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Decision 88 12 092 DEC 19 1988

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of the Commission's Division of Ratepayer Advocates for Modification of Resolution No. T-12079 Re Revenue Requirement Impact of 1988 Attrition for Pacific Bell.	Application 88-05-009 (Filed May 6, 1988)
Application of GTE California Incorporated, a corporation, (U 1002 C), for authority to increase certain intrastate rates and charges for telephone services to offset 1989 financial attrition.	Application 88-07-017 (Filed July 15, 1988)
In the Matter of the Application of PACIFIC BELL (U 1001 C), a corporation, for a review of its cost of capital and capital structure.	Application 88-07-019 (Filed July 15, 1988)

(Appearances are listed in Appendix A.)

I N D E X

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O P I N I O N

I. Summary of Decision

This decision addresses 1989 financial attrition issues for Pacific Bell and GTE-California Incorporated (GTE-C).

The decision adopts the terms of the Settlement Agreement and Stipulation presented by all parties in Pacific Bell's financial attrition proceeding (Application (A.) 88-07-019), authorizing Pacific Bell to earn a return on common equity of 13.00% and a return on total capital of 11.34%. The average cost of debt is 9.21%. The adopted capital structure is 43.75% debt and 56.25% common equity. Adoption of the Settlement Agreement will result in a revenue requirement reduction of approximately $127.1 million, although the final revenue impact will not be known until the Commission Advisory and Compliance Division (CACD) completes its review of the utility's 1989 operational attrition filing.

GTE-C's 1989 financial attrition application (A.88-07-017) was contested. Following evidentiary hearings, the decision authorizes GTE-C to earn a return on common equity of 13.00% and a return on total capital of 11.13%. The adopted cost factors for long-term debt, short-term debt, and preferred stock are 9.03%, 8.2%, and 6.34%, respectively. The adopted capital structure is composed of 40.50% long-term debt, 2.00% short-term debt, 2.50% preferred stock, and 55.00% common equity. The revenue requirement impact of this decision is an increase of approximately $13.7 million, although the final impact hinges on review of GTE-C's 1989 operational attrition filing.

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II. Procedural Background

On May 6, 1988, the Division of Ratepayer Advocates (DRA) filed Application (A.) 88-05-009 seeking modification of our 1988 attrition resolution (Resolution T-12079) in order to obtain clarification of the operational attrition mechanism, and issuance of an order requiring Pacific Bell and GTE-C to file 1989 financial attrition applications to be heard on a consolidated record.[1] In Decision (D.) 88-06-024 we granted DRA's request, requiring GTE-C to file a 1989 operational attrition advice letter by October 1, 1988 (consistent with our treatment of Pacific Bell for the 1989 attrition year); we also specified that Pacific Bell and GTE-C should file separate applications, testimony, and exhibits constituting their affirmative showings for attrition year 1989 capital structure and cost of capital review.[2]

A prehearing conference (PHC) was held before Administrative Law Judge (ALJ) Carew on June 21, 1988. At that time, a schedule was adopted for the submission of testimony and for evidentiary hearings both on financial attrition and disputed operational attrition issues. However, at the PHC DRA indicated that it wished to convene workshops to attempt to resolve the disputed operational attrition issues. These workshops were held at the end of June, 1988, and on July 12, 1988, DRA filed its Attrition Methodology Workshop Report (the Report). That Report,

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1 Other relief requested in the DRA application relative to the mid-sized telephone companies (ConTel of California, Inc., Citizens Utilities Company of California, and Roseville Telephone Company) is addressed in a separate decision issued in this docket.

2 In compliance with D.88-06-024, on July 15, 1988 Pacific Bell filed A.88-07-019 and GTE-C filed A.88-07-017. These matters have been consolidated with DRA's A.88-05-009 pursuant to Rule 55 of the Commission's Rules of Practice and Procedure.

including attached stipulation, embodied the consensus resolution of all disputed operational attrition issues by DRA, Pacific Bell, GTE-C, AT&T Communications of California (AT&T-C), and TURN. In D.88-09-028, we considered and adopted that stipulation for purposes of the review of 1989 operational attrition issues for Pacific Bell and GTE-C.[3]

With the issuance of D-88-09-028 and resolution of the disputed 1989 operational attrition issues, hearings commenced on October 17, 1988, limited to financial attrition issues. These hearings continued through October 19, 1988.

In support of its financial attrition request, Pacific Bell presented the testimony of Lydell Christensen, John A. Hardy, and Dr. James H. Vander Weide. DRA presented the testimony of Christopher J. Blunt. The Federal Executive Agencies (FEA) presented testimony by Philip R. Winter. In view of the fact that a complete settlement was reached in Pacific Bell's application, as discussed more fully below, this testimony was identified but not received in evidence.

GTE-C presented the testimony of two witnesses in support of its financial attrition request: Joseph F. Brennan and Charles J. O'Rourke. DRA submitted the testimony of Christopher J. Blunt. In addition, the City of Los Angeles (Los Angeles) presented the testimony of Manuel Kroman.

At the conclusion of evidentiary hearings, this matter was submitted subject to receipt of concurrent briefs filed

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3 The outcome reflected in D.88-09-028 relative to the three disputed operational attrition issues (a data point forecasting controversy; questions about the calculation of the composite salaries and wages factor; and clarification of the productivity sharing mechanism) are reflected in the October 1, 1988 attrition filings of Pacific Bell and GTE-C. CACD is charged with reviewing the operational attrition filings and preparing a resolution for Commission consideration.

November 1, 1988. Briefs addressing the GTE-C financial attrition request were filed by GTE-C, DRA, FEA, Los Angeles, and API Alarm Systems (API). Briefs were not submitted in the Pacific Bell financial attrition proceeding, given the pendency of the "Motion for Waiver Pursuant to Rule 51.10 and Motion to Adopt Settlement Agreement and Stipulation," tendered for filing on October 20, 1988.

Comments on the ALJ's Proposed Decision

On November 18, 1988, the ALJ's Proposed Decision was served on all parties in accordance with Rule 77.1 of the Commission's Rules of Practice and Procedure. Pacific Bell, GTE-C, and DRA filed Opening Comments on December 8, 1988. No party filed Reply Comments.

We have made serveral changes in response to Pacific Bell's Comments. In addition to correcting a typographical error in Finding of Fact 1, we have revised Finding of Facts 8 and 9 to conform them to the revisions we have made in the Discussion portions of the Proposed Decision which articulate our rationale for approving the Settlement Agreement and Stipulation. In addition we have added an explanation of the manner in which we arrived at the conclusion that the Settlement Agreement is in the public interest, with reference to the parties' pre-settlement positions. This also address DRA's concern about references to the settlement process in the Proposed Decision.

In response to GTE-C's Comments we have modified the Proposed Decision to adopt a 13% ROE for attrition year 1989.

III. Pacific Bell's Financial Attrition Request

A. The Application

In A.88-07-019 Pacific Bell sought to decrease its authorized intrastate rate of return from 12.12% to 11.96%, premised on an average debt cost of 9.21% and a return on common

equity of 14.0%. Pacific Bell also sought recognition of the reasonableness of its capital structure objective of 40% debt and 60% equity. Believing that it would be difficult to attain a 40% debt ratio sooner than year-end 1989, Pacific Bell specifically requested authorization of a capital structure composed of 42.5% debt and 57.5% equity debt ratio for 1989. Further, Pacific Bell requested discontinuance of the imputation of 6% voting preferred stock in its capital structure, as ordered by D.82-05-007.

B. The Settlement Agreement

On Monday, October 17, 1988, the day evidentiary hearings on Pacific Bell's application were scheduled to begin, counsel for Pacific Bell and DRA informed the assigned ALJ that the two parties had been negotiating over the weekend, and were very close to a settlement of all issues. At the request of counsel, the ALJ allowed additional time for settlement negotiations involving all parties to the proceeding. Over the course of the next few days, the settlement proponents obtained the agreement of all parties to the terms of the settlement.[4] On October 20, 1988, the parties filed a "Motion for Waiver Pursuant to Rule 51.10 and Motion to Adopt Settlement Agreement and Stipulation" (the Motion). This Motion is attached to this order as Appendix B.

The parties agree that, for intrastate ratemaking purposes Pacific Bell's 1989 attrition year rates shall be based upon the following:

1. The return on common equity for Pacific Bell for attrition year 1989 shall be 13%;

2. The average cost of debt for Pacific Bell for attrition year 1989 shall be 9.21%;

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4 Bay Area Teleport, Western Burglar and Fire Alarm Association, and TURN signed the settlement agreement and stipulation, indicating that they did not opppose its adoption.

3. The debt and equity ratio utilized to set rates for Pacific Bell for attrition year 1989 shall be 43.75% debt and 56.25% equity, and the actual debt and equity ratio may vary;

4. The rate of return on total capital for Pacific Bell for attrition year 1989 shall be 11.34%.

As the Motion indicates, every party in the proceeding either agreed to the terms and conditions of the settlement or stated that they did not oppose such terms and conditions. The parties have requested, pursuant to Rule 51.10 of the Commission's Rules of Practice and Procedure, that the Commission waive its rules on stipulations and settlements to the extent necessary to allow it to issue its decision based solely on the Motion and the Agreement.

The Motion states:

"* * * The diverse interests represented by the parties and the unanimity of their position with respect to the Agreement demonstrate that the public interest will not be impaired by the waiver of those Rules.

"Consistent with Rule 51.8 of the Commission's Rules, the parties entered into the Agreement on the basis that the Commission's adoption of the terms and conditions set forth therein not be construed as a precedent regarding any principle or issue in any current or future proceeding. The parties expressly recognize that the issues resolved by the Agreement should not be construed as reflecting the views or position of any party except as a reasonable and appropriate compromise of the issues involved with Pacific Bell's Application. The Agreement is, therefore, a complete and total settlement of Pacific Bell's Application. Further, each party specifically agrees that this Settlement and its terms and conditions shall not be used in any manner whatsoever in GTE-California, Inc.'s Application No. 88-07-017." (Motion, p. 4.)

The request for a waiver of the Commission's rules is keyed to the requirement of Rule 51.1(b) which covers the manner of proposing settlements or stipulations to the Commission. That rule provides:

> "Prior to signing any stipulation or settlement, the settling parties shall convene at least one conference with notice and opportunity to participate provided to all parties for the purpose of discussing stipulations and settlements in a given proceeding. Written notice of the date, time, and place shall be furnished at least seven (7) days in advance to all parties in the proceeding. Notice of any subsequent meetings may be oral, may occur less than seven (7) days in advance, and may be limited to prior conference attendees and those parties specifically requesting notice."

Given the 11th hour nature of the settlement discussions, the parties other than Pacific Bell and DRA were unaware of the settlement terms prior to the first day of hearing. Thus there was no prior settlement conference with notice and opportunity to participate, as required by Rule 51.1. However, during October 17 to 19th the settlement proponents met with all parties present for the hearings in San Francisco and explained the terms and conditions of the settlement to them. In addition, the settlement proponents contacted all appearances of record to ensure that there was total agreement to the settlement. In view of these extra-ordinary efforts, the Motion to Waive the provisions of Rule 51.1 should be granted, because the due process protections afforded by that section were effectively extended to all parties.[5]

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5 In an abundance of caution the ALJ asked the other parties in the proceeding whether they needed an opportunity to file comments on the settlement proposal. None of these parties responded affirmatively (1 RT 30: 21-25). Because this is an uncontested settlement, parties have not filed comments pursuant to Rules 51.4 and 51.5.

Rule 51.1(e) of the Rules of Practice and Procedure specifies that "The Commission will not approve stipulations or settlements, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law, and in the public interest." In this situation, the Settlement was presented just before evidentiary hearings were to begin. There was extensive discussion on the record about preparation of a joint exhibit in support of the Settlement, but in this instance the parties preferred to have their prepared testimony marked for identification for the Commission's consideration in reviewing the Settlement terms, so no formal testimony was taken in support of the Settlement (1 RT 22 - 30).

The settling parties have asserted in their Motion that "the Commission may take official notice and consider the prepared testimony of Pacific and DOD, as well as those portions of the prepared testimony of the DRA witness and the City of Los Angeles concerning Pacific's Application which were marked for identification in this proceeding but which were not received into evidence, for the sole purpose of recognizing the recommendations of the parties concerning cost of capital and capital structure and that the terms of the Agreement constitute a compromise by each party." (Emphasis added.) (Motion p. 5.) In considering the pre-settlement positions of the parties, we may have undertaken a more critical review than that contemplated by the parties; however, as a practical matter we cannot approve the settlement without making findings of fact and conclusions of law on the material issue that the settlement is in the public interest (PU Code § 1705).

The settling parties opted to provide us with the settlement document and their pre-settlement prepared testimony, in lieu of a Joint Exhibit to be received into the record. These were the only tools available to us in discharging our statutory obligation under PU Code § 1705. In the absence of a formal

record, we considered this information fully and critically in order to reach a determination that the settlement was reasonable, consistent with law, and in the public interest.

C. Rate of Return Recommendations for Attrition Year 1989

Pacific Bell's presently authorized rate of return is depicted in the following table:

Pacific Bell (Present Authorization)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.10%	9.17%	4.13%
Preferred Stock	2.80	8.02	0.22
6% Preferred Stock	0.60	6.00	0.04
Common Equity	51.50	15.00	7.73
Total	100.00%		12.12%

This table depicts the present authorization pursuant to Resolution T-12079 (1988 attrition year). With the exception of the cost of long-term debt and preferred stock, which were updated in the 1987 and 1988 attrition years, the present authorization tracks the outcome of the 1986 test year rate decision. (D.86-01-026.)[6] Pacific Bell's present authorization contrasts with the recommendations of the active parties for the 1989 attrition year, depicted in the following four tables:

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6 The adopted cost of long-term debt in D.86-01-026 was 10.03%; this figure was modified in Resolution T-12007 for the 1987 attrition year to 9.25%, and in Resolution T-12079 for the 1988 attrition year to 9.17%. The weighted cost of long-term debt thus changed from 4.52% in 1986, to 4.17% in 1987, to 4.13% in 1988. The cost of preferred stock adopted in D.86-01-026 was 8.37%, and was modified to 8.02% in the two attrition years. The adopted weighted cost of preferred stock in D.86-01-026 was 0.23%, and was changed to 0.22% in the two attrition years.

Pacific Bell (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	42.50%	9.21%	3.91%
Preferred Stock	-	-	-
Common Equity	57.50	14.0	8.05
Total	100.00%		11.96%

DRA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.00%	9.21%	4.14%
Preferred Stock	-	-	-
Common Equity	55.00	12.50*	6.88
Total	100.00%		11.02%

*Mid-point of 12.25%-12.75% range.

Los Angeles (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.00%	9.21%	4.144%
Preferred Stock	-	-	-
Common Equity	55.00	13.25	7.288%
Total	100.00%		11.432%

FEA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.00%	9.21%	4.145%
Preferred Stock	5.00	9.00	0.450
Common Equity	50.00	11.4	5.700
Total	100.00%		10.295%

Proposed Settlement

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	43.75%	9.21%	4.029%
Preferred Stock	-	-	-
Common Equity	56.25	13.00%	7.312
Total	100.00%		11.34%

Review of the pre-settlement recommendations demonstrates a significant difference on the issue of the appropriate capital structure for the 1989 attrition year. More specifically, the percentage of common equity in the capital structure reflected in these recommendations ranges from FEA's 50% to Pacific Bell's 57.5%. In addition, most of the recommendations, with the exception of the FEA proposal, eliminate preferred stock from the capital structure. This is a major change from the presently authorized capital structure, especially considering the 6% imputation imposed by the Commission in D.82-05-007. There is also a significant difference in the parties' initial recommendations on the cost factor applicable to common equity for the attrition year. These figures range from FEA's 11.4% to Pacific Bell's 14.0%.

In the proposed settlement, the parties recommend a capital ratio of 43.75% long term debt and 56.25% common equity, with no allowance for preferred stock. The cost factors are 9.21% for long term debt and 13% for common equity. This provides for a rate of return of 11.34%.

D. Capital Structure

1. Pacific Bell's Pre-Settlement Position

Pacific Bell recommends a capital structure of 42.5% debt and 57.5% equity, although its goal is 40% debt and 60% equity. It believes this capital structure responds to the increase in business risks arising from added competition, faster technological

change, the regulatory environment, and the potential opening of the intraLATA market.

Pacific Bell believes that the reduction of its debt ratio from 45.10% to 42.5% is an interim step that will strengthen existing credit ratings, thereby lowering future debt costs and increasing credit capacity and financial flexibility. It asserts that improvement in its financial integrity is an appropriate element of incentive-based regulation. Pacific Bell's Christensen maintains that reducing the amount of leverage in the capital structure should result in improved credit ratings and lower debt cost, since financial leverage is a key financial factor used by rating agencies to determine a company's credit rating. (Exhibit 1, p. 27.)

Christensen concludes that Pacific Bell has a low margin of safety in its credit ratings.[7] Christensen adds that if the U.S. economy deteriorates, it could squeeze safety margins further, producing lower credit ratings and increased debt rate costs for Pacific Bell. (Exhibit 1, pp. 28-29.)

Christensen also asserts that Pacific Bell's high debt ratio reduces its financial flexibility to raise capital as necessary or to refinance maturing issues, because additional debt may not be obtainable on reasonable terms. This raises the spectre of financing capital needs partially or completely with equity, at a time when the market is unfavorable. In short, Christensen

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7 Pacific Bell's Hardy corroborates this view, asserting that pre-tax fixed charge coverage is presently in the upper half of the "A" benchmark range although this will decline with the lower income tax rate in 1988. One of the effects of tax reform is that pre-tax interest coverage will be reduced. Assuming all of the variables remain constant, according to Hardy, the lower tax rate reduces income tax expense, which in turn lowers income tax before interest and, taxes thereby lowering pre-tax interest coverage. This causes a real reduction in earnings protection for creditors.

asserts that Pacific Bell would be in a much better position to obtain capital under adverse conditions or to obtain capital on reasonable terms if credit quality were bolstered through a lower debt ratio.

Witness Christensen also believes that the 6% voting preferred stock imputed by D.82-05-007 should no longer be included in the projected capital structure because it is inappropriate in a post-divestiture environment, and constitutes an artificial understatement of Pacific Bell's cost of capital. (Pacific Bell has no outstanding shares of preferred stock in its capital structure.) Christensen asserts that the Commission did not intend this imputation to be a permanent adjustment to the capital structure, and that ratepayers have benefitted from the imputation for nearly five years.

2. DRA's Pre-Settlement Position

DRA's Blunt recommends that the Commission discontinue imputing the voting 6% preferred stock for these 1989 attrition proceedings because all preferred stock has been eliminated from Pacific Bell's balance sheet (Exhibit 9, pp. 23-24).

Blunt takes issue, however, with Pacific Bell's proposed attrition year capital structure. He cites the Commission's concerns during its last cost of capital review in A.85-01-034:

> "Department of Defense's Langsam said a 52% equity ratio needlessly drives up the rate of return. Aside from the cost of equity exceeding that of embedded long-term debt, Langsam correctly notes that the cost of debt is deductible for computing income tax expense. Any decrease in the cost of debt or equity capital resulting from an increase in the equity ratio will, from the ratepayer's perspective, be more than offset by the higher revenue requirement which results from increasing the equity ratio. Langsam listed examples of five state regulatory commissions which have used imputed capital structures to derive a rate of return, and an example of its use by the Federal Energy Regulatory Commission [Citation omitted]. He notes that PacBell's

moving of its equity ratio above 50% is not the result of its being unable to raise debt capital, but instead is a move which is in the interest of the holding company, Telesis. If we adopt a 50-50 capital structure there is ample opportunity for PacBell to bring its actual capital structure in line during the test year, Langsam said, or the other option for management is to not alter the capital structure and simply book an overall return less than that authorized.

"PacBell is in the position today of funding most of its construction budget with internally-generated funds; this was not the case several years back. Having the equity ratio move above 50% indeed drives the overall cost of service up, and whether the increase is even close to being offset by lower debt cost in the marketplace depends on many almost imponderable vagaries, not the least of which are the inclinations of security ratings agencies. During cross-examination by PacBell, Langsam conceded that currently PacBell's equity ratio is indeed close to his target of 50%, but he noted that if it keeps increasing, eventually this Commission will have to adopt an imputed capital structure in some future proceeding, and by then matters could reach the point that it will be all the more painful for everyone concerned [Citation omitted].

"This is a valid and sobering observation. Although we conclude that the capital structure recommended by staff is reasonable, with a common equity component of 52.10%, we do not want to see the equity component rise about 55%. We are placing PacBell on notice that if it rises about 55%, we will not hesitate to impute a different capital structure which is more in line with the interests of ratepayers than those of PacBell and/or Telesis. . . ." (D.86-01-026, mimeo. pp. 13-14.)

As Blunt notes, Pacific Bell has exceeded the Commission's implied 55% limitation, and now requests a 57.5% common equity ratio. DRA believes its own recommended 45% debt/55%

equity capital ratio, which recognizes an increase in the equity component, is consistent with the concerns expressed in D.86-01-026, while at the same time holding the company to its actual 1987 financial equity and debt ratios, thereby imposing no hardship on the company. Nonetheless, DRA believes that the Commission's past concerns are still valid. DRA believes that Pacific Bell could maintain its "A" bond rating and still increase debt to 50% of capitalization, well above DRA's current recommendation.

While ratepayers benefit from higher bond ratings when new debt is locked in at lower costs than a lower bond rating would ensure, DRA reminds us that Pacific Bell has not planned any new debt issues in 1988 or 1989, and therefore ratepayers would not directly receive any benefits from improved debt ratings. In fact, according to DRA, Pacific Bell's internal cash flow meets its 1988/1989 capital expenditure needs, just as was noted in Langsam's 1985 testimony. In sum, DRA believes that the proposed increase in equity ratio is unnecessary to protect the solid "A" bond rating. It also points out that ratepayers will receive diminished tax benefits from the proposed lower debt levels.

DRA also provides an analysis of Pacific Bell's payout ratios for years 1984 through 1987, and suggests that the utility's payout is considerably higher than that of comparable companies (Exhibit 9, p. 28, Schedule No. 10). The analysis demonstrates that the payout ratio and dividend growth increased even when Pacific Bell's net income growth declined (Exhibit 9, p. 29, Schedule No. 11). When Pacific Bell's income growth slipped to less than 2% between 1986 and 1987, the utility increased dividends by more than 19%. Blunt notes that all common equity dividends are paid to the Pacific Telesis parent company, which also owns several subsidiaries not financed by independent debt or equity issues; Pacific Telesis finances these other endeavors using cash. To Blunt, this raises the sensitive question whether ratepayers are

generating the cash for diversification and whether the revenue requirements (i.e., capital structure and rate of return) are reflecting the goals of the consolidated corporation rather than the needs of the regulated entity.

According to DRA, Pacific Bell's actions since 1984 exemplify the situation described in the 1986 decision. DRA believes that if Pacific Bell is not seeking to minimize its cost of capital, the regulatory process should continue to impute a capital structure to protect ratepayers' interests. DRA concludes that ratepayers would save about $33.8 million if the Commission adopts its recommended capital structure.

3. Los Angeles' Pre-Settlement Position

Los Angeles' Kroman believes that imputation of a lesser leveraged capital structure produces an actual equity return significantly in excess of the nominal authorized return on equity (ROE). According to Kroman, a nominal authorized 14% ROE with an imputed capital structure of 40% debt, 60% equity, would produce an actual ROE of 14.772%. With a 42.5%-57.5% imputation, 14% nominal equates to 14.386% actual (Exhibit 13, Chart 5, p. 26). Since higher equity ratios reduce financial risk, what may be an appropriate ROE at a lower equity ratio will probably be excessive at a higher imputed equity ratio (Exhibit 12, p. 28).

Kroman also addresses the applicant's argument relative to the benefits of reducing the leverage in the capital structure, noting that maintaining or increasing bond ratings by lessening such leverage does not necessarily benefit the ratepayers:

> "The fact that utilities generally carry a single A bond rating and, absent extraordinary circumstances such as cancelled nuclear construction projects, have demonstrated no disability in raising new capital at market rates, suggests that these witnesses may be overstating the case." (Exhibit 12, p. 8.)

4. FEA's Pre-Settlement Position

FEA's Winter recommends that the capital structure used for ratemaking in this proceeding contain no more than 55% common equity and no less than 45% debt. He believes that a ratemaking judgment of the adequacy of a firm's rate of return should include an assessment of the economy and efficiency of the firm's operations under the Bluefield Water Works standard. Thus he maintains it is illogical and inequitable for the Commission to conclude that Pacific Bell's reported returns on common equity are excessive or inadequate without first verifying that the capital structure and other operating factors that affect reported returns are consistent with cost efficient operation.

Winter describes two examples of steps that a utility may take to capture excess returns for its stockholders through its choice of a sub-optimal capital structure. First, a utility may allow its common equity ratio to increase above cost efficient levels during prosperous times. Increased equity ratios during prosperous times will reduce reported rates of return on common equity below those that would otherwise be reported (i.e., greater (not less) leverage is known to increase rates of return during prosperous times). A utility may benefit from this strategy if regulators compare these reported rates of return against previously allowed rates of return to determine whether the firm's earnings are excessive. Since reported rates of return are lowered by this strategy, earned rates would remain closer to previously allowed rates and reduce probability of a rate reduction. A second strategy is to allow an increase in the common equity ratio but not adjust the rate of return request to reflect the resulting lower financial risks. All else equal, a reduction in financial risk reduces the investor-required rate of return, and unless the regulatory body recognizes this reduction in ratemaking, stockholders reap excessive returns.

Winter also asserts that the reduction in capital costs associated with higher credit ratings is insufficient to offset costs of maintaining the higher rating for investment grade utility companies.

Winter also believes that greater debt in the company's capital structure would be cost beneficial in all but the most difficult credit markets. He concludes that this is true even if the lower statutory tax rates associated with recent tax reform are used in the analysis. (See, generally, Exhibit 4, pp. 18 to 20.)

FEA's Winter also recommends that the Commission add a small layer of preferred stock to the capital structure. From a risk theory perspective, he believes the layer of preferred stock would reduce business risks, while increasing in some measure the company's financial risks. Of these two risk factors, he assigns business risks a higher priority since the company must successfully combat business risks to remain a going concern.

In sum, FEA's Winter recommends a structure containing 45% to 50% debt, 50% to 55% common equity, and 5% to 10% preferred stock, as offering lower overall capital costs. Structures within these ranges would be consistent with a single-A or stronger credit rating and offer adequate financial flexibility to the company. Although structures within these ranges are not the lowest cost structures, in his view they reduce costs from current levels and are therefore a move in the right direction. While the company has the prerogative of maintaining a higher cost structure, the higher costs of this structure should be borne by stockholders not ratepayers.

Finally, Winter asserts that although Pacific Bell's Christensen, Hardy, and Vander Weide explicitly or implicitly support the proposed 40% to 42.5% debt ratios and 57.5% to 60% equity ratios, none of these witnesses has provided quantitative evidence of the relative costs of alternative capital structures. Minimization of overall capital costs through choice of capital

structure is not an apparent goal of the company based on the testimony it has filed in this case, according to Winter.

5. Discussion

While the initial positions of the parties vary greatly, they have presented us with an uncontested settlement, wherein they propose a capital structure of 56.25% equity and 43.75% debt, with no allowance for preferred stock. The settlement proponents present this as a reasonable and appropriate compromise of the issues raised in Pacific Bell's application, with the caveat that the proposed settlement is not to be construed as precedent setting relative to any principle or issue in any current or future proceeding.

The compromise capital structure is well within the ranges of the parties' pre-settlement positions. For example, Pacific Bell's pre-settlement capital structure contained 42.5% debt and 57.5% equity. DRA's recommended capital structure contained 45% debt and 55% equity. FEA's recommended capital structure contained 45% debt, 5% preferred, and 50% equity.

While the compromise capital structure consisting of 43.75% debt and 56.25% equity represents a 475 basis points increase in the presently authorized equity component and a 135 basis points reduction in the presently authorized debt component, these changes are well within the range of the parties' recommendations for the 1989 attrition year as demonstrated above. On that basis we believe the recommended capital structure is in the public interest.

