Pacific Gas and Electric (PG&E) pursuant to the terms of a power sales agreement that was signed in July, 1984 (Exh. 34, p.8 & 9).

59. Steinberg discussed why Pacific should be allowed to recover the costs of Colstrip Unit 3:

1. The Company's decision to participate in the Colstrip Project was made in an effort to furnish adequate service to anyone in its service area requesting such service, as required by 69-3-201, MCA.

2. The Company's participation in the Colstrip Project was a prudent management decision.

3. The Montana Board of Natural Resources and Conservation, in an order dated July 22, 1976, found the Colstrip 3 and 4 project to be needed and the best resource available for the applicants, including Pacific, to provide reliable electric service to their customers.

4. Colstrip Unit 3 is a used and useful resource which has been providing benefits to the Company's Montana customers since it began commercial operation on January 10, 1984.

5. Pacific's system does not have what is referred to as "excess capacity". (Exh. 34, p.10 & 11)

60. Towers, an expert witness for MCC, evaluated the loads and resources studies presented by PP&L. Towers evaluated the 1985-1986 operating year and

found that PP&L had a peak surplus of 67 MW. Based upon his finding of excess generating capacity, Towers recommended that Colstrip No. 3 be excluded from rate base and that Pacific be allowed to retain any benefits derived from the Black Hills sale (MCC Exh. 2, p.7).

61. During the hearing, Towers was asked by staff about the new loads and resources study presented by the Company. Towers indicated that he had not verified each and every one of the changes. He agreed with using a seasonal peak rather than the old method of using a one month peak. Towers questioned whether the downrating of the Mid-Columbia Resources is proper in light of existing reserve requirements (Tr. p.498 to 500).

62. Also during the hearing, the staff requested that PP&L provided an analysis of the net present value to the ratepayer were Colstrip 3 to be included in the rate base, with the benefits of the Black Hills power sales contract flowing to the ratepayer. (Tr. p.504, 505)

On February 19, 1985, PP&L responded to the request with a late filed exhibit. The analysis showed a present value benefit of $29.2 million with an overall cost of capital of 10.83 percent (the MCC capital structure). Using an overall cost of capital of 11.04 percent (the PP&L target capital structure) produced a net present value benefit of $21.9 million. PP&L also prepared a sensitivity analysis which showed that variation in escalation rates did not affect the net present value benefit. MCC did not respond to the net present value benefit analysis.

Commission Analysis

63. In Docket 83.10.71, the Commission refused to allow Colstrip 3 into PP&L's rate base based on a finding that the Company had a large amount of excess capacity. The record in ;

this Docket indicates that on a peak basis Pacific will be deficit by 19 MW in the 1986-87 operating year. On an energy basis, the Company has a surplus of 361 MW in the 1985-86 operating year. In the 1989-90 operating year the Company projects loads and resources to be in balance on an energy basis.

64. The Commission rejects the argument raised by PP&L that the investment in

Colstrip 3 should be recovered because PP&L's decision to invest in the plant was prudent. The question before the Commission is whether Colstrip 3 is actually used and useful (Findings of Fact 63 to 66 Order No. 5028c).

65. Again in this Docket, PP&L argues that the question of need was resolved by the Board of Natural Resources in an order dated July 22, 1976. On December 12, 1984 the Montana Supreme Court issued an opinion which stated in part:

The record now before us does not demonstrate that the determination by the BNRC under the Siting Act is the same as the determination required of the PSC under Section 69-3-109, MCA (No. 84-290).

Under this decision, PP&L's position is without merit.

66. With respect to the revisions to loads and resources presented by the Company, the Commission accepts the changes with the exception of the reduction of the Mid-Columbia resources. In the next rate case, PP&L is directed to file detailed testimony and exhibits which support this modification.

67. While the Applicant still has surplus energy, the Commission notes with approval the Company's continuing efforts to market power to reduce the surplus. In addition to the Black Hills power sale, PP&L has signed a firm contract with Exxon for 128 average MW in the 1987-88 operating year (Exh. 33, Table 2). In addition, instead of supplying partial requirements as reflected in the March 1984 Plan, Pacific is now committed to supplying 100 percent of Cheyenne Light, Fuel and Power Company's requirements (Exh. 32, p.2).

68. In previous cases involving rate base treatment for new generating plants, the Commission has strictly applied the "actually used and useful" standard contained in Montana law. In these cases, for PP&L as well as other utilities, if a new plant creates excess capacity it has not been allowed rate base treatment.

