- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH -

In the Matter of the Application of MOUNTAIN FUEL SUPPLY COMPANY to Increase Rates and Charges.	))))	DOCKET NO. 93-057-01 ORDER ON REHEARING

ISSUED: December 1, 1994

SYNOPSIS

The Commission having granted rehearing and reconsideration on the issues of unbilled revenue and cost of capital herein reaffirms its January 10, 1994, Order.

BY THE COMMISSION:

The Commission issued a rate Order in this Docket on January 10, 1994. Within the statutorily established time for filing, Mountain Fuel Supply Company ("Mountain Fuel" or "Company"), the Division of Public Utilities ("Division") and Geneva Steel Company ("Geneva") filed requests for reconsideration. We have disposed previously of all issues raised for reconsideration save two raised by Mountain Fuel: (1) unbilled revenues and (2) cost of capital. On those issues the Commission took additional testimony and filings from the parties. By this Order we make final disposition of those issues.

UNBILLED REVENUES

With regard to the unbilled revenues issue, Mountain Fuel argues that "the Commission's decision to impute unbilled revenues is not supported by factual findings or legal analysis, is not based on record evidence, is arbitrary and capricious, and results in rates that are not just and reasonable." More specifically the Company argued:

1. The Commission's Order on unbilled revenues lacks required findings of fact and analysis, which renders it inadequate as a matter of law.
2. The unbilled revenue adjustment unlawfully adds additional revenues to a test period that already properly matches revenues and expenses.
3. Unbilled revenue at the end of the year is offset by the prior year's collection, and is not an accumulating balance that should be amortized in future rates. Imputing unbilled revenues based on past growth is unlawful retroactive ratemaking.
4. Proper ratemaking for deferred taxes should not include amortization of unbilled revenues.

We agree that on the issue of unbilled revenues the Order requires additional findings and rationale. That fact has to do with the previous state of the record. The Court has made it clear that there must be sufficient findings so that the Court can understand how the Commission's conclusions were reached. Mountain States Legal Found. v. Public Serv. Comm'n, 636 P2d 1047 (Utah

1981). The Court has also stated that the Commission need not follow the format of trial courts but may articulate its findings in a narrative, discursive style, so long as the factual basis for the decision is clear. U.S. WEST Communications, Inc. v. Public Serv. Comm'n, Supreme Court No. 910408, filed July 29, 1994.

Accordingly, we supplement our January 10, 1994, Order with additional findings and explanations.

"Unbilled revenues" are revenues not yet received, or recorded by the Company, for services already rendered. The unbilled revenue problem arises because the Company reports revenues on an "as-billed" basis for financial and ratemaking purposes, and on an "as-delivered" basis for tax purposes. The difference is one of timing: only part of the gas volumes actually delivered during any year will have been billed (thus, revenues are "as-billed") while income taxes will have been calculated on the basis of all volumes delivered (thus, revenues are "as-delivered" and include unbilled revenues). For ratemaking purposes, this results in a difference in income taxes, namely a deferred income tax debit, which is an addition to rate base upon which a return is allowed and income taxes paid.

The record in the present docket shows that the deferred income tax debit associated with unbilled revenues has been included in rates since December 1, 1990, the rate-effective date for Docket No. 89-057-15. As an addition to rate base, the deferred income tax debit increases recoverable expenses. The unbilled revenues which gave rise to the rate base addition, however, were not at that time included in rates.

Prior to the January 10, 1994 Order in this docket, revenues reported on an as-billed basis were used for ratemaking purposes in Mountain Fuel rate cases, even though expenses and investments were effectively on an as-delivered basis. The Committee of Consumer Services ("Committee") and Division witnesses testified that two problems have been created. First, test-year revenues, expenses and investments are improperly matched in time. Second, the test year is unbalanced by the addition of expenses and the exclusion of associated revenues. The net effect has been detrimental to ratepayers. In our Report and Order issued January 10, 1994, we stated, "in order to properly match test-year revenues with test-year expenses including taxes, and to maintain accrual accounting for deferred income taxes, we find it appropriate to phase into rates unbilled revenues and the corresponding deferred taxes over a five-year period." We decline to alter this ordered outcome but in the following provide a more explicit rationale supporting it.

