(Decision No. 78811)

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF COLORADO

* * *

IN THE MATTER OF THE APPLICATION OF PUBLIC SERVICE COMPANY OF COLORADO FOR A DETERMINATION BY THIS COMMISSION THAT IT IS ENTITLED TO ADDITIONAL ELECTRIC AND GAS REVENUES, AND AUTHORIZING IT TO FILE NEW ELECTRIC AND GAS RATES AND TARIFFS TO PROVIDE A FAIR RATE OF RETURN.	APPLICATION NO. 24900 DECISION OF THE COMMISSION GRANTING THE APPLICATION IN PART AND AUTHORIZING THE FILING OF NEW RATES.

October 4, 1971

Appearances: Bryant O'Donnell, Esq., and
Donald D. Cawelti, Esq.,
Denver, Colorado,
for Applicant;
D. Monte Pascoe, Esq.,
Denver, Colorado, for
Colorado Project/Common Cause;
David W. Furgason, Esq.,
Denver, Colorado, for
CF&I Steel Corporation;
Carolyn McNeill, Esq., Denver, Colorado, and
Arnold Fieldman, Esq., Albuquerque,
New Mexico, for The Atomic Energy
Commission and all other executive
agencies of the United States;
Elbridge Burnham,
Denver, Colorado, <u>pro se</u>;
Max P. Zall, Esq., and
Robert Dowler, Esq.,
Denver, Colorado, for
City and County of Denver;
Leland M. Coulter, Esq.,
Aurora, Colorado, for
City of Aurora;
Lew Trenner,
Englewood, Colorado, <u>pro se</u>;
Samuel Henry,
Denver, Colorado, <u>pro se</u>;
Polinar Rael,
San Pablo, Colorado, <u>pro se</u>;
Girts Krumins, Esq.,
Denver, Colorado, for the
Staff of the Commission.

PROCEDURE AND RECORD

The Public Service Company of Colorado (hereinafter referred to either by full corporate name or as Applicant or Public Service) on April 7, 1971, filed with this Commission the above-entitled application. By this application, Applicant seeks authority from the Commission to file new gas and electric rates that would produce an increase in gross revenues of $11,259,823 on the basis of the test year 1970.

On April 9, 1971, the Commission issued Notice of Application Filed and Notice of Hearing to be held May 11 and 12, 1971, at 10 a.m. in the Hearing Room of the Commission, 507 Columbine Building, 1845 Sherman Street, Denver, Colorado.

On April 14, 1971, Protest and Petition for Leave to Intervene was filed by CF&I Steel Corporation by and through their attorney, David W. Furgason. Leave to intervene was granted on April 19, 1971. On April 22, 1971, the City and County of Denver, by and through Max P. Zall, City Attorney, and Brian H. Goral, Assistant City Attorney, filed a Protest to the above-entitled application. On June 14, 1971, a Protest of the City of Aurora, Colorado, was filed by Leland M. Coulter and Richard Kaufman, Attorneys. On April 26, 1971, the U.S. Atomic Energy Commission on behalf of itself and all other executive agencies of the United States, by and through its attorney, Arthur Fieldman, filed a Petition for Leave to Intervene and Protest, which was granted on April 29, 1971. On May 7, 1971, Elbridge G. Burnham filed a Petition for Leave to Intervene, which was granted on May 10, 1971.

On April 27, 1971, Colorado Project/Common Cause, by and through its attorney, D. Monte Pascoe, filed a Motion to Dismiss, Objection of Temporary Increase in Rates, Protest and Request to be a Designated Party, or in the Alternative to Intervene. By Commission Decision No. 77508, dated April 29, 1971, the above-captioned pleadings were set for hearing on Tuesday, May 4, 1971, at 10 a.m. in the Hearing Room of the Commission, 500 Columbine Building, 1845 Sherman Street, Denver, Colorado. As a result of this hearing, the Motion to Dismiss, filed on April 27, 1971, by Colorado Project/Common Cause, was denied by Decision No. 77564, dated May 5, 1971; Leave to Intervene was granted.

Letters and petitions containing approximately 11,000 signatures of Applicant's customers protesting the rate increase have been received by the Commission. The witness from San Pablo in Costilla County, Mr. Polinar Rael, had alone collected 169 signatures on his petition. Another 10,000 of such signatures were on petition forms provided by Colorado Project/Common Cause.

The hearing on the above-entitled application began on May 11 and 12 and was continued to June 14, 1971. Hearings resumed again on June 15, 16, 17, 18, 25, 28, July 1 and 2, 1971. Customer witnesses who were present and so desired were heard on each of the hearing days. At the conclusion of the hearings the matter was taken under advisement by the Commission. Briefs were ordered due July 19, 1971.

Applicant's Exhibits 1 through 25 A and 26 through 46; Atomic Energy Commission Exhibits A through M; CF&I Exhibits A through F; Public witness Exhibits A and B; Colorado Project/Common Cause Exhibits 1 through 30; Elbridge Burnham's Exhibits 1 through 4 and Staff Exhibits A through I were offered and admitted into evidence.

FINDINGS OF FACT

From the record herein the Commission finds as fact that:

1. Public Service Company of Colorado is a public utility engaged in the business of generation, transmission, distribution and sale of electric energy and distribution and sale of natural gas in various areas in the State of Colorado. To a lesser degree, Public Service is also engaged in steam distribution and water and bus operations. The utility operations, including its gas and retail electric rates and service, are under the jurisdiction of the Commission, and the Commission has jurisdiction over the subject matter of these proceedings. Applicant's wholesale electric rates and service are under the jurisdiction of the Federal Power Commission. In the findings to follow, all items relating

to rate base, revenues, expenses and earnings applicable to wholesale electric service have been eliminated to the end that only the operating results under Commission jurisdiction are ultimately considered.

2. The test year for determination of rate base, rate of return and revenue requirements for Public Service Company in this proceeding is the 12-month period ending December 31, 1970. During this period, Applicant served an average of 483,320 electric and 398,017 gas customers.

3. The rate base of the Applicant for the electric department for the test year is $505,721,421, properly consisting of:

A.	Average plant in service including allocations	$588,765,041
B.	Average plant held for future use	346,297
C.	Average prepayments	524,416
D.	Average materials and supplies	12,985,199
E.	Construction work in progress	57,672,318
F.	Deduction of contributions in aid	5,123,251
G.	Deduction of customer advances for construction	825,354
H.	Deduction of the applicable reserve for depreciation and amortization	131,375,975
I.	Less: Rate Base Allocated to Federal Power Commission Jurisdiction Sales	17,247,270

4. The total operating revenue of the electric department of Public Service Company excluding wholesale sales under FPC jurisdiction, after in-period adjustments for changes in rates, amounts to $126,570,419 for the test year. The operating revenue deductions for the same period before in-period adjustments were $97,168,079. Necessary in-period adjustments reduce this figure by $2,429,085, resulting in an adjusted figure of operating revenue deductions in the amount of $94,738,994. These deductions, among other things, exclude $194,712 in advertising expenses from sales

expense; $94,013 in consulting fees, ECAP* advertising, executive salaries allocated to subsidiaries and $210,799 in donations and certain club dues from administrative and general expenses; and appropriate adjustments to state and federal income taxes including the elimination of the provision for a contingency accrual of $124,121.

5. Net operating revenue for the electric department as adjusted for the test year is $31,831,425, while interest during construction for the same period is $2,546,933. The net operating earnings of the electric department after all necessary and proper adjustments in the test year is $34,378,358, resulting in a rate of return of 6.80% on rate base.

6. The rate base of Public Service gas department for the test year is $107,645,150 properly consisting of:

A.	Average utility plant in service including allocations	$156,058,582
B.	Average gas stored underground	175,635
C.	Average plant held for future use	11,007
D.	Average prepayments	113,306
E.	Average materials and supplies	1,458,944
F.	Average construction work in progress	4,944,254
G.	Average cash working capital	697,063
H.	Deduction of contributions in aid	17,594,265
I.	Deduction of customer advances for construction	1,242,268
J.	Deduction of appropriate reserves for depreciation and amortization	36,977,108

7. The test year revenues for the gas department of Public Service amounted to $70,144,238, after in-period adjustments for the test year including changes in rates and weather normalization. The net operating revenue deductions for the same period before adjustments

*Electric Companies' Advertising Program amounted to $61,050,937. Necessary in-period adjustments including weather normalization increase this figure by $1,120,335, resulting in an adjusted figure of operating revenue deductions in the amount of $62,171,272. These deductions, among other things, exclude $87,783 in donations and certain club dues and $21,048 in certain consulting fees and executive salaries allocated to subsidiaries from administrative and general expenses; and appropriate adjustments to state and federal income taxes, including elimination of the provision for a contingency accrual of $38,456.