69. Although this approach is entirely proper, the Commission finds that evidence in this case requires a different kind of analysis, one that has been adopted by several other regulatory commissions. PP&L's net present value analysis of the Black Hills contract clearly demonstrates that ratepayers will be better off if Colstrip 3 is ratebased and the benefits of the Black Hills contract are enjoyed by them when compared to an exclusion of rate base treatment. In its previous analyses, the PSC has focused on the issue of whether ratepayers should be burdened with excess capacity via rate base treatment of large new generating plants. Such a burden has not been allowed. In this case however, the evidence shows that, because of the Black Hills contract, allowing rate base treatment will result in a substantial net benefit, rather than a burden, to rate payers. Because of this result, it would be illogical to conclude that Colstrip 3 is not "actually used and useful. n The Commission finds that when a utility can show a substantial net benefit to the ratepayer as a result of rate base treatment for a generating plant, it will be considered actually used and useful for the convenience of the public. Where, as here, there is acknowledged excess capacity, that fact will be carefully weighed in deciding whether rate base treatment should be afforded. In such situations utilities must show, as PP&L has in this case, a clear and substantial economic benefit to ratepayers before rate base treatment is granted.

70. Towers indicated that if Colstrip 3 were included in rate base in this Docket, several adjustments to the amounts claimed by PP&L should be made.
He recommended that common plant costs be reduced by 22 percent to reflect the level of common plant which would have been built for one plant. In the area of transmission, Towers recommended that if both 500 KV lines were not needed, one of the lines should be accorded deferred ratemaking treatment (MCC Exh. 2, p.l9).
With respect to common plant costs, the Commission does not find any support on the record for including 100 percent of these costs. The study performed by the Montana Power Company indicates that 78 percent of common costs would be required for a single plant. Therefore, the Commission accepts Towers' recommendation.

71. With respect to Towers recommendation to accord one of the 500 KV

transmission lines deferred ratemaking treatment, Steinberg presented this rebuttal:

Presuming that Colstrip 1-3 would even be operated at full load with only one 500 KV transmission line available, the system would not be stable for the following reasons. If Units 1-3 were operating at full load and the only available 500 KV line incurred a forced outage, the Colstrip plant would be connected to the system by a single 230 KV transmission line. As a result, Unit 3 and one or both of the other two units would have to be immediately shutdown or dropped in order to prevent destruction of the 230 KV line due to its limited power transfer capability. If all three units were dropped, load would have to be curtailed in the Montana service territory at a minimum. Even if only two Colstrip units had to be dropped, system instabilities and load shedding could result in the system depending on the then existing operating conditions (Exh. 34, pp.15,16).

The Commission accepts Steinberg's testimony and, therefore, finds that both 500 KV transmission lines should be included in rate base.

72. In this and future rate cases, PP&L will be required to flow through all revenues from the Black Hills contract on an actual basis. All surplus energy will be reflected as off-system sales using the firm sales normalization adjustment which has been approved in the past.

Sale of Malin-Midpoint Transmission Line Tax Deductions

73. The Economic Recovery Tax Act of 1981 allowed an owner of equipment in

use to transfer the resulting investment tax credits (ITC) to a qualified taxpayer in exchange for a cash payment. The Company entered into such an arrangement, a "safe harbor lease", with Standard Oil Company of Indiana in December of 1981. When PP&L received authorization for this transaction, the Commission clearly indicated that the proceeds from this sale would be subject to a ratemaking determination.

74. In Docket Nos. 81.8.70, 82.4.28, and 83.5.36, MCC witness, Mr. George Hess, proposed that the proceeds PP&L received from the sale of these Federal tax deductions, pursuant to a safe harbor lease transaction, should be amortized above the net operating revenue line and that the unamortized balance should be deducted from rate base. The Hess exhibits in those Dockets reflected his recommendation that the investment tax credits-related proceeds should be amortized over a period of five years, and the remainder of the proceeds should be amortized over a 30 year period in reverse order of the tax deductions associated with lease payments less interest income.

75. The Commission Orders associated with all the above Dockets reflected the acceptance of the proposed Hess method of giving proper ratemaking treatment for the safe harbor transaction.

76. In those previous Dockets, the Company contended that the Hess method for the amortization of the safe harbor proceeds could jeopardize the Company's tax benefits resulting from its safe harbor lease transaction because of the supposed likelihood of the Treasury Department disallowing the Hess proposal as proper treatment. The Commission addressed these concerns in the relevant Orders by explaining that the Commission does not want to jeopardize PP&L's tax benefits from its safe harbor lease transaction. However, the Commission found that no Treasury regulations had yet been promulgated, and it was not clear that, when and if any such regulations were adopted, they would address the ratemaking treatment of a utility's "proceeds", rather than "public utility propertyn, from a safe harbor transaction.