A. Failure to Include Unbilled Revenue in Ratemaking Revenue Creates an Unmatched Test-Year.

The record shows that under the Company's cycle billing practice, a portion of the gas delivered to a customer during any month is billed to that customer in the following month. Thus the revenues received from billing do not match in time the delivery of gas or the costs incurred to provide service. When resultant "as-billed" revenues are used in conjunction with expenses and investments associated with the actual delivery of service ("as-delivered") to establish test-year results, we find that the test year will not properly match revenues with expenses and investments. A portion of the revenues for service delivered during the test year is excluded (that which is unbilled at the end of the test year). A portion of the revenues for service delivered during the year preceding the test year is included (that which is unbilled at the end of the preceding year). Thus, we find that cycle billing is the source of the unbilled revenue problem. In a rate proceeding, steps are usually taken to eliminate this sort of revenue-expense-investment timing mismatch.

The Company contended that its method of calculating test-year revenues does not give rise to such a timing mismatch. The record shows that the Company calculates test-period revenues as the 12-month sum of the product of normalized prices, weather-normalized monthly billed use per meter, and the normalized number of meters. This measure, the Company claimed, is independent of the as-billed revenue reported for financial purposes. According to the Company, this calculation yields revenues which properly match the as-delivered expenses and investments in the test period. We observe, however, that this revenue calculation begins with the volumes associated with the revenues reported for financial purposes; that is, with as-billed revenues. Subsequent normalizing manipulations do not create an estimate independent of this starting point. As-billed volumes have merely been weather-normalized. We therefore find that the Company's revenue calculation does not produce a measure of revenues coincident in time with expenses and investments. The problem of the mismatched test year remains.

The record also shows that unbilled revenues will continue to grow so long as the Company's gas sales volumes grow, year to year. Growth brought about by increasing numbers of customers has more than offset the effects of decreasing use per customer. This is revealed on the record by the growth of unbilled revenues during the 1987 to 1992 period. By the end of 1992, accumulated unbilled revenues stood at nearly $28 million.

Therefore, we conclude that a failure to incorporate unbilled revenues in the test year will understate ratemaking revenues, and will produce a timing mismatch of revenues with expenses and investments.

B. Including the Tax Consequences of Unbilled Revenues but not the Unbilled Revenues in the Test Year Will Result in an Unbalanced Test Year, Inequitable to Ratepayers.

The origin of the unbilled revenue problem dates to the Company's decision to continue to report revenues for financial and ratemaking purposes on an as-billed basis when the Tax Reform Act of 1986 required companies to move to reporting revenues on an as-delivered basis for tax purposes. We find that Company decision-making is responsible for the tax timing difference. The difference is the income tax associated with unbilled revenues. For ratemaking purposes, the taxes on unbilled revenues are deferred, accumulate year to year, and are included in rate base. Hence, rates are increased by the amount of the carrying charge on the accumulated deferred income tax balance. By 1992, this deferred tax balance was estimated to be more than $10 million. Based on record evidence, we estimate a $1.4 million increase in cost of service attributable to the deferred tax.[1]

The Tax Reform Act of 1986 requires the recognition for tax purposes of unbilled revenue over a four-year period. By the end of 1990, the Company was fully accruing all unbilled revenues, that is, reporting all revenues on an as-delivered basis, for tax purposes. The Company, however, continued to report revenues on an as-billed basis for financial and ratemaking purposes. We note that this was contrary to our decision in Docket No. 78-035-21, in which Utah Power and Light Company was ordered to recognize unbilled revenues for ratemaking purposes in order to correct a mismatch caused by system growth.

