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Colstrip 3

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Colstrip 3

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TABLE OF CONTENTS

LIST OF TABLES

CHAPTER I

PURPOSE STATEMENT

The Colstrip 3 Electric Generating Plant rate case filed by the Montana Power Company (MPC) was not only a contested issue, but it attracted wide media attention. What Montana Power does is of great interest to most people in the state. This paper identifies the primary issue of Colstrip 3 as the "used and useful" requirement of the Public Service Commission, i.e., the proven need for a facility before it could be included in the rate base of Montana Power. This "prove you need it" requirement must be met before the utility is allowed to include the facility into a rate increase request. Looking back, opposition to Colstrip 3 related rate increase request was principally due to the record amount of the increase asked for and the fact that it was much greater than originally estimated by Montana Power.

Throughout the course of this 27 month rate case, the two primary participants were Montana Power Company and the Montana Public Service Commission (PSC) which consisted of a five member elected board. However, this paper suggests a "third party" to this rate case. But, even though rarely mentioned it was somewhat obscured in its economic significance. Who was this so-called "third party"? It is the various rating agencies whose job it is to publish financial information about companies such as Montana Power. These rating agencies grade each of the Company's securities. Standard & Poor's is one such agency, and Moody's is another.

The Colstrip 3 rate case is one illustration of the role that rating agencies play. The purpose of this paper is to provide a better understanding of the importance rating agencies played in the Colstrip 3 case.

CHAPTER II

HISTORY OF THE MONTANA POWER COMPANY

Montana Power Company was formed on December 12, 1912 by the merger of four small hydroelectric generating companies. Throughout the ensuing 74 years, Montana Power has served the nation's second largest utility territory of 107,600 square miles, 73% of Montana's land area, by providing electricity and natural gas to 79% of Montana's population.

Montana Power is a diversified corporation operating principally in energy-related businesses. The Company is currently organized into two basic units as indicated below.

The Montana Power Company
Corporate Office

Utility Division
Electric and Natural Gas Utility Systems

Entech, Inc.
Nonregulated Business Enterprises

The Utility Division is responsible for the operation of the Company's electric and natural gas utilities under rate jurisdiction of the Montana Public Service Commission. Electricity sales to other utilities are under jurisdiction of the Federal Energy Regulatory Commission.

Entech, Inc. is a wholly-owned subsidiary of Montana Power engaged in non-utility business activities. Its lines of business include the mining of coal and metals, the development and production of oil and natural gas, electronics, telecommunications, and real estate.

The following list of subsidiaries is provided to illustrate the diversification of Montana Power.

Utility Division:

- Electric Utility.
- Gas Utility.
  - Canadian-Montana Gas Company, Limited.
  - Canadian-Montana Pipe Line Company.
- Montana Power International Finance (Netherlands Antilles)
- Colstrip Community Services Company.

Entech, Incorporated:

- Western Energy Company	Minerals
- Northwestern Resources Company	Minerals
- Dorado Energy Group	Minerals
- Montana Mining Company (Brazil)	Minerals
- Roan Resources, Limited	Oil and Gas
- Altana Exploration Company	Oil and Gas
- Intercontinental Energy Corporation	Oil and Gas
- North American Resources Company	Oil and Gas

-	Tetragenics Company	Technology
-	Telecommunications Resources, Inc.	Technology
-	Sunlight Development Company	Real Estate
-	Special Resource Management, Inc.	Hazardous Waste

Montana Power Company's electric generating facilities are composed of hydroelectric and steam plants. The majority of the steam plants are coal fired, only one plant is being fired by either natural gas or oil and is currently shut down due to high operating costs. Montana Power may be fortunate not owning or operating any nuclear generating plants in 1986.

A composite list, Table I, represents Montana Power's electric resources available for the year 1985. Notice, however, that Colstrip Unit 4 is not included in the list. Montana Power decided to sell its 30% share of Unit 4, which represents 210,000 kilowatts, to United States Trust Company of New York as owner-trustee. The sale became official on December 30, 1985.

This decision by Montana Power to sell its 210 megawatt share of Colstrip 4 was made because of financial difficulties after the PSC refused to allow Montana Power to charge users of Colstrip 3 generated power on the grounds that this facility's power was not needed.

Table I

ELECTRIC RESOURCES

Name	Location	Capacity Kilowatts (Kw)
	Internal Combustion	
Lake Diesel	Yellowstone Park	2,750
Old Faithful	Yellowstone Park	2,000
	Total Internal Combustion	**4,750 Kw**
	Generating Plants Hydroelectric	
Kerr	Flathead River	180,000
Thompson Falls	Clark Fork River	40,000
Milltown	Clark Fork River	3,400
Flint Creek	Flint Creek	1,100
Madison	Madison River	8,500
Hauser	Missouri River	16,500
Holter	Missouri River	49,000
Black Eagle	Missouri River	18,000
Rainbow	Missouri River	35,000
Cochrane	Missouri River	50,000
Ryan	Missouri River	60,000
Morony	Missouri River	47,000
Mystic Lake	East Rosebud River	11,500
	Total Hydro	**520,000 Kw**
	Generating Plants Steam-Electric	
Bird Steam Plant	Billings *	0
Corette Steam Plan	Billings	180,000
Colstrip Unit 1	Colstrip * *	165,000
Colstrip Unit 2	Colstrip * *	165,000
Colstrip Unit 3	Colstrip * * *	210,000
	Total Steam-electric	**720,000 Kw**
	Other	
Firm Contracts and Replacement Power		194,254 Kw
		=======
	Total Available, 1985	**1,439,004 Kw**

* The Bird Steam Plant is not in service.
* * Represents 50% share of Colstrip Units 1 and 2.
* * * Represents 30% share of Colstrip Unit 3.

CHAPTER III

COLSTRIP 3 RATE CASE

A. Colstrip 3 Introduction

Montana Power began construction of Colstrip 3 in September, 1979, after nearly eight years of planning. Colstrip 3 was the third of four generating facilities planned for construction at the mine mouth at Colstrip, Montana. Under the original agreements, Montana Power would own portions of all four plants and would be responsible for the operation of the plants for the partners.

Some highlights, based on newspaper clippings and Montana Power information are presented here in chronological order to explain what events transpired up to the time when the Colstrip 3 rate case was filed.

- February, 1971. Colstrip area is selected by Montana Power as the site for future development of Colstrip 3 and 4 due to mine mouth location.
- August, 1972. Montana Power completes a systems study on the possibility of building Colstrip 3 and 4.
- September, 1972. Montana Power and four other utilities sign a joint letter of intent to build Colstrip 3 and 4.

- November, 1972. Montana Power is designated Colstrip project manager by the other four utilities.
- January, 1973. Montana State Board of Health asks Joseph McElwain, at the time, Montana Power Executive Vice President, if the Company is considering building Colstrip Units 3 and 4. "This is not true," McElwain said.
- February, 1973. George O'Connor, then Montana Power Company President, tells the Utility's Board of Directors that the firm is studying the possibility of building Colstrip 3 and 4 with four other utilities.
- March, 1973. Montana Power's coal mining subsidiary, Western Energy Company, agrees to commit 170 million tons of coal to the Colstrip project.
- June, 1973. Montana Power Company, Pacific Power and Light Company, Puget Sound Power and Light Company, Portland General Electric Company, and Washington Water Power Company officially and publicly file applications with the State Department of Natural Resources and Conservation for permits to build Colstrip 3 and 4. A filing fee of $1.23 million was paid.

Montana Power's O'Connor said, "Based on in-depth studies we have already conducted, we are utterly convinced that Colstrip plants can be built and operated with minimal environmental effect."

O'Connor said the proposed plants should be in full operation by 1978 or, "We in Montana and throughout the Northwest face the bleak prospect of power deficits that translate directly into lost jobs and productivity over a wide range of economic activity."

- June, 1973. The five utilities unsuccessfully seek a waiver of the 600-day period for the Department of Natural Resources to study the Colstrip project.
- December, 1974. Department of Natural Resources issues a 2,000 page draft environmental impact statement on Colstrip project and conducts public hearings throughout the state.
- January, 1975. Department of Natural Resources officially recommends against construction of Colstrip 3 and 4, saying that if such plants are built, "Montana could become a boiler room for the nation."

The Department of Natural Resources argued that coal should be shipped by rail out of the state instead of being burned at Colstrip and being transmitted out of state by power lines. It concluded: "The Department is not persuaded that the obligation of Montana to the rest of the nation or the Pacific Northwest necessarily goes beyond making energy available through reasonable alternatives."

- January, 1975. Montana's newly elected five-member Public Service Commission unanimously opposes construction of Colstrip 3 and 4, contending the plants are unnecessary.
- March, 1975. State Board of Natural Resources begins hearings on Colstrip 3 and 4, but hearings are halted so the Board of Health can determine if the plants will meet air and water quality standards.
- November, 1975. Board of Health unanimously rules that Colstrip 3 and 4 would not violate federal and state water and air quality standards. Board of Natural Resources' hearings are allowed to resume.
- June, 1976. Members of the Board of Natural Resources secretly gathered in Helena to work on a Colstrip decision. At a public meeting the next day, the Board decides by 4-3 vote to conditionally issue the utilities a certificate of environmental compatibility and public need for the power plants, enabling construction to proceed.
- July, 1976. Northern Cheyenne Tribe announces it will petition the U.S. Environmental Protection

Agency (EPA) to designate its reservation near Colstrip as an area with pristine air quality standards.

- July, 1976. Northern Cheyenne and Northern Plains Resource Council appeal the Board of Natural Resources decision approving Colstrip, contending the Board committed substantial errors in the process.
- October, 1976, the EPA's regional administrator rules that Colstrip 3 and 4 are covered by the agency's regulations designed to prevent the significant deterioration of air quality.
- June, 1977. The five utilities decide to proceed with the construction of the power plants despite numerous court appeals.
- August, 1977. EPA agrees to designate Northern Cheyenne Indian Reservation as Class I or pristine in air quality, a move that may prevent construction of Colstrip plants.
- October, 1977. More than 100 angry union members stage a protest in front of the Federal Building in Billings over the work stoppage at Colstrip caused by the EPA's designation of Northern Cheyenne Reservation as Class I in air quality. They bear signs that say "Starvation kills faster than bad

air" and "Out of work and hungry? Eat an environmentalist."

