UNITED STATES OF AMERICA
NUCLEAR REGULATORY COMMISSION

BEFORE THE ATOMIC SAFETY AND LICENSING BOARD

In the Matter of	)	
	)	
CONSUMERS POWER COMPANY	)	Docket Nos. 50-329
	)	50-330
(Midland Plant, Units 1 and 2)	)	
	)	

NRC STAFF SUPPLEMENTAL TESTIMONY OF ARNOLD H. MELTZ
ON APPLICANT'S ABILITY TO FINANCE CONSTRUCTION OF THE MIDLAND PLANT

The ability of an investor-owned utility to finance a construction program over a future period is a function of a number of variables, the most important of which is the level of profitability. Profitability can be assessed by referring to the return a company earns on the capital it employs in its business and comparing it to the risk-adjusted returns earned elsewhere in the economy. The concept of a fair rate of return on investment is deeply ingrained in public utility regulation. Whether or not an electric utility can finance a construction program requiring large amounts of external financing will depend in part on its ability to earn such a fair rate of return. A fair rate of return on total capital will result in the return on common equity being fair and reasonable, since common equity is a component of total capital. All other things being equal, this latter return is the best indication of a company's profitability and will have a substantial impact on other facets of a company's financial performance.

Although a fair rate of return might be characterized as the most

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significant variable affecting a company's ability to finance its proposed construction program, it needs to be coupled with a reasonably balanced capital structure to be assured that senior securities will remain marketable. The average investor-owned electric utility historically has had a capital structure comprised of around 50-55 percent long-term debt, 10-15 percent preferred stock, and 30-40 percent common equity. Given a particular capital structure with its embedded costs of debt and preferred stock, the return on common equity will determine the level of interest and preferred dividend coverages. These coverages in turn will significantly affect the ratings assigned to a company's senior securities by the principal rating agencies and, consequently, the price demanded by the marketplace to purchase these securities. The return on common equity will also affect the expected rate of dividend growth and thus the price and attractiveness of the company's common stock. When large amounts of securities need to be sold to finance a construction program, the ability to sell common stock is the key to the maintenance of a reasonably balanced capital structure. In addition, the return on common equity affects the level of internally generated funds through its impact on retained earnings, although the primary source of internally generated funds is depreciation.

The achievement by Consumers Power Company of an adequate level of profitability, i.e., a fair rate of return, depends in large part on the responsiveness of the regulatory authorities, primarily the Michigan

Public Service Commission. Rational regulatory policies dictate that rates be set to cover the cost of service, including the cost of capital. Assuming rational financial planning, it is axiomatic that such rates will enable a company to maintain its credit and attract the capital necessary to meet anticipated construction expenditures. Given a persistent inflationary bias in our economy, it must be assumed that Consumers Power Company will be requesting rate relief from the regulatory authorities on a regular basis. Indeed, Consumers Power Company's recent common stock prospectus, dated November 9, 1976, states: "The Company will need significant and timely rate increases if revenues and income are to reach and be maintained at levels which will result in sufficient internally generated funds to meet its operational requirements and permit external financing of its construction program at reasonable cost."

In view of the foregoing, it should be apparent that one can never be certain that Consumers Power Company, or any other electric utility, can successfully complete a construction program stretching out over a number of years. The best one can hope to do is assess the rationality of Consumers Power Company's financial planning to determine whether its proposed construction program, which includes the Midland Plant, appears attainable, given rational regulatory policies.

A review of Consumers Power Company's recent financial history indicates a substantial improvement in its financial position since earnings per share plummeted to $1.34 in 1974 from the prior year's $2.41. In addition to problems that were common to the utility industry during this period, Consumers Power Company's situation was made much worse by the Palisades outage. With Palisades on line for most of 1975 and some rate relief granted by the Michigan Public Service Commission, earnings per share rebounded strongly in 1975 to $2.65. Recently reported earnings for 1976 show a further improvement to a record level $3.63 per share. The estimated 12.6% return on common equity achieved in 1976 is in line with the 12.75% authorized by the Michigan Public Service Commission in Consumer Power Company's most recent rate case and is significantly better than the average industry performance in 1976. In order to maintain or improve upon that level of profitability, Consumers Power Company will need to request further rate relief, and at the end of January it did just that, applying to the Michigan Public Service Commission for a record $164.2 million annual electric rate increase. According to Consumers Power Company, as reported in the Wall Street Journal on February 1, 1977, about $79.4 million of its total request deals with proposed accounting changes which, although not increasing earnings, will "improve the quality of earnings by increasing the internal cash generation needed for financing the construction program."

According to the common stock prospectus previously mentioned, Consumers Power Company estimates its construction program for the five years ended

1980 will cost $2.7 billion. Furthermore, the prospectus states: "In order to finance this program and to meet remaining debt maturities during this period of approximately $103.8 million, it will be necessary for the Company to sell substantial additional securities, the amounts and types of which have not yet been determimed." During 1976 Consumers Power Company successfully sold over $330 million of debt and equity securities, about $100 million of which was represented by common stock. In aduition, the November common stock prospectus indicates that over $120 million of internally generated cash was available for the twelve months ended June 30, 1976. Since Consumers Power Company's first mortgage bonds and preferred stock are subject to earnings coverage provisions, the common stock prospectus points out that: "The amounts of additional First Mortgage Bonds and Preferred Stock which can be issued in future years will be contingent upon increases in earnings through rate increases or otherwise."

In Consumers Power Company's response to Interrogatory 3 of "Licensee's Further Answers To Interrogatories From All Intervenors Except Dow Chemical Company Dated December 27, 1976," it included six projected sources and uses of funds statements with respect to Consumers Power Company's electric operations covering the period of the Midland Plant's construction, demonstrating how its total construction program might be financed. The most pessimistic projection, Attachment C-2, assumes a return on common equity of 12.75% and no credits for the planned sales of generating capacity to certain electric cooperatives.

Implicit in these projections is a capital structure objective of 53% debt, 12% preferred-preference and 35% common equity. As Attachment C-2 demonstrates, Consumers Power Company's total construction program will be covered by internal and external sources of funds, while maintaining coverage levels on mortgage bonds and preferred stock in excess of minimum requirements. While the projections shown on Attachment C-2 appear reasonable, all of the assumptions made in preparing the projections were not revealed in the response to Interrogatory 3, and net internally generated funds were not broken down into their component items. Consequently, the projections are not as informative as they might have been. If it can be shown that Consumers Power Company made reasonable assumptions with respect to such items as interest and preferred dividend rates, common stock prices, dividend growth, dividend-payout ratios, and depreciation accruals, the reasonableness of the projections could be more accurately gauged. In addition, the projections assume the approval of certain accounting changes designed to improve internal cash generation. If not approved, while the rate of return remains at 12.75%, Consumers Power Company states that the entire construction program could not be financed "as planned." In that event, there are still options available to finance the Midland Plant, such as selling additional securities or increasing the Midland Plant's priority, since it only represents about 40% of the total construction budget.

Conclusion

Based upon our review of Consumers Power Company's recent financial history, coupled with its response to Interrogatory 3, it is our judgment that the financing of the Midland Plant appears attainable. Whether it will be attained is not something one can answer with any degree of certainty. The construction schedule may be affected in the future by factors beyond the control of Consumers Power Company--primarily regulatory policies and capital market conditions. This situation is not unique to Consumers Power Company, however, as such constraints are faced by all regulated investor-owned electric utilities.