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BEFORE THE ARIZONA CORPORATION COMMISSION

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8 IN THE MATTER OF THE APPLICATION OF  
 9 ARIZONA WATER COMPANY, AN ARIZONA  
 10 CORPORATION, FOR A DETERMINATION  
 11 OF THE FAIR VALUE OF ITS UTILITY  
 12 PLANT AND PROPERTY, AND FOR  
 13 ADJUSTMENTS TO ITS RATES AND  
 14 CHARGES FOR UTILITY SERVICE AND  
 15 FOR CERTAIN RELATED APPROVALS  
 16 BASED THEREON.

Docket No. W-01445A-08-0440

Arizona Corporation Commission  
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**APPENDIX IN SUPPORT OF  
RUCO'S REPLY BRIEF**

The Residential Utility Consumer Office ("RUCO") hereby submits this Appendix in support of its Reply Brief which was filed October 30, 2009, in the above-referenced matter.

**RESPECTFULLY SUBMITTED** this 2nd day of November 2009

Michelle L. Wood  
Counsel

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2 the foregoing were filed this 2nd day  
of November, 2009 with:

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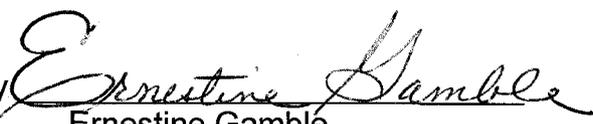
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By   
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# APPENDIX

Westlaw.

35-A M.R.S.A. § 303

Page 1

**C**

Maine Revised Statutes Annotated Currentness

Title 35-A. Public Utilities (Refs &amp; Annos)

▣ Part 1. Public Utilities Commission (Refs &amp; Annos)

▣ Chapter 3. Rates of Public Utilities

→ **§ 303. Valuation of property for fixing rates**

In determining just and reasonable rates, tolls and charges, the commission shall fix a reasonable value upon all the property of a public utility and upon an electric plant to the extent paid for by the utility on the premises of any of its customers, which is used or required to be used in its service to the public within the State and a fair return on that property. In fixing a reasonable value, the commission shall give due consideration to evidence of the cost of the property when first devoted to public use and the prudent acquisition cost to the utility, less depreciation on each, and any other material and relevant factors or evidence, but the other factors shall not include current value. In making a valuation, the commission may consult reports, records or other information available to it in the office of any state office or board.

## CREDIT(S)

1987, c. 141, § A, 6, eff. July 1, 1987; 1987, c. 613, § 2.

## HISTORICAL AND STATUTORY NOTES

1988 Main Volume

## Derivation:

R.S.1954, c. 44, § 18.

Laws 1957, c. 400, § 2.

Former 35 M.R.S.A. § 52.

## 2009 Electronic Pocket Part Update

## 1987 Legislation

Laws 1987, c. 613, in the first sentence, inserted “and upon an electric plant to the extent paid for by the utility on the premises of any of its customers, which is”.

## NOTES OF DECISIONS

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397 A.2d @576

Westlaw.

397 A.2d 570  
 (Cite as: 397 A.2d 570)

Page 1

**H**

Supreme Judicial Court of Maine.  
 MARS HILL & BLAINE WATER COMPANY  
 v.  
 PUBLIC UTILITIES COMMISSION.  
 WALDOBORO WATER COMPANY  
 v.  
 PUBLIC UTILITIES COMMISSION.  
 GREENVILLE WATER COMPANY  
 v.  
 PUBLIC UTILITIES COMMISSION.  
 NORTHERN WATER COMPANY  
 v.  
 PUBLIC UTILITIES COMMISSION.  
 EASTPORT WATER COMPANY  
 v.  
 PUBLIC UTILITIES COMMISSION.  
 Feb. 2, 1979.

Water companies, which were subsidiaries of water works corporation which in turn was wholly owned by parent corporation, sought review of certain decisions rendered by Public Utilities Commission during their rate cases. The Supreme Judicial Court, Godfrey, J., held that: (1) Commission committed no error in its calculation of effective tax rate for purposes of determining water companies federal income tax expense for rate-making purposes; (2) there was no error or abuse of discretion in Commission's requiring that, for rate-making purposes, water companies' flow-through benefits of both state and federal accelerated depreciation; (3) Commission's finding of rate of return of 9.6% Was reasonable and nonconfiscatory, and (4) there was no error warranting interference with Commission's reasoned decision that cost of equity was 12.0%.

Appeal denied; decrees and orders of Commission affirmed; judgment for Public Utilities Commission.

West Headnotes

**[1] Public Utilities 317A ↪ 194**

317A Public Utilities  
 317AIII Public Service Commissions or Boards  
 317AIII(C) Judicial Review or Intervention  
 317Ak188 Appeal from Orders of Commission  
 317Ak194 k. Review and Determination in General. Most Cited Cases  
 (Formerly 317Ak32)  
 Decisions of Public Utilities Commission concerning its rate-making methods are entitled to be given considerable deference by Supreme Judicial Court, whose review is limited to determining whether Commission's methodology and result were reasonable and supported by substantial evidence. 35 M.R.S.A. §§ 303, 305.

**[2] Public Utilities 317A ↪ 122**

317A Public Utilities  
 317AII Regulation  
 317Ak119 Regulation of Charges  
 317Ak122 k. Mode of Regulation. Most Cited Cases  
 (Formerly 317Ak7.3)  
 Because rate-making is prospective in nature, Public Utilities Commission should not limit itself to utility's experience during any single year when such a limitation would produce an inaccurate assessment of its true financial situation.

**[3] Public Utilities 317A ↪ 122**

317A Public Utilities  
 317AII Regulation  
 317Ak119 Regulation of Charges  
 317Ak122 k. Mode of Regulation. Most Cited Cases  
 (Formerly 317Ak7.3)  
 It is reasonable and proper for Public Utilities Commission to assess a utility's effective annual federal income tax rate over a period of years in order to determine an average effective tax rate for setting

397 A.2d 570  
(Cite as: 397 A.2d 570)

of rates to be effective in future.

**[4] Public Utilities 317A ↪122**

317A Public Utilities  
317AII Regulation  
317Ak119 Regulation of Charges  
317Ak122 k. Mode of Regulation. Most Cited Cases  
(Formerly 317Ak7.3)

**Public Utilities 317A ↪194**

317A Public Utilities  
317AIII Public Service Commissions or Boards  
317AIII(C) Judicial Review or Intervention  
317Ak188 Appeal from Orders of Commission  
317Ak194 k. Review and Determination in General. Most Cited Cases  
(Formerly 317Ak32)

Methodology used by Public Utilities Commission in its rate-making determinations lies within Commission's expertise and discretion, need not be suggested by any witness in record and is subject only to test of reasonableness; if methodology is reasonable, then result will not be disturbed if factual findings employed in that methodology are supported by record.

**[5] Public Utilities 317A ↪122**

317A Public Utilities  
317AII Regulation  
317Ak119 Regulation of Charges  
317Ak122 k. Mode of Regulation. Most Cited Cases  
(Formerly 317Ak7.3)

**Public Utilities 317A ↪165**

317A Public Utilities  
317AIII Public Service Commissions or Boards  
317AIII(B) Proceedings Before Commissions  
317Ak165 k. Evidence. Most Cited Cases  
(Formerly 317Ak15)  
Public Utilities Commission's method of averaging

effective tax rates for parent corporation's consolidated system of subsidiary water companies was reasonable and substantial evidence supported findings of fact to which method was applied.

**[6] Constitutional Law 92 ↪4372**

92 Constitutional Law  
92XXVII Due Process  
92XXVII(G) Particular Issues and Applications  
92XXVII(G)17 Carriers and Public Utilities

92k4372 k. Water, Sewer, and Irrigation. Most Cited Cases  
(Formerly 92k298(3))

In order to substantiate their claim that Public Utilities Commission's implementation of allegedly novel approach of averaging effective federal income tax rates without adequate notice and opportunity to be heard constituted denial of due process, water companies were required to show: (1) that Commission was contemplating a change in long-standing policy which would adversely affect them, (2) that they did not receive a sufficiently particularized notice of contemplated change, and (3) that lack of such notice subjected them to substantial prejudice. U.S.C.A.Const. Amends. 5, 14.

**[7] Constitutional Law 92 ↪4372**

92 Constitutional Law  
92XXVII Due Process  
92XXVII(G) Particular Issues and Applications  
92XXVII(G)17 Carriers and Public Utilities

92k4372 k. Water, Sewer, and Irrigation. Most Cited Cases  
(Formerly 92k298(3))

Public Utilities Commission's averaging of effective federal income tax rates of parent corporation's consolidated system of subsidiary water companies was not a change in long-standing policy; thus, water companies could not successfully claim there was a change in policy of which they had no notice

397 A.2d 570  
(Cite as: 397 A.2d 570)

so as to render Commission's implementation of such methodology a denial of due process. U.S.C.A.Const. Amends. 5, 14.

**[8] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Public Utilities Commission's decision to "flow-through" all benefits of accelerated depreciation with respect to federal and state income taxes to rate payers of water companies, which were subsidiaries of parent corporation, was valid exercise of Commission's rate-making power and was not incompatible with applicable Internal Revenue Code provision. 26 U.S.C.A. (I.R.C.1954) § 167(l).

**[9] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Public Utilities Commission's decision to "flow-through" all benefits of accelerated depreciation with respect to state income taxes to rate payers of water companies, which were subsidiaries of parent corporation was not controlled by federal income tax law. 26 U.S.C.A. (I.R.C.1954) § 167(l).

**[10] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited

Cases

If, prior to August, 1969, water companies, which were subsidiaries of parent corporation, were using accelerated depreciation with flow-through, they were required to continue to flow through benefits of accelerated depreciation with respect to the federal income tax liability for their pre-1970 properties, unless they satisfied their burden to convince Public Utilities Commission that a change to normalization would be in public interest so as to be permitted by Commission to change accounting method. 26 U.S.C.A. (I.R.C.1954) § 167(l) (1).

**[11] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Where water companies, which were subsidiaries of parent corporation, provided no evidence as to method of accounting used during July, 1969, accounting period with respect to their pre-1970 properties, Public Utilities Commission could treat water companies as having used a flow-through method of accounting prior to August, 1969, in accordance with Commission's long-standing policy of flowing through benefits of accelerated depreciation.

**[12] Waters and Water Courses 405 ↪ 203(12)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(12) k. Review by Courts and Injunction Against Enforcement. Most Cited Cases  
Water companies, which were subsidiaries of parent corporation and which provided no evidence as to method of accounting used during July, 1969, accounting period with respect to their pre-1970 properties, failed to sustain their burden of showing

397 A.2d 570  
(Cite as: 397 A.2d 570)

that Public Utilities Commission abused its discretion in deciding to require flow-through of benefits of accelerated depreciation for pre-1970 properties for federal income tax purposes. 35 M.R.S.A. § 307; 26 U.S.C.A. (I.R.C.1954) § 167(l)(1).

**[13] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Where water companies, which were subsidiaries of parent corporation, provided no evidence that they had made valid election of accounting method under Internal Revenue Code section governing depreciation methods with respect to post-1969 public utility property, Public Utilities Commission was not prohibited from determining water companies' rates on basis of accelerated depreciation with flow-through for their post-1969 properties. 26 U.S.C.A. (I.R.C.1954) § 167(l)(1), (l)(2), (l)(2)(A-C).

**[14] Public Utilities 317A ↪ 129**

317A Public Utilities  
317AII Regulation  
317Ak119 Regulation of Charges  
317Ak129 k. Rate of Return. Most Cited Cases  
(Formerly 317Ak7.10)  
A utility must be allowed sufficient revenues both to meet its operating expenses and to provide for a proper return on investment.

**[15] Public Utilities 317A ↪ 129**

317A Public Utilities  
317AII Regulation  
317Ak119 Regulation of Charges  
317Ak129 k. Rate of Return. Most Cited Cases

(Formerly 317Ak7.10)

Where utilities that are less intensively capitalized than water companies, such as transit utilities, are concerned, proper return to investors may be determined by means of an "operating ratio" rather than by means of a "rate of return."

**[16] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Public Utilities Commission's finding of 9.6% rate of return of subsidiary water companies of parent corporation, which was a conglomerate with holdings inside and outside utility field, was reasonable and nonconfiscatory.

**[17] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Where subsidiary corporation, which owned subsidiary water companies, was in process of attempting to shift to a 60/40 capital structure and where water companies' ratepayers had been incurring higher debt costs associated with that attempt, Public Utilities Commission's imputation of 60/40 capital structure to subsidiary, rather than actual 57/43 structure, in order to determine cost of capital was reasonable and supported by substantial evidence.

**[18] Public Utilities 317A ↪ 120**

317A Public Utilities  
317AII Regulation

397 A.2d 570  
(Cite as: 397 A.2d 570)

317Ak119 Regulation of Charges  
317Ak120 k. Nature and Extent in General. Most Cited Cases  
(Formerly 317Ak7.1)  
Rate-making for utilities is prospective in nature.

**[19] Public Utilities 317A ↪ 124**

317A Public Utilities  
317AII Regulation  
317Ak119 Regulation of Charges  
317Ak124 k. Value of Property; Rate Base. Most Cited Cases  
(Formerly 317Ak7.5)  
In Public Utilities Commission's cost of capital determinations, experience of test year is not sole factor to be considered with respect to adjustment for attrition.

**[20] Public Utilities 317A ↪ 194**

317A Public Utilities  
317AIII Public Service Commissions or Boards  
317AIII(C) Judicial Review or Intervention  
317Ak188 Appeal from Orders of Commission  
317Ak194 k. Review and Determination in General. Most Cited Cases  
(Formerly 317Ak32)  
Supreme Judicial Court's limited analysis of Public Utilities Commission's cost-of-equity determinations involve a determination of reasonableness in result and methodology and whether result and methodology are supported by substantial evidence.

**[21] Public Utilities 317A ↪ 129**

317A Public Utilities  
317AII Regulation  
317Ak119 Regulation of Charges  
317Ak129 k. Rate of Return. Most Cited Cases  
(Formerly 317Ak7.10)  
Choice of methods to compute such factors as cost of equity, at least in realm where rational persons could disagree, belongs to Public Utilities Commis-

sion.

**[22] Public Utilities 317A ↪ 165**

317A Public Utilities  
317AIII Public Service Commissions or Boards  
317AIII(B) Proceedings Before Commissions  
317Ak165 k. Evidence. Most Cited Cases  
(Formerly 317Ak15)  
As a proper exercise of its rate-making powers and responsibilities, Public Utilities Commission may reject evidence of one expert on proper methodology for cost of equity determinations and accept evidence of another.

**[23] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Public Utilities Commission's rejection of water companies' cost-of-equity testimony based on reasons, articulated in decree, supported by opposing expert's criticisms, was reasonable and sufficient.

**[24] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases  
Public Utilities Commission's determination of water companies' cost of equity at 12.0%, by use of discounted cash flow formula, applied to conglomerate which owned water companies' immediate parent corporation, was not improper.

**[25] Public Utilities 317A ↪ 189**

317A Public Utilities

397 A.2d 570  
(Cite as: 397 A.2d 570)

317AIII Public Service Commissions or Boards  
317AIII(C) Judicial Review or Intervention  
317Ak188 Appeal from Orders of Commission  
317Ak189 k. In General. Most Cited Cases

(Formerly 317Ak27)

Where water companies' did not assign as error Public Utilities Commission's failure to make explicit adjustment to offset dilution in its cost of equity determination, Supreme Judicial Court was not required to address issue on appeal.

**[26] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases

In its decree in rate case, Public Utilities Commission was not required to explain in detail each individual factor used in determining water companies' cost of equity and to what extent each factor contributed to Commission's ultimate determination; Commission was required only to exercise reasonable judgment based on substantial evidence.

**[27] Public Utilities 317A ↪ 120**

317A Public Utilities  
317AII Regulation  
317Ak119 Regulation of Charges  
317Ak120 k. Nature and Extent in General. Most Cited Cases  
(Formerly 317Ak7.1)

Rate-making is not an exact science and often calls for estimations and predictions.

**[28] Public Utilities 317A ↪ 165**

317A Public Utilities  
317AIII Public Service Commissions or Boards  
317AIII(B) Proceedings Before Commissions

317Ak165 k. Evidence. Most Cited Cases

(Formerly 317Ak15)

Cost of equity determined for a utility during one proceeding has some evidentiary value, but is not controlling, with respect to cost to be found in subsequent proceeding.

**[29] Waters and Water Courses 405 ↪ 203(6)**

405 Waters and Water Courses  
405IX Public Water Supply  
405IX(A) Domestic and Municipal Purposes  
405k203 Water Rents and Other Charges  
405k203(6) k. Establishment and Regulation by Public Authority in General. Most Cited Cases

Although Public Utilities Commission erroneously reasoned that its adjustment of subs subsidiary water companies' cost of equity was consistent with decline of debt of subsidiary water works, such error did not justify setting aside Commission's cost of equity finding as to subs subsidiary water companies.

\*573 Verrill & Dana by Roger A. Putnam (orally), John R. McKernan, Jr., Portland, for plaintiffs.

David J. Fletcher, Calais, for amicus curiae, City of Eastport.

Thomas R. Gibbon (orally), Horace S. Libby, Public Utilities Comm'n, Augusta, for defendant.

Before POMEROY, WERNICK, GODFREY and NICHOLS, JJ., and DUFRESNE, A. R. J.

GODFREY, Justice.

Mars Hill & Blaine Water Company, Waldoboro Water Company, Greenville Water Company, Northern Water Company, and Eastport Water Company ("Water Companies") seek this Court's review of certain decisions rendered by the Public Utilities Commission during 1977 in their rate cases. We affirm the Commission's decision in each of those cases.

Each of the Water Companies is a member of the

397 A.2d 570  
(Cite as: 397 A.2d 570)

same family of water companies certain members of which sought review of Commission actions in *Mechanic Falls Water Co. v. Public Utilities Commission, Me.*, 381 A.2d 1080 (1977). The Water Companies are subsidiaries of General Waterworks Corporation ("General Waterworks") which, in turn, is wholly owned by I. U. International Corporation ("I. U. International").

The procedural posture of these companies is substantially similar to that of their sister companies in *Mechanic Falls Water Co. v. Public Utilities Commission, supra*. Between April and August of 1976, each of the Water Companies filed with the Commission\*574 both a schedule of proposed increased rates and a complaint against itself alleging that its existing rates were unreasonable, unjust, inadequate, and unjustly discriminatory. Pending a final determination, the Commission suspended the proposed rates of each company, pursuant to 35 M.R.S.A. s 69, for an initial three-month period and then for an additional five-month period.

On November 8, 1976, in response to motions by the Commission's staff and the Water Companies, the Commission ordered that the individual rate cases be consolidated for hearing and resolution of certain common issues. The consolidated hearings were held on December 14, 15, and 16, 1976, and on January 12 and 24, 1977.

On November 30, 1976, the City of Eastport, a customer of the Eastport Water Company, filed a petition to intervene, which was granted on December 14, 1976. Because the City of Eastport was generally satisfied with the Commission's decision, it did not participate in the early stages of the proceedings in the Law Court. However, on November 21, 1977, the City filed with this Court a "Motion to File Brief as Intervener or Amicus Curiae," limited to the sole issue of the correct tax rate to be applied for determining Eastport Water Company's federal income tax expense. The motion was granted on November 22, 1977, by order of Justice Pomeroy for the Court.

On January 26, 1977, the Commission issued a preliminary decision in *Mars Hill & Blaine Water Company's* application for a rate increase, authorizing the filing of new rates substantially below those requested by the company.

The Commission issued its final decision with respect to *Mars Hill & Blaine Water Company* on February 18, 1977. *Re Mars Hill & Blaine Water Co.*, 19 P.U.R. 4th 380 (Me. Pub. Util. Comm'n 1977). Because the final decree granted *Mars Hill & Blaine Water Company* only \$86 more in revenues than the preliminary decree, the company chose not to revise its schedule of rates already put into effect pursuant to the preliminary decree.

The Commission's decree of February 18, 1977, also included its final decisions on the consolidated issues, which are now the subject of review in this case. These decisions were incorporated into the individual decrees issued for the other four Companies: *Waldoboro Water Company* (March 2, 1977), *Greenville Water Company* (March 2, 1977), *Northern Water Company* (April 27, 1977), and *Eastport Water Company* (May 18, 1977).

The Water Companies seasonably initiated the instant proceedings for judicial review by invoking this Court's "appeal" jurisdiction under 35 M.R.S.A. s 303 <sup>FN1</sup> and its "complaint" jurisdiction under 35 M.R.S.A. s 305. <sup>FN2</sup> Because the issues before this Court are the same in each case, the parties filed a motion for consolidation, which was granted by Justice Pomeroy for the Court on September 22, 1977. Oral arguments were presented on December 19, 1977.

FN1. Section 303 provides in pertinent part:

"An appeal from a final decision of the commission may be taken to the law court on questions of law in the same manner as an appeal from a judgment of the Superior Court in a civil action."

397 A.2d 570  
(Cite as: 397 A.2d 570)

FN2. Section 305 provides in pertinent part:

“Notwithstanding sections 303 and 304, in all cases in which the justness or reasonableness of a rate, toll or charge by any public utility or the constitutionality of any ruling or order of the commission is in issue, the law court shall have jurisdiction upon a complaint to review, modify, amend or annul any ruling or order of the commission, but only to the extent of the unlawfulness of such ruling or order.”

Some of the issues arising from the proceedings below are identical to issues raised by the General Waterworks subsidiaries involved in *Mechanic Falls Water Co. v. Public Utilities Commission*, supra, which was then pending before this Court. The parties have agreed to waive briefs and oral argument and to be bound by the decision of this Court in the *Mechanic Falls* case with respect to the following matters: management and service fees, depreciation on contributed property, allocation of rate \*575 case costs, staff participation in Commission actions, and the chronic tax loss theory for calculation of an effective federal income tax rate. The parties' agreement was embodied in the Law Court's order of September 22, 1977. Our decision in *Mechanic Falls* resolved all those matters in favor of the Commission.

We shall now consider the substantive issues remaining in this case, guided by the appropriate standard of review under 35 M.R.S.A. ss 303 and 305, as discussed in *New England Telephone & Telegraph Co. v. Public Utilities Commission*, Me., 390 A.2d 8, 15 (1978), and *Mechanic Falls Water Co. v. Public Utilities Commission*, supra at 1090-91.

#### I. Averaging of Annual Effective Federal Income Tax Rates

The Water Companies filed federal income tax re-

turns on a consolidated basis with I. U. International in the same manner and to the same effect as their sister water companies in *Mechanic Falls Water Co. v. Public Utilities Commission*, Me., 381 A.2d 1080 (1977). In that case we held that the Commission could disregard the standard 48 per cent federal corporate income tax rate in determining their federal income tax expense for rate-making purposes, and, instead, employ a lower “effective tax rate” which reflects their proportionate share of the consolidated group's actual tax liability. Our opinion contained a thorough discussion of the issues involved and warrants no repetition or expansion here. See also *Maine Water Co. v. Public Utilities Commission*, Me., 388 A.2d 493, 494-95 (1978). The Water Companies are bound by this determination of the propriety of the effective tax rate approach by the Law Court's consolidation order of September 22, 1977.

In *Mechanic Falls Water Co. v. Public Utilities Commission*, supra, we approved the Commission's calculation of an effective tax rate of 28 per cent for 1974, which was used to determine the companies' federal income tax expense for rate-making purposes. In the present case the Commission determined that the effective tax rate for 1975 was 36.84 per cent.<sup>FN3</sup> Then, the Commission “averaged” the 1974 and 1975 effective tax rates to produce a 33 per cent tax rate for purposes of determining the Water Companies' federal income tax expense for rate-making purposes.<sup>FN4</sup>

FN3. The Water Companies do not challenge the Commission's determination that the effective tax rate for 1975 is 36.84%.

FN4. Neither do the Water Companies challenge the Commission's calculation that the average of 28% And 36.84% Is 33%. The accurate calculations show the average of 28% And 36.84% If 32.42%. Obviously the higher rate of 33% Works for their benefit.

The Water Companies challenge the Commission's

397 A.2d 570  
(Cite as: 397 A.2d 570)

calculation of a 33 per cent effective tax rate on two grounds: First, they argue that the Commission's "averaging" of the individual effective tax rates for 1974 and 1975 was, in and of itself, unjustified. Second, they claim that the Commission's averaging approach constituted a change in past rate-making policy, requiring sufficient notice thereof, which, they argue, was not provided in this case. We reject each of these contentions.

[1] As this Court recently emphasized in *New England Telephone & Telegraph Co. v. Public Utilities Commission, Me.*, 390 A.2d 8 (1978), we must give considerable deference to the rate-making methods employed by the Commission.

"As we repeatedly emphasize throughout this opinion, the Legislature has vested the Commission with the authority and duty to exercise its expertise and skill in the setting of just and reasonable rates. The Commission must necessarily be allowed to exercise wide discretion in setting rates, which is essentially a legislative function. Our role upon review is limited to the consideration of errors of law. We may not interfere with the Commission's findings if the methodology and result are reasonable and are supported by substantial evidence in the record. The Commission may exercise reasonable discretion in selecting methods by \*576 which to establish just and reasonable rates. It is not bound to any particular methodology, whether suggested by its own Staff or by the utility." *Id.* at 48-49.

Accordingly, choice of methods to compute such factors as the effective tax rate belongs to the Commission, at least in the realm where rational persons could disagree. *Central Maine Power Co. v. Public Utilities Commission, Me.*, 382 A.2d 302, 317 (1978). Therefore, our review is limited to whether the Commission's methodology and result were reasonable and whether they were supported by substantial evidence.