8. Net operating revenue for the gas department as adjusted for the test year is $7,972,966. After adding interest during construction of $71,691, the net operating earnings of the gas department for the test year is $8,044,657, or 7.47% return on rate base.

9. The rate base of Public Service Company combine gas and electric departments for the test year is $613,366,571, while the adjusted net operating earnings is $42,423,015, resulting in a rate of return of 6.92% on rate base.

10. Construction work in progress is necessary to provide utility service to the public and is properly classified in the rate base as long as net operating revenues are adjusted by the full amount of the interest charged construction during the year to determine net operating earnings and the rate of return.

11. The use of a test year concept requires that proper relationships be established between rate base, revenues and expenses that might prevail for a reasonable period in the future when the rates will be in effect. To reasonably maintain such relationships, it is necessary and proper to make certain normalizing and annualizing adjustments to test-year figures. Some of the adjustments included in the findings above are:

a. Customer advances for construction. The lowest average of the last five years is more appropriate than the test year figure since these advances are subject to refund during a five-year period.

b. An increase in wage rates paid to Applicant's employees that occurred during a test year must be annualized to properly reflect more current costs of doing business.

c. The increase in FICA tax rates taking effect on January 1, 1971, must be considered as an adjustment since this is an item beyond Applicant's control without any offsetting factors.

d. An increase in intrastate coal freight rates taking effect shortly after the end of the test year but having been authorized by the Commission during the test year is in the same category as "c" above.

e. Casualty losses must be adjusted to a reasonable average figure based on past history. In this proceeding a provision of $300,000 for casualty losses instead of the actual losses of $100,000 during the test year is reasonable and appropriate.

f. Electric sales advertising expense should be adjusted to recognize expenses of other comparable utilities and historical trends, as shown by Public Service's own annual expenditures in this respect. During the past 10 years, Applicant's electric sales advertising expense varied from a low of 67¢ per customer in 1962 to a high of $1.22 in 1966, with a gradual decline since. The weighted average for 10 large combination utilities in 1970 was 61¢ per customer. A reasonable allowance for electric sales advertising for rate-making purposes in this proceeding is 61¢ per customer per year rather than the $1.01 per customer expended during the test year.

g. Changes in income taxes because of all other adjustments.

12. Certain business-related service club dues, franchise-connected and miscellaneous expenses of Public Service are reasonable and necessary business expenses that must be considered in determining total operating revenue deductions for rate-making purposes in this proceeding. However, donations and charitable contributions ($292,846), as well as dues to clubs of a social connotation (such as the Denver Club and Denver Athletic Club - $5,736) are not proper expenses for rate-making purposes. Such expenditures are more properly chargeable to the owners of the utility than to its customers, and have therefore been excluded from operating expenses in the findings above.

13. A reasonable allowance for income taxes should be estimated on the basis of known tax deductions and a contingency allowance in this regard is unnecessary and improper for rate-making purposes, and therefore has not been allowed.

14. Expenses of $43,986 incurred in connection with the Electric Companies' Advertising Program (ECAP) are not necessary and proper expenses for rate-making purposes and have been excluded in this proceeding. Such advertising is done largely outside of Applicant's service territory and does not identify Public Service Company of Colorado as the sponsor. No benefit has been shown to accrue to ratepayers by this advertising program.

15. Other expenses not properly includable as reasonable and necessary for rate-making purposes include $36,704 of consulting fees paid to retired officials of Applicant, as well as a portion of executive salaries and the salaries of their confidential secretaries, attributable to management of subsidiaries. In this proceeding 9.11% of such salaries are properly allocated to operations other than gas and electric departments of Public Service.

16. Reserves for accumulated investment tax credit and certain deferred income taxes as well as the reserve for injuries and damages constitute cost-free funds to Applicant and will be subsequently considered in determining the overall cost of capital; accordingly, such reserves cannot properly be, and are not, deducted from rate base.

17. The fair rate of return of the combined gas and electric departments of Public Service at this time is 7.5%, which rate of return is both adequate and necessary to service its debt, pay a reasonable dividend, provide for reasonable accumulation of surplus, attract necessary new capital, and maintain the financial integrity of the company.

18. The fair rate of return applicable only to the gas department of Public Service at this time is 7.7%.

19. In determining the cost of capital, due consideration must be given to Applicant's investment in subsidiaries and other property ($13,495,234), which are equity investments in nature; Applicant's advances to subsidiaries ($18,501,171), which are associated with debt capital; as well as other sources of funds which are cost free. In considering the tax reserves mentioned in Finding No. 16, it is found that such reserves are being continuously reduced. Such reduction occurs because of amortization of such reserves to operating income, which, in itself, reduces the revenues required of Applicant's customers. As total capital continues to grow, a reduction in the aggregate amount of these reserves results in an even faster reduction in the proportion of capital being supplied from this source. At the end of the test year, deferred tax reserves amounted to $19,820,684, or approximately 3% of total capital. The proper and reasonable amount to be included in capitalization is one-half (1/2) of the amount at the end of the test year or $9,910,342. The reserve for injuries and damages is likewise a source of cost-free funds, but, unlike the deferred tax reserves, can be expected to reasonably follow the trend of other capital and, therefore, the average amount for the year ($574,739) should also be included. A reasonable capital structure, therefore, for ratemaking purposes in this proceeding is as follows:

	Pro Forma Capitalization	Adjustments	Adjusted Pro Forma Capitalization	%
Deferred Taxes and Operating Reserves		10,485,081	10,485,081	1.59
Long-Term Debt	378,800,000	(18,501,171)	360,298,829	54.62
Preferred Stock	80,000,000		80,000,000	12.13
Common Equity	222,352,542	(13,495,234)	208,857,308	31.66
	681,152,542	(21,511,324)	659,641,218	100.00

20. An overall rate return of 7.5% on the rate base as determined herein would result in an approximate rate of return on common equity of 12.8% as follows:

	% of Total Capital	Annual Rate %	Proportional Cost %
Deferred Taxes and Operating Reserves	1.59	0.00	0.00
Preferred Stock	12.13	4.73	.57
Long-Term Debt	54.62	5.26	2.87
Common Equity	31.66	12.82	4.06
		Fair Rate of Return	7.50

21. A rate of return on common equity of Applicant in the range of 12.5 to 13.2% is fair and reasonable and commensurate with returns on investments in other enterprises having corresponding risks. A 7.5% overall rate of return on rate base will, for a reasonable time in the future, result in a return on common equity of Applicant within such range.

22. The required net operating earnings, based on the test year conditions and after applying the fair rate of return of 7.5% to the appropriate value of Public Service's property devoted to providing gas and retail electric service to the public (rate base), are $46,002,493.

23. The required net operating earnings for the gas department, based on the test year conditions and after applying the fair rate of return of 7.7% to the appropriate value of Public Service's property devoted to providing gas service to the public (rate base), are $8,288,677.

24. Applicant's existing rates produce, and will continue to produce, less than a fair rate of return on both electric and gas operations; the earnings deficiency, based on the test year, is as follows:

	Electric	Gas	Total
Required net operating earnings (Findings No. 22 and No. 23)	$37,713,816	$8,288,677	$46,002,493
Adjusted net operating earnings for the test year (Findings Nos. 5, 8 & 9)	34,378,358	8,044,657	42,423,015
Indicated earnings deficiency	$ 3,335,458	$ 244,020	$ 3,579,478

25. In order to produce $1 of net operating earnings, a gross revenue increase of $2.067081 for electric and $2.023634 for gas is required because of additional income and franchise taxes. Accordingly, gross increases of $6,894,662 in retail electric revenues and $493,807 in gas revenues are required to overcome the earnings deficiency stated in Finding No. 24. These revenue increases amount to approximately 5½% on electric and .7% on gas, or 3-3/4% overall. The distribution of such increases is not a subject of this proceeding, so that the impact on individual customers or groups of customers cannot be determined.

26. Applicant's retail electric rates have not been increased since 1960, while several minor decreases have taken place since that time. Applicant's gas rates during the same period have increased about 9%.

27. The dollar amounts computed in the findings above are based on actual conditions during the test year, with all necessary adjustments that establish relationships which will prevail for a reasonable period in the future. The actual future dollar amounts of revenue, expenses and rate base are, of course, all expected to change, however, reasonably in proportion to each other.*

*For instance, once the proper relationship is established, further increases of 10% each in rate base, revenues and expenses would keep the rate of return constant.