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[1] The change in cost of service = [10.08% + 38.25% *1.6194 * 6.11%] * $10.072 million = $1.396 million, where 10.08% is the allowed rate of return on rate base, 38.25% is the composite state and federal income tax rate, 1.6194 is the Income-to-Revenue Multiplier, 6.11% is the weighted cost of preferred and common equity, and $10.072 million is the 12/31/92 value of the deferred income tax debit.

In Docket No. 89-057-15, the accumulated deferred income taxes associated with unbilled revenues were, for the first time, proposed by the Company for inclusion in rates. As no party opposed the adjustment, it was accepted without examination. No corresponding adjustment to revenues was made, however, and as we learn in the present docket, the revenues that gave rise to the tax obligation were ignored for ratemaking purposes. We find that the test year under these conditions is improperly constructed.

We note that this deferred tax obligation will only reverse over the life of the entire enterprise; i.e., until the revenue stream declines to zero. So long as this obligation exists, the associated carrying charges will be recovered in rates. We conclude that it was the Company decision to book revenues differently for tax and for financial purposes which caused, contrary to prior Commission order, this adverse and until now unchallenged cost-of-service consequence.

Following the initial decision and during rehearing, the Company formally proposed an alternative approach to the unbilled revenue problem. The proposal was to remove the deferred tax obligation from ratemaking. No revenue adjustment to account for unbilled revenues would, however, be made. We find this proposal inadequate on two counts and therefore reject it. First, it does not solve the test-year timing mismatch created by cycle billing. Second, it is inconsistent with accrual accounting.

C. An Unmatched Test Year May Be An Acceptable Short-Run Outcome in the Pursuit of Longer-Run Ratemaking Objectives.

A 12-month set of revenues, expenses, and investments, matched in time, is a principal aspect of a properly constructed test year and a standard of regulatory practice. The Company has contended that phasing-in unbilled revenues will result in the inclusion of more than 12-months of revenues in the test year, thus producing an unmatched test year. We conclude this is an acceptable short-term phenomenon designed to achieve a long-term balance equitably and in a manner consistent with ratemaking objectives.

For example, adoption of accrual accounting may introduce a short-term imbalance or test-year mismatch, yet it is routinely urged upon the Commission in this jurisdiction by the Company and other parties. Thus, we decided, both in rulemaking and in certain specific cases to include more than 12-months of post-retirement-benefits-other-than-pension expenses in rates so that at the end of 20 years a proper balance would obtain. We permitted the "South

Georgia" adjustment, which included more than 12-months of taxes in rates for 17 years, the average life of plant at the time the decision was made, in order to correct past under-accruals. As previously mentioned, we decided in Docket No. 78-035-21 to include unbilled revenues in Utah Power's rates in order to correct a mismatch caused by system growth.

We conclude that it is appropriate and not unusual to accept, in the general move to accrual accounting embraced in this jurisdiction, a short-term violation of the test-year matching principle. We further conclude that phasing unbilled revenue into ratemaking revenue over five years, the proposed solution to the unbilled revenue problem in this docket, is appropriate. It would remove the timing mismatch of revenues, expenses, and investments by placing them all on an as-delivered basis. We recognize that this remedy will create a mismatch of another sort; that is, a short-term mismatch by deliberate regulatory action to create a long-term match. We deem the long-term match more important than this short-term mismatch.

The gas portion of unbilled revenues should be addressed by all parties in the next Mountain Fuel pass-through docket.

COST OF CAPITAL

In its request for rehearing, the Company posits that the 11 percent allowed rate of return on equity is too low because a properly interpreted record supports a higher rate. More specifically, the Company alleges:

1. That the 12 percent we allowed U S WEST Communications, Inc. on April 15, 1993, means that 11 percent for Mountain Fuel is too low.
2. That if we had properly assessed the new business risks caused by FERC Order 636, we would have allowed a higher equity return.
3. That contrary to our Order, the evidence on financial risk does not support selection of the allowed return from the lower portion of the range of reasonable returns and;
4. That we incorrectly assumed that the Company would not be seeking external financing and were influenced by this to order an 11 percent return on equity, which is too low.