- March, 1978. State District Judge Bennett reverses decisions by Board of Natural Resources approving Colstrip 3 and 4, condemning its proceedings as a "procedural travesty."
- June, 1978. EPA refuses to issue a permit for Colstrip 3 and 4, saying air pollution from the plants will violate Class I air quality designation of the Northern Cheyenne Reservation.
- April, 1979. Montana Supreme Court rules the Board of Natural Resources did commit procedural errors and gives the Board 90 days to correct them so that Colstrip construction can proceed.
- September, 1979. Montana Supreme Court upholds the Board of Natural Resources' 1976 permit ruling which clears the way for construction to resume at Colstrip.
- September, 1979. Reversing itself, EPA said Colstrip power plants 3 and 4 won't violate pristine air quality designation of Northern Cheyenne Reservation.
- September, 1979. Utilities sign agreement with Northern Cheyenne Indian Tribe, meeting federal environmental concerns and creating job training

for Indians.

- March, 1981. State sues the Bonneville Power Administration and eventually wins, forcing the federal agency to comply with the state siting law on power lines out of Colstrip.
- June, 1981. U.S. Ninth Circuit Court of Appeals rejects Northern Plains Resources Counsel appeal of EPA ruling on air standards.
- August, 1982. Colstrip construction work force peaks at 4,180 employees.
- May, 1983. Board of Natural Resources calls for a hearing on whether to revoke the utility's permit in controversy over whether potential seepage from sludge pond violates condition in permit. Montana Power sued to block the hearing and won in District Court.
- September, 1983. Utilities conduct steam blow on Unit 3 getting it ready for turbine roll.
- September, 1983. Montana Power seeks a record $96.4 million annual electric rate increase.

Colstrip electricity is produced by coal-fired generating plants located at the mouth of the largest coal deposit in the nation.

Every square foot of land in the Colstrip area contains a 24-foot thick seam of coal that weighs one ton. Thus, there are 40,000 tons of coal beneath every acre of land. Montana Power, as of late 1983, had leases on about 585 million tons of coal. When Colstrip 3 is fully operational, it will burn 450 tons of coal each hour - or about one coal train per day.

Colstrip coal produces 8,600 BTU's (British Thermal Units) of heat per pound. It contains 25% moisture, 9% ash and only 0.8% sulfur. It is because of these huge reserves of low-sulfur coal that Montana Power's generating plants are at Colstrip. Montana Power purchased the town of Colstrip and adjoining leases from the Northern Pacific Railroad in 1950.

The rate increase sought for Colstrip 3 would cost much more than anyone, including Montana Power, had estimated. Montana Power attributes some of the error to the perils of forecasting power requirements.

One of those perils, Montana Power officials say, was the Anaconda Minerals Company. In the mid 1970's, when Colstrip 3 and 4 were in the planning stage, Anaconda Company said it would need 219 megawatts per year by 1982 to keep its plants and mills operating. However, due to the shutdown of the the Anaconda Company in Montana, the Company used only 51 megawatts in 1982, a 168 megawatt difference in projected demand was experienced as a result.

Another peril was the economic recession. If one considers that the Colstrip 3 and 4 project was planned in 1971, Montana Power forecasts are understandable. Montana Power's forecasts were in error. They may have been as accurate as other utility's forecasts, but not a one predicted the events that occurred during this period.

To be more specific, power deficits forecasted in 1976 for the year 1979-1980, without Colstrip, 3 proved to be inaccurate for four reasons.

- Since 1976, the Pacific Northwest had not experienced a recurrence of the critically low water conditions. These severely reduce the amount of hydroelectricity available from dams. In planning for Colstrip and other new plants, the Company uses critical water conditions.
- From 1977 to 1983, Montana Power was able to acquire 10% of the energy produced as a by-product from the Hanford Nuclear Plant in Richland, Washington. At the time of the 1976 hearings before the State Board of Natural Resources on the Colstrip projects, this purchased electricity supply was not forecasted as available, and thus was not included in the supply forecasts.
- The closure of Anaconda Company smelter and refinery

and the shutdown of its mining operations in Butte affected power requirements. Anaconda Company reduced the amount of electricity in its contract with Montana Power from 212 megawatts to 170 megawatts in 1975. The amounts dropped to 153 megawatts in late 1976 and to 85 megawatts in December, 1980 after the plant closures. In May, 1983, Anaconda reduced its contract amount from 85 megawatts to 11.8 megawatts when it suspended its mining operation in Butte.

- The nationwide economic recession from 1980 to 1983 caused the base loads to be 55 megawatts to 65 megawatts less than Montana Power had expected.

B. $96.4 Million Electric Rate Request

As Colstrip 3 neared completion with an on-line date of January, 1984, Montana Power began preparation of a rate case filing to be presented to its regulating agency, the Montana Public Service Commission. The primary purpose of the rate case filing was to include the investments of Colstrip 3 into rate base in order to earn a return on those investments.

On September 30, 1983, Montana Power filed new rate requests. The request amounted to a record $96.4 million, boosting its revenues by 55.4%, resulting in a rise in the electricity rate from the current rate of 3.98 cents per kilowatt hour to 6.35 cents per kilowatt hour.

By statute, the PSC must act on a rate increase request within nine months. If not, it automatically takes effect, subject to latter rebate. In this particular case, Montana Power agreed to extend the nine-month deadline by one month due to the delays in responding to the large volume of requests for more information. As a result of this delay, the PSC had until July 30, 1984, to complete its rate order. Otherwise it risked having the entire rate increase request take effect.

Most of the 55.4% increase could be directly attributed to the addition of Montana Power's 30% share of Colstrip power plant 3 to the Utility's rate base. The rate base consists of the Company's plant and investments. By statute, Montana Power is allowed rates which earn a market level return based on its plant investments.

In a prepared statement, Montana Power Executive Vice President Jack Burke defended the rate request. He said that the Utility officials recognize the $96.4 million increase "is a large figure" but said two additional factors must be taken into consideration.

First, Montana Power's 210 megawatt share of Colstrip 3 "is not only needed but will continue in use as a reliable source of energy for decades." Burke said Colstrip 3 energy would be at the cheapest cost of any thermal plant coming on line during the rest of the century.

Second, Burke said the Colstrip project was on schedule and under budget, "In sharp contrast to delays and cost overruns which have plagued major electric generating plants being built elsewhere."

While the overall requested rate increase totaled 55.4%, the amount varied among different customer classes. Large industries faced a 65.4% boost, residential customers would pay 59.8% higher rates, irrigators would see their bills rising by 55.4% and smaller businesses and government agencies would face a 47.9% hike.

Listed below is the breakdown as to how the rate increase would affect each customer class.

- Residential	$ 39.7 million	or	59.8%
- General	$ 33.5 million	or	47.9%
- Irrigation	$ 1.3 million	or	55.4%
- Street Lighting	$ 2.9 million	or	108.7%
- Industrial Contract	$ 17.8 million	or	65.4%
- Government Contract	$ 606,675	or	54.6%

From the onset of the rate request, it was anticipated that there would be certain major issues arising in the rate case.

The first of these issues was the question of whether

Montana Power needed its share of power generated by Colstrip 3. At the time there existed electricity surpluses in the Pacific Northwest.

Under Montana law rate payers pay costs of plants only if the power produced is "used and useful." This particular issue, "used and useful" became the central issue in the case. In two other recent cases, the PSC imposed that law to disallow some costs that other utilities in the state attempted to pass on to its users.

In 1981, the PSC determined that 30 megawatts of the 80 megawatts of electricity Montana-Dakota Utilities Company (MDU) was obtaining from a North Dakota power plant were "unneeded excess capacity." As a result, MDU shareholders, not users of power, absorbed those costs. These amounted to $2.1 million a year.

Again in 1983, the PSC denied Pacific Power and Light Company (PP&L) rate increases to pay its cost of abandoning two nuclear power plants in Oregon and Washington. PP&L had sought an increase of $2.025 million per year over five years to cover these costs.

Montana Power was aware of these two cases, but management differentiated Montana Power and the other utility requests saying it amounted to comparing apples to oranges to plums. Unlike the MDU and PP&L plants, Montana Power's Colstrip facility was in Montana. Furthermore, the Colstrip project had been certified by Montana's State Board of Natural Resources under the Major Facility Siting Act in 1976. Montana Power took the position that all of its share of power from Colstrip 3 was needed. Consequently, the plant would be "used and useful" when it came on line.

Another issue management expected to surface was whether the Colstrip plant was constructed as economically as possible. There had been charges that the project was costing more than it should through excessive labor and material costs. Montana Power denied this, saying that such allegations were unfounded.

Montana Power seemed confident the PSC would thoroughly investigate project construction and was equally confident such inquiries would substantiate Montana Power's claims that the project was not only under budget but also on schedule. Montana Power observed too that 35% of the cost of Colstrip 3 was for air pollution control equipment, meeting state and federal clean air standards.

The final issue was how rates would be allocated among the different classes of customers. The PSC had previously attempted to devise a new method for allocating rates to different customer classes. In the last Montana Power electric rate case, it tried to do so and proposed reducing the rates for residential, small business and government customers and boosting the rates for irrigators and major industries. However, that attempt to categorize users was overturned in District Court and appealed to the Montana Supreme Court.

Montana Power's last electric rate increase occurred in the Summer of 1982. At that time, it filed for a record $52.9 million increase and eventually received a $31.9 million increase in May, 1983. Montana Power was now seeking a rate of return of 12.56%, compared with 11.63% authorized in the May, 1983, order.

For years, Public Service Commissioners and Montana Power had engaged in a public debate about how much the addition of Colstrip power plants 3 and 4 would increase electricity rates.

The Commissioners warned that adding the two coal-fired power plants to Montana Power's rate base could cause a 100% increase in electric bills.

But Montana Power officials protested PSC figures as excessive and estimated the total increase at closer to 50%. However, Montana Power management once again missed its estimates. Colstrip 3 and 4 would cost consumers much more than the Company projected.

The Colstrip 3 rate increase was intended to include total costs of power transmission lines and more than one-half the costs of facilities that both Colstrip 3 and 4 would share. The total Colstrip 3 and 4 project and transmission lines would eventually cost $1.8 billion.

Montana Power's current electric rate base prior to the Colstrip 3 and 4 inclusion was $468 million. Adding Montana Power's share of the $1.8 billion Colstrip 3 and 4 project would add $540 million. It would more than double the existing rate base. Colstrip 3 and associated transmission lines would add $344 million to its current rate base to bring it to $802 million.