As the evidence indicates, the effective tax rate of a consolidated system, calculated on the "chronic loss" theory approved in *Mechanic Falls Water Co.*

*v. Public Utilities Commission, supra*, may be subject to considerable fluctuation from year to year. In fact, the Water Companies' own witness, David Surwit, stated that utility rates, based upon an annual single effective tax rate, would have a tendency "to bounce up and down like a yo-yo."

[2][3] In *Central Maine Power Co. v. Public Utilities Commission*, 382 A.2d at 317, we stated:

"This Court has made clear, in the context of regulating this very public utility, that the experience of one test year is not the sole factor to be considered by the Commission."

See also *New England Telephone & Telegraph Co. v. Public Utilities Commission*, 390 A.2d at 49-50. Because rate making is prospective in nature, the Commission should not limit itself to the utility's experience during any single year when such a limitation would produce an inaccurate assessment of its true financial situation. *Central Maine Power Co. v. Public Utilities Commission*, 153 Me. 228, 236, 136 A.2d 726, 732 (1957). It is reasonable and proper for the Commission to assess a utility's effective annual federal income tax rate over a period of years in order to determine an average effective tax rate for the setting of rates to be effective in the future.

This is not a case in which the Commission is "splitting the difference" between conflicting figures endorsed by its staff and the utility. See *Casco Bay Lines v. Public Utilities Commission, Me.*, 390 A.2d 483, 488-89 (1978).<sup>FN5</sup> Rather, the Commission has reasonably determined that a more proper effective tax rate may be calculated by averaging the individual effective tax rates for the past two years. "Ratemaking is not an exact science and often calls for estimations and predictions." 390 A.2d at 494.

FN5. We did not reach the merits of the utility's challenge to the Commission's averaging of annual expense figures in the *Casco Bay Lines* case. See 390 A.2d at

397 A.2d 570  
(Cite as: 397 A.2d 570)

[4] The methodology used by the Commission in its rate-making determinations need not be suggested by any witness in the record.<sup>FN6</sup> The methodology itself lies within the Commission's expertise and discretion, and is subject only to a test of reasonableness. If the methodology is reasonable, then the result will not be disturbed if the factual findings employed in that methodology are supported by the record. In the circumstances, we cannot find that the Commission's method is unreasonable.

FN6. However, we do find the following statement in Dr. Shipman's Mechanic Falls testimony, which was incorporated into the record in the proceedings below:

"Perhaps it goes without saying that an examination of the tax information for the years 1970-1973 should be undertaken to determine whether there is any consistency in the apparent tax rate, and to arrive at an average figure for the five-year period."

[5] We also find that the record adequately supports the Commission's determination. The Commission was warranted in finding a 28 per cent effective tax rate for the I. U. International consolidated system in 1974. The Commission simply took official notice of its finding in *Re Mechanic Falls Water Co.*, 13 P.U.R. 4th 347 (Me. Pub. Util. Comm'n 1976), which finding we subsequently approved in *Mechanic Falls Water Co. v. Public Utilities Commission, Me.*, 381 A.2d 1080 (1977). The 1975 effective\*577 tax rate of 36.84 per cent was derived from calculations based on the same formula used by the Commission in the Mechanic Falls case. *Re Mars Hill & Blaine Water Co.*, 19 P.U.R. 4th 380, 384 (Me. Pub. Util. Comm'n 1977).<sup>FN7</sup> We find that the record provides sufficient support for the Commission's use of those figures.

FN7. During the proceedings below, the Commission ordered the Water Companies to compute their effective tax rate for 1975

based on the formula developed in *Mechanic Falls* and to supply the background data, calculations, and results to the Commission. The calculations submitted by the Water Companies pursuant to the Commission's order showed a 1975 effective tax rate of 36.59%. On appeal, the Water Companies have not questioned this discrepancy between their calculation and the Commission's figure of 36.84%.

We hold that the Commission's method of averaging effective tax rates was reasonable and that substantial evidence supports the findings of the facts to which the method was applied. We find no substantive error in its averaging of effective tax rates in this case.

The Water Companies' second objection to the Commission's averaging of effective tax rates is that this allegedly novel approach was used by the Commission without adequate notice or opportunity to be heard on the issue. The Water Companies cite *New England Telephone & Telegraph Co. v. Department of Public Utilities*, 371 Mass. 67, 354 N.E.2d 860, 871 (1976), for the principle that a utility commission should not make a major change in rate-making policy without sufficient warning to the utility involved in order that it may prepare its presentation.

Although this Court has held that the Commission is not bound by rate-making policies used in prior cases, *New England Telephone & Telegraph Co. v. Public Utilities Commission*, 390 A.2d at 55; *Central Maine Power Co. v. Public Utilities Commission*, 382 A.2d at 319, we have also recognized that the affected utility is entitled to notice "sufficient to enable it to present evidence on any issue relevant to that proceeding." *Mechanic Falls Water Co. v. Public Utilities Commission*, supra at 1103. Moreover,

"Where . . . the Commission is contemplating a change in a long-standing policy which would adversely affect a utility, a general notice of a rate

397 A.2d 570  
(Cite as: 397 A.2d 570)

proceeding may not be sufficient. . . . In such circumstances, due process may require a more particularized notice so that the utility could introduce evidence on that issue if it so desires." Id.

[6] The Water Companies must make three showings in order to substantiate their claim of denial of such due process: (1) that "the Commission is contemplating a change in a long-standing policy which would adversely affect a utility"; (2) that the utility did not receive a sufficiently "particularized notice" of the contemplated change; and, (3) that the lack of such notice subjected the utility to "substantial prejudice."

[7] The Water Companies have not made even the first of those showings. They have failed to show that the Commission's averaging of annual effective tax rates constituted a change in policy. The Commission introduced the effective-tax-rate approach in *Re Mechanic Falls Water Co.*, 13 P.U.R. 4th 347 (Me. Pub. Util. Comm'n, Jan. 26, 1976), only a few months before the Water Companies submitted their rate increase requests. The effective tax rate theory was still in its formative stages at the time of the proceedings below. No real change in policy occurred. Rather, the Commission was already using an average effective tax rate in those circumstances where the annual effective tax rates for more than one year were properly before it. The Water Companies do not disprove the Commission's assertion that in *Re Mechanic Falls Water Co.*, supra, and in *Re Continental Telephone Co.*, 18 P.U.R. 4th 636 (Me. Pub. Util. Comm'n, Jan. 21, 1977), there was only one annual effective tax rate available from the record.<sup>FN8</sup> On the other hand, \*578 in *Re Maine Water Co.*, (Me. Pub. Util. Comm'n, F.C. No. 2156, July 2, 1976), *Aff'd Maine Water Co. v. Public Utilities Commission, Me.*, 388 A.2d 493 (1978), and in *Re Camden and Rockland Water Co.*, (Me. Pub. Util. Comm'n, F.C. No. 2132, March 26, 1976), where the Commission had available from the record effective tax rates for more than one year, it averaged such effective tax rates.

FN8. Although the Water Companies claim

that in the *Mechanic Falls* case the Commission had before it the consolidated system's tax return data for 1970 through 1974, the Commission's decree in that case states:

"No party presented testimony concerning an effective tax rate for years other than 1974 and 1973. The only testimony concerning an effective tax rate for 1973 was a rough calculation without Mr. Clougherty's adjustments. Nevertheless, this rough calculation showed that an effective tax rate for 1973, using Dr. Shipman's method, would be close to that of 1974." *Re Mechanic Falls Water Co.*, supra at 355.

Therefore, by averaging the 1974 and 1975 effective tax rates in this case, the Commission was following a policy which it had recently formulated and was currently applying. The Water Companies cannot now successfully claim that there was a change in policy of which they had no notice.<sup>FN9</sup>

FN9. Moreover, the Commission's "Notice of Consolidated Hearing" dated November 8, 1976, designated as one issue for resolution "the proper federal income tax rate."

We hold that the Commission committed no error in its calculation of a 33 per cent effective tax rate for purposes of determining the Water Companies'

federal income tax expense for rate-making purposes. II. Flow-Through of Income Taxes Deferred Because of Accelerated Depreciation

[8] This Court is again confronted with the Commission's treatment of the depreciation deduction for purposes of determining the proper income tax expense for rate-making purposes. In three recent cases, we have considered carefully the arguments with respect to "normalization" versus "flow-through" methods of accounting, especially in the light of I.R.C. s 167(L) (1978) (Tax Reform Act of 1969 s 441(a)): *New England Telephone &*

397 A.2d 570  
(Cite as: 397 A.2d 570)

Telegraph Co. v. Public Utilities Commission, Me., 390 A.2d 8, 15-25 (1978); Central Maine Power Co. v. Public Utilities Commission, Me., 382 A.2d 302, 318-21 (1978); Mechanic Falls Water Co. v. Public Utilities Commission, Me., 381 A.2d 1080, 1100-03 (1977). See also Central Maine Power Co. v. Public Utilities Commission, 153 Me. 228, 246-49, 136 A.2d 726, 737-39 (1957).

In its decision below, the Commission continued the policy it established in *Re Central Maine Power Co.*, 15 P.U.R. 4th 455 (Me. Pub. Util. Comm'n 1976), *Aff'd*, *Central Maine Power Co. v. Public Utilities Commission*, Me., 382 A.2d 302 (1978), that the benefits of accelerated depreciation with respect to state income taxes would be "flowed through" to the Water Companies' rate-payers. The Commission also ordered the flow-through of the benefits of accelerated depreciation with respect to federal income taxes on both pre-1970 and post-1969 public utility property.

With only a general policy discussion of the merits of normalization versus flow-through, the Water Companies' brief challenges the Commission's decision to flow through all the benefits of accelerated depreciation for federal and state income tax purposes. Over twenty years ago, in *Central Maine Power Co. v. Public Utilities Commission*, 153 Me. 228, 136 A.2d 726 (1957), we held that for rate-making purposes the Commission could properly require flow-through of the benefits of accelerated depreciation. We reaffirmed that holding in *Mechanic Falls Water Co. v. Public Utilities Commission*, Me., 381 A.2d 1080 (1977). Recent cases have focused on the effect of s 167(L) of the Internal Revenue Code on a utility's continued ability to take advantage of accelerated depreciation. Where we have found no conflict between the Commission's actions and section 167(L), we have continued to leave the treatment of accelerated depreciation to the Commission's discretion and expertise. *Central Maine Power Co. v. Public Utilities Commission*, supra (1978); *Mechanic Falls Water Co. v. Public Utilities Commission*, \*579 supra

(1977). On the other hand, where we have found that the Commission's actions arbitrarily "jeopardized" a utility's ability to take accelerated depreciation under section 167(L), we have held the Commission's actions to be an unreasonable exercise of power and abuse of discretion. *New England Telephone & Telegraph Co. v. Public Utilities Commission*, supra (1978).

In this case we find no incompatibility between the Commission's actions and the provisions of section 167(L) of the Internal Revenue Code and therefore uphold the Commission's exercise of its rate-making power.

#### A. State Income Taxes

[9] In *Central Maine Power Co. v. Public Utilities Commission*, supra (1978), this Court held that federal income tax law, as expressed in section 167(L), had no controlling effect upon the Commission's treatment of the benefits of accelerated depreciation for state income tax expense purposes. That issue remains a matter of state law. Thus, the Commission's decision in this respect must be sustained under the authority of *Central Maine Power Co. v. Public Utilities Commission*, supra (1978), and *Central Maine Power Co. v. Public Utilities Commission*, supra (1957).

#### B. Federal Income Taxes Pre-1970 Property

[10] In *Mechanic Falls Water Co. v. Public Utilities Commission*, Me., 381 A.2d 1080, 1101 (1977), we discussed the operation of section 167(L) (1), which concerns pre-1970 public utility property: <sup>FN10</sup>

FN10. I.R.C. s 167(l)(1) provides:

"(1) Pre-1970 public utility property.

(A) In general. In the case of any pre-1970 public utility property, the term "reasonable allowance" as used in subsec-

397 A.2d 570  
(Cite as: 397 A.2d 570)

tion (a) means an allowance computed under

(i) a subsection (L ) method (straight-line depreciation), or

(ii) the applicable 1968 method (the method used prior to August of 1969) for such property.

Except as provided in subparagraph (B), clause (ii) shall apply only if the taxpayer uses a normalization method of account- ing.

(B) Flow-through method of accounting in certain cases. In the case of any pre-1970 public utility property, the taxpayer may use the applicable 1968 method for such property if

(i) the taxpayer used a flow-through method of accounting for such property for its July 1969 accounting period, or

(ii) the first accounting period with respect to such property is after the July 1969 accounting period, and the taxpayer used a flow-through method of accounting for its July 1969 accounting period for the property on the basis of which the applicable 1968 method for the property in question is established.”

“For pre-1970 property, the Code provides that a utility may use 1) straight-line depreciation, 2) the method used prior to August of 1969 if it also employs normalization, or 3) accelerated depreciation with flow-through, but only if that method was used prior to August of 1969. In interpreting the pre-1970 utility property provision, the United States Supreme Court has declared that a utility may not unilaterally switch from flow-through to normalization. Rather, if a utility is flowing through the benefits of accelerated depreciation, it must continue to do so unless the appropriate regulatory body permits a change. Federal Power Commission v. Mem-

phis Light, Gas and Water Division, 411 U.S. 458, 93 S.Ct. 1723, 36 L.Ed.2d 426 (1973).”

If, before August, 1969, the Water Companies were using accelerated depreciation with flow-through, they must continue to flow through the benefits of accelerated depreciation with respect to pre-1970 property, unless permitted to change to normalization by the Commission. Moreover, “The burden was on the Companies to convince the Commission that a change from flow-through to normalization would be in the public interest.” *Mechanic Falls Water Co. v. Public Utilities Commission*, supra, at 1101.

[11] In its decree, the Commission notes that the Water Companies provided no evidence or documentation as to the method of accounting used during the July, 1969, accounting period. See *Re \*580Mars Hill & Blaine Water Co.*, 19 P.U.R. 4th 380, 389 (Me. Pub. Util. Comm'n 1977).<sup>FN11</sup> The Water Companies may thus be treated as if they used a flow-through method of accounting prior to August, 1969, in accordance with the Commission's long-standing policy of flowing through the benefits of accelerated depreciation. See 35 M.R.S.A. s 307. Moreover, at the time of the proceedings before the Commission, there was no showing that the Commission had ever permitted the Water Companies to change to a normalization method of accounting. The burden was therefore on the Water Companies to seek the Commission's permission to change from a flow-through to a normalization method of accounting.

FN11. The decree provides an opportunity to the Water Companies to submit documentation with respect to their accounting methods. 19 P.U.R. 4th at 389. In a letter dated 10 days after the Commission's decree counsel for the Water Companies reserved the right to provide the documentation. However, the record and briefs contain no indication that such information was ever provided.

[12] The choice between flow-through and normal-

397 A.2d 570  
(Cite as: 397 A.2d 570)

ization rests in the sound judgment of the Commission. *Central Maine Power Co. v. Public Utilities Commission*, supra (1957). On the basis of the record we cannot find that the Water Companies have sustained their burden of showing that the Commission abused its discretion in deciding to require the flow-through of the benefits of accelerated depreciation for pre-1970 property. See *Mechanic Falls Water Co. v. Public Utilities Commission*, supra at 1102.

### C. Federal Income Taxes Post-1969 Property

[13] With respect to post-1969 public utility property, the Internal Revenue Code provides that a utility may use as a method of depreciation:

“(A) a subsection (L ) method (straight-line depreciation),

(B) a method otherwise allowable under this section (accelerated depreciation) if the taxpayer uses a normalization method of accounting, or

(C) the applicable 1968 method (the method used prior to August of 1969), if, with respect to its pre-1970 public utility property of the same (or similar) kind most recently placed in service, the taxpayer used a flow-through method of accounting for its July 1969 accounting period.” I.R.C. s 167(L )(2).

If the conditions provided by subparagraph (C) are met, the Commission may, in its discretion, require a public utility to use accelerated depreciation with flow-through for post-1969 property for rate-making purposes without jeopardizing the utility's right to take accelerated depreciation.

In paragraph (4)(A) of section 167(L ) of the Code Congress provided a method by which utilities could avoid the effect of paragraph (2)(C), set forth above:

“If the taxpayer makes an election under this subparagraph before June 29, 1970, in the manner prescribed by the Secretary, in the case of taxable

years beginning after December 31, 1970, paragraph (2)(C) shall not apply with respect to any post-1969 public utility property, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in paragraph (3)(A) and does not represent the replacement of existing capacity.” I.R.C. s 167(L )(4)(A).

If the Water Companies had made a valid election under this subparagraph, the available depreciation methods would be limited to those provided in s 167(L )(2)(A) and (B), namely, straight-line depreciation or accelerated depreciation with normalization. *Treas.Reg. s 1.167(L )-2(a)(1)* (1978). See *Federal Power Commission v. Memphis Light, Gas & Water Division*, 411 U.S. 458, 93 S.Ct. 1723, 36 L.Ed.2d 426 (1973). In the present case, the Water Companies did not produce evidence that they had made any election under paragraph (4)(A).

The flow-through of the benefits of accelerated depreciation on post-1969 property was at issue in \*581 *New England Telephone & Telegraph Co. v. Public Utilities Commission, Me.*, 390 A.2d 8 (1978). In that case, *New England Telephone*, which had been using a straight-line depreciation method, switched from straight-line to accelerated depreciation with normalization on its post-1969 property. Thus, paragraph (2)(C) of section 167(L ) was not applicable because *New England Telephone* had not used a flow-through method of accounting for its July, 1969, accounting period. We held that the Commission abused its discretion in requiring flow-through of the benefits of accelerated depreciation for rate-making purposes while ordering the Company to continue using a normalized method of accounting in its regulated books of account.

The present case differs from *New England Telephone* in a crucial respect: Unlike *New England Telephone*, the Water Companies were subject to the operation of paragraph (2)(C) of I.R.C. s 167(L ).

397 A.2d 570  
(Cite as: 397 A.2d 570)

As we noted in the discussion of pre-1970 property, above, the Commission could properly act on the basis that before August, 1969, the Water Companies' rates had been determined by using accelerated depreciation with flow-through and thus the conditions for application of I.R.C. s 167(L)(2)(C) have been satisfied. Nothing in I.R.C. s 167(L) prevents the Commission from determining the Water Companies' rates on the basis of accelerated depreciation with flow-through for post-1969 property.

In conclusion, we find no error or abuse of discretion in the Commission's requiring that, for rate-making purposes, the Water Companies flow through the benefits of both state and federal accelerated depreciation.

### III. Rate of Return

[14][15] As we explained in *Mechanic Falls Water Co. v. Public Utilities Commission, Me.*, 381 A.2d 1080, 1095 (1977), a utility must be allowed sufficient revenues both to meet its operating expenses and to provide a proper return on investment. In this case the Commission calculated the Water Companies' return by multiplying the utility's rate base by the rate of return found by the Commission to be appropriate.<sup>FN12</sup> This Court has regarded capital cost, when competently computed, as "essentially and practically the equivalent of fair rate of return." *Central Maine Power Co. v. Public Utilities Commission*, 156 Me. 295, 307, 163 A.2d 762, 769 (1960). Accordingly, the Commission determined the rate of return for the Water Companies by analyzing their cost of capital.

FN12. Where less "capital-intensive" utilities, such as transit utilities, are concerned, the proper return to investors may be determined by means of an "operating ratio" rather than by means of a "rate of return." See *Casco Bay Lines v. Public Utilities Commission, Me.*, 390 A.2d 483, 490-91 (1978).

The cost of capital is calculated by determining the separate costs of the different items composing the capital structure of the utility. A weighted cost for each item is derived by multiplying the cost of that item by its ratio to the total capital. Those weighted costs are then added to produce the utility's overall cost of capital as the basis for an appropriate rate of return. See *New England Telephone & Telegraph Co. v. Public Utilities Commission, Me.*, 390 A.2d 8, 32-33 (1978).

[16] Before proceeding to its determination of the cost of capital, the Commission must decide upon which corporate entity it will focus its analysis. Like their sister water companies in *Mechanic Falls Water Co. v. Public Utilities Commission*, supra, the Water Companies here are substantially wholly owned by General Waterworks Corporation. The Water Companies appear to have little, if any, debt outstanding, their capitalization consisting almost entirely of common equity supplied by General Waterworks.

General Waterworks in turn is ultimately wholly owned by I. U. International Corporation, a large conglomerate with holdings both inside and outside the utility field. General Waterworks' actual capital structure at the time of the Commission hearings \*582 appeared to consist of 57% Debt and 43% Common equity. General Waterworks does its financing primarily through the issuance of debt and does not appear to have issued any equity since 1970.

During the proceedings before the Commission, the Water Companies' testimony focused on General Waterworks' cost of capital as the appropriate measure of rate of return. The Companies' witness, Mr. Mulle, recommended the use of General Waterworks' actual capital structure, consisting of 57% Debt and 43% Equity ("57/43 capital structure"). Mr. Mulle's calculations of cost of equity were based on the cost of equity for General Waterworks. The Water Companies agreed with the Commission that the appropriate cost of debt was 8.0%, determined on the same basis as General Water-

397 A.2d 570  
(Cite as: 397 A.2d 570)

works' cost of debt in *Re Mechanic Falls Water Co.*, 13 P.U.R. 4th 347 (Me. Pub. Util. Comm'n 1976).

The Commission found that the appropriate capital structure to be used for cost of capital determinations was the 60% Debt and 40% Equity ("60/40 capital structure") it had used for General Waterworks in *Re Mechanic Falls Water Co.*, supra. Applying the "discounted cash flow" ("DCF") formula to figures developed with respect to I. U. International's common equity, the Commission staff recommended a cost of equity between 12.0% and 12.6%. The Commission found that the cost of debt was the undisputed 8% and that the cost of equity was 12.0%. The Commission applied these costs to the 60/40 capital structure to produce a cost of capital of 9.6%, as follows:

Accordingly, the Commission concluded that the Water Companies were entitled to a rate of return of 9.6%. The Water Companies challenge that rate of return as unreasonable and confiscatory, claiming that the minimum fair rate of return should be 10.7%.

We sustain the Commission's finding of a rate of return of 9.6% as reasonable and non-confiscatory. We now review in more detail the individual factors in the Commission's calculations of cost of capital.

#### A. Capital Structure

[17] In its decree the Commission stated that it was computing the Water Companies' cost of capital "on a 60/40 capital structure." *Re Mars Hill & Blaine Water Co.*, 19 P.U.R. 4th 380, 391 (Me. Pub. Util. Comm'n 1977). The Commission explained its use of a 60/40 capital structure in a footnote:

"In the Mechanic Falls case, all parties agreed on a 60/40 capital structure as being consistent with General Waterworks' target level of debt. The company here seeks a 57/43 structure, but we continue

to feel that the 60/40 structure is well balanced and consistent with the fact that Maine customers have been paying the higher yield associated with the company's effort to reach the 60/40 structure. *Id.* at 391 n. 11.

The Water Companies now contend that the Commission must use General Waterworks' actual 57/43 capital structure in its cost-of-capital determinations in this case. They argue that the Commission has supplied no findings of fact or justification for its use of any capital structure other than General Waterworks' actual 57/43 capital structure.<sup>FN13</sup> The facts do not support this argument.

FN13. In *Mechanic Falls Water Co. v. Public Utilities Commission*, Me., 381 A.2d 1080, 1095 (1977), the water utilities and the Commission agreed "that the capital structure of General, consisting of 60% Debt and 40% Equity, would be used in computing the Companies' fair rate of return." The use and approval of a 60/40 capital structure in that case does not control the determination of the proper capital structure in this case. *Central Maine Power Co. v. Public Utilities Commission*, 153 Me. 228, 252-53, 136 A.2d 726, 740-41 (1957).

The record supports a finding of the following facts: In response to pressure from regulatory commissions, the management of General Waterworks decided to shift to a 60/40 capital structure. To that end, General\*583 Waterworks sought review by the Securities and Exchange Commission of a planned change in its bond indenture. The purpose of the change was to allow General Waterworks to pay 100% of its earnings to I. U. International in dividends in order to facilitate attainment of a 60/40 capital structure. To gain the consent of bond holders to a change in the bond indenture, the interest rates on General Waterworks' bonds were adjusted upward by 0.25%. That increase was a factor in computing the cost of debt allowed by the Commission. Thus, the Water Companies' ratepayers were

397 A.2d 570  
(Cite as: 397 A.2d 570)

being charged with increased debt costs associated with the effort to reach a 60/40 capital structure. During cross-examination, Mr. Mulle admitted that General Waterworks was still attempting to achieve the 60/40 capital structure.

In *New England Tel. & Tel. Co. v. Public Utilities Comm'n, Me.*, 390 A.2d 8, 39 (1978), we recognized two categories of situation in which a utility commission may adopt a capital structure other than the utility's test-year capital structure for purposes of determining its cost of capital. Although the facts of the present case do not fit precisely into either category, the Commission's use of a 60/40 capital structure is supported by the record as constituting a reasonable exercise of the Commission's expert judgment. The record supports the conclusion that General Waterworks was attempting to shift to a 60/40 capital structure and that the ratepayers have been incurring higher debt costs associated with the attempt.<sup>FN14</sup>

FN14. The Commission contended on appeal that because it was merely presented with the task of determining an appropriate hypothetical capital structure for the Water Companies the capital structure of which both the Water Companies and the Commission staff chose to disregard, it was not required to provide any specific findings or justifications for disregarding the test-year capital structure of General Waterworks.