DISCUSSION

During the past few years the Commission has heard and decided a number of rates cases involving fixed utilities (gas, electric, water and telephone), some involving the largest utilities in the state. As a result, certain regulatory principles have been firmly established as part of Commission policy in these matters. In particular, Commission decisions in Application No. 23116 (Decision No. 72385 dated January 7, 1969), involving Mountain States Telephone and Telegraph Company; in I&S Docket No. 640 (Decision No. 74240 dated January 28, 1970), involving Public Service Company of Colorado, the Applicant herein; and in I&S Docket No. 668 (Commission Decision No. 77230 dated March 25, 1971) again involving Mountain States Telephone and Telegraph Company, are of particular importance. It should be further noted that Decision No. 72385 was appealed to the Supreme Court of the State of Colorado and was affirmed with respect to all items of rate base, rate of return and all but one item of expense (imputation of accelerated depreciation for tax purposes). Consequently, such recent Commission decisions and rulings of the Supreme Court serve to establish a firm basis for the rate-making process. It should be noted that the Applicant herein--perhaps reluctantly--generally presented its case following the regulatory principles established by Decision No. 74240. Nevertheless, several hotly contested issues appeared in the case, and, in addition, the Commission has adopted several new regulatory principles, all of which merit some discussion.

It must first be emphasized that rate making is a legislative function delegated to the Commission on a state-wide basis. It has not always been so. Prior to 1953, the Commission was a creature of statute that did not have jurisdiction over public utilities within home-rule cities.*

*Except as to telephone rates which the Supreme Court declared to be a matter of state-wide concern in 1952, PUC vs. Mountain States Telephone and Telegraph Co., 125 Colo. 167, 243 P.2d 397.

In 1953 the people of the City and County of Denver voted in favor of a Charter Amendment pursuant to which the power to regulate public utilities within the City and County of Denver reverted to the Public Utilities Commission. In 1954 the people of the State of Colorado passed an Amendment to the Constitution of the State of Colorado (Article XXV) providing for Commission jurisdiction over public utilities inside and outside all home-rule cities. By these actions, the electorate of the State of Colorado entrusted the power and authority to regulate public utility rates throughout the state to the Public Utilities Commission (or such other agency as the legislature may in the future designate) and made it its duty to adopt all necessary rates and charges for public utility service. In some instances such power had been previously vested in the electorate itself. It is therefore abundantly clear to the Commission that it solely is charged with the responsibility to exercise its judgment and expertise in these matters, applying them to the evidence and opinions of experts available to it as a result of public hearings.

The Commission fully realizes the importance of utility rate levels to the people of the State of Colorado, as much as it appreciates the importance of availability of adequate utility service. In discharging its responsibilities it must apply the rules of law to the facts that are established; it cannot, as has been suggested, deny a rate increase on the sole basis that "most people are against it." This by no means indicates, as has been suggested, that the Commission more or less ignores testimony of public witnesses; opinions of others certainly influence the judgments made, and are welcomed and appreciated.

It must also be observed that the Commission is bound to adopt rates that are just, reasonable and necessary, as such concepts have been defined by law. The Commission certainly is sympathetic to the plight of those with limited incomes to whom even a small rate increase is of great importance. The solution in our view, however, is an increase in such incomes--which is beyond the power and jurisdiction of the Commission--

and not an arbitrary reduction in rates to the entire body of ratepayers to aid that segment which finds it difficult to afford higher rates. Such action would not only be unlawful, but also extremely shortsighted. Dependable and adequate utility service which is needed by all could not long be provided under those circumstances. Nor can the Commission properly use its rate-making power to achieve goals that are the concern of other agencies, as has been suggested; for example, the remedies for inadequate welfare payments must be pursued in the agencies established for those purposes.

It should be added that this decision in no way indicates what, if any, impact an aggregate increase in rates would have upon any particular customer or group of customers. The distribution of any rate increase among the various classes and levels of service will be determined in a later proceeding after the Applicant files its proposed new rates. This comment also applies to suggestions that the rate structure should be redesigned.

Donations and Charitable Contributions

The significant change in this decision from prior Commission decisions is the exclusion of donations and charitable contributions from operating expenses for rate-making purposes. The Commission has previously held that the reasonable amount of such charitable contributions is properly includable. Our decision in this matter should not be interpreted that a public utility corporation need not make charitable contributions. The difficulty which we have sought to resolve is that in making such charitable contributions, utility management, which is employed by the stockholders, makes unilateral decisions as to how such funds should be distributed. The ratepayer, if such expenditures are allowed for rate-making purposes, is the real contributor, yet he has no part in the decision-making process and may totally disagree as to the proper distribution of such funds. A public utility corporation needs, of course, to participate in the affairs of the community and such contributions are legitimate and appropriate; likewise, the benefits of such contributions certainly accrue to the owners of the corporation. It is, therefore, our judgment at this time that such expenses are more properly charged to stockholders than ratepayers.

Advertising Expense

One of the contested issues in this proceeding concerned advertising expense. Protestant, Colorado Project/Common Cause, took the position that all advertising by Public Service should be eliminated as not being in the public interest. The implication of this sweeping statement is that most, if not all, advertising generally utilized by business throughout the country may be contrary to public interest. The Commission is hardly in the position of indicting an entire industry! It is, of course, true that not all businesses require or should use the same amount of advertising in order to sell its product. Particularly, a public utility selling an essential service, requires considerably less advertising to accomplish its goal than some more competitive businesses. Advertising expense, particularly for a public utility, is certainly a more or less discretionary type of expense. As the figures for Public Service itself indicate, such expenses fluctuate greatly from year to year. It is therefore the type of expense that requires some particular scrutiny by the Commission to determine a reasonable allowance for rate-making purposes. In contrast, there are many operating and maintenance expenses that vary direct with unit costs and the volume of service provided. They are, therefore, much more independent of management judgment. This is not necessarily true of advertising expense. Accordingly, while we have no basis to rule that all advertising expense is unnecessary, but, on the contrary, must find that there is much informative advertising that benefits the customer, we still must examine the amount involved to determine what is a reasonable allowance to be built into the rate structure. In order to do this we must first observe that while the test year concept, as customarily used by this Commission, involves the examination of the operating results for a past period, the rationale and proper application of this concept is often obscured during the proceeding. It must again be reiterated, as we have done in several past decisions, that the use of a past test year does not imply that we are attempting to determine whether the rates were just and reasonable <u>in the past</u>. Likewise, the examination of test-year operating results is not for the purpose of determining whether the earnings of the utility were adequate or inadequate <u>during the test year</u>. The test-year figures are used as a basis on which a proper relationship between rate base, revenues and expenses can be developed that would prevail for a reasonable period in the future so that the level of just and reasonable rates, again for the future, can be determined. For this reason, numerous annualizing and normalizing adjustments are made. The fact that a utility might have earned more or less than a fair rate of return during the test year is in itself not controlling. There are a number of expenses that need to be normalized or adjusted to reflect the levels that can reasonably be expected to prevail in the future. For instance, it is customarily accepted, as has been done in this case, that both revenues derived from gas sales and the cost of such gas must be normalized to reflect normal weather conditions.

In examining the electric sales advertising expense by Public Service for the years 1961 through 1970, we find that the lowest expenditure occurred in 1962, of $258,000 or 67¢ per customer. A peak was reached in 1966, when $523,000 or $1.22 per customer was expended. In 1970, the expenditure was slightly less than $490,000 or $1.01 per customer. The trend is even more pronounced in the gas department. In 1962, the advertising expense was 38¢ per customer. In 1966, expenditures reached 67¢ per customer. In 1970, it declined to 42¢ per customer.

It is evident that the gas department advertising expense has been restored to virtually the same level on a per-customer basis as in the early 1960s, and it would be reasonable to assume that electric department advertising levels should likewise decline. The level of gas department advertising is also well below the industry in general.

Some of the company's advertising efforts with regard to electric sales have been directed toward air-conditioning. Such load-building efforts have been appropriate in the past since the company experienced a winter peak and had spare generating and transmission capacity in the summer. Improvement of the load factor by building summer load results in economies and benefits to ratepayers. The evidence does, however, show that the company has accomplished a great deal of summer load building already, to the extent that the summer peak begins to approach the winter peak. Under those circumstances, it would appear appropriate that advertising of air-conditioning would decrease in the future. We cannot accept as reasonable, the premise advocated by Applicant's witness that the company should continue aggressive promotion of summer electric loads until such time as the summer peak actually exceeds the winter peak, and then switch to advertising electric heat. Public Service is a combination electric and gas company and is not in a position of the electric utility that must compete with a gas utility for its share of the load that can be served by both sources of energy. Consequently, we have accepted the Staff position that an allowance of 61¢ per customer per year should be made for electric sales advertising for rate-making purposes. This figure, amounting to about 5¢ a month per customer, is based upon advertising expenses by 10 large combination gas and electric utilities. We find this comparison to be most reasonable under the present circumstances.*

*A similar approach with respect to sales promotion expense has been previously taken by the Commission In re San Isabel Electric Assn., I&S Docket No. 679, Decision No. 77468.