At the time of filing of the Colstrip 3 rate request, Montana Power declined to discuss what percentage increase would be sought for Colstrip 4 because their application for a rate increase was almost two years in the future. They acknowledged that forecasting utility rates, which involve looking at worldwide political and economic conditions among other things, is not easy.

The rate request brought immediate consumer opposition. Consumers complained to various state officials by mail, telephone and in person. The State Consumer Council also received many letters. The Council acknowledged that more letters than usual were being received concerning this specific rate request.

Public sentiment throughout the state grew, all of it in opposition to the filed rate request. By late October of 1983, AFL-CIO Executive Secretary Jim Murray said the labor group would work with other "people groups" to oppose "rate increases which are unfair, unjust, and inequitable." He indicated that if the Colstrip 3 plant capacity was not needed, Montana Power's stockholders, not consumers, should foot the bill. In addition, Murray said the PSC "should not allow rate increases that encourage corporate irresponsibility in the MPC case." The Utility made a mistake according to Murray.

By early 1984, Montana Power was being pressured by opposition groups. In February of 1984, Montana Power began a five-week advertising campaign in Montana's daily newspapers explaining their third and fourth power plants at Colstrip together with their rates and rate distribution system.

Montana Power perceived that, although the coal-fired plants had been in the news since they applied for permits in 1973, many people appeared not to understand that Montana Power owns but 30% of Colstrip 3 and 4. The fact is that four out-of-state utility companies own the remainder.

Montana Power was criticized for the ads but considered the ads as part of a continuing long-term effort to have consistent dialogue with their customers. Many people felt the ads were an effort to influence public opinion concerning the Colstrip 3 rate hearings pending before the PSC.

October 22, 1983 marked dedication day for Colstrip 3 and 4. Together, these twin plants would generate 1,500 megawatts of electricity used in Montana, Oregon, and Washington. The combined project of Units 3 and 4 represented the largest industrial development, private or public, in Montana's history. This date also marked "turbine roll" on Unit 3.

It was a decade ago that the four Pacific Northwest energy companies with Montana Power formed a consortium to build the plants and related transmission lines. To get the necessary governmental permits as well as fending off of lawsuits brought by environmentalists, ranchers, farmers, and other litigants required many years. The original cost estimate of $500 million escalated through the years to $1.8 billion by the time the project was completed.

As previously stated, Montana Power, the project manager, owns 30% of the two plants. The other owners are Puget Sound Power and Light, 25%; Portland General Electric, 20%; Washington Water Power, 15%; and Pacific Power and Light, 10%.

Units 3 and 4 are "big sisters" of Units 1 and 2 which were completed in 1975-76, each generating 330 megawatts. The first two units are owned equally by Montana Power and Puget Sound Power and Light.

On March 2, 1984, the PSC refused to grant Montana

Power authority to increase its rates even temporarily in order to recover its costs of building and operating the Colstrip 3 power plant. Montana law states that only the portion of any operating plant that is deemed "used and useful" may be added to the Utility's rate base.

The Company had asked permission to begin immediate collection of another $42.3 million to $81.3 million per year from its customers during the time the Commission was considering the Company's request for the $96.4 million rate increase.

The PSC announced it would follow its past practice of not granting interim rate increases for new utility plants. In addition, the Commission indicated there was too much controversy in the main case concerning whether or not Colstrip 3 was even needed and that it would be inappropriate to allow the Company to collect moneys to pay for it before that controversy was aired in public hearings, which were scheduled to begin on March 27, 1984.

In documents filed with the Commission, Montana Power said that refusal to grant an interim increase could be staggering for the Company and could jeopardize its ability to provide the present level of service. Before deciding to exclude Colstrip 3 costs from the interim rate increase, the Commission heard their own counsel summarize objections to any temporary hike. The objections were filed by the group of industrial customers, the Northern Plains Resource Council, Montana Irrigators Association, and District XI Human Resources Council of Missoula. All objectors challenged the need for Colstrip 3 electricity.

The Company responded with similar documents that the issue of whether the plant was needed had been settled a decade ago and could not be considered again by the PSC. The Board of Natural Resources said that plant was needed when it issued the construction permit for Colstrip 3 and its twin number 4. Under Montana law, the PSC should be prohibited from inquiry, after the fact, into the need for Colstrip 3, the Company said.

The Public Service Commission said that it would consider as regular business expenses, for inclusion in any potential temporary increase, the interest which Montana Power had paid on moneys borrowed for construction of Colstrip 3. Following that approach, the Commission would then be acting as if the plant was still under construction. In fact, it was completed and on-line. The Company had sited $50 million worth of financing costs in the main application for a permanent rate increase.

On March 6, 1984, Montana Power reversed its role and asked the PSC to submit testimony detailing positions it would take in the Utility's upcoming rate hearing. The motion was filed three weeks before the PSC began its hearings on Montana Power's request to increase its electricity rates.

Normal procedure is for the PSC staff to formally ask questions of a utility before a rate hearing. It is unusual however, for a utility to make that same request of the regulatory agency itself.

In a memorandum, Montana Power stated it made the request because of "troublesome" occurrences in past rate cases. Many times in past proceedings before the PSC, new information surfaced and had been placed on the record by the PSC staff. Trial and hearing lawyers seek to eliminate this element of surprise. Sometimes a final order had been issued by the PSC, only later had Montana Power learned what had been at issue during the hearing in the minds of the Commission and staff. Montana Power believed that prior to the hearings it was entitled to know the positions of the PSC and its staff under the constitutional guarantee of due process of law.

On March 16, 1984, the PSC denied Montana Power's "discovery" request to know the written position of the PSC staff concerning the Utility's electric rate increase case.

The documents filed by Montana Power with the Commission complained the PSC was becoming not only both judge and jury but advocate as well in rate cases. However, the

Commission, following the advice of legal counsel, denied the motions on grounds that the staff's role and interests in the case were already well-known to the Company.

Further, the requested amendments would have required the staff to submit pre-filed testimony stating its positions on issues and the basis for those positions. Montana Power also demanded that the PSC staff, both in its role as advisor to the Commission and its alleged role as "independent analyst", submit a list of all exhibits it planned to introduce as evidence at the hearing and an explanation of them.

Montana Power also asked for permission to submit "discovery" requests. That is, to question orally the PSC staff members in advance of hearings - and to be granted necessary extra time to review the requested information on staff positions before the Company was required to submit its pre-filed rebuttal testimony answering other witnesses.

Company attorney Daniel O. Flanagan stated that the tendency of PSC staff to raise its own issues and arguments during hearings before the Commission had become "troublesome". "The PSC staff had engaged in an unprecedented level of discovery" Flanagan said in written arguments to support his motions. He said the Constitution, Montana State Laws, and Montana Administrative Rules all require that parties of contested cases have reasonable notice of disputed issues and an opportunity to be heard in a meaningful manner and in a meaningful time.

On March 19, 1984, Montana Power made an "11th-hour" appeal for an interim rate increase. Montana Power stated it would soon experience serious cash flow problems unless the PSC granted a temporary power rate increase. They also stressed that they were spending large sums for operating the new Colstrip 3 power plant. Those operating expenses were in addition to millions spent to build the plant. As of that date, Montana Power had not received one cent back.

The Commission was scheduled to vote on March 20, 1984, on the issue of granting a limited interim rate increase, but not for the actual construction or operational costs of Colstrip 3.

Montana Power's position was that unless a major increase was granted soon, the Company would have to consider curtailing portions of its $100 million capital construction plan for 1984 and also cut back on other Company operations.

On March 20, 1984, the PSC approved an immediate $3.9 million per year electric rate increase - $38.4 million less than the minimum the Company said it could get by on. The Commission's order meant an average increase of about 2.1% per year in power bills for residential customers.

The interim order temporarily rejected all claims for recovery of Montana Power's investment in construction and operation of Colstrip 3 which was on-line and producing electricity.

The Commission stated that the temporary increase merely updated factors of already approved portions of Montana Power's overall electric utility rate base. Montana Power had asked the Commission to grant a $81.3 million immediate rate increase while the agency considered a $96.4 million permanent hike. The Company had said it would accept a minimum of $42.3 million for the time being - enough at least to begin offsetting some costs of the new plant and other more recent expenses. The $3.9 million allowance thus was far from the Company's request, a rather obvious point but cited by Montana Power Spokesman Dean Conklin. "It's a far cry from $81 million and a far cry from $42 million," Conklin said.

In deciding the interim rate increase, the Commission took notice of what it called the unprecedented controversy over the underlying $96.4 million rate case. PSC policies, the order said, do not allow interim rate increases based on major new plant additions prior to a thorough exploration in a public hearing underlying issues associated with those new facilities.

It could not, the Commission said, dispute that the

Company was currently incurring expenses because of Colstrip 3, but Commissioners said the proper recognizable levels of those expenses was still in question.

Shortly after the PSC granted Montana Power its interim rate hike of only $3.9 million, Utility President Paul Schmechel said on March 22, 1984, that Montana consumers, in the long run, would suffer if Montana Power was not allowed to recover full costs of Montana Power's share of Colstrip Power Plant 3. Whatever portion of the electricity from Colstrip 3 not allowed in its rate base would have to be sold out of state.

The Company also indicated they would have to seriously consider "permanently disposing" of its interest in Colstrip 4 if the PSC disallowed Montana Power's 30% share of Colstrip 3. If the PSC did not provide for a reasonable rate-base on Colstrip 3, Montana Power would be forced to dispose of whatever percentage of that resource not included in rate base.

The only way Montana Power could receive revenue approaching its investment in Colstrip 3 would be to sell power on a contract basis over the long run. This would mean that at the time Montana Power consumers grew into all of Colstrip 3, that plant simply would not be available. At that time, Montana Power would then have no choice but to acquire new electricity at higher costs. Contracts for selling power out of state would be the only possibility Montana Power would have of assuring the finanacial viability of the electric utility.

On March 21, 1984, Montana Power announced they would reduce budgets for construction, maintenance, and training in view of the PSC's refusal to grant the larger interim rate increase requested. The Company identified the following projects as being considered for curtailment:

- The Alkalai Creek-Baseline 230 Kv transmission line and substation in Billings.
- A 161 Kv transmission line from Bonner to Missoula.
- 161 Kv transmission lines in the Bozeman and Ennis areas, plus lines and substations in the Bridger, Laurel and Bitterroot Valley areas.