We cannot accept that argument. The record demonstrates that the Water Companies' cost of capital was to be determined by using General Waterworks' cost of capital in the context of its appropriate capital structure.

The Commission used General Waterworks' 8.0% Cost of debt in its cost-of-capital calculations. Similarly, it determined a cost of equity at 12.0% For General Waterworks. Its decree states, "Because General Waterworks sells no

common stock on the open market and because it is wholly owned and controlled ultimately by I. U. International, we will impute the I. U. cost of equity to General Waterworks and apply it to the General Waterworks' capital structure . . . ." *Re Mars Hill & Blaine Water Co.*, 19 P.U.R. 4 th 380, 392 (Me. Pub. Util. Comm'n 1977). Moreover, the testimony of Mr. Robert L. Packard, principal witness for the Commission staff on rate of return, indicated that he was calculating the Water Companies' rate of return on the basis of General Waterworks' cost of capital in the context of its own appropriate capital structure. Thus, the Commission focused on the question of the appropriate capital structure to attribute to General Waterworks.

Therefore, we have disregarded the Commission's characterization of the issue on appeal and have proceeded to the real issue before this Court: Was the Commission's imputation of a 60/40 capital structure to General Waterworks, in order to determine its cost of capital, reasonable and supported by substantial evidence in the record?

We find support for this approach in *New England Telephone & Telegraph Co. v. Department of Public Utilities*, 360 Mass. 443, 275 N.E.2d 493 (1971). The evidence in that case showed that the utility's debt ratio during the test year of 1969 was 40%, but that a planned issuance of debt during 1970 would raise its debt ratio to about 45%. In its decision the Department allocated a 50% Debt ratio to the utility for rate-making purposes. Though the Massachusetts court held that a 50% Ratio was excessive, it approved the use of the impending debt ratio in the Department's calculation of the cost of capital, saying:

"We believe that in the determination of rates for future application the Department should have considered the reasonably foreseeable impending change in the debt ratio to 45% And determined

397 A.2d 570  
(Cite as: 397 A.2d 570)

whether that was or would be reasonable.” 360 Mass. at 468, 275 N.E.2d at 509.

[18][19] Ratemaking is prospective in nature. With respect to adjustment for attrition, the experience of the test year is not the sole factor to be considered by the Commission. \*584 Central Maine Power Co. v. Public Utilities Commission, Me., 382 A.2d 302, 317 (1978); See also, New England Telephone & Telegraph Co. v. Public Utilities Commission, Me., 390 A.2d 8, 49 (1978). Also, as we have said in the context of determining allowable utility expenses for rate-making purposes, “facts which with certainty will gain life in the future, but do not affect the operations of the test year, must be weighed by the fact finder . . . .” Central Maine Power Co. v. Public Utilities Commission, 153 Me. 228, 242, 136 A.2d 726, 735 (1957). The Commission’s decision to use a 60/40 capital structure is thus consistent with this Court’s past treatment of Commission actions with respect to future expenses and attrition. It is also consistent with rulings of public utility regulating agencies in other jurisdictions; E. g., Re Southern Natural Gas Co., 24 F.P.C. 26, 35 P.U.R. 3d 179 (1960) (actual capitalization adjusted for imminent financing of short-term debt); Re New York State Electric & Gas Corp., 88 P.U.R. 3d 300 (N.Y. Pub. Serv. Comm’n 1971) (capital structure revised to reflect refunding of bond issue maturing in near future); Pennsylvania Public Utility Commission v. York Telephone & Telegraph Co., 53 P.U.R. 3d 146 (Pa. Pub. Util. Comm’n 1963) (capital structure with higher debt ratio considered appropriate in view of refinancing of short-term debt). See also Re Potomac Electric Power Co., 83 P.U.R. 3d 113 (D.C. Pub. Serv. Comm’n 1970) (recognizing debt and preferred stock issued in year following test year in computing cost of debt and preferred stock.)<sup>FN15</sup>

FN15. “We are mindful, first, of the task we are undertaking here. We are attempting to establish the cost of capital for Pepco for a period in the future. The first element is the cost of debt and preferred

stock and, in accordance with the analysis of all the expert testimony, we base our computation on the embedded cost of those types of securities. It is frankly too unrealistic and theoretical for us to ignore the issuance of securities which have already had an undeniable and continuing effect on the cost of debt and preferred stock.” Id. at 137.

In the circumstances, the Commission properly adopted a 60/40 capital structure for the purpose of determining General Waterworks’ cost of capital.

#### B. Cost of Debt

The parties agree that the Water Companies’ cost of debt for purposes of the rate proceedings is 8.0%. Therefore the cost of debt is not in issue in this case. Compare New England Telephone & Telegraph Co. v. Public Utilities Commission, Me., 390 A.2d 8, 33-34 (1978); Mechanic Falls Water Co. v. Public Utilities Commission, Me., 381 A.2d 1080, 1096 (1977).

#### C. Cost of Equity

In New England Telephone & Telegraph Co. v. Public Utilities Commission, Me., 390 A.2d 8, 37-38 (1978), this Court explained its necessarily limited scope of review of the Commission’s cost-of-equity determinations:

“Our analysis of the record on this issue has demonstrated that the determination of the cost of equity is one of the most difficult and complex tasks facing the Commission. The Commission must utilize to the fullest its regulatory expertise and skill to analyze the highly technical economic and financial data presented on this issue. We cannot and will not attempt to second guess the Commission on such matters lying particularly within its area of expertise. Only when its actions are unreasonable or unsupported by substantial evidence may we intervene. New England Telephone and Tele-

397 A.2d 570  
(Cite as: 397 A.2d 570)

graph Co. v. Public Utilities Commission, 148 Me. 374, 377, 94 A.2d 801, 803 (1953). Moreover, the burden of proof rests upon (the utility) to demonstrate that the Commission has committed legal error. 35 M.R.S.A. s 307; Central Maine Power Co. v. Public Utilities Commission, supra, 156 Me. at 299, 163 A.2d at 765 (1960).”

[20] Our limited analysis of the Commission's cost-of-equity determination is basically twofold: (1) whether it is reasonable in result and methodology, and (2) whether it is supported by substantial evidence.

Cost of equity is often the subject of disagreement between the utility and the Commission staff, and this case is no exception. The Water Companies presented the \*585 testimony of Mr. Mulle, who recommended a minimum cost of equity of 14% For General Waterworks. The Commission staff presented the testimony of Mr. Packard, who suggested a cost of equity of 12.2% Based upon a recommended range of 12.0% To 12.6%. The Commission found the Water Companies' cost of equity to be 12.0%.

The Water Companies raise a number of objections to the Commission's finding. First, they assert that Mr. Mulle's approach was superior to that used by Mr. Packard for determining the cost of equity. Mr. Mulle employed several methods and approaches plus a number of “adjustments” to arrive at his recommended cost of equity. Mr. Packard relied almost exclusively on the discounted cash flow (“DCF”) method for calculating the cost of equity.<sup>FN16</sup> The Commission rejected Mr. Mulle's approach for a number of reasons articulated in its decree.

FN16. In *New England Telephone & Telegraph Co. v. Public Utilities Commission*, Me., 390 A.2d 8 (1978), we sustained the Commission's reliance on a DCF formula used by Mr. David A. Kosh to calculate the cost of equity in that case. Of course, our approval of the Commission's use of the DCF method in that case does not automat-

ically warrant its approval in this case. We must evaluate each case on its own merits to see if the method and result are reasonable and supported by substantial evidence. In *Mechanic Falls Water Co. v. Public Utilities Commission, Me.*, 381 A.2d 1080 (1977), we sustained a Commission determination of the cost of equity based on a “comparable earnings” test.

It is not necessary for us to review each of Mr. Mulle's approaches and the Commission's reasons for rejecting them. Compare *New England Telephone & Telegraph Co. v. Public Utilities Commission*, supra at 35-36 (1978). The Commission's decree reflects adequate consideration of each of those approaches, explaining the Commission's reasons for rejecting them. Those reasons have support in Mr. Packard's criticisms found in the record.

[21][22][23] We hold that the Commission's treatment of the Water Companies' cost-of-equity testimony was both reasonable and sufficient. *New England Telephone & Telegraph Co. v. Public Utilities Commission*, supra at 36 (1978). Choice of methods to compute such factors as cost of equity, at least in the realm where rational persons could disagree, belongs to the Commission. *Central Maine Power Co. v. Public Utilities Commission*, Me., 382 A.2d 302, 317 (1978). As a proper exercise of its rate-making powers and responsibilities, the Commission may reject the evidence of one expert and accept the evidence of another. *Central Maine Power Co. v. Public Utilities Commission*, 153 Me. 228, 253, 136 A.2d 726, 741 (1957).

[24] Our remaining consideration is whether the result and the method actually used by the Commission were reasonable and supported by substantial evidence. The Commission relied heavily on the testimony of Mr. Packard who used the DCF method to determine the cost of equity. He stated that this method defines the cost of equity as the market rate of discount that equates the present value of all expected future dividends per share with the current market price of the stock. According to the basic

397 A.2d 570  
(Cite as: 397 A.2d 570)

equation presented by Mr. Packard, the cost of existing equity is equal to the sum of the current percentage dividend yield and the anticipated percentage growth in dividends per share.

Mr. Packard then selected the corporation to whose stock the DCF formula would be applied. Three corporate levels were considered for purposes of cost-of-equity analysis: the Water Companies, General Waterworks, and I. U. International. Both the Commission staff and the Water Companies disregarded, for purposes of cost-of-capital analysis, the corporate level of the Water Companies themselves, whose capital structure consists essentially of 100% Common equity, nearly all owned by General Waterworks. Mr. Mulle focused his analysis at the General Waterworks level for purposes of determining the cost of equity.

On the other hand, Mr. Packard focused on I. U. International in order to derive a cost of equity by means of the DCF formula. He explained that this was the corporate level at which investors desiring to \*586 invest in the Water Companies would make their common equity purchases, because neither General Waterworks nor the Water Companies have an active market in which their stock is traded. He testified that the cost of equity to General Waterworks was essentially the same as the cost of equity to I. U. International.

The Commission adopted Mr. Packard's approach:

“(T)he commission notes that Mr. Packard's calculations were based on the cost of equity for I. U. International. Because General Waterworks sells no common stock on the open market and because it is wholly owned and controlled ultimately by I. U. International, we will impute the I. U. cost of equity to General Waterworks and apply it to the General Waterworks' capital structure used in F.C. No. 2120 (Re Mechanic Falls Water Co., 13 P.U.R. 4th 347 (Me. Pub. Util. Comm'n 1976)).” Re Mars Hill & Blaine Water Co., 19 P.U.R. 4th 380, 392 (Me. Pub. Util. Comm'n 1977).

Accordingly, Mr. Packard analyzed the history of I. U. International's common stock and dividends in order to derive the figures to be used in his DCF formula. He calculated I. U. International's current dividend yield to be approximately 8.2% (within a range of 7.7% To 8.6%) and its anticipated growth in dividends per share to be approximately 4.0% (within a range of 3.6% To 4.6%) to produce a DCF cost of equity of approximately 12.2%. However, he stated that a current yield of 8.2% Was relatively high, especially compared to yields prior to November, 1976. He testified that the 4.0% Anticipated growth rate was therefore generous and not reflective of the decline in earnings per share during 1975 and 1976. During subsequent oral testimony, Mr. Packard recommended a range for the cost of equity of 12.0% To 12.6% On the basis of his calculations.

The Commission settled on a 12.0% Cost of equity. It reasoned in part:

“We have reduced the return on equity from the 12.2 per cent recommended by the staff to 12.0 per cent which brings the rate of return (computed on a 60/40 capital structure and the undisputed 8.0 per cent cost of debt) to 9.6 per cent. Our decision in this matter is supported by the recent action of the New York commission in the New Rochelle case provided to us by Mr. Putnam. In that proceeding the commission reversed the hearing examiner's decision to grant a 13.0 per cent return on equity and instead allowed 11.5 per cent, computed on the basis of a General Waterworks' growth rate of 3.3 per cent (compared to Mr. Packard's 4.0 per cent for I. U. International) and a dividend yield of 8.2 per cent. The New York commission noted that the capital market's required return from water companies was declining and the dividend yield in January, 1977, for the list of 16 ‘comparable’ water companies had fallen to 7.4 per cent.

“Mr. Mulle himself also recognized that recent declines in the cost of debt had lowered the cost of equity about half a percentage point since June, 1976. Since we had found the cost of equity to Gen-

397 A.2d 570  
(Cite as: 397 A.2d 570)

eral Waterworks to be 12.6 per cent a year ago, our adjustment to 12.0 per cent as of today is consistent with the decline (though not the level) attested to by Mr. Mulle." *Re Mars Hill & Blaine Water Co.*, supra at 391-92 (footnotes omitted).

We find no error warranting interference in the Commission's reasoned decision that the cost of equity is 12.0%. Our careful review of the record convinces us that use of the DCF formula is a reasonable method of determining the cost of equity in this case. The selection of ratemaking methods lies primarily within the discretion and expertise of the Commission. We find sufficient evidence in the record to support the Commission's application in this case of the DCF formula.

We also find the use of I. U. International as the focus of the DCF analysis to be reasonable and within the Commission's area of expertise and discretion. Because General Waterworks has no stock which is actively traded on the open market, the Commission could properly apply the DCF \*587 formula to I. U. International's common equity, which is subject to the competitive effects of the marketplace. The Commission could reasonably find that General Waterworks' cost of equity is essentially the same as I. U. International's cost of equity, and thereby impute that cost to General Waterworks.

We note one difference between the Commission's application of the DCF formula in *New England Telephone & Telegraph Co. v. Public Utilities Commission*, supra (1978), and its application in this case. In *New England Telephone*, the DCF formula, used by the witness for the Commission staff, Mr. David A. Kosh ("anticipated dividends and expected future growth"), provided what he termed a "bare cost of equity." 390 A.2d at 36. *New England Telephone* and the Commission agreed that the "bare cost of equity" was not an adequate measure of *New England Telephone's* cost of equity for rate-making purposes. Because the cost of financing and market pressure associated with a new stock issue may result in "dilution" of the investment of existing stockholders, the Commission made an explicit

adjustment to the "bare cost of equity" to maintain an appropriate "market-to-book" ratio for *New England Telephone's* common stock. 390 A.2d at 36-37.

In the present case the DCF formula used by Mr. Packard ("current yield" plus "anticipated growth in dividends per share") provided what he termed a "cost of existing equity." From a comparison of the record in this case with *New England Telephone*, it appears that Mr. Packard's cost of existing equity is the equivalent of Mr. Kosh's bare cost of equity. However, in this case, the Commission made no explicit adjustment to offset dilution as it did in *New England Telephone*.

[25] We need not consider whether the Commission was required to provide explicitly a "dilution adjustment" in this case, where the DCF approach was used to determine cost of equity, because the absence of such an explicit adjustment is not assigned as error by the Water Companies on appeal. Compare *Maine Water Co. v. Public Utilities Commission, Me.*, 388 A.2d 493, 496 (1978). Moreover, the record of the proceedings before the Commission indicates that the subject of an adjustment for dilution-producing factors was considered by the witnesses and the Commission and could have been reflected in the Commission's final determination of a 12.0% Cost of equity, which we find is supported by substantial evidence.

The Water Companies launch a number of other attacks on the Commission's finding of a 12.0% Cost of equity as allegedly having no support in the record. They argue that because Mr. Packard recommended a 12.2% Cost of equity, the Commission's 12.0% Cost-of-equity figure lies outside the record. In fact, Mr. Packard recommended a range of 12.0% To 12.6% For the cost of equity. Therefore, the Commission's figure is directly supported by Mr. Packard's testimony.

The Commission is not bound to use only those figures recommended by witnesses. On the basis of evidence in the record and with the use of its own

397 A.2d 570  
(Cite as: 397 A.2d 570)

expertise, it may make its own informed judgment as to the proper cost of equity, whether or not that cost is specifically recommended by any witness. *Maine Water Co. v. Public Utilities Commission*, *supra* at 496.

[26][27] The Water Companies also argue that the Commission failed to explain adequately its reasons for adopting a 12.0% Cost of equity instead of the 12.2% Recommended by Mr. Packard. However, the Commission's decree states that Mr. Packard admitted that his yield figure was "relatively high" and that his growth rate was "generous." The Water Companies reply that the Commission has not adequately explained which and to what extent each of these individual factors caused it to conclude that the recommended cost of equity should be 12.0% Instead of 12.2%. The Commission is not required to go into such detail in its decree. "Ratemaking is not an exact science and often calls for estimations and predictions." \*588 *Casco Bay Lines v. Public Utilities Commission*, Me., 390 A.2d 483, 494 (1978). The Commission need not, and often cannot, specify its reasons in such detail as the Water Companies request. It is sufficient if the Commission exercises reasonable judgment based on substantial evidence. See *Maine Water Co. v. Public Utilities Commission*, Me., 388 A.2d 493, 498 (1978).

[28][29] One minor issue remains. In its decree the Commission said:

"Mr. Mulle himself also recognized that recent declines in the cost of debt had lowered the cost of equity about half a percentage point since June, 1976. Since we had found the cost of equity to General Waterworks to be 12.6 per cent a year ago (*Re Mechanic Falls Water Co.*, 13 P.U.R. 4th 347 (Me. Pub. Util. Comm'n Jan. 26, 1976)), our adjustment to 12.0 per cent as of today is consistent with the decline (though not the level) attested to by Mr. Mulle." *Re Mars Hill & Blaine Water Co.*, *supra* at 392.

The Water Companies contend that the record does

not support the quoted statement. Although we agree that the Commission's reasoning in the quoted statement is faulty,<sup>FN17</sup> the error does not justify our setting aside the Commission's finding of a 12.0% Cost of equity. We have already found that the Commission's determination is supported by substantial evidence elsewhere in the record. Moreover, it is unnecessary for the Commission to reconcile its cost-of-equity finding in this case with a finding it made a year earlier with respect to General Waterworks. The cost of equity determined for a utility during one proceeding has some evidentiary value, but is not controlling, with respect to the cost to be found in the subsequent proceeding. *Central Maine Power Co. v. Public Utilities Commission*, 153 Me. 228, 252-53, 136 A.2d 726, 740-41 (1957).

FN17. We find nothing in the record indicating that the cost of equity could not have risen after the Commission's decision in *Mechanic Falls* and before it experienced the decline testified to by Mr. Mulle.

In conclusion, we hold the Commission's finding of a rate of return of 9.6% For the Water Companies, based on a 9.6% Cost of capital to General Waterworks, using a 60/40 capital structure, 12.0% Cost of equity, and 8.0% Cost of debt, to be reasonable and supported by substantial evidence.

The entry in each case must be:

Section 303 appeal denied; decrees and orders of the Public Utilities Commission affirmed.

Judgment for defendant Public Utilities Commission on the section 305 complaint.

McKUSICK, C. J., did not sit.

ARCHIBALD and DELAHANTY, JJ., did not sit.

DUFRESNE, A. R. J., sat by assignment.

Me., 1979.

*Mars Hill & Blaine Water Co. v. Public Utilities Commission*

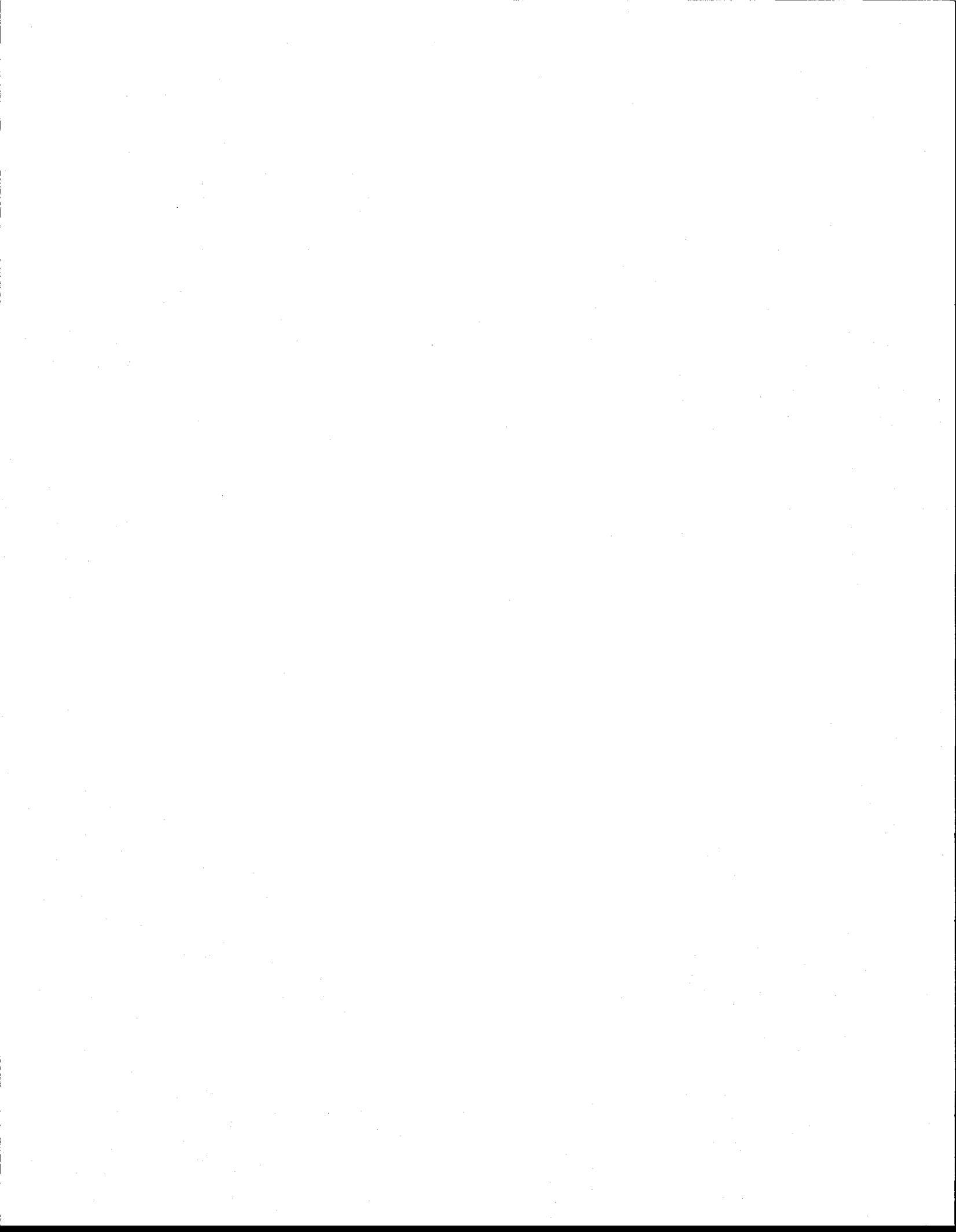
397 A.2d 570

397 A.2d 570  
(Cite as: 397 A.2d 570)

Page 23

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30 TX ADC § 291.34

30 TAC § 291.34

Tex. Admin. Code tit. 30, § 291.34

Page 1

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**TEXAS ADMINISTRATIVE CODE**  
**TITLE 30. ENVIRONMENTAL QUALITY**  
**PART 1. TEXAS COMMISSION ON ENVIR-**  
**ONMENTAL QUALITY**  
**CHAPTER 291. UTILITY REGULATIONS**  
**SUBCHAPTER B. RATES, RATE-MAKING,**  
**AND RATES/TARIFF CHANGES**

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Current through September 30, 2009

§ 291.34. Alternative Rate Methods

(a) Alternative rate methods. To ensure that retail customers receive a higher quality, more affordable, or more reliable water or sewer service, to encourage regionalization, or to maintain financially stable and technically sound utilities, the commission may utilize alternate methods of establishing rates. The commission shall assure that rates, operations, and service are just and reasonable to the consumers and to the utilities. The executive director may prescribe modified rate filing packages for these alternate methods of establishing rates.

(b) Single issue rate change. Unless a utility is using the cash needs method, it may request approval to increase rates to reflect a change in any one specific cost component. The following conditions apply to this type of request.

(1) The proposed effective date of the single issue rate change request must be within 24 months of the effective date of the last rate change request in which a complete rate change application was filed.

(2) The change in rates is limited to those amounts necessary to recover the increase in the specific cost component and the increase will be allocated to the rate structure in the same manner as in the previous rate change.

(3) The scope of a single issue rate proceeding is limited to the single issue prompting a change in rates. For capital items this includes depreciation and return determined using the rate of return established in the prior rate change proceeding.

(4) The utility shall provide notice as described in § 291.22(a)-(e) of this title (relating to Notice of Intent To Change Rates), and the notice must describe the cost component and reason for the increased cost.

(5) A utility exercising this option shall submit a complete rate change application within three years following the effective date of the single issue rate change request.

(c) Phased and multi-step rate changes. In a rate proceeding, the commission may authorize a phased, stepped, or multi-year approach to setting and implementing rates to eliminate the requirement that a utility file another rate application.

(1) A utility may request to use the phased or multi-step rate method:

(A) to include the capital cost of installation of utility plant items that are necessary to improve service or achieve compliance with commission regulations in the utility's rate base and operating expenses in the revenue requirement when facilities are placed in service;

(B) to provide additional construction funds after major milestones are met;

(C) to provide assurance to a lender that rates will be immediately increased when facilities are placed in service;

(D) to allow a utility to move to metered rates from unmetered rates as soon as meters can be installed at all service con-

nections;

(E) to phase in increased rates when a utility has been acquired by another utility with higher rates;

(F) to phase in rates when a utility with multiple rate schedules is making the transition to a system-wide rate structure; or

(G) when requested by the utility.