77. To emphasize the Commission's stance that PP&L's tax benefits should not be

jeopardized, the Commission, in Order No. 5009a of Docket No. 83.5.36, stated:

If the Treasury Department promulgates rules contrary to the Commission's position, i.e. the Commission's acceptance of the Hess proposal, or if PP&L is able to get a Treasury ruling that the Commission's position is improper, the Commission will review the matter.
(Order No. 5009a, p.23, Finding No. 53)

In Docket No. 83.5.36, the Commission, therefore, continued to find, as it had in the previous two Dockets, that PP&L's tax benefit sale should be treated for ratemaking purposes in the manner proposed by MCC witness Hess, with the corresponding various adjustments. (Order No. 5009a, p.23, Finding No. 54)

78. In the current proceeding, Docket No. 84.7.38, on page 10, lines 1 through 5 of her original testimony, PP&L witness Warsinske stated, "Additionally, the Company has treated the unamortized portion of the investment tax credit related tax benefits associated with the sale of the Malin-Midpoint transmission line as a rate base reduction which is consistent with Commission Order, Docket No. 83.5.36. n (PP&L Exh. 11, p.10)

79. During cross-examination, Ms. Warsinske struck the above statement from the record in recognition of the fact that the Company did not comply with the approved treatment in Order No. 5009a of Docket No. 83.5.36. This retraction became necessary as a result of PP&L's response to the MPSC Data Request dated December 21, 1984 (entered into the record by the PSC staff, TR, pp.587-588). In PP&L's response to that data request, Mr. Watson stated:

Ms. Warsinske's testimony is in error on that point. Mr. Pearson has treated the exchange consistent with prior Company filings. . . . Further, the Company apologizes for any confusion which may have resulted with respect to this issue.
(PP&L Response to PSC Data Request dated December 21, 1984)

80. In actuality, as discussed above, the Company filed its case proposing the same treatment as put forth in previous general rate application filings. Watson

explained, "The Company has proposed to provide the tax benefit to Montana customers as though the exchange had not occurred." (PP&L Response to PSC Data Request dated December 21, 1984) 81. In support of its proposal, PP&L sponsored no testimony showing why its approach should be adopted. PP&L also did not testify that the approach approved in Order No. 5009a of Docket No. 83.5.36, as proposed by MCC witness Hess, was incorrect or inappropriate in this proceeding. PP&L merely presented its own approach under the guise of mitigating this rate case by claiming to be in full compliance with the previously approved method. When the "error" was discovered, no justification for the Company's actual approach, as being somehow superior to the method in which the Company's previous claim of compliance had been testified, was presented. In summary, PP&L presented no evidence to indicate why the previously approved method should be abandoned by the Commission in this proceeding.

82. The only attempt at defense of the Company's real proposal was to read into the record MCC's response to the same PSC Data Request dated December 21, 1984. The MCC response, however, while indicating MCC witness Towers' personal opinion on the matter based on his testimony on this issue in PP&L's Wyoming jurisdiction, clearly showed that the IRS has not ruled contrary to the approved method in Order No. 5009a of Docket No. 83.5.36. In response to the aforementioned PSC Data request, MCC replied, "To the best of his [Towers'] knowledge, there is no additional evidence to present to the Commission in this case inasmuch as the Treasury Department has neither promulgated the specific rules required by TEFRA [Tax Equity and Fiscal Responsibility Act of 1982] nor ruled on any request by PP&L or any other utility for a private letter ruling on this subject." (MCC Response to PSC Data Request dated December 21, 1984)

83. Concerning MCC's response to that PSC Data Request, under cross-examination by staff counsel Ms. Winebrenner, Mr. Towers responded:

Q Has there been any change since December 21 regarding that statement? Would that still be correct today?

A. It would be, to the best of my knowledge.

Q. So considering the opinions of the parties in this docket, including yours and

PP&L's, it would be correct that there has been no specific IRS Rulings or any decisions that have been promulgated that would specifically indicate that the Commission's treatment of the Malin mid point [sic] tax benefits in the last docket, the last general rate case docket, is improper; would that be true?

A. That's correct. (TR, Vol. 2, pp.506-507)

84. Indeed, PP&L concurred with the above MCC statement when Mr. Pearson was cross-examined by Ms. Winebrenner:

Q. Mr. Pearson, again, concerning the Malin Mid Point [sic] Tax Benefits, the sale of those tax benefits and how those have been treated by the Commission, has there been, to your knowledge, any specific IRS Rulings or any other decisions concerning how those tax benefits should be treated that have occurred between the period of the last general rate case for PP&L in Montana and today?