Maintenance projects considered for deferral included replacement of 200 feet of spillway at Rainbow Dam near Great Falls, rewinding of two generators at Rainbow Dam, and upgrading work at Black Eagle, Ryan and Holter Dams.

"Coping with this cash flow shortage until the final decision occurs in July is our main problem with this temporary rate order," Montana Power President and Chief Executive Officer Paul Schmechel said in a news release. "Every department in every area is being required to share in the reduction of expenditures," he stated.

Montana Power had a $100 million capital construction budget plan for 1984. The Utility's new philosophy was to balance its outflow of cash with existing short-term borrowing limits. Captial spending, in the near term, was limited to an amount that would not exceed the total of plant retirements, depreciation and deferred taxes.

C. <u>PSC Hearings Begin</u>

Public Service Commission hearings began on March 27, 1984. The initial hearings presented testimony between Montana Power and official intervenors of the case. Opening rounds of testimony in the Montana House Chamber also included appearances by public witnesses including former State Legislators and State Representatives.

As expected, the initial testimony focused on the "used and useful" issue. The president of one environmental organization testified that there is a subtle difference between laws which allow a power plant to be built and laws which require them to be declared "useful" before power customers can be forced to pay for them.

On March 28, 1984, Montana Power's chief financial officer admitted doubts about the Company's ability to recover full costs of its new Colstrip 3 power plant. Frank Woy, Montana Power's Vice President for Finance, testified during the PSC's hearings that the plant had been an immense financial burden on the Company. In sworn testimony prior to the opening of oral hearings, Woy said that without an opportunity to earn a greater rate of return, the electric Utility's earnings would be inadequate to sustain the Company's credit ratings and projected operations. Credit ratings are essential to keeping utility capital costs down and in turn, consumer rates at market prices.

At the time Montana Power made the decision to go ahead with the $344 million plant and associated facilities of Colstrip 3, it was of a magnitude consistent with the Company's strong financial standing in the market for utilities with similar projects. Comparable utilities elsewhere had such projects. No one foresaw the chain of economic events - high levels of inflation, an economic recession, then high interest rates - which took place during the decade-long development of the Colstrip project.

Futhermore, at that time, the Company had no experience with, nor received little or no feedback market reactions from the nation's investment community. The PSC's decision to delay all requested interim rate relief associated with Colstrip 3 until a final order was issued in the current rate case was bound to make an impression on those companies elsewhere in the United States supplying the money Montana Power needed.

During testimony on April 6, 1984, Eugene Meyer, Vice President of Kidder, Peabody & Company of New York, a Wall

Street Investment Company, said that Standard & Poor's, a prominant rating agency, was awaiting the outcome of the current rate case presented to the PSC before deciding whether to maintain or to downgrade MPC's "A" rating. He said the rating agencies and investors themselves were particularly concerned about the utility Company's cash flow status.

The essence of the problem was whether the cash generated internally would be sufficient to cover the Utility's cash outflows. If not, the Utility would have to search out additional outside capital to pay its current bills. In Standard & Poor's judgement the Utility's financial position would be weakened and less secure if and when that new financing became available. Capital costs currently being paid by the Utility would be increased.

For a utility company, cash comes from the sale of products to its customers. For the most part, this is in the form of regulated rates. Cash flow is a key to the money markets' willingness to supply the money a utility needs to provide service to customers. Maintenance of financial credit worthiness is absolutely essential if a utility is to have access to capital markets at prime market rates of interest. Capital from money markets is necessary to finance new construction which in turn, is used to serve the utility's customers better. It is important to note that regulated utilities are distinguishable from other business enterprises in that they serve customers under a state granted franchise which requires, amoung other things, that customers be served upon request at reasonable rates.

In April of 1984, PSC satellite hearings began throughout the state of Montana. The satellite hearings were separate from technical portions of the hearings. During technical hearings, expert witnesses representing various groups and Montana Power would testify and be questioned by the PSC and its counsel representing the different interest groups. By contrast, satellite hearings were intended as a forum for citizens, not expert witnesses. Any citizen could testify. Satellite hearings were conducted by members of the PSC. In its orders in past rate cases, the PSC had cited testimony both from members of the public appearing at satellite hearings and expert witnesses.

There were 26 satellite hearings held around the state beginning on April 16, and running until April 24. As one might have suspected, the majority of testimony at these satellite hearings was opposed to the increase. Prominent were statements similar to those made by expert opposition witnesses about Colstrip 3 being excess generation capacity, that Montana Power made poor investment decisions, and that stockholders, not customers, should be required to pay for

Colstrip 3.

The gavel fell May 30, 1984, on the state PSC's public hearings on Montana Power's request for the $96.4 million electric rate increase. The hearings began March 27, 1984, but the case remained open for final written arguments by attorneys for the Utility, State Department of Public Service Regulation, and the many intervenors who presented testimony opposing the rate hike. The literally truckloads of evidence and testimony to the Commission were expected to take several months of deliberation.

On June 22, 1984, Montana Power announced that completion of the Colstrip 4 Power Plant had been delayed for nine additional months at the request of three of the five utility partners. Asking for the delay were Montana Power, Washington Water Power and Pacific Power and Light. Puget Sound Power and Light and Portland General Electric would have preferred to maintain the original schedule of completion.

Colstrip 4 had been scheduled for turbine testing by April 1, 1985, with commercial production July 1, 1985. The delay meant testing would not begin until late 1985 or early 1986, and production in the Spring of 1986.

Several reasons were cited for the delay. Montana Power said the delay would help the Company meet its cash flow problems. Washington Water Power could not use the electricity prior to July, 1986, because the 500 kilovolt power lines being constructed by Bonneville Power Administration to ship Colstrip 4 power to the Pacific Northwest would not be completed until that date. Pacific Power and Light had been trying to sell its share of Colstrip 4 power. It's forecasters said the Pacific Northwest was expected to have a surplus of electricity into the 1990's. Puget Sound Power and Light did not seek an extension because they would be able to use their share of the electricity as scheduled.

Costs of interest were expected to rise because of the delay but the total project cost would remain within the original budget. This was primarily due to the productivity gains which were reached since construction began in September, 1979. The delay in completion of the fourth power plant at Colstrip would put some 300 workers out of jobs by the end of the year.

D. PSC Denies Request

On July 30, 1984, the State Public Service Commission voted 5-0 to grant Montana Power only a fraction of its electric rate increase request and refused to allow the Company to charge customers for its share of Colstrip power plant 3 because that energy "was not needed". Montana Power was granted a $4.1 million annual electric rate increase, including the $3.9 million interim increase. The PSC fully expected their final order to be appealed to court.

On the same day, only hours after the PSC order, Montana Power President Paul Schmechel offered a compromise to the PSC. In a major switch of positions, Schmechel said that as a compromise, Montana Power would be willing to see only half of its 210 megawatt share of Colstrip 3 added to the Company's rate base at the time, with the rest phased-in later under certain conditions. Montana Power had insisted during eight weeks of hearings before the PSC that all of its 210 megawatts be included in its rate base because all of the power was needed. But the PSC refused to allow any of Colstrip 3 into the rate base, maintaining that power was not needed and, therefore, not used and useful under state law. As a result, the PSC held that consumers should not be required to pay for Colstrip 3 power.

Montana Power officials were surprised by the PSC decision. Based on earlier action by the PSC in March, Montana Power expected that at least part of Colstrip 3 would be allowed into rate base. Montana Power officials were asked why Montana Power insisted during the rate hearings that it was entitled to have all 210 megawatts included into rate base but now was willing to settle for one half that. Montana Power replied that the Company believed it was procedurally correct in asking for all of Colstrip 3 and that it was not within its discretion to make a lesser offer during the hearing.

The PSC decision and its earlier one granting a $3.9 million temporary rate increase in March brought about an immediate response from the financial markets, the suppliers of capital. Montana Power was placed on credit watch by rating agencies which is generally preliminary to having bond ratings lowered. When borrowing money, Montana Power would then have to pay higher market rates because the risk is rated as having increased. On July 30, 1984, Montana Power's common stock dropped from the $28-29 per share range in March to below $22 per share. Montana Power President Paul Schmechel commented that the Utility's earnings were one-half of those a year ago "and we cannot continue to do business this way".

In a special meeting on August 2, 1984, Montana Power Directors said their goal was to maintain the present dividend on common stock at $2.80 per share. They felt that despite the recent PSC order that the Company must not reduce its dividend. Its financial integrity in the market place must be maintained, so management reasoned.

During the middle part of August, 1984, Montana Power was able to obtain a relatively favorable market rate of interest on a $25 million bond issue related to Colstrip. The PSC immediately used this money market fact to show that their recent rate order did not adversely effect Montana Power's credit rating. But according to Frank Woy, MPC Vice President for Finance, the Company's financial standing in the investment community was indeed in some jeopardy because of the PSC's refusal to increase rates to recover its Colstrip 3 investment.

The Company's ability to obtain a more favorable 6.55% interest rate on bonds sold to finance pollution control equipment on Colstrip 3 and 4 was due to the financial strength of Morgan Guaranty Trust, a triple "A" rated investment bank. Montana Power pays Morgan $175,000 per year for a "letter of credit." That letter of credit made low bond rates possible because Morgan stood behind Montana Power. The annual payments to Morgan are, in a rough sense, an insurance premium for which Morgan underwrites and guarantees repayment of Montana Power's bonds. Because Morgan Guaranty Trust had a triple "A" rating by bond rating firms in Wall Street, the issue of tax exempt pollution control bonds benefited from the Morgan's investment bank's rating, rather than Montana Power's bond rating. Montana Power's current rating for top-priority debt was "A" and for subordinant debt was "A-minus".

Two leading Wall Street bond rating firms put Montana

Power on a "credit watch" with negative implications in the Spring of 1984, after the PSC denied most of the $81.3 million a year interim rate increase sought. As stated a "credit watch" usually precedes a rating reduction. On April 29, 1984, Standard & Poor's Corporation, one of the bond rating firms, said the Commission's interim order raised serious questions about the Commission's intentions with respect to Montana Power's right to recover its investment in Colstrip 3. Standard & Poor's credit watch bulletin said the Commission would have to provide "substantially more responsive treatment" in its final order if Montana Power's "A" rating was to be preserved.

Neither Standard & Poor's nor Moody's Investor Services Inc. had updated its "credit watch" or Montana Power's bond rating since the Commission denied rate recovery on any of Montana Power's Colstrip 3 investment on July 30, 1984. Montana Power officials met with rating agencies to discuss updates during the week of August 13, 1984. Bond ratings represent one widely used measure of estimating market risk. In bond raters views, the recent order of the PSC significantly increased risk levels associated with the securities of Montana Power.