(2) Construction schedules and cost estimates for new facilities that are the basis for the phased or multi-step rate increase must be prepared by a licensed professional engineer.

(3) Unless otherwise specified in the commission order, the next phase or step cannot be implemented without verification of completion of each step by a licensed professional engineer, agency inspector, or agency subcontractor.

(4) At the time each rate step is implemented, the utility shall review actual costs of construction versus the estimates upon which the phase-in rates were based. If the revenues received from the phased or multi-step rates are higher than what the actual costs indicate, the excess amount must be reported to the executive director prior to implementing the next phase or step. Unless otherwise specified in a commission order or directed by the executive director, the utility may:

(A) refund or credit the overage to the customers in a lump sum; or

(B) retain the excess to cover shortages on later phases of the project. Any revenues retained but not needed for later phases must be proportioned and refunded to the customers at the end of the project with interest paid at the rate on deposits.

(5) The original notice to customers must in-

clude the proposed phased or multi-step rate change and informational notice must be provided to customers and the executive director 30 days prior to the implementation of each step.

(6) A utility that requests and receives a phased or multi-step rate increase cannot apply for another rate increase during the period of the phase-in rate intervals unless:

(A) the utility can prove financial hardship; or

(B) the utility is willing to void the next steps of the phase-in rate structure and undergo a full cost of service analysis.

(d) Cash needs method. The cash needs method of establishing rates allows a utility to recover reasonable and prudently incurred debt service, a reasonable cash reserve account, and other expenses not allowed under standard methods of establishing rates.

(1) A utility may request to use the cash needs method of setting rates if:

(A) the utility is a nonprofit corporation controlled by individuals who are customers and who represent a majority of the customers; or

(B) the utility can demonstrate that use of the cash needs basis:

(i) is necessary to preserve the financial integrity of the utility;

(ii) will enable it to develop the necessary financial, managerial, and technical capacity of the utility; and

(iii) will result in higher quality and more reliable utility service for customers.

(2) Under the cash needs method, the allowable

components of cost of service are: allowable operating and maintenance expenses; depreciation expense; reasonable and prudently incurred debt service costs; recurring capital improvements, replacements, and extensions that are not debt-financed; and a reasonable cash reserve account.

(A) Allowable operating and maintenance expenses. Only those expenses that are reasonable and necessary to provide service to the ratepayers may be included in allowable operations and maintenance expenses and they must be based on the utility's historical test year expenses as adjusted for known and measurable changes and reasonably anticipated, prudent projected expenses.

(B) Depreciation expense. Depreciation expense may be included on any used and useful depreciable plant, property, or equipment that was paid for by the utility and that has a positive net book value on the effective date of the rate change.

(C) Debt service costs. Debt service costs are cash outlays to an unaffiliated interest necessary to repay principal and interest on reasonably and prudently incurred loans. If required by the lender, debt service costs may also include amounts placed in a debt service reserve account in escrow or as required by the commission, Texas Water Development Board, or other state or federal agency or other financial institution. Hypothetical debt service costs may be used for:

(i) self-financed major capital asset purchases where the useful life of the asset is ten years or more. Hypothetical debt service costs may include the debt repayments using an amortization schedule with the same term as the estimated service life of the asset using

the prime interest rate at the time the application is filed; and

(ii) prospective loans to be executed after the new rates are effective. Any pre-commitments, amortization schedules, or other documentation from the financial institution pertaining to the prospective loan must be presented for consideration.

(D) Recurring capital improvements, replacements, and extensions that are not debt-financed. Capital assets, repairs, or extensions that are a part of the normal business of the utility may be included as allowable expenses. This does not include routine capital expenses that are specifically debt-financed.

(E) Cash reserve account. A reasonable cash reserve account, up to 10% of annual operation and maintenance expenses, must be maintained and revenues to fund it may be included as an allowable expense. Funds from this account may be used to pay expenses incurred before revenues from rates are received and for extraordinary repair and maintenance expenses and other capital needs or unanticipated expenses if approved in writing by the executive director. The utility shall account for these funds separately and report to the commission as required by the executive director. Unless the utility requests an exception in writing and the exception is explicitly allowed by the executive director in writing, any funds in excess of 10%, shall be refunded to the customers each year with the January billing either as a credit on the bill or refund accompanied by a written explanation that explains the method used to calculate the amounts to be refunded. Each customer must receive the same refund amount. These reserves are not for the personal use of the management

30 TX ADC § 291.34  
30 TAC § 291.34  
Tex. Admin. Code tit. 30, § 291.34

Page 4

or ownership of the utility and may not be used to compensate an owner, manager, or individual employee above the amount approved for that position in the most recent rate change request unless authorized in writing by the executive director.

(3) If the revenues collected exceed the actual cost of service, defined in paragraph (2) of this subsection, during any calendar year, these excess cash revenues must be placed in the cash reserve account described in paragraph (2)(D) of this subsection and are subject to the same restrictions.

(4) If the utility demonstrates to the executive director that it has reduced expenses through its efforts, and has improved its financial, managerial, and technical capability, the executive director may allow the utility to retain 50% of the savings that result for the personal use of the management or ownership of the utility rather than pass on the full amount of the savings through lower rates or refund all of the amounts saved to the customers.

(5) If a utility elects to use the cash needs method, it may not elect to use the utility method for any rate change application initiated within five years after beginning to use the cash needs method. If after the five-year period, the utility does elect to use the utility method, it may not include in rate base, or recover the depreciation expense, for the portion of any capital assets paid for by customers as a result of including debt service costs in rates. It may, however, include in rate base, and recover through rates, the depreciation expense for capital assets that were not paid for by customers as a result of including debt service costs in rates. The net book value of these assets may be recovered over the remaining useful life of the asset.

**Source:** The provisions of this § 291.34 adopted to be effective February 4, 1999, 24 TexReg 738;

amended to be effective May 5, 2005, 30 TexReg 2528; amended to be effective September 28, 2006, 31 TexReg 8106.

30 TAC § 291.34, 30 TX ADC § 291.34

30 TX ADC § 291.34  
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LEXSEE 435 SO.2D 608

**State of Mississippi, Ex Rel. Bill Allain, Attorney General, for the Use and benefit of the State of Mississippi and the Electrical Consumers of the State of Mississippi, Mississippi Legal Services Coalition and Others, Mississippi Power & Light Company, City of Jackson, Mississippi v. Mississippi Public Service Commission**

No. 53,709

Supreme Court of Mississippi

*435 So. 2d 608; 1983 Miss. LEXIS 2502*

March 9, 1983

**PRIOR HISTORY:** [**\*\*1**] Appeal from Chancery Court, Hinds County; James Arden Barnett, Chancellor.

John L. Maxey, II, Jackson, Mississippi

**DISPOSITION:** THE OPINION OF THE CHANCERY COURT ON APPEAL IS AFFIRMED IN PART AND REVERSED IN PART AND REMANDED TO THE PUBLIC SERVICE COMMISSION FOR APPROPRIATE PROCEEDINGS NOT INCONSISTENT WITH THIS OPINION.

Stanley Taylor, Jr., Biloxi, Mississippi, for Appellants.

Bennett E. Smith, Jackson, Mississippi

Walter Brown, Natchez, Mississippi, for Appellees.

**CORE TERMS:** customer, projected, rate base, substantial evidence, electric, depreciation, operating expenses, plant, tax credits, consumer, ratepayers, staff, error of law, accumulated, acquisition, tax savings, chancery, deposit, amortization, residential, rate base, rate of return, accelerated amortization, accounting, manifest, recommended, inclusion, stock dividends, consolidated, donations

**JUDGES:** Patterson, C.J., Roy Noble Lee and Prather, JJ. Walker, P.J.; Broom, P.J.; Roy Noble Lee, Bowling, Hawkins, Dan M. Lee, Prather and Robertson, JJ., concur.

**OPINION BY:** PATTERSON**OPINION**

**COUNSEL:** Bill Allain, Attorney General, Frank Spencer and Larry J. Stroud, Special Assistant Attorneys General, Jackson, Mississippi

Gay Dawn Horne, Jackson, Mississippi

Tim Hancock, Jackson, Mississippi

Wise, Carter, Child &amp; Caraway, Jackson, Mississippi

James K. Child, Jr., Jackson, Mississippi

Henderson S. Hall, Jr., Jackson, Mississippi

Cupit &amp; Maxey, Jackson, Mississippi

[**\*610**] On May 28, 1980, Mississippi Power & Light Company (hereinafter MP&L) filed its Notice of Intention to Change Rates with the Mississippi Public [**\*\*2**] Service Commission (hereinafter Commission), for services on or after July 1, 1980. The proposed rates were designed to produce \$68,786,000 in additional gross annual operating revenues for the projected test year ending on June 30, 1981. The Commission suspended [**\*611**] the effective dates for the change in rates and set times for public hearings. MP&L filed a refunding bond, pursuant to statute, which authorized it to place the proposed rates into effect. After extensive public hearings<sup>1</sup> the Commission on November 24, 1980, authorized new rates designed to produce additional gross operating revenues of \$48,277,442 to MP&L.

<sup>1</sup> Consisting of 35 volumes, 4219 pages.

On December 23, 1980, the Mississippi Legal Services Coalition (hereinafter Legal Services), the Attorney General on behalf of the State of Mississippi and on behalf of the electrical customers within the affected area, filed separate appeals in the Chancery Court of the First Judicial District of Hinds County. The appeals were consolidated [\*\*3] for consideration and adjudication.

The Attorney General, the Cities of Jackson, Cleveland and Ruleville, the Town of Merigold and Hinds County, each filed petitions to intervene. Although the chancery court, in its capacity as an intermediate appellate court, permitted the Attorney General to participate in the appeal it nevertheless rescinded this order prior to final judgment, reasoning that the Attorney General was not a proper party. The court permitted the City of Cleveland to withdraw its petition to intervene and allowed the City of Jackson, the City of Ruleville, Town of Merigold and Hinds County to intervene as parties.

The chancery court affirmed the rate increase granted by the Commission to MP&L, with the exception of a customer charge of \$3.25, which was found to be not supported by substantial evidence, and remanded that issue to the Commission for further consideration. Presently, there is no appeal from that action.

The Attorney General appealed the chancellor's denial of his motion to intervene. We held in *State v. Miss. Pub. Serv. Com'n.*, 418 So. 2d 779 (Miss. 1982), that when an Attorney General has common-law powers, as in this state, he has the inherent [\*\*4] right to intervene in all suits affecting the public interest when he has no personal interest therein. Accordingly, the motion of MP&L to strike the Attorney General's assignments of error with respect to the merits of the rate case was overruled. The Attorney General, Legal Services and the City of Jackson have appealed from the final judgment of the chancery court. They assign as error the Court's affirmation of the Commission's:

1. Use of a projected test year as sponsored by MP&L for the determination of the company's rate base and operating expenses in order to establish new electrical rate schedules in that it was not supported by substantial evidence, was contrary to the manifest weight of the evidence and also constituted an error of law;

2. Denial of accelerated amortization of the excess accumulated federal tax reserve was contrary to the manifest weight of the evidence and constituted an error of law;

3. Allowing MP&L to reclassify charitable donations as operating expenses for rate making purposes was not supported by substantial evidence and constituted an error of law;

4. Not excluding consolidated tax savings from MP&L's company's operating expenses for [\*\*5] rate making purposes;

5. Granting MP&L comprehensive inter-period tax allocations constituted an error of law;

6. Inclusion of customer deposits and advances and MP&L's rate base constituted an error of law;

7. Allowance of the entire amount of MP&L's investment tax credits to be added to the company's rate base was not supported by substantial evidence, was contrary to the manifest weight of the evidence and constituted an error of law;

8. Allowance of plant held for future use to be included in MP&L's rate base was not supported by substantial evidence, was in excess of the statutory authority of the commission and also constituted an error of law;

[\*612] 9. Inclusion of long term debt interest and preferred stock dividends as funds available to offset cash working capital requirements of MP&L was contrary to the manifest weight of the evidence and constituted an error of law;

10. Not rejecting the biased testimony of MP&L's witness in favor of the unbiased testimony of the Commission's expert witness;

11. Approving the acquisition adjustment of the purchase of Capital Electric Power Association by MP&L was not supported by substantial evidence, contrary [\*\*6] to the manifest weight of the evidence and also an error of law;

12. Denial of accelerated amortization of excess depreciation reserve of MP&L constituted an error of law;

13. Permitted the amortization of the DeSoto County Plant Site Environmental Impact Study in arriving at the net utility operating income figure of \$23,095,000 for the projected test year.

Legal Services urges two additional assignments of error:

1. The Court's adoption of the approved rate increase by the Commission was unjust, unreasonable, and unreasonably discriminatory in the face of the overwhelming weight of the evidence and was not based on substantial evidence, in that it resulted in the disproportionate impact on impoverished ratepayers of MP&L;

2. The court's approving the adoption by the Commission of the classification of residential consumers, which created regular residential, electric water heating and total electric classes, was unjust, unreasonable and unreasonably discriminatory.

MP&L supports and defends the Commission's order insofar as it approved and allowed new rates and charges to produce \$48,277,442 in additional gross annual operating revenues for the projected test year [\*\*7] ending June 30, 1981. MP&L, however, argues the Commission erred in:

1. Not including construction work in progress (CWIP) in the rate base; and
2. Not finding MP&L had a cost of equity of 18%.

We consider MP&L as an appellee, except as to the above two assignments of error which we shall discuss at the conclusion of this opinion.

The decision of the Commission although affirmed by the chancery court on appeal was not unanimous. Commissioners Johnson and Snyder were of the opinion that a \$48,277,442 rate increase was proper for a fair rate of return to MP&L and not unreasonable to its electrical consumers in the affected area. Commissioner Havens, although joining the majority in some aspects of the suit, was of the opinion that a \$27,024,455 increase would afford a fair rate of return to the utility as well as being reasonable to the consumers.

The duties of the Commission are awesome and their responsibilities great in a most difficult, ongoing situation. *Mississippi Code Annotated* § 77-3-39 (1972), authorizes the Commission to establish rates that are just and reasonable to the ratepayers and which will yield a fair rate of return to the utility for its services. [\*\*8] In effect the Commission is the counterpart of the market place by which other businesses are measured. This is so because public utilities are monopolies engaged in the business of furnishing necessary services to the public. Obviously, the legislative intent in creating the Public Service Commission was to interpose an authoritative body between the ratepayers of the utility and the investors in the utility so that their respective interests, necessarily antagonistic, might be equitably served. The crucible of the competitive public market place to which business concerns, other than monopolies, are necessarily exposed is thus avoided so that economic waste by overlapping and duplicating services will not occur.

The findings of the Commission are subject to appellate review by the Chancery Court of the First Judicial District of Hinds County and ultimately by this Court. The rate-making decisions are thereby passed from the initial authoritative Commission to the courts for review and judicial decision. [\*\*613] Unfortunately, the decisions are never final in the sense that utilities are subject to fluctuation of prices, inflation, vagaries of weather, business movement, [\*\*9] and numerous other factors affecting their operations. These variables necessitate frequent applications for rate adjustments by the utilities

for their very existence and this necessarily impinges upon the pocketbooks of the utilities' subservient customers. In striving to lend stability to this ongoing balancing act between investors and consumers, the legislature has established a standard of just return to the utility and reasonable rates to the consumer. In *Southern Bell T. & T. Co. v. Miss. Pub. Serv. Com'n.*, 237 Miss. 157, 238, 241, 113 So. 2d 622, 654, 656 (1959), this was construed as follows:

The reasonableness or unreasonableness of the rates charged, or to be charged, by a public utility for its service or product is not to be determined by any definite rule or legal formula, and is not measurable with any great degree of exactness, but is a question of fact calling for the exercise of sound discretion, good sense, and a fair, enlightened, and independent judgment. In determining whether a rate is reasonable, each case must rest on its special facts. 73 C.J.S., 1032, Public Utilities, par. 25 a, and cases cited.

What appellant in this case is entitled [\*\*10] to is "just and reasonable" rates which will yield "a fair rate of return" to the appellant upon the reasonable value of the property used or useful in furnishing service. A fair return is one which, under prudent and economical management, *is just and reasonable to both the public and the utility.* From the standpoint of the Company it is important that there be enough revenue not only for operating expenses but also for the capital cost of the business, which includes service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks and sufficient to assure confidence in the financial integrity of the business. *What the public is entitled to demand is that no more be exacted from the rate payers than the services are reasonably worth.* (Emphasis added).

The chancery court on appeal has limited authority. *Mississippi Code Annotated* § 77-3-67 (4), (Supp. 1982), provides in part:

The [Commission's] order shall not be vacated or set aside either in whole or in part, except for errors of law, unless the court finds that the order [\*\*11] of the commission is not supported by substantial evidence, is contrary to the manifest weight of the evidence, is in excess of the statutory authority or jurisdiction of the commission, or violates constitutional rights.

In *Miss. Pub. Serv. Com'n. v. Miss. Power Co.*, 337 So. 2d 936 (Miss. 1976), the legal principles relating to the Commission's authority in establishing rates were set out in some detail as was the authority of the chancery court and this Court on review in rate cases. We followed *Tri-State Transit Co. of La. v. Dixie Greyhound Lines*, 197 Miss. 37, 19 So. 2d 441 (1944), stating: "The sole question presented for decision is whether or not the action of the commission was arbitrary, not supported by substantial evidence or was manifestly against the evidence." 337 So. 2d at 939.

We review this case with these principles in mind.

The first issue presented by the appellants is the propriety of a projected test year used by the Commission in arriving at the rate base for the utility. If its utilization is not supported by substantial evidence then its employment by the Commission was arbitrary.

In approving or rejecting a proposed rate increase [\*\*12] it is necessary for the Commission to have an identified time period in which operating expenses and revenues of the utility can be measured with the greatest accuracy and reliability. The Commission therefore requires<sup>2</sup> the utility proposing a [\*\*614] rate change to submit with its application its expenses and revenues based upon (1) an actual operating statement (historical test year); (2) pro forma operating statement (historical test year adjusted for known changes); and (3) a pro forma operating statement showing estimates of expenses and revenues.

<sup>2</sup> See MPSC Rules and Regulations Governing Public Utility Service, Rule 7, Application to Adjust Rates (1980).

The application for the rate change by MP&L apparently stated the above requisites, however, the Commission did not require and MP&L did not substantiate the reasonableness or worth of the projected test year by substantial evidence in our opinion. Indeed the Commission<sup>3</sup> had considerable doubt concerning its use of the [\*\*13] projected test year stating:

The Company proposes a projected test year for rate base and revenue operating results. Section 5 of the Notice reflects these results for the projected test year ending June 30, 1981. The Commission realizes the difficulty in evaluating the evidence relied upon in the development of a projected test year since, in some instances, it is based on forecasts which do not provide the same level of documentation and potential for review as is available in an historical test year. In this case, however, the Company has developed a pro forma historical year as a further test of the results to be derived from the new rates. These results are contained in Section 4 of the Notice. The Commission's staff witnesses based their analyses on an average historical year rate base compared with actual operating results which were adjusted for known and measurable changes.

The Commission finds that the form of capital structure and the form of rate base consistent with said structure, as recommended by the staff witnesses are appropriate and should be accepted in most instances. However, the Commission further finds that the staff's recommendations where appropriate [\*\*14] should be made applicable to the Company's projected test year results. This is consistent with the principles previously recognized by this Commission and the Mississippi Supreme Court with regard to use of a projected test year. We shall continue to evaluate the appropriateness of utilizing a projected test year in each case. However, current inflationary pressures, the fact that rates are made for the future, and the need to assure that future service requirements are met by the Company, require that in this instance the projected test year be utilized as the basis for application of the staff witnesses' recommendations. This finding is further supported by the fact that the Company furnished results on a pro forma historical year as a further test of its projected year.

<sup>3</sup> Commissioner Havens dissented rejecting the projected test year.

The Commission's reasoning in adopting the projected test year was partially based upon the misplaced notion that this Court has authorized, apparently exclusively, [\*\*15] the use of a projected test year in determining rate base. While it is probably true we have considered rate cases in which a projected test year was utilized, the issue as such has never been previously isolated by an assignment of error for adjudication by this Court. Since this is so, we must review the evidence before the Commission in determining whether it erred in this case. The methodology engaged by the Commission to determine rate base is of course not decided by legal dogma but rather lies within the Commission's authority. The appropriate formula or method for the determination must be selected by the Commission through the exercise of sound discretion and independent judgment in evaluating the evidence of the utility demonstrating such formula's suitability for rate making purposes under the circumstances then existing. *Southern Bell T. & T. Co. v. Miss. Pub. Serv. Com'n.*, 237 Miss. 157, 113 So. 2d 622 (1959); *Federal Power Commission v. Hope*, 320 U.S. 591, 88 L. Ed. 333, 64 S. Ct. 281 (1944); *Bluefield Co. v. Pub. Serv. Com'n.*, [\*615] 262 U.S. 679, 67 L. Ed. 1176, 43 S. Ct. 675 (1923).

As stated the Commission has the authority and necessarily [\*\*16] the duty to employ the formula it thinks best to determine the rate base. However, the utility seeking change has the burden of proof to establish the need for the increase so that it may obtain a reasonable rate of return upon the value of its assets for the services rendered as well as the burden of substantiating its reasonableness to the consumer. *Miss. Pub. Serv. Com'n. v. Miss. Power Co.*, 337 So. 2d 936 (Miss. 1976). We are of the opinion this burden includes substantial evidence that the formula adopted for use in calculating rates is reasonable and best suited for such determination.

In support of the use of the test year witness Lubow testified the projection developed by him was based on an actual forecast of MP&L. He was of the opinion this approach eliminated some problems inherent in using historic periods because the projections are based upon a forecast of normal conditions and do not include out-of-period or abnormal events which always appear in definitive historical periods. He suggested a projected year more closely approximates utility operations as they will exist in the period when the proposed rates become effective. He admitted, however, that projections [\*\*17] based upon forecasts, projections upon projections, are difficult to evaluate or verify because they do not provide the level of documentation and accuracy afforded by the use of a historic period.

Commission witness, Weiss, corroborated the testimony of Lubow in the difficulties encountered in evaluating and verifying the projected test year. He found

virtually every projection and forecast in MP&L's test year difficult, if not impossible, to verify and evaluate. Several requests, all overlooked or ignored, were made of MP&L to furnish schedules indicating how the forecast compared with the actual data for the first quarter of the test year. Although the data was available, the information was not furnished to the Commission until after the close of the hearing. It indicated that MP&L had grossly overestimated its operating expenses for the three months in question. These events provoked comment from Commissioner Havens who stated in dissent:

In my opinion, the use of the historic test year rather than the projected test year is usually far more reliable. . . .

Further, MP&L failed to produce evidence in its direct or rebuttal testimony or by way of exhibit which would [\*\*18] establish a prima facie case for a projected test year.

For these reasons, I feel that MP&L failed to meet the burden of proof required by law and the majority is mistaken in accepting the speculative projected test year and its attendant figures. . . .

It would be difficult for me to believe that MP&L has not carefully examined the results that have occurred since the rate increase became effective. It would be equally difficult for me to believe that MP&L would not have attempted to enter such results in the record if they had substantiated the filing which MP&L made. Since MP&L failed to provide the Commission staff with the requested information on the actual results in the projected test year, I must construe the failure as evidence against the accuracy of the projected test year.

We think the great weight of the evidence supports Commissioner Havens' conclusions. We do not find substantial evidence by MP&L to support the Commission's adoption of the projected test year for rate making purposes. While we do think that MP&L's records could be accepted as prima facie proof for rate making purposes, we do not believe the projected figures, which themselves rest [\*\*19] upon a forecast, are entitled to such recognition. The results are based upon a formula more speculative than others and were substantially eroded by comparison with the results of the first three

months of actual use. The employment of the projected test year under the existing circumstances was, in our [\*616] opinion, arbitrary inasmuch as it was not supported by substantial evidence.

Appellants next contend the Commission's denial of an accelerated amortization of excess accumulated federal tax reserve was contrary to the manifest weight of the evidence and was an error of law.

As a result of the Revenue Act of 1978, which provided the corporate income tax rate commencing with 1979 would decrease from 48% to 46% for taxable income in excess of \$100,000, MP&L has an excess accumulated tax reserve of approximately \$1.8 million. The funds without question are composed of customer contributed capital. This tax reduction has caused the balance to be excessive in that more deferred taxes have accrued in the past than will be needed in the future. Since the funds are no longer needed for payment of taxes the question becomes how the excess should be returned to the ratepayers.

[\*\*20] Staff witness Weiss and Legal Services witness Taubman, testified the reserve maintained by MP&L was excessive and should be returned to the ratepayers whose remittance had created the reserve. Weiss was of the opinion it should be returned over a two year period and Taubman suggested an immediate refund or credit. However, MP&L witness Lubow, testified both suggestions should be rejected.

The testimony of MP&L and its arguments have been substantially rebutted by the Attorney General. Witness Lubow contended that it would be speculative and unrealistic to presume some permanent tax savings as a result of the change in the federal income tax rate. The record refutes this however, as the lowering of the tax rate, first from 52% to 48%, and then to 46% at present demonstrates a downward trend in corporate income taxes. Lubow next argued the adjustment proposed was not permissible under generally accepted accounting principles. However, as stated by the court in *Alabama-Tennessee Natural Gas Co. v. Federal Power Com'n.*, 359 F.2d 318, 336 (5th Cir. 1966), "accounting for tax purposes . . . may be valuable tools, but they cannot dictate ratemaking policies." See also *Public Systems v. Fed. Energy Reg. Com'n.*, 196 U.S. App. D.C. 66, 606 F.2d 973 (D.C. Cir. 1979). Somewhat similarly he contended that a letter from the Federal Power Commission required MP&L to amortize the excess tax reserves at the same rate as the original tax rate. This letter, dated August 20, 1977, was well in advance of the 1979 tax reduction and therefore is of no value in the determination of this issue. Lubow next stated that the adjustment that Weiss suggested had been rejected in several other jurisdictions. Nevertheless, the Attorney General directs

our attention to many other jurisdictions which have adopted such a procedure. It should also be noted that the Commission, in the recent 1981 Mississippi Power Company utility case, adopted this exact procedure for accelerated amortization of excess tax reserves.