No, there have not. I believe Mr. Watson confirmed that earlier this week. (TR, Vol. 2, P.528)

85. Based on the record in this proceeding, the Commission finds no compelling reason to deviate from the MCC proposed method approved in Order No. 5009a of Docket No. 83.5.36. This method was also approved in the two previous PP&L general Dockets, 82.4.28 and 81.8.70. The Company has failed to present any evidence which would indicate that a change in treatment would be proper. MCC and PP&L both have said that no IRS ruling has been promulgated which would require a change in treatment. The Commission, therefore, finds the treatment of the proceeds from the sale of the Malin-Midpoint tax benefits, as approved in Order No. 5009a of Docket No. 83.5.36, to be proper in this proceeding, resulting in a net income increase in the amount of $103,000 and a rate base increase in the amount of $31,000. The net result is a revenue requirement decrease of $199,000, using the approved overall rate of return of 11.24 percent. The source of these numbers is the workpapers included in PP&L's response to the PSC Data Request dated December 21, 1984. PP&L reiterated these adjustments during the

hearing (TR, Vol. 2, p.528) and MCC verified the accuracy of the Company's calculations in its response to the PSC Data Request dated December 21, 1984.

86. As the Commission stated in Order No. 5009a of Docket No. 83.5.36, should the Treasury Department promulgate rules contrary to the Commission's position, or should PP&L receive a Treasury ruling that the Commission's position is improper, the Commission will review the matter.

Debt/Equity Exchange

87. As discussed in the Capital Structure portion of this Order, MCC witness Dr. Smith recommended to adjust all of the affected capital balances to reverse the exchange of first mortgage and pollution control bonds for shares of new preferred stock done during 1982. The Commission accepted Smith's proposal.

88. To be consistent with Dr. Smith's recommendation, MCC witness Peterson proposed to eliminate the Company's proposed $99,000 amortization of the net gain on the debt/equity exchange (MCC Exh. 4, p.4).

89. As discussed in the Capital Structure portion of this Order, the Commission finds the related Sections of Order No. 4975 in Docket No. 82.7.53 to be the overriding factor in this issue. Therefore, the Commission finds MCC's proposal to reverse the effects of the 1982 debt/equity exchange to be proper in this proceeding, resulting in an increase to income taxes deferred in prior years in the amount of $99,000.

Stipulation

90. During the course of the hearing in this proceeding, PP&L and MCC negotiated a Stipulation Agreement (Stipulation) which served to effectively settle many of the issues in this case. While agreeing to accept certain aspects of MCC's and PP&L's proposals for purposes of this proceeding only, both parties maintain objections to various portions of the other's testimony and exhibits. As a result of negotiations, however, PP&L and MCC jointly have proposed a Stipulation, subject to the approval of the Commission.

91. Coal Costs. MCC witnesses Peterson and Towers worked together in recommending that PP&L's requested coal expense be reduced by $178,000 to reflect what MCC regards as excessive costs for coal burned at Pacific's Dave Johnston and Jim Bridger steam plants (MCC Exh. 4, Schedule 3, p.2 of 6; Stipulation, pp.1-2). PP&L and MCC agreed in the Stipulation that the MCC adjustment should be reduced to incorporate the actual 1984 reclamation accrual rate for the Bridger plant's coal supply (Stipulation, p.2).

92. Errors in Tax Computation. During the course of proceedings, the Company found that it had incorrectly calculated its test period income tax allowance, and that its tax allowance
was understated. PP&L overstated its tax depreciation by $117,000 and its depletion allowance by $24,000. In the Stipulation, MCC agreed not to resist these corrections to Pacific's test period income tax allowance (Stipulation, p.2).

93. Elasticity. PP&L proposed that the Commission approve an elasticity adjustment of $463,000 to reflect the effects of price elasticity of demand on Pacific's sales (PP&L Exh. 7). The MCC contends that such an adjustment is inappropriate, in part, because the Company's quantification of the effects of price elasticity of demand did not reflect a known and measurable change (MCC Exh. 3). Pacific agrees, for purposes of this proceeding, to withdraw its request for an elasticity adjustment (Stipulation, p.2).

94. Miscellaneous Adjustments. MCC proposed various adjustments related to the following issues: plant held for future use, labor expenses, booking adjustments, deferred state income taxes, institutional advertising expenses, and pre-1981 investment tax credits (MCC Exhs. 3 and 4). In the Stipulation, the Company accepts the foregoing miscellaneous MCC adjustments (Stipulation, p.3).