On August 27, 1984, Standard & Poor's downgraded Montana Power's stock and bond ratings. The reductions were greater than expected by Montana Power officials. The action a direct result of the PSC's refusal to include Colstrip 3 investments into rate base, followed a similar downgrading by Moody's on August 16, 1984. The lower credit ratings would force Montana Power to pay higher rates of interest for money borrowed.

According to financial sources, the ratings were lowered as indicated below by Standard & Poor's:

- Senior debt from A to BBB minus.
- Subordinated debt from A minus to BB plus.
- Preferred stock from BBB plus to BB.
- Commercial paper from A-2 to A-3.

Standard & Poor's considers a debt rating lower than BBB minus as predominately speculative. With this announcement, Standard & Poor's said it found the PSC order "particularly disquieting in that it would appear to portend further punitive regulatory treatment for the Colstrip 4 plant under construction at that time. The order would have a material adverse affect on cash flow, interest coverage, and earned returns, and could result in further difficulties for Montana Power capital markets.

Standard & Poor's expected the Utility to fare better before the Montana Supreme Court, to whom it had appealed, than it did before the PSC, but doubted that Montana Power would get back its original ratings. If the State Supreme Court lets the PSC decision stand, Standard & Poor's said, it is questionable whether Montana Power could maintain even its current downgraded ratings.

It was announced on September 27, 1984, that despite financial problems, Montana Power's Board of Directors voted to pay the regular October quarterly dividend of 70 cents per share of common stock. The reason Montana Power maintained the current dividend level in the face of declined earnings was simple. Although lowering the dividends would have temporarily helped the Company's cash situation, it would not have solved its earnings problem. A characteristic of utility stocks is that stock prices are related to dividend yield. Cutting the dividends would cause the price of Montana Power stock to drop, which in turn would reduce common stock as a source of captial.

The Board's action was aimed at protecting long-term interests of the Company, rather than applying a short-term action that would have an adverse market reaction. Montana Power's 1984 earnings through August 31, 1984, had declined to $20.2 million, compared with $43.7 million over the same period in 1983.

E. Phased-in Rate Request

On November 15, 1984, Montana Power announced that it would file for a $129.6 million rate increase to be phased-in during the next four years, but promised to reduce rates by $47.1 million during the three years thereafter.

Details of the amended rate request indicated these changes between then and 1991:

- $35 million or a 20% increase in January, 1985.
- $24.4 million or 11% more on July 1, 1986.
- $31.3 million or 13% more on July 1, 1987.
- $38.9 million or 14% more on July 1, 1988, bringing the total to $129.6 million.
- A decrease of $7.8 million or 2.5% in 1989.
- A further decrease of $15.2 million or 5.1% in 1990.
- Another decrease of $24.1 million or 8.4% in 1991, for a total decrease of $47.1 million.

The net effect would be that Montana Power customers would be paying $82.5 million per year more beginning in 1991 than they are paying now. The Company's new plan for recovering costs of Colstrip 3 would be good for consumers because it would ease the pain of paying for Colstrip 3 over several years rather than one single increase as the Company earlier proposed.

Montana Power was confident that the phased-in rate request would be granted by the PSC. One of the primary reasons was that the new request was based on more up-to-date operating conditions. The new test year would be 1983 rather than 1982, as used in the original rate case.

Due to serious financial conditions in Montana Power's electric division, Montana Power filed its new phased-in rate request, even though its last case was still under court review at two levels. It was their philosophy that all possible courses in seeking a resolution to these problems needed to be pursued. Another reason for the new rate case was to preserve Colstrip 3 for future Montana customers.

On December 12, 1984, the Montana Supreme Court unanimously upheld the state PSC's right to conclude, as it did earlier, that the Colstrip 3 power plant was not needed to meet present-day consumer demands. The court ruled that the 1976 approval of the plant by the Board of Natural Resources, including its finding that the plant would be needed, in fact, did not preclude the PSC from reaching an opposite conclusion after the plant was constructed.

Specifically, the court said the Major Facility Siting Act, under which the Board of Natural Resources determined the plant was needed, did not directly or indirectly repeal the PSC's separate authority to determine whether a power plant was actually useful to consumers.

The Supreme Court said the Major Facility Siting Act was an enviromental law, while the PSC's law governs rate-making, and the two are simply unrelated as presently written. Montana Power still had an appeal before the District Court in Butte on the PSC ruling that ordered only $4.1 million of a requested $96.4 million rate hike.

The price of Montana Power common stock plunged to a four year low on December 13, 1984, and its trading was suspended for 49 minutes on the New York Stock Exchange as stockholders scrambled to sell their holdings quickly in the wake of the adverse ruling by the Montana Supreme Court.

The price of a common share of Montana Power stock closed at 18 that day, which was 5 5/8 lower than the 23 5/8 closing price the day before. It was the largest percentage loss for that day on the "Big Board". The volume of trading of Montana Power stock was 675,000 shares that day, four times the normal rate. Trading of Montana Power stock was suspended at midday Eastern Standard Time because "sell orders" greatly outpaced "buy orders".

The drop in price brought an immediate, one-day market loss of over $105 million for the holders of 21.2 million outstanding shares of Montana Power common stock. The price of Montana Power common stock that year (1984) ranged from a low of 21 1/8 in late July after the PSC decision, to a high of 30 3/8 in January.

On December 27, 1984, the PSC granted Montana Power a $21.4 million interim rate increase, including about $8.5

million for a portion of their investment in Colstrip 3 power plant. The Commission's order raised electric rates by about 12 percent. As earlier indicated, the Commission ruled that Colstrip 3 was not needed to meet customer demands for power. That ruling was still being reviewed in District Court. But the Commission said that based on present evidence from Montana Power, the new power plant was needed for one month in 1983, the new so-called "test year" being used by the Commission to determine Montana Power's financial needs. Most of the rest of the $21.4 million increase was necessary to meet higher costs of Montana Power's normal business operations.

On December 28, 1984, Montana Power, for the first time since 1947, cut its quarterly dividend on common stock from 70 cents to 50 cents a share. This action, recommended by Montana Power management, was unanimously approved by its Board of Directors. The reduced dividend was paid January 31, 1985, to all persons owning common stock as of January 8, 1985.

Montana Power's Directors resisted lowering the dividend in September fearing it would cause many stockholders to sell the stock, driving down the stock price. But at this board meeting the Directors had little choice but to reduce the December dividend. The Company's 1984 income did not meet what was required to pay the 70 cent quarterly dividend.

Montana Power's common stock dropped again on December 31, 1984, by 1 1/8 on the New York Stock Exchange. The stock closed at 19 1/4 and Montana Power was fourth-ranked among losers on the stock exchange at noon that day, when ups and downs are compared. It had dropped 1 3/8 points, to 19 points, a 6.7% decline.

The opening day of hearings before the PSC for the phased-in rate request was May 29, 1985. At these hearings, on May 30, Montana Power reduced it $82.4 million annual net electric rate request to $73.8 million, to be phased-in over seven years. The change was the result of more current information used in determining the requested amount.

June 17, 1985, was an important day for Montana Power. On this day District Judge Mark Sullivan of Butte ruled in favor of Montana Power in its challenge of a PSC decision denying a $92.3 million electric rate increase. Judge Sullivan said that the PSC, in the previous year, illegally decided that electricity from the new Colstrip 3 power plant was not needed and should not be allowed the rate increase to cover its investment in the facility.

In a strongly worded decision, Judge Sullivan called the PSC's method of determining the usefulness of the coal-fired Colstrip 3 plant "unreasonable, arbitrary, and clearly erroneous". Sullivan said the PSC unlawfully decided the need for Colstrip 3 when it refused to consider the need for the plant in meeting the Utility's current peak power requirements by assuming Montana Power could meet its customer demands by purchasing from other sources-namely the Hanford Project in Washington State. Montana Power rejected Hanford power because Colstrip 3 was already under construction when Hanford became available. Sullivan continued that the PSC had no authority to interfere in such "basic management of a utility" unless it finds that the management decisions were "imprudent or otherwise unreasonable".

Sullivan wrote, "It is completely unreasonable to contend that at any given point in time, an electric utility's generation resources must precisely match its customer's loads and reserve obligation and that any generating capacity over that amount is excess capacity which is to be excluded from rate base." He continued, saying that for the PSC to reasonably determine the need for Colstrip 3, the Commission must consider Montana Power's obligation to serve its customers now and in the foreseeable future. However, the PSC wrongly judged the need for the plant based on electricity demands during 1982, before the Colstrip plant began operation, and not on future requirements.

Montana Power on June 30, 1985, raised its electricity rates $13.6 million per year immediately after informing the PSC. The decision was the result of the June 17, 1985 ruling by District Court Judge Mark Sullivan that the PSC had unlawfully denied Montana Power the $96.4 million rate hike in 1984.

Based on the contention that the PSC had not taken final action on the rate request within the nine months required by State Law, Montana Power implemented its new rates. The Utility believed that Sullivan's decision sending the request back to the PSC for reconsideration meant the case was not closed and, therefore, the time limit had elapsed.

Montana Power indicated that the interim hike, combined with the $13.6 million increase would raise the level of their rates to $35 million, which was the first step of the phased-in rate plan that had been proposed by Montana Power.

The State PSC along with State Attorney General Mike Greely and various other organizations attempted to appeal Judge Sullivan's decision but all attempts were either withdrawn by attorneys or failed in court hearings.

F. PSC Approves Phased-In Request

August 26, 1985, proved to be another important day for Montana Power. The State Public Service Commission voted 4-1 to increase Montana Power Company's electric rates by $80.3 million, or 40%, phased in over eight years. Most of the rate increase would go to pay for Montana Power's share of Colstrip 3 power plant.

In effect, the PSC reversed its controversial 1984 decision, still being argued in the courts, refusing to allow Montana Power to charge customers for Colstrip 3 on the grounds that it was not needed. The PSC used that rationale to deny Montana Power all but $4.1 million of the $96.4 million it sought in 1984.

In 1985 the PSC ruled that Montana Power's 210 megawatt share of Colstrip 3 electricity was needed, making the plant "used and useful" under state law.

Commissioner Chairman Clyde Jarvis of Helena said that, unlike the previous year, no evidence was presented that Colstrip 3 was not used and useful. The PSC bases its decisions on the record presented in that specific rate case and thus was allowing Montana Power to charge customers for Colstrip 3.