Finally, Lubow contended the adjustment would endanger the company's tax benefits for accelerated depreciation in that the Internal Revenue Service could rule this adjustment constituted a flow through of benefits which is prohibited by *Internal Revenue Code § 167(1)*. MP&L did not introduce, nor do we find that the Internal Revenue Service has issued such a letter [\*\*22] ruling even though the accelerated amortization of the excess tax reserves by public service commissions has been regularly occurring since 1979.

In following witness Lubow's reasoning, the Commission stated:

While it is the desire of the Commission to carefully consider any reasonable or proper "flow-through" adjustment which may benefit the rate payer, care must be given to adhere to present tax laws and regulations and the possible effect of any such adjustment on the tax reserves so accumulated.

The rebuttal testimony offered by the Company supports the position that to adopt "flow-through" adjustment recommended by the staff witness could jeopardize the entire Company reserve accumulated for deferred income taxes. Further, such an adjustment has been denied in other jurisdictions and at this time, [\*617] until the issue is finally settled, the Commission is unable to accept this recommendation.

Commissioner Havens, disagreeing with the majority, reasoned the excess funds should be returned as soon as practical so the present customers who were primarily responsible for the reserve accounts would be assured of obtaining at least part of their money in [\*\*23] return. Havens suggested that four years would be an appropriate period in which to amortize the excess funds.

After review of the evidence concerning the issue, we are of the opinion the Commission's order is not supported by substantial evidence. If the excess funds were returned over a twenty year period as the Commission directs, many taxpayers would never receive any return on the excess they have paid. It is appropriate we think that the ratepayers receive the benefit of this overaccrual

since they provided the deferred taxes in paying for the utilities' services. We are of the opinion this issue should be remanded to the Commission for a determination of the appropriate method and time by which the excess will be returned to the ratepayers who contributed to the excess reserve.

Appellants next contend the Commission erred in permitting MP&L to reclassify charitable donations as an operating expense of the utility for rate making purposes.

In allowing MP&L to reclassify \$284,000 in donations as an operating expense, the Commission relied upon *United Gas Corp. v. Miss. Pub. Serv. Com'n.*, 240 Miss. 405, 127 So. 2d 404 (1961), in which we held reasonable donations could [\*\*24] be considered proper operating expenses. The Commission admits *United Gas Corp.* should perhaps be reexamined during this age of soaring costs.

Upon reconsideration we are of the opinion this item can no longer be justified as a proper operating expense of a utility. In *United Gas Corp.*, the Commission excluded donations totaling \$2,707 in 1957 and \$1,136 in 1958. Obviously circumstances have drastically changed since 1961 when the cost of utility service was relatively inexpensive and moreover, the argument was not then advanced that the donations of a utility might include charities, or other recipients, not satisfactory to the ratepayers. We are cognizant of the importance of such contributions to the donees and the public relation benefits that result to the utility from such but, nevertheless think in the present economy future customers should not be burdened with this cost, however small.

We are of the opinion the Commission did not err in this case by relying on *United Gas Corp.* because it authorizes such. However, we opine further that such contributions should not be considered an essential cost of conducting the business of a public utility in other cases [\*\*25] in the future.

Appellants contend the Commission erred in not excluding consolidated tax savings from MP&L's operating expenses. The question is whether the Commission, in determining just and reasonable rates for MP&L, made a proper adjustment for federal income taxes in calculating the Company's cost of service.

The record reveals in the years 1978 and 1979 MP&L realized \$3.2 million in federal income tax savings by filing a consolidated tax return with its parent and sister companies. Staff witness Weiss recommended a reduction in the historical test year submitted of operating expenses of \$3.2 million. MP&L contended the savings resulted from the issuance of short term debt by the parent company from which MP&L had received no capital contribution and therefore no reduction should be

made. Weiss rebutted this contention, testifying although MP&L received no capital contribution, the issuance of such debt was a regular procedure and did not change the fact that MP&L had received an allocation of the tax savings. MP&L conceded its savings had averaged over \$1.5 million for each of the six years prior to 1979.

The Commission's order did not address this contested issue. [\*\*26] It seems the Commission, [\*618] by adopting MP&L's projected test year which did not include the tax savings, gave no consideration to the benefits flowing from the consolidated return. MP&L's tax expense was thereby computed on the basis of a projected separately filed return which was in fact never actually filed.

We therefore are of the opinion the Commission erred in allowing MP&L to claim tax expenses based upon a hypothetical federal income tax liability calculated for a separate return. We suggest to the Commission in ruling on this issue the reasoning in *City of Muncie v. Pub. Serv. Com'n.*, 177 Ind. App. 155, 378 N.E.2d 896, 898-99 (1978), wherein the Indiana Court held:

The Commission cannot arbitrarily allow a tax expense computed on the basis of a separate tax return when such a return was not actually filed. This does not mean that the expenses and revenues of affiliated companies must be attributed to Petitioner for rate-making purposes. Rather, it means that some determination must be made as to the tax savings accruing to *Petitioner* as a result of its participation in the filing of a consolidated federal income tax return. In this manner, a [\*\*27] more accurate computation of *Petitioner's* actual federal income tax liability can be made.

We feel that by automatically assuming a tax rate of 48%, without any determination of the effective tax rate, and without any determination of the properly allowable income tax expense, the Commission is allowing an additional, hidden return on capital to the shareholders at the expense of the rate-payer. Furthermore, our research indicates that at least thirteen other jurisdictions have reached the same conclusion on this issue. n1 (Footnote omitted).

It is our opinion the Commission erred in permitting a hypothetical tax expense to be included in the operating expenses of the utility when the evidence reveals MP&L's participation in the consolidated tax return inexorably reduced its income tax liability. Upon remand, we think the Commission should make some determination of such tax saving and proportionately reduce its operating expenses by this amount.

Appellants complain that the Commission erred in granting MP&L comprehensive inter-period tax allocation not required by federal statute or regulation.

It is conceded that normalization of tax savings arises as a possibility [\*\*28] when a utility experiences tax benefits generated by timing differences between the accounting method used for tax purposes and the method used for rate making purposes. The Commission allowed MP&L, who was already normalizing the tax savings resulting from the use of accelerated depreciation as required by federal law, to extend its tax normalization to include tax provisions associated with injury and damage reserve, debt portions of allowance for funds used during construction income, capitalized taxes, donations and costs of removal.

Staff witness Weiss and Legal Services' witness Taubman urged the Commission to utilize "flow through" of tax benefits contending "normalization" created a hypothetical tax expense to be incurred by present ratepayers. MP&L offered substantial evidence to the effect that such allocation was required under the Federal Energy Regulatory Commission Uniform System of Accounts and further:

Absent comprehensive interperiod tax allocation, utility service is priced below its actual cost. Subsidies are thus created for current ratepayers at the expense of future customers.

... Tax normalization treatment is an integral component of proper [\*\*29] utility ratemaking in that it achieves the equitable distribution of costs over the life of an asset and provides proper price signals in the consumption of electric energy.

As noted by the Attorney General, MP&L, and the Commission, there appears to be reasons both for and against the use of "normalization" versus "flow-through."

The record establishes that there was presented to the Commission a choice [\*\*619] of policy as to which method to employ. The method chosen (normalization) appears to be in accord with the practice of a number of

other regulatory agencies. Under the accepted principles of judicial review, we cannot say that the determination of the Commission in regard to this issue was unreasonable nor arbitrary, but rather was supported by substantial evidence.

The Commission's refusal to deduct customer deposits and advances from MP&L's rate base for the projected test year in the amount of \$9,809,000 is urged by appellants as an error of law.

Appellants contend that since these funds are not supplied by the utilities' investors, MP&L should not be allowed to earn a return on them. The Attorney General contends the expenses associated with customer [\*\*30] deposits and advances (i.e., interest) should properly be classified as an operating expense and thus deducted from the rate base. Weiss testified it was his understanding that interest expense for customer deposits is charged as an operating expense (above-the-line accounting entry). However, MP&L asserts interest on customer deposits is in fact charged as an expense to shareholders (below-the-line accounting entry) not to customers. Since they are not cost-free items, MP&L argues the Commission acted correctly in not deducting an amount equal to customer deposits and advances from the rate base. We agree.

In *Miss. Pub. Serv. Com'n. v. Miss. Power Co.*, 366 So. 2d 656, 661 (Miss. 1979), we held:

The Commission omitted from the rate base it established, if otherwise correct, customer deposits which have been held by us to be a part of the debt of a public service corporation. (citation omitted) These should be included in the rate base anticipated on this remand.

See *Miss. Pub. Serv. Com'n. v. Miss. Valley Gas Co.*, 327 So. 2d 296 (Miss. 1976).

We are of the opinion, that in line with the above cited cases the Commission was correct in not excluding these [\*\*31] items from MP&L's rate base. The Commission's refusal to deduct an amount equal to customer deposits and advancements from the rate base is supported by substantial evidence and does not constitute an error of law.

Appellants next contend the Commission erred in allowing the entire amount of MP&L's investment tax credits to be added to the company's rate base.

The investment tax credit, originally introduced in the Revenue Act of 1962, permits an eligible utility to receive a "tax credit" of a specified percentage of the cost of the utility's investment in certain new qualified capital investments against the utility's current income tax liability. This Act, which did not expressly specify rate making treatment of the tax credit by state or federal regulatory commissions was amended in 1962 by expressly prohibiting federal regulatory agencies from using the tax credit to reduce federal income taxes as a component of cost of service, but applied no such bar to state regulatory commissions. Therefore, between 1962 and 1969, when the investment tax credit was terminated, state regulatory commissions were free to decide the appropriate treatment of tax savings resulting from the [\*\*32] investment tax credits.

In 1971 the investment tax credit was reinstated as the Job Development Investment Credit. The Revenue Act of 1971 restricted a utility from sharing the benefit of the tax credit and indirectly restricted the authority of the state regulatory commission to share the benefits of the credit with its consumers.

It is not contended that the post-1971 tax credit should have been deducted from MP&L's rate base, rather appellants argue that pre-1971 tax credits should have been deducted.

The Commission urges that the determination of whether to deduct pre-1971 investment tax credits from the rate base lies within their discretion and that they exercised such when they ordered "accumulated deferred investment tax credit will not be deducted from rate base based on certain interpretations of current income tax laws and regulations."

[\*620] As stated in *Miss. Pub. Serv. Com'n. v. Miss. Valley Gas Co.*, 327 So. 2d 296, 297 (Miss. 1976),

It is true that on appeal the findings of the public service commission are considered prima facie correct and the appellate court will not substitute its judgment for that of the commission, provided substantial [\*\*33] evidence exists to support its findings or its findings are not manifestly against the weight of the evidence.

We must therefore examine the evidence for a proper determination of this issue.

Weiss, testified that a "certain portion" of accumulated deferred investment tax credits which he later identified as pre-1971 tax credits should be excluded from

the rate base as customer-contributed capital under the "prudent investment theory." On cross-examination it became apparent that he had included post-1971 job development investment tax credit along with pre-1971 credit in the amount to be deducted from the rate base in that category for a total of \$17,120,450. Weiss then recommended this figure should be reduced by any amount representing post-1971 job development investment tax credit and stated that although he did not know how much was post-1971, if MP&L would provide the amount, he would make the proper adjustment. This information was not furnished so Weiss estimated the 13 month average pre-1971 investment tax credit and deducted \$2,602,447 rather than \$17,120,450.

No evidence was introduced to indicate that such a deduction was forbidden by the income tax laws. [\*\*34] We are of the opinion that because the Commission denied the pre-1971 investment tax credit deduction based upon "interpretations of income tax laws and regulations" and the testimony does not reflect that income tax laws forbid such a deduction, the Commission's finding was not supported by substantial evidence. We therefore reverse and remand this issue for a determination of whether pre-1971 credit can properly be included in the rate base.

Appellants next assert the Commission erred in permitting plant held for future use to comprise a part of MP&L's rate base.

The Commission included \$3,150,000 for plant held for future use in MP&L's rate base stating that "because this Commission has in the past gone on record in recommending the acquisition and development of such plant, we approve its inclusion."

In *South Hinds Water Company v. Mississippi Public Service Commission*, 422 So. 2d 275, 283 (Miss. 1982), we noted that "[a] public utility company is entitled to a fair return only upon the value of such of its property as is useful and being used in service for the customers' benefit," and found, "if the property will be employed within a reasonable time, and if the [\*\*35] utility's management can show a definite plan as to how the property will be employed for public service, then the property's value may be included in the rate base."

The only evidence presented to justify its inclusion in this case consisted of a schedule of three sites for future generating stations listing only their location and monetary amount and testimony to the ill effects on the investors if this rate base request was denied.

We are of the opinion that because MP&L failed to produce evidence of how and when the property would be employed, as was the case in *South Hinds Water Company*, the Commission erred in allowing the inclu-

sion of plant held for future use in the rate base. <sup>4</sup> This is not to say that on remand, under proper proof, that this item cannot be approved.

4 In *South Hinds Water Company*, we held: "The land in question was a couple of vacant lots in south Jackson, and there was no evidence produced as to when the land would be placed into public service, nor was there any precise indication of a proposed use. In the absence of such evidence, it was proper to exclude the value of the land from the rate base total." Slip op. at 11-12.

[\*\*36] Appellants contend the Commission erred in excluding long term debt interest and [\*621] preferred stock dividends from funds available to offset MP&L's cash working capital requirements.

Wilson, testifying for the Commission, expressed his opinion that long term debt interest and preferred stock dividends should be included in the calculation of cash working capital, but MP&L disagreed, explaining as follows:

As part of the regulatory process this Commission will determine a rate of return which compensates the Company's investors for the use of their capital. This return as earned becomes available to investors who have discretionary control over the use of such funds. That is, the Company's earnings may be used to pay dividends, to reduce debt, or to reinvest in utility construction projects. Because these earnings are associated with investor capital, interest expense and preferred stock dividends are recorded by the Company on a so called below the line basis for accounting and rate making purposes. Therefore, these components of non-operating income should necessarily be excluded from the determination of utility cash working capital.

The Commission [\*\*37] accepted the staff's utilization of a lead and lag study to support its cash working capital requirement but adjusted it, with other adjustments, to exclude long term debt interest and preferred stock dividends as expense items.

The chancery court found the adjustments made by the Commission to be "amply supported by the evidence in the record," and further held,

The matter of the exclusion by the Commission of the long term debt interest and payment of stock dividends from the lead and lag study was a judgment call by the Commission and left the cash working capital well within the formula approved by FERC which would have provided for the higher amount that the company had asked for. No error here by the Commission.

We are of the opinion the order of the Commission should be affirmed as to the exclusion of long term debt interest and preferred stock dividends from cash working capital under the following rationale:

Interest on long-term debt is not a cost-of-service expense but rather a below-the-line item that must be paid out of corporate earnings. As such the funds in these accounts constitute corporate funds which belong unconditionally to the [\*\*38] pipeline and the stockholders and, thus, Florida Gas cannot be required to utilize them, without remuneration, as working capital for the benefit of the consumers. These accruals differ markedly from such items as prepaid purchased gas or accrued federal income taxes which are paid by the consumer as part of the rates for the sole purpose of meeting those expenses. Re *Florida Gas Transmission Co.*, 93 P.U.R.3d 477, 489 (Fed. Power Com'n. 1972).

The Attorney General assigns as error the Commission's rejection of the unbiased testimony of staff witness Weiss in favor of the alleged biased testimony of MP&L witness Lubow. It is contended the Commission had a legal obligation to adopt the findings of its expert witness in that Weiss' position was analagous to a master at equity. We are of the opinion this argument is without merit.

In *Southern Bell T. & T. Co. v. Miss. Pub. Serv. Com'n.*, 237 Miss. 157, 228-29, 113 So. 2d 622, 649 (1959), this Court stated:

The Commission is the tryer of facts in a rate case; and in its consideration of the various elements that are generally considered in determining the rate base, it is

within the province of the Commission [\*\*39] to determine the weight to be given to the evidence, the reliability of the estimates and opinions, and the credibility of the witnesses. There is nothing in the law that compels the Commission to accept the opinion evidence of the Company's employees as proof of the reasonable value of the Company's property for rate-making purposes, if, in the opinion of the Commission, that evidence is conjectural, unrealistic and unreliable.

*See also Miss. Pub. Serv. Com'n. v. Miss. Power Co., 337 So. 2d 936 (Miss. 1976).*

[\*622] The same rationale would hold true for an expert that the Commission hired to help evaluate the need for a rate increase. Since the Commission is the sole judge of the credibility of the witnesses they were free to accept and/or reject recommendations of any of the witnesses, including Weiss. We therefore affirm on this assignment.

Appellants next assert the Commission erred in approving the acquisition adjustment<sup>5</sup> to operating expenses of the purchase of Capital Electric Power Association by MP&L.

5 In 1 A. Priest, *Principles of Public Utility Regulation* 75-76 (1969), an example of acquisition adjustment is given:

There is a sharp conflict over the propriety of amortizing, out of operating expenses, the difference between the *bona fide*, arm's length purchase price of utility property and the "original cost" of that property, *i.e.*, its cost to the person who first devoted it to public use. Company A, engaged in an expansion program approved by the regulatory agencies which supervise it, believes that the public interest will be served if it acquires the properties of Company B. But B is not required to sell and A cannot condemn its facilities. After hard, strenuous trading, A agrees to buy and B to sell at a price \$300,000 in excess of B's original cost. That excess or difference is an "Acquisition Adjustment."

[\*\*40] The Commission allowed an adjustment of \$3,631,992 to be amortized at the rate of \$181,000 per year for the 20 years remaining life of the facility. Appellants contend there was no proof offered by MP&L to justify either the price in excess of the book value paid or

that the plant and physical assets of Capital Electric Power Association would benefit all MP&L customers. Lubow, testifying for MP&L, stated:

While this amount has not been included as part of utility rate base, the recovery of such costs through customer rates over its service life is a properly includible electric operating expense as the acquisition was made for the benefit of all customers served by the Company both before and after the acquisition of the additional territorial area.

An exhibit to his testimony indicated that the original cost of the property was \$11,345,776 and deducted therefrom the accumulated depreciation and contribution in aid of construction leaving the original cost less depreciation of \$7,533,506. Therefore, the acquisition adjustment above the cost of the property is \$3,631,992.

Witness Weiss, unaware the Commission had previously approved the acquisition by MP&L, [\*\*41] thought for rate making purposes, payment in excess of the book value of the plant was not a prudent investment. Therefore, he contended the acquisition adjustment should not have been allowed.

Our research reveals that public utilities amortization of acquisition adjustment is a proper component of cost of service and should be included as a proper operating expense when proven by the utility to be beneficial. We are cognizant of the fact that two witnesses had diametrically opposed views on this issue. Weiss argued such a purchase was not prudent in the context of rate-making purposes and Lubow contended the acquisition of the plant and its physical assets was for the benefit of all MP&L customers. We cannot say that the Commission, being responsible for authorizing such purchases by utilities as the one above, erred in this determination.

Appellants next contend the Commission's denial of the accelerated amortization of the excess depreciation reserve maintained by MP&L was error.<sup>6</sup>

6 This excess differs from the excess accumulated federal tax reserve discussed previously in that the depreciation reserve is set aside for the depreciation of assets of the Company. When the tax rate was reduced, this resulted in an overfunding of the accumulated depreciation reserve.

[\*\*42] One of the recommendations made to the Commission by Weiss was that they order the accelerated amortization of an excess depreciation reserve maintained by MP&L. Weiss stated:

Theoretical reserve studies were performed on the Company's plant-in-service as of December 31, 1974 and December 31, 1978. These studies reveal the presence [\*623] of excess depreciation reserves in the amounts of \$7,799,000 and \$20,945,000, respectively. This means that as of December, 1978, the Company has collected almost \$21,000,000 in excess depreciation expenses from its customers. This \$21 million represents a capital contribution made by the customers and for which the Company pays no interest expense. There is no basis upon which the Company should be permitted to continue using these funds.

Weiss recommended these funds be returned to the rate-payers over the anticipated two year life of the rates resulting from this proceeding.

Production	-0-
Transmission	147,000
Distribution	547,000
General	103,000
	797,000

In rebuttal, Soper (the project manager of Ebasco in charge of the studies which identified the amount of the MP&L depreciation reserves) testified that the remaining life method of amortization of the excess depreciation was generally accepted by most regulatory bodies. Soper testified that procedures used for rate-making purposes should be as close as possible to the utility's normal accounting procedures and by varying such, abnormalities in the projected test year might result. Lubow also opined the adjustments made by Weiss were in direct conflict with generally accepted accounting [\*\*44] principles.

The Commission concluded the two year depreciation proposed by Weiss did not follow basic depreciation methods. They were also of the opinion Weiss erred in not considering the production plant depreciation along with transmission, distributing and general plant distribution.

Commissioner Havens discussed what he decided should be done about the depreciation reserve in his dissent stating:

Weiss testified he received his information from annual MP&L reports to the Federal Energy Regulatory Commission which Legal Services now contends would have to be considered conclusive evidence of the facts which MP&L put in the report. The [\*\*43] report which Weiss relied upon states:

In the year 1979 a study was made by Ebasco Services, Inc. of the Company's depreciable electric plant in service as of December 31, 1978. The study indicated the Company's Reserve for Depreciation is in excess of reserve requirements at December 31, 1978 in the amount of \$20,945,230. The Company has elected to amortize this excess over the remaining life of each functional group, reducing the annual depreciation for each function as follows:

The Commission heard extensive testimony from both the staff and the Company as to the treatment of the \$20.9 million which had accumulated as excess depreciation reserve and the excess amount in the deferred tax reserve, and I am of the opinion that these excess reserve amounts should be returned to ratepayers in a time frame which is between that suggested by the staff and Company witnesses. The Company recommended that these amounts be amortized over the remaining life of the asset, and the Commission witness Weiss recommended amortization over a two-year period.

As mentioned previously in this Dissent, it is my belief that each of these excess reserves should be returned to the ratepayers as soon as possible. A four-year period of amortization of the excess reserves [\*\*45] would be equitable to the ratepayers and also to the Company and is, I feel, a reasonable compromise of the

two positions. These adjustments have the effect of reducing the net income received by the Company to \$25,566,436.

It is clear several different views were expressed as to how and when this excess reserve should be returned to MP&L customers. However, we are of the opinion the Commission's order is not supported by substantial evidence. The rationale on this issue is the same as we expressed in regard to the accelerated amortization of the excess accumulated federal tax reserve. We agree with Commissioner Havens that the excess should be returned as soon as [\*624] reasonably possible to the ratepayers and therefore, we remand to the Commission for a determination of an appropriate time frame in which the excess should be returned. Rates of a utility, in our opinion, may be predicated only upon such operating expenses supported by substantial evidence as are actual and necessary. This necessitates consideration by the Commission of this issue on remand.

Appellants assert the Commission erred in permitting the amortization of the DeSoto County plant site [\*\*46] environmental impact study in arriving at the net utility operating income figure of \$23,095,000 for the projected test year.

The record indicates this study was done pursuant to an order of the Commission in 1977. It requested MP&L to begin immediate plans for at least one new coal fired electric generating facility to be built due to the unusual weather conditions in Mississippi which were causing a demand for increased electricity at an unprecedented rate.

MP&L offered proof that the study resulted in a determination the plant would not be needed until at least the early 90's. Although the plans to construct the new plant have not been abandoned entirely, it is now of insignificant value. Lubow testified the cost of the study was \$1,717,325 and requested that MP&L be allowed to amortize it over two years as a cost of service. The Commission's order held:

The amortization of the DeSoto County plant site environmental impact study is supported by the weight of the testimony, but consideration will be given this matter at the time the DeSoto County plant is constructed.

Commissioner Havens, in his dissent, agreed the Company should be allowed to amortize [\*\*47] the cost

but concluded MP&L did not support the amortization by the weight of the evidence.

Appellants first argue the Commission's order was inconsistent in that it appears they intended not to amortize this amount through the income statement but rather treat it as construction work in progress. The Commission asserts that although the language of their order is not clear they did not intend to include the adjustment which is clearly shown by their adoption of MP&L's figure of \$23,095,000. The Commission now contends what they meant by their order ("but consideration will be given this matter at the time the DeSoto County plant is constructed") was that an adjustment will be made as to plant cost by a decrease in cost to reflect the adjustment made at the present time. Therefore, this argument is without merit.

As to the amortization not being supported by substantial evidence, as contended by appellants and Commissioner Havens, we note all three Commissioners agreed that the cost of the study should be amortized. Since the evidence discloses MP&L's capacities do not require a new plant to be built at this time, it would be unreasonable and unjust to penalize the Company by [\*\*48] not allowing them to recoup the costs of a project the Commission ordered to be conducted. We are therefore of the opinion the Commission should be affirmed as to this issue.

Legal Services urges two additional assignments of error. First, it is asserted the order of the Commission adopting the approved rate increase was unjust, unreasonable and discriminatory in that it resulted in a disproportionate impact on the impoverished ratepayers of MP&L.