Annualizing Adjustments to Test-Year Results

A large number of annualizing adjustments to bring the test-year results up-to-date have been made in this proceeding and most of them, such as annualizing the effect of a gas rate increase in early 1970, the expiration of the Federal Income Tax Surcharge on July 1, 1970, etc., are uncontroversial. Protestants, however, argue forcibly against annualizing the effects of a wage increase on June 1, 1970, an increase in FICA taxes on January 1, 1971, and the increase in coal freight rates in March of 1971. This Commission has traditionally, and with good reasons, observed the principle of making adjustments for all known changes during the test year (so-called "in-period adjustments"), and has further accepted selected use of period adjustments, i.e., adjustments for known changes occurring after the test year, the latter being limited to changes completely beyond the utility's control for which no offsetting benefits or reductions in cost can be found, such as tax rates. We have therefore ruled that the increase in FICA tax rates occurring on January 1, 1971, is a proper adjustment. The increase in coal freight rates is a somewhat different situation; however, we find this adjustment proper and acceptable since the change was already determined by decision of the Commission itself during the test year, even though the effect occurred a few months later. Concerning wage adjustments, it has been a firm principle utilized by this Commision that in-period changes are accepted while out-of-period changes are not. The evidence and arguments presented by Protestants failed to convince us that a change or deviation from this principle is warranted. Protestants based their argument on statistical data that indicate that labor cost per unit of sales has remained fairly constant in spite of recurring wage increases in the past. The same statistical data, however, reveal a fatal defect in this reasoning in that the cost of labor per unit of sales in 1970, the test year, was in fact higher than in the previous year.

Casualty Losses

The principle of normalizing expenses for rate-making purposes, as we discussed under advertising expense, applies similarly to the item of casualty losses. Protestants maintained that only actual losses during the test year should be considered. In this particular case, actual losses during the test year happened to be lower than average during the past few years. Casualty losses are, of course, a fluctuating figure, depending upon the amount of disaster that visits utility facilities. To use the figure of actual losses during the test year is improper for rate-making purposes regardless of whether the amount happens to be lower than or higher than a normalized figure. We, therefore, accept Applicant's normalized figure of $300,000.

Income Tax Contingency Item

Applicant proposes that income taxes be computed on the basis of all known tax deductions plus an allowance for contingencies. The rationale advanced for this approach is that the income tax return for the test year is yet to be filed and the actual tax liability will not be known for some time--actually only after the Internal Revenue Service has examined the return. We find this to be insufficient reason to arbitrarily increase the company's best estimate of what the taxes will ultimately be. There has been no showing that the company's tax computations in the past, made on the same basis, have been substantially changed by the IRS resulting in an increase in taxes of this magnitude, nor has any other fact been shown that would possibly warrant such an allowance.

Miscellaneous Expense Items

Applicant has made no claim that country club dues that may have been paid should be included in expenses for rate-making purposes However, it does claim dues to service clubs and the Denver Club and Denver Athletic Club. We would certainly expect that the company would provide for participation by its employees in various service club activities just like any other business in this state and we find that this is a proper expense for rate-making purposes. It is our opinion, however, that the Denver Club and Denver Athletic Club bear the same social connotation as a country club and memberships in such clubs are not necessary for utility purposes.

Certain other minor expenses classified in the Uniform System of Accounts as "Civic and Political" are primarily incurred in connection with procurement of franchises and other necessary activities concerning Applicant's utility business and are proper for rate-making purposes; the title of the classification should not misleadingly imply that any political contributions are involved.

Construction Work in Progress

Considerable discussion regarding the propriety of including construction work in progress in rate base has been had in all recent rate cases and this one is no exception. The subject has been discussed by the Commission at length in all the decisions referred to. Again we find that it is both appropriate and necessary that construction work in progress be included in rate base as long as operating income is credited with the entire amount of interest-charged construction during the year. There is no question but that a growing utility must regularly and routinely construct new plant for replacement of worn-out or obsolete plant as well as additional plant in order to provide continuous and adequate service to the public. It is axiomatic that such investment in construction work in progress bears a cost of capital just like any other investment. One way of recovering this cost of capital is to capitalize these costs in the form of "interest-charged construction." By this method the recovery of these costs is postponed to the time when the plant is placed in service. A general rule is that, barring unusual circumstances, construction work in progress must be included in rate base if interest is not capitalized.

A logical extension of this rule is that if construction work in progress is included in rate base and interest-charged construction is credited to income, any remaining earnings deficiency created thereby represents plant under construction on which interest has not been charged or has been charged in an amount less than the cost of capital. To take the position that the utility is fairly compensated for its investment in construction work in progress by the amount of interest charged construction which is recovered in subsequent years through depreciation charges and return on the undepreciated portion, no matter what the amount of the interest charged to construction is, would be ludicrous. We have previously observed that if the amount of interest-charged construction equaled the return on the construction work in progress, the effect would be zero as to revenue requirements and it would not matter whether the construction work in progress was or was not included in rate base. This observation could hardly be the basis for the position that if the effect is not zero, construction work in progress should be excluded. On the contrary, in this situation, either the utility or the customer would be penalized. It is our express finding herein that the construction work in progress involved in this proceeding is a proper and necessary element of rate base since it is investment devoted to providing utility service to the public. There may, of course, be situations where different treatment would be appropriate. This could possibly occur in the case of an extraordinary construction project not done in the usual course of business, the inclusion of which would distort test year figures. This, however, is not the case in this proceeding.

Capitalization

The determination of a proper and reasonable capital structure of a utility in a rate case is extremely important since the cost rates of various types of capital funds are applied to the capital structure. The situation is complicated by the fact that a utility often has sources of capital other than its permanent conventional capital. In this case, Public Service has in the past accumulated certain tax reserves which in effect constitute interest-free and cost-free money requiring no return. Likewise, it has established a reserve for injuries and damages for the deferred payment of claims. Protestants suggest that the balances in these reserves be deducted from rate base directly. In many cases, the Commission has followed this procedure. In other cases, such as the two Mountain States Telephone and Telegraph decisions previously mentioned, the problem has been eliminated by computing the properly allocable fixed charges and common equity to the Colorado jurisdictional operation and computing the rate of return on equity on this basis. This method which may be described as "the end-result method" shortcuts the problem of cost-free funds and gives them zero cost. Neither method is an applicable or appropriate one in the instant proceeding. The use of either of these methods or a combination thereof assumes that the relationship of the cost-free funds to the total rate base or to total capital will continue in the same proportion as it was during the test year. Normally, when there is growth in rate base there is an increased growth in capital and an increased growth in all the elements of each. To elaborate, if the rate base can be expected in the future to increase by, say, 50%--and all existing relationships are reasonable--it can logically be expected that such items as Plant in Service, Reserve for Depreciation, Contributions in Aid of Construction, Common Equity, Long-Term Debt, etc., are going to increase also by approximately 50%. The same can be expected for certain reserves such as the reserve for injuries and damages, as it too has a relationship to the amount of property and volume of business of the utility. Tax reserves such as accumulated investment tax credit, and deferred income taxes under the normalization method, as long as such tax benefits are available and new plant is being added, would likewise continue to increase in the proportion to the plant being added. Since the investment tax credit has been repealed and is no longer available to Public Service, and since Public Service pursuant to Commission order changed to flow-through accounting in 1961, none of these reserves can grow. Furthermore, Public Service is amortizing the accumulated investment tax credit over the remaining life of existing plant and, in addition, with special permission of this Commission, is rapidly amortizing the deferred tax reserves. This amortization in itself reduces the revenue requirements that would be otherwise included in rates by some $2,000,000 annually. More importantly, however, not only are the absolute dollar amounts in these reserves on a decrease, the proportion of such cost-free funds as related to total capital will decrease even more rapidly as the dollar amounts of total capital increase. It is therefore our finding and conclusion that the most appropriate way to account for these cost-free funds in this case is to include one-half (1/2) of the tax reserves and the 1970 average reserve for injuries and damages as cost-free capital. We find this is the most appropriate way to give the proper weight to these cost-free funds without destroying future relationships. It is, of course, realized that with a 7.5% overall rate of return the actual rate of return on common equity would initially be higher than that computed using the capital structure as outlined, but that it would gradually decline as the factor of cost-free funds became less, but, in any event, fluctuate within a reasonable range.