However, there is one area in which the parties could have provided additional information in support of their compromise, and we believe that we should provide some guidance for the future. In D.86-12-026, the last decision reviewing Pacific Bell's cost of capital, the Commission expressed concerns that the equity component in the capital structure not exceed 55%, and that the 6% preferred stock imputation remain in place "...until we find

some means of equitably ending it from the ratepayers' perspective." (Id., mimeo. pp. 13-16.) Had the parties addressed (and attempted to assuage) these explicit concerns in their Settlement Agreement (or elsewhere as appropriate), they would have greatly facilitated our determination that the settlement is in the public interest.

E. Cost of Debt

In its pre-settlement testimony, Pacific Bell projected a 9.21% embedded cost of debt as of December 31, 1988. Pacific Bell's witness proposed use of this level, although he stated that by the end of 1989, the embedded cost of debt would rise to 9.27%. However, in light of the timing of maturities he saw no reason to increase the 9.21% level. (Exhibit 1, p. 33.) As shown in the preceding comparative tables, all parties recommended a 9.21% long-term debt cost factor in their pre-settlement testimony, and in the proposed settlement. Given that fact, we will adopt 9.21% as the cost of debt for attrition year 1989.

When multiplied by the adopted debt ratio of 43.75%, the 9.21% cost factor produces a weighted cost of long-term debt for the 1989 attrition year of 4.029%.

F. Cost of Equity

The following table summarizes the positions of the parties:

Summary of ROE Recommendations

Party	ROE (Percent)
Pacific Bell*	14.00
DRA*	12.25-12.75
Los Angeles*	13.25
FEA*	11.40
Proposed Settlement	13.00

*Pre-Settlement Position

1. Pacific Bell's Pre-Settlement Position (Christensen and Vander Weide)

Pacific Bell's Christensen recommended a 14.00% cost of common equity in attrition year 1989, based on the risk premium analysis and discounted cash flow (DCF) model. Christensen's risk premium analysis used the regional holding companies (RHCs) as a check of reasonableness; however, since the RHCs have lower debt ratios than Pacific Bell and thus less financial risk, Christensen used them as a floor. For Pacific Telesis Group, Christensen's results showed a risk premium on the yield of 30-year Treasury Bonds (during February 1984 to June 1988) ranging from 3.2 to 6.7% and averaging 5.1%. For the RHC's, the risk premium ranged from 2.9 to 6.5% and averaged 4.7%. Adding the average risk premiums calculated above to July 1988 forecasted average 30-year Treasury Bond yields. (9.95% in 1989) results in a projected cost of common equity of 14.7 to 15.1% under Christensen's risk premium analysis.

In his DCF analysis, Christensen assumed that the cost of common equity for Pacific Telesis Group would be largely representative of the cost of common equity for Pacific Bell.[8] Christensen's DCF analysis concluded that there has been a systematic increase in the cost of equity since the 4th quarter of 1987 (Exhibit 1, p. 41); taking this increasing trend into account (12-month average 13.5%; 6-month average (January to June 1988) 13.9%; 3-month average (April to June 1988) 14.0%) he concluded that the appropriate DCF-based cost of common equity for Pacific Bell is 14%.

Based on the two models, Christensen derived the range of 14.0 to 15.1%. In conjunction with his recommended capital

8 Pacific Bell has no publicly traded equity securities, but represents approximately 93% of Pacific Telesis Group's total assets and 92% of total revenues.

structure based on 57.5% common equity and 42.5% long term debt, Christensen recommends a 14.00% cost of equity.

Christensen's risk premium and DCF models were complemented by his analysis of current economic conditions including current business risks and financial risks confronting Pacific Bell. He views the unsettled and volatile economic conditions in the US and world financial markets, the large Federal deficit and trade imbalances, the longevity of the economic expansion and the sharp decline in the dollar as exerting additional inflationary pressures. He also believes that Pacific Bell faces increasing competition and the threat of bypass associated with accelerating technological developments and the rapid influx of competition. He notes that the spectrum of intraLATA competition, a topic to be addressed in Order Instituting Investigation (I.) 87-11-033, impacts investor-perceived risk, although to some extent this has already been factored into investors' decisions (Exhibit 1, p. 18). He also points to the risk of obsolescence, given Pacific Bell's capital intensity; and he notes that there is investor uncertainty regarding the manner in which regulators will attempt to balance the interests of ratepayers and local exchange companies.
(Exhibit 1, p. 22.) Overall, Christensen concludes that there has been an increase in business and investment risks, exerting upward pressure upon investor-required returns and the cost of equity.

Pacific Bell's Vander Weide also discussed the current state of the economy (specifically the Federal deficit's impact on real interest rates (i.e., they have increased and remained high), the foreign trade deficit and the concomitant drop in the value of the dollar, the Federal Reserve's role in supporting interest rates, and increased volatility and investor caution about the direction of the economy and the level of inflation that may lie ahead). Vander Weide also cites the competitive factors Pacific Bell faces in a time of transition from social to economic pricing.

In Vander Weide's view, rapidly changing telecommunications technology also places risk on Pacific Bell, because these changes are the primary driver behind the increasing level of competition faced by the telephone companies.

Vander Weide concludes that these economic changes undoubtedly increase investors' perceptions of Pacific Bell's risk. Regulatory and Federal court rulings have opened many formerly protected areas to competitive alternatives which technological advances have permitted customers to pursue. Moreover, because the transition from social to economic pricing is far from complete, incentives exist for customers to use alternatives to Pacific Bell's services. This combination of financial incentives and technological capability results in higher risk for telecommunications firms in general. Vander Weide believes that the implied risks for Pacific Bell are particularly great because of the unique communications environment in California.

As a final note, Vander Weide points to the fact that investors are aware of the potential for change in the way that Pacific Bell is regulated. He believes that the uncertain outcome of the Commission's I.87-11-033, and specifically the manner in which the issue of lifting the intraLATA competition ban is addressed, will have a significant impact on Pacific Bell's earning ability and is therefore a major risk to investors (Exhibit 3, pp. 23-24).

Vander Weide used a quarterly DCF model to estimate Pacific Bell's cost of equity for the 1989 attrition year. (Exhibit 3, p. 26 l. 15-16.) Vander Weide performed a correlation analysis to identify the historically oriented growth rates best describing the firm's stock price for 1981, 1982, and 1983; then he performed a regression study comparing the historical growth rates with the consensus analysts' forecasts. In every case the regression equations containing consensus analysts' forecasts statistically outperformed the equations containing historical

growth estimates. Vander Weide used a simple average of the high and low stock prices for each firm for a 3-month period including the month currently under observation and its prior two months. He also included a 5% allowance for flotation costs and market pressure (Exhibit 3, p. 29). Vander Weide applied the DCF approach to four groups of companies: The Pacific Telesis Group, the RHCs, a group of six large independent telecommunications companies, and a group of risk-comparable companies (Exhibit 3, Schedule 4). Based on his analysis Vander Weide concludes that Pacific Bell's DCF cost of equity is at least 14.0%.

Vander Weide also used a risk premium approach, studying the comparable returns received by bond and stock investors over the last 50 years. He estimated the returns on stock and bond portfolios using stock price and dividend yield data on the Standard and Poor's (S&P) 500 and bond yield data on Moody's Aa-utility bonds and derived a risk premium of 5.88%. Vander Weide also conducted a second study using stock data on the S&P 40 utilities rather than the S&P 500 and derived a risk premium of 4.96%. Thus, Vander Weide believes that investors today require an equity return of approximately 4.5 to 5.5 percentage points above the expected yield on Aa-rated long-term debt issues. Since the long-term yield on Aa-rated bonds is currently about 10%, the addition of a 4.5 to 5.5 percentage points risk premium results in an expected 14.5%-15.5% return on equity.

Based on his review of economic conditions and on the DCF and risk-premium methods applied above, Vander Weide concludes that the cost of common equity for Pacific Bell is within the range of 14% to 15.5%; he recommends that Pacific Bell be allowed a fair rate of return on common equity at 14.5%.

2. DRA's Pre-Settlement Position

DRA's Blunt recommended a range of 12.25% to 12.75% return on common equity based on the DCF model, the risk premium method, and a comparable earnings analysis. While acknowledging

the bypass argument and the notion that increasing competition triggered by technological advancements may accelerate the departure of business customers from traditional systems which are part of the public network, Blunt notes that Pacific Bell's earnings have increased 44.6% since divestiture (Exhibit 9, p. 42). He regards this as solid evidence that the bypass threat has yet to affect earnings. While acknowledging the possibility that, in the near future (beyond 1990), technological advances and/or regulatory actions could increase the possibility that business customers may leave the system, Blunt maintains that using market-driven analyses such as DCF and risk premium will account for and reflect any solid evidence on this issue.

Blunt applied the comparable earnings standard as an aid in selecting comparable companies for use in the DCF and risk premium analyses, and to support the reasonableness of his recommended range of return on common equity. Blunt selected a group composed of seven independent communications companies and seven regional holding companies as well as ten gas distribution companies (the Group) (Exhibit 9, pp. 40-41).

Blunt used an average of historical, analysts' forecasts and sustainable growth rates in the DCF analysis, in the belief that a consensus of historical, forecasted, and sustainable growth rates best indicates investor-growth rate expectations for the near future. The average composite growth rate for Blunt's group of companies was 5.82%. (Exhibit 9, Table 16.)

Blunt's study indicates that the investor-required return for the seven independent telecommunications companies (IND) (combining the average 3-month and 6-month expected yield and average growth rate) is 11.71% and 11.87% respectively. For the same period, the analysis shows an identical return on equity expectation of 12.42% and 12.53% for the seven regional holding companies and ten gas distribution companies in the group. Combining the results of the DCF analysis for the seven

independents and seven regional holding companies shows an average expected ROE of 12.07% and 12.20%. The results of the DCF analysis produced a composite group average investor-required return on equity of 12.21% and 12.34% when the average 3-month and 6-month expected yields are combined with average growth rates (Exhibit 9, Table 17).

Blunt included no adjustment for flotation costs on the rationale that there is no need to compensate investors for dilution when none is occurring (the market-to-book ratio for Pacific Telesis is 151), and Pacific Bell has not issued equity capital since divestiture and actually reduced its retained earnings in 1987, projecting to pay out 100% of its available earnings to Pacific Telesis in 1988 and 1989. In light of these facts, Blunt feels there is no justification for including flotation costs (Exhibit 9, p. 53).

In his risk premium analysis Blunt derived the premiums by comparing DCF estimated returns on equity with "AA" and "A" Utility Bond yields and 3- to 5-year government issues from 1980 through 1987 (disregarding years prior to 1980 due to changing Federal Reserve Board monetary policy). The estimated ROEs were determined by combining the company's annual dividend yield with historical 10-year average dividend and earnings growth rates; data for the gas distribution companies was substituted (due to unavailability of historical data for the RHCs) and the historical expected ROEs were thus derived.

Next, Blunt combined Data Resources Incorporated's (DRI) current forecast for yields on "AA" and three to five year issues for 1989 with the respective average equity risk premiums to derive a range for expected ROEs. He also performed a similar task using Blue Chip Financial's 1989 forecasts for A Bond yields and 2-5 year government Treasury notes. The range of expected ROEs combining the historical risk premiums with 1989 attrition year forecasted "AA" and "A" yields is 13.06% and 12.37% respectively and 12.86%,

12.53%, and 12.87% using forecasts for intermediate term government issues (Exhibit 9, P. 56). Blunt's recommended range of 12.25% to 12.75% return on common stock equity falls within the range of expected returns produced by the risk premium analysis.

3. Los Angeles' Pre-Settlement Position

Los Angeles' Kroman criticizes reliance on the DCF methodology, the risk premium methodology, and the capital asset pricing model (CAPM). He believes the Commission has already expressed its view that there are serious pitfalls in placing heavy reliance on such models, as a substitute for informed judgment. (Exhibit 12, p. 15.)

Kroman also criticizes the applicants' risk assessment arguments, believing that they have failed to distinguish between changes in absolute versus relative risk. In the absolute sense, Kroman agrees that it may be true that telecommunications utilities are confronted with increasing risks largely from competitive pressures. However, in a relative sense this differs not at all from the arguments being made by the natural gas and electric utilities. Kroman cites the plight of many entities in the unregulated sector including the steel, automobile, oil, machine tool, computer, and farm sectors all of which are severely impacted by fiercely competitive pressures. Kroman contends that increased risks are impacting not only telecommunications utilities but practically the entire spectrum of American business (Exhibit 12, p. 17). He believes that discussion of one utility industries' risks without reference to the risk of the economy can provide only an incomplete, inconclusive, and superficial framework for supporting a requested rate of return. Kroman also refers to recent issues of S&P's "Credit Week" reports and similar information on Pacific Telesis from Moody's Handbook of Common Stocks. He beleives there is little if any indication in Moody's Handbook for example, that Moody's is warning investors of Pacific Telesis' increasing risks; the comments are in fact quite positive.

Kroman believes that if the Commission is to consider absolute risks, it should look to objective sources; he believes that the views of the applicants' witness regarding the risks of the telecommunication companies and of the applicants are clouded by their lack of objectivity.

Kroman believes that economic conditions and the level of interest rates are significant elements to be considered in arriving at a fair rate of return. He has reviewed certain data indicating the direction and magnitude of change in the cost of common equity, comparing conditions shortly before the issuance of D.86-01-026 with more recent conditions. He has examined the change in DCF-calculated cost of common equity over these time periods to obtain an indication of the magnitude and direction of change. Using Vander Weide's calculations, Kroman demonstrates that the indicated cost of common equity has decreased on average by 2-1/2 percentage points over that time interval (Exhibit 13, Table 15). Kroman also believes that it is significant that Pacific Bell plans no new outside financing for the 1989 attrition year, whereas Pacific Bell had projected the need for such financing in its last rate case (A.85-01-034).

Kroman prepared a chart (Exhibit 13, Chart 4) showing the relationship between the percent return on common equity and the corresponding pre-tax interest coverage at debt ratios of 42.5% and 45%. With a nonimputed debt ratio of 45%, Kroman believes Pacific Bell could satisfy S&P's minimum A-rating benchmark of 3.5 times interest coverage with an ROE of less than 11-1/2%; imputing a 42.5% debt ratio would enable Pacific Bell to achieve the same pre-tax interest coverage with more than a one percentage point reduction in ROE. Given all of these factors, Kroman recommends a return on common equity for the 1989 attrition year of 13.25% based on a capital structure of 45% debt and 55% common equity.

4. FEA's Pre-Settlement Position

FEA's Winter recommends a return on common equity of 11.40% based on a 50% equity component. Winter uses a DCF analysis, and secondarily an historical risk premium and "recent required returns" (comparable risk) analysis to check the reasonableness of the DCF analysis.

Winter provides an analysis of current macro-economic conditions and recent trends as a backdrop for his cost of capital analysis. He highlights the Federal Reserve's action to reduce the monetary growth rate and concomitantly, the potential for higher inflation (Exhibit 4, pp. 28-29). He also states that although inflation rates have recently turned upward, inflation continues within the range that has existed since 1985. Although monthly fluctuations in inflation rates have raised concern in both 1987 and 1988 that these rates were headed upward, no clear upward trend has materialized. He indicates that annualized inflation rate expectations range between 4.0% and 5.6% for the 1988-89 period. He believes that if inflation continues to fall between 4 and 5% and credit demands are consistent with allowed monetary growth, without oil or other price shocks, interest rates should remain within recent ranges.

Winter uses the Pacific Telesis Group as a starting point for analysis of Pacific Bell's cost of common equity; he indicates that the parent's stock was relatively trendless during the June 17 to September 30, 1988 period, consistent with the Dow Jones, and S&P Utility indices.

According to Winter, investment publications frequently mention two primary sources of risk faced by Pacific Bell and its parent. The first source is attributable to inroads that competitors may make into the regulated utility's service offerings. Winter believes that generally, however, these inroads have been occurring at a slower rate than initially expected and bypass of the local switch and exchange loop has been infrequent.

Even when bypass has occurred, he maintains that it has often been partial with the local operating company receiving associated private line revenues. The current opinion generally expressed in investment publications is that revenue lost to competition will be relatively insignificant (Exhibit 4, p. 34). Winter also believes that Pacific Bell has improved productivity of its telephone operations and that the California Commission has approved price flexibility and phased out toll access subsidies, all of which should help minimize the potential negative effects of competition. However, a second source of potentially greater investment risk is diversification into unregulated businesses; Pacific Telesis Group has invested in a variety of relatively risky nonutility ventures including real estate, cellular, mobile and paging services, financial services, and international marketing of communications services. Based on investment firm reports, diversification has increased the investment risk faced by utility firms. Winter refers to a June 1986 Salomon Brothers' Report stating that diversification has not boosted profits or increased shareholder value. According to Winter, the Report indicates that Pacific Telesis Group's net income has actually been reduced, rather than increased, by its diversification efforts. The Salomon Brothers' calculations show that diversification diluted the parent company's earnings by approximately 6% during the first quarter of 1986. Nonutility operations were, as a whole, unprofitable for calendar year 1986 based on S&P's June 22, 1987 Credit Week. (Exhibit 4, pp. 35-36.)

In sum, Winter believes that, over the near term, Pacific Bell has taken steps considered to minimize the primary source of the risk it faces (i.e., that due to competition); however, Pacific Telesis has taken steps that have increased (and are likely to continue to increase) its overall investment risk. Because of this divergence, with Pacific Bell taking the lower risk path and Pacific Telesis Group the higher risk path, Winter considers

Pacific Bell to have slightly lower overall investment risks than its parent. According to Winter this risk differential means that Pacific Bell's cost of common equity is slightly smaller, perhaps by 20 to 30 basis points, than its parent's cost of equity. Notwithstanding this caveat, Winter relies on Pacific Telesis Group market data as a starting point for estimating the cost of equity to Pacific Bell.

According to Winter, Pacific Telesis Group's returns on equity have exceeded those of more risky large corporations by an average of 180 basis points during 1985-1987. (Exhibit 4, pp. 38-41.) Based on this comparison, Winter believes that the parent's rate of earnings has been excessive during each of the past three years.

In his DCF analysis, Winter relies on a constant growth model, which is based on the assumption that investors expect equal growth in price and dividends over an infinite future holding period. (Exhibit 4, p. 33.) He has chosen the constant growth method because it is generally accepted for ratemaking. Winter concludes that a growth rate range of 4.5% to 6.0% is representative of investor expectations for long-term Pacific Telesis Group growth (Exhibit 4, p. 50). He calculates a current dividend yield of 6.03% (Exhibit 4, p. 52). A current dividend yield of 6.03% coupled with expected growth rates of 4.5% to 6.0% indicate investor common equity requirements between 10.80% and 12.39%. (Exhibit 4, p. 53.)

In using the historical risk premium approach as a check on the reasonableness of the DCF analysis, Winter found, based on geometric mean returns, that a portfolio of Moody's 24 Utilities returned approximately 166 basis points more than long-term Government Bonds during the period 1929 to 1987. Winter computed the average of the premiums that would have been realized over all whole-year holding periods of one year to ten years during 1929 to 1987. The average premium was 367 basis points. However, Winter

maintains that there have been significant changes in the risk premium between utility stocks and bonds in recent years, and that some authorities have concluded that long-term bond investing has become as speculative as stock investing. He believes that reduced risk premiums between stocks and bonds recorded in 1979 to 1981 continue to prevail. Due to these reduced risk premiums, he maintains that the lower end of the 166 to 367 basis points premium spread is more appropriate (Exhibit 3, p. 59).

As a final check on his DCF analysis, Winter reviewed recent required turns on other competing investments (July, August, and September '88 issues of the S&P Bond Guide). The required returns are discounted cash flow returns calculated from the current price of the bond and the expected income stream (coupon payments and return of the bond's face amount upon maturity), consistent with determination of Winter's DCF findings for Pacific Telesis Group. Winter believes that the common equity of Pacific Bell and its parent is more risky than triple-A-rated bonds because of greater uncertainty concerning the amount and timing of the future income stream. However, this uncertainty is significantly less than that associated with the potential income stream from the typical bond rated triple-C (Exhibit 4, p. 62: 13-18).

In sum, Winter's point estimate for Pacific Bell's cost of equity is 11.4%. This is 20 basis points below the midpoint of his DCF range for Pacific Telesis Group, in recognition of the slightly lower risk associated with Pacific Bell's common equity. The DCF, risk premium, and risk/return analysis performed relied on recently recorded stock prices and recent long-term Treasury Security and Corporate bond yields. In Winter's view, the results are indicative of investor return requirements during the period 6/17/88 to 9/30/88, in which these prices and yields were recorded. Winter maintains that the 11.4% finding offers a premium of approximately 140 basis points over recent required returns on the

company's debt and equals recent required returns on junk bonds rated double-B by S&P.

Winter recommends no adjustment for flotation, on the rationale that it is inequitable to ratepayers (Exhibit 4, p. 70). Based on recent market prices if stock sales were to occur, they would likely be at prices above book value given PTG's current market-to-book ratio of approximately 1.5. In his view, accretion, rather than dilution, will be the likely result of such sales.

5. Discussion

The pre-settlement recommendations on the cost of equity for attrition year 1989 cover a wide range (11.4% to 14.00%), and the proposed settlement contains a stipulated ROE of 13.00%. That figure is well within the recommended ranges, and no party to the proceeding opposes its adoption.

Adoption of the 13% compromise figure appears to be a reasonable compromise; it represents a 200 basis point reduction in the currently authorized 15% return on equity which has been in place since 1986, and therefore furthers the ratepayer interest in recognition of an improved financial environment since January 1986. Adoption of the Proposed Settlement results in a revenue requirement reduction of $127 million.

IV. GTE-C's Financial Attrition Request

A. The Application

On July 15, 1988, in accordance with the Commission's directive in D.88-06-024, GTE-C filed its 1989 financial attrition request, seeking an increase in its intrastate revenues of

approximately $67 million.[9] GTE-C sought to increase its authorized intrastate rate of return from 10.90% to 12.08%, premised on a long-term debt cost of 9.03%, short-term debt cost of 8.75%, preferred stock cost factor of 6.35%, and return on common equity of 14.50%. This request was premised on a capital structure composed of 38.2% long-term debt, 1.9% short-term debt, 2.7% preferred stock, and 57.2% common equity.

GTE-C requested that the revenue requirement increase proposed in its application be implemented by a uniform increase in its three current billing surcharges, to be collected on a bill and keep basis, and that these changes be made effective January 1, 1989 to be implemented simultaneously with the surcharge changes resulting from GTE-C's 1989 operational attrition rate adjustment filed October 1, 1988.

B. Rate of Return Recommendation for Attrition Year 1989

GTE-C's presently authorized rate of return is depicted in the following table:

GTE-C (Present Authorization)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	41.50%	9.01%	3.74%
Short-Term Debt	2.50	7.00	0.18
Preferred Stock	2.50	6.41	0.16
Common Stock Equity	53.50	12.75	6.85
Total	100.00%		10.90%

9 In a September 30, 1988 update, submitted in accordance with the ALJ Ruling of June 24, 1988, GTE-C reduced its requested revenue requirement increase to $66.201 million. This reduction reflected the use of the 1988 test year rate base adopted in D.88-08-061 to derive the company's 1989 attrition year rate base.

GTE-C's present authorization contrasts with the recommendations of the active parties for the 1989 attrition year, depicted in the following tables:

GTE-C (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	38.20%	9.03%	3.45%
Short-Term Debt	1.90	8.75	0.17
Preferred Stock	2.70	6.35	0.17
Common Equity	57.20	14.50	8.29
Total	100.00%		12.08%

DRA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	40.50%	9.03%	3.66%
Short-Term Debt	2.00	8.50	0.17
Preferred Stock	2.50	6.34	0.16
Common Equity	55.00	12.50*	6.88
Total	100.00%		10.87%

*Mid-point of 12.25-12.75% range.

Los Angeles (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	38.20%	9.03%	3.45%
Short-Term Debt	1.90	8.75	0.17
Preferred Stock	2.70	6.35	0.17
Common Equity	57.20	13.00	7.44
Total	100.00%		11.23%

A review of these recommendations reveals a difference on the appropriate capital structure for the 1989 attrition year. The percentage of common equity in the capital structure reflected in these recommendations ranges from GTE-C's 57.2% to DRA's 55%.[10] The second major issue in the proceeding relates to the appropriate return on common equity for attrition year 1989. GTE-C is requesting an increased ROE of 14.50. DRA recommends a reduction in the current ROE from 12.75% to 12.50%. Los Angeles' Kroman recommends an increase from the current 12.75% to 13.00%. In contrast to the disposition of Pacific Bell's financial attrition, the issues raised in GTE-C's application were litigated. Indeed, each party who signed the Settlement Agreement in A.88-07-019 explicitly agreed that the settlement terms and conditions would not be used in any manner whatsoever in GTE-C's A.88-07-017. Therefore we proceed to analyze the record developed in A.88-07-017.

C. Capital Structure

While capital structure is an issue for attrition year 1989, all witnesses support some increase from the present 53.5% authorized equity percentage. DRA recommends 55% and GTE-C recommends 57.2%.

1. GTE-C's Position

GTE-C's witness O'Rourke testified that the common equity ratio of 58% projected for year-end 1989 places the company in the

10 Los Angeles' witness Kroman accepted GTE-C's capital structure in his analysis, and concentrated primarily on the issue of the appropriate ROE for the attrition year; we do not regard his use of these percentages as an endorsement of GTE-C's recommended capital structure, especially in view of his arguments on the merits vel non of higher bond ratings, infra.

strong A to weak AA S&P bond rating category. O'Rourke describes S&P's bond rating criteria as follows:[11]

	A	AA
Pre-tax Fixed Charge Coverage	3.5x-5.5x	Above 4.5
Total Debt/Total Capitalization	40%-52%	Under 42%
Net Cash Flow/Long-Term Debt	25%-35%	Above 30%

O'Rourke indicates that this common equity ratio is still below the average ratio for the comparable telephone companies he reviewed (Exhibit 8, p. 3). O'Rourke asserts that the higher projected common equity percentage "is a conservative move to reduce financial risk and exposure to interest rate volatility." (Exhibit 7, p. 3.) O'Rourke maintains that GTE-C should maintain its AA-bond rating, consistent with the trend established by most major telephone companies, which are reducing financial leverage by improving their total equity position, in order to protect against the shock of volatile interest rate increases and higher business risk keyed to increased competition.

O'Rourke considered his list of comparable telephone companies on the basis of size and markets served as of December 1987. The comparable companies also have publicly traded debt. Because of GTE-C's size, he considered telephone companies with total capital of at least $1.8 billion. These companies are all rated in the AA category and O'Rourke believes GTE-C is considered comparable, by knowledgeable investors. All of these companies have total capital in the range of $2 billion to $12 billion and long-term debt ratios in the range of 35% to 44%. O'Rourke notes that the average common equity ratio is 59%, while the high/low range is 63.7%/55.7%. (Exhibit 8, p. 3.)

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11 This material is derived from Exhibit 8, page 4.

GTE-C argues that DRA's recommended 55% equity ratio is rooted in misunderstanding of the factors that make the higher equity ratio essential. More specifically, GTE-C states that DRA has provided misleading information (Exhibit 9, Schedule 3) as to the length of time GTE-C's bonds have been rated AA and as to its commercial paper ratings over the same period. GTE-C assets that it was not until late 1986 that it obtained its current "weak" AA rating from both Moody's and S&P. GTE-C asserts that it achieved this rating only as a result of substantial increases in its equity ratio and pre-tax times interest coverage. Further, it maintains that the current rating is still well below the average ratings for other large telephone utilities (Exhibit 13, p. 1).

GTE-C also objects to DRA's reliance on certain Value Line data indicating that telecommunications service companies facing comparable business risks are projected to have equity ratios for 1988 and 1989 of only 54% and 55%. GTE-C believes that many of the companies included in this Value Line projection do not fall into S&P's high risk local exchange carrier classification and are not representative of the companies with which GTE-C must compete for debt capital. Further, the companies used do not have the same Value Line safety rankings. (2 RT 182.) Finally, GTE-C asserts that the Value Line report includes certain projected equity ratios for 1987, 1988, and 1989 which are well above the equity ratio recommended by DRA (2 RT 184: 1-20).

GTE-C believes that DRA's witness has inappropriately focused on whether his recommendation will jeopardize GTE-C's current bond ratings; GTE-C believes the appropriate focus should be whether the recommended ratios will enable it to maintain its current bond rating. According to GTE-C, DRA's capital structure includes less equity and more debt (long-term and short-term) than required by S&P's for an AA bond rating; concomitantly, if DRA's 12.50% midpoint ROE is adopted, GTE-C asserts that it will only

achieve a pre-tax times interest coverage of 3.78 times (Exhibit 9, p. 59).