Legal Services argues that Mississippi has the lowest income per capita in the United States, and if MP&L gets the rate increase requested, it would put their rates in the top 25% of the nation. Witness after witness testified concerning how the rate increase would impact upon the poor and the elderly.

Like all the other questions presented by this appeal, this issue cannot be decided in total isolation. The customers' ability to pay is a factor that must be considered in determining the reasonableness of the increase rate which is ultimately granted by the Commission. The Commission addressed this issue stating:

[\*625] In addition to the above mentioned evidence, this Commission heard meaningful and sobering testimony [\*\*49] from public witnesses on fixed incomes, senior citizens, others identified as being below the poverty line, and representatives of such persons. The impact of

any increase in the cost of electric service on such persons was given serious consideration by this Commission.

take into account the nature of the use, the quantity and quality used, the time when used, the purpose for which used, and any other reasonable consideration.

In *Southern Bell T. & T. Co. v. Miss. Pub. Serv. Com'n.*, 237 Miss. 157, 113 So. 2d 622, we held a public utility is entitled to a fair return measured by a consideration of what is just and reasonable to both the public and the utility.<sup>7</sup> Although we recognize that the customer's ability to pay is a vital factor to be considered by the Commission in setting rates for a utility, we agree with MP&L's argument and the Commission's finding that it is a factor to be considered with other facts and is not paramount nor controlling. *Telluride Power Co. v. Public Utilities Com'n.*, 8 F. Supp. 341 (D.C. Utah, 1934). The record reveals the Commission heard extensive testimony from public witnesses and the Commission's order clearly indicates such factors were given serious consideration. Therefore, we hold the Commission's order was not unjust, unreasonable nor discriminatory in this regard.

<sup>7</sup> *Miss. Code Ann. § 77-3-33 (1)* (1972), states:

No rate made, deposit or service charge demanded or received by any public utility shall exceed that which is just and reasonable. Such public utility, the rates of which are subject to regulation under the provisions of this article, may demand, collect and receive fair, just and reasonable rates for the services rendered or to be rendered by it to any person. Rates prescribed by the commission shall be such as to yield a fair rate of return to the utility furnishing service, upon the reasonable value of the property of the utility used or useful in furnishing service.

[\*\*50] Second, Legal Services contends the Commission's approval of three classes of residential consumers in the rate charged by MP&L is error.

In following its past pattern, MP&L classified residential consumers into three classes: regular residential, electric water heating and total electric. These rates, which reflect a summer/winter differential proportionately applicable to each class, result in cheaper rates for usage by the total electric consumer, which Legal Services submits is unlawful.

*Miss. Code Ann. § 77-3-33* (1972), states in part:

(3) Such utility may employ in the conduct of its business suitable and reasonable classifications of its service, patrons, rates, deposits and service charges. The classification may, in any proper case,

From this we note that classification of consumer rates is not discriminatory per se. The question seems to be whether the rate charged by MP&L to the three classes of residential consumers comports with the standard of reasonableness required by statute.

Schimpf, [\*\*51] Director of Rates for MP&L, testified why MP&L classified consumers into three categories and why rates for a total electric consumer are less expensive:

Normally a total electric home can be served by MP&L with no additional investment cost. Facilities are sized and built to serve air conditioning for summer peak loads. Any additional margin that the company receives during the off season or the winter period is margin that would otherwise not have been produced were the customer not total electric. Now since this margin goes to satisfy a portion of the revenue requirements of the company it represents revenue that will not have to come from other customers. In this way all customers of the company receive a benefit from the winter season sales that are made to total electric customers. And the overall level of rates is reduced from what it would have been. The same is true of electric water heating customers. Since water heaters use more energy in the off peak, or winter season, in the same way as [\*\*626] electric heating customers, total electric rate is certainly not discriminatory. It is available to any customer who requests service and has the required appliances.

[\*\*52]

In addressing this issue, the Commission's order stated:

The Commission finds that the Company is moving toward straight rates for residential service. The Commission feels strongly, and the evidence at the hearing supports the conclusion, that flat rates are desirable, especially for senior citizens

and low income consumers of this state, which groups are primarily low usage customers. For this reason, the Company should give serious consideration to a rate structure involving straight or flat rates on residential rate schedules as soon as possible.

Within the next several months, this Commission intends to hold generic hearings on structure and design of rates, and pending these hearings and the conclusions drawn therein, the Commission will approve the rate design proposed by the Company in its Notice, but with the understanding that such approval is of a temporary nature.

Although conceding they have not gone far enough, the Commission found, and we agree, that the classification proposed by MP&L is reasonable in that it is based upon the type and quality of service furnished, i.e., totally electric customers usually receive a larger quantity and [\*\*53] the cost of such service is less expensive because of the greater quantity used. Although we think the Commission should continue to consider straight or flat rates for residential consumers we cannot say, from the evidence, that their action in approving the continuance of these classifications was unreasonable, arbitrary or capricious.

MP&L assigns as error the Commission's failure to allow construction work in progress (CWIP) in the amount of \$19,412,000 in the rate base.

Two major factors were advanced by MP&L for inclusion of CWIP in the rate base: (1) during the projected test year \$27,478,000 in CWIP will become completed and (2) all the CWIP proposed will become used or useful during the projected test year. MP&L offered evidence that the customer benefits from such because a sustained construction program assures each customer of continued reliable electric service and future rate base depreciation and tax cost will be lowered.

This issue was addressed in *United Gas Corp. v. Miss. Pub. Serv. Com'n.*, 240 Miss. 405, 426, 127 So. 2d 404, 412 (1961), wherein this Court stated:

When the work is completed and the plant is put into service, its entire cost, including [\*\*54] interest, taxes and other overhead, is capitalized. Hence the Commission concluded, correctly we think, that the company could suffer no injustice by the exclusion of such con-

struction from the rate base. It also noted that a substantial portion of the construction work was designed for new customers, and, if the item were placed in the rate base, the additional revenue produced should be considered; otherwise existing customers would have to pay a return on property construction for future customers. United offered no evidence as to its anticipated revenues from this construction. The exclusion of this item from the rate base is well established. *Mississippi Southern Bell Case, supra*, 237 Miss. at 208-210, 236, 113 So.2d 622; *Ark. Power and Light Co. v. Ark. Public Serv. Comm.*, 226 Ark. 225, 289 S.W.2d 668, 14 P.U.R.3d 38 (1956).

We are of the opinion the Commission did not err in excluding CWIP from the proposed rate base. As MP&L contends it would lower future rate base depreciation and tax costs which would benefit future customers as opposed to existing customers. It must also be noted that although MP&L presented evidence as to what percentage of the [\*\*55] CWIP would be "used or useful" during the test year, they did not show what percentage would be used or useful during any given time during the test year. Therefore, the Commission found the inclusion of these projects would [\*\*627] not reflect the actual expenditures, and it appears to us this was correct. Had MP&L proven what percentage would go "on-line" during what particular months of the year, and made the appropriate adjustments, the Commission's order seems to indicate this amount could properly have been included. We are of the opinion that since MP&L did not meet its burden of proof concerning this issue, the Commission was correct in denying its inclusion in the rate base.

MP&L contends the Commission erred in not accepting Dunn's testimony that MP&L's cost of equity is 18%, and in not applying that figure to Dr. Legler's capital structure, which was used by the Commission and is accepted by MP&L.

The Commission's order recites:

This Commission has evaluated the testimony of Mr. Dunn and finds that it cannot accept a cost of capital which is based on a cost of equity at 18%. When considered in the light of the other testimony introduced in this cause, the [\*\*56] comparable returns generated by the electric utility industry are not at the 18% return on

common equity as contained in Mr. Dunn's testimony. The Commission finds that there are certain subjective judgments contained in the analyses of Mr. Dunn which result in a cost of equity in excess of that which is realistic based on current conditions. . . .

On the other hand, the staff witness, Dr. John B. Legler, presented thorough and comprehensive testimony with regard to an appropriate capital structure for the Company and a cost of equity for his conclusion on the Company's cost of capital. Dr. Legler agrees with Mr. Dunn that the cost of equity to utilities has risen during the last several years but does not agree that it is as high as the Company's witness suggests. Dr. Legler used two methods to estimate the cost of equity capital: (1) applications of finance theory, and (2) allowed and earned returns comparison. The applications of finance theory considered are the bond yield plus risk premium method, and the dividend yield plus growth (DCF) method. First, Dr. Legler developed cost rates for the capital components of debt, preferred stock, and common equity. He then developed [\*\*57] an appropriate capital structure and lastly developed the overall cost of capital by applying the component cost rates to his adopted capital structure. The Commission finds that the capital structure recommended by the staff witness Legler to be more appropriate to develop an overall cost of capital for the Company

.....

Although the increase in revenues which is allowed to the Company in this order of \$48,277,442 is substantially lower than that sought by the Company, the Commission finds that the substantial evidence in this record supports a conclusion that these additional revenues will produce a rate of return sufficient to enable the Company to attract capital, to maintain its financial integrity, to cover its increased cost and provide for future adequate and dependable electric service to its customers and service areas. Further, the aforesaid level of revenues will permit the Company to maintain its coverages for the issuance of additional capital to provide adequate and dependable electric service.

After careful review we find this determination by the Commission is supported by substantial evidence, is not contrary to the manifest weight of the evidence [\*\*58] and is not in excess of statutory authority of the Commission. Therefore, the Commission's determination to reject a cost of equity of 18% is affirmed.

THE OPINION OF THE CHANCERY COURT ON APPEAL IS AFFIRMED IN PART AND REVERSED IN PART AND REMANDED TO THE PUBLIC SERVICE COMMISSION FOR APPROPRIATE PROCEEDINGS NOT INCONSISTENT WITH THIS OPINION.

WALKER, and BROOM, P.J.; and ROY NOBLE LEE, BOWLING, HAWKINS, DAN M. LEE, PRATHER AND ROBERTSON, JJ., CONCUR.

117 R.I. @414

Westlaw.

368 A.2d 1194

20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194

(Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

Page 1

**C**

Supreme Court of Rhode Island.  
NARRAGANSETT ELECTRIC CO.

v.

William W. HARSCH et al.  
No. 75-218-M.P.

Jan. 13, 1977.

Electric company brought petition for certiorari seeking review of report and order of the Public Utilities Commission in a rate proceeding instituted by the company. The Supreme Court, Paolino, J., held, inter alia, that the services of the Attorney General were properly available to the division of public utilities and carriers rather than the Commission, and the division rather than the Commission was a proper party to the petition, but that formal errors with respect thereto had no effect on the rights of the parties; that no abuse of discretion was shown with respect to disallowing claim for cash working capital, allocation of additional tax depreciation between interstate and intrastate accounts, and inclusion of posttest year interest expense in computing federal income tax requirement; but that reconsideration was required with respect to normalization of tax benefits, attrition allowance, and rate of return; and that the Commission could not properly rely on ability of consumers to pay for services in setting the cost of equity.

Petition denied in part and sustained in part and records returned to the Commission.

West Headnotes

**[1] Statutes 361 ↪ 184**

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k180 Intention of Legislature

361k184 k. Policy and Purpose of Act.

Most Cited Cases

**Statutes 361 ↪ 190**

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k187 Meaning of Language

361k190 k. Existence of Ambiguity. Most

Cited Cases

(Formerly 361k205)

**Statutes 361 ↪ 206**

361 Statutes

361VI Construction and Operation

361VI(A) General Rules of Construction

361k204 Statute as a Whole, and Intrinsic

Aids to Construction

361k206 k. Giving Effect to Entire Statute.

Most Cited Cases

(Formerly 361k205)

Where statute is not entirely clear, court must attempt to ascertain the legislative intention from a consideration of the legislation in its entirety, viewing the language used therein in the light of the nature and purpose of the enactment.

**[2] Public Utilities 317A ↪ 120**

317A Public Utilities

317AII Regulation

317Ak119 Regulation of Charges

317Ak120 k. Nature and Extent in General.

Most Cited Cases

(Formerly 317Ak7.1)

The General Assembly intended by 1969 enactment to segregate the judicial and administrative attributes of rate-making and utilities regulation and to vest them separately and respectively in the Public Utilities Commission and the division of public utilities and carriers or the administrator thereof. Gen.Laws 1956, §§ 39-1-1 et seq., 39-1-3, 39-1-7, 39-1-11 to 39-1-13, 39-1-32, 39-4-2; Rules of Civil Procedure, rule 16.

**[3] Public Utilities 317A ↪ 163**

317A Public Utilities

317AIII Public Service Commissions or Boards

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

317AIII(B) Proceedings Before Commissions

317Ak163 k. Parties. Most Cited Cases

(Formerly 317Ak13)

The division of public utilities and carriers, in addition to its broad regulatory powers, is to appear on behalf of the public to present evidence and make arguments in rate cases before the Public Utilities Commission, despite contention that the consumers' council is the only qualified party in interest representing the public sector; participation of the council is discretionary. Gen.Laws 1956, §§ 39-1-1, 39-1-11, 39-1-17, 39-5-1, 42-42-5.

**[4] Attorney General 46 ↪6**

46 Attorney General

46k5 Powers and Duties

46k6 k. In General. Most Cited Cases

The Attorney General or his designee is required, in most instances, to represent the division of public utilities and carriers in its role as party before the Public Utilities Commission, though the division may retain legal counsel of its own within the strictures of statute, freeing the Attorney General to intervene, when necessary, on behalf of the state or its citizens as customers of a utility company. Gen.Laws 1956, §§ 39-1-19, 39-1-20.

**[5] Public Utilities 317A ↪141**

317A Public Utilities

317AIII Public Service Commissions or Boards

317AIII(A) In General

317Ak141 k. Nature and Status. Most Cited

Cases

(Formerly 317Ak1)

The Public Utilities Commission is required to determine and adjudicate matters before it as an impartial and independent quasi-judicial tribunal. Gen.Laws 1956, §§ 39-1-3, 39-1-11.

**[6] Attorney General 46 ↪6**

46 Attorney General

46k5 Powers and Duties

46k6 k. In General. Most Cited Cases

**Electricity 145 ↪11.3(7)**

145 Electricity

145k11.3 Regulation of Charges

145k11.3(7) k. Judicial Review and Enforcement.

Most Cited Cases

(Formerly 145k1.3(7))

In electric rate case, proper role of the Attorney General was to represent the division of public utilities and carriers, not the Public Utilities Commission, but fact that the Attorney General's brief on certiorari seeking review of Commission's report and order was submitted on behalf of the Commission rather than the division was only a formal error which was not ground for reversal. Gen.Laws 1956, § 39-1-19.

**[7] Electricity 145 ↪11.3(7)**

145 Electricity

145k11.3 Regulation of Charges

145k11.3(7) k. Judicial Review and Enforcement.

Most Cited Cases

(Formerly 145k1.3(7))

Public Utilities Commission was not a proper party to petition for certiorari to review report and order of the Commission in electric rate proceeding, but fact that the commissioners rather than the division of public utilities and carriers or its administrator were specified as respondents constituted only a formal error which had no effect on the rights of the parties.

**[8] Public Utilities 317A ↪120**

317A Public Utilities

317AII Regulation

317Ak119 Regulation of Charges

317Ak120 k. Nature and Extent in General.

Most Cited Cases

(Formerly 317Ak7.1)

**Public Utilities 317A ↪194**

317A Public Utilities

317AIII Public Service Commissions or Boards

317AIII(C) Judicial Review or Intervention

317Ak188 Appeal from Orders of Commission

317Ak194 k. Review and Determination in

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

#### General. Most Cited Cases

(Formerly 317Ak32)

Matters with respect to cash working capital needed by utility, for purposes of setting rates, are addressed to the sound discretion of the Public Utilities Commission, and in absence of an abuse of discretion, disallowance of a particular sum will not be set aside.

#### [9] Electricity 145 ⚡ 11.3(1)

##### 145 Electricity

##### 145k11.3 Regulation of Charges

##### 145k11.3(1) k. In General. Most Cited Cases

(Formerly 145k1.3(1))

No abuse of discretion was shown in electric rate case in Public Utilities Commission's determination which disallowed item for cash working capital on ground that utility was part of an integrated area wide electric system that was fairly and adequately compensated by the working capital allowance awarded to affiliated electric wholesaler and on ground that utility had no need to pay its bills to wholesaler within two days when a 30-day grace period was allowed before interest accrued.

#### [10] Public Utilities 317A ⚡ 127

##### 317A Public Utilities

##### 317AII Regulation

##### 317Ak119 Regulation of Charges

##### 317Ak127 k. Depreciation. Most Cited Cases

(Formerly 101k3821/2)

"Depreciation" as considered in utility rate cases is the process of continued loss to property resulting from factors such as wear and tear and technological obsolescence which eventually leads to retirement of the property, while amounts by which accelerated depreciation exceeds guideline depreciation under the tax laws and guideline exceeds book depreciation are appropriately referred to as "additional tax depreciation."

#### [11] Electricity 145 ⚡ 11.3(3)

##### 145 Electricity

##### 145k11.3 Regulation of Charges

##### 145k11.3(3) k. Valuation of Property and Depreciation. Most Cited Cases

(Formerly 145k1.3(3))

In electric rate case, specified and reasonable basis was shown for allocating excess of book over guideline depreciation, which resulted from federal environmental regulations forcing premature retirement of certain of electric company's facilities, strictly on the basis of the percentage of that figure attributable to interstate power-generating facilities, despite contention that interstate customers had in past years benefitted by flow through of construction tax benefits and usual excess of guideline over book depreciation and that burden of tax liabilities should not be shifted to utility's only interstate customer.

#### [12] Public Utilities 317A ⚡ 122

##### 317A Public Utilities

##### 317AII Regulation

##### 317Ak119 Regulation of Charges

##### 317Ak122 k. Mode of Regulation. Most Cited

Cases

(Formerly 317Ak7.3)

It is accepted practice to base future rates upon known past and present conditions through the use of data gathered during a specified test period, but when known and measurable posttest year changes affect with certainty the test year data, the Public Utilities Commission may, within its sound discretion, give effect to those changes, and the Commission has broad discretion in making pro forma adjustments to test year data, provided that there is substantial evidence in the record warranting its action.

#### [13] Electricity 145 ⚡ 11.3(4)

##### 145 Electricity

##### 145k11.3 Regulation of Charges

##### 145k11.3(4) k. Operating Expenses. Most Cited

Cases

(Formerly 145k1.3(4))

In electric rate case, company failed to demonstrate an abuse of discretion in including in calculation of company's federal tax requirement a deduction for interest expense which rose as a consequence of a posttest year bond issue.

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

**[14] Public Utilities 317A ↪ 195**

317A Public Utilities

317AIII Public Service Commissions or Boards

317AIII(C) Judicial Review or Intervention

317Ak188 Appeal from Orders of Commission

317Ak195 k. Presumptions in Favor of Order or Findings of Commission. Most Cited Cases  
 (Formerly 317Ak33)

Public Utilities Commission's determinations with respect to adjustment to test year data in rate cases are presumptively reasonable and will not be interfered with unless utility satisfies reviewing court by clear and convincing evidence that determination is clearly, palpably and grossly unreasonable.

**[15] Public Utilities 317A ↪ 194**

317A Public Utilities

317AIII Public Service Commissions or Boards

317AIII(C) Judicial Review or Intervention

317Ak188 Appeal from Orders of Commission

317Ak194 k. Review and Determination in

General. Most Cited Cases

(Formerly 317Ak32)

When reviewing decisions of the Public Utilities Commission, court's concern is not with the method used to attain a particular result but with the fairness and reasonableness of the end result itself, which requires a balancing of investor and consumer interests, but this does not absolve the Commission of its primary responsibility to fairly and substantially support its findings by legal evidence and to make such findings sufficiently specific to enable court to ascertain whether the underlying facts afford a reasonable basis for the result reached.

**[16] Electricity 145 ↪ 11.3(4)**

145 Electricity

145k11.3 Regulation of Charges

145k11.3(4) k. Operating Expenses. Most Cited

Cases

(Formerly 145k1.3(4))

Public Utilities Commission's treatment in electric rate

case of question of normalizing certain tax benefits which would accrue as result of construction overhead and interest on a construction debt, as opposed to flow through to be reflected currently in lower rates, was deficient where apparently based on mere recitation of well-known economic facts extant in state, including high unemployment and already high electric rates.

**[17] Public Utilities 317A ↪ 129**

317A Public Utilities

317AII Regulation

317Ak119 Regulation of Charges

317Ak129 k. Rate of Return. Most Cited Cases

(Formerly 317Ak7.10)

**Public Utilities 317A ↪ 195**

317A Public Utilities

317AIII Public Service Commissions or Boards

317AIII(C) Judicial Review or Intervention

317Ak188 Appeal from Orders of Commission

317Ak195 k. Presumptions in Favor of Order

or Findings of Commission. Most Cited Cases

(Formerly 317Ak33)

Where attrition of rate of return by such factors as inflation has been clearly demonstrated by a utility company, an adjustment to that company's rate of return is appropriate, but where the Public Utilities Commission denies such relief, its decision is presumptively reasonable and the burden is on the company to show by clear and convincing evidence that it is clearly, palpably and grossly unreasonable.

**[18] Electricity 145 ↪ 11.3(6)**

145 Electricity

145k11.3 Regulation of Charges

145k11.3(6) k. Proceedings Before Commissions.

Most Cited Cases

(Formerly 145k1.3(6))

In electric rate case, Public Utilities Commission's method of specifying those offsetting factors tending to eliminate effects of attrition on rate of return was a val-

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

id regulatory approach; while burden was on company to present evidence that those offsetting factors were less than sufficient to neutralize the effects of erosion, burden fell on the Commission in the first instance to support its conclusions with legal evidence sufficiently specific to enable reviewing court to ascertain if the facts on which those conclusions were premised afforded a reasonable basis for the result reached.

**[19] Electricity 145 ⚡ 11.3(7)**

145 Electricity  
 145k11.3 Regulation of Charges  
 145k11.3(7) k. Judicial Review and Enforcement.  
 Most Cited Cases  
 (Formerly 145k1.3(7))

In electric rate case, neither side satisfactorily shouldered its burden with respect to question of requested attrition adjustment over and above requested return on equity to reflect such factors as inflation and lags in revenue collection, and case would be remanded for reconsideration in light of more up-to-date information regarding residual effects of the strike and company's growth and earnings pattern since Public Utilities Commission issued its report and order, together with clarification as to reason why company's calculations were considered suspect.

**[20] Public Utilities 317A ⚡ 123**

317A Public Utilities  
 317AII Regulation  
 317Ak119 Regulation of Charges  
 317Ak123 k. Reasonableness of Charges in General. Most Cited Cases  
 (Formerly 101k3821/2)

Utility rate must be reasonable and just and must look toward the immediate future as well as to the moment, and thus a utility is permitted an opportunity to earn a return on the value of property utilized for the public convenience equal to returns generally achieved at the same time and in the same general part of the country on investments in other enterprises having corresponding risks and uncertainties, and return should be sufficient to permit utility to maintain financial integrity, attract necessary capital, and fairly compensate investors

for risks they have assumed, yet provide appropriate protection to the relevant public interests, both existing and foreseeable.

**[21] Public Utilities 317A ⚡ 195**

317A Public Utilities  
 317AIII Public Service Commissions or Boards  
 317AIII(C) Judicial Review or Intervention  
 317Ak188 Appeal from Orders of Commission  
 317Ak195 k. Presumptions in Favor of Order or Findings of Commission. Most Cited Cases  
 (Formerly 317Ak33)

Rate of return allowed by the Public Utilities Commission in a given case is entitled to a presumption of reasonableness until the utility comes forth with clear and convincing evidence that it is clearly, palpably and grossly unreasonable, and the Commission is permitted broad discretion and the choice of methodology, which will not be disturbed as long as the end result is fair and reasonable.

**[22] Electricity 145 ⚡ 11.3(7)**

145 Electricity  
 145k11.3 Regulation of Charges  
 145k11.3(7) k. Judicial Review and Enforcement.  
 Most Cited Cases  
 (Formerly 145k1.3(7))

Reviewing court would not second-guess Public Utilities Commission's choice of discounted cash flow method of fixing a return on equity in electric rate case, and thus, insofar as 12.5% return reflected proper considerations which that method imports and represented a reasonable return on equity, it would not be disturbed.

**[23] Public Utilities 317A ⚡ 129**

317A Public Utilities  
 317AII Regulation  
 317Ak119 Regulation of Charges  
 317Ak129 k. Rate of Return. Most Cited Cases  
 (Formerly 317Ak7.10)  
 Though the Public Utilities Commission is entrusted

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

with a broad charter to be ever mindful of the needs of the consumer as well as the investor, in fixing a rate of return, the appropriate manner in which to protect consumer interest is for the Commission to assure that the utility company is permitted to earn a return no greater than is necessary to maintain the financial health of the company, and it is error to rely on the ability of consumers to pay for services in setting a cost of equity, though local economic conditions do have a bearing in establishing appropriate return on equity, in evaluating the desirability of the company's stock as an investment opportunity. Gen.Laws 1956, § 39-1-1.

**\*\*1197 \*431** Edwards & Angell, Edward F. Hindle, Knight Edwards, Deming E. Sherman, Providence, for petitioner.

Julius C. Michaelson, Atty. Gen., R. Daniel Prentiss, Special Asst. Atty. Gen., for Public Utilities Commission.

Roberts & Willey Inc., Dennis J. Roberts, II, Providence, for Rhode Island Consumers' Council.