Another aspect of proper capitalization that needs to be considered is the treatment of Applicant's investments in subsidiary companies and other (nonutility) property as well as its cash advances to subsidiaries. With respect to Public Service, the problem is not great because of the relatively small amounts involved and the fact that subsidiaries are primarily engaged in utility business. The problem is exaggerated in case of other utilities that have substantial investments in nonutility properties and subsidiaries which are in effect financed by mortgaging the parent's utility property. It is important in such cases to determine the true nature of such investments and cash advances to assure that the cost of capital computed for the utility business is not increased because of the utility's ventures in other fields. We must reemphasize, however, that this is not the problem in the case of Public Service. Nevertheless, it is important and proper to adjust capital structure to eliminate the effect of the subsidiaries upon the parent corporation. In other words, what would the capital structure be if the parent company did not have the subsidiaries?*

The investment of subsidiaries represents the common stock ownership by the parent company. Just like any other equity, it should be earning a rate commensurate with rates of return on equity investments, more particularly, with the rate of return on equity considered reasonable in this proceeding. The assumption that this equity investment is financed by the parent company's common stock, preferred stock and long-term debt on a ~~pro-rata~~ basis, would give additional leverage to the parent company's equity owners due to the lower cost of long-term debt and preferred stock. Additional leverage would increase the return on the equity portion of the investment at the expense of the parent company's ratepayers. The parent company's long-term debt is secured by a mortgage on its utility assets and any benefit from the lower cost of this long-term debt should accrue to the ratepayers who support the investment in utility property. We have

*It should be noted that there is nothing improper or unusual about the fact that Public Service has certain utility and, to a very minor degree, nonutility subsidiaries. Colorado Project/Common Cause attempted to show that Public Service had more investments in and receivables from associated companies than 10 "comparable" large combination utilities. The comparison made used the corporate balance sheet of Public Service and consolidated balance sheets of some of the other utilities. The result of consolidation is, of course, to wash out any intercompany transactions with the result that no investment in or receivables from associated companies involved in the consolidation are shown, making such a comparison meaningless.

therefore deducted the investments in subsidiaries and other property (which is also not bondable under the mortgage) from the common equity of Applicant to determine a reasonable capital structure applicable in this proceeding. Likewise, we accept the Staff position with regard to advances to subsidiaries. These cash advances are in effect short-term demand loans upon which interest is paid and are in reasonable proportion to the equity investment in subsidiaries. Such advances therefore are in the nature of a debt rather than equity investment. This conclusion is further supported by the fact that these advances fluctuate considerably and all of the outstanding balances at the end of 1970 had been repaid by the subsidiaries at the time of the hearing. Most logically, such cash advances should be deducted from short-term indebtedness of the parent company as the parent is simply a conduit that channels short-term money to the subsidiaries as required. Since we have used pro forma capitalization which includes the latest $40,000,000 bond issue, as a result of which all short-term indebtedness was repaid and none is outstanding, advances to subsidiaries have been properly deducted from the long-term debt component of the capitalization. In associating the advances to subsidiaries with debt capital of the parent, we have carefully considered the fact that the subsidiaries are likewise engaged in utility business and could reasonably, on their own, finance their own operations with a substantial percentage of debt. This should be carefully distinguished from other cases where the advances are to nonutility subsidiaries and in reality and substance are equity investments since a nonutility enterprise could not reasonably have nearly as high a debt ratio.

Rate of Return

The determination of a fair rate of return on rate base involves:

1. Determination of a proper capital structure;
2. Determination of the cost of senior capital (long-term debt and preferred stock);

3. Assignment of zero cost to cost-free funds;

4. Determination of the cost of common equity.

The reasonable and proper capital structure has been discussed above. The cost rates of senior capital are contractually established and, as usual, are noncontroversial. The cost-free funds involved have already been discussed. The crucial remaining determination involves the fair rate of return on common equity.

As has been stated many times by this Commission, by almost every other regulatory body in the nation, as well as by the Courts, the cost of common equity cannot be determined by any precise mathematical formula. In considering what constitutes a fair rate of return on equity, considerable judgment must be applied to all available data. Several approaches to the problem have been developed by experts, but none are perfect. The Applicant uses essentially a comparable earnings standard in arriving at a 13% fair rate of return. The comparison in this case, as in I&S Docket No. 640, is made with 10 large combination gas and electric utilities. There are, of course, no two companies that can be directly compared. The selection of a group of companies and averaging the rates of return earned by the component companies does not necessarily lessen the problem of lack of comparability. Often, however, this is the only approach that can be used as, for instance, in cases where there is no public market in the utility's common stock which can be used to determine how the securities are evaluated by market forces. Furthermore, in comparing rates of return of other utilities, we do not necessarily know whether the other utilities are in fact earning a fair rate. Obviously, if the group of utilities used in comparison are not earning a fair return, the resulting rate of return will not be a fair one. With all the shortcomings, comparisons with other utility companies do provide useful guidelines and indicate the range in which judgment can be applied. Making any comparison is, of course, frought with difficulties and one must be particularly sure that likes are compared with likes. The time span and the companies must be selected in a reasonable and unbiased manner. Most importantly, the method of computation of the rates of return must be consistent for all companies in the comparison. The comparisons made by the economist testifying for Colorado Project/Common Cause are of little value. An attempt was made to compare the earnings of Public Service with a broad spectrum of industrial and other nonfinancial firms; yet he was unable to draw from this comparison a conclusion as to what was a fair rate of return for Public Service. Rates of return of industrial companies can, of course, offer some guiding measurement if better ones are not present and we do not condemn the concept of such comparison in itself. The real defects in this comparison are: (1) The use of a single year during which the earnings of industrial companies in general had declined, and (2) the rates of return for the other companies had been computed on a completely different basis than the rate of return on common equity of Applicant.

The rates of return for the corporations computed in the Common Cause exhibits were computed on net worth rather than on common equity. The exhibits define net worth as follows: "Net worth is equivalent to shareholders' equity or 'book net assets' or capital and surplus." We do not know, nor did the witness explain, just exactly how the First National City Bank, the source of the data, computes net worth, and whether or not different methods for different companies are used. It is perfectly obvious, however, that "shareholders' equity, 'book net assets' or capital and surplus" are different concepts and each is much larger than common equity which normally constitutes but a portion of the three measurements. The witness was, of course, correct in stating the elementary proposition that earnings of gas and electric utilities, Public Service in particular, fluctuate less than the earnings of industrial companies. This is exactly one of the reasons why comparison of a gas and electric utility with industrial companies is at least difficult and certainly impossible on the basis of a single year of earnings.

The witness for CF&I Steel Corporation also testified on rate of return, using several comparisons with other utility companies. Utilizing two groups of companies, the witness arrived at rates of return on common equity of other companies for the 10 years 1960 through 1969, as follows:

Group one - average 11.2% - range 8.4 to 13.3%

Group two - average 12.6% - range 9.8 to 16.4%.

On the basis of these and some other comparisons the witness concluded that a rate of return on common equity of 12.71%* "is comparable to that of other utilities and could even be said to be generous when compared with other companies operating in original cost states."

The Staff witness on cost of capital utilized the discounted cash flow formula and arrived at the fair rate of return of equity in the range of 12.6% to 13.2%. Like any other formula, the discounted cash flow method requires considerable use of judgment in the selection of time periods to arrive at the reasonable figure for expected future growth of earnings. In other respects, this formula does attempt to measure investor expectations upon which common stock of the particular company in question are purchased. This Commission has found the discounted cash flow formula a useful guideline in determining fair rate of return on equity and has commented on it in some length in the other decisions to which reference has previously been made. It does have the advantage that it uses market price as a determinant of what investors require. It is our opinion that market price must be considered in one way or another in this respect. During cross-examination, an attempt was made to impeach Staff testimony by using earnings-price ratios as an indication of the cost of common equity. The use of an earnings-price ratio without proper adjustments has

*The rate of return on common equity computed by the witness as having been earned with existing rates on a test year pro forma basis, using the witness's adjustments, by the jurisdictional portion of the electric department.

been previously commented upon by the Commission in I&S Docket No. 640, Decision No. 74240, and it is not necessary to repeat our observations as to the complete lack of a valuable measurement of earnings-price ratio that does not consider expected future growth in earnings. Accordingly, it has been our finding and conclusion, considering rates of return on equity earned by comparable utilities and the evaluation of rates required by investors as measured by the discounted cash flow formulas, as well as recent price earnings ratios (keeping in mind necessary adjustments for future growth), that a fair, reasonable and necessary rate of return on common equity of Applicant at this time is in the range of 12½% to 13.2% and that a rate of return on rate base of 7½% will produce and continue to produce for a reasonable period a rate of return on common equity in this range. Furthermore, we see no change in circumstances that would require us to deviate from the ruling in Decision No. 74240 that the gas department rate of return should be .2% higher than the overall rate of return for Applicant.