Montana Power had requested a phased-in increase of $86.5 million over seven years. The PSC reduced the request to $80.3 million and extended the phase-in period to eight years to lessen impact on consumers.

Listed below is a year-by-year summary showing how the consumers would be affected by the phased-in electric rate increase in the PSC's final order:

- August, 1985. No effect. Rates already had been raised by $35 million or 19.4% through two interim increases that will remain in effect.

- August, 1986. Rates will increase by an additonal $15.3 million or 7.1%.
- August, 1987. Rates will rise by $19.95 million or 8.6%.
- August, 1988. Rates will go up by $25.2 million or 10%.
- August, 1989. Rates will increase by $26.4 million or 9.6%.
- August, 1990. Rates will begin dropping with a $7.8 million decrease or 2.6%.
- August, 1991. Rates will go down by $13.6 million or 4.6%.
- August, 1992. Rates will fall by $20.1 million or 7.2%.

The final appeal before the State Supreme Court was settled on November 27, 1985, which was the final chapter on the controversial Colstrip 3.

G. Rating Agencies and Rating Symbols

The purpose of this section is to provide information about rating agencies and their rating symbols. Further, its aim is to provide a better understanding of the significance and the magnitude of the changes of Montana Power bond ratings during the Colstrip 3 rate case.

To assist financial markets in determining qualitative gradations, various rating agencies sell their service of rating the market quality of securities. Both Standard & Poor's and Moody's market and sell their rating service. These services rank issues in an ordinal number related to their measureable risk. From a negative point of view (i.e., of loss potential) this is the risk of default and the magnitude of such a default to holders of such securities as Montana Power. The bond ratings and rating symbols used by Standard & Poor's and Moody's are given in Table II. These systems of rating bonds use three or four general classes represented by A, B, C, and possibly D. Within each class there are three grades.

Generally, only the first three grades of each agency are considered to be of investment grade. This is true without regard to the category or type of bond. Under present commercial bank regulations, bonds rated in the top four grades are generally regarded as eligible for bank investment portfolios by their supervising government regulatory agencies.

Major Class A for both services includes only conservative investment issues. Assets must have a liquidating value ample to cover the securities; average earnings must exceed interest by a suitable margin so that changes in earnings will have no effect on the price of bonds of this class.

Class B securities are sometimes designated as "businessmen type investments." These securities yield a higher rate of annual income than Class A but also contain elements of uncertainty not found in higher major classes. In the highest group of Class B securities, the investment features outweight the speculative elements, but speculative factors exist. In the lower Class B group speculative factors predominate. The upper groups in this class may be said to be of investment grade, but the lowest group is merely a better grade of speculative issues.

Class C securities are speculative. Few investors would be interested in even the highest of Grade C issues. They may have possibilites for the future, but the risks are great. The lowest grade is uncertain as to both its current position and future prospects. Little substantive earning power is found in this grade, either present or future.

The D group used by Standard & Poor's indicates bonds in default, the specific grades indicating relative salvage value.

Table II

Symbols Used in Rating Bonds

Moody's Investors Service		Standard & Poor's Corporation	
Rating	Meaning	Rating	Meaning
Aaa	Best Quality	AAA	Highest Grade
Aa	High Quality	AA	High Grade
A	Higher Medium Quality	A	Upper Medium Quality
Baa	Lower Medium Quality	BBB	Medium Grade
Ba	Possess Speculative Elements	BB	Lower Medium Grade
B	Lack Characteristics of Desirable Investment	B	Speculative
Caa	Poor Standing	CCC	Outright Speculations
Ca	Speculative in a High Degree	CC	Outright Speculations
C	Extremely Poor Prospects	C	Income Bonds on Which no Interest is Being Paid
		D	In Default, with Rating Indicating Relative Salvage Value

MOODY'S BOND RATING SERVICE

The purpose of Moody's ratings is to provide investors with a system of ordinal ratings by which relative investment qualities of bonds may be noted.

Gradations of investment quality are indicated by rating symbols, each symbol representing a group in which the quality characteristics are broadly the same. There are nine ordinal ratings used to designate quality from the least investment risk to that denoting greatest investment risk.

Bonds carrying the same rating are not of absolutely equal quality. In a broad sense they are alike in position: but since there are a limited number of rating classes used in grading thousands of bond issues, the symbols cannot reflect fine shadings of risk gradations which exist.

Listed below are Moody's bond rating symbols along with their description of each:

'Aaa' Bonds which are rated 'Aaa' are judged to be of the best quality. They carry the least degree of investment risk and are generally referred to as "gilt edge". Interest payments are protected by a large and/or exceptionally stable margin. Principal is secure. While the various protective elements are likely to change, such changes as can be prudently visualized are unlikely to impair the fundamentally strong position of such issues.

'Aa' Bonds which are rated 'Aa' are judged to be of high quality by all standards. Together with the 'Aaa' group, they comprise what are generally known as high grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in 'Aaa' securities or fluctuation of protective elements may be of greater amplitude or there may be elements present which make the long term risks appear somewhat larger than 'Aaa' securities.

'A' Bonds which are rated 'A' possess many favorable investment attributes and are to be considered as upper medium grade obligations. Factors giving security to principal and interest are considered adequate but elements may be present which suggest a susceptibility to impairment sometime in the future.

'Baa' Bonds which are rated 'Baa' are considered as medium grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

'Ba' Bonds which are rated 'Ba' are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class.

'B' Bonds which are rated 'B' generally lack characteristics of the desirable investment. Assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.

'Caa' Bonds which are rated 'Caa' are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interst.

'Ca' Bonds which are rated 'Ca' represent obligations which are speculative in a high degree. Such issues are often in default or have other marked shortcomings.

'C' Bonds which are rated 'C' are the lowest rated class of bonds, and issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.

It should be noted that Moody's applies cardinal numbers, 1, 2 and 3 within each ordinal rating classification from 'Aa' through 'B' in its bond rating system. The cardinal modifier 1 indicates that the security ranks in the higher end of its ordinal rating grade; the cardinal number 2 indicates a mid-range ranking; and 3 indicates that the issue ranks in the lower end of its grade.

STANDARD & POOR'S BOND RATING SERVICE

A Standard & Poor's bond rating is a current assessment of the credit worthiness of an obligor with respect to a specific debt obligation. This assessment may take into consideration obligors such as guarantors, insurers, or lessees.

The bond rating is not a recommendation to purchase, sell or hold a security, nor does it comment as to market price or suitability for a particular investor.

The ratings are based on current information furnished by the issuer or obtained by Standard & Poor's or from other sources considered reliable. Audits are not performed in connection with any rating, and on occasion, unaudited finanacial information is relied upon. The ratings may be changed, suspended or withdrawn as a result of changes in or unavailability of such information or for other circumstances.

The ratings are based, in varying degrees, on the following considerations:

I. Likelihood of default - capacity and willingness of the obligor as to timely payment of interest and repayment of principal in accordance with terms of the obligation.

II. Nature and provisions of the obligation.

III. Protection afforded by and relative position of, the obligation in the event of bankruptcy, reorganization or other arrangement under the laws of bankruptcy and other laws affecting creditors' rights.

Rating symbols and definitions which are used by Standard & Poor's are listed below:

'AAA' Bonds rated 'AAA' have the highest rating assigned by Standard & Poor's. Capacity to pay interest and repay principal are extremely strong.

'AA' Bonds rated 'AA' have a very strong capacity to pay interest and repay principal and differ from the highest rated issues only in small degrees.

'A' Bonds rated 'A' also have a strong capacity to pay interest and repay principal, although they are somewhat more susceptible to adverse effects of changes in circumstances and economic conditions than bond in the two higher-rated categories.

'BBB' Bonds rated 'BBB' are regarded as having an adequate capacity to pay interest and repay principal. Whereas, they normally exhibit adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a lesser capacity to pay interest and repay principal for bonds in this category than for bonds in the three higher-rated categories.

'BB'
'B'
'CCC'
'CC' Bonds rated 'BB', 'B', 'CCC' and 'CC' are regarded, on balance, as predominantly speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. 'BB' indicates the lowest degree of speculation and 'CC' the highest degree of speculation. While such bonds will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.

'C' The rating 'C' is reserved for income bonds on which no interest is being paid.

'D' Bonds rated 'D' are in default, and payment of interest and/or repayment of principal is in arrears.

The ratings from 'AA' to 'BB' may be modified by addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

CHAPTER IV

CONCLUSIONS

One might conclude that final approval of the phased-in rate plan suggests that Montana Power was not defeated by the PSC. This is not necessarily true. The final order issued by the PSC was a compromise by both participants. Although Montana Power would have preferred the original rate plan, it settled for the phased-in plan. This severely limited the amount of immediate rate relief for a financially troubled company.

The PSC based its original denial on the basis of "used and useful", under existing Montana State law. However, the base year of 1982 that the PSC was required to use in the original case did not accurately reflect and depict the actual balance between loads and resources. In the phased-in rate case the base year, 1983, was used. This effectively changed the basis of the earlier decision. As this new information, based on a more current test year, became part of the new rate case it became a deciding factor in the final opinion ordered by the PSC to allow Colstrip 3 into rate base.

To contend that Montana Power defeated the PSC may be accurate in degree. Colstrip 3 was a ligitimate rate base item and this required proof under the conditions set by law. In the end Montana Power succeeded in proving this to the PSC and the rate request was then approved. Montana Power has never gloated over the final approval order but was nonetheless pleased that they succeeded in placing Colstrip 3 into rate base even with a phased-in plan. Montana Power has continued to pledge cooperation with the PSC.

Throughout the Colstrip 3 rate case there was almost no mention made of the importance that the ratings of Montana Power's securities had and the actions taken to sustain them at pre-rate case levels.

Table III shows changes in Montana Power's securities ratings during the period of the Colstrip 3 rate case. Even though Montana Power's securities are rated by more than Standard & Poor's Corporation and Moody's Investor Service, Inc., these two rating agencies are the largest, most prestigious agencies in the industry and are representative of the others.

During this period of time Moody's downgraded Montana Power securities twice while Standard & Poor's downgraded only once. The time of the downgradings corresponded very directly to their appraisal of adverse conditions at Montana Power. Both rating agencies downgraded Montana Power in August, 1984. Moody's on August 16, and Standard & Poor's on August 27. This was in response to the news that the PSC had decided to disallow Colstrip 3 into rate base. The decision by the PSC was officially announced on July 30, 1984.