95 Cash Working Capital MCC witness Peterson recommended
that the Commission reduce PP&L's rate base by removing compensating bank balances and service fees, working funds, and employee accounts receivable from PP&L's cash working capital
allowance (MCC Exh. 33. The Company contends that its proposed cash working capital allowance constitutes the net cash requirements for the operation of the

utility contributed by PP&L's investors (PP&L Exh. 36). The MCC accepts, for purposes of this proceeding, PP&L's proposed cash working capital allowance (Stipulation, p.3).

96. Washington Generating Tax. MCC witness Peterson proposed that the Washington Generating Tax paid by PP&L be allocated to customers in all of the states served by the Company (MCC Exh. 3). PP&L contends that taxes on electricity sold within the State of Washington are already allocated directly to the State of Washington, and that the generating tax, which is based on energy exported from the State of Washington, should be allocated to PP&L's customers in states other than Washington (PP&L Exh. 36). The MCC accepts, for purposes of this proceeding, PP&L's proposed allocation of the Washington Generating Tax (Stipulation, pp.3-4).

97. Unbilled Revenues. In 1983, PP&L revised its accounting treatment of amoun~s billed, but not received, during the preceding year. Prior to 1983, the Company recognized revenues at the time customers were billed; in 1983 PP&L began accruing estimated unbilled revenues. The MCC proposed an adjustment to reflect the cumulative effect of the Company's accounting change. The MCC contends that its proposed adjustment is necessary because PP&L had understated revenues in prior years (MCC Exh. 3).

98. The Company contends that the MCC's proposed adjustment would result in a mismatch of revenues and expenses, that rates have been just and reasonable in the past, and that PP&L received no cash benefit from its change in accounting practice (PP&L Exh. 36). The MCC accepts, for purposes of this proceeding, PP&L's proposed treatment of unbilled revenues (Stipulation, p.4).

99. AFUDC Accrual Rates. MCC witness Towers proposed that the rate at which PP&L accrues AFUDC be lowered, and that the Company's AFUDC accrual for 1983 be recalculated to reflect the lower rate (MCC Exh. 2). The MCC proposal would not affect PP&L's revenue requirement. The Company contends that it has applied correctly the methodology prescribed by the Federal Energy Regulatory Commission for calculating AFUDC, and that the MCC's proposal would be administratively burdensome (PP&L Exh. 36). The MCC accepts, for purposes of this proceeding, the Company's proposed AFUDC accrual rate (Stipulation, pp.4-

5).

100. The Company and the MCC agree in the Stipulation that issues related to PP&L's capital structure, cost of capital, and to PP&L's required generating capacity remain contested. Upon resolution of these issues, it may be necessary to adjust the revenue requirement as contained in this Stipulation. Specifically, the interest expense calculation, the inclusion of Colstrip Unit 3 plant and expenses, and the rate of return on rate base will have to be revised should the final order differ from the MCC's proposed capital structure, cost of capital and generating capacity assumptions. (Stipulation, pp.5-6)

101. The Company and the MCC agree that acquiescence to the proposals of the other part~r by this Stipulation shall not be deemed an acceptance of the underlying rationale for any particular proposal. PP&L and MCC further agree that they may, in any future proceeding, raise issues resolved for purposes of the instant proceeding by this Stipulation. (Stipulation, p.6)

102. The Company and the MCC understand and agree that the Commission's acceptance of this Stipulation shall not constitute precedent and may not be relied upon as precedent for any particular ratemaking treatment of the issues resolved by this Stipulation (Stipulation, p.6).

103. The agreement of PP&L and the MCC to this Stipulation is subject to the Commission's acceptance of the Stipulation in its entirety. This Stipulation is not severable. (Stipulation, p.6)

104. The Commission believes that the give-and-take process in the development of this Stipulation has resulted overall in a positive agreement, beneficial to both the Company and its Montana customers. The Commission, therefore, accepts the proposed Stipulation as being proper in this proceeding.

Pro Forma Interest

105. MCC witness Peterson calculated pro forma interest expense in an effort to include interest on construction. Peterson reflected "the effect of synchronizing (a)

test year interest expense for determining the income tax allowance with (b) the interest component in MCC witness Dr. Smith's recommended rate of return." (MCC Exh. 3, p.24)

106. The Commission finds that a pro forma interest adjustment is proper to reflect the tax effect of interest on construction. By utilizing the approved rate base and weighted cost of long-term debt in the methodology, the Commission finds an increase to Montana Corporation License Tax in the amount of $4,000 and an increase to Federal Income Tax in the amount of $25, 0Q0 to be proper in this proceeding. Rate Base

107. PP&L proposed an average rate base of $68,701,000. Based on the cumulative effect of the several approved adjustments to rate base in this proceeding, the Commission finds $68,367,000 to be the proper level of average rate base for the year ended March 31, 1984, adjusted for known and measurable changes.