CONCLUSION

The Commission concludes that the existing gas and retail electric rates of Applicant do not and will not in the foreseeable future produce a fair and reasonable rate of return to Applicant; that such rates are in the aggregate not just and reasonable or adequate; that, based on test year condition, the revenue deficiency for Applicant is as stated in Finding No. 25 hereinabove; that Applicant should be authorized to file new gas and electric rates and tariffs that would, on the basis of the test year conditions, produce additional revenues equivalent to the revenue deficiency stated above; and that the following Order should be entered.

O R D E R

THE COMMISSION ORDERS THAT:

1. Applicant be, and hereby is, authorized to file such new and not unjustly discriminatory gas rates and tariffs that would, on

the basis of the conditions of the 1970 test year, produce additional revenues of not more than $493,807.

2. Applicant be, and hereby is, authorized to file such new and not unjustly discriminatory retail electric rates and tariffs that would, under the conditions of the test year 1970, produce additional electric revenues of not more than $6,894,662.

3. The tariff revisions referred to in paragraphs 1 and 2 hereof shall be filed to become effective upon thirty (30) days' notice in accordance with 115-3-4 (1), CRS 1963, as amended.

4. This Order is subject to such orders and regulations as may be promulgated by the President of the United States, or his delegate, pursuant to Title II of Public Law 91-379, August 15, 1970, 84 Stat. 799, as amended (commonly known as the Economic Stabilization Act of 1970, 12 USC 1904, footnote).

5. All pending motions not previously ruled upon by the Commission be, and hereby are, denied.

6. This Order shall become effective twenty-one (21) days from the day and date hereof.

THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF COLORADO

Commissioners

COMMISSIONER HENRY E. ZARLENGO DISSENTING.

Dated at Denver, Colorado, this
4th day of October, 1971.
vjr

ADDITIONAL CONCURRING REMARKS BY COMMISSIONER EDWIN R. LUNDBORG:

I concur in the foregoing decision of the Commission authorizing Public Service Company of Colorado to file new rate schedules which will produce increased gross revenues of $6,894,662 for the Electric Department and $493,807 for the Gas Department. In concurring, however, I think it necessary to point out certain serious deficiencies and inconsistencies in the foregoing decision which, in my opinion, while not being of sufficient magnitude to render the authorized increase in gross revenues unreasonably low, are nevertheless of sufficient importance to require additional remarks -- on my part -- rather than accepting them as proper when they are not.

The rate-making process is not by any means an exact science and regulatory commissions are allowed wide latitude in exercising their informed discretion in determining the reasonableness of rates, rates of return and gross earnings of public utilities as well as in determining what factors should be given paramount consideration in arriving at such determinations. Although there are many regulatory theories and principles utilized as guidelines by various regulatory commissions in the rate-making process, it is the end result rather than the method of arriving at the end result which is important in determining whether the ultimate decision is reasonable or unreasonable, as held by courts of appellate jurisdiction -- including the Supreme Court of the United States.

Since I cannot say that the end result of the foregoing decision of the Commission is unreasonable (the increase in gross revenues allowed), I concur with such decision, even though I consider the amount of gross revenues allowed to be on the low side of reasonableness and would have employed different methods with respect to certain aspects of arriving at the total increase in gross revenues to be allowed. I think it important to express my separate views or remarks with the hope that such expression will result in future consistency in our decisions.

Our foregoing decision states and recognizes that previous decisions of this Commission and rulings of the Supreme Court of the State of Colorado "establish a firm basis for the rate-making process." Our decision further observes that the Applicant in this proceeding presented its case in a manner consistent with previous decisions of this Commission. Our decision, however, in the instant proceeding significantly departs from our previous decisions, which, we have stated, should provide "a firm basis for the rate-making process." As a result, our previous decisions provide no basis at all -- much less a firm basis -- and it would appear that we, in effect, expect the utilities we regulate to rely upon and conduct their operations in conformity with our previous decisions, while at the same time we, as Commissioners, appear to feel perfectly free to abandon or change our previous pronouncements on various elements of rate-making at any time it suits our fancy. This is precisely what has been done in the present proceeding with respect to certain items which I will hereinafter point out and comment on.

Our foregoing decision disallows as a proper operating expense a certain portion of the advertising expenses of Applicant. The record reflects that the advertising expenses of Applicant in the present proceeding are actually lower than they were in previous years, yet never before has this Commission -- to my knowledge -- disallowed as an operating expense any portion of this utility's advertising expenses. To do so now, with nothing in the record to suggest that such advertising expenses were improperly incurred is, in my opinion, improper and constitutes an intrusion on the managerial discretion of the Applicant. In addition, with respect to advertising expenses, we have for the first time disallowed that portion represented by advertising in certain magazines of nationwide circulation on the theory that the distribution of these magazines is not confined to Applicant's service area. In my view, this makes absolutely no regulatory sense whatever, since the record reflects the Applicant is paying only a portion of the expenses of such nationwide advertising, with the rest of the electric utility industry paying the balance. Therefore, the net result is that the expenses of Applicant relating to nationwide advertising are proportionate only to its service area and should be considered as service area advertising and, therefore, be allowed as an operating expense.

In addition to my opinion that this Commission should be consistent with its past decisions and should not attempt to intrude itself upon the good faith managerial decisions of public utilities under its jurisdiction, the United States Supreme Court in West Ohio Gas Company v. Public Utilities Commission of Ohio, 294 U.S. 63, 79 L.Ed. 761, specifically precludes us from doing so with respect to the very item here under consideration, i.e., advertising expenses, and no case has been cited in any of the briefs submitted by the protesting parties hereto or in our decision to the contrary.

Our foregoing decision also eliminates or disallows as an operating expense charitable donations of the Applicant. To my knowledge, this is the first time this Commission has ever disallowed charitable donations as a legitimate business and operating expense. The only reason given for the disallowance in this proceeding is that the ratepayer has no voice in the determination of who and in what amount the recipient of the charitable donation may be. Merely because the ratepayer does not determine the management policy with respect to charitable donations in no way detracts from the fact that charitable donations are legitimate business expenses. The ratepayer does not determine the level of wages or salaries paid to employees of a utility, nor of the price paid for coal, or other business supplies, and matters of a similar nature, yet, in my opinion, we would never disallow these proper business expenses for rate-making purposes.

Of more importance, however, is the fact that less than two years ago this very Commission -- with each Commissioner concurring -- unanimously held that charitable donations were a proper allowable expense for rate-making purposes, with the voice of the ratepayer being exactly the same then as it is now. Again, there is nothing in this record which would justify our complete departure from our previous decisions. Neither the law nor the evidence with respect to charitable donations and advertising expenses have changed since previous Commission decisions on this very subject. The only thing that has changed, it appears, is the so-called "administrative expertise" of this Commission.

As is noted in the foregoing decision, the Commission is sympathetic -- and rightly so -- to the low-income group which cannot afford even a small rate increase. The Applicant in this proceeding, by its charitable contributions, supports many worthy charities which in turn make services, facilities and goods available primarily to the very same limited low-income group for which this Commission expresses sympathy. It is obvious that the action of this Commission in disallowing charitable contributions as a rate-making expense will result in a reduction of charitable contributions by the Applicant in the future. In my view, charitable contributions are an appropriate and proper business expense of the Applicant and the disallowance of this expense is not in the long-range public interest.

Our foregoing decision also utilizes a fair rate of return of 7.50% in determining the increase in gross revenues to which the Applicant is entitled. Here again, while I think 7.50% is on the low side of a reasonable range of rate of return, I concur with this determination but point out that such finding again constitutes an inconsistency with our previous decisions. In the rate case involving this very same Applicant concluded by our decision of less than two years ago (Decision No. 74240), this Commission then <u>unanimously</u> found a rate of return of 7.50% to be fair and reasonable for rate-making purposes based upon the then cost of money. The record in this proceeding clearly shows that the cost of money has increased in that interim period. Consequently, if we are to be consistent with our previous decisions involving this very Applicant as well as other rate-making decisions in the immediate past, we would have necessarily arrived at a rate of return higher than 7.50%.

As indicated at the outset, I concur in the determination of the level of increased gross earnings which should be allowed to the Applicant in this proceeding, since I cannot find that such increase is unreasonably low. Where I depart from the decision allowing such increased gross revenues is in certain of the methods utilized to determine those gross revenues -- the methods of which are completely inconsistent with our previous decisions.