#### OPINION

**\*398 PAOLINO**, Justice.

This is a statutory petition for *certiorari* brought by the Narragansett Electric Company (the company) pursuant to G.L.1956 (1969 Reenactment) s 39-5-1, seeking a review of the Public Utilities Commission's (the commission) report and order in a rate proceeding instituted by the company. Briefs have been submitted by the company, the Attorney General (on behalf of the commission) and the Rhode Island Consumers' Council (the council).

According to the record before us, the company is engaged in the generation, purchase, transmission, distribution and sale of electricity. All of the company's common stock is owned by the New England Electric System (NEES), a holding company chartered under the terms of the Public Utility Holding Company Act of 1935. The company is also affiliated with the New England Power Company (NEPCO) which is a Massachu-

setts corporation **\*399** engaged in wholesale electric generation and transmission. NEPCO has approximately **\*\*1198** 30 customers which purchase all or a major portion of their requirements from NEPCO and which, in turn, sell and distribute electricity at retail to ultimate consumers. NEPCO is engaged in interstate business and is thus regulated by the FPC. Since 1967, with the approval of the FPC, the company and NEPCO have operated together under a so-called 'integrated facilities contract' by which the company purchases virtually all of its energy requirements from NEPCO. Under the 1967 contract, the company's and NEPCO's generating and transmission facilities are integrated in order to maximize efficiency. Costs incurred by the company in connection with its integrated facilities are offset as credits against its power bills from NEPCO.

On September 27, 1974, the company filed with the commission a proposed upward revision of its rates, tolls and charges so as to realize an additional \$10.2 million annually. The company proposed to collect said additional sums commencing on November 1, 1974, with the exception of \$5.4 million which the company sought to start collecting as of October 15, 1974, on an emergency basis subject to possible refund. General Laws 1956 (1969 Reenactment) s 39-3-13.

The commission docketed the company's application and on October 11 and 17, 1974, conducted hearings regarding the requested emergency relief. On October 15, 1974, the commission entered an order suspending implementation of the entire application for 6 months, s 39-3-11, and on November 1, 1974, the request for emergency rate relief was denied.

Thereupon the company submitted prepared testimony and exhibits purporting to support the propriety of the \$10.2 million increase in revenues. Public hearings on the proposed increases spanned the period between June 10, **\*400** 1975 and July 14, 1975. At those hearings, the proposal was evaluated on the basis of data compiled during a test year composed of the 12 months ending March 31, 1975.

Shortly after the conclusion of the hearing, by an order dated July 31, 1975, the commission rejected the com-

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

pany's proposed rate increase and found instead that the company was only entitled to additional annual revenues of \$909,000. The company was directed to revise its proposal to reflect this finding and to resubmit it for implementation.

On August 6, 1975, the company filed its statutory petition for certiorari seeking review of the commission's decision. We thereupon ordered the writ to issue. *Naragansett Elec. Co. v. Harsch*, No. 75-218 M.P. (R.I., Order Filed August 8, 1975).

*I. The Roles of the Attorney General and the Commission*

At the outset we are confronted with two interrelated issues raised in our order of February 26, 1976, *Naragansett Elec. Co. v. Harsch*, R.I., 352 A.2d 400 (1976), wherein we denied without prejudice the company's motion that the Attorney General be barred from filing a brief in the present case. In that order, we directed the parties to brief and argue the questions whether the Attorney General represented the public or the Public Utilities Commission and whether or not the commission is a proper party to this petition.

Inasmuch as the entire field of utilities regulation is governed by statute, the resolution of these questions lies in our reading of the pertinent provisions of the general laws. See generally G.L.1956 (1969 Reenactment) title 39, as amended by P.L.1969, ch. 240, s 1. Prior to 1969, all authority to regulate utilities and to set and approve rates was vested in the Division of Public Utilities within the Department of Business Regulation. All matters involving proposed changes in rates were submitted to the administrator\*401 of said division for hearing, investigation and the issuance of \*\*1199 appropriate orders. Persons aggrieved by such orders were entitled to judicial review thereof in the Superior Court within the strictures of the Administrative Procedures Act. [FN1] In essence, therefore, the administrator and the Division of Public Utilities exercised a board range of administrative powers and whatever judicial powers were incidental to the general duties to conduct hearings and to make investigations as to the propriety of pro-

posed changes in utility rates.[FN2]

FN1. The Administrative Procedure Act is found in G.L.1956 (1969 Reenactment) ch. 35 of title 42.

FN2. This arrangement would seem to conform to the historical view that the regulation of utilities and the setting of rates for the future is a legislative function. A corollary of this view is that proceedings to determine proper rates, while possessing some attributes of a court trial are more accurately perceived as a delegated legislative function. Pillsbury, administrative Tribunals, 36 Harv.L.Rev. 405, 420 (1923).

With the enactment of P.L.1969, ch. 240, s 1, the General Assembly effected a major revision of the processes by which proposed rate changes were to be scrutinized and by which utilities were generally to be regulated. Most significantly, the newly enacted s 39-1-3 created within the Department of Business Regulation a Public Utilities Commission (the commission) and a Division of Public Utilities and Carriers (the division) which were both ordained as independent bodies free from the jurisdiction of the department director. In the following language, the jurisdictions and powers of the two new units were set forth by the Legislature:

'\* \* \* The (Public Utilities) commission shall serve as a quasi-judicial tribunal with jurisdiction, powers, and duties to hold investigations and hearings involving the rates, tariffs, tolls and charges and the sufficiency and reasonableness of facilities and accommodations of (various) public utilities \* \* \*. The administrator\*402 (of the Division of Public Utilities and Carriers) shall exercise the jurisdiction, supervision, powers and duties not specifically assigned to the commission. By virtue of his office, the chairman of the public utilities commission shall be the public utilities administrator who shall supervise and direct the execution of all laws relating to public utilities and carriers and all regulations and orders of the commission governing the conduct and charges of public utilities, and who shall perform such other duties and have such powers as are herein-after set forth.' General Laws 1956 (1969 Reenact-

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

ment) s 39-1-3.

[1][2] Inasmuch as the statute is not entirely clear in its delineation of the powers of the commission and division respectively, we must attempt herein to ascertain the legislative intention from a consideration of the legislation in its entirety, viewing the language used therein in the light, nature, and purpose of the enactment thereof. *Mason v. Bowerman Bros.*, 95 R.I. 425, 431, 187 A.2d 772, 776 (1963). In so doing, it is our belief that the only meaningful way in which to read the present statute and specifically, the above-quoted provision, is that the General Assembly intended by its enactment to segregate the judicial and administrative attributes of ratemaking and utilities regulation and to vest them separately and respectively in the commission and the administrator (or division).[FN3] Other provisions in title 39 support this interpretation. For instance, the commission is clothed with the 'powers of a court of record' in determining and **\*\*1200** adjudicating matters within its jurisdiction (s 39-1-7). It is further empowered to make orders and render judgments and to enforce the **\*403** same by suitable process (s 39-1-7). The commission is defined at one point in the statute as an 'impartial, independent body' which renders decisions affecting both the public interest and private rights[FN4] based upon the law and the evidence (s 39-1-11). The commission is permitted, in much the same manner as a trial justice in the courts, to conduct prehearing conferences and issue prehearing orders which control the conduct of the rate case (s 39-1-12). Cf. Super.R.Civ.P. 16. The several commissioners are empowered to administer oaths, to summon and examine witnesses, to compel production and examination of papers, books and other evidence, and to apply to a Superior Court justice to have persons held in contempt of the commission's process (s 39-1-13). Furthermore, the commission has been granted broad powers to issue appropriate orders preventing irreparable injury to the public interest (s 39-1-32), and to order additions, alterations or extensions to a utility's plant or equipment when such are deemed necessary (s 39-4-2).

FN3. In *Providence Gas Co. v. Public Util. Comm'n*, 116 R.I. 80, 352 A.2d 630 (1976),

this court superficially acknowledged the bifurcation of functions between the Division of Public Utilities and Carriers and the Public Utilities Commission. We held that while one person was both the division's administrator and the commission's chairman, he could not pretend to act in one capacity in dealing with matters more properly addressed to him in the other capacity. *Id.* at 84, 352 A.2d at 632.

FN4. It has been held by certain authorities that the true test for differentiating between administrative and judicial functions is that only by the latter may a question of private rights be decided, based upon a claim arising out of past wrongs and involving a determination of facts or the construction and application of existing law. See *Trybulski v. Bellows Falls Hydro-Elec. Corp.*, 112 Vt. 1, 8, 20 A.2d 117, 121 (1941).

[3][4][5] In contrast to the aforementioned judicial powers enjoyed by the commission are the general and administrative powers conveyed to the administrator and the division as set forth in ch. 3 of title 39. Of particular relevance to this case, though, is the interrelationship which the statute has established between the commission and the administrator (or division) in matters dealing with rates, tariffs, tolls and charges. Section 39-1-11 requires that the commission's adjudications be based upon the law and upon the evidence as 'presented before it by the division and by the parties in interest.' It would appear, therefore, that **\*404** the Legislature perceived that, in matters brought for hearing before the commission, the division would assume a role not unlike that of a party in interest. This version of the legislative intent is further borne out by a later passage in the same title which requires that, upon the issuance of a writ of certiorari by this court, citations shall issue from the clerk 'to all parties in interest, including the public utility administrator.' Section 39-5-2. Thus, it would appear that the party-like posture of the administrative arm of the bifurcated regulatory machinery has been purposely carried through to the appellate level.

One final passage of the General Laws lending support

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

to the position that the division appears as an adversary participant before the commission in rate hearings also resolves the question raised by our order of February 26, 1976, regarding the Attorney General's participation in these and similar proceedings. That is, by the authority of s 39-1-19, the Attorney General or a designee shall honor the request of the administrator to 'appear and represent the division in any hearing, investigation, action or proceeding under this title \* \* \*.' Such hearings, actions and proceedings include, of course, hearings before the commission (s 39-1-11), and certiorari proceedings before this court (s 39-5-1). Thus, it seems manifest that, in pursuit of the public interest set forth in s 39-1-1, the Legislature has conceived a system whereby the Division of Public Utilities and Carriers, in addition to its broad regulatory powers, appears on behalf of the public to present evidence and to make arguments before the commission.[FN5] \*\*1201 The Attorney\*405 General or his designee is required, in most instances, [FN6] to represent the division in this role, s 39-1-19, and the commission is required to determine and to adjudicate matters before it as an impartial and independent quasi-judicial tribunal. [FN7] Sections 39-1-3 and 39-1-11.

FN5. We cannot be swayed in our determination of this issue by the argument that the Rhode Island Consumers' Council is the only qualified party-in-interest representing the public sector. Section 39-1-17, indeed, provides that, in rate cases, the council shall be a party-in-interest and, as such, that it is entitled to receive all notices, etc. That section states further, however, that the council 'may file complaints, institute proceedings, participate as a party in administrative hearings, and institute or participate in any appeal to the supreme court as an aggrieved party.' Section 39-1-17 (emphasis added.) By the terms of this passage, the participation of the council is obviously discretionary. The Legislature could not have intended that the protection of the public interest, which is the very premise of the statute, s 39-1-1, would be contingent upon such circumstances as budgetary limitations on the

activity of the council.

Furthermore, there is no language in any section dealing with the council's participation which indicates that its role in these matters, should it choose to exercise it, is preemptive with regard to the participation of the Division of Public Utilities and Carriers. Indeed, G.L.1956 (1969 Reenactment) s 42-42-5, as amended by P.L.1969, ch. 33, s 1, provides that nothing in that chapter of the General Laws ' \* \* shall be so construed as to exclude any other attorney or counsel for any person, association or corporation,' when the council chooses to participate in a given case.

FN6. It is to be noted that, to avoid any potential conflict of interest where the division and the state, or citizens thereof, call upon the Attorney General to represent each of them in their respective positions in the same case, s 39-1-19 enables the division to retain legal counsel of its own within the strictures of s 39-1-20. This has the effect, of course, of freeing the Attorney General to intervene, when necessary, on behalf of the state or its citizens as customers of a utility company.

FN7. In order to appreciate that this marks a departure from the historical view of rate fixing and utility regulation as administrative or legislative, rather than a judicial function, compare Rhode Island's statutory provisions in this regard with Pillsbury, Administrative Tribunals, 36 Harv.L.Rev. 405, 420 (1923).

[6] Thus, in answer to the first question presented by our order regarding whether the Attorney General represents the public or the commission, we hold that, strictly speaking, he represents neither. The language of s 39-1-19 is abundantly clear in specifying that the Attorney General shall serve as counsel, upon request of the administrator, to the division in all hearings, investigations, actions and proceedings arising under title 39. The arguments presented\*406 to us to this issue would indicate that all parties have been laboring under the

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

misapprehension that the Attorney General's services were available to the commission rather than to the division.[FN8] In the present case, the fact that the Attorney General's brief was submitted on behalf of the Public Utilities Commission rather than on behalf of the Division of Public Utilities and Carriers is only a formal error which is not a ground for reversal.

FN8. While, in view of past practice, this distinction between the commission and the division might appear to be a semantical one, all concerned parties would do well in the future to harken to the wording of the statute as interpreted herein, lest serious conflicts of roles develop.

We do not reach or decide, in this case, whether it is proper for the Attorney General to supply staff counsel to the commission and division under s 39-1-20 as well as to the division alone under s 39-1-19.

[7] With regard to the second question posed by our order, that is, whether the commission is a proper party to this petition, we hold that it is not. It is apparent from the foregoing discussion of the relevant statutory provisions that the Legislature intended that the commission shall sit as a quasi-judicial tribunal and that its administrative affiliate, the division, would appear before it, through counsel, as an adversary participant in the commission's hearings. It is clear also that the Legislature envisioned that the division would similarly be a participant in and be represented by the Attorney General in certiorari proceedings before this court. Turning to the present case, the fact that the named respondents are the Public Utilities Commissioners\*\*1202 individually and in their official capacities is not a fatal flaw. Specifying the commissioners rather than the administrator or the division as respondent constitutes only a formal error which has absolutely no effect upon the rights of the parties.

## *II. Cash Working Capital-Purchased Power Expense*

Cash working capital is the amount of cash required by

the company to continue operations during the interim \*407 between the rendition of services to its retail customers and receipt of payment therefor. *New England Tel. & Tel. Co. v. Public Util. Comm'n, R.I.*, 358 A.2d 1, 18 (1976). In the instant case, the company requested that its rate base include a working capital allowance of \$7.8 million, of which \$7.011 million was attributed to purchased power expense. The company produced evidence to the effect that under a 1967 contract it purchased virtually all of its primary electricity for resale from NEPCO, was billed for that power 12 days after each service month, and, despite the fact that no interest penalty accrued until 30 days after receipt of the bill, paid such bill within 2 days of its delivery. The company also produced a lag study which demonstrated that the company was not reimbursed for these cash outlays by its retail customers for 28.22 days. In order to compensate for the depletion in its cash reserves that this lag causes, the company claims a need for a cash working capital allowance in excess of \$7 million.

[8][9] At the hearing before the commission, this item of cash working capital was attacked on the ground that paying purchased power bills when rendered constituted an unnecessary prepayment which worked to the detriment of the company's customers. Even though such bills may be technically due when rendered, it was argued that the company is, in effect, given 30 days in which to pay such bills because no interest accrues until 30 days has passed after the rendering. The commission adopted this reasoning and rejected the company's contention that it had an affirmative contractual duty to pay the NEPCO bill when it was rendered. The entire request for cash working capital to cover purchased power expense was, therefore, rejected.

In reaching its ultimate conclusion on this issue, the commission found as a fact that the company and NEPCO are parts of one integrated system and that inquiry into \*408 the propriety of this single item of rate base cannot be artificially limited to any single entity within the system. The commission found further that, as a result of this interrelationship, the company's intrastate customers support, in their rates, the 45-day working capital allowance given to NEPCO by the FPC.

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

Page 11

That is, because the entire power system receives payment from the ultimate consumer within 42.2 days after the service month in which NEPCO delivers primary electricity to the company, NEPCO's 45-day lag has been accounted for.

The commission also grounded its denial of this items of cash working capital in its reading of the terms of the 1967 contract between the company and NEPCO. It was reasoned that because the company is effectively granted 42 days after the service month in which to pay its bill to NEPCO (12 days from the end of the service month to delivery of the bill plus 30 days' grace before interest is charged), it has demonstrated no need for cash working capital for purchased power expense to cover a lag of 28.22 days.

This is not the first time this court has been asked to review exclusion of this item from this company's rate base. In *Rhode Island Consumers' Council v. Smith*, 113 R.I. 384, 399-402, 322 A.2d 17, 25-26 (1974), this company sought a cash working capital allowance sufficient to cover the same 28.2-day lag. In that case we held that a utility cannot claim an allowance for cash working capital as a matter **\*\*1203** of right but that such an allowance is addressed to the sound discretion of the commission. The determination of the size of such an allowance, when awarded, is a question of fact, which may vary from case to case. *Id.* at 401, 322 A.2d at 26. In applying these principles to a set of circumstances virtually identical to those presented in the **\*409** case at bar,[FN9] this court concluded that the factual issue had merely been resolved by the commission against the company; that, because the company was given a grace period in which to pay purchased power bills before interest would be charged, the suggested addition to the rate base was not required to enable the company to meet its current obligations. *Id.* at 401, 322 A.2d at 26, quoting *Alabama-Tennessee Nat. Gas Co. v. FPC*, 203 F.2d 494 (3d Cir. 1953). We concluded that it did not seem fair to burden the ultimate power consumer with the higher rates that would result from the company's choice to pay power bills before they start to incur interest. *Rhode Island Consumers' Council v. Smith*, 113 R.I. 384, 401, 322 A.2d 17, 26

(1974).

FN9. In reference to this issue, the only significant difference between the earlier case and the case at bar is that in the former the company was charged interest on unpaid purchased power bills commencing 60 days rather than 30 days after rendition. *Rhode Island Consumers' Council v. Smith*, 113 R.I. 384, 400, 322 A.2d 17, 25 (1974).

Nothing has been presented by the company in the instant case to demonstrate that the nature of its affiliation with NEES and NEPCO has changed since 1974 when the earlier case was decided. We believe, therefore, that our earlier decision controls in this instance despite the company's attempt to distinguish that case from this one. Even assuming, as the company alleges, that this court erred in that case by stating that other affiliates of NEPCO do not pay their bills when due, this narrow finding of fact was not the sole basis for our affirmance of the commission's decision. The thrust of that decision remains that the commission found as a fact that the existence of a grace period, of which the company chose not to take advantage, rendered the requested sum unnecessary to meet current obligations.

Similarly, in the instant case, the commission has found **\*410** as a fact that the integrated area-wide electric system is fairly and adequately compensated by the working capital allowance awarded to NEPCO based on the 45-day lag between delivery of power to the company and payment for that power by the retail customer.

The commission found additionally as a fact that, on the basis of its reading of the payment provisions of the 1967 contract between NEPCO and the company, 'there is no working capital requirement for purchased power.'

The facts, as found by the commission, preponderate against granting the requested allowance. We have stated that these matters are addressed to the commission's sound discretion. In the absence of an abuse of that discretion, a disallowance of a particular sum as cash working capital will not be set aside. *Rhode Island Consumers' Council v. Smith*, 113 A.2d 384, 395,

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

322 A.2d 17, 23 (1974). The company's arguments on this appeal have failed to convince us that the commission's findings constitute an abuse of discretion. Specifically, we find the company's attempt to characterize their choice of a bill-paying policy as a business management judgment (and thus presumably to benefit by the broad deference given to such judgment) singularly unconvincing. As we stated on an earlier occasion: '(t)he Commission is merely requiring the utility to exercise the kind of prudent money management the ratepayer has a right to expect from a regulated monopoly.' *Id.* at 402, 322 A.2d at 26.

**\*\*1204 III. Allocation of Additional Tax Depreciation**

The second issue raised by the company's petition for certiorari is whether the commission properly allocated certain sums representing additional tax depreciation between interstate and intrastate accounts. It is the company's basic position that the commission acted arbitrarily and abused its discretion by assigning nearly all of one portion of such depreciation to an interstate account.

**\*411** [10] Depreciation, of course, is the process of continued loss to property resulting from factors such as wear and tear and technological obsolescence which eventually leads to the retirement of that property. The amount of depreciation experienced annually may be reflected as a deduction from income for tax purposes.

The Internal Revenue Service (IRS) permits the company to calculate depreciation of some property on an accelerated scale which has the effect of allowing a larger depreciation early in the life of the property and smaller amounts later on. The IRS also provides a guideline depreciation scale which sets annual depreciation for certain other property in more constant amounts over the life of the property. Even more conservative than either of these scales is the depreciation of property as carried on the company's own books of account.

The amounts by which accelerated exceeds guideline depreciation and guideline exceeds book depreciation

are appropriately referred to as additional tax depreciation. Internal Revenue Service regulations require that additional tax depreciation on property acquired after 1969 be normalized. See IRC sec. 167(1). That is, for ratemaking purposes, a utility treats the additional tax depreciation as if the tax deduction for that amount of depreciation did not exist and computes the amount of tax that would be owed if the deduction were, in fact, income and adds the amount of the hypothetical tax to the cost of service. The cost of service and, therefore, the rates charged to customers are artificially inflated. The effect of this accounting procedure is to collect from current rate payers those taxes which will not, in fact, become due until some future date and thus to spread the tax burden more evenly among present and future customers of the utility.

On the other hand, additional depreciation on property acquired prior to 1970 is treated as a flow-through item. **\*412** That is, the tax deduction to which the company is entitled for depreciation is reflected currently in the company's tax calculations and this tax benefit is thus passed on immediately to the consumer in the form of lower rates.

In the present case, the company experienced a total difference between accelerated and guideline depreciation on all property (both interstate and intrastate) of \$2,569,000 of which \$380,000 was attributable to pre-1970 properties and \$2,189,000 was attributable to post-1969 additions to property. Although the additional tax depreciation attributable to pre-1970 properties was lowered by the commission from \$380,000 to \$259,000 in order to reflect the ratio of intrastate to total rate base, none of the parties seems to dispute the accuracy of these figures nor does any party question the various allocations that the commission made of these sums between interstate and intrastate accounts.[FN10]

FN10. It appears to the court that, in allocating each of three categories of additional tax depreciation between intrastate and interstate accounts, the commission has employed three distinct methodologies. The excess of accelerated depreciation over guideline depreciation for pre-1970 property was allocated on the

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

basis of the ratio of intrastate to interstate rate base (approximately 70:30). The same figure for post-1969 additions was allocated entirely to the intrastate side of the ledger. Finally, the excess of book over guideline depreciation was allocated almost, though not quite, entirely to interstate (approximately 90:10).

Little is offered by any party to these proceedings to explain this disparate treatments of similar accounts. The state's bare assertion that identification of specific assets with specific company functions was impossible in this case is hardly instructive and the company's protestations that tax benefits have been flowed through to its retail customers in the past seems fairly irrelevant. It is, therefore, with some confusion that we approach this problem. As we stated earlier, the parties differ only as to the disposition of the latter portion of additional tax depreciation, that is, the excess of book over guideline depreciation, and no issue has been made of the other allocations. On this basis then we feel free to examine the disputed sums in isolation from those, which, though contradictory in their formulation, are undisputed.

**\*\*1205** The sole point of disagreement arises from the commission's **\*413** treatment of the difference between guideline and book depreciation for the test year. Because certain federal environmental regulations will have forced the premature retirement of certain of the company's facilities by 1982, the company was forced also to accelerate its book depreciation of those facilities. This resulted in book depreciation exceeding guideline depreciation and thus a negative entry was required for this portion of additional tax depreciation in the amount of \$1.069 million. In its filing, the company sought to have this entire sum offset against the aggregate difference between tax and book depreciation. The net result of the company's approach would have been to decrease the company's intrastate tax deduction thereby producing an inflated intrastate tax expense. Naturally, such increased expense would have been re-

flected in higher rates.

The commission's resolution of the dispute involving the allocation of these sums was relatively simple. It adopted the view proffered by the council's witness that because most of the excess of book over guideline depreciation was attributable to the generation plant in Providence, Rhode Island, and because this plant is identified as a part of the electric system's interstate rate base, \$967,000 of the excess must be excluded from the company's intrastate cost of service. Consequently, only the remaining \$102,000 of the proposed \$1.069 million was allocated to offset the aggregate difference between accelerated and guideline depreciation of intrastate rate base. The resulting higher tax deduction precipitated a lower tax liability on intrastate rate base and thus a lower cost of service than the company would liked to have had approved.

[11] The gravamen of the company's objection to this portion of the report and order is that, although the production facilities in Providence are interstate in character, its intrastate customers have, in past years, benefited by a **\*414** flow through of construction tax benefits and the usual excess or guideline over book depreciation. The company maintains that it would be inequitable at this point to shift the burden of tax liabilities to its only interstate customer, NEPCO, when that entity has never been the beneficiary of the company's past favorable tax status.

In a more speculative vein, the company alleges that the FPC will probably not allow this shifting of burdens from intrastate to interstate customers and, thus, that the ultimate tax burden will fall upon the company's security holders, presumably in the form of reduced dividends.