Revenue Requirement

108. The following table, based on the terms of the Stipulation and the Commission decisions concerning all other issues in this proceeding, shows that additional annual revenues in the amount of $1,478,000 are needed by the Applicant in order to provide the opportunity to earn an overall return of 11.24 percent:

PACIFIC POWER & LIGHT COMPANY
Revenue Requirement to Produce
11.24% Rate of Return
Test Year - March 31, 1984
(000)

	PP&L Pro Forma	Approved PP&L Ad-justments	Approved MCC Ad-justments	Approved PSC Ad-justments	Approved Pro Forma	Increase Required to Produce 11.24% Return	Final Total
Operating Revenues	$29,084				$29,084	$1,478	$30,562
Operating Revenue Deductions							
Operating Expenses	$16,276		($208)		16,068	$5	$16,073
Depreciation & Amortization	2,581		0	($7)	2,574		2,574
Taxes Other Than Income	1,178		0	(3)	1,175	1	1,176
State Income Taxes	251		14	6	271	99	370
Federal Income Tax @ 46%	1,595	$65	91	39	1,790	632	2,422
Investment Tax Credit @ 85%	(1,247)	(55)	(77)	(2)	(1,381)	(537)	(1,918)
Net Federal Income Tax	348	10	14	37	409	95	504
Deferred Income Taxes	470		(27)	(6)	437		437
Income Taxes Deferred in Prior Years	(170)		99		(71)		(71)
Deferred Investment Tax Credit	1, 239		77	2	1,318	537	1,855
Restored Investment Tax Credit	0	55	8	0	63		63
Net ITC Adjustment	1, 239	55	85	2	1,381	537	1,918
Amortization of Proceeds from Sale	0		0	(103)	(103)		(103)
Total Operating Revenue Deductions	$22,173	$65	($23)	($74)	$22,141	$737	$22,878
Net Operating Income	$6,911	(565)	$23	$74	$6,943	$741	$7,684
Average Rate Base	$68,701	($28)	($112)	($194)	$68,367		$68,367
Rate of Return	10.06%				10.16%		11.24%

PART D
COST OF SERVICE, PRICES AND LINE EXTENSION POLICY

109. Long Run Incremental Cost Study. PP&L proposes a LRIC calculation for structuring revised prices (Direct testimony of Mr. Gregory N. Duvall, Exh. 16 & 17). The LRIC model is largely unchanged from those filed in recent cases. The calculation, however, is significantly different from recent years as a result of, primarily, revisions to the PP&L generation and transmission expansion plans.

110. Table 1 provides a summary of the LRIC. The MCC did not file testimony on the LRIC calculations. The MPSC accepts the PP&L proposal, but would note the following concerns.

111. The first concern is the use of the BPA 7f (new resource pool) rate for marginal generation supply costs. The regulatory objective is to simulate a competitive market outcome. It is not clear whether the 7f rate is an adequate market price signal reflecting social opportunity costs, or an artificial (average embedded cost) price resulting from market failure and imperfect economic regulation (e.g. See Tr. p. 561-562 and Data Response No. PSC 66).

112. Even if the 7f rate is the result of imperfect regulation and not an accurate indicator of marginal social opportunity costs, it is not clear that using it to structure PP&L's prices is entirely incorrect. The MPSC is applying a competitive market outcome to PP&L, not BPA. To the extent BPA's ; prices fail to reflect marginal social opportunity cost, it is an
economic problem in which the MPSC's role would be that of an intervenor.

113. It is also worth noting that the use of supply purchase

prices to represent a utility's marginal supply cost is not unique. For several years the Montana Power Company's marginal gas supply cost has been equated with the Canadian Border Price. The Canadian Border Price is a national average with no known correlation with gas production costs. To the extent the 7f rate does not reflect marginal cost, market pressure will tend to force the rate in the right direction -- just as declining U.S. imports are forcing the Canadians to restructure a de-averaged marginal cost-based natural gas border price.

114. The second and third concerns are somewhat related. PP&L's generation LRIC ignores the time period between the present and the date of supply expansion. The LRIC calculation is indifferent to whether the system is supply deficient in the year 1985 or surplus until 2025. The resulting prices appear to fail to indicate the relative scarcity (i.e. value) of electricity resources over time. Whether the system is awash in a surplus or faced with prospective shortages, the LRIC would result in the same prices (e.g. See Tr. p. 555-556).