An administrative agency such as this Commission, in my opinion, should be consistent in its rulings and decisions to virtually the same extent as are courts of record. Public utilities and other parties appearing in rate proceedings are entitled to place some degree of confidence in our ability to follow our own decisions. I, therefore, hope that the views and remarks I have expressed herein, will assist in precluding the inconsistencies contained in the foregoing decision of the Commission from serving as a precedent in future rate-making cases.

COMMISSIONER HENRY E. ZARLENGO DISSENTING:

I respectfully dissent.

The majority decision authorizes an increase in revenues for gas in the sum of $493,807.00 and for electricity in the sum of $6,894,662.00, or a total increase in revenues in the sum of $7,388,469.00. What is needed is a change in the Company's present method of financing not an increase in rates. There is available a means of financing which will, if ordered by the Commission, save the Company's customers millions of dollars in financing costs. The Company should be ordered to increase its debt ratio. This it can do without detriment to itself and with great benefit to the customers. Not only would this save the customers tremendous sums but would coincidentally also boost the present rate of return to the stockholders.

Under the law, the facts, and for the reasons hereinafter set out, this increase in revenues is not warranted, cannot be justified, and is arbitrary.

It is axiomatic that the first duty of a public utility is to provide good service at the lowest cost to its customers.

Under the law, the Commission cannot arbitrarily interfere with the utility's exercise of its managerial discretion -- neither can management arbitrarily exercise its managerial discretion. If this were not true, the rights of ownership of the utility would be nullified and on the other hand the regulatory powers of the Commission would be destroyed. There is no conflict in these principles, and they can live side by side so long as sound judgment is exercised on the part of the Commission and on the part of the utility.

The law provides that:

> "All charges made, demanded or received by any public utility, . . . for any service rendered or to be rendered, shall be just and reasonable . . ." (1963 CRS 115-3-1).

> "The power and authority is . . . vested in the public utilities commission of the state of Colorado, and it is . . . made its duty to adopt all necessary rates, charges -- of every public utility . . ., and to generally supervise and regulate every public utility in this state

and <u>to do all things</u>, whether specifically designated . . . , or <u>in addition</u> thereto, which are necessary or <u>convenient</u> in the exercise of <u>such power</u> . . ." (1963 CRS 115-3-2).

"Every unjust or unreasonable charge made, <u>demanded</u>, or <u>received</u> for such rate, fare, product or <u>commodity</u> or <u>service</u> is hereby prohibited and declared <u>unlawful</u>." (CRS 1963 115-3-1). (Emphasis supplied.)

Under the law, the Commission is not only given very broad powers but is also charged with the <u>duty</u> to exercise such powers in the <u>adoption</u> of charges which "shall be just and reasonable," and any "unjust or unreasonable charge" is "prohibited and . . . unlawful."

The increases in charges authorized will include money for payment of income taxes which can be avoided; i.e., income taxes which will accrue on revenues utilized to pay dividends on future stock issues. As such taxes, and consequently the charges required to pay them, can be avoided the increases are not "just and reasonable" and therefore "prohibited and . . . unlawful". Avoidance of such charges may be achieved by taking advantage of higher debt ratios which will very substantially reduce the Company's income taxes thereby effecting very substantial savings to the customers without detriment to the Company, or its stockholders.

A utility in need of long-term financing may secure such financing by issuance of either additional stock, or bonds.

Over the past years the Company has secured its long-term financing by resorting to more equity financing than it should have; i.e., by the issuance of stock, rather than by debt financing, i.e. issuance of bonds, with the result that on December 31, 1970 the Company had a ratio of only 52.8% debt and 47.2% equity. Maintenance of such low debt ratios in the past has cost the customers annually millions of dollars which could have been saved had the Company adhered to a more reasonable and realistic, and consequently more saving method of financing; i.e., by the use of more debt financing. This mistake should not be perpetuated.

The taxable income of a corporation is taxed under Section 11 of the Internal Revenue Code (1971) at 48%, and under Section 138-1-3 (2), 1963 CRS, at 5%. Because of reciprocal inter se deductions allowed by said laws, the composite tax is conservatively at least 50%, which rate for income taxes will be used herein. As corporation income taxes are so very substantial, taxes are a most important factor in deciding whether to acquire financing by the issuance of stock, or bonds. Interest on debt is a deductible expense in calculating income subject to income taxes, while dividends are a sharing of income and are not a deductible expense.

As the cost of equity financing is not a deductible income tax expense, the money collected from the customers to pay the cost of equity financing comes from income which is taxed at the composite rate of at least 50%. Thus, for every $1.00 required to pay the cost of equity the Company must collect from the customers $1.00 to pay such cost and $1.00 to pay the income tax, or $2.00. On the other hand, for every dollar required to pay interest on debt, interest being a deductible expense, the Company need not collect an additional dollar. In a recent rate case expert witness Melwood W. Van Scoyoc put it very clearly this way, to wit:

> "The customers of a utility are specifically required to carry the burden of taxes. In substance and equity, the customers of the utility are the taxpayers even though the utility files a tax return and issues the check to the taxing authority. The utility is basically a conduit for the collection of taxes along with its other costs from its customers."

Thus, for income tax purposes alone, the customers are made to pay at least 100% more in cost of financing whenever the Company resorts to equity financing rather than debt financing, or double.

That the high cost of equity financing over debt financing is prohibitive, and determined efforts should be made to avoid it, is demonstrated with arithmetic precision by making the following assumptions.

Assuming in the future the Company will need an average of $40 million* of additional financing each year and such financing would be by debt at the rate of 7¼%,* the cost to the customers would be as follows:

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* These assumptions are based on the fact that the Company borrowed thus far in 1971 $40,000,000 in February 1971 at 7¼% (Public Service Exhibit No. 7), and are used only for illustration. The amount probably will be much higher, further accentuating the inequity.

$.0725 X $40,000,000 or $ 2,900,000 for the first year,

$.0725 X $80,000,000 or $ 5,800,000 for the second year,

$.0725 X $400,000,000 or $29,000,000 for the tenth year; and,

the total cost for such debt financing over the full ten-year period would be $159,500,000.

On the other hand, assuming such financing would be by means of equity at the rate of 12.8%, the rate authorized by the majority, the cost to the customers, because of the doubling effect of income taxes, would be as follows:

12.8% X 2 or $.256 X $40,000,000 or $10,240,000 for the first year,

12.8% X 2 or $.256 X $80,000,000 or $20,480,000 for the second year,

12.8% X 2 or $.256 X $400,000,000 or $102,400,000 for the tenth year; and,

the total cost for such equity financing over the full ten-year period would be $563,200,000.

Thus, it would cost the customers because of income taxes alone:

for the 1st year	$ 7,340,000 more,
for the 2nd year	$ 14,680,000 more,
for the 10th year	$ 73,400,000 more; and
for the full 10-year period	$403,700,000 more; a fantastic

difference.

Again, during ~~the~~ test year 1970, the customers paid total revenues in the sum of $200,187,873; the Company had earnings of $42,423,015; had a debt ratio of 52.8%; and, assuming earnings on equity of 10.4% * had the debt ratio during such test year been 60% instead of 52.8%, all else remaining constant, to maintain the same earnings on equity of 10.4%,* it would have required revenues from the customers in the total sum of $196,201,925 or $3,985,948 less; and, had the debt ratio been 70%, it would have required revenues in the total sum of $191,550,583, or $8,637,290 less.

Nevertheless, the Commission ignores the present opportunity to require future higher debt ratios for the benefit of the customers.

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* See table page 46.

It is alleged generally that higher debt ratios will "jeopardize" the Company's financial status because of alleged increase in "risk" to the stockholders which in turn will increase the cost of equity. This contention wholly disregards the fact that (a) the Company is a <u>monopoly</u> providing a service which is as essential and necessary to the public as are our police, fire, medical, and hospital services, for without electric and gas service these other services cannot function; and (b) that the Commission <u>cannot arbitrarily</u> refuse reasonable increases in revenues when needed. Informed investors and creditors know this. As a matter of fact, investment in the Company's bonds is, for all intents and purposes, as secure as investment in good municipal bonds. But, <u>even assuming</u> that with higher debt ratios the cost of debt financing will increase, and <u>even assuming</u> that such cost in the future should <u>equal</u> the cost of equity financing, an <u>inconceivable concept</u>, the customers would still be saving <u>at least</u> 100% in the cost of financing.

It is important to note the record contains no evidence that the Company in the future may have to pay more for <u>debt</u> than for <u>equity</u>, or that higher debt ratios will not be beneficial to the customers.

Low debt ratios tend to provide profitable investment opportunity to stockholders rather than service to customers at the <u>lowest</u> possible cost.