We resolve those arguments as follows:

With regard to the argument that the rate of return allowed U S WEST Communications, Inc. ("USWC") is somehow a benchmark to which the Commission must refer in setting a return for Mountain Fuel, we find that there is no basis for comparing the two companies on this record and, therefore, no basis for establishing similar returns. Mountain Fuel is like USWC only insofar as both are regulated public utilities and both face competition in some markets formerly closed to entry, which would suggest increasing risk. However, there the similarities end. These two companies are in different industries having different market characteristics, face different business and financial risks, have different managements and so on.

The Company has argued that our Order is internally inconsistent in speaking of the business risk effects of FERC Order 636. In the section on cost of capital, we found that increasing risk was already incorporated in the market assessment of the value of local distribution company shares. Our discussion of a stipulation by the parties establishing an incentive program for Mountain Fuel's participation in a post-Order 636 capacity release program did address the presence of new risk. These findings are not inconsistent. Mountain Fuel's participation in the new and largely untried capacity release market carries some risk and that is one reason the stipulation created an incentive for the Company. By linking risk to the incentive with respect to the capacity release program, we were not implying an overall increase in business risk for Mountain Fuel. Discussion of changes in business risk was made only in the cost-of-capital section of the Order.

In contrast to this single issue, our cost-of-capital discussion of business risk took into consideration all aspects of the post-Order 636 operating environment contained in the record and found on balance that an allowed return of 11 percent was warranted.

In its rehearing testimony, the Company merely reasserted the argument it made in the initial hearings that the post-FERC 636 Order environment is riskier than before. However, we found persuasive the quantitative analysis presented by the Division, based on the proposition that FERC Order 636 effects were known to the market a full year before the hearings in this Docket. This and the testimony of other witnesses shows that to the extent such risk existed, it had already been reflected in the stock prices used in each witness's cost-of-capital estimation model. In other words, to accept the Company's position would result in double-counting. There was also on the record a Standard and Poor's report which concluded that Mountain Fuel faced easier adjustment to the post-Order 636 environment than did most local distribution utilities.

With regard to financial risk the record shows that Mountain Fuel's capital structure contains more equity than do those of comparable companies. The record also shows that with increased equity in the capital structure there is less financial risk. Where risk is less, it follows that the return should be less. Two of three witnesses testifying on this issue recommended that allowed return should be reduced to account for lower financial risk, that it should be in the lower part of the range (10.7% to 11.8% and not in dispute here) and further, that the return granted should be 11% or less. These recommendations influenced our decision of 11%.

Another factor is the short-term need of the utility under consideration to go to the capital markets. In this case there was no evidence that Mountain Fuel might soon enter the capital markets. The Company asserted that periods of unusual construction activity were behind it. Indeed, based upon testimony in the record, were it to seek financing for the amounts suggested in its rehearing request ($17 million debt; $20 million equity), the Company's debt-to-equity ratio would actually decrease, further reducing financial risk. There was no evidence indicating that the 11 percent return allowed would in any way inhibit the raising of capital by the Company. The Division adduced testimony in this record indicating that the allowed return of 11 percent maintains adequate interest coverage and the Committee's witness testified that 11 percent is within the range of returns then being granted by commissions for local distribution utilities.

In conclusion, the record evidence clearly supports an award of 11 percent return and we decline to award the Company anything higher.

ORDER

NOW, THEREFORE IT IS HEREBY ORDERED that the Commission having previously reheard and reconsidered the issues of unbilled revenues and cost of capital, affirms its previous Order of January 10, 1994.

DATED at Salt Lake City, Utah, this 1st day of December, 1994.

/s/ Stephen F. Mecham, Chairman

(SEAL) /s/ James M. Byrne, Commissioner

/s/ Stephen C. Hewlett, Commissioner

Attest:

/s/ Julie Orchard
Commission Secretary