115. PP&L maintains that the de-escalated expansion cost is an appropriate price signal (TR. p. 557-558 and Data Pesponse No. PSC-68). However, this appears counter to economic logic. When the consumer makes a long-run capital investment - whether it is a $3,000 natural gas furnace/duct or a multimillion dollar industrial process -- he should be exposed to the present value of the stream of future opportunity costs.[1]

116. A related concern is possibly off-setting. In ignoring the period between the present and the date of supply expansion, the LRIC ignores the interim flow of opportunity costs. For example, the discounted (or de-escalated) cost of

distantly future expansion may be substantially less than the willingness of a different electric utility to pay for generation.

117. A final concern relates to the transmission LRIC. In this Docket, PP&L maintains that the LRIC of transmission is exclusively demand-related. This position follows from the resource plan: PP&L plans only 7f purchases which would not require energy-related transmission expansion. However, the resale market in the Western U.S. appears to indicate that transmission capacity for energy sales is a relatively scarce resource. It is not clear why PP&L's energy prices should not reflect that scarcity.

118. PP&L's LRIC is used here as the best evidence of record. The MPSC expects that the concerns stated above will be addressed in future cases.

119. Revised Prices. PP&L proposes to use its LRIC to structure revised prices which generate authorized revenues

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[1] Note that given a constant stream of value over 40 years and a 6% discount rate, nearly 50% of the present value of the stream is in the first 10 years. :

(Direct Testimony of Lorie J. Harris, Exh. Nos. 19, 21, 22R). Given the authorized revenues, PP&L proposes to modify the revenue level per price schedule by a uniform percentage of the difference between the existing revenue level and the LRIC. This represents a slight change from recent dockets where each price schedule revenue level was set at an equal percent of LRIC.

120. The MCC did not file a position on the PP&L proposal. The MPSC finds the proposal acceptable. It presents a more moderate approach to revising prices and given the frequency of PP&L filings, it should provide an adequate mechanism for following a moving target -- the LRIC.

121. PP&L proposes two other significant changes to the structure of prices. The LRIC suggests a shift in the relative value of demand versus energy. In response, PP&L proposes to increase demand prices by twice the percent that energy prices are increased. The second change features a reduction in the inverted differential found in the Schedule 7 (residential) energy price. PP&L proposes to reduce the differential by one-half, based on the relationship between the tail block price and unit energy and demand LRIC.

122. The MCC did not testify on the price changes. The MPSC finds the proposed changes moderate and acceptable. The Schedule 7 tail block price, however, is not to be lowered below the sum of the secondary level demand and energy unit LRIC.

123. Line Extension Policy. PP&L proposes six changes to its line extension policy (Direct testimony of Mr. J.M. Brookhouse, Exhs. 23, 24 and 25). The proposed changes are:

1) change the extension allowance to an amount equal to the cost of the required transformer, meter and service plus 300 feet of primary line for all customer classes,

2) change the method of calculating refunds for line extensions,

3) specify the conditions under which the company will

provide facilities in new developments in advance of permanent customers,

4) specify the conditions under which the company will allow an applicant for service to contract construction of his own overhead line,

5) eliminate payments for the difference in cost between overhead and underground facilities, and

6) revise the limitations on residential heating loads.

124. PP&L maintains that the changes will:

1) assist in having a policy that customers will easily understand,

2) simplify the number and the complexity of line extension calculations,

3) reduce as much as practical the administrative burden, and

4) adopt a policy that neither penalizes nor rewards customers for their electric end use decisions.

125. The MCC did not file testimony on the proposed line extension policy changes. The proposed changes have been accepted by the Wyoming, Washington, and Idaho Commissions (TR. p. 580).

126. The MPSC finds the proposed changes in line extension policy acceptable.

TABLE 1

SUMMARY OF LRIC*

	Generation	Transmission	Distribution & Billing
Demand ($/KW)			
Sch 7	45.88	20.59	30.34
Sch 22 0-15 KW	45.88	20.59	84.22
16-100 KW	45.88	20.59	45.72
100-1000 KW	45.88	20.59	26.11
Sch 48T	45.88	20.59	11.78
Energy (¢/KWH)			
Sch 7	2.274	–	_
Sch 22 0-15 KW	2.274	_	_
16-100 KW	2.274	_	_
100-1000 KW	2.274	_	_
Sch 48T	2.274	_	_
Customer ($/Meter)			
Sch 7	_	_	188.36
Sch 22 0-15 KW	_	_	213.65
16-100 KW	-	-	442.73
100-1000 KW	-	-	1265.43
Sch 48T	-	-	1928.73

*1984 dollars, Schedules 7, 22, and 48 are residential, general service, and industrial, respectively. Source: Exh. 17, Table 17-8.