GTE-C asserts that the DRA capital structure and proposed ROE would almost certainly result in a bond rating reduction, which would over time have a negative impact on ratepayers by increasing the cost of new debt financing and also increasing the ROE to which GTE-C's investors are entitled. In support of the latter argument, GTE-C cites the calculation of its witness Brennan (Exhibit 6, Schedule 21), illustrating the difference in interest expense between a utility meeting the minimum criteria for an A bond rating and a utility meeting the minimum criteria for an AA bond rating. Brennan asserts that the required return on equity is 16.9% for the A-rated utility, whereas the requirement for the AA-rated firm is only 15.2% premised on the cost of debt used in Schedule 21 of Exhibit 6. (1 RT 80-83.)

In sum GTE-C asserts that the record clearly establishes that a 57.2% equity ratio will help achieve its goal of maintaining its current bond rating. The higher equity ratio will help minimize the risk of a bond rating downgrade (provided the return on common equity is adequate), and thereby avoid the increase in future debt costs and ROE, which it believes would necessarily result from a bond rating decrease.

2. DRA's Position

DRA asserts that its recommended 55% common equity ratio is fairer to the ratepayer than GTE-C's 57.2% request. Since the cost of common equity is the highest cost of the capital structure components, DRA believes it is appropriate to consider a capital structure which provides sufficient interest coverage to maintain a reasonable bond rating and net cash flow to debt ratio. While GTE-C would prefer to stay below a 40% debt ratio and above a 4.5 times pre-tax interest coverage in order to maintain its bond rating, DRA submits that GTE-C could pay $20 million more in interest and still maintain the 4.5 times pre-tax interest coverage

necessary to sustain that rating. This interest would cover about $196 million in additional debt at the current 10.197% interest rate on AA bonds. The current debt ratio requested by GTE-C is only 40.1% for 1989 (including long-term and short-term debt), and therefore DRA believes that GTE-C has room for additional debt before reaching the S&P guideline of 42%.

In general, DRA notes that increases in the debt ratio and decreases in the equity ratio represent tax savings to ratepayers. The least expensive option for a company to finance growth however, is through internal cash flow. A company may control its cash flow in part by controlling its dividend policy. DRA notes that for 1989 GTE-C plans no debt or equity funding. It plans to finance capital investments solely from internal sources. DRA also notes that GTE-C is wholly owned by a holding company, GTE Corporation, and therefore it has added flexibility in using internally-generated cash, since common dividends are all paid to the parent company, and the dividend payout ratio is not driven by market expectations.

DRA observes that since 1983 GTE-C's long-term debt ratio has declined from 56.98% to 40.86% The preferred stock equity ratio has declined also while the common stock equity ratio has continuously increased from 40.12% in 1983 to 53.44% at the end of 1987. This has occurred in part because GTE-C has increased new common stock issues to its parent, replacing debt (Exhibit 9, pages 17-18). DRA notes that GTE-C plans to add an additional $45 million in common equity this year;[12] this new funding will increase its common equity ratio to between 56% and 57% depending on how much of the new equity is used to retire maturing debt. GTE-C's long-term debt ratio will drop below 41.3% continuing its 5-year slide. DRA notes that the result of the shift in capital

12 A.88-10-006 is currently pending before this Commission.

structure is a higher cost of capital for ratepayers (Concurrent Brief of DRA, pp. 4-5).

Asserting that continued increases in equity appear to be unwarranted, DRA points out that GTE-C has the ability to fund capital expansion internally or through debt but has opted for infusions of new common stock equity. DRA believes the resulting higher GTE-C revenue requirement to does not seem to be offset by any benefits to ratepayers. There will be no further improvements in bond rating, financial stability or reduced debt costs.

DRA submits that in the ideal market, competitive companies seek to minimize financing costs, and prefer cheaper financing opportunities over more expensive undertakings within the range permitted by the bond rating guidelines. Regulated utilities, however, may seek to maximize return rather than minimize costs when the returns are passed on to ratepayers without fear of competition. Therefore, DRA is concerned over the build up in common stock equity ratios without apparent ratepayer benefit. Of special concern is the fact that the utility in question is wholly owned, and the higher weighted common equity costs accrue only to the benefit of the shareholders. The holding company can use the dividends flowing from the regulated subsidiary to finance unregulated enterprises of other subsidiaries. DRA submits that when a regulated capital structure appears to produce ever higher returns flowing to the parent company without appropriate benefits flowing to the ratepayers, the increased common equity ratio and increased costs to ratepayers should be denied. Therefore, DRA recommends a 55% common equity cap for GTE-C for the 1989 attrition year. Staff believes that this recommendation is well within industry norms, as evidenced by the average for Value Line's projected common equity ratios for 1988 and 1989 (54% and 55% respectively) and should be adopted. (Exhibit 9, pp. 20-22.)

3. Los Angeles' Position

As mentioned earlier, Los Angeles' Kroman uses the requested capital structure in terms of illustrating the return on equity recommendation which was his primary focus in this proceeding. However, Kroman also addresses GTE-C's argument that it must maintain its bond rating in the attrition year, and in that regard, Kroman's analysis addresses part of the debate over the appropriate capital structure. Kroman disputes the implication of GTE-C's witnesses that higher bond ratings result in lower money cost rates which are passed through to customers resulting in lower service prices (Exhibit 12, p. 8). In particular Kroman challenges Brennan's analysis that the total cost of service for the lesser "A"-rated utility exceeds that of an "AA" rated utility (Exhibit 6, Schedule 21). Kroman asserts that Brennan has obviously assumed that the differential in bond yields between the A and AA categories is 0.5 percentage point.[13] Using an alternative spread of 0.17 percentage point (the median differential over the period January 1946 through June 1988) between the two bond rating groups, Kroman derives a result indicating that the annual total cost of service for the AA-rated utility substantially exceeds that of the A-rated utility (Exhibit 13, Table 3).

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13 In D.87-12-070, and other Commission decisons, the 50 basis points spread is authorized, "if appropriate" in connecton with long-term bonds to be issued in the attrition year. (D.87-12-070, Finding of Fact 4.) This is a far cry from GTE-C's implicit argument that we have explicitly recognized that a spread of 50 basis points is appropriate between an A and AA rated utility bonds, for purposes of the Brennan analysis (3 RT 363: 20 to 365: 16).

A comparison of the Kroman/Brennan analysis (Table 3, Exhibit 13 versus Schedule 21, Exhibit 6) follows:

		AA		A	
1	Bond Rating	Brennan	Kroman	Brennan	Kroman
	Debt Leverage	Under 42%	Under 42%	40%-52%	
3	Use	42% (max)	42%	52%	
4	Assumed Yield on Public Utility Bonds	10.5%	10.825%*	11.0%	
5	Weighted Effective Cost Rate (ln 3 x ln 4)	4.41%	4.5465%	5.72%	
6	Total Capital (Millions)	$4,000	$4,000	$4,000	
7	Interest Expense (Millions) (ln 6 x ln 7)	$1.76.4	181.86	$228.8	
8	Coverage	Above 4.5x	4.5x	3.5x	
9	Before Income Tax Income (millions)(ln 7 x ln 8)	$793.8	$818.37	800.80	

*Reflects median differential of 0.175 percentage point (vs 0.5 percentage point in Exh. 6, Schedule 21) with A yield assumed at 11%, per Mr. Brennan.

Thus, while the interest cost component of overall costs to be borne by ratepayers may be somewhat reduced as a result of higher bond ratings, Kroman asserts that it is far outweighed by the increase in the equity cost component, with a significant increase in the resultant overall cost of service. Kroman asserts that there is no sound basis in the record for fixing GTE-C's rate of return at a level claimed necessary to maintain its current bond rating. In his view, a determination of rates on the basis of achieving and/or maintaining high bond ratings is entirely one sided and shortchanges the interests of ratepayers. Moreover he argues there is no evidence whatsoever indicating that GTE-C would be unable to maintain its current bond rating if the Commission does not adopt its recommendation. (City of Los Angeles Brief, p. 7.)

4. FEA's Position

In its brief, FEA argues that the GTE-C capital structure recommendation should not be adopted. FEA believes that even the DRA proposed 55% equity, 40.5% long-term debt, 2.0% short-term debt and 2.5% preferred stock ratio is too equity heavy, preferring instead a capital structure containing 50% equity, 45% debt and 5% preferred stock (but in no event more than 50% equity). (FEA Brief, pp. 3-4.)

5. Discussion

We do not believe that GTE-C has carried its burden of proof on the issue of the necessity of increasing its common equity ratio to 57.2% in order to maintain its AA bond rating. First, as DRA points out, when GTE-C received its AA rating, mathematically its equity ratio was 52% (2 RT 163). In addition DRA notes, there is still some "maneuvering room" between GTE-C's combined long-term debt/short-term debt recommendation of 40.1% and the "under 42%" figure listed in the S&P's bond rating criteria. That fact, coupled with the undisputed fact that GTE-C has no plans to issue long-term debt during the 1989 attrition year (Application, p. 4)[14] supports a recommendation more in line with that of DRA (40.50% long-term debt, 2.00% short-term debt).

Los Angeles' Kroman has also demonstrated that a slight adjustment in the assumed differential in bond yields between A and AA bonds to account for a longer timeframe, shows that the annual total cost of service for the AA-rated utility substantially exceeds that of the "A" utility. The use of a five-year data base, as reflected during GTE-C's cross-examination of Kroman does not alter the outcome of Kroman's demonstration (3 RT 363: 1-17). The cost for AA becomes 807.78, while the cost for A is unchanged: 800.8.

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14 "GTE-C does not at this time anticipate issuing any long-term debt during the 1989 attrition year. Instead, its construction program and other capital requirements will be met through the sale of common equity and from internally-generated funds." (Application, pp. 3-4.)

Both Kroman and DRA correctly observe that higher bond ratings may well result in a reduction in the interest cost component, but this reduction is far outweighed by the increase in the equity cost component which itself has a far more significant impact on the overall cost of service, if we are to believe the accuracy of Kroman's calculations. Determining rates on the basis of achieving and/or maintaining a high bond rating may indeed be a one-sided view that shortchanges the ratepayer.

Moreover, there is no tangible evidence in the record indicating that General would be unable to maintain its current bond rating if its recommended capital structure were not approved.

Finally we note that GTE-C's O'Rourke also justified his common equity ratio of 58% as a conservative move to reduce financial risk and exposure to interest rate volatility. He stated that the improvement in total equity position helps protect a company against the shock of volatile interest rate increases and higher business risk brought on through increased competition. However, his analysis was not explicitly premised on any formal quantification of these impacts (Exhibit 7, p. 3).

Taking all of these matters into account, it appears reasonable to accept DRA's alternative to GTE-C's recommended capital structure for the 1989 attrition year. This alternative, with its 55% equity cap, represents an increase over the presently authorized percentage, but is within the parameters of Value Line projections for 1988 and 1989; it is also more responsive than GTE-C's proposal to the concerns that capital structure be cost-effective from the ratepayer perspective.

D. Cost of Debt

There is no disagreement among the parties as to the cost of GTE-C's embedded long-term debt for 1989 (9.03%), since no new long-term debt is scheduled to be issued in that year.

In its brief, however, GTE-C asserts that the 9.03% cost could change if the Commission denies its request to issue $45 million in new common equity in 1988, and/or finds that the DRA's proposed 55% equity ratio is reasonable. GTE-C currently plans to finance its construction program in 1989 with $45 million in new

common equity scheduled to be issued later this year and through internally-generated funds, including retained earnings. If the new equity is not issued at year-end 1988, GTE-C argues in its brief that its common equity ratio will still increase to approximately 57% by year-end 1989.[15] In its brief, GTE-C asserts that it would have to consider increasing its dividend payout ratio in order to reduce its equity ratio if the Commission adopts a capital structure that does not at least recognize the growth in its equity ratio from retained earnings; that if it is forced to increase its dividend payout, it would have to consider other sources such as new debt to finance its construction program in 1989; that if this option is elected, GTE-C's pre-tax times interest coverage would decline further, in turn, placing additional downward pressure on its current bond ratings (Concurrent Brief of GTE-C, p. 8). However, these arguments were not developed on the record, and are premised on certain facts that may or may not transpire depending upon the outcome of this decision (i.e., the 57% equity ratio by year-end 1989). Thus these arguments cannot assist the Commission in its deliberations on the cost of debt. That cost remains 9.03%, which we adopt for long-term debt for 1989.

GTE-C's proposed capital structure assumes a cost factor for short-term debt of 8.75%, compared with DRA's 8.50%. Both estimates are substantially higher than the short-term debt cost of 7.00% used in D.87-12-070. However, as the parties acknowledge that decision also established the method for forecasting GTE-C's

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15 The basis for this statment is 2 RT 117-118. However, at 2 RT 103: 23-105:7 GTE's witness O'Rourke testified that GTE-C's year-end common equity ratio is 56.34%, assuming debt retirements and issuance of the $45 million of common stock. O'Rourke testified that if the common stock for some reason were not issued, the year-end 1988 common equity ratio would be 55%. Later on redirect, O'Rourke testified that the 1989 common equity ratio of 58% would decline by approximately a full point to below 57% if no common equity were issued in 1989. His redirect testimony obviously assumes the GTE-C-recommended common equity percentage is adopted in this decision.

short-term debt costs for attrition years 1989 and 1990: "The reasonable short-term debt cost is the Blue Chip Financial Forecast Consensus 1-Month Commercial Paper as of October 1 for the attrition year." (D.87-12-070, Finding of Fact 4.) That forecast is 8.2%, which we adopt.

E. Cost of Preferred Stock

According to GTE-C's O'Rourke, the embedded cost of preferred stock will be 6.38% in 1988, dropping to 6.31% in 1989, due to a mandatory redemption of $4 million. The average cost of preferred stock for 1989 is estimated to be 6.35%. GTE-C has no plans, according to O'Rourke, to issue preferred stock during the 1988-1989 period.

DRA calculates the average effective dividend rate of preferred stock for 1989 as 6.34% (Exhiit 9, Table 4). This is an average-year figure which includes changes projected to occur in GTE-C's outstanding preferred stock due to a mandatory redemption.

There is virtually no difference in the GTE-C/DRA cost factor recommendations, and we adopt 6.34% as the cost factor for preferred stock for the 1989 attrition year.

F. Cost of Equity

1. Summary of ROE Recommendations

The following table summarizes the positions of the parties:

Party	ROE (Percent)
GTE-C	14.50
DRA	12.25-12.75*
Los Angeles	13.00

* Midpoint recommended

2. GTE-C's Showing

GTE-C's financial attrition request of $66 million is premised on a 57.2% common equity ratio, as discussed previously, and an ROE of 14.5%. In GTE-C's 1988 test-year rate case, the Commission adopted an ROE for 1988 of 12.75%. GTE-C maintains that the Commission adopted 12.75%, which was below the 13.25% recommended by the ALJ in his proposed decision, because it elected

not to make approximately $534 million in additional revenues subject to refund pending issuance of a final decision in the proceeding during the first half of 1988.[16] These revenues were associated with the additional test-year revenue requirement reductions proposed by DRA in that proceeding. The Commission stated that it acted to "...further reduce the risk that General will face in 1988, a reduction which is reflected in our adopted return on equity." (D.87-12-070, mimeo. p. 23.)

General maintains that its equity investors are entitled to a higher ROE for the 1989 attrition year than that adopted in D.87-12-070 because of dramatic increases in interest rates in 1988 over 1987, and the further substantial increases forecasted for 1989, as well as serious shortcomings in DRA's DCF and risk premium analysis (Concurrent brief of GTE-C, pp. 9-10). GTE-C maintains that all of the witnesses in this proceeding have recognized these changing financial conditions, and have increased their recommended returns in the 1989 attrition year accordingly.

In support of its requested ROE GTE-C presented the testimony of Joseph F. Brennan. Brennan was GTE-C's witness in the 1988 test year proceeding, during which he recommended a 15% ROE. In this proceeding, Brennan has used three methodologies: A single stage constant growth DCF model; a modified DCF model; and the Capital Asset Pricing Model (CAPM) (Exhibit 6, Schedule 1, page 1 of 2). Brennan's recommended ROE of 14.5% represents the midpoint

16 That decision was ultimately issued in August, 1988 (D.88-08-061).

of the range (14.4% to 15.7%) derived by application of these three models.[17] Brennan also provided a risk analysis.

Brennan believes that regulated telephone companies have greater business risks compared to many other kinds of utility companies. He believes the telephone industry is faced with competition for virtually all of its services even at the local network access level, and while regulators may help a telephone utility to preserve its markets by, for example, prohibiting intraLATA competition, they cannot preserve many markets for a telephone utility in today's environment. Brennan points to competitor inroads in the following areas:

- Bypass is GTE-C's major competitive threat in the exchange marketplace.
- Competitors cannot build a system for less money than GTE-C, but they price it lower because it does not support other parts of their business. This type of competition will be driven by high volume users looking to reduce their cost for network transport.

17 In connection with these models Brennan used 2 barometer groups of telephone companies as a proxy for GTE-C, whose stock is not publicly traded. The two barometer groups of telephone companies included three independent operating telephone companies (Cincinatti Bell, Inc., Rochester Telephone Corporation, and Southern New England Telecommunications Corp.) and seven regional holding companies (American Information Technologies Corp., Bell Atlantic Corporation, Bell South Corporation, Nynex Corporation, Pacific Telesis Group, Southwestern Bell Corporation, US West, Inc.). Brennan also used a barometer group of 8 gas distribution companies (Exhibit 6, Schedule 11) as a check on his analysis. Additionally, Brennan adjusted upward the market-derived ROE range for his two telephone company groups "...in recognition of a lower investor-perceived investment risk for the two telephone groups compared to GTE-C, since these groups were used as a proxy for GTE-C. The basis of this judgment is the difference in bond rating for GTE-C and the average bond rating for each barometer group of telephone companies." (Exhibit 5, p. 4.)

- Technology has placed the competitor in the enviable position of gaining immediately from state-of-the-art technology without concern for capital recovery of investments in outdated technology. As a result, competitive inroads may be made by interexchange carriers and major customers looking to build their own capacity.

- Major competitors may also include cellular franchise holders, large business customers building their own networks to reach IXC points of presence (POP), e.g., within GTE-C's service area, other carriers using CATV or joint ventured Networks to bypass exchange company services.

- Major competitors include AT&T-C, Wang, and MCI, all of whom have high national account visibility. (Exhibit 5, p. 12.)

Brennan analyzed the market data for his group of comparable companies under the DCF approach, giving equal weight to the constant growth DCF model and to a modified model designed to recognize an investor-expected price earnings multiple change.

The constant growth DCF model, based on an analysis of publicly rated common stock, is a technique utilizing market price, reported earnings per share and dividend payments per share in a calculation to determine the implicit return required by the investor and reflected in the market price of the stock (Exhibit 5, p. 27). The required imputs are an estimate of the current dividend yield of a security and an estimate of the growth rate in earnings and dividends. Brennan derived a constant growth DCF cost of equity of 11.6% for the barometer group of independent telephone companies, 12.8% for the barometer group of regional holding companies, and 13.4% for the barometer group of gas distribution companies (Exhibit 5, p. 34; Exhibit 6, Schedule 16).

Brennan conducted a second DCF study, because he believes there are serious limitations in the constant growth DCF model. Specifically, he believes that the assumption in the constant

growth DCF computation that investors use a single growth rate for the infinite future is unrealistic (Exhibit 5, p. 28). He asserts that while the typical DCF model proceeds from the premise that the rate of growth reflected in the price of stock is a particular rate over time, in fact, the growth rate can and does vary from period to period.

Brennan's modified DCF analysis is rooted in the belief that investor behavior is better explained by considering several independent variables such as changes in price earnings ratios, various industry-specific factors, and various company-specific financial characteristics such as common equity ratios (Exhibit 5, pp. 36-37, Appendix B; Concurrent Opening Brief of GTE-C, p. 19).

Brennan took into account dividends expected over the next 12 months in developing his dividend yield and the growth in value related to next year's expected earnings, and an assumed expected price-earnings multiple increase of 0.25 times. Using this approach, Brennan derived a cost-of-common equity of 13.4% for the independent telephone group, 15.3% for the seven regional holding comapnies, and 15.9% for the gas distribution companies (Exhibit 5, pp. 37-38).

Brennan averaged the results of his two DCF analyses to derive the following common equity recommendation: 12.5% for the three independents; 14.1% for the seven regional holding companies; and 14.7% for the gas distribution companies (Exhibit 5, p. 38; Exhibit 6, Schedule 1).

Brennan also performed a third study using the CAPM model. Under the CAPM approach the expected rate of return is determined by a risk-free rate of return plus a market premium proportional to the nondiversifiable risk. The nondiversifiable risk is obtained by the application of a beta (an indication of the relative risk of the security to the risk of the market). Betas are published by, among others, Value Line. (Exhibit 5, p. 38.)

Brennan used Treasury Bond yields to determine the appropriate risk-free rate of return using September '88 T-Bond yield forecasts (9.7%) and also Treasury Bond yield forecasts of Value Line and Blue Chip for the year 1989 (8.8% and 9.7%, respectively). Based on these sources he concluded that a reasonable estimate of the risk-free rate for 1989 is 9.3%.

He next determined the appropriate market premium by determing three to five-year forecasts of capital gain yields on common stock investments. These forecasts indicate a projected annual capital appreciation of 15.83%. When the average annual dividend yield of 3.1% is added to the average annual appreciation, the total market return is 18.9%. The total market return less the 9.3% return on a risk-free investment produces a market premium of 9.6%.

Brennan also considered historical risk premiums, relying on a 7.4% figure for the period 1926 to 1987 published in 1988 by Ibbotson and Associates. By giving equal weight to his projected risk premium and to the historical risk premium issued by Ibbotson and Associates, Brennan concluded that the appropriate market premium to use in the CAPM computation is 8.5% (Exhibit 5, p. 40). Brennan's CAPM-derived common equity cost is 15.0% for the three independents, 16.8% for the seven RHCs, and 15.2% for the eight gas distribution companies. (Exhibit 5, p. 40.)

Finally, as noted in Exhibit 6, Schedule 1, Brennan increased both the high end and the low end of his range by 0.2% to recognize the fact that GTE-C's bond ratings are below the average ratings of either of the other two telecommunications groups used in his analysis. Given the fact that GTE-C's bond rating is AA- whereas the two telephone company groups employed as proxies carry average bond ratings of AA or AAA, Brennan concluded that the investor-required ROE for GTE-C should be increased by at least 0.2% to recognize this difference in risk. His resulting ROE range is 14.4% to 15.7%; his specific ROE recommendation is 15%, the

midpoint of the range. However, as reflected in the testimony of GTE-C's O'Rourke, GTE-C's request in this proceeding is premised on an ROE of 14.5%.

3. DRA's Showing

DRA witness Blunt recommends a return on equity for the 1989 attrition year of 12.50%, premised on a recommended range of 12.25% to 12.75%. Blunt used the DCF and risk premium methodologies; however, he initially selected 24 telecommunications and gas distribution companies (group), based on comparability of business and financial risks to GTE-C. He selected telecommunications and gas distribution companies whose cumulative bond rating is identical to GTE-C's rating. Further, the groups' average equity ratio is similar to GTE-C's current common equity ratio. And, the seven independent telephone companies and seven regional holding companies included in the group are engaged in similar business pursuits. They are regulated or have subsidiaries that are regulated. The gas distribution companies are selected because they are experiencing similar business risks moving from a near monopoly to a more competitive environment.

Blunt states that since divestiture, telecommunications utilities have been expressing fears about the threat of bypass and its detrimental effects on their earnings and market share. However, Blunt believes there is solid evidence that the threat of bypass has yet to affect GTE-C's earnings, since there has been a 54.3% increase in earnings since divestiture (Exhibit 9, p. 42). Blunt asserts that using a market-driven analysis (such as DCF and risk premium) will account for and reflect any solid evidence of increased competition and its adverse impact on earnings.

Blunt's DCF analysis is summarized at Exhibit 9, Table 17. The results of Blunt's analysis were previously described in connection with Pacific Bell's financial attrition application, supra. This analysis produced a composite group average investor-required return on equity of 12.21% and 12.34%

when the average 3-month and 6-month expected yields are combined with average growth rate (Exhibit 9, Table 17). Blunt's DCF analysis included no adjustment for flotation costs, as discussed earlier in this opinion. The market-to-book ratio for GTE-C is 166, and GTE-C does not plan to issue common stock equity during 1989. Blunt relied upon these facts to support his argument that there is no reason to adjust the results of the DCF analysis for flotation costs. Blunt also used the risk premium analysis to support his recommendation. His application of that analysis is discussed in detail in connection with Pacific Bell's application, supra.

4. Los Angeles' Showing

Kroman recommends a return on common equity of 13% for the 1989 attrition year.

Initially Kroman asserts that GTE-C has failed to meet its burden of proof because its rate of return showing relies upon subjective and flawed methodologies. More specifically, Kroman assets that both the DCF and CAPM methodologies pre-select market data which produce numbers that can be fitted into neat, simplistic formulas said to produce investors' expected and required return on common equity. He believes that:

> "...inasmuch as the DCF formula is stated in terms of dividend yield plus growth rate, it is obvious that the result is a simple, direct function of whatever dividend yield or market price the analyst chooses to select. The proposition that anyone can accurately ascertain and specify by single number the widely diverse expectations of some 47-million investors is patently incredible." (Los Angeles' Brief, p. 8.)

To test whether GTE-C's DCF numbers have investment relevance, Kroman performed a correlation analysis between (1) a large investment advisory service's "buy-hold-sell" recommendations on 78 electric utilities, and (2) the difference between each utility's most recently recorded return on average common equity

and its DCF-determined cost of common equity. Logically and realistically, Kroman states that one would expect that investors would be advised to sell stocks in utilities not earning their cost of equity, buy stocks which are earning above their equity costs, and hold those stocks which are earning at about their equity cost. However, the results of Kroman's regression analysis show that whether or not a utility is earning its DCF-determined cost of equity has virtually no effect on the advice recommendations offered to investors. (Los Angeles Brief, p. 11; Exhibit 12, pp. 11-12.)

With all of its faults, Kroman believes that the DCF model is still superior to the CAPM model. The critical factor in the CAPM formula, the beta, is based upon past relative stock price movements and is thus incapable of predicting future relationships. Kroman also criticizes GTE-C's CAPM methodology for reliance on interest rates forecasts.

At bottom, Kroman agrees with the observation of this Commission in D.87-12-070 that variations in the result obtained from these models are indicative of their limited value as guides, and that the Commission must exercise its judgment rather rely on any particular methodology in determining the cost of common equity (D.87-12-070, mimeo. p. 22).

Kroman's second major argument is that GTE-C's business and financial risks have not changed appreciably since the Commission last authorized a reasonable rate of return in D.87-12-070. Kroman believes that GTE-C has engaged in a strategy of exaggeration, and has failed to produce objective, independent,

or disinterested evidence relative to risk as seen by the outside investment community.[18]

A further flaw in GTE-C's risk allegations is the failure to distinguish between changes in absolute risks and changes in relative risks. Kroman maintains that increased risks are currently affecting not only telecommunications utilities (or GTE-C in particular) but the entire spectrum of American business. He points to data indicating the number of long-term debt rating changes which S&P tabulated for the full year 1986 and the first half of 1988, segregated among industrial companies, utilities, and other companies. According to Kroman, that evidence demonstrates that not one telecommunications utility was downgraded in this time period (Exhibit 13, Table 6, p. 6).

Kroman also examined financial community credit-worthiness comments focused on the telecommunications industry in general and GTE-C in particular. (See Exhibit 13, Tables 12, 13, and 14.) He states that the telecommunications services industry is generally viewed favorably and that the trend to riskiness is not reflected in issuance of investor alarms. He points to certain comments in Moody's Bond Survey concerning proposed new long-debt issues as being inconsistent with the utility's pessimistic claims.

Kroman maintains that the process of determining rate of return requires the application of informed, fair, and well-balanced judgment, and that the evidence relied upon must be complete and credible. He maintains that economic conditions and the level of interest rates are significant elements to be considered in arriving at a recommendation for a fair rate of

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18 For example, Kroman introduced evidence demonstrating that the debt ratings of the large telephone utilities are vastly superior to those of most of the electric utilities (Exhibit 13, Tables 1 and 2, pp. 1-2).

return,and that current conditions do not differ substantially from the conditions existing at the time D.87-12-070 was issued.