Lacking competent, relevant and material evidence, rather than speculate as to what might happen should the Company continue to increase its debt ratio, the debt ratio <u>should continually</u> be increased until such time as the Company finds by competent evidence that the <u>overall</u> cost to the customers of further increasing debt capitalization would be more than that of equity, or will in some other respect be more detrimental to them than by increasing equity. There is no competent evidence in the record to support a finding that much higher debt ratios are not economically feasible. It is not enough to oppose the competent illustrative figures herein set out with the vague objections, conjecture, and speculation of the Company's expert witnesses. (170 Colo. 556, 463 P.2d 465). The <u>welfare of the customers</u>, <u>not of stockholders</u>, should come first. By testing the market place over a period of time the proper evidence will be forthcoming. In the meantime, as the debt ratio increases the customers will stand to be progressively saved many millions of dollars by the substantial lowering of the Company's composite cost of capital.

It is claimed that the Company will not be able "to attract" additional equity capital if the return on equity is not now increased. Why should the customers be so severely penalized in order "to attract" additional equity capital when the acquisition of additional equity capital will be so greatly disadvantageous to them, which equity capital is not now, and may not, if ever, be needed for at least a long and indefinite time in the future? Assuming that a 70% debt ratio were to be achieved in the future, a debt ratio not shown by any competent evidence in the record to be detrimental in any way to the Company, the stockholders, or the customers, it will take based on the assumptions used approximately 17 years before such debt ratio is achieved. In the following illustration it is assumed that no stock will be sold, that each year debt capital will be increased by $40 million and that each year the internally generated equity growth will be $8,793,129.* The progression indicates it will take approximately 17 years to achieve a 70% debt ratio.

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* Amount of internally generated equity growth during the test year. Actually, as the capitalization increases the internally generated equity will also increase.

EXAMPLE

DEBT RATIOS ARE ASSUMED WITHOUT SALE OF STOCK AND RESORTING ONLY TO DEBT FUNDS

The pro forma debt and equity from Staff Exhibit I are increased by $40,000,000 and $8,793,129 respectively and rounded to the nearest $1,000. The $8,793,129 is the amount of equity increase during the test year coming from internal earnings and not from the sale of stock. The $40,000,000 is the latest debt sale by the Company. On this basis it will take the Company slightly over 3 years to reach a 60% debt ratio; and 17 years to reach a 70% debt ratio.

End of		Years Required	Amount $	Assume 60% Debt $	Assume 70% Debt $
Year 0	Common Stock Equity		222,353,000	222,353,000	
Current	Preferred Stock		80,000,000	80,000,000	
Year	Debt		378,800,000	453,529,000	
	Additional Debt Required			74,729,000	
Year 1	Common Stock Equity		231,146,000	231,146,000	
	Preferred Stock		80,000,000	80,000,000	
	Debt		418,800,000	466,719,000	
	Additional Debt Required	1		47,919,000	
Year 2	Common Stock Equity		239,939,000	239,939,000	
	Preferred Stock		80,000,000	80,000,000	
	Debt		458,800,000	479,908,000	
	Additional Debt Required	2		21,108,000	
Year 3	Common Stock Equity		248,732,000	248,732,000	
	Preferred Stock		80,000,000	80,000,000	
	Debt		498,800,000	493,098,000	
	Additional Debt Required	/3/		-0-	
Year 4	Common Stock Equity		257,525,000		257,525,000
	Preferred Stock		80,000,000		80,000,000
	Debt		538,800,000		787,558,000
	Additional Debt Required	4			248,758,000
Year 5	Common Stock Equity		266,318,000		266,318,000
	Preferred Stock		80,000,000		80,000,000
	Debt		578,800,000		808,076,000
	Additional Debt Required	5			229,276,000

DEBT RATIOS ARE ASSUMED WITHOUT SALE OF STOCK AND RESORTING ONLY TO DEBT FUNDS

End of		Years Required	Amount $	Assume 60% Debt $	Assume 70% Debt $
Year 6	Common Stock Equity		275,111,000		275,111,000
	Preferred Stock		80,000,000		80,000,000
	Debt		618,800,000		828,593,000
	Additional Debt Required	6			209,793,000
Year 7	Common Stock Equity		283,904,000		283,904,000
	Preferred Stock		80,000,000		80,000,000
	Debt		658,800,000		849,110,000
	Additional Debt Required	7			190,310,000
Year 8	Common Stock Equity		292,697,000		292,697,000
	Preferred Stock		80,000,000		80,000,000
	Debt		698,800,000		869,627,000
	Additional Debt Required	8			170,827,000
Year 9	Common Stock Equity		301,491,000		301,491,000
	Preferred Stock		80,000,000		80,000,000
	Debt		738,800,000		890,145,000
	Additional Debt Required	9			151,345,000
Year 10	Common Stock Equity		310,284,000		310,284,000
	Preferred Stock		80,000,000		80,000,000
	Debt		778,800,000		910,662,000
	Additional Debt Required	10			131,862,000
Year 11	Common Stock Equity		319,077,000		319,077,000
	Preferred Stock		80,000,000		80,000,000
	Debt		818,800,000		931,179,000
	Additional Debt Required	11			112,379,000
Year 12	Common Stock Equity		327,870,000		327,870,000
	Preferred Stock		80,000,000		80,000,000
	Debt		858,800,000		951,697,000
	Additional Debt Required	12			92,897,000

DEBT RATIOS ARE ASSUMED WITHOUT SALE OF STOCK AND RESORTING ONLY TO DEBT FUNDS

End of		Years Required	Amount $	Assume 60% Debt $	Assume 70% Debt $
Year 13	Common Stock Equity		336,663,000		336,663,000
	Preferred Stock		80,000,000		80,000,000
	Debt		898,800,000		972,214,000
	Additional Debt Required	13			73,414,000
Year 14	Common Stock Equity		345,456,000		345,456,000
	Preferred Stock		80,000,000		80,000,000
	Debt		938,800,000		992,731,000
	Additional Debt Required	14			53,931,000
Year 15	Common Stock Equity		354,249,000		354,249,000
	Preferred Stock		80,000,000		80,000,000
	Debt		978,800,000		1,013,248,000
	Additional Debt Required	15			34,448,000
Year 16	Common Stock Equity		363,042,000		363,042,000
	Preferred Stock		80,000,000		80,000,000
	Debt		1,018,800,000		1,033,766,000
	Additional Debt Required	16			14,966,000
Year 17	Common Stock Equity		371,836,000		371,836,000
	Preferred Stock		80,000,000		80,000,000
	Debt		1,058,800,000		1,054,283,000
	Additional Debt Required	17			-0-

	Capitalization	Imbedded Cost of Debt and Preferred	RETURN ON EQUITY	Cost	Overall Return (Composite Cost)
		ACTUAL			
	%	%	%	%	%
Debt	52.8 (a)	5.0 (b)		2.6	
Preferred	12.5	4.77 (c)		.6	
Equity	34.7		10.4		6.8 (d)
		ASSUMED			
Debt	60.0	5.0		3.0	
Preferred	10.6	4.77		.5	
Equity	29.4		11.2		6.8
Debt	70.0	5.0		3.5	
Preferred	7.9	4.77		.4	
Equity	22.1		13.1		6.8

(a) Public Service Exhibit No. 12
(b) Public Service Exhibit No. 7
(c) Public Service Exhibit No. 8
(d) Staff Exhibit F page 3 of 4

The result is a rise in the return on equity at 60% debt ratio from 10.4% to 11.2% and at 70% debt ratio from 10.4% to 13.1%. This is due to the fact that as the proportion of higher cost equity financing decreases, and the proportion of lower cost debt financing increases, the average cost of financing is reduced resulting in higher equity return.

Moreover, since the additional funds realized from the increasing debt will become productive in providing additional services, which in turn will provide additional revenues, the return on equity will be given an additional boost.

The Commission has its mandate. In the case of Colorado Municipal League, et al, vs. PUC, et al, ___Colo.___, 473 P.2d 960, the management failed to take advantage of accelerated depreciation for the benefit of its customers. In this case the management is failing to take advantage of the higher debt ratios.

The Court said:

"However, no matter how much deference we have and should have for highly-trained management, when that management abuses its managerial discretion to the detriment of its customers, our regulatory commissions have a duty to declare the abuse and make such orders as will give to ratepayers the advantage of those economies of which management has failed to avail itself."

CONCLUSIONS

The Commission should:

1. Order Public Service Company of Colorado to continue to increase its debt ratio in the normal course of financing until such time as competent evidence indicates that further increase in the debt ratio will be detrimental to the customers.

2. Leave the return on equity as it is.

3. Not authorize increases in charges to the customers as being unjust and unreasonable and contrary to the law.

THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF COLORADO

Henry E. Zarlengo
Commissioner

Dated at Denver, Colorado,
this 4th day of October, 1971.
hbp