PART E

MOTION TO STRIKE

127. During the hearing, the Montana Consumer Counsel moved to strike portions of PP&L witness Dr. James H. Vander Weide's rebuttal testimony, specifically page 24 lines 14 through 25, and page 25, lines 1 through 22. The testimony objected to concerns Dr. Vander Weide's reference to a written statement made and filed by Dr. Ibbotson in an unrelated Federal Communications Commission telephone utility hearing. MCC contends the testimony is hearsay that does not come under any of the hearsay exceptions in the Montana Rules of Evidence; the Commission agrees.

The Commission conducts its rate hearing under the contested case provisions of the Montana Administrative Procedure Act. The Act provides in Section 2-4-612(2), MCA, that unless otherwise provided by statute, the common law and statutory rules of evidence apply in contested case proceedings. The Commission has also adopted in its Administrative Rule 38.2.4201, the Montana Rules of Evidence.

The Commission finds, therefore, that MCC's motion to strike is well-founded, and should be granted.

CONCLUSIONS OF LAW

1. The Applicant, Pacific Power and Light Company, furnishes electric service to consumers in Montana, and is a "public utility" under the regulatory jurisdiction of the Montana Public Service Commission. 69-3-101, MCA.

2. The Commission properly exercises jurisdiction over the Applicant's rates and operations. 69-3-102, MCA and Title 69, Chapter 3, Part 3, MCA.

3. The Commission has provided adequate public notice of all proceedings and opportunity to-be heard to all interested parties in this Docket. Title 2, Chapter 4, MCA.

4. The rate level and rate structure approved herein are just, reasonable, and not unjustly discriminatory. 69-3-330, MCA.

ORDER

1. The Pacific Power and Light Company shall file rate schedules which reflect increased annual revenues of $1,478,000.

2. The increased rates authorized herein shall be effective for service rendered on and after April 22, 1985.

3. Rate schedules filed shall comport with all Commission determinations set forth in this Order.

4. The Applicant's tariff submittal shall reflect the current BPA Exchange Credit for qualifying schedules.

5. All motions and objections not ruled upon are denied.

DONE AND DATED this 22nd day of April, 1985 by a vote of 3-1.

CLYDE JARVIS, Chairman

HOWARD L. ELLIS, Vice Chairman

JOHN B. DRISCOLL, Commissioner

TOM MONAHAN, Commissioner
Voting To Dissent - Dissenting
(Opinion attached)

ATTEST:

Trenna Scoffield
Commission 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.

DISSENTING OPINION
by
TOM MONAHAN
Public Service Commissioner
in

Pacific Power and Light Company
Docket No. 84.7.38
Order No. 5128
April 22, 1985

DISSENT

Docket No. 84.7.38
Order No. 5128

In the 1984 Pacific Power and Light rate case, the PSC ruled that because the company had an excess generating capacity, its share of Colstrip #3 was not "used and useful" and its inclusion in PP&L's rate base would be denied. This was the identical argument the PSC used in denying Montana Power's inclusion of its share of Colstrip 3 in its rate base.

In the 1985 PP&L rate case, the PSC has reversed its previous stand that Colstrip 3 could not be included in rate base on the basis that because PP&L has made a sale of Colstrip power to Black Hills Power & Light Company, consisting of 15 MW, commencing on January 1, 1984 and increasing in 15 MW increments to a total of 75 MW by 1988, Colstrip 3 may now be included in PP&L's rate base.

Inclusion of Colstrip 3 in PP&L's rate base will allow the profits from the Black Hills sale to accrue to the benefit of Montana ratepayers rather than exclusively to PP&L shareholders. This is the rationale for this decision and certainly it is a plus factor. However, because the contract is levelized, the benefits will not be positive for at least six years and will not be tangible for ten, fifteen or more years.

In spite of the tentative benefits possible in this decision, the heart of the PSC decision to exclude Colstrip 3 was the fact that PP&L was in a surplus power position and did not need Colstrip 3 or 4. At the present time, PP&L has an excess of 361 megawatts on an energy basis. They still do not need Colstrip 3 or 4 and the Black Hills contract could have been fulfilled from other PP&L power sources.

Because Montana PP&L ratepayers will be immediately saddled with the costs of Colstrip 3, because any benefits will not accrue to Montana PP&L ratepayers for a number of years, because Montana law says a property must be used and useful before it can be included in a utility's rate base, because PP&L has an energy surplus of 361 MW and a surplus of 67 peak MW over reasonable reserves, I dissent from the decision made on this date by the Montana PSC to include Colstrip 3 in Pacific Power and Light's rate base.

TOM MONAHAN
Commissioner