Kroman has also developed data indicative of the direction and magnitude of change in the cost of common equity, comparing conditions shortly before issuance of D.87-12-070 with more recent economic developments. (See Exhibit 13, Table 15, p. 16; Table 16, p. 17.) For six independent telecommunications companies, the cost of common equity has decreased on average by 2-1/2 percentage points. Similarly, for seven regional holding companies the average indicated decrease in the cost of common equity was 3 percentage points. A comparison of GTE-C's prior and current submissions for three independent telephone companies, 7 RHCs and 8 gas distributors (Mr. Brennan's proxy groups) demonstrates no change at all in an average of the averages of the three groups of companies. (Exhibit 13, Table 17, p. 18.)

Kroman also performed a correlation analysis over the period July 1, 1969 through December 22, 1987, reviewing General's authorized rates of return on common equity and the prime interest rates prevailing at the times of such authorizations. The result shows a coefficient of determination between authorized returns on common equity and the corresponding interest rates of 0.725% (Exhibit 13, Chart 3, p. 23). Thus, nearly three-quarters of the variations of ROE may be explained by variations in the prime rate. Kroman does not recommend that such a simplistic approach be solely and directly employed to determine a proper return on common equity. However, these data clearly establish that there has logically been a significant correlation between the applicant's authorized ROE and the prime interest rate. The mathematical result of this anlaysis produces a 12.93% return on common equity at a 10% prime interest rate (Exhibit 12, p. 25).

Finally, Kroman also explored the relationship between the return on common equity and the corresponding pre-tax interest coverage for the applicant, since GTE-C emphasized its importance

during these proceedings. Kroman accordingly observes that GTE-C could achieve a pre-tax interest coverage implicit in D.87-12-070 with a very modest ROE of approximately 11%.

In sum, Kroman concludes that since the Commission last fixed GTE-C's return on common equity at 12.75% for test-year 1988, short-term interest rates have risen modestly, but no other significant changes have occurred which should markedly increase GTE-C's current business or financial risks. Kroman submits that an allowance for common equity of 13.0% with a corresponding overall rate of return set at 11.23% together represent the highest rates justified by an accurate and complete consideration of the record.

5. FEA's Position

In its brief submitted in this proceeding, FEA argues that the record justifies no higher than the 10.73% overall rate of return which would result from the lower end of DRA witness Blunt's cost of equity range (12.25%). In FEA's view, there are absolutely no indications in the economy that the cost of capital will even approach 15%, as GTE-C's witnesses assert, during the next year.

6. API's Position

In its brief submitted in this proceeding, API asserts that GTE-C's cost of equity analysis is upwardly biased and should be rejected. More specifically, API challenges Brennan's conclusion that the seven regional Bell telephone companies and the eight distribution companies--which produce returns of 14.1% and 14.7% respectively--are comparable for cost of capital purposes to GTE-C. API notes that the only other group of non-Bell Telephone Companies examined in Brennan's DCF analysis produced an expected equity return of 12.5%. API concludes that Brennan's DCF analysis thus produced upwardly biased equity cost estimates.

API also disputes the results of Brennan's CAPM analysis. It challenges Brennan's historical risk premium analysis as an unsuitable proxy for future investor expectations. API also

challenges Brennan's forecasted risk premium, based on his testimony that he used a market appreciation rate of 80% over a four-year period (API Brief, p. 5). API notes that Brennan failed to answer questions put to him as to whether GTE-C's stock had experienced such appreciation over the last four-year period. (API Brief, p. 5.)

In sum, API asserts that GTE-C's cost of equity recommendation should be rejected and that the Commission should rely upon the record evidence submitted by the other parties in this proceeding.

7. Discussion

The recommended ROEs range from DRA's 12.25%-12.75%, to Los Angeles' 13.0%, to GTE-C's 14.50%. The various ROE models employ differing assumptions and imputs, and are in that sense, imperfect proxies for calculating the investor-required return on equity. It is apparent that all of these models have their flaws, and, as we have routinely stated in past decisions, the models should not be used rigidly or as definitive proxies for the determination of the investor-required return on equity. For example, Los Angeles' Kroman criticizes GTE-C's use of the DCF model and the CAPM model, and generally believes that other factors, such as interest rate levels and economic conditions are more valuable tools. API criticizes GTE-C's CAPM and DCF analyses more specifically. GTE-C itself spent much time and effort criticizing DRA's use of the constant growth DCF methodology and DRA's selection of the companies included in its barometer group. GTE-C also accuses DRA of manipulating the imput data in its risk premium analysis. Clearly, the arguments over inconsistencies in the use of these models are not confined to the ROE showing any one party.

With particular reference to DRA's cost of capital analysis, we are not convinced by GTE-C's arguments that DRA has manipulated the selection of companies in its barometer group in

order to obtain a predetermined outcome (i.e., a lower ROE). On cross-examination by the City of San Diego, DRA's witness clarified that exclusion of three new telephone companies and one gas company (inclusion of which GTE-C objected to) resulted in a reduction in the discount rate of approximately 10 to 15 basis points; therefore, by including the companies DRA's witness concluded that the result of the DCF analysis was actually increased (Tr. Vol. 3, p. 310).

We believe that the observation of a utility witness in an earlier Pacific Telephone general rate case (cited in Los Angeles' Brief, at p. 9) bears repeating:

> "To get empirical about it is almost impossible unless one could climb inside the mind of the common stock investor and know exactly what growth rate he is anticipating. That has always been impossible. No methodology I know of, including the widespread use of DCF, is able to climb inside the heads of all investors and come up with the right numbers, primarily because where one can use the mechanics of multiplying a retention rate times a projected rate of return on equity, that only gives you growth from plow-back, which is only one-third of the equation possibly. The other two ways for earnings to increase is if the investor is antcipating some improvement in the company's actual rate of return on equity, and then a third is the sale of stock above book value. ***." (A.83-01-022, RT. pp. 692-693.)

At bottom, the models are only helpful as rough gauges of the realm of reasonableness. In the final analysis we must rely on informed judgment rather than on any particular formula approach to establish the reasonable return on common equity. To do so, we assess the forecasts of overall economic conditions, the range of returns earned by comparable companies, and the relative risks faced by the particular utility under consideration (D.87-12-070, p. 20). In December 1987 when we last reviewed GTE-C's cost of equity, the prime interest rate was 8.7% to 9.00%, the discount

rate was 6.00%, the Dow Jones Utility Bond Average stood at 85.90, and the Dow Jones Utility Stock Average at 178.05. At the time hearings were held in this matter, the prime rate was 10%, and other short-term interest rates had also increased since year-end 1987, although to a lesser extent. Long-term utility bond yields are now a full percentage point lower than at the time of D.87-12-070 and stock yields are about 25 basis points lower. The Dow Jones Averages remain at about their former levels. In addition, GTE-C projects no new outside financing for the 1989 attrition year, whereas it had projected such a need in its last rate case.

This underscores the great weight of the evidence in this proceeding that GTE-C's levels of business and/or financial risk for attrition year 1989 are no greater than they were at the time D.87-12-070 was issued. Indeed, the improved equity ratio adopted in this decision is a positive factor for GTE-C. While GTE-C has argued that it is entitled to an increase in its currently authorized 12.75% ROE because that figure was premised on a lower risk now eliminated with issuance of D.88-08-061, we believe any such increase should be minimal, in recognition of the increase in short-term interest rates since year-end 1987. All things considered, we believe that a reasonable ROE for attrition year 1989 is 13.00%. This figure is well within the range of recommendations in the record, and falls at neither extreme.

Findings of Fact

1. In its 1989 financial attrition application, Pacific Bell sought to decrease its authorized intrastate rate of return from 12.12% to 11.96% premised on an average debt cost of 9.21%, a common equity return of 14.00%, and a capital structure composed of 42.5% debt and 57.5% equity.

2. Based on the testimony served prior to the scheduled commencement of hearings, the parties' 1989 attrition year recommendations varied greatly in such matters as the appropriate

percentage of common equity to be reflected in the capital structure, the elimination of preferred stock, and the cost factor applicable to common equity.

3. On the day evidentiary hearings were scheduled to begin, Pacific Bell and DRA indicated they were close to settlement of all issues. The settlement proponents thereafter continued negotiations, which involved all parties in the proceeding.

4. The parties reached an agreement resolving all issues and presented a Settlement Agreement and Stipulation (Appendix B hereto) signed by all parties. Bay Area Teleport, Western Burglar and Fire Alarm Association, and TURN signed the agreement, indicating that they did not oppose its adoption; all other parties specifically requested that the Commission adopt the settlement.

5. The parties have agreed that for intrastate ratemaking purposes, Pacific Bell's 1989 attrition year rates shall be based on: (1) a 13.00% return on common equity; (2) a 9.21% average cost of debt; (3) a capital ratio composed of 43.75% debt and 56.25% equity; and (4) a 11.34% overall rate of return.

6. Although the settlement proponents did not comply with Rule 51.1(b) of the Commission's Rules of Practice and Procedure, which requires the convening of at least one conference with at least 7 days advance notice and opportunity to participate provided to all parties for the purpose of discussing stipulations and settlements in a given proceeding, the proponents' extensive and successful efforts to involve all parties in the process after October 17 were sufficient to justify granting a waiver from Rule 51.1(b).

7. Pursuant to Rule 51.1(e), an uncontested settlement, such as that presented by the parties in A.88-07-019, will not be approved unless it is reasonable in light of the whole record, consistent with law, and in the public interest.

8. We will adopt the uncontested settlement agreement as reasonable because, on the whole, it is within the range of

recommendations presented to us in testimony served prior to settlement; further it is in the public interest to the extent that it will provide ratepayers the immediate benefits of a reduced revenue requirement.

9. In its 1989 financial attrition application GTE-C sought to increase its authorized intrastate rate of return from 10.90% to 12.08%, premised on a long-term debt cost of 9.03%, short-term debt cost of 8.75%, preferred stock cost of 6.35%, and common equity return of 14.50%, and a capital structure composed of 38.2% long-term debt, 1.9% short-term debt, 2.7% preferred stock, and 57.2% common equity.

10. While capital structure was an issue in dispute for the 1989 attrition year, all witnesses supported some increase in the presently authorized 53.5% equity percentage (DRA recommended 55% and GTE-C 57.2%).

11. GTE-C asserted that its requested 57.2% equity percentage was key to maintaining its current AA bond rating, but evidence presented by DRA tended to demonstrate that GTE-C has additional flexibility prior to reaching the Standard & Poor's 42% guideline for the AA rating, and that the additional equity build-up may not be cost-effective from the ratepayer perspective. These cost-effectiveness concerns were validated by the calculations of Los Angeles' witness which challenged GTE-C's assertions that the total cost of service is lower for AA rated utilities than for A rated utilities.

12. GTE-C asserts that it has no plans to issue long-term debt during the 1989 attrition year.

13. There is no tangible evidence in the record indicating that GTE-C would be unable to maintain its current bond rating if its recommended capital structure were not approved.

14. Higher bond ratings may well reduce interest costs, but in the case of GTE-C's proposed capital structure, the benefits of this reduction may be outweighed by an increase in the equity cost

component, which has a more significant impact on the overall cost of service.

15. DRA recommended capital structure, including its 55% equity percentage cap, which represents an increase over the presently authorized percentage, is reasonable in line with Value Line projections for 1988 and 1989, and is more responsive than GTE-C's proposal to the cost-effectiveness concerns discussed herein.

16. Cost factors of 9.03% for long-term debt, 8.2% for short-term debt, and 6.34% for preferred stock are virtually undisputed and, on that basis, reasonable for adoption for attrition year 1989.

17. Since December 1987, when we last reviewed GTE-C's cost of equity, short-term interest rates have risen modestly, but no other significant changes have occurred which would markedly increase GTE-C's current business or financial risks. Indeed the improved equity ratio adopted in this decision is a positive factor for GTE-C.

18. Based on our analysis of overall economic conditions, the range of returns earned by comparable companies illustrated in the various models used in this proceeding, and the relative risks faced by GTE-C, a reasonable ROE for attrition year 1989 is 13.00%; this results in an overall rate of return of 11.13%.

Conclusions of Law

1. The parties' request for waiver of Rule 51.1(b) of the Rules of Practice and Procedure should be granted because the due process protections embodied in these provision were effectively, albeit belatedly, extended to all parties by the settlement proponents.

2. The terms and conditions of the Settlement Agreement and Stipulation (Appendix B hereto), embodying a complete, total, and uncontested settlement of A.88-07-019 should be adopted in

furtherance of the ratepayer interest in immediate recognition of Pacific Bell's reduced revenue requirement for attrition year 1989.

3. GTE-C has not carried its burden of proof justifying an increase in its common equity ratio from the 53.50% adopted in December 1987, to 57.2%.

4. DRA's recommended capital structure for GTE-C, including its 55% equity percentage cap, should be adopted for the 1989 attrition year.

5. Cost factors of 9.03% for long-term debt, 8.2% for short-term debt, and 6.34% for preferred stock should be adopted for the 1989 attrition year.

6. A return on common equity of 13.00% should be adopted for GTE-C for attrition year 1989, resulting in an overall rate of return of 11.13%.

O R D E R

IT IS ORDERED that:

1. The following cost of capital is adopted for Pacific Bell for attrition year 1989 in accordance with the terms of the Settlement Agreement and Stipulation hereby adopted in its entirety:

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	43.75%	9.21%	4.029%
Preferred Stock	-	-	-
Common Equity	56.25	13.00	7.312
Total	100.00%		11.34%

2. The terms of the Settlement Agreement and Stipulation attached hereto as Appendix B are incorporated herein.

3. On or before December 28, 1988, Pacific Bell shall have filed advice letters and/or supplemental advice letters pursuant to

General Order 96-A to implement its 1989 attrition allowance effective January 1, 1989, based on (1) our resolution issued today in connection with its 1989 operational attrition advice letter filing, and (2) its financial attrition showing, as adjusted to reflect the rate of return adopted herein. Such advice letter shall also reflect the bill and keep surcharge/surcredit mechanism developed in response to the directives of D.88-08-024, and designed to coordinate the reflection of current memoranda account balances in rates with 1989 attrition, and interLATA and intraLATA SPF-to-SLU changes, using an estimated 1989 billing base.

4. The following cost of capital is adopted for GTE California Incorporated (GTE-C) for attrition year 1989:

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	40.50%	9.03%	3.66%
Short-term Debt	2.00	8.20	0.16
Preferred Stock	2.50	6.34	0.16
Common Equity	55.00	13.00	7.50
Total	100.00%		11.13%

5. On or before December 28, 1988 GTE-C shall have filed advice letters and/or supplemental advice letters pursuant to General Order 96-A to implement its 1989 attrition allowance effective January 1, 1989, based on (1) our resolution issued today in connection with its 1989 operational attrition advice letter filing, and(2) its financial attrition showing, as adjusted to reflect the rate of return adopted herein. Such advice letter shall also reflect the bill and keep surcharge/surcredit mechanism

developed in response to the directives of D.88-08-024, and designed to coordinate the reflection of current memoranda account balances in rates with 1989 attrition, and interLATA and intraLATA SPF-to-SLU changes, using an estimated 1989 billing base.

This order is effective today.

Dated December 19, 1988, at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners

We will file a written concurring opinion.

/s/ STANLEY W. HULETT
President

/s/ G. MITCHELL WILK
Commissioner

I will file a written concurring opinion.

/s/ DONALD VIAL
Commissioner

I will file a written concurring opinion.

/s/ FREDERICK R. DUDA
Commissioner

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Victor Weisser, Executive Director

APPENDIX A

List of Appearances

Applicant in A.88-05-009: Rufus G. Thayer, Attorney at Law, Hassan Mirza and Terry Mowrey, for Division of Ratepayer Advocates.

Applicant in A.88-07-017: Richard M. Cahill and Kenneth K. Okel, Attorneys at Law, for GTE-California, Incorporated.

Applicant in A.88-07-019: Daniel J. McCarthy and Michael D. Sasser, Attorneys at Law, for Pacific Bell.

Interested Parties: Mark Barmore, Attorney at Law, for Toward Utility Rate Normalization; Pelavin, Norberg & Beck, by Alvin H. Pelavin, Jeffrey F. Beck, Lizbeth M. Morris, Attorneys at Law, John H. Engel, Attorney at Law, and A. J. Smithson, for Citizens Utilities Company of California; E. Garth Black and Mark B. Shull, for Roseville Telephone Company; Orrick, Herrington & Sutcliffe, by Robert J. Gloistein, Attorney at Law, and Thomas J. Burke, for Contel of California, Inc.; Randolph W. Deutsch, Richard A. Bromley, Attorneys at Law, for AT&T Communications, Inc.; John W. Witt, City Attorney, by William S. Shaffran and Leslie Girard, Deputy City Attorneys, for City of San Diego; C. Hayden Ames, Attorney at Law, for Chickering & Gregory; Jerry Appleby by Ken Joseph for Jerry Appleby-Security Pacific Automation Company; Benjamin H. Dickens, Jr., Attorney at Law, for API Alarm Systems; Earl Nicholas Selby, Attorney at Law, for Bay Area Teleport; Cecil O. Simpson, Jr., Attorney at Law, for U.S. Department of Defense and all other Federal Executive Agencies; Shelley Ilene Smith, Assistant City Attorney, for City of Los Angeles; Manuel Kroman and Sidney J. Webb, appearing for themselves.

(END OF APPENDIX A)

APPENDIX B

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of PACIFIC BELL (U 1001 C), a corporation, for a review of its cost of capital and capital structure.	Application 88-07-019

MOTION FOR WAIVER PURSUANT TO RULE 51.10 AND
MOTION TO ADOPT SETTLEMENT AGREEMENT AND STIPULATION

In Ordering Paragraph No. 3 of Resolution T-12079, dated April 13, 1988, the California Public Utilities Commission ("Commission") ordered Pacific Bell ("Pacific") to file an application, testimony and exhibits for capital structure and cost of capital review for 1989. In response, on July 15, 1988, the Application of Pacific Bell for a Review of its Cost of Capital and Capital Structure (A.88-07-019) along with supporting testimony and exhibits (hereinafter "Pacific's Application") was filed by Pacific with the Commission. Prepared testimony was also submitted by the Commission's Division of Ratepayer Advocates ("DRA"), the City of Los Angeles ("City of L.A."), and the U.S. Department of Defense and all other Federal Executive

Agencies ("DOD"). The matter was set for hearings beginning October 17, 1988.

Pursuant to discussions held on the first day of scheduled hearings, the parties to Pacific's Application agreed and stipulated, for intrastate ratemaking purposes, that Pacific Bell's 1989 attrition year rates shall be based upon the following:

1. The return on common equity for Pacific for attrition year 1989 shall be 13 percent;
2. The average cost of debt for Pacific for attrition year 1989 shall be 9.21 percent;
3. The debt and equity ratio utilized to set rates for Pacific for attrition year 1989 shall be 43.75 percent debt and 56.25 percent equity, and the actual debt and equity ratio may vary;
4. The rate of return on total capital for Pacific for attrition year 1989 shall be 11.34 percent.

A summary of the recommendations of Pacific, the DRA, the City of L.A., and the DOD, and the terms of this Settlement Agreement and Stipulation ("Agreement") with respect to Pacific's Application, are set forth below.

APPENDIX B

Comparison of Parties' Recommendations
with the Proposed Settlement Agreement and Stipulation

	Pacific	DRA	City of L.A.	DOD	Proposed Settlement
% Debt	42.5	45	45	45	43.75
% Preferred Stock	-	-	-	5	-
% Equity	57.5	55	55	50	56.25
Cost of Debt	9.21	9.21	9.21	9.21	9.21
Cost of Preferred Stock	-	-	-	9.0	-
Cost of Equity	14	12.25-12.75	13.25	11.4	13.0
Rate of Return	11.96	11.02*	11.43	10.30	11.34

*Utilizes midpoint of cost of equity recommendation

The undersigned parties desire to resolve the issues associated with Pacific's Application and have, therefore, entered into the Agreement which is incorporated herein. The parties entered into this Agreement on the basis that all of the elements of the Agreement be adopted, without modification of any individual element of the Agreement.

Every appearance in this proceeding has either agreed to the terms and conditions of the Agreement or stated that they will not oppose it. Accordingly, pursuant to Rule 51.10 of the

Commission's Rules of Practice and Procedure ("Rules"), the parties request that the Commission waive its Rules on Stipulations and Settlements to the extent necessary to allow the Commission to issue its decision based solely on this Motion and Agreement incorporated herein. The diverse interests represented by the parties and the unanimity of their position with respect to the Agreement demonstrate that the public interest will not be impaired by the waiver of those Rules.

Consistent with Rule 51.8 of the Commission's Rules, the parties entered into the Agreement on the basis that the Commission's adoption of the terms and conditions set forth therein not be construed as a precedent regarding any principle or issue in any current or future proceeding. The parties expressly recognize that the issues resolved by the Agreement should not be construed as reflecting the views or position of any party except as a reasonable and appropriate compromise of the issues involved with Pacific's Application. The Agreement is, therefore, a complete and total settlement of Pacific's Application. Further, each party specifically agrees that this settlement and its terms and conditions shall not be used in any manner whatsoever in GTE California, Inc.'s Application No. 88-07-017.

In addition, the Commission may take official notice and consider the prepared testimony of Pacific and the DOD, as well as those portions of the prepared testimony of the DRA (Witness Blunt) and the City of L.A. (Witness Kroman) concerning Pacific's

Application which were marked for identification in this proceeding but which were not received into evidence, for the sole purpose of recognizing the recommendations of the parties concerning cost of capital and capital structure and that the terms of the Agreement constitute a compromise by each party. Each party recognizes that the terms of the Agreement represent a compromise between the various recommendations proposed by those parties who filed testimony concerning Pacific's recommendation.

This Agreement recognizes that the return on equity recommendations ranged from 11.40 percent to 14.00 percent, and the compromise of 13.00 percent was greater than DOD's recommended 11.40 percent and DRA's midpoint recommendation of 12.50 percent yet less than Pacific's recommendation of 14.00 percent and close to the City of L.A.'s recommendation of 13.25 percent. Furthermore, the return on debt of 9.21 percent was not contested by any party. The capital structure recommendations varied as to the recommended percentage of debt which should be utilized for ratemaking in the 1989 attrition year. Pacific recommended 42.5 percent debt while all other parties recommended 45 percent debt. The Agreement utilizes a midpoint of 43.75 percent debt. The overall rate of return in the Agreement, 11.34 percent, similarly represents a compromise between the DOD's recommendation of 10.30 percent, DRA's recommendation of 11.02 percent, the City of L.A.'s recommendation of 11.43 percent, and Pacific's recommendation of 11.96 percent. For all of these reasons, the terms of the Agreement are a reasonable compromise,

and each party further agrees that the Agreement reached is in the public interest.

For all the foregoing reasons, the undersigned parties respectfully request the Commission to grant these Motions and adopt the Settlement Agreement and Stipulation contained herein.

Respectfully submitted,

Party	By	Dated
DIVISION OF RATEPAYER ADVOCATES		10/15/88
PACIFIC BELL		
GTE CALIFORNIA, INCORPORATED		10/18/88
CITY OF LOS ANGELES		10/18/88
U.S. DEPARTMENT OF DEFENSE AND ALL OTHER FEDERAL EXECUTIVE AGENCIES		10/15/88
API ALARM SYSTEMS		10/18/88
CITY OF SAN DIEGO		10/15/88

APPENDIX B

Party	By	Dated
SIDNEY J. WEBB		

I have read the foregoing MOTION FOR WAIVER PURSUANT TO RULE 51.10 AND MOTION TO ADOPT SETTLEMENT AGREEMENT AND STIPULATION, and do not oppose adoption of the Settlement Agreement and Stipulation.

Party	By	Dated
TOWARD UTILITY RATE NORMALIZATION	Mark E. Barmore (RTS)	10/14/88

APPENDIX B

Party	By	Dated
CITIZENS UTILITIES COMPANY OF CALIFORNIA	[signature]	10/19/88

APPENDIX B

Party	By	Dated
ROSEVILLE TELEPHONE COMPANY	Mark P. Schultz	12/13/88

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Party	By	Dated
CONTEL OF CALIFORNIA, INC.	Orrick, Herrington & Sutcliffe Robert J. Gloistein	October 18, 1988

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Party	By	Dated
AT&T COMMUNICATIONS OF CALIFORNIA, INC.		10/18/89

APPENDIX B

Party	By	Dated
CHICKERING & GREGORY	C. Hayden Ames	Oct 18 1988

APPENDIX B

Party	By	Dated
JERRY APPLEBY - SECURITY PACIFIC AUTOMATION COMPANY, INC.		

APPENDIX B

Party	By	Dated
MANUEL KROMAN	[signature]	10-18-88

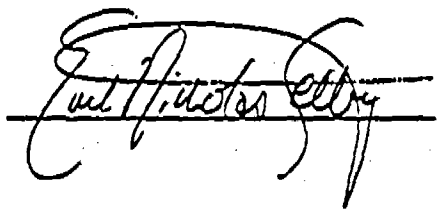
APPENDIX B

I have read the foregoing MOTION FOR WAIVER PURSUANT TO RULE 51.10 AND MOTION TO ADOPT SETTLEMENT AND STIPULATION and do not oppose adoption of the Settlement Agreement and Stipulation.

Party	By	Dated
WESTERN BURGLAR AND FIRE ALARM ASSOCIATION		October 18, 1988

APPENDIX B

I have read the foregoing MOTION FOR WAIVER PURSUANT TO RULE 51.10 AND MOTION TO ADOPT SETTLEMENT AGREEMENT AND STIPULATION, and do not oppose adoption of the Settlement Agreement and Stipulation.

Party	By	Dated
BAY AREA TELEPORT		10-19-88

(END OF APPENDIX B)

A.88-05-009
D.88-12-092

STANLEY W. HULETT, President and G. MITCHELL WILK, Commissioner, Concurring:

We support the majority decision in this case, and we are generally pleased with the workings of the combined cost of capital proceeding.

At the same time, this order brings into focus for us just how crucial our adopted rates of return and capital structure are for ensuring the financial stability and health of the utilities we regulate. We have noted that recent movements in many financial and economic indices point toward 1989 being a year of greater risk and uncertainty, perhaps even greater than the financial attrition orders which we adopt today may reflect.

Since the returns compensate utility shareholders for the risks they bear in investing in these companies, we believe that we must, in times of uncertainty, be prepared to re-evaluate the strength of each of our utilities' financial structure. Failure to do so only hurts ratepayers to the extent inappropriate capital structure jeopardizes the ability of utilities to serve the lowest possible cost of capital.

In order to provide an ongoing and up-to-date picture of the utilities' financial health, we will ask the Commission's Advisory and Compliance Division to provide quarterly reports on financial indices and other measures of risk to help determine whether the Commission should revisit the rates we set today.

STANLEY W. HULETT, President

G. MITCHELL WILK, Commissioner

December 19, 1988
San Francisco, California

DONALD VIAL, Commissioner, Concurring:

I concur in the decision, but I think it was a serious mistake to have deleted major portions of the ALJ's discussion in arriving at the same outcome in reference to PacBell's Attrition. In this respect I must distinguish myself from my fellow Commissioners by pointing out that the adopted decision gives short shrift to a serious problem concerning evidentiary support for Pacific's stipulated 56% equity 43.759% debt capital structure and 13.0% return on equity. While the parties' pre-settlement positions were supported by pre-filed testimony, the numbers in the settlement were not justified by any evidence bearing directly on the settlement. Despite repeated requests by the ALJ for evidentiary support, the parties did not respond with any evidence. As a result, the ALJ painstakingly reviewed the pre-filed testimony in an attempt to find evidence to support the settlement figures in their testimony intended to support an equity ratio ranging from 50% to 57.5% and a return on equity of 11.4% to 14.0%. With much concern about evidentiary support, the ALJ approved the stipulation.

The ALJ's Proposed Decision was circulated on November 18 as required by Section 311 of the Public Utilities Code. Upon reviewing the utility's response, and in response to the request of my fellow Commissioners, the ALJ prepared a substantially revised draft of her proposed decision which became the adopted decision. Pages 19-24 in the Proposed Decision, which expressed reservations about the compromise cap structure have been deleted and replaced with text at pages 20 and 21 that is less critical, while providing some guidance to the parties. Pages 37-38 of the Proposed Decision, which discusses adoption of the compromise 13% ROE for PacBell, have been re-written "in a more positive tone."