Table III

Changes in Montana Power Company Security Ratings

		Moody's	Standards & Poor's
1/1/83	Senior Debt	A-3	A
	Unsecured Debt	Baa-1	A-
	Preferred Stock	A-3	BBB+
	Commercial Paper	P-1	A-2
8/16/84	Senior Debt	Baa-3	
	Unsecured Debt	Ba-1	No
	Preferred Stock	Ba-1	Change
	Commercial Paper	P-3	
8/27/84	Senior Debt		BBB-
	Unsecured Debt	No	BB+
	Preferred Stock	Change	BB
	Commercial Paper		A-3
1/2/85	Senior Debt	Ba-1	
	Unsecured Debt	Ba-2	No
	Preferred Stock	Ba-2	Change
	Commercial Paper	P-3	
10/7/85	Senior Debt		BBB+
	Unsecured Debt	No	BBB
	Preferred Stock	Change	BBB
	Commercial Paper		A-2
12/16/85	Senior Debt	A-3	
	Unsecured Debt	Baa-1	No
	Preferred Stock	Baa-1	Change
	Commercial Paper	P-2	

On January 2, 1985, Moody's again downgraded Montana Power securities. This correlates with the announcement by Montana Power officials on December 28, 1984, that they would be forced to cut the fourth quarter dividends due to the financial trouble associated with the Colstrip 3 case.

Later, both rating agencies raised the ratings on Montana Power securities. The upgraded ratings were the result of an August 27, 1985, final order by the PSC to approve the phased-in rate request. Standard & Poor's upgraded their ratings on October 7, 1985, and Moody's upgraded on December 16, 1985. Neither of the ratings at this time were to the level of the pre-rate case ratings. The improved credit ratings meant Montana Power would be able to negotiate lower interest rates when it borrowed money.

It is interesting to note that the changes in ratings of Montana Power securities showed little or no effect on the price of their common stock. Table IV indicates the daily closing price of Montana Power's common stock for the period of the Colstrip 3 rate case. During the period of the three downgradings, the stock price remained essentially unchanged. Although after the two upgradings in late 1985, Montana Power common stock continued to climb.

Table IV

Daily Closing Prices of Montana Power Common Stock

1983

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC
1									27 1/4		27 3/4	29 3/4
2									27 1/4		27 7/8	29 1/2
3										27 7/8	27 7/8	
										27 3/8	27 7/8	
5										28 1/8		29 3/8
6									27 3/8	28 5/8		29 1/8
7									27 1/2	28 1/4	27 3/4	29 1/8
8									27 3/4		28 1/8	29
9									27 3/4		28 1/8	29 3/8
10										28 1/4	28	
11										28 1/2	28	
12									28 1/8	28 3/8		29 5/8
13									28	28 1/4		29 3/4
14									28 1/8	28	27 7/8	29 7/8
15									28 1/8		28 1/8	29 7/8
16									28 1/8		28	29 7/8
17										28 1/4	28 1/4	
18										27 7/8	28 1/4	
									28 1/2	28		30 1/8
									28 3/8	27 7/8		29 7/8
									28 3/8	27 7/8	28 1/2	30 1/4
									28 1/4		28 3/4	29 5/8
									28 3/8		28 3/4	29 [illegible]
										27 3/4		
										27 7/8	28 7/8	
									28 5/8	27 7/8		
									28 5/8	27 7/8		28 7/8
									28 5/8	27 3/4	29 1/8	28 7/8
									28 5/8		29 1/2	28 7/8
									27 7/8		29 1/2	29 3/8
										27 7/8		

Table IV
Daily Closing Prices of Montana Power Common Stock
1984

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC
1		29 7/8	28 5/8		25 1/2	25 3/8		22		24 5/8	23 5/8	
2		29 3/4	28 3/4	26 3/4	24 3/4		25 3/8	22 1/4		24 3/8	23 7/8	
3	29 1/2	29 3/4		26 1/8	24 3/4		25 1/4	22 1/8	Labr Day	23 7/8		23 7/8
4	29 3/4			26 3/8	24 1/2	25 5/8			22 1/2	24 1/4		24
5	29 5/8		28 3/4	25 7/8		25 1/4	25 1/8		22 1/2	24 1/4	24 7/8	23 5/8
6	29 5/8	30 1/4	28 1/2	25 7/8		25 3/8	25	22 1/4	23		24 3/4	24 1/2
7		30	28 1/4		24 7/8	25 3/8		22 3/4	22 7/8		24 1/2	24 1/4
8		30	28 1/4		25 1/2	25 3/8		23 1/8		24 1/4	24 5/8	
9	29 7/8	29 5/8	28 1/4	25 7/8	25 5/8		25 1/8	23 3/8		24 1/4	25	
10	29 7/8	29 1/8		25 7/8	25 7/8		25 1/8	23 1/8	23 1/8	24 1/8-4		24 1/8
11	29 7/8			25 3/4	26	25 1/4	24 7/8		23 1/4	24 1/2		24 3/8
12	30 1/4		28 1/4	26		25 3/8	25		23	24 5/8	Vet.Day	23 5/8-5
13	30 3/8	29	28 1/8	26		25 5/8	25	23 1/8	23 3/8		24 3/4	18 -6
14		28 5/8	28 1/8		25 3/4	25 1/2		23 1/8	23 5/8		25	18 1/2
15		28 1/2	28 3/8		25 5/8	25 5/8		22 7/8		24 1/2	25 1/8	
16	30	28 3/4	28 1/4	25 3/4	25 5/8		24 7/8	22 5/8-2		24 1/4	25 1/8	
17	30	38 5/8		25 7/8	25 1/2		25	23	23 5/8	25		17 1/4
18	30			25 7/8	25 1/2	25 5/8	24 3/4		23 3/4	25 5/8		17 1/8
19	29 7/8		28	26 1/8		25 5/8	25		24 1/8	25 1/8	25	17 -7
20	29 7/8	Pres.Day	28 1/4			25 7/8	25	22 7/8	24 3/8		25	18 3/4
21		28 5/8	28 1/4		25 5/8	25 3/4		22 5/8	24 7/8		24 7/8	
22		28 1/4	28 3/8		25 1/2	25 7/8		22 5/8		24 7/8	Thksgvng	
23	-29 5/8	28 1/4	28 1/8	26 1/4	25 3/8		24 7/8	22 3/4-3		24 7/8	Holiday	
	29 5/8	28		26 1/4	25		24 5/8	22 1/2	24 3/4	25		
	29 1/2			25 7/8	24 3/4	25 7/8	24 5/8		24 1/2	25		X-mas
	29 1/2		28	26		26	23 1/4-1		24 3/4	24 1/2	24 3/4	18 1/2
	29	28 3/8	28	25 7/8		26	23 1/8	22 3/8	25 1/8		25	20 1/4
		28 1/2	28		Mem.Day	26		22 3/8	25 1/8		25 1/8	20 3/8-8
		28 1/2	27 1/2		24 3/4	25 3/8		22		24 1/4	24 7/8	
	28 1/2		27	25 3/4	24 7/8		21 7/8	22 1/8		24 1/4	24 1/4	
	29			25 1/4	25 1/8		21 3/8	22 1/8	24 3/8	23 5/8		19 1/4

News media says PSC will deny Colstrip 3
Moody's Downgrade
Standard & Poor's Downgrade
Judicial Review

-5 In AFT Supreme Court 7-0 vs. MPC
-6 Low of 16 5/8
-7 PSC votes interim increase in new case
-8 Divident cut from .70 to .50

Table IV

Daily Closing Prices of Montana Power Common Stock

1985

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC
1		19 1/2	22 1/8	22 3/4	21 7/8-2		28 1/8	27 5/8		28 1/4	30 1/2	
2	19			22 3/4	23		28	27 7/8-4	Labr Day	28 1/4		31 3/4
3	19 1/4			22 7/8	23 1/4	24 3/4	28 1/2		29 1/8	28 1/4		32
4	19 [illegible]	19 3/4	22 1/8	22		[illegible] 1/8			29 5/8	28 1/2	30 1/	32 [illegible]
5		20 3/8	22			25 1/2	28 7/8	28 1/8	29 3/8		30	32 1/4
6		20 3/4	22 1/4		23 7/8	25 1/2		27 3/8	29 7/8		30 1/8	32 1/4
7	19 1/2	21 3/4	22 1/8		23 3/4	25 1/2		27 5/8		27 7/8	30 3/8	
8	19 5/8	21 3/8	22 3/8	22 3/4	23 5/8		28 1/8	27 3/4		27 1/8-6	30 1/2	
9	20 1/8			22 3/8	23 5/8		28 3/4	27 7/8	30 5/8	27		32 1/2
10	20 1/4			21 1/2-1	23 3/4	25 3/8	29		30 1/8	27 7/8		32 7/8
11	20 3/8	21 3/8	22 1/2	21 1/2		25 5/8	29 1/4		30	28 1/8	Vet.Day	33 1/8
12		21 1/8	22 1/2	21 5/8		26	29	28 1/8	29 1/8		30 3/4	33 1/8
13		21 1/2	22 3/8		23 3/4	26		28 1/4	28 3/4		30 1/2	33 1/8
14	20 3/4	22	22 1/4		23 1/2	26		28 5/8		28 1/4	30 1/2	
15	20 3/4	22 7/8	22 1/4	21 3/4	23 5/8		29	28 7/8		28 1/2	30 1/4	
16	20 7/8			21 3/4	23 7/8		29	28 7/8	29	28 5/8		33 3/8
17	20 1/2			21 1/2	24 1/2	26 1/8-3	28 3/4		28 3/4	26 7/8		34 1/8-9
18	20 5/8	Pres.Day	22 1/8	21 1/2		27 7/8	28 1/8		29	29 3/4	30 5/8	33 1/4
19		22 5/8	22 1/4	21 3/4		27 7/8	28	29 1/8	28 7/8		30 1/4	32 3/8
20		22 5/8	22		24 3/4	27 5/8		29 1/2	28 7/8		30 5/8	32 3/4
21	20 1/2	22 1/2	21 3/4		24 5/8	27 7/8		29 1/2		30 1/8	30 5/8	
22	20 3/8	22 5/8	21 7/8	21 3/4	24 1/8		27 7/8	29 1/4		30 1/4	30 7/8	
23	20 1/8			21 3/4	23 7/8		27	29 1/8	29	30 1/4-7		32 1/4
24	19 5/8			21 7/8	24 1/8	27 3/4	27 1/8		28 7/8	30 1/8		32 1/4
25	19 3/4	22 1/4	21 3/4	22		27 7/8	27 1/4		28 1/2	29 7/8	30 7/8	
26		22	22 1/4	21 7/8		28 3/8	26 5/8	29 1/4	28 3/8		30 7/8	32 1/2
27		22	22 1/4		Mem.Day	28 3/4		29 1/4-5	Hurricane		31 -8	32 3/4
28	19 5/8	22	22 5/8		24 1/8	28 1/4		28 7/8	Gloria	29 3/4	Thksgvng	
29	19 3/8		23	21 5/8	24 1/4		26 1/4	28 7/8		30	31 3/8	
30	19 1/4			21 7/8	24 1/4		26 7/8	29 3/8	28 1/2	30 5/8		33
31	19 1/2				24 5/8		26 5/8			30 5/8		32 1/2