Because utilities and their regulatory overseers rarely indulge in simplicity, that characteristic, when ascribed to a particular regulatory methodology, is not necessarily a vice. Thus, unless the company shows that the commission abused its discretion, we cannot fault the commission's chosen method of allocating the excess of book over guideline depreciation strictly on the basis of the percentage of that figure attributable to interstate

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

power generating facilities. The company's attempt to invoke\*\*1206 the aid of equity to alleviate the burden that this allocation of tax liabilities precipitates upon its sole interstate customer in no way undermines the presumed reasonableness that the commission's decision on this point enjoys. The commission reached its result on the basis of undisputed legal evidence both as to dollar amounts and as to inter/intrastate ratios. These findings were set forth in specific language in the report and order and they provide a specified and reasonable basis for the result reached. Rhode Island Consumers' Council v. Smith, 111 R.I. 271, 277, 302 A.2d 757, 762 (1973). That part of the company's petition regarding the

*allocation of additional tax depreciation is, therefore, denied. \*415 IV. Interest Expense Deduction from the Company's Federal Income Tax Requirement*

The next question raised by the company is whether the commission erroneously included in its calculation of the company's federal tax requirement a deduction for the interest expense which arose as a consequence of a post-test year bond issue.

In calculating its federal tax liability, the company is entitled to an income deduction for its interest expense. In the present case, the company sought to include in its interest expense deduction only the actual interest expense incurred by it during the test year. The council rejected this approach and suggested the inclusion in the account of 'the forward looking interest expense based on the actual cost of outstanding debt pro-formed to accommodate the annualized expense of the April, 1975 bond issue of \$15,000,000, and the retirement of \$7,500,000 of debt during 1975.' In adopting the latter position, the commission described the issue as being whether the change in interest expense based on already-determined capital structure (that is, including the 1975 bond issue) over actual expense in the test year is sufficiently 'known and measurable' to warrant its inclusion in the calculation of the company's taxes. The commission held that the change in interest expense was known and measurable and that there was 'no element of speculation involved.' Thus, it arrived at a total interest expense figure of \$7,642,000.

The company attacks the inclusion of post-test-year interest expense as being hypothetical and suggests that the commission's decision in this regard runs counter to our own decision in Rhode Island Consumers' Council v. Smith, 113 R.I. 384, 395-96, 322 A.2d 17, 23-24 (1974). That is, the company reads that decision to state that only those expenses actually incurred may be included in the company's tax deduction.

\*416 We believe that the company misstates the thrust of the relevant portion of our decision in Rhode Island Consumers' Council v. Smith, id. That case involved a dispute over what types of interest expense are property included as deductions from taxable income. Specifically, the parties therein debated whether interest expense on short-term debt qualified as a deduction or whether the company would prevail in its method of excluding such debt from its capital structure. Id. at 395-96, 322 A.2d at 23-24. This is to be contrasted to the instant case wherein there is no dispute as to deductibility of the interest expense arising from the 1975 bond issue. The only issue herein is whether that interest expense, having been incurred subsequent to the test year, should be reflected as a pro forma adjustment to test year calculations.

[12] Ratemaking, by its very nature, is prospective and in order to neutralize the negative effects of speculation and guesswork about future economic conditions, it is accepted practice to base future rates upon known past and present conditions through the use of data gathered during a specified test period. Rhode Island Consumers' Council v. Smith, 111 R.I. 271, 278, 302 A.2d 757, 763 (1973). This process of \*\*1207 prognostication creates a conflict between the need to lend some finality to ratemaking by utilizing a well-defined, finite test period and the need to base calculations upon the latest available relevant data which often pertains to time periods other than the test period. Duquesne Light Co. v. Pennsylvania Pub. Util. Comm'n, 174 Pa.Super. 62, 69, 99 A.2d 61, 64 (1953). A satisfactory resolution of this conflict is that when known and measurable post-test-year changes affect with certainty the test-year data, the commission may, within, its sound discretion, give effect to those changes. Rhode Island Consumers'

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

Council v. Smith, 113 R.I. 384, 393, 322 A.2d 17, 22 (1974). Regarding the inclusion of relevant data other \*417 than that which pertains directly to a utility's test-period experience, it has been observed that:

'If the test period used does not reflect the present operating experience of the company and the reasonably expected future economic conditions which the company will be confronted with, or if adjustments in the test period are not made so as to take these two factors into consideration and give effect to them, then the rate-making process does not and cannot become an honest and intelligent forecast of probable conditions of the company in and during a reasonable period in the immediate future.' (Emphasis added.) Southern Bell Tel. & Tel. Co. v. Tennessee Pub. Serv. Comm'n, 17 P.U.R.3d 311, 319 (Tenn.Ch.Ct.1957).

We believe, therefore, that the commission has broad discretion in making pro forma adjustments to test-year data provided that there is substantial evidence in the record warranting its action. Pittsburgh v. Pennsylvania Pub. Util. Comm'n, 182 Pa.Super. 551, 560, 128 A.2d 372, 376 (1956).

[13][14] The company has not demonstrated an abuse of discretion in this case. The issuance of \$15 million in bonds and the retirement of \$7.5 million of debt constitutes a significant change in the company's capital structure which will obviously create an escalation of the company's interest expense presently and in the near future. The commission, employing the method proffered by the council's witness, computed an amount of interest expense based upon the capital structure of the company at that time as used by the company's own witness in his testimony before the commission. The commission felt that this approach did not yield speculative results, and in the absence of something more than the naked assertion by the company that the interest figure is 'hypothetical,' we are constrained to agree. The commission's determinations in these matters are presumptively reasonable and will not be interfered with unless the company satisfies us by clear and convincing\*418 evidence that it is clearly, palpably and grossly unreasonable. Rhode Island Consumers' Council v. Smith, 111 R.I. 271, 295, 302 A.2d 757, 772 (1973).

The company has come forth with no such showing in this case. In fact, it appears to the court that this adjustment to test-year data is just the sort of known and measurable future economic condition of which the authorities overwhelmingly approve. We find no error in the interest expense deduction as determined by the commission.

#### V. Normalization of Tax Benefits

The next question raised by the company's petition concerns whether the company will be permitted to adopt the accounting procedure of normalizing certain tax benefits which accrue as the result of construction overhead and interest on construction debt, or whether these benefits will, as they have in the past, be flowed through so as to be reflected currently in lower rates.

After noting the arguments for and against the proposed revision of accounting methods, the commission characterized its choice between the interest of the company in improving its internal cash flow and the interest of the ratepayers in being charged \*\*1208 the lowest possible rates as a 'purely judgmental exercise.' In its judgment, 'the economic conditions extant in the State of Rhode Island today,' including high unemployment and already high electric rates, constrained it to opt in favor of the consumer and to reject the proposed normalization accounting.

[15][16] It is settled that, when reviewing the commission's decisions, our concern is not with the method used to attain a particular result but with the fairness and reasonableness of the end result itself. FPC v. Hope Natural Gas Co., 320 U.S. 591, 602, 64 S.Ct. 281, 287-88, 88 L.Ed. 333, 344-45 (1944). And it is true that the determination that a result is fair and reasonable requires a balancing of investor and consumer interests. \*419Id. at 603, 64 S.Ct. at 288, 88 L.Ed. at 345. This general formula does not, however, absolve the commission of its primary responsibility to fairly and substantially support its findings by legal evidence and to make such findings sufficiently specific to enable this court to ascertain whether the underlying facts afford a reasonable basis for the result reached. Town of

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

*Jamestown v. Kennelly*, 81 R.I. 177, 180-81, 100 A.2d 649, 651 (1953). Thus, even if we were to draw every fair and reasonable inference from the facts recited in this portion of the report and order, it is our belief that the commission has not met its burden in this matter. We had occasion to observe recently that a mere recitation of well-known economic facts of life constitutes no more than a description of the state of the economy and does little to provide an evaluative insight into the reasonableness of a utility company's proposals—in this case, the propriety of normalizing tax benefits. *New England Tel. & Tel. Co. v. Public Util. Comm'n*, R.I., 358 A.2d 1, 13 (1976).

We, therefore, hold that the treatment given this proposition by the commission was deficient. The matter of normalization of tax benefits is remanded to the commission for supplemental consideration, perhaps in the light of the division's own arguments under the present petition.

#### VI. Attrition Allowance

The commission rejected the proposed inclusion, in the company's rate of return, of an attrition adjustment of 2.1% over and above the requested 15.3% return on equity, which, with various adjustments for taxes, amounts to an additional \$1.846 million in the cost of service for the test year. Fundamentally, the company's position is that factors such as inflation and various lags in revenue collections have created an attrition of earnings in recent years and that its rate of return should be adjusted to account for such attrition as is likely to occur in the future.

\*420 [17] Attrition or erosion of earnings has been described as:

\* \* \* the lessening or diminution of a rate of earnings caused by and resulting from the addition of plant at a cost higher than the cost for similar additions at the time rates were last established. It results directly from the fact that new additions to plant at a cost higher than the previous average produces a new cost greater than the old while the rate of return previously established is re-

lated to (but not based upon) the old, or lower cost.' *Re Baltimore Gas and Elec. Co.*, 24 P.U.R.3d 247, 256 (Md.P.S.C.1958).

While recognition of erosive trends is a relatively recent development, it is now generally conceded that where such attrition has been clearly demonstrated by a utility company, an adjustment to that company's rate of return is appropriate. 1 Priest, *Principles of Public Utility Regulation* at 204 (1969); See *Legislature of the County of Rockland v. New York State Pub. Serv. Comm'n*, 49 A.D.2d 484, 487, 375 N.Y.S.2d 650, 652 (1975).

The most often-cited reasons for allowing these adjustments are: (1) they utility \*\*1209 company had a need to earn a fair rate of return for a reasonable period in the future, *Re Mountain States Tel. & Tel. Co.*, 7 P.U.R.3d 115, 119 (Ariz.Corp.Comm'n 1954); (2) continued erosion of earnings harms the public interest insofar as poor earnings require the utility to go into the money market in a disadvantageous position, *Re Public Serv. Co.*, 34 P.U.R.3d 186, 216 (Colo.P.U.C.1960); and (3) the inability of the utility to earn a fair rate of return for substantial periods of time tends to cause each rate case to follow closely upon the heels of the next previous rate increase. *City of Lynchburg v. Chesapeake & Potomac Tel. Co.*, 200 Va. 706, 715, 107 S.E.2d 462, 469, 28 P.U.R.3d 368, 375 (1959); *State v. New Jersey Bell Tel. Co.*, 30 N.J. 16, 27-28, 152 A.2d 35, 41-42, 29 P.U.R.3d 87, 93 (1959).

This court has acknowledged the commission's duty to recognize erosive trends in determining whether to permit \*421 a company to collect its requested rate relief, *Rhode Island Consumers' Council v. Smith*, 113 R.I. 232, 247, 319 A.2d 643, 651 (1974), but we have stated also that the commission's chosen method of compensating for such erosion enjoys a presumption of reasonableness and that its decision on such matters will be allowed to stand absent a convincing showing to the contrary. *New England Tel. & Tel. Co. v. Public Util. Comm'n*, R.I., 358 A.2d 1, 11 (1976). And it follows from this that where, as in the present case, the commission denies all relief of this sort, the decision is presumptively reasonable and the burden is upon the company to show by clear and convincing evidence that it is

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

clearly, palpably and grossly unreasonable. Rhode Island Consumers' Council v. Smith, 111 R.I. 271, 295, 302 A.2d 757, 772 (1973). We turn now to an examination of the arguments and the evidence upon which they are based to determine if such a showing has been made.

In this case, the commission's refusal to adjust the company's rate of return to reflect an attrition factor is based upon two major premises. The first is that there are offsetting factors appearing in the record, which tend to absorb and therefore neutralize the projected effects of erosion. The commission maintains, and correctly so, that the rate of return is not a guarantee that earnings will attain that particular level. The company's earnings, in response to various factors in the economy, may fall short of the rate of return or they may possibly exceed it. The commission, after making a vague reference to the company's performance this year, indicated that the latter 'might be the case' for this company this year. Additionally, the commission indicated that a recent work stoppage at the company raised the 'possibility' of a windfall of profits for the company and that, even prior to the strike, the company and NEES experienced a 'great surge \*422 in earnings.' On these bases, the commission substantiated its belief that the adjustment for attrition was 'theoretically suspect.'

The commission's second premise was that the company's calculation of the proposed adjustment was wholly invalid. Specifically, the commission pointed out the fact that the company's reliance on certain figures to support its proposed attrition adjustment was inconsistent with its previous rejection of those same figures as a measure of the company's earnings. The commission partially adopted the company's earlier view in holding that the calculation was of 'too questionable a nature to support the adjustment' for attrition.

To support its general claim that the commission acted arbitrarily and abused its discretion in this regard, the company retorts that there are no findings in the record which indicate the likelihood of a significant windfall resulting from the work stoppage and that the actual impact of the strike could not have been ascertained at the time the report and order was issued. By way of affirm-

ative rebuttal, the company poses the hypothesis that the higher wages which will be paid under the new union contract might result in higher costs \*\*1210 for construction and maintenance projects which were necessarily deferred for the duration of the strike. While the company admits this to be speculation, it maintains that it is no less so than the commission's own suppositions.

In response to the commission's findings regarding the 'surge' in the company's and NEES's earnings, the company cites the fact that, in its own case, it still showed a revenue deficiency of \$10 million for the test year. It states further that NEES is not requesting rate relief in these proceedings and that the state of its earnings is fairly irrelevant.

Finally, the company alleges that, in its analysis of the \*423 company's calculations of attrition, the commission misread and misconstrued the evidence relied upon and that, contrary to the commission's findings, the figures relied upon support rather than undermine the calculations.

[18] We note initially that the commission's method of specifying those offsetting factors tending to eliminate the effects of attrition, is recognized as a valid regulatory approach. 1 Priest, Principles of Public Utility Regulation at 204-06 (1969), citing Southwestern Bell Tel. Co. v. State Corp. Comm'n, 192 Kan. 39, 84, 386 P.2d 515, 553, 51 P.U.R.3d 113, 155 (1963). While the burden is upon the company to present evidence that these offsetting factors are less than sufficient to neutralize the effects of erosion, 1 Priest, supra at 204, the burden falls upon the commission in the first instance to support its conclusions with legal evidence sufficiently specific to enable us to ascertain if the facts upon which those conclusions are premised afford a reasonable basis for the result reached. Town of Jamestown v. Kennelly, 81 R.I. 177, 180-81, 100 A.2d 649, 651 (1953).

[19] We are not satisfied that either side to the instant controversy has satisfactorily shouldered its burden. We do, however, appreciate the fact that, at the time this matter was under consideration before the commission, the long- and short-term effects of a major work stop-

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

page could not have been foreseen. Because it appears that the economic aftershock of the strike will have a significant effect on the company's future earnings and, in turn, upon the projected attrition of those earnings, and because the case will be remanded to the commission for reconsideration of other matters, we remand this portion of the case for reconsideration in the light of more up-to-date information regarding the residual effects of the strike.

We next consider the matter of the company's having experienced a 'surge in earnings.' In this case, the commission\*424 expressly relied upon evidence that the company's earnings on common equity had increased substantially between the calendar year 1974 and the first quarter of 1975. While we concur in the commission's finding that an increase in earnings on common equity tends to offset whatever attrition to earnings the company has experienced, its effect upon the rate of return, like the effects of the work stoppage, may be better evaluated in light of the company's actual operating experience since the commission rendered its report and order. *Rhode Island Consumers' Council v. Smith*, 111 R.I. 271, 298, 302 A.2d 757, 773 (1973). We, therefore, remand this question to the commission in light of the company's growth-in-earnings pattern since the commission issued its report and order in this case. What we said about the residual effect of the strike applies with equal force to the company's surge in earnings.

With regard to the disputed use of certain calculations by the company in support of its proposed attrition adjustment, we cannot discern from the face of the report and order the precise reason why the company's calculations were considered suspect. All that is supplied is a concession that those calculations are not totally invalid\*\*1211 coupled with the assertion that they are 'of too questionable a nature to support the adjustment.' From this we are unable to conclude whether or not those calculations may form a basis for disallowing the attrition adjustment. We, therefore, remand this matter for reconsideration and a supplementary de-

cision. *United Transit Co. v. Nunes*, 99 R.I. 501, 504-05, 209 A.2d 215, 217-18 (1965).

*VII. The Rate of Return*

[20] The rate of return allowed to a utility company is the percentage by which that company's rate base is multiplied in order to determine the revenues needed to pay expenses and to acquire investment capital. To calculate \*425 the rate of return, the costs of each component of capital, viz., debt, preferred stock and common equity, are weighted according to the ratio that each bears to the total capital structure of the company, and the resultant figures are added together to yield a sum which is the rate of return. [FN11] This rate must be reasonable and just and must look toward the immediate future as well as to the moment. Thus, a utility is permitted an opportunity to earn a return on the value of property utilized for the public convenience equal to returns generally achieved at the same time and in the same general part of the country on investments in order enterprises having corresponding risks and uncertainties. *Rhode Island Consumers' Council v. Smith*, 111 R.I. 271, 292-93, 302 A.2d 757, 770 (1973). This court has also adopted the standard for reviewing the reasonableness of an allowed return as promulgated by the United States Supreme Court in the *Permian Basin Area Rate Cases*, 390 U.S. 747, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968), that a return should be sufficient to permit the utility '\* \* \* to maintain financial integrity, attract necessary capital, and fairly compensate (its) investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable.' *Id.* at 792, 88 S.Ct. at 1373, 20 L.Ed.2d at 350.

FN11. The rate of return in this case was computed as follows:

Type of Capital	Capital Structure	Cost Rate	Weighted Cost
Debt	53.7%	7.17%	3.85%

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

Preferred Stock	13.4%	5.82%	.78%
Common Equity	32.9%	12.5%	4.11%

Composite Cost of Capital 8.74%

Because the returns to investors in preferred stock and debt are contractually fixed at predetermined levels, the most controversial element of the rate of return is, in most cases, the return on equity. *Narragansett Elec. Co. v. Kennelly*, 88 R.I. 56, 83-84, 143 A.2d 709, 725 (1958). This arises, of course, from the fact that common stock pays no \*426 fixed yield but only dividends which, if they are paid at all, are paid in an amount and at a time specified by the company's management. *Nichols and Welch, Ruling Principles of Utility Regulation, Rate of Return, Supp. A at 222-23* (1964). The instant case presents no exception to this general pattern in that the only dispute with regard to the rate of return herein centers around the cost of equity.

The company's witnesses at the hearing below calculated an overall rate of return of 9.68% based in part on a proposed return on equity of 15.3%. This latter figure was derived from a complicated statistical analysis which compared the company's performance with that of some 90 other companies on the basis of 49 correlated variables. We will make no attempt to evaluate the utility of the company's approach but note only that the commission discarded it as being nonpredictive and without theoretical basis. The commission opted instead for the so-called Discounted \*\*1212 Cash Flow method employed by its own witness which yielded a return on equity of 12.0% assuming no need in the near term future for equity financing or 13.5% if such financing were to become necessary. Since the record contained testimony by company witnesses that neither the company nor NEES[FN12] would require equity financing in the near future, the commission chose the 12.0% figure. Citing what it regarded as fairness to the company's existing or 'captive' investors, the return on equity was finally pegged at 12.5% the rate which had been allowed since the previous rate case.

FN12. The commission rejected the suggestions of both sides of this controversy that the capital structure of NEES be used in calculat-

ing the rate of return. Thus, the commission used only the company's capital structure including debt services on short-term obligations. See note 11 supra.

While the report and order contains a statement to the effect that the choice of a 12.0% cost of equity was based \*427 upon evidence that no new equity financing was necessary in the near future, the true basis of the conclusion reached in this respect was somewhat obscured by the inclusion of an addendum of sorts which sets forth additional reasons for minimizing the allowed return on equity. Responding to its duty under the *Hope*[FN13] and *Bluefield* [FN14] decisions, the commission claimed to have reviewed all the relevant evidence and to have taken into consideration, 'all the interests it is (its) duty to guard.' Specifically, the commission took notice of the fact that construction of new plant has brought the company to a point where it has an excess capacity of 20 to 40%. The commission thereupon decried the alleged need for construction financing. The commission also seized this opportunity to unburden itself of its adamant opposition to unnecessary growth of utilities. Secondly, the commission noted that the state of the economy and the resultant inability of some consumers to pay increased rates are such that any upward pressure on the rate of return should be resisted. Lastly, the commission stated that after a rather poor performance during 1974, the company has resumed a normal growth-in-earnings pattern and that this fact supports its conclusion that the existing return on equity of 12.5% is just and reasonable.

FN13. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944).

FN14. *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

The company's objections to this facet of the decision are twofold. First, the company strenuously objects to

368 A.2d 1194  
 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
 (Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

any reliance whatsoever upon the consumer's ability to pay for services rendered, echoing the by-now familiar expression that 'utility companies are not eleemosynary institutions.' Second, the company argues that to differentiate between enterprises that will require equity financing and those \*428 that will not has the effect of luring investors in only to penalize them when they have done so; and that any on-going enterprise has a continuing need to raise capital to support its construction program.

[21] The rate of return allowed by the commission in a given rate case is entitled to a presumption of reasonableness until the company comes forth with clear and convincing evidence that it is clearly, palpably and grossly unreasonable. Rhode Island Consumers' Council v. Smith, 111 R.I. 271, 295, 302 A.2d 757, 772 (1973). So too, the commission is permitted broad discretion in its choice of methodology and that choice will not be disturbed as long as the end result is fair and reasonable. New England Tel. & Tel. Co. v. Public Util. Comm'n, R.I., 358 A.2d 1, 19 (1976).

[22] Applying these standards of review to the instant matter, we will not, as we have not in the past, second-guess the commission's choice of the Discounted Cash Flow method of fixing a return on equity. Thus, insofar as the 12.5% return reflects the proper considerations which \*\*1213 that method imports and insofar as that figure represents a reasonable return on equity, it will not be disturbed. While we can appreciate the relevance in determining the cost of equity of excess plant, see Ex Parte Reserve Tel. Co., 16 P.U.R.3d 197, 201 (La.P.S.C.1956), and the recent resumption of normal earnings growth, we are troubled by the commission's reliance, in this narrow sphere, upon the consumers' ability to pay for services rendered.

[23] It is indeed true that the commission's work is affected with a public interest, G.L.1956 (1969 Reenactment) s 39-1-1, and that the commission is entrusted with a broad charter to be ever mindful of the needs of the consumer as well of the investor. Permian Basin Area Rate Cases, supra, 390 U.S. at 792, 88 S.Ct. at 1373, 20 L.Ed.2d at 350; \*429 Rhode Island Consumers' Council v. Smith, 111 R.I. 271, 293, 302 A.2d 757, 770

(1973). However, it is well settled that, with regard to fixing a rate of return, the appropriate manner in which to protect consumer interests is for the commission to assure that the utility company is permitted to earn a return no greater than is necessary to maintain the financial health of the company. That is, the consumer is treated fairly if he pays no more than the cost of the service that has been rendered to him including a reasonable profit. Re Potomac Elec. Power Co., 83 P.U.R.3d 113, 143 (D.C.P.S.C.1970).

The foremost expression of the law in this respect was provided by the Washington Supreme Court in 1934, a time at which consumers were in more dire straits than today's electric power consumers. That court stated that

'\* \* \* public service companies are not eleemosynary institutions, and they cannot be compelled to devote their property to a public use except upon the well-recognized basis of a fair and reasonable return therefor. Through general taxation only, in common with all taxpayers, can they be compelled to contribute to the relief of the distressed.' State ex rel. Puget Sound Power & Light Co. v. Department of Pub. Works, 179 Wash. 461, 468, 38 P.2d 350, 353, 7 P.U.R.(n.s.) 14, 19 (1934).

We agree with these principles and hold that, in this case, the commission has erred in relying upon the ability of consumers to pay for services in setting a cost of equity. However, as we stated earlier, the report and order is somewhat vague in specifying the exact extent to which each of the named factors influenced the ultimate choice of 12.5% as a cost of equity. Inasmuch as the inability of consumers to pay the cost of service is the only criterion suffering a fatal infirmity, the matter of the return on equity is remanded for a clarification of the commission's position in this respect and, if necessary, an appropriate adjustment in the cost-of-equity figure.

\*430 This holding should not be read to import that local economic conditions do not have a bearing in establishing an appropriate return on equity. We have already stated that the process of fixing a return on equity is a process of comparing the company being examined with other similar enterprises having similar risks. Thus, the

368 A.2d 1194  
20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194  
(Cite as: 20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194)

cost of equity is very much a measure of the desirability of the company's stock as an investment opportunity and local economic conditions, including employment, population and standard of living, have a significant impact on investor confidence. *Re Diamond State Tel. Co.*, 21 P.U.R.3d 417, 436 (Del.P.S.C.1958). Our only statement in this case with regard to local conditions is that specific reliance by the commission on the consumers' ability to pay is error.

### *Conclusion*

The company's petition for certiorari as it relates to the following topics is denied: I. The Roles of the Attorney General and the Commission; II. Cash Working Capital-Purchased Power Expense; III. Allocation of Additional Tax Depreciation and IV. Interest Expense Deduction from the Company's Federal Income Tax Requirement.

**\*\*1214** The company's petition for certiorari as to the remaining topics is sustained: V. Normalization of Tax Benefits; VI. Attrition Allowance; and VII. The Rate of Return.

The records certified to this court are ordered returned to the commission. As to topics V, VI and VII, the commission should reconsider the testimony in the present record supplemented by such further testimony as may be offered pursuant to the petition of any party or by its own direction or as may be required to fulfill the directives of this opinion, and it should then make further findings and orders in harmony with this opinion. Any party thereafter dissatisfied may, by filing a motion in this court within 7 days following the commission's action, bring the matter before us for further consideration. In that event it will be set down for argument upon the briefs now before us and upon such supplemental record and briefs as may be required. Jurisdiction for the review of the commission's supplementary decision and amended order is retained in this court.

R.I. 1977.  
*Narragansett Elec. Co. v. Harsch*  
20 P.U.R.4th 112, 117 R.I. 395, 368 A.2d 1194

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