The ALJ's task in this case was to evaluate what is in the record before us and to use her judgment in deciding whether or not it adequately supports the parties' position. If there is

doubt in her mind about the reasonableness of the parties' request, then that doubt should be resolved before the request is granted. It should not be swept under the rug. To be fair and effective, our decision making process must be candid. Otherwise, the Commission may find itself committed to a regulatory course from which it cannot escape since it never knew how it got there.

Industry observers should also note that this Commission may not review Pacific's capital structure and return on equity again before the company's California Plan for Rate Stability, (its recommendation for an alternative to traditional cost-of-service ratemaking) is acted upon. The Commission had not anticipated a review of these matters, usually addressed in financial attrition or general rate case applications, in the course of its investigation into alternative regulatory frameworks for local exchange companies (OII 87-11-033 "the OII"). Thus, it appears even more crucial to have either firmly supported capital structure and ROE numbers or a clear idea of what issues remain to be addressed. The ALJ wrote that the 13% ROE was an issue that would benefit from the evidentiary hearings to be held in connection with the next review of PacBell's cost of capital. She anticipated that this review would occur over the next few months when PacBell's testimony in the OII is reviewed. The fact that this acknowledgement of subsequent review is excised gives me concern about whether or not the Commission is going to deal with the costs and benefits of a particular ROE. As detailed below, the ALJ based her approval of the stipulated capital structure and ROE on the fact that the settlement offered ratepayers an immediate and substantial reduction in rates, and contemplated that capital structure and return on equity could be revisited in the context of the upcoming investigation. By excising the ALJ's draft discussion, this Commission shows that it has no interest in revisiting the issue.

With this in mind, I offer the ALJ's original discussion of the capital structure provided for in the compromise, (pages 19-24 of the ALJ Carew's Proposed Decision) for the record in order to bring into sharp focus the inadequacy of the decision's substitute language approving the capital structure compromise. The ALJ's discussion, which I would have much preferred to have been left in the final decision, rather than be excised, is as follows:

...

"In the settlement agreement, the parties state that the settlement of the capital structure issues is in the public interest because it is a reasonable compromise. However, in reciting the terms of their compromise (Settlement Agreement p. 5), the parties say nothing about the variance in their capital structure equity ratio recommendations; they speak only in terms of the recommended percentage of debt, indicating that Pacific Bell recommended 42.5% debt while all other parties recommended 45% debt.

"We have real concerns over the proposed settlement's disposition of the percentage of common equity issue. Approval of the proposed settlement will increase the percentage of common equity authorized in Pacific Bell's capital structure from 51.50% at present to 56.25%. If the concerns expressed by FEA's Winter, City's Kroman, and DRA's Blunt are legitimate, the substantial increase in the equity component of Pacific Bell's capital structure may not be consistent with a cost-efficient operation. Indeed, we would have welcomed the opportunity to hear evidence on whether a capital structure in the range recommended by FEA's Winter (45% debt/55% equity) is more cost-efficient, and whether Winter's criticism that Pacific Bell's affirmative showing lacks quantitative evidence of the

relative costs of alternative capital structures is valid.

"DRA's Blunt raised issues about the impacts of a high equity component on Pacific Telesis, which are disquieting, to say the least, given this Commission's longstanding concerns about the impacts of diversification. These questions too, were subordinated to the goal of reaching a compromise.

"In addition, it is undisputed that the proposed settlement's recommended capital structure will lower Pacific Bell's financial risk by increasing the common equity percentage over that presently authorized. Presumably the settling parties have decided that the recommended 13% return on equity takes that diminished risk into account, but we have some concerns that it does not, and that it may therefore be excessive. These are issues which will benefit from more careful review during the evidentiary hearings to be held in connection with the next review of Pacific Bell's cost of capital. Since Pacific Bell has submitted such testimony in I.87-11-033.87-11-033, we anticipate that this review will be conducted over the next few months. But for that fact, we would seriously consider reconvening evidentiary hearings to explore these issues further.

"For the moment, we put aside our qualms about the high equity percentage because the parties, who represent extremely diverse views on the issue, have presented us with an uncontested and unanimous compromise of the issue. For this reason alone, and understanding that we will have an early opportunity to revisit the issue, we approve the compromise capital ratio comprised of 43.75% long term debt and 56.25% common equity.

"In so doing, we effectively eliminate preferred stock from the capital structure for the 1989 attrition year. However, in order to provide a framework for addressing the issue in the next cost of capital review, we address certain key concerns.

"Prior to entering into the proposed settlement, FEA had recommended that the capital structure include a layer of preferred stock, on the rationale that:

> 'Preferred stock sales offer an acceptable means of obtaining new, or replacement, funding. Numerous firms, both utility and nonutility, have utilized preferred stock in their capital structures. Financing via this means offers advantages over some alternatives and should therefore be considered in the capital structure analysis.' (Exhibit 4, p. 8.)

"Nonetheless, FEA joined with the other parties in the proceeding to recommend the capital structure included in the proposed settlement, which does not contain a preferred stock component.

"In addition, the compromise capital structure represents a significant change from the present authorization, because it removes the 6% preferred stock imputation imposed by the Commission in D.82-05-007.

"D.82-05-007 was issued in the proceeding initiated by the Pacific Telephone and Telegraph Company (PT&T) seeking approval of an Agreement and Plan of Merger with AT&T. Under the terms of the merger, AT&T would acquire all the outstanding voting preferred and common shares of PT&T, which would thereafter be cancelled, leaving one share of Pacific Transition Corporation (PTC) common stock as the sole

remaining voting share of PT&T.[1] PT&E had $82 million of voting preferred shares outstanding carried at a cost of 6%. With Cancellation of this 6% preferred, as proposed, PT&T's capital ratios of preferred and common would change; $82 million would shift from preferred on AT&T's balance sheet to common equity. In effect the voting preferred would be converted into common equity, which at PT&T's last authorized return granted in D.93367 would be carried at a cost of 17.4%. The difference between the 6% cost of PT&T's outstanding voting preferred and the 17.4% cost of common equity was projected to increase PT&T's revenue requirement by $11.480 million annually.

"To address this concern, the Commission staff recommended that the Commission should either deny the request to cancel the 6% voting preferred, or impute a 6% cost to $82 million of common stock equity in every future rate case of Pacific. Either of these recommendations were designed to eliminate the cost to ratepayers of cancelling the voting preferred.

"In D.82-05-007, the Commission adopted the staff recommendation to impute a 6% cost to $82 million of common equity in future Pacific general rate proceedings.

"This imputation has been made in every subsequent ratemaking proceeding for Pacific Bell. Most recently in D.86-01-026 the Commission stated:

> 'We will continue to impute the $82 million at 6% voting preferred stock to PacBell's capital structure as recommended by TURN, which lowers the common equity component from 52.10% to 51.50%. PacBell and staff

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1 PTC, the "disappearing corporation" in the merger arrangement, was ultimately merged into PT&T.

> recommend eliminating this imputation, which was adopted in the last rate proceeding (d.84-04-104), because we are in a post-divestiture environment and this increment of low cost capital is gone. TURN's brief is persuasive. the 6% preferred was recalled to suit the interests of Pacific Telephone's majority shareholder, AT&T, just prior to divestiture, and make the spinoff of Pacific Telephone easier. The loss of this $82 million of cheap capital worked to benefit shareholders and increase the overall cost of capital borne by ratepayers.' (d.86-01-026, mimeo. p. 15.)

"In A.85-01-034 TURN had recommended a present worth adjustment to PacBell's revenue requirement as a means of essentially making it "buy out" ratepayers and compensate them for the loss of the 6% preferred stock, amortizing the impact over test-year '86 and the two following attrition years. The Commission rejected this approach, agreeing with Pacific Bell that the details of such a one-time buyout adjustment warranted detailed hearing-room analysis to review the applicable discount rate, term, et cetera, and stating:

> 'It may be that in the next proceeding staff or PacBell will propose such an adjustment in lieu of our continuing the adjustment we adopt again today, and which we will continue to adopt until we find some means of equitably ending it from the ratepayers' perspective.'
> (D.86-01-026, mimeo, p. 16.)

"In pre-settlement testimony, both Pacific Bell and DRA recommended discontinuance of the 6% imputation on the rationale that the capital structure contained no preferred stock. However, neither DRA nor Pacific Bell proposed any sort of adjustment as contemplated by the Commission in D.86-01-026 designed to equitably end the adjustment from the ratepayers' perspective. Instead, all parties to the proceeding, including FEA

(which proposed a layer of preferred stock (through not explicitly 6% voting preferred) in its pre-settlement testimony) and TURN which had litigated this issue extensively in Phase 1 of A.85-01-034, compromised in a manner that effectively eliminated the 6% imputation for the attrition year. Nonetheless, we also understand that these parties have reserved their rights for the future, and on this basis alone we adopt the compromise. We will revisit the entire issue of Pacific Bell's capital structure in the next cost-of-capital review, where we hope to see these issues fully aired."

The ALJ's language discussing the adoption of the 13% return on equity compromise is equally revealing of the inadequacy of the adopted language in the decision. I would have preferred the following ALJ discussion, which originally appeared at pages 37 and 38 of her Proposed Decision:

"The pre-settlement recommendations on the cost of equity for attrition year 1989 cover a wide range (11.4% to 14.00%), and the proposed settlement contains a stipulated ROE of 13.00%. While that figure is well within the recommended ranges, and no party to the proceeding opposes its adoption, there are serious questions not addressed in the settlement document. As discussed previously, the proposed settlement contains general language that the result proffered to the Commission is in the public interest, and that in recommending the 13% figure the parties have compromised their presettlement positions. However, given the general nature of this language, and our lack of detailed knowledge about the implicit trade-offs involved in the parties' negotiating process, we are

left with certain doubts about the reasonableness of the compromise.

"On the one hand, adoption of the 13% compromise figure appears, on the surface, to be a reasonable compromise; it represents a 200 basis point reduction in the currently authorized 15% return on equity which has been in place since 1986, and therefore furthers the ratepayer interest in recognition of an improved financial environment since January 1986. However, some of the recommendations presented in this proceeding indicate that a far lower return on equity may be appropriate for the attrition year. Nonetheless, because of the unanimity of the settlement, these recommendations are not in evidence before us.

"We have also indicated our concern that the capital structure proposed in the settlement document may not be the most cost effective capital structure we might have chosen after reviewing all the evidence. Given the high equity component in the recommended capital structure, we may have given serious consideration to adopting a lower ROE in recognition of reduced risk.

"For now, we are constrained to adopt the 13% ROE contained in the proposed settlement. Our only alternative rejection of the settlement or submission to the parties of a "counter proposal", is feasible because it would preclude us from resolving this matter by the end of the year and providing to ratepayer's the benefits of the reduced ROE embodied in the settlement agreement. Essentially, the proposed settlement results in a revenue requirement reduction of $127 million and that provides some rationale for adopting it and resolving this matter as attrition year 1989

begins. Thus we approve the settlement in accord with Rule 51.1(e). We accept this outcome, with the realization that the parties will revisit cost-of-capital in I.87-11-033, where such testimony has been presented. We believe there is great benefit inherent in a thorough review of these issues in I.87-11-033 over the next few months."

With these modifications, I think the Commission would have been in a much better position to take another look at the cost of capital in the context of Phase II regulatory reform proposals being heard in the OII. Unfortunately, the Commission has discarded the ALJ's perceptive analysis and appears ready to overlook the need for a more thorough analysis of these issues in the course of its investigation of alternative regulatory frameworks for local exchange companies.

Donald Vial, Commissioner

December 19, 1988
San Francisco, CA

FREDERICK R. DUDA, Commissioner, concurring.

Although I concur in the adoption of this decision, I have great concerns regarding the capital structure adopted for Pac Bell.

Approval of the capital structure agreed to during settlement negotiations will increase the percentage of common equity authorized in PacBell's capital structure from 51.50% to 56.25%. While I understand the utility's obvious interest in having as large a percentage of equity as possible in order to retain a favorable bond rating and increase shareholder profits, I am not convinced that the equity ratio we adopt today is consistent with a cost effective utility operation.

A capital structure burdened with too great an equity component increases costs to ratepayers while providing no corresponding benefits. Once a favorable bond rating is achieved, an increase in equity does little or nothing to reduce the utility's cost of capital. But an increase in equity does reduce the level of debt and, subsequently, the level of interest deduction available to the utility to reduce its tax burden.

Although PacBell's high level of current earnings and self-generation of virtually all the funds necessary for modernization make it easy for PacBell to increase the equity component at this time, my fears that PacBell's equity component has grown too large are not abated by the testimony submitted in this proceeding prior to the settlement. FEA's Winter, City's Kroman, and DRA's Blunt all expressed concern about PacBell's equity rich capital structure. The capital structure - return on equity settlement was presented without any indication why these

witnesses now thought that 56.5% was a reasonable figure, and it may be that it resulted from the give and take of parties too eager to reach a settlement for settlement's sake.

I am also concerned about the effect of a high equity component on the PacBell - Pac Telesis relationship. DRA's Blunt raised cross-subsidy issues which are very significant in light of the Commission's long standing concerns about the impact of diversification. These issues were not resolved to my satisfaction, having become subordinated to the goal of reaching a compromise.

In addition, I am concerned that the settlement figure for return on equity may not adequately take into account the reduction in financial risk resulting from the very substantial increase in authorized equity.

The above issues would benefit from a more careful review during the evidentiary hearings to be held in connection with the next review of PacBell's cost of capital. Since PacBell has submitted such testimony in the new regulatory framework proceeding, I anticipate that this review will be conducted over the next few months. But for that fact, I would be inclined to reject the settlement in favor of reconvening hearings to explore these issues further.

Another issue of great concern to me is the decision's removal of the 6% preferred stock imputation imposed by the Commission in D.82-05-007.

D.82-05-007 was issued in the proceeding intitated by the Pacific Telephone and Telegraph Company (PT&T) seeking approval of an Agreement and Plan of Merger with AT&T. Under the terms of the merger, AT&T would acquire all the outstanding voting preferred and common shares of PT&T, which would thereafter be cancelled, leaving one share of Pacific Transition Corporation (PTC) common stock as the sole remaining voting share of PT&T.

PT&T had $82 million of voting preferred shares outstanding carried at a cost of 6%. With cancellation of this 6% preferred, as proposed, PT&T's capital ratios of preferred and common would change; $82 million would shift from preferred on AT&T's balance sheet to common equity. In effect, the voting preferred would be converted to common equity, which at PT&T's last authorized return granted in D.93367 would be carried at a cost of 17.4%. The difference between the 6% cost of PT&T's outstanding voting preferred and the 17.4% cost of common equity was projected to increase PT&T's revenue requirement by $11.480 million annually.

To address this concern, the Commission staff recommended that the Commission should either deny the request to cancel the 6% voting preferred, or impute a 6% cost to $82 million of common equity in every future rate case of PacBell. Either of these recommendations were designed to eliminate the cost to the ratepayers of cancelling the voting preferred.

In D.82-05-007, the Commission adopted the staff recommendation to impute a 6% cost to $82 million of common equity in future PacBell general rate proceedings.

This imputation has been made in every subsequent ratemaking proceeding for PacBell. Most recently, in D.86-01-026 the Commission stated:

> "We will continue to impute the $82 million at 6% voting preferred stock to PacBell's capital structure as recommended by TURN, which lowers the common equity component from 52.10% to 52.50%. PacBell and staff recommend eliminating this imputation, which was adopted in the last rate proceeding (D.84-04-104), because we are in a post-divestiture environment and this increment of low cost capital is gone. TURN's brief is persuasive. The 6% preferred was recalled to suit the interests of Pacific Telephone's majority shareholder, AT&T, just prior to divestiture, and make the spinoff of Pacific Telephone easier. The loss of this $82 million of cheap capital worked to benefit shareholders and to increase the overall cost of capital borne by ratepayers." (D.86-01-026, mimeo. p. 15)

In A.85-01-034 TURN had recommended a present worth adjustment to PacBell's revenue requirement as a means of essentially making it "buy out" ratepayers and compensate them for the loss of the 6% preferred stock, amortizing the impact over test year 1986 and the two following attrition years. The Commission rejected this approach, agreeing with PacBell that the details of such a one time buyout adjustment warranted detailed hearing-room analysis to review the applicable discount rate, term, et cetera, and stating:

> "It may be that in the next proceeding staff or PacBell will propose such an adjustment in lieu of our continuing the adjustment we adopt again today, and which we will continue to adopt until we find some means of equitably ending it from the ratepayers' perspective." (D.86-01-026, mimeo. p. 16.)

In pre-settlement testimony, both PacBell and DRA recommended discontinuance of the 6% imputation on the rationale that the capital structure contained no preferred stock. However, neither DRA nor PacBell proposed any sort of adjustment as contemplated by the Commission in D.86-01-026 designed to equitably end the adjustment from the ratepayers' perspective. Instead, all parties to the proceeding, including FEA, and TURN, which had litigated this issue extensively in Phase 1 of A.85-01-034, compromised in a manner that effectively eliminated the 6% imputation <u>for the attrition year</u>. Nonetheless, I understand that these parties have reserved their rights for the future, and on this basis alone I can accept the compromise. I hope this issue wil be fully aired when we revisit the entire issue of PacBell's capital structure in the next cost-of-capital review.

Before I leave this subject, I will simply note that the 6% imputation was made for very good reasons - to compensate ratepayers for allowing the conversion of PT&T preferred stock to common equity which at that time earned 17.4%. It is clearly

disinengenuous to say that the imputation is no longer important since there is no more preferred stock in the capital structure, since the elimination of the preferred stock was the underlying cause of the imputation in the first place. I am not impressed by the arguments made by DRA and PacBell to that effect.

I will close by stating that I am going along with this decision only because I understand that PacBell's capital structure will soon be reexamined in connection with the new regulatory framework proceeding, and because I understand that the 6% preferred stock imputation is not permanently eliminated by this decision, but is merely set aside as part of a settlement compromise affecting the 1989 attrition year only.

Frederick R. Duda, Commissioner

December 19, 1988
San Francisco, California

ALJ/LTC/rsr

Item 6
Agenda 12/19/88

Decision 88 12 092 DEC 19 1988 (Mailed 11/18/88)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of the Commission's Division of Ratepayer Advocates for Modification of Resolution No. T-12079 Re Revenue Requirement Impact of 1988 Attrition for Pacific Bell.	Application 88-05-009 (Filed May 6, 1988)
Application of GTE California Incorporated, a corporation, (U 1002 C), for authority to increase certain intrastate rates and charges for telephone services to offset 1989 financial attrition.	Application 88-07-017 (Filed July 15, 1988)
In the Matter of the Application of PACIFIC BELL (U 1001 C), a corporation, for a review of its cost of capital and capital structure.	Application 88-07-019 (Filed July 15, 1988)

(Appearances are listed in Appendix A.)

O P I N I O N

I. Summary of Decision

This decision addresses 1989 financial attrition issues for Pacific Bell and GTE-California Incorporated (GTE-C).

The decision adopts the terms of the Settlement Agreement and Stipulation presented by all parties in Pacific Bell's financial attrition proceeding (Application (A.) 88-07-019), authorizing Pacific Bell to earn a return on common equity of 13.00% and a return on total capital of 11.34%. The average cost of debt is 9.21%. The adopted capital structure is 43.75% debt and 56.25% common equity. Adoption of the Settlement Agreement will result in a revenue requirement reduction of approximately

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$127.1 million, although the final revenue impact will not be known until the Commission Advisory and Compliance Division (CACD) completes its review of the utility's 1989 operational attrition filing.

GTE-C's 1989 financial attrition application (A.88-07-017) was contested. Following evidentiary hearings, the decision authorizes GTE-C to earn a return on common equity of 12.75% and a return on total capital of 10.99%. The adopted cost factors for long-term debt, short-term debt, and preferred stock are 9.03%, 8.2%, and 6.34%, respectively. The adopted capital structure is composed of 40.50% long-term debt, 2.00% short-term debt, 2.50% preferred stock, and 55.00% common equity. The revenue requirement impact of this decision is approximately $6.4 million, although the final impact hinges on review of GTE-C's 1989 operational attrition filing.

In addition, pursuant to Decision (D.) 88-08-024 in Order Instituting Investigation (I.) 87-11-033, for both Pacific Bell and GTE-C there are memoranda account and advice letter impacts which will converge with the 1989 financial and operational attrition impacts at year-end 1988, thereby affecting existing billing surcharges/surcredits.[1] As of the date of publication of this proposed decision, the overall year-end change in billing surcharges/surcredits remains to be calculated. However, it will be included in the Commission's final decision.

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1 "We will require Pacific and GTE-C make advice letter filings no later than October 1, 1988 and that the Commission's Advisory and Compliance Division (CACD) hold workshops shortly thereafter, to develop bill-and-keep surcharge/surcredit mechanisms to be effective January 1, 1989 which coordinate with 1989 attrition and interLATA and intraLATA SPF-to-SIU changes, and which use an estimated 1989 blling base. ****" (D.88-08-024, mimeo. p. 19.)

II. Procedural Background

On May 6, 1988, the Division of Ratepayer Advocates (DRA) filed Application (A.) 88-05-009 seeking modification of our 1988 attrition resolution (Resolution T-12079) in order to obtain clarification of the operational attrition mechanism, and issuance of an order requiring Pacific Bell and GTE-C to file 1989 financial attrition applications to be heard on a consolidated record.[2] In D.88-06-024 we granted DRA's request, requiring GTE-C to file a 1989 operational attrition advice letter by October 1, 1988 (consistent with our treatment of Pacific Bell for the 1989 attrition year); we also specified that Pacific Bell and GTE-C should file separate applications, testimony, and exhibits constituting their affirmative showings for attrition year 1989 capital structure and cost of capital review.[3]

A prehearing conference (PHC) was held before Administrative Law Judge (ALJ) Carew on June 21, 1988. At that time, a schedule was adopted for the submission of testimony and for evidentiary hearings both on financial attrition and disputed operational attrition issues. However, at the PHC DRA indicated that it wished to convene workshops to attempt to resolve the disputed operational attrition issues. These workshops were held at the end of June, 1988, and on July 12, 1988, DRA filed its Attrition Methodology Workshop Report (the Report). That Report,

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2 Other relief requested in the DRA application relative to the mid-sized telephone companies (ConTel of California, Inc., Citizens Utilities Company of California, and Roseville Telephone Company) is addressed in a separate decision issued in this docket.

3 In compliance with D.88-06-024, on July 15, 1988 Pacific Bell filed A.88-07-019 and GTE-C filed A.88-07-017. These matters have been consolidated with DRA's A.88-05-009 pursuant to Rule 55 of the Commission's Rules of Practice and Procedure.

including attached stipulation, embodied the consensus resolution of all disputed operational attrition issues by DRA, Pacific Bell, GTE-C, AT&T Communications of California (AT&T-C), and TURN. In D.88-09-028, we considered and adopted that stipulation for purposes of the review of 1989 operational attrition issues for Pacific Bell and GTE-C.[4]

With the issuance of D-88-09-028 and resolution of the disputed 1989 operational attrition issues, hearings commenced on October 17, 1988, limited to financial attrition issues. These hearings continued through October 19, 1988.

In support of its financial attrition request, Pacific Bell presented the testimony of Lydell Christensen, John A. Hardy, and Dr. James H. Vander Weide. DRA presented the testimony of Christopher J. Blunt. The Federal Executive Agencies (FEA) presented testimony by Philip R. Winter. In view of the fact that a complete settlement was reached in Pacific Bell's application, as discussed more fully below, this testimony was identified but not received in evidence.

GTE-C presented the testimony of two witnesses in support of its financial attrition request: Joseph F. Brennan and Charles J. O'Rourke. DRA submitted the testimony of Christopher J. Blunt. In addition, the City of Los Angeles (Los Angeles) presented the testimony of Manuel Kroman.

At the conclusion of evidentiary hearings, this matter was submitted subject to receipt of concurrent briefs filed

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4 The outcome reflected in D.88-09-028 relative to the three disputed operational attrition issues (a data point forecasting controversy; questions about the calculation of the composite salaries and wages factor; and clarification of the productivity sharing mechanism) are reflected in the October 1, 1988 attrition filings of Pacific Bell and GTE-C. CACD is charged with reviewing the operational attrition filings and preparing a resolution for Commission consideration.

November 1, 1988. Briefs addressing the GTE-C financial attrition request were filed by GTE-C, DRA, FEA, Los Angeles, and API Alarm Systems (API). Briefs were not submitted in the Pacific Bell financial attrition proceeding, given the pendency of the "Motion for Waiver Pursuant to Rule 51.10 and Motion to Adopt Settlement Agreement and Stipulation," tendered for filing on October 20, 1988.

A.88-07-019 did not proceed to hearing and technically, the filing of comments on the proposed decision is not required pursuant to Rule 77.1. However, we believe the public interest is served by allowing parties the option of filing comments on A.88-07-019.

III. Pacific Bell's Financial Attrition Request

A. The Application

In A.88-07-019 Pacific Bell sought to decrease its authorized intrastate rate of return from 12.12% to 11.96%, premised on an average debt cost of 9.21% and a return on common equity of 14.0%. Pacific Bell also sought recognition of the reasonableness of its capital structure objective of 40% debt and 60% equity. Believing that it would be difficult to attain a 40% debt ratio sooner than year-end 1989, Pacific Bell specifically requested authorization of a capital structure composed of 42.5% debt and 57.5% equity debt ratio for 1989. Further, Pacific Bell requested discontinuance of the imputation of 6% voting preferred stock in its capital structure, as ordered by D.82-05-007.

B. The Settlement Agreement

On Monday, October 17, 1988, the day evidentiary hearings on Pacific Bell's application were scheduled to begin, counsel for Pacific Bell and DRA informed the assigned ALJ that the two parties had been negotiating over the weekend, and were very close to a settlement of all issues. At the request of counsel, the ALJ allowed additional time for settlement negotiations involving all parties to the proceeding. Over the course of the next few days, the settlement proponents obtained the agreement of all parties to

the terms of the settlement.[5] On October 20, 1988, the parties filed a "Motion for Waiver Pursuant to Rule 51.10 and Motion to Adopt Settlement Agreement and Stipulation" (the Motion). This Motion is attached to this order as Appendix B.

The parties agree that, for intrastate ratemaking purposes Pacific Bell's 1989 attrition year rates shall be based upon the following:

1. The return on common equity for Pacific Bell for attrition year 1989 shall be 13%;

2. The average cost of debt for Pacific Bell for attrition year 1989 shall be 9.21%;

3. The debt and equity ratio utilized to set rates for Pacific Bell for attrition year 1989 shall be 43.75% debt and 56.25% equity, and the actual debt and equity ratio may vary;

4. The rate of return on total capital for Pacific Bell for attrition year 1989 shall be 11.34%.

As the Motion indicates, every party in the proceeding either agreed to the terms and conditions of the settlement or stated that they did not oppose such terms and conditions. The parties have requested, pursuant to Rule 51.10 of the Commission's Rules of Practice and Procedure, that the Commission waive its rules on stipulations and settlements to the extent necessary to allow it to issue its decision based solely on the Motion and the Agreement.

The Motion states:

> "* * * The diverse interests represented by the parties and the unanimity of their position with respect to the Agreement demonstrate that

5 Bay Area Teleport, Western Burglar and Fire Alarm Association, and TURN signed the settlement agreement and stipulation, indicating that they did not opppose its adoption.

the public interest will not be impaired by the waiver of those Rules.

"Consistent with Rule 51.8 of the Commission's Rules, the parties entered into the Agreement on the basis that the Commission's adoption of the terms and conditions set forth therein not be construed as a precedent regarding any principle or issue in any current or future proceeding. The parties expressly recognize that the issues resolved by the Agreement should not be construed as reflecting the views or position of any party except as a reasonable and appropriate compromise of the issues involved with Pacific Bell's Application. The Agreement is, therefore, a complete and total settlement of Pacific Bell's Application. Further, each party specifically agrees that this Settlement and its terms and conditions shall not be used in any manner whatsoever in GTE-California, Inc.'s Application No. 88-07-017." (Motion, p. 4.)

The request for a waiver of the Commission's rules is keyed to the requirement of Rule 51.1(b) which covers the manner of proposing settlements or stipulations to the Commission. That rule provides:

"Prior to signing any stipulation or settlement, the settling parties shall convene at least one conference with notice and opportunity to participate provided to all parties for the purpose of discussing stipulations and settlements in a given proceeding. Written notice of the date, time, and place shall be furnished at least seven (7) days in advance to all parties in the proceeding. Notice of any subsequent meetings may be oral, may occur less than seven (7) days in advance, and may be limited to prior conference attendees and those parties specifically requesting notice."

Given the 11th hour nature of the settlement discussions, the parties other than Pacific Bell and DRA were unaware of the settlement terms prior to the first day of hearing. Thus there was no prior settlement conference with notice and opportunity to participate, as required by Rule 51.1. However, during October 17 to 19th the settlement proponents met with all parties present for the hearings in San Francisco and explained the terms and conditions of the settlement to them. In addition, the settlement proponents contacted all appearances of record to ensure that there was total agreement to the settlement. In view of these extra-ordinary efforts, the Motion to Waive the provisions of Rule 51.1 should be granted, because the due process protections afforded by that section were effectively extended to all parties.[6]

In order to provide a framework for analysis of the acceptability of the settlement agreement, the pre-settlement positions of the parties are outlined below.

C. Rate of Return Recommendations for Attrition Year 1989

Pacific Bell's presently authorized rate of return is depicted in the following table:

Pacific Bell (Present Authorization)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.10%	9.17%	4.13%
Preferred Stock	2.80	8.02	0.22
6% Preferred Stock	0.60	6.00	0.04
Common Equity	51.50	15.00	7.73
Total	100.00%		12.12%

6 In an abundance of caution the ALJ asked the other parties in the proceeding whether they needed an opportunity to file comments on the settlement proposal. None of these parties responded affirmatively (1 RT 30: 21-25). Because this is an uncontested settlement, parties have not filed comments pursuant to Rules 51.4 and 51.5.

This table depicts the present authorization pursuant to Resolution T-12079 (1988 attrition year). With the exception of the cost of long-term debt and preferred stock, which were updated in the 1987 and 1988 attrition years, the present authorization tracks the outcome of the 1986 test year rate decision. (D.86-01-026.)[7] Pacific Bell's present authorization contrasts with the recommendations of the active parties for the 1989 attrition year, depicted in the following four tables:

Pacific Bell (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	42.50%	9.21%	3.91%
Preferred Stock	-	-	-
Common Equity	57.50	14.0	8.05
Total	100.00%		11.96%

DRA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.00%	9.21%	4.14%
Preferred Stock	-	-	-
Common Equity	55.00	12.50*	6.88
Total	100.00%		11.02%

*Mid-point of 12.25%-12.75% range.

7 The adopted cost of long-term debt in D.86-01-026 was 10.03%; this figure was modified in Resolution T-12007 for the 1987 attrition year to 9.25%, and in Resolution T-12079 for the 1988 attrition year to 9.17%. The weighted cost of long-term debt thus changed from 4.52% in 1986, to 4.17% in 1987, to 4.13% in 1988. The cost of preferred stock adopted in D.86-01-026 was 8.37%, and was modified to 8.02% in the two attrition years. The adopted weighted cost of preferred stock in D.86-01-026 was 0.23%, and was changed to 0.22% in the two attrition years.

Los Angeles (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.00%	9.21%	4.144%
Preferred Stock	-	-	-
Common Equity	55.00	13.25	7.288%
Total	100.00%		11.432%

FEA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	45.00%	9.21%	4.145%
Preferred Stock	5.00	9.00	0.450
Common Equity	50.00	11.4	5.700
Total	100.00%		10.295%

Proposed Settlement

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	43.75%	9.21%	4.029%
Preferred Stock	-	-	-
Common Equity	56.25	13.00%	7.312
Total	100.00%		11.34%

Review of the pre-settlement recommendations demonstrates a significant difference on the issue of the appropriate capital structure for the 1989 attrition year. More specifically, the percentage of common equity in the capital structure reflected in these recommendations ranges from FEA's 50% to Pacific Bell's

57.5%. In addition, most of the recommendations, with the exception of the FEA proposal, eliminate preferred stock from the capital structure. This is a major change from the presently authorized capital structure, especially considering the 6% imputation imposed by the Commission in D.82-05-007. There is also a significant difference in the parties' initial recommendations on the cost factor applicable to common equity for the attrition year. These figures range from FEA's 11.4% to Pacific Bell's 14.0%.

In the proposed settlement, the parties recommend a capital ratio of 43.75% long term debt and 56.25% common equity, with no allowance for preferred stock. The cost factors are 9.21% for long term debt and 13% for common equity. This provides for a rate of return of 11.34%.

D. Capital Structure

1. Pacific Bell's Pre-Settlement Position

Pacific Bell recommends a capital structure of 42.5% debt and 57.5% equity, although its goal is 40% debt and 60% equity. It believes this capital structure responds to the increase in business risks arising from added competition, faster technological change, the regulatory environment, and the potential opening of the intraLATA market.

Pacific Bell believes that the reduction of its debt ratio from 45.10% to 42.5% is an interim step that will strengthen existing credit ratings, thereby lowering future debt costs and increasing credit capacity and financial flexibility. It asserts that improvement in its financial integrity is an appropriate element of incentive-based regulation. Pacific Bell's Christensen maintains that reducing the amount of leverage in the capital structure should result in improved credit ratings and lower debt cost, since financial leverage is a key financial factor used by rating agencies to determine a company's credit rating. (Exhibit 1, p. 27.)

Christensen concludes that Pacific Bell has a low margin of safety in its credit ratings.[8] Christensen adds that if the U.S. economy deteriorates, it could squeeze safety margins further, producing lower credit ratings and increased debt rate costs for Pacific Bell. (Exhibit 1, pp. 28-29.)

Christensen also asserts that Pacific Bell's high debt ratio reduces its financial flexibility to raise capital as necessary or to refinance maturing issues, because additional debt may not be obtainable on reasonable terms. This raises the spectre of financing capital needs partially or completely with equity, at a time when the market is unfavorable. In short, Christensen asserts that Pacific Bell would be in a much better position to obtain capital under adverse conditions or to obtain capital on reasonable terms if credit quality were bolstered through a lower debt ratio.

Witness Christensen also believes that the 6% voting preferred stock imputed by D.82-05-007 should no longer be included in the projected capital structure because it is inappropriate in a post-divestiture environment, and constitutes an artificial understatement of Pacific Bell's cost of capital. (Pacific Bell has no outstanding shares of preferred stock in its capital structure.) Christensen asserts that the Commission did not intend this imputation to be a permanent adjustment to the capital

8 Pacific Bell's Hardy corroborates this view, asserting that pre-tax fixed charge coverage is presently in the upper half of the "A" benchmark range although this will decline with the lower income tax rate in 1988. One of the effects of tax reform is that pre-tax interest coverage will be reduced. Assuming all of the variables remain constant, according to Hardy, the lower tax rate reduces income tax expense, which in turn lowers income tax before interest and, taxes thereby lowering pre-tax interest coverage. This causes a real reduction in earnings protection for creditors.

structure, and that ratepayers have benefitted from the imputation for nearly five years.

2. DRA's Pre-Settlement Position

DRA's Blunt recommends that the Commission discontinue imputing the voting 6% preferred stock for these 1989 attrition proceedings because all preferred stock has been eliminated from Pacific Bell's balance sheet (Exhibit 9, pp. 23-24).

Blunt takes issue, however, with Pacific Bell's proposed attrition year capital structure. He cites the Commission's concerns during its last cost of capital review in A.85-01-034:

> "Department of Defense's Langsam said a 52% equity ratio needlessly drives up the rate of return. Aside from the cost of equity exceeding that of embedded long-term debt, Langsam correctly notes that the cost of debt is deductible for computing income tax expense. Any decrease in the cost of debt or equity capital resulting from an increase in the equity ratio will, from the ratepayer's perspective, be more than offset by the higher revenue requirement which results from increasing the equity ratio. Langsam listed examples of five state regulatory commissions which have used imputed capital structures to derive a rate of return, and an example of its use by the Federal Energy Regulatory Commission [Citation omitted]. He notes that PacBell's moving of its equity ratio above 50% is not the result of its being unable to raise debt capital, but instead is a move which is in the interest of the holding company, Telesis. If we adopt a 50-50 capital structure there is ample opportunity for PacBell to bring its actual capital structure in line during the test year, Langsam said, or the other option for management is to not alter the capital structure and simply book an overall return less than that authorized.
>
> "PacBell is in the position today of funding most of its construction budget with internally-generated funds; this was not the case several years back. Having the equity ratio move above 50% indeed drives the overall cost of service up, and whether the increase is

> even close to being offset by lower debt cost in the marketplace depends on many almost imponderable vagaries, not the least of which are the inclinations of security ratings agencies. During cross-examination by PacBell, Langsam conceded that currently PacBell's equity ratio is indeed close to his target of 50%, but he noted that if it keeps increasing, eventually this Commission will have to adopt an imputed capital structure in some future proceeding, and by then matters could reach the point that it will be all the more painful for everyone concerned [Citation omitted].
>
> "This is a valid and sobering observation. Although we conclude that the capital structure recommended by staff is reasonable, with a common equity component of 52.10%, we do not want to see the equity component rise about 55%. We are placing PacBell on notice that if it rises about 55%, we will not hesitate to impute a different capital structure which is more in line with the interests of ratepayers than those of PacBell and/or Telesis. . . ."
> (D.86-01-026, mimeo. pp. 13-14.)

As Blunt notes, Pacific Bell has exceeded the Commission's implied 55% limitation, and now requests a 57.5% common equity ratio. DRA believes its own recommended 45% debt/55% equity capital ratio, which recognizes an increase in the equity component, is consistent with the concerns expressed in D.86-01-026, while at the same time holding the company to its actual 1987 financial equity and debt ratios, thereby imposing no hardship on the company. Nonetheless, DRA believes that the Commission's past concerns are still valid. DRA believes that Pacific Bell could maintain its "A" bond rating and still increase debt to 50% of capitalization, well above DRA's current recommendation.

While ratepayers benefit from higher bond ratings when new debt is locked in at lower costs than a lower bond rating would ensure, DRA reminds us that Pacific Bell has not planned any new debt issues in 1988 or 1989, and therefore ratepayers would not

directly receive any benefits from improved debt ratings. In fact, according to DRA, Pacific Bell's internal cash flow meets its 1988/1989 capital expenditure needs, just as was noted in Langsam's 1985 testimony. In sum, DRA believes that the proposed increase in equity ratio is unnecessary to protect the solid "A" bond rating. It also points out that ratepayers will receive diminished tax benefits from the proposed lower debt levels.

DRA also provides an analysis of Pacific Bell's payout ratios for years 1984 through 1987, and suggests that the utility's payout is considerably higher than that of comparable companies (Exhibit 9, p. 28, Schedule No. 10). The analysis demonstrates that the payout ratio and dividend growth increased even when Pacific Bell's net income growth declined (Exhibit 9, p. 29, Schedule No. 11). When Pacific Bell's income growth slipped to less than 2% between 1986 and 1987, the utility increased dividends by more than 19%. Blunt notes that all common equity dividends are paid to the Pacific Telesis parent company, which also owns several subsidiaries not financed by independent debt or equity issues; Pacific Telesis finances these other endeavors using cash. To Blunt, this raises the sensitive question whether ratepayers are generating the cash for diversification and whether the revenue requirements (i.e., capital structure and rate of return) are reflecting the goals of the consolidated corporation rather than the needs of the regulated entity.

According to DRA, Pacific Bell's actions since 1984 exemplify the situation described in the 1986 decision. DRA believes that if Pacific Bell is not seeking to minimize its cost of capital, the regulatory process should continue to impute a capital structure to protect ratepayers' interests. DRA concludes that ratepayers would save about $33.8 million if the Commission adopts its recommended capital structure.

3. Los Angeles' Pre-Settlement Position

Los Angeles' Kroman believes that imputation of a lesser leveraged capital structure produces an actual equity return significantly in excess of the nominal authorized return on equity (ROE). According to Kroman, a nominal authorized 14% ROE with an imputed capital structure of 40% debt, 60% equity, would produce an actual ROE of 14.772%. With a 42.5%-57.5% imputation, 14% nominal equates to 14.386% actual (Exhibit 13, Chart 5, p. 26). Since higher equity ratios reduce financial risk, what may be an appropriate ROE at a lower equity ratio will probably be excessive at a higher imputed equity ratio (Exhibit 12, p. 28).

Kroman also addresses the applicant's argument relative to the benefits of reducing the leverage in the capital structure, noting that maintaining or increasing bond ratings by lessening such leverage does not necessarily benefit the ratepayers:

> "The fact that utilities generally carry a single A bond rating and, absent extraordinary circumstances such as cancelled nuclear construction projects, have demonstrated no disability in raising new capital at market rates, suggests that these witnesses may be overstating the case." (Exhibit 12, p. 8.)

4. FEA's Pre-Settlement Position

FEA's Winter recommends that the capital structure used for ratemaking in this proceeding contain no more than 55% common equity and no less than 45% debt. He believes that a ratemaking judgment of the adequacy of a firm's rate of return should include an assessment of the economy and efficiency of the firm's operations under the Bluefield Water Works standard. Thus he maintains it is illogical and inequitable for the Commission to conclude that Pacific Bell's reported returns on common equity are excessive or inadequate without first verifying that the capital structure and other operating factors that affect reported returns are consistent with cost efficient operation.

Winter describes two examples of steps that a utility may take to capture excess returns for its stockholders through its choice of a sub-optimal capital structure. First, a utility may allow its common equity ratio to increase above cost efficient levels during prosperous times. Increased equity ratios during prosperous times will reduce reported rates of return on common equity below those that would otherwise be reported (i.e., greater (not less) leverage is known to increase rates of return during prosperous times). A utility may benefit from this strategy if regulators compare these reported rates of return against previously allowed rates of return to determine whether the firm's earnings are excessive. Since reported rates of return are lowered by this strategy, earned rates would remain closer to previously allowed rates and reduce probability of a rate reduction. A second strategy is to allow an increase in the common equity ratio but not adjust the rate of return request to reflect the resulting lower financial risks. All else equal, a reduction in financial risk reduces the investor-required rate of return, and unless the regulatory body recognizes this reduction in ratemaking, stockholders reap excessive returns.

Winter also asserts that the reduction in capital costs associated with higher credit ratings is insufficient to offset costs of maintaining the higher rating for investment grade utility companies.

Winter also believes that greater debt in the company's capital structure would be cost beneficial in all but the most difficult credit markets. He concludes that this is true even if the lower statutory tax rates associated with recent tax reform are used in the analysis. (See, generally, Exhibit 4, pp. 18 to 20.)

FEA's Winter also recommends that the Commission add a small layer of preferred stock to the capital structure. From a risk theory perspective, he believes the layer of preferred stock would reduce business risks, while increasing in some measure the

company's financial risks. Of these two risk factors, he assigns business risks a higher priority since the company must successfully combat business risks to remain a going concern.

In sum, FEA's Winter recommends a structure containing 45% to 50% debt, 50% to 55% common equity, and 5% to 10% preferred stock, as offering lower overall capital costs. Structures within these ranges would be consistent with a single-A or stronger credit rating and offer adequate financial flexibility to the company. Although structures within these ranges are not the lowest cost structures, in his view they reduce costs from current levels and are therefore a move in the right direction. While the company has the prerogative of maintaining a higher cost structure, the higher costs of this structure should be borne by stockholders not ratepayers.

Finally, Winter asserts that although Pacific Bell's Christensen, Hardy, and Vander Weide explicitly or implicitly support the proposed 40% to 42.5% debt ratios and 57.5% to 60% equity ratios, none of these witnesses has provided quantitative evidence of the relative costs of alternative capital structures. Minimization of overall capital costs through choice of capital structure is not an apparent goal of the company based on the testimony it has filed in this case, according to Winter.

5. Discussion

While the initial positions of the parties vary greatly, they have presented us with an uncontested settlement, wherein they propose a capital structure of 56.25% equity and 43.75% debt, with no allowance for preferred stock. The settlement proponents present this as a reasonable and appropriate compromise of the issues raised in Pacific Bell's application, with the caveat that the proposed settlement is not to be construed as precedent setting relative to any principle or issue in any current or future proceeding.

The settlement rules state that:

"The Commission may reject a proposed stipulation or settlement without hearing whenever it determines that the stipulation or settlement is not in the public interest. Upon rejection of the settlement, the Commission may take various steps, including the following:

"1. Hold hearings on the underlying issues, in which case the parties to the stipulation may either withdraw it or offer it as joint testimony.

"2. Allow the parties time to re-negotiate the settlement.

"3. Propose alternative terms to the parties to the settlement which are acceptable to the Commission and allow the parties reasonable time within which to elect to accept such terms or to request other relief."

In the settlement agreement, the parties state that the settlement of the capital structure issues is in the public interest because it is a reasonable compromise. However, in reciting the terms of their compromise (Settlement Agreement p. 5), the parties say nothing about the variance in their capital structure equity ratio recommendations; they speak only in terms of the recommended percentage of debt, indicating that Pacific Bell recommended 42.5% debt while all other parties recommended 45% debt.

We have real concerns over the proposed settlement's disposition of the percentage of common equity issue. Approval of the proposed settlement will increase the percentage of common equity authorized in Pacific Bell's capital structure from 51.50% at present to 56.25%. If the concerns expressed by FEA's Winter, City's Kroman, and DRA's Blunt are legitimate, the substantial increase in the equity component of Pacific Bell's capital structure may not be consistent with a cost-efficient operation. Indeed, we would have welcomed the opportunity to hear evidence on whether a capital structure in the range recommended by FEA's Winter (45% debt/55% equity) is more cost-efficient, and whether Winter's criticism that Pacific Bell's affirmative showing lacks quantitative evidence of the relative costs of alternative capital structures is valid.

DRA's Blunt raised issues about the impacts of a high equity component on Pacific Telesis, which are disquieting, to say the least, given this Commission's longstanding concerns about the impacts of diversification. These questions too, were subordinated to the goal of reaching a compromise.

In addition, it is undisputed that the proposed settlement's recommended capital structure will lower Pacific Bell's financial risk by increasing the common equity percentage over that presently authorized. Presumably the settling parties have decided that the recommended 13% return on equity takes that diminished risk into account, but we have some concerns that it does not, and that it may therefore be excessive. These are issues which will benefit from more careful review during the evidentiary hearings to be held in connection with the next review of Pacific Bell's cost of capital. Since Pacific Bell has submitted such testimony in I.87-11-033, we anticipate that this review will be conducted over the next few months. But for that fact, we would seriously consider reconvening evidentiary hearings to explore these issues further.

For the moment, we put aside our qualms about the high equity percentage because the parties, who represent extremely diverse views on the issue, have presented us with an uncontested and unanimous compromise of the issue. For this reason alone, and understanding that we will have an early opportunity to revisit the issue, we approve the compromise capital ratio comprised of 43.75% long term debt and 56.25% common equity.

In so doing, we effectively eliminate preferred stock from the capital structure for the 1989 attrition year. However, in order to provide a framework for addressing the issue in the next cost of capital review, we address certain key concerns.

Prior to entering into the proposed settlement, FEA had recommended that the capital structure include a layer of preferred stock, on the rationale that:

> "Preferred stock sales offer an acceptable means of obtaining new, or replacement, funding. Numerous firms, both utility and nonutility, have utilized preferred stock in their capital structures. Financing via this means offers advantages over some alternatives and should therefore be considered in the capital structure analysis." (Exhibit 4, p. 8.)

Nonetheless, FEA joined with the other parties in the proceeding to recommend the capital structure included in the proposed settlement, which does not contain a preferred stock component.

In addition, the compromise capital structure represents a significant change from the present authorization, because it removes the 6% preferred stock imputation imposed by the Commission in D.82-05-007.

D.82-05-007 was issued in the proceeding initiated by The Pacific Telephone and Telegraph Company (PT&T) seeking approval of an Agreement and Plan of Merger with AT&T. Under the terms of the merger, AT&T would acquire all the outstanding voting preferred and common shares of PT&T, which would thereafter be cancelled, leaving

one share of Pacific Transition Corporation (PTC) common stock as the sole remaining voting share of PT&T.[9] PT&T had $82 million of voting preferred shares outstanding carried at a cost of 6%. With cancellation of this 6% preferred, as proposed, PT&T's capital ratios of preferred and common would change; $82 million would shift from preferred on AT&T's balance sheet to common equity. In effect the voting preferred would be converted into common equity, which at PT&T's last authorized return granted in D.93367 would be carried at a cost of 17.4%. The difference between the 6% cost of PT&T's outstanding voting preferred and the 17.4% cost of common equity was projected to increase PT&T's revenue requirement by $11.480 million annually.

To address this concern, the Commission staff recommended that the Commission should either deny the request to cancel the 6% voting preferred, or impute a 6% cost to $82 million of common stock equity in every future rate case of Pacific. Either of these recommendations were designed to eliminate the cost to ratepayers of cancelling the voting preferred.

In D.82-05-007, the Commission adopted the staff recommendation to impute a 6% cost to $82 million of common equity in future Pacific general rate proceedings.

This imputation has been made in every subsequent ratemaking proceeding for Pacific Bell. Most recently in D.86-01-026 the Commission stated:

> "We will continue to impute the $82 million at 6% voting preferred stock to PacBell's capital structure as recommended by TURN, which lowers the common equity component from 52.10% to 51.50%. PacBell and staff recommend eliminating this imputation, which was adopted in the last rate proceeding (D.84-04-104), because we are in a post-divestiture

9 PTC, the "disappearing corporation" in the merger arrangement, was ultimately merged into PT&T.

> environment and this increment of low cost capital is gone. TURN's brief is persuasive. The 6% preferred was recalled to suit the interests of Pacific's Telephone's majority shareholder, AT&T, just prior to divestiture, and make the spinoff of Pacific Telephone easier. The loss of this $82 million of cheap capital worked to benefit shareholders and increase the overall cost of capital borne by ratepayers." (D.86-01-026, mimeo. p. 15.)

In A.85-01-034 TURN had recommended a present worth adjustment to PacBell's revenue requirement as a means of essentially making it "buy out" ratepayers and compensate them for the loss of the 6% preferred stock, amortizing the impact over test-year '86 and the two following attrition years. The Commission rejected this approach, agreeing with Pacific Bell that the details of such a one-time buyout adjustment warranted detailed hearing-room analysis to review the applicable discount rate, term, et cetera, and stating:

> "It may be that in the next proceeding staff or PacBell will propose such an adjustment in lieu of our continuing the adjustment we adopt again today, and which we will continue to adopt until we find some means of equitably ending it from the ratepayers' perspective." (D.86-01-026, mimeo. p. 16.)

In pre-settlement testimony, both Pacific Bell and DRA recommended discontinuance of the 6% imputation on the rationale that the capital structure contained no preferred stock. However, neither DRA nor Pacific Bell proposed any sort of adjustment as contemplated by the Commission in D.86-01-026 designed to equitably end the adjustment from the ratepayers' perspective. Instead, all parties to the proceeding, including FEA (which proposed a layer of preferred stock (though not explicitly 6% voting preferred) in its pre-settlement testimony) and TURN which had litigated this issue extensively in Phase 1 of A.85-01-034, compromised in a manner that effectively eliminated the 6% imputation for the attrition year.

Nonetheless, we also understand that these parties have reserved their rights for the future, and on this basis alone we adopt the compromise. We will revisit the entire issue of Pacific Bell's capital structure in the next cost-of-capital review, where we hope to see these issues fully aired.

E. Cost of Debt

In its pre-settlement testimony, Pacific Bell projected a 9.21% embedded cost of debt as of December 31, 1988. Pacific Bell's witness proposed use of this level, although he stated that by the end of 1989, the embedded cost of debt would rise to 9.27%. However, in light of the timing of maturities he saw no reason to increase the 9.21% level. (Exhibit 1, p. 33.) As shown in the preceding comparative tables, all parties recommended a 9.21% long-term debt cost factor in their pre-settlement testimony, and in the proposed settlement. Given that fact, we will adopt 9.21% as the cost of debt for attrition year 1989.

When multiplied by the adopted debt ratio of 43.75%, the 9.21% cost factor produces a weighted cost of long-term debt for the 1989 attrition year of 4.029%.

F. Cost of Equity

The following table summarizes the positions of the parties:

Summary of ROE Recommendations

Party	ROE (Percent)
Pacific Bell*	14.00
DRA*	12.25-12.75
Los Angeles*	13.25
FEA*	11.40
Proposed Settlement	13.00

*Pre-Settlement Position

1. Pacific Bell's Pre-Settlement Position (Christensen and Vander Weide)

Pacific Bell's Christensen recommended a 14.00% cost of common equity in attrition year 1989, based on the risk premium analysis and discounted cash flow (DCF) model. Christensen's risk premium analysis used the regional holding companies (RHCs) as a check of reasonableness; however, since the RHCs have lower debt ratios than Pacific Bell and thus less financial risk, Christensen used them as a floor. For Pacific Telesis Group, Christensen's results showed a risk premium on the yield of 30-year Treasury Bonds (during February 1984 to June 1988) ranging from 3.2 to 6.7% and averaging 5.1%. For the RHC's, the risk premium ranged from 2.9 to 6.5% and averaged 4.7%. Adding the average risk premiums calculated above to July 1988 forecasted average 30-year Treasury Bond yields. (9.95% in 1989) results in a projected cost of common equity of 14.7 to 15.1% under Christensen's risk premium analysis.

In his DCF analysis, Christensen assumed that the cost of common equity for Pacific Telesis Group would be largely representative of the cost of common equity for Pacific Bell.[10] Christensen's DCF analysis concluded that there has been a systematic increase in the cost of equity since the 4th quarter of 1987 (Exhibit 1, p. 41); taking this increasing trend into account (12-month average 13.5%; 6-month average (January to June 1988) 13.9%; 3-month average (April to June 1988) 14.0%) he concluded that the appropriate DCF-based cost of common equity for Pacific Bell is 14%.

10 Pacific Bell has no publicly traded equity securities, but represents approximately 93% of Pacific Telesis Group's total assets and 92% of total revenues.

Based on the two models, Christensen derived the range of 14.0 to 15.1%. In conjunction with his recommended capital structure based on 57.5% common equity and 42.5% long term debt, Christensen recommends a 14.00% cost of equity.

Christensen's risk premium and DCF models were complemented by his analysis of current economic conditions including current business risks and financial risks confronting Pacific Bell. He views the unsettled and volatile economic conditions in the US and world financial markets, the large Federal deficit and trade imbalances, the longevity of the economic expansion and the sharp decline in the dollar as exerting additional inflationary pressures. He also believes that Pacific Bell faces increasing competition and the threat of bypass associated with accelerating technological developments and the rapid influx of competition. He notes that the spectrum of intraLATA competition, a topic to be addressed in I.87-11-033, impacts investor-perceived risk, although to some extent this has already been factored into investors' decisions (Exhibit 1, p. 18). He also points to the risk of obsolescence, given Pacific Bell's capital intensity; and he notes that there is investor uncertainty regarding the manner in which regulators will attempt to balance the interests of ratepayers and local exchange companies. (Exhibit 1, p. 22.) Overall, Christensen concludes that there has been an increase in business and investment risks, exerting upward pressure upon investor-required returns and the cost of equity.

Pacific Bell's Vander Weide also discussed the current state of the economy (specifically the Federal deficit's impact on real interest rates (i.e., they have increased and remained high), the foreign trade deficit and the concomitant drop in the value of the dollar, the Federal Reserve's role in supporting interest rates, and increased volatility and investor caution about the direction of the economy and the level of inflation that may lie ahead). Vander Weide also cites the competitive factors Pacific

Bell faces in a time of transition from social to economic pricing. In Vander Weide's view, rapidly changing telecommunications technology also places risk on Pacific Bell, because these changes are the primary driver behind the increasing level of competition faced by the telephone companies.

Vander Weide concludes that these economic changes undoubtedly increase investors' perceptions of Pacific Bell's risk. Regulatory and Federal court rulings have opened many formerly protected areas to competitive alternatives which technological advances have permitted customers to pursue. Moreover, because the transition from social to economic pricing is far from complete, incentives exist for customers to use alternatives to Pacific Bell's services. This combination of financial incentives and technological capability results in higher risk for telecommunications firms in general. Vander Weide believes that the implied risks for Pacific Bell are particularly great because of the unique communications environment in California.

As a final note, Vander Weide points to the fact that investors are aware of the potential for change in the way that Pacific Bell is regulated. He believes that the uncertain outcome of the Commission's I.87-11-033, and specifically the manner in which the issue of lifting the intraLATA competition ban is addressed, will have a significant impact on Pacific Bell's earning ability and is therefore a major risk to investors (Exhibit 3, pp. 23-24).

Vander Weide used a quarterly DCF model to estimate Pacific Bell's cost of equity for the 1989 attrition year. (Exhibit 3, p. 26 l. 15-16.) Vander Weide performed a correlation analysis to identify the historically oriented growth rates best describing the firm's stock price for 1981, 1982, and 1983; then he performed a regression study comparing the historical growth rates with the consensus analysts' forecasts. In every case the regression equations containing consensus analysts' forecasts

statistically outperformed the equations containing historical growth estimates. Vander Weide used a simple average of the high and low stock prices for each firm for a 3-month period including the month currently under observation and its prior two months. He also included a 5% allowance for flotation costs and market pressure (Exhibit 3, p. 29). Vander Weide applied the DCF approach to four groups of companies: The Pacific Telesis Group, the RHCs, a group of six large independent telecommunications companies, and a group of risk-comparable companies (Exhibit 3, Schedule 4). Based on his analysis Vander Weide concludes that Pacific Bell's DCF cost of equity is at least 14.0%.

Vander Weide also used a risk premium approach, studying the comparable returns received by bond and stock investors over the last 50 years. He estimated the returns on stock and bond portfolios using stock price and dividend yield data on the Standard and Poor's (S&P) 500 and bond yield data on Moody's Aa-utility bonds and derived a risk premium of 5.88%. Vander Weide also conducted a second study using stock data on the S&P 40 utilities rather than the S&P 500 and derived a risk premium of 4.96%. Thus, Vander Weide believes that investors today require an equity return of approximately 4.5 to 5.5 percentage points above the expected yield on Aa-rated long-term debt issues. Since the long-term yield on Aa-rated bonds is currently about 10%, the addition of a 4.5 to 5.5 percentage points risk premium results in an expected 14.5%-15.5% return on equity.

Based on his review of economic conditions and on the DCF and risk-premium methods applied above, Vander Weide concludes that the cost of common equity for Pacific Bell is within the range of 14% to 15.5%; he recommends that Pacific Bell be allowed a fair rate of return on common equity at 14.5%.

2. DRA's Pre-Settlement Position

DRA's Blunt recommended a range of 12.25% to 12.75% return on common equity based on the DCF model, the risk premium

method, and a comparable earnings analysis. While acknowledging the bypass argument and the notion that increasing competition triggered by technological advancements may accelerate the departure of business customers from traditional systems which are part of the public network, Blunt notes that Pacific Bell's earnings have increased 44.6% since divestiture (Exhibit 9, p. 42). He regards this as solid evidence that the bypass threat has yet to affect earnings. While acknowledging the possibility that, in the near future (beyond 1990), technological advances and/or regulatory actions could increase the possibility that business customers may leave the system, Blunt maintains that using market-driven analyses such as DCF and risk premium will account for and reflect any solid evidence on this issue.

Blunt applied the comparable earnings standard as an aid in selecting comparable companies for use in the DCF and risk premium analyses, and to support the reasonableness of his recommended range of return on common equity. Blunt selected a group composed of seven independent communications companies and seven regional holding companies as well as ten gas distribution companies (the Group) (Exhibit 9, pp. 40-41).

Blunt used an average of historical, analysts' forecasts and sustainable growth rates in the DCF analysis, in the belief that a consensus of historical, forecasted, and sustainable growth rates best indicates investor-growth rate expectations for the near future. The average composite growth rate for Blunt's group of companies was 5.82%. (Exhibit 9, Table 16.)

Blunt's study indicates that the investor-required return for the seven independent telecommunications companies (IND) (combining the average 3-month and 6-month expected yield and average growth rate) is 11.71% and 11.87% respectively. For the same period, the analysis shows an identical return on equity expectation of 12.42% and 12.53% for the seven regional holding companies and ten gas distribution companies in the group.

Combining the results of the DCF analysis for the seven independents and seven regional holding companies shows an average expected ROE of 12.07% and 12.20%. The results of the DCF analysis produced a composite group average investor-required return on equity of 12.21% and 12.34% when the average 3-month and 6-month expected yields are combined with average growth rates (Exhibit 9, Table 17).

Blunt included no adjustment for flotation costs on the rationale that there is no need to compensate investors for dilution when none is occurring (the market-to-book ratio for Pacific Telesis is 151), and Pacific Bell has not issued equity capital since divestiture and actually reduced its retained earnings in 1987, projecting to pay out 100% of its available earnings to Pacific Telesis in 1988 and 1989. In light of these facts, Blunt feels there is no justification for including flotation costs (Exhibit 9, p. 53).

In his risk premium analysis Blunt derived the premiums by comparing DCF estimated returns on equity with "AA" and "A" Utility Bond yields and 3- to 5-year government issues from 1980 through 1987 (disregarding years prior to 1980 due to changing Federal Reserve Board monetary policy). The estimated ROEs were determined by combining the company's annual dividend yield with historical 10-year average dividend and earnings growth rates; data for the gas distribution companies was substituted (due to unavailability of historical data for the RHCs) and the historical expected ROEs were thus derived.

Next, Blunt combined Data Resources Incorporated's (DRI) current forecast for yields on "AA" and three to five year issues for 1989 with the respective average equity risk premiums to derive a range for expected ROEs. He also performed a similar task using Blue Chip Financial's 1989 forecasts for A Bond yields and 2-5 year government Treasury notes. The range of expected ROEs combining the historical risk premiums with 1989 attrition year forecasted

"AA" and "A" yields is 13.06% and 12.37% respectively and 12.86%, 12.53%, and 12.87% using forecasts for intermediate term government issues (Exhibit 9, P. 56). Blunt's recommended range of 12.25% to 12.75% return on common stock equity falls within the range of expected returns produced by the risk premium analysis.

3. Los Angeles' Pre-Settlement Position

Los Angeles' Kroman criticizes reliance on the DCF methodology, the risk premium methodology, and the capital asset pricing model (CAPM). He believes the Commission has already expressed its view that there are serious pitfalls in placing heavy reliance on such models, as a substitute for informed judgment. (Exhibit 12, p. 15.)

Kroman also criticizes the applicants' risk assessment arguments, believing that they have failed to distinguish between changes in absolute versus relative risk. In the absolute sense, Kroman agrees that it may be true that telecommunications utilities are confronted with increasing risks largely from competitive pressures. However, in a relative sense this differs not at all from the arguments being made by the natural gas and electric utilities. Kroman cites the plight of many entities in the unregulated sector including the steel, automobile, oil, machine tool, computer, and farm sectors all of which are severely impacted by fiercely competitive pressures. Kroman contends that increased risks are impacting not only telecommunications utilities but practically the entire spectrum of American business (Exhibit 12, p. 17). He believes that discussion of one utility industries' risks without reference to the risk of the economy can provide only an incomplete, inconclusive, and superficial framework for supporting a requested rate of return. Kroman also refers to recent issues of S&P's "Credit Week" reports and similar information on Pacific Telesis from Moody's Handbook of Common Stocks. He beleives there is little if any indication in Moody's Handbook for example, that Moody's is warning investors of Pacific

Telesis' increasing risks; the comments are in fact quite positive. Kroman believes that if the Commission is to consider absolute risks, it should look to objective sources; he believes that the views of the applicants' witness regarding the risks of the telecommunication companies and of the applicants are clouded by their lack of objectivity.

Kroman believes that economic conditions and the level of interest rates are significant elements to be considered in arriving at a fair rate of return. He has reviewed certain data indicating the direction and magnitude of change in the cost of common equity, comparing conditions shortly before the issuance of D.86-01-026 with more recent conditions. He has examined the change in DCF-calculated cost of common equity over these time periods to obtain an indication of the magnitude and direction of change. Using Vander Weide's calculations, Kroman demonstrates that the indicated cost of common equity has decreased on average by 2-1/2 percentage points over that time interval (Exhibit 13, Table 15). Kroman also believes that it is significant that Pacific Bell plans no new outside financing for the 1989 attrition year, whereas Pacific Bell had projected the need for such financing in its last rate case (A.85-01-034).

Kroman prepared a chart (Exhibit 13, Chart 4) showing the relationship between the percent return on common equity and the corresponding pre-tax interest coverage at debt ratios of 42.5% and 45%. With a nonimputed debt ratio of 45%, Kroman believes Pacific Bell could satisfy S&P's minimum A-rating benchmark of 3.5 times interest coverage with an ROE of less than 11-1/2%; imputing a 42.5% debt ratio would enable Pacific Bell to achieve the same pre-tax interest coverage with more than a one percentage point reduction in ROE. Given all of these factors, Kroman recommends a return on common equity for the 1989 attrition year of 13.25% based on a capital structure of 45% debt and 55% common equity.

4. FEA's Pre-Settlement Position

FEA's Winter recommends a return on common equity of 11.40% based on a 50% equity component. Winter uses a DCF analysis, and secondarily an historical risk premium and "recent required returns" (comparable risk) analysis to check the reasonableness of the DCF analysis.

Winter provides an analysis of current macro-economic conditions and recent trends as a backdrop for his cost of capital analysis. He highlights the Federal Reserve's action to reduce the monetary growth rate and concomitantly, the potential for higher inflation (Exhibit 4, pp. 28-29). He also states that although inflation rates have recently turned upward, inflation continues within the range that has existed since 1985. Although monthly fluctuations in inflation rates have raised concern in both 1987 and 1988 that these rates were headed upward, no clear upward trend has materialized. He indicates that annualized inflation rate expectations range between 4.0% and 5.6% for the 1988-89 period. He believes that if inflation continues to fall between 4 and 5% and credit demands are consistent with allowed monetary growth, without oil or other price shocks, interest rates should remain within recent ranges.

Winter uses the Pacific Telesis Group as a starting point for analysis of Pacific Bell's cost of common equity; he indicates that the parent's stock was relatively trendless during the June 17 to September 30, 1988 period, consistent with the Dow Jones, and S&P Utility indices.

According to Winter, investment publications frequently mention two primary sources of risk faced by Pacific Bell and its parent. The first source is attributable to inroads that competitors may make into the regulated utility's service offerings. Winter believes that generally, however, these inroads have been occurring at a slower rate than initially expected and bypass of the local switch and exchange loop has been infrequent.

Even when bypass has occurred, he maintains that it has often been partial with the local operating company receiving associated private line revenues. The current opinion generally expressed in investment publications is that revenue lost to competition will be relatively insignificant (Exhibit 4, p. 34). Winter also believes that Pacific Bell has improved productivity of its telephone operations and that the California Commission has approved price flexibility and phased out toll access subsidies, all of which should help minimize the potential negative effects of competition. However, a second source of potentially greater investment risk is diversification into unregulated businesses; Pacific Telesis Group has invested in a variety of relatively risky nonutility ventures including real estate, cellular, mobile and paging services, financial services, and international marketing of communications services. Based on investment firm reports, diversification has increased the investment risk faced by utility firms. Winter refers to a June 1986 Salomon Brothers' Report stating that diversification has not boosted profits or increased shareholder value. According to Winter, the Report indicates that Pacific Telesis Group's net income has actually been reduced, rather than increased, by its diversification efforts. The Salomon Brothers' calculations show that diversification diluted the parent company's earnings by approximately 6% during the first quarter of 1986. Nonutility operations were, as a whole, unprofitable for calendar year 1986 based on S&P's June 22, 1987 Credit Week. (Exhibit 4, pp. 35-36.)

In sum, Winter believes that, over the near term, Pacific Bell has taken steps considered to minimize the primary source of the risk it faces (i.e., that due to competition); however, Pacific Telesis has taken steps that have increased (and are likely to continue to increase) its overall investment risk. Because of this divergence, with Pacific Bell taking the lower risk path and Pacific Telesis Group the higher risk path, Winter considers

Pacific Bell to have slightly lower overall investment risks than its parent. According to Winter this risk differential means that Pacific Bell's cost of common equity is slightly smaller, perhaps by 20 to 30 basis points, than its parent's cost of equity. Notwithstanding this caveat, Winter relies on Pacific Telesis Group market data as a starting point for estimating the cost of equity to Pacific Bell.

According to Winter, Pacific Telesis Group's returns on equity have exceeded those of more risky large corporations by an average of 180 basis points during 1985-1987. (Exhibit 4, pp. 38-41.) Based on this comparison, Winter believes that the parent's rate of earnings has been excessive during each of the past three years.

In his DCF analysis, Winter relies on a constant growth model, which is based on the assumption that investors expect equal growth in price and dividends over an infinite future holding period. (Exhibit 4, p. 33.) He has chosen the constant growth method because it is generally accepted for ratemaking. Winter concludes that a growth rate range of 4.5% to 6.0% is representative of investor expectations for long-term Pacific Telesis Group growth (Exhibit 4, p. 50). He calculates a current dividend yield of 6.03% (Exhibit 4, p. 52). A current dividend yield of 6.03% coupled with expected growth rates of 4.5% to 6.0% indicate investor common equity requirements between 10.80% and 12.39%. (Exhibit 4, p. 53.)

In using the historical risk premium approach as a check on the reasonableness of the DCF analysis, Winter found, based on geometric mean returns, that a portfolio of Moody's 24 Utilities returned approximately 166 basis points more than long-term Government Bonds during the period 1929 to 1987. Winter computed the average of the premiums that would have been realized over all whole-year holding periods of one year to ten years during 1929 to 1987. The average premium was 367 basis points. However, Winter

maintains that there have been significant changes in the risk premium between utility stocks and bonds in recent years, and that some authorities have concluded that long-term bond investing has become as speculative as stock investing. He believes that reduced risk premiums between stocks and bonds recorded in 1979 to 1981 continue to prevail. Due to these reduced risk premiums, he maintains that the lower end of the 166 to 367 basis points premium spread is more appropriate (Exhibit 3, p. 59).

As a final check on his DCF analysis, Winter reviewed recent required turns on other competing investments (July, August, and September '88 issues of the S&P Bond Guide). The required returns are discounted cash flow returns calculated from the current price of the bond and the expected income stream (coupon payments and return of the bond's face amount upon maturity), consistent with determination of Winter's DCF findings for Pacific Telesis Group. Winter believes that the common equity of Pacific Bell and its parent is more risky than triple-A-rated bonds because of greater uncertainty concerning the amount and timing of the future income stream. However, this uncertainty is significantly less than that associated with the potential income stream from the typical bond rated triple-C (Exhibit 4, p. 62: 13-18).

In sum, Winter's point estimate for Pacific Bell's cost of equity is 11.4%. This is 20 basis points below the midpoint of his DCF range for Pacific Telesis Group, in recognition of the slightly lower risk associated with Pacific Bell's common equity. The DCF, risk premium, and risk/return analysis performed relied on recently recorded stock prices and recent long-term Treasury Security and Corporate bond yields. In Winter's view, the results are indicative of investor return requirements during the period 6/17/88 to 9/30/88, in which these prices and yields were recorded. Winter maintains that the 11.4% finding offers a premium of approximately 140 basis points over recent required returns on the

company's debt and equals recent required returns on junk bonds rated double-B by S&P.

Winter recommends no adjustment for flotation, on the rationale that it is inequitable to ratepayers (Exhibit 4, p. 70). Based on recent market prices if stock sales were to occur, they would likely be at prices above book value given PTG's current market-to-book ratio of approximately 1.5. In his view, accretion, rather than dilution, will be the likely result of such sales.

5. Discussion

The pre-settlement recommendations on the cost of equity for attrition year 1989 cover a wide range (11.4% to 14.00%), and the proposed settlement contains a stipulated ROE of 13.00%. While that figure is well within the recommended ranges, and no party to the proceeding opposes its adoption, there are serious questions not addressed in the settlement document. As discussed previously, the proposed settlement contains general language that the result proffered to the Commission is in the public interest, and that in recommending the 13% figure the parties have compromised their presettlement positions. However, given the general nature of this language, and our lack of detailed knowledge about the implicit trade-offs involved in the parties' negotiating process, we are left with certain doubts about the reasonableness of the compromise.

On the one hand, adoption of the 13% compromise figure appears, on the surface, to be a reasonable compromise; it represents a 200 basis point reduction in the currently authorized 15% return on equity which has been in place since 1986, and therefore furthers the ratepayer interest in recognition of an improved financial environment since January 1986. However, some of the recommendations presented in this proceeding indicate that a far lower return on equity may be appropriate for the attrition year. Nonetheless, because of the unanimity of the settlement, these recommendations are not in evidence before us.

We have also indicated our concern that the capital structure proposed in the settlement document may not be the most cost effective capital structure we might have chosen after reviewing all the evidence. Given the high equity component in the recommended capital structure, we may have given serious consideration to adopting a lower ROE in recognition of reduced risk.

For now, we are constrained to adopt the 13% ROE contained in the proposed settlement. Our only alternative, rejection of the settlement or submission to the parties of a "counter proposal", is infeasible because it would preclude us from resolving this matter by the end of the year and providing to ratepayer's the benefits of the reduced ROE embodied in the settlement agreement. Essentially, the proposed settlement results in a revenue requirement reduction of $127 million and that provides some rationale for adopting it and resolving this matter as attrition year 1989 begins. Thus we approve the settlement in accord with Rule 51.1(e). We accept this outcome, with the realization that the parties will revisit cost-of-capital in I.87-11-033, where such testimony has been presented. We believe there is great benefit inherent in a thorough review of these issues in I.87-11-033 over the next few months.

IV. GTE-C's Financial Attrition Request

A. The Application

On July 15, 1988, in accordance with the Commission's directive in D.88-06-024, GTE-C filed its 1989 financial attrition request, seeking an increase in its intrastate revenues of

approximately $67 million.[11] GTE-C sought to increase its authorized intrastate rate of return from 10.90% to 12.08%, premised on a long-term debt cost of 9.03%, short-term debt cost of 8.75%, preferred stock cost factor of 6.35%, and return on common equity of 14.50%. This request was premised on a capital structure composed of 38.2% long-term debt, 1.9% short-term debt, 2.7% preferred stock, and 57.2% common equity.

GTE-C requested that the revenue requirement increase proposed in its application be implemented by a uniform increase in its three current billing surcharges, to be collected on a bill and keep basis, and that these changes be made effective January 1, 1989 to be implemented simultaneously with the surcharge changes resulting from GTE-C's 1989 operational attrition rate adjustment filed October 1, 1988.

B. Rate of Return Recommendation for Attrition Year 1989

GTE-C's presently authorized rate of return is depicted in the following table:

GTE-C (Present Authorization)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	41.50%	9.01%	3.74%
Short-Term Debt	2.50	7.00	0.18
Preferred Stock	2.50	6.41	0.16
Common Stock Equity	53.50	12.75	6.85
Total	100.00%		10.90%

11 In a September 30, 1988 update, submitted in accordance with the ALJ Ruling of June 24, 1988, GTE-C reduced its requested revenue requirement increase to $66.201 million. This reduction reflected the use of the 1988 test year rate base adopted in D.88-08-061 to derive the company's 1989 attrition year rate base.

GTE-C's present authorization contrasts with the recommendations of the active parties for the 1989 attrition year, depicted in the following tables:

GTE-C (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	38.20%	9.03%	3.45%
Short-Term Debt	1.90	8.75	0.17
Preferred Stock	2.70	6.35	0.17
Common Equity	57.20	14.50	8.29
Total	100.00%		12.08%

DRA (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	40.50%	9.03%	3.66%
Short-Term Debt	2.00	8.50	0.17
Preferred Stock	2.50	6.34	0.16
Common Equity	55.00	12.50*	6.88
Total	100.00%		10.87%

*Mid-point of 12.25-12.75% range.

Los Angeles (Recommendation)

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-Term Debt	38.20%	9.03%	3.45%
Short-Term Debt	1.90	8.75	0.17
Preferred Stock	2.70	6.35	0.17
Common Equity	57.20	13.00	7.44
Total	100.00%		11.23%

A review of these recommendations reveals a significant difference on the appropriate capital structure for the 1989 attrition year. The percentage of common equity in the capital structure reflected in these recommendations ranges from GTE-C's 57.2% to DRA's 55%.[12] The second major issue in the proceeding relates to the appropriate return on common equity for attrition year 1989. GTE-C is requesting an increased ROE of 14.50. DRA recommends a reduction in the current ROE from 12.75% to 12.50%. Los Angeles' Kroman recommends an increase from the current 12.75% to 13.00%. In contrast to the disposition of Pacific Bell's financial attrition, the issues raised in GTE-C's application were litigated. Indeed, each party who signed the Settlement Agreement in A.88-07-019 explicitly agreed that the settlement terms and conditions would not be used in any manner whatsoever in GTE-C's A.88-07-017. Therefore we proceed to analyze the record developed in A.88-07-017.

C. Capital Structure

While capital structure is an issue for attrition year 1989, all witnesses support some increase from the present 53.5% authorized equity percentage. DRA recommends 55% and GTE-C recommends 57.2%.

1. GTE-C's Position

GTE-C's witness O'Rourke testified that the common equity ratio of 58% projected for year-end 1989 places the company in the

12 Los Angeles' witness Kroman accepted GTE-C's capital structure in his analysis, and concentrated primarily on the issue of the appropriate ROE for the attrition year; we do not regard his use of these percentages as an endorsement of GTE-C's recommended capital structure, especially in view of his arguments on the merits vel non of higher bond ratings, infra.

strong A to weak AA S&P bond rating category. O'Rourke describes S&P's bond rating criteria as follows:[13]

	A	AA
Pre-tax Fixed Charge Coverage	3.5x-5.5x	Above 4.5
Total Debt/Total Capitalization	40%-52%	Under 42%
Net Cash Flow/Long-Term Debt	25%-35%	Above 30%

O'Rourke indicates that this common equity ratio is still below the average ratio for the comparable telephone companies he reviewed (Exhibit 8, p. 3). O'Rourke asserts that the higher projected common equity percentage "is a conservative move to reduce financial risk and exposure to interest rate volatility." (Exhibit 7, p. 3.) O'Rourke maintains that GTE-C should maintain its AA-bond rating, consistent with the trend established by most major telephone companies, which are reducing financial leverage by improving their total equity position, in order to protect against the shock of volatile interest rate increases and higher business risk keyed to increased competition.

O'Rourke considered his list of comparable telephone companies on the basis of size and markets served as of December 1987. The comparable companies also have publicly traded debt. Because of GTE-C's size, he considered telephone companies with total capital of at least $1.8 billion. These companies are all rated in the AA category and O'Rourke believes GTE-C is considered comparable, by knowledgeable investors. All of these companies have total capital in the range of $2 billion to $12 billion and long-term debt ratios in the range of 35% to 44%. O'Rourke notes that the average common equity ratio is 59%, while the high/low range is 63.7%/55.7%. (Exhibit 8, p. 3.)

13 This material is derived from Exhibit 8, page 4.

GTE-C argues that DRA's recommended 55% equity ratio is rooted in misunderstanding of the factors that make the higher equity ratio essential. More specifically, GTE-C states that DRA has provided misleading information (Exhibit 9, Schedule 3) as to the length of time GTE-C's bonds have been rated AA and as to its commercial paper ratings over the same period. GTE-C asserts that it was not until late 1986 that it obtained its current "weak" AA rating from both Moody's and S&P. GTE-C asserts that it achieved this rating only as a result of substantial increases in its equity ratio and pre-tax times interest coverage. Further, it maintains that the current rating is still well below the average ratings for other large telephone utilities (Exhibit 13, p. 1).

GTE-C also objects to DRA's reliance on certain Value Line data indicating that telecommunications service companies facing comparable business risks are projected to have equity ratios for 1988 and 1989 of only 54% and 55%. GTE-C believes that many of the companies included in this Value Line projection do not fall into S&P's high risk local exchange carrier classification and are not representative of the companies with which GTE-C must compete for debt capital. Further, the companies used do not have the same Value Line safety rankings. (2 RT 182.) Finally, GTE-C asserts that the Value Line report includes certain projected equity ratios for 1987, 1988, and 1989 which are well above the equity ratio recommended by DRA (2 RT 184: 1-20).

GTE-C believes that DRA's witness has inappropriately focused on whether his recommendation will jeopardize GTE-C's current bond ratings; GTE-C believes the appropriate focus should be whether the recommended ratios will enable it to maintain its current bond rating. According to GTE-C, DRA's capital structure includes less equity and more debt (long-term and short-term) than required by S&P's for an AA bond rating; concomitantly, if DRA's 12.50% midpoint ROE is adopted, GTE-C asserts that it will only

achieve a pre-tax times interest coverage of 3.78 times (Exhibit 9 p. 59).

GTE-C asserts that the DRA capital structure and proposed ROE would almost certainly result in a bond rating reduction, which would over time have a negative impact on ratepayers by increasing the cost of new debt financing and also increasing the ROE to which GTE-C's investors are entitled. In support of the latter argument, GTE-C cites the calculation of its witness Brennan (Exhibit 6, Schedule 21), illustrating the difference in interest expense between a utility meeting the minimum criteria for an A bond rating and a utility meeting the minimum criteria for an AA bond rating. Brennan asserts that the required return on equity is 16.9% for the A-rated utility, whereas the requirement for the AA-rated firm is only 15.2% premised on the cost of debt used in Schedule 21 of Exhibit 6. (1 RT 80-83.)

In sum GTE-C asserts that the record clearly establishes that a 57.2% equity ratio will help achieve its goal of maintaining its current bond rating. The higher equity ratio will help minimize the risk of a bond rating downgrade (provided the return on common equity is adequate), and thereby avoid the increase in future debt costs and ROE, which it believes would necessarily result from a bond rating decrease.

2. DRA's Position

DRA asserts that its recommended 55% common equity ratio is fairer to the ratepayer than GTE-C's 57.2% request. Since the cost of common equity is the highest cost of the capital structure components, DRA believes it is appropriate to consider a capital structure which provides sufficient interest coverage to maintain a reasonable bond rating and net cash flow to debt ratio. While GTE-C would prefer to stay below a 40% debt ratio and above a 4.5 times pre-tax interest coverage in order to maintain its bond rating, DRA submits that GTE-C could pay $20 million more in interest and still maintain the 4.5 times pre-tax interest coverage

necessary to sustain that rating. This interest would cover about $196 million in additional debt at the current 10.197% interest rate on AA bonds. The current debt ratio requested by GTE-C is only 40.1% for 1989 (including long-term and short-term debt), and therefore DRA believes that GTE-C has room for additional debt before reaching the S&P guideline of 42%.

In general, DRA notes that increases in the debt ratio and decreases in the equity ratio represent tax savings to ratepayers. The least expensive option for a company to finance growth however, is through internal cash flow. A company may control its cash flow in part by controlling its dividend policy. DRA notes that for 1989 GTE-C plans no debt or equity funding. It plans to finance capital investments solely from internal sources. DRA also notes that GTE-C is wholly owned by a holding company, GTE Corporation, and therefore it has added flexibility in using internally-generated cash, since common dividends are all paid to the parent company, and the dividend payout ratio is not driven by market expectations.

DRA observes that since 1983 GTE-C's long-term debt ratio has declined from 56.98% to 40.86% The preferred stock equity ratio has declined also while the common stock equity ratio has continuously increased from 40.12% in 1983 to 53.44% at the end of 1987. This has occurred in part because GTE-C has increased new common stock issues to its parent, replacing debt (Exhibit 9, pages 17-18). DRA notes that GTE-C plans to add an additional $45 million in common equity this year;[14] this new funding will increase its common equity ratio to between 56% and 57% depending on how much of the new equity is used to retire maturing debt. GTE-C's long-term debt ratio will drop below 41.3% continuing its 5-year slide. DRA notes that the result of the shift in capital

14 A. 88-10-006 is currently pending before this Commission.

structure is a higher cost of capital for ratepayers (Concurrent Brief of DRA, pp. 4-5).

Asserting that continued increases in equity appear to be unwarranted, DRA points out that GTE-C has the ability to fund capital expansion internally or through debt but has opted for infusions of new common stock equity. DRA believes the resulting higher GTE-C revenue requirement to does not seem to be offset by any benefits to ratepayers. There will be no further improvements in bond rating, financial stability or reduced debt costs.

DRA submits that in the ideal market, competitive companies seek to minimize financing costs, and prefer cheaper financing opportunities over more expensive undertakings within the range permitted by the bond rating guidelines. Regulated utilities, however, may seek to maximize return rather than minimize costs when the returns are passed on to ratepayers without fear of competition. Therefore, DRA is concerned over the build up in common stock equity ratios without apparent ratepayer benefit. Of special concern is the fact that the utility in question is wholly owned, and the higher weighted common equity costs accrue only to the benefit of the shareholders. The holding company can use the dividends flowing from the regulated subsidiary to finance unregulated enterprises of other subsidiaries. DRA submits that when a regulated capital structure appears to produce ever higher returns flowing to the parent company without appropriate benefits flowing to the ratepayers, the increased common equity ratio and increased costs to ratepayers should be denied. Therefore, DRA recommends a 55% common equity cap for GTE-C for the 1989 attrition year. Staff believes that this recommendation is well within industry norms, as evidenced by the average for Value Line's projected common equity ratios for 1988 and 1989 (54% and 55% respectively) and should be adopted. (Exhibit 9, pp. 20-22.)

3. Los Angeles' Position

As mentioned earlier, Los Angeles' Kroman uses the requested capital structure in terms of illustrating the return on equity recommendation which was his primary focus in this proceeding. However, Kroman also addresses GTE-C's argument that it must maintain its bond rating in the attrition year, and in that regard, Kroman's analysis addresses part of the debate over the appropriate capital structure. Kroman disputes the implication of GTE-C's witnesses that higher bond ratings result in lower money cost rates which are passed through to customers resulting in lower service prices (Exhibit 12, p. 8). In particular Kroman challenges Brennan's analysis that the total cost of service for the lesser "A"-rated utility exceeds that of an "AA" rated utility (Exhibit 6, Schedule 21). Kroman asserts that Brennan has obviously assumed that the differential in bond yields between the A and AA categories is 0.5 percentage point.[15] Using an alternative spread of 0.17 percentage point (the median differential over the period January 1946 through June 1988) between the two bond rating groups, Kroman derives a result indicating that the annual total cost of service for the AA-rated utility substantially exceeds that of the A-rated utility (Exhibit 13, Table 3).

15 In D.87-12-070, and other Commission decisons, the 50 basis points spread is authorized, "if appropriate" in connecton with long-term bonds to be issued in the attrition year. (D.87-12-070, Finding of Fact 4.) This is a far cry from GTE-C's implicit argument that we have explicitly recognized that a spread of 50 basis points is appropriate between an A and AA rated utility bonds, for purposes of the Brennan analysis (3 RT 363: 20 to 365: 16).

A comparison of the Kroman/Brennan analysis (Table 3, Exhibit 13 versus Schedule 21, Exhibit 6) follows:

		AA		A	
1	Bond Rating	Brennan	Kroman	Brennan	Kroman
	Debt Leverage	Under 42%	Under 42%	40%-52%	
3	Use	42% (max)	42%	52%	
4	Assumed Yield on Public Utility Bonds	10.5%	10.825%*	11.0%	
5	Weighted Effective Cost Rate (ln 3 x ln 4)	4.41%	4.5465%	5.72%	
6	Total Capital (Millions)	$4,000	$4,000	$4,000	
7	Interest Expense (Millions) (ln 6 x ln 7)	$1.76.4	181.86	$228.8	
8	Coverage	Above 4.5x	4.5x	3.5x	
9	Before Income Tax Income (millions) (ln 7 x ln 8)	$793.8	$818.37	800.80	

*Reflects median differential of 0.175 percentage point (vs 0.5 percentage point in Exh. 6, Schedule 21) with A yield assumed at 11%, per Mr. Brennan.

Thus, while the interest cost component of overall costs to be borne by ratepayers may be somewhat reduced as a result of higher bond ratings, Kroman asserts that it is far outweighed by the increase in the equity cost component, with a significant increase in the resultant overall cost of service. Kroman asserts that there is no sound basis in the record for fixing GTE-C's rate of return at a level claimed necessary to maintain its current bond rating. In his view, a determination of rates on the basis of achieving and/or maintaining high bond ratings is entirely one sided and shortchanges the interests of ratepayers. Moreover he argues there is no evidence whatsoever indicating that GTE-C would be unable to maintain its current bond rating if the Commission does not adopt its recommendation. (City of Los Angeles Brief, p. 7.)

4. FEA's Position

In its brief, FEA argues that the GTE-C capital structure recommendation should not be adopted. FEA believes that even the DRA proposed 55% equity, 40.5% long-term debt, 2.0% short-term debt and 2.5% preferred stock ratio is too equity heavy, preferring instead a capital structure containing 50% equity, 45% debt and 5% preferred stock (but in no event more than 50% equity). (FEA Brief, pp. 3-4.)

5. Discussion

We do not believe that GTE-C has carried its burden of proof on the issue of the necessity of increasing its common equity ratio to 57.2% in order to maintain its AA bond rating. First, as DRA points out, there is still some "maneuvering room" between GTE-C's combined long-term debt/short-term debt recommendation of 40.1% and the "under 42%" figure listed in the S&P's bond rating criteria. That fact, coupled with the undisputed fact that GTE-C has no plans to issue long-term debt during the 1989 attrition year (Application, p. 4)[16] supports a recommendation more in line with that of DRA (40.50% long-term debt, 2.00% short-term debt).

Los Angeles' Kroman has also demonstrated that a slight adjustment in the assumed differential in bond yields between A and AA bonds to account for a longer timeframe, shows that the annual total cost of service for the AA-rated utility substantially exceeds that of the "A" utility. The use of a five-year data base, as reflected during GTE-C's cross-examination of Kroman does not alter the outcome of Kroman's demonstration (3 RT 363: 1-17). The cost for AA becomes 807.78, while the cost for A is unchanged: 800.8.

Both Kroman and DRA correctly observe that higher bond ratings may well result in a reduction in the interest cost

16 "GTE-C does not at this time anticipate issuing any long-term debt during the 1989 attrition year. Instead, its construction program and other capital requirements will be met through the sale of common equity and from internally-generated funds." (Application, pp. 3-4.)

component, but this reduction is far outweighed by the increase in the equity cost component which itself has a far more significant impact on the overall cost of service, if we are to believe the accuracy of Kroman's calculations. Determining rates on the basis of achieving and/or maintaining a high bond rating may indeed be a one-sided view that shortchanges the ratepayer.

Moreover, there is no tangible evidence in the record indicating that General would be unable to maintain its current bond rating if its recommended capital structure were not approved.

Finally we note that GTE-C's O'Rourke also justified his common equity ratio of 58% as a conservative move to reduce financial risk and exposure to interest rate volatility. He stated that the improvement in total equity position helps protect a company against the shock of volatile interest rate increases and higher business risk brought on through increased competition. However, his analysis was not explicitly premised on any formal quantification of these impacts (Exhibit 7, p. 3).

Taking all of these matters into account, it appears reasonable to accept DRA's alternative to GTE-C's recommended capital structure for the 1989 attrition year. This alternative, with its 55% equity cap, represents an increase over the presently authorized percentage, but is within the parameters of Value Line projections for 1988 and 1989; it is also more responsive than GTE-C's proposal to the concerns that capital structure be cost-effective from the ratepayer perspective.

D. Cost of Debt

There is no disagreement among the parties as to the cost of GTE-C's embedded long-term debt for 1989 (9.03%), since no new long-term debt is scheduled to be issued in that year.

In its brief, however, GTE-C asserts that the 9.03% cost could change if the Commission denies its request to issue $45 million in new common equity in 1988, and/or finds that the DRA's proposed 55% equity ratio is reasonable. GTE-C currently plans to finance its construction program in 1989 with $45 million in new common equity scheduled to be issued later this year and through internally-generated funds, including retained earnings. If the

new equity is not issued at year-end 1988, GTE-C argues in its brief that its common equity ratio will still increase to approximately 57% by year-end 1989.[17] In its brief, GTE-C asserts that it would have to consider increasing its dividend payout ratio in order to reduce its equity ratio if the Commission adopts a capital structure that does not at least recognize the growth in its equity ratio from retained earnings; that if it is forced to increase its dividend payout, it would have to consider other sources such as new debt to finance its construction program in 1989; that if this option is elected, GTE-C's pre-tax times interest coverage would decline further, in turn, placing additional downward pressure on its current bond ratings (Concurrent Brief of GTE-C, p. 8). However, these arguments were not developed on the record, and are premised on certain facts that may or may not transpire depending upon the outcome of this decision (i.e., the 57% equity ratio by year-end 1989). Thus these arguments cannot assist the Commission in its deliberations on the cost of debt. That cost remains 9.03%, which we adopt for long-term debt for 1989.

GTE-C's proposed capital structure assumes a cost factor for short-term debt of 8.75%, compared with DRA's 8.50%. Both estimates are substantially higher than the short-term debt cost of 7.00% used in D.87-12-070. However, as the parties acknowledge that decision also established the method for forecasting GTE-C's short-term debt costs for attrition years 1989 and 1990: "The reasonable short-term debt cost is the Blue Chip Financial Forecast

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17 The basis for this statment is 2 RT 117-118. However, at 2 RT 103: 23-105:7 GTE's witness O'Rourke testified that GTE-C's year-end common equity ratio is 56.34%, assuming debt retirements and issuance of the $45 million of common stock. O'Rourke testified that if the common stock for some reason were not issued, the year-end 1988 common equity ratio would be 55%. Later on redirect, O'Rourke testified that the 1989 common equity ratio of 58% would decline by approximately a full point to below 57% if no common equity were issued in 1989. His redirect testimony obviously assumes the GTE-C-recommended common equity percentage is adopted in this decision.

Consensus 1-Month Commercial Paper as of October 1 for the attrition year." (D.87-12-070, Finding of Fact 4.) That forecast is 8.2%, which we adopt.

E. Cost of Preferred Stock

According to GTE-C's O'Rourke, the embedded cost of preferred stock will be 6.38% in 1988, dropping to 6.31% in 1989, due to a mandatory redemption of $4 million. The average cost of preferred stock for 1989 is estimated to be 6.35%. GTE-C has no plans, according to O'Rourke, to issue preferred stock during the 1988-1989 period.

DRA calculates the average effective dividend rate of preferred stock for 1989 as 6.34% (Exhibit 9, Table 4). This is an average-year figure which includes changes projected to occur in GTE-C's outstanding preferred stock due to a mandatory redemption.

There is virtually no difference in the GTE-C/DRA cost factor recommendations, and we adopt 6.34% as the cost factor for preferred stock for the 1989 attrition year.

F. Cost of Equity

1. Summary of ROE Recommendations

The following table summarizes the positions of the parties:

Party	ROE (Percent)
GTE-C	14.50
DRA	12.25-12.75*
Los Angeles	13.00

* Midpoint recommended

2. GTE-C's Showing

GTE-C's financial attrition request of $66 million is premised on a 57.2% common equity ratio, as discussed previously, and an ROE of 14.5%. In GTE-C's 1988 test-year rate case, the Commission adopted an ROE for 1988 of 12.75%. GTE-C maintains that the Commission adopted 12.75%, which was below the 13.25% recommended by the ALJ in his proposed decision, because it elected not to make approximately $534 million in additional revenues subject to refund pending issuance of a final decision in the

proceeding during the first half of 1988.[18] These revenues were associated with the additional test-year revenue requirement reductions proposed by DRA in that proceeding. The Commission stated that it acted to "...further reduce the risk that General will face in 1988, a reduction which is reflected in our adopted return on equity." (D.87-12-070, mimeo. p. 23.)

General maintains that its equity investors are entitled to a higher ROE for the 1989 attrition year than that adopted in D.87-12-070 because of dramatic increases in interest rates in 1988 over 1987, and the further substantial increases forecasted for 1989, as well as serious shortcomings in DRA's DCF and risk premium analysis (Concurrent brief of GTE-C, pp. 9-10). GTE-C maintains that all of the witnesses in this proceeding have recognized these changing financial conditions, and have increased their recommended returns in the 1989 attrition year accordingly.

In support of its requested ROE GTE-C presented the testimony of Joseph F. Brennan. Brennan was GTE-C's witness in the 1988 test year proceeding, during which he recommended a 15% ROE. In this proceeding, Brennan has used three methodologies: A single stage constant growth DCF model; a modified DCF model; and the Capital Asset Pricing Model (CAPM) (Exhibit 6, Schedule 1, page 1 of 2). Brennan's recommended ROE of 14.5% represents the midpoint of the range (14.4% to 15.7%) derived by application of these three models.[19] Brennan also provided a risk analysis.

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18 That decision was ultimately issued in August, 1988 (D.88-08-061).

19 In connection with these models Brennan used 2 barometer groups of telephone companies as a proxy for GTE-C, whose stock is not publicly traded. The two barometer groups of telephone companies included three independent operating telephone companies (Cincinatti Bell, Inc., Rochester Telephone Corporation, and

(Footnote continues on next page)

Brennan believes that regulated telephone companies have greater business risks compared to many other kinds of utility companies. He believes the telephone industry is faced with competition for virtually all of its services even at the local network access level, and while regulators may help a telephone utility to preserve its markets by, for example, prohibiting intraLATA competition, they cannot preserve many markets for a telephone utility in today's environment. Brennan points to competitor inroads in the following areas:

- Bypass is GTE-C's major competitive threat in the exchange marketplace.
- Competitors cannot build a system for less money than GTE-C, but they price it lower because it does not support other parts of their business. This type of competition will be driven by high volume users looking to reduce their cost for network transport.
- Technology has placed the competitor in the enviable position of gaining immediately from state-of-the-art technology without concern for capital recovery of investments in outdated technology. As a result, competitive inroads may be made by

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(Footnote continued from previous page)

Southern New England Telecommunications Corp.) and seven regional holding companies (American Information Technologies Corp., Bell Atlantic Corporation, Bell South Corporation, Nynex Corporation, Pacific Telesis Group, Southwestern Bell Corporation, US West, Inc.). Brennan also used a barometer group of 8 gas distribution companies (Exhibit 6, Schedule 11) as a check on his analysis. Additionally, Brennan adjusted upward the market-derived ROE range for his two telephone company groups "...in recognition of a lower investor-perceived investment risk for the two telephone groups compared to GTE-C, since these groups were used as a proxy for GTE-C. The basis of this judgment is the difference in bond rating for GTE-C and the average bond rating for each barometer group of telephone companies." (Exhibit 5, p. 4.)

interexchange carriers and major customers looking to build their own capacity.

- Major competitors may also include cellular franchise holders, large business customers building their own networks to reach IXC points of presence (POP), e.g., within GTE-C's service area, other carriers using CATV or joint ventured Networks to bypass exchange company services.

- Major competitors include AT&T-C, Wang, and MCI, all of whom have high national account visibility. (Exhibit 5, p. 12.)

Brennan analyzed the market data for his group of comparable companies under the DCF approach, giving equal weight to the constant growth DCF model and to a modified model designed to recognize an investor-expected price earnings multiple change.

The constant growth DCF model, based on an analysis of publicly rated common stock, is a technique utilizing market price, reported earnings per share and dividend payments per share in a calculation to determine the implicit return required by the investor and reflected in the market price of the stock (Exhibit 5, p. 27). The required inputs are an estimate of the current dividend yield of a security and an estimate of the growth rate in earnings and dividends. Brennan derived a constant growth DCF cost of equity of 11.6% for the barometer group of independent telephone companies, 12.8% for the barometer group of regional holding companies, and 13.4% for the barometer group of gas distribution companies (Exhibit 5, p. 34; Exhibit 6, Schedule 16).

Brennan conducted a second DCF study, because he believes there are serious limitations in the constant growth DCF model. Specifically, he believes that the assumption in the constant growth DCF computation that investors use a single growth rate for the infinite future is unrealistic (Exhibit 5, p. 28). He asserts that while the typical DCF model proceeds from the premise that the rate of growth reflected in the price of stock is a particular rate

over time, in fact, the growth rate can and does vary from period to period.

Brennan's modified DCF analysis is rooted in the belief that investor behavior is better explained by considering several independent variables such as changes in price earnings ratios, various industry-specific factors, and various company-specific financial characteristics such as common equity ratios (Exhibit 5, pp. 36-37, Appendix B; Concurrent Opening Brief of GTE-C, p. 19).

Brennan took into account dividends expected over the next 12 months in developing his dividend yield and the growth in value related to next year's expected earnings, and an assumed expected price-earnings multiple increase of 0.25 times. Using this approach, Brennan derived a cost-of-common equity of 13.4% for the independent telephone group, 15.3% for the seven regional holding comapnies, and 15.9% for the gas distribution companies (Exhibit 5, pp. 37-38).

Brennan averaged the results of his two DCF analyses to derive the following common equity recommendation: 12.5% for the three independents; 14.1% for the seven regional holding companies; and 14.7% for the gas distribution companies (Exhibit 5, p. 38; Exhibit 6, Schedule 1).

Brennan also performed a third study using the CAPM model. Under the CAPM approach the expected rate of return is determined by a risk-free rate of return plus a market premium proportional to the nondiversifiable risk. The nondiversifiable risk is obtained by the application of a beta (an indication of the relative risk of the security to the risk of the market). Betas are published by, among others, Value Line. (Exhibit 5, p. 38.)

Brennan used Treasury Bond yields to determine the appropriate risk-free rate of return using September '88 T-Bond yield forecasts (9.7%) and also Treasury Bond yield forecasts of Value Line and Blue Chip for the year 1989 (8.8% and 9.7%,

respectively). Based on these sources he concluded that a reasonable estimate of the risk-free rate for 1989 is 9.3%.

He next determined the appropriate market premium by determing three to five-year forecasts of capital gain yields on common stock investments. These forecasts indicate a projected annual capital appreciation of 15.83%. When the average annual dividend yield of 3.1% is added to the average annual appreciation, the total market return is 18.9%. The total market return less the 9.3% return on a risk-free investment produces a market premium of 9.6%.

Brennan also considered historical risk premiums, relying on a 7.4% figure for the period 1926 to 1987 published in 1988 by Ibbotson and Associates. By giving equal weight to his projected risk premium and to the historical risk premium issued by Ibbotson and Associates, Brennan concluded that the appropriate market premium to use in the CAPM computation is 8.5% (Exhibit 5, p. 40). Brennan's CAPM-derived common equity cost is 15.0% for the three independents, 16.8% for the seven RHCs, and 15.2% for the eight gas distribution companies. (Exhibit 5, p. 40.)

Finally, as noted in Exhibit 6, Schedule 1, Brennan increased both the high end and the low end of his range by 0.2% to recognize the fact that GTE-C's bond ratings are below the average ratings of either of the other two telecommunications groups used in his analysis. Given the fact that GTE-C's bond rating is AA- whereas the two telephone company groups employed as proxies carry average bond ratings of AA or AAA, Brennan concluded that the investor-required ROE for GTE-C should be increased by at least 0.2% to recognize this difference in risk. His resulting ROE range is 14.4% to 15.7%; his specific ROE recommendation is 15%, the midpoint of the range. However, as reflected in the testimony of GTE-C's O'Rourke, GTE-C's request in this proceeding is premised on an ROE of 14.5%.

3. DRA's Showing

DRA witness Blunt recommends a return on equity for the 1989 attrition year of 12.50%, premised on a recommended range of 12.25% to 12.75%. Blunt used the DCF and risk premium methodologies; however, he initially selected 24 telecommunications and gas distribution companies (group), based on comparability of business and financial risks to GTE-C. He selected telecommunications and gas distribution companies whose cumulative bond rating is identical to GTE-C's rating. Further, the groups' average equity ratio is similar to GTE-C's current common equity ratio. And, the seven independent telephone companies and seven regional holding companies included in the group are engaged in similar business pursuits. They are regulated or have subsidiaries that are regulated. The gas distribution companies are selected because they are experiencing similar business risks moving from a near monopoly to a more competitive environment.

Blunt states that since divestiture, telecommunications utilities have been expressing fears about the threat of bypass and its detrimental effects on their earnings and market share. However, Blunt believes there is solid evidence that the threat of bypass has yet to affect GTE-C's earnings, since there has been a 54.3% increase in earnings since divestiture (Exhibit 9, p. 42). Blunt asserts that using a market-driven analysis (such as DCF and risk premium) will account for and reflect any solid evidence of increased competition and its adverse impact on earnings.

Blunt's DCF analysis is summarized at Exhibit 9, Table 17. The results of Blunt's analysis were previously described in connection with Pacific Bell's financial attrition application, supra. This analysis produced a composite group average investor-required return on equity of 12.21% and 12.34% when the average 3-month and 6-month expected yields are combined with average growth rate (Exhibit 9, Table 17). Blunt's DCF analysis included no adjustment for flotation costs, as discussed

earlier in this opinion. The market-to-book ratio for GTE-C is 166, and GTE-C does not plan to issue common stock equity during 1989. Blunt relied upon these facts to support his argument that there is no reason to adjust the results of the DCF analysis for flotation costs. Blunt also used the risk premium analysis to support his recommendation. His application of that analysis is discussed in detail in connection with Pacific Bell's application, supra.

4. Los Angeles' Showing

Kroman recommends a return on common equity of 13% for the 1989 attrition year.

Initially Kroman asserts that GTE-C has failed to meet its burden of proof because its rate of return showing relies upon subjective and flawed methodologies. More specifically, Kroman assets that both the DCF and CAPM methodologies pre-select market data which produce numbers that can be fitted into neat, simplistic formulas said to produce investors' expected and required return on common equity. He believes that:

> "...inasmuch as the DCF formula is stated in terms of dividend yield plus growth rate, it is obvious that the result is a simple, direct function of whatever dividend yield or market price the analyst chooses to select. The proposition that anyone can accurately ascertain and specify by single number the widely diverse expectations of some 47-million investors is patently incredible." (Los Angeles' Brief, p. 8.)

To test whether GTE-C's DCF numbers have investment relevance, Kroman performed a correlation analysis between (1) a large investment advisory service's "buy-hold-sell" recommendations on 78 electric utilities, and (2) the difference between each utility's most recently recorded return on average common equity and its DCF-determined cost of common equity. Logically and realistically, Kroman states that one would expect that investors would be advised to sell stocks in utilities not earning their cost

of equity, buy stocks which are earning above their equity costs, and hold those stocks which are earning at about their equity cost. However, the results of Kroman's regression analysis show that whether or not a utility is earning its DCF-determined cost of equity has virtually no effect on the advice recommendations offered to investors. (Los Angeles Brief, p. 11; Exhibit 12, pp. 11-12.)

With all of its faults, Kroman believes that the DCF model is still superior to the CAPM model. The critical factor in the CAPM formula, the beta, is based upon past relative stock price movements and is thus incapable of predicting future relationships. Kroman also criticizes GTE-C's CAPM methodology for reliance on interest rates forecasts.

At bottom, Kroman agrees with the observation of this Commission in D.87-12-070 that variations in the result obtained from these models are indicative of their limited value as guides, and that the Commission must exercise its judgment rather rely on any particular methodology in determining the cost of common equity (D.87-12-070, mimeo. p. 22).

Kroman's second major argument is that GTE-C's business and financial risks have not changed appreciably since the Commission last authorized a reasonable rate of return in D.87-12-070. Kroman believes that GTE-C has engaged in a strategy of exaggeration, and has failed to produce objective, independent, or disinterested evidence relative to risk as seen by the outside investment community.[20]

A further flaw in GTE-C's risk allegations is the failure to distinguish between changes in absolute risks and changes in

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20 For example, Kroman introduced evidence demonstrating that the debt ratings of the large telephone utilities are vastly superior to those of most of the electric utilities (Exhibit 13, Tables 1 and 2, pp. 1-2).

relative risks. Kroman maintains that increased risks are currently affecting not only telecommunications utilities (or GTE-C in particular) but the entire spectrum of American business. He points to data indicating the number of long-term debt rating changes which S&P tabulated for the full year 1986 and the first half of 1988, segregated among industrial companies, utilities, and other companies. According to Kroman, that evidence demonstrates that not one telecommunications utility was downgraded in this time period (Exhibit 13, Table 6, p. 6).

Kroman also examined financial community credit-worthiness comments focused on the telecommunications industry in general and GTE-C in particular. (See Exhibit 13, Tables 12, 13, and 14.) He states that the telecommunications services industry is generally viewed favorably and that the trend to riskiness is not reflected in issuance of investor alarms. He points to certain comments in Moody's Bond Survey concerning proposed new long-debt issues as being inconsistent with the utility's pessimistic claims.

Kroman maintains that the process of determining rate of return requires the application of informed, fair, and well-balanced judgment, and that the evidence relied upon must be complete and credible. He maintains that economic conditions and the level of interest rates are significant elements to be considered in arriving at a recommendation for a fair rate of return, and that current conditions do not differ substantially from the conditions existing at the time D.87-12-070 was issued.

Kroman has also developed data indicative of the direction and magnitude of change in the cost of common equity, comparing conditions shortly before issuance of D.87-12-070 with more recent economic developments. (See Exhibit 13, Table 15, p. 16; Table 16, p. 17.) For six independent telecommunications companies, the cost of common equity has decreased on average by 2-1/2 percentage points. Similarly, for seven regional holding companies the average indicated decrease in the cost of common

equity was 3 percentage points. A comparison of GTE-C's prior and current submissions for three independent telephone companies, 7 RHCs and 8 gas distributors (Mr. Brennan's proxy groups) demonstrates no change at all in an average of the averages of the three groups of companies. (Exhibit 13, Table 17, p. 18.)

Kroman also performed a correlation analysis over the period July 1, 1969 through December 22, 1987, reviewing General's authorized rates of return on common equity and the prime interest rates prevailing at the times of such authorizations. The result shows a coefficient of determination between authorized returns on common equity and the corresponding interest rates of 0.725% (Exhibit 13, Chart 3, p. 23). Thus, nearly three-quarters of the variations of ROE may be explained by variations in the prime rate. Kroman does not recommend that such a simplistic approach be solely and directly employed to determine a proper return on common equity. However, these data clearly establish that there has logically been a significant correlation between the applicant's authorized ROE and the prime interest rate. The mathematical result of this anlaysis produces a 12.93% return on common equity at a 10% prime interest rate (Exhibit 12, p. 25).

Finally, Kroman also explored the relationship between the return on common equity and the corresponding pre-tax interest coverage for the applicant, since GTE-C emphasized its importance during these proceedings. Kroman accordingly observes that GTE-C could achieve a pre-tax interest coverage implicit in D.87-12-070 with a very modest ROE of approximately 11%.

In sum, Kroman concludes that since the Commission last fixed GTE-C's return on common equity at 12.75% for test-year 1988, short-term interest rates have risen modestly, but no other significant changes have occurred which should markedly increase GTE-C's current business or financial risks. Kroman submits that an allowance for common equity of 13.0% with a corresponding overall rate of return set at 11.23% together represent the highest

rates justified by an accurate and complete consideration of the record.

5. FEA's Position

In its brief submitted in this proceeding, FEA argues that the record justifies no higher than the 10.73% overall rate of return which would result from the lower end of DRA witness Blunt's cost of equity range (12.25%). In FEA's view, there are absolutely no indications in the economy that the cost of capital will even approach 15%, as GTE-C's witnesses assert, during the next year.

6. API's Position

In its brief submitted in this proceeding, API asserts that GTE-C's cost of equity analysis is upwardly biased and should be rejected. More specifically, API challenges Brennan's conclusion that the seven regional Bell telephone companies and the eight distribution companies--which produce returns of 14.1% and 14.7% respectively--are comparable for cost of capital purposes to GTE-C. API notes that the only other group of non-Bell Telephone Companies examined in Brennan's DCF analysis produced an expected equity return of 12.5%. API concludes that Brennan's DCF analysis thus produced upwardly biased equity cost estimates.

API also disputes the results of Brennan's CAPM analysis. It challenges Brennan's historical risk premium analysis as an unsuitable proxy for future investor expectations. API also challenges Brennan's forecasted risk premium, based on his testimony that he used a market appreciation rate of 80% over a four-year period (API Brief, p. 5). API notes that Brennan failed to answer questions put to him as to whether GTE-C's stock had experienced such appreciation over the last four-year period. (API Brief, p. 5.)

In sum, API asserts that GTE-C's cost of equity recommendation should be rejected and that the Commission should rely upon the record evidence submitted by the other parties in this proceeding.

7. Discussion

The recommended ROEs range from DRA's 12.25%-12.75%, to Los Angeles' 13.0%, to GTE-C's 14.50%. The various ROE models employ differing assumptions and imputs, and are in that sense, imperfect proxies for calculating the investor-required return on equity. It is apparent that all of these models have their flaws, and, as we have routinely stated in past decisions, the models should not be used rigidly or as definitive proxies for the determination of the investor-required return on equity. For example, Los Angeles' Kroman criticizes GTE-C's use of the DCF model and the CAPM model, and generally believes that other factors, such as interest rate levels and economic conditions are more valuable tools. API criticizes GTE-C's CAPM and DCF analyses more specifically. GTE-C itself spent much time and effort criticizing DRA