1 Wall Street Journal-MPC may have to writedown Colstrip 3
2 Arguments before Judge Sullivan
3 Sulivan decision for MPC
4 PSC asks draft of $78 million
5 PSC approves $80 million

-6 Moody upgrade
-7 Supreme Court argument on Greely standing
-8 Supreme Court kicks out Greely appeal
-9 Dividend increased from $.50 to $.60

Table IV

Daily Closing Prices of Montana Power Common Stock

1986

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC
1				35 3/8								
2	31 5/8			35 1/8								
3	32 1/4	33 1/4	33 1/8	35 1/2								
4		33 1/8	33 1/2	35 1/4								
5		33 1/2	33 3/4									
6	32 1/2	33 1/4	33 3/4									
7	33 1/8	32 1/2	34 3/8	35								
8	32 3/4			35 3/8								
9	31 3/4			35 3/4								
10	32 1/4	32 7/8	35	35 7/8								
11		33	35 1/2	35 3/4								
12		33 1/8	36 1/8									
13	32 3/8	33 5/8	35 3/4									
14	32 1/8	33 3/4	35 3/4	36								
15	31 3/4			35 7/8								
16	31 3/4			36 1/4								
17	31 7/8		35 3/8	36 3/8								
18		33 1/4	35	36 1/2								
		33 5/8	34 5/8									
	31 3/4	33 3/4	34 5/8									
	32 1/8	33 3/4	35 1/8	37 1/8								
	32			36 5/8								
	31 7/8			[illegible]								
	32 3/4	33 5/8	35 1/4	36								
		33 1/4	35 1/8	35 3/8								
		32 7/8	35 1/8									
	32 1/2	32 3/4	35 7/8									
	33 1/2	33 1/8		35 3/8								
	33			34 3/4								
	33 1/2			34 1/4								
	34 1/8		35 5/8									

Montana Power's common stock price although not greatly affected by the changes in ratings, did react to the more publicized actions of the Public Service Commission and court rulings. The most pronounced example was on December 13, 1984, when Montana Power common stock hit a low of 16 5/8 as a result of the previous day's Supreme Court ruling against Montana Power.

During the Colstrip 3 rate case, most of the attention was focused on the effect that the rulings were having on the stock prices. Although this is very important, perhaps an even more important portion of the Montana Power's financing was being forgotten. The access to borrowed funds and the ready sale of its bonds are crucial to the financing of a utility.

The effect of rating agency decisions to change the ratings on Montana Power securities thus had its greatest impact on the borrowing of funds and on the marketability of its bond issues.

When Montana Power was denied Colstrip 3 investment into rate base on July 30, 1984, the rules of the game changed. Montana Power had made the assumption that, at worst, a major portion of the rate request would be allowed. The final PSC order approving only $4.1 million of the $96.4 million request took Montana Power by surprise. Both short-term and long-term financing plans had been made assuming the rate request would be approved. The result was a shortage of income and a severe cash flow problem.

In order to compensate for the loss of required funds, Montana Power opted to curtail spending rather than depend on new (and more expensive) short-term borrowing. Montana Power announced that the Company would enter an austerity program in which both construction and maintenance programs were reduced, employee salaries frozen, and even an early retirement plan was considered. The latter, as a cost saving method, was abandoned when it was realized that a majority of those who qualified for early retirement were in key positions that would require replacement, thus nullifying any cost savings.

Montana Power's philosophy was to reduce spending to a point at which they could rely on established lines of credit at existing rates. Indications show that they were successful in doing so. This management philosophy proved to be even more critical as time passed and as their securities were downgraded by the various rating agencies. Montana Power knew that lower ratings indicated a higher cost on borrowed funds as a result of greater credit risk for any new bond issues. Montana Power decided not to participate in the market place as they would under normal business conditions, and instead balanced existing lines of credit with spending to eliminate the need for new and more expensive sources of financing.

Although Montana Power survived the crisis without enduring increased costs of funds, there was indeed a price paid by the Utility associated with the downgrading of its securities and the resulting austerity program. Many man-hours of labor were expended in budget meetings, strategy meetings, and information gathering, along with travel expenses (some to the rating agencies). Other types of costs include a lower quality of service to the customer caused by construction and maintenance cuts, and a lowering of employee morale due to frozen salaries and lack of funds to perform their job functions properly.

Even today, Montana Power continues to operate under financial constraints. Top management has decided that Montana Power will not request additional rate increases while the phased-in increases are in effect through 1991. In order to operate under this decision, Montana Power will limit their annual expenditures to the level of total plant retirements, depreciation, and deferred taxes, thus requiring no further increase in rates.

In 1983, Montana Power Company implemented a reorganization plan which grouped all of their non-utility subsidiaries under a new subsidiary, Entech, Inc. The utility portion of the Company is grouped into its Utility Division.

The split between regulated and non-regulated portions of the business was forced by two separate issues. For several years, decisions by regulators of large utility monopolies have been to deregulate their operations and to limit the extent that the utilities monopolize the industry. The prime example of this type of action has been the de-regulation of the Bell Telephone System. They have been forced by their regulators to break their control of the telecommunications network they had created, were limited to the type of services they could provide and had to give up segments of their system to other companies, particularly the local phone sales and services.

Other large utility monopolies were also forced into sharing their market. Several large natural gas transmission utilities are now forced by law to allow other companies to use their transmission pipeline network to transport products to the market place.

Montana Power was aware of these changes, and in order to be better prepared for the new laws, decided to separate the regulated utility portion of business from non-regulated activites. This change should prove to place Montana Power in a better position to continue to operate successfully in the newer changing times.

Another reason for separating the business between the regulated and non-regulated activities is probably more obvious and direct. Although the Colstrip 3 rate request and its associated problems was not filed until September 30, 1983, and was not initially denied by the PSC until July 30, 1984, Montana Power realized that the most profitable method of operation for most of its subsidiaries would be to conduct business in non-regulated markets. By continuing to include its non-utility operations in its utility business, the entire Company would fall under regulation by the PSC. This meant that all of its operations were limited to a regulated rate-of-return and would also be under jurisdiction of the PSC. Montana Power chose to break away from the PSC control as much as possible by separating its non-utility subsidiaries. This business plan appeared to be to the future benefit of the subsidiaries because problems associated with the Colstrip 3 rate case that caused the Utility Division considerable financial difficulty. By creating Entech, Inc., Montana Power was able to operate its subsidiaries outside the control of the PSC and without the difficulties of regulation. It's clear that Montana Power anticipates that there will be continued conflicts with the PSC on regulatory and particularly rate-related requests in the future.

Montana Power was not necessarily a pioneer in this area. Many utilities around the country were also separating their activities, and many more continue to do so today.

For the future, Montana Power should consider legal changes in the system. Two areas of concern may create better results in upcoming rate cases. The first item would be the method in which projects are allowed into rate base. Currently, a project that is under construction is not allowed into rate base until it is completed and in use. For major construction projects, such as generating plants, the time from start to finish involves several years. If projects under construction could be added to rate base gradually, say on an annual basis and on percentage completed, this would eliminate the large rate request and rate shock at the end of the project and also provide a return on investment earlier for the utility.

The second item might be for legislative review of the system by which Public Service Commissioners are elected to the Commission. At this time, the five commissioners are elected from their respective districts. The problem here is that many times commissioners are elected that lack qualification or are elected because they promise to vote against all rate increases. This sounds irrational, but it happens. An alternative to the elected Commissioner would be an appointed Commission. This change could be instrumental in providing equitable rate consideration in future cases.

In conclusion, the Colstrip 3 rate case was a strong learning experience for Montana Power. The Company was forced to operate under conditions that required innovative solutions in areas unfamiliar to management, i.e., financial problems, austerity programs, and an unpredictable Public Service Commission. It appears to this writer that Montana Power is on a recovery path. The phased-in rate schedule has been approved by the PSC, Montana Power securities have been upgraded, public opinion of the Company has improved, and its common stock has recently topped $42 per share.

After a long rough period, things are beginning to look better for Montana Power. With Colstrip 3 troubles behind, Montana Power will now be able to concentrate on other business activities. In 1985, nonutility operations accounted for 32% of their $57 million income. Montana Power has developed the Jewett Lignite Mine in Texas to supply Houston Lighting and Power's new Limestone power plant and has plans of getting another new mine into production in Alabama as early as 1987.

Montana Power is also developing the Chartam Gold Property near Helena which they acquired from the Anaconda Company in 1985. Total acquired mining rights include some 800,000 acres containing lead, zinc, copper, and precious metals. They have also formed a partnership with a Brazilian firm to explore for gold in both Brazil and the United States.

Along with mining interests, Montana Power has three startup companies under way to exploit their expertise in microwave communications, power plant automation products and hazardous waste disposal.

In 1985, Montana Power's earnings were nearly 40% below their 1983 high but were up 10% from the 1984 low and up another 20% in the first half of 1986. For Montana Power, the immediate future looks a lot more promising than the recent past. Earnings should continue to climb for the foreseeable future - partly due to the rate phase-in plan and partly because of the nonutility interests.

The lessons learned and the experience gained during this rate case might well be the subject for another paper. Few at Montana Power will soon forget the era of Colstrip 3. Would Montana Power fund a further study to assay the knowledge gained from this rate case? One who read this paper suggested a Ph.D. dissertation type study might be appropriate.

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29. The Great Falls Tribune, August 15, 1984.

30. The Great Falls Tribune, August 24, 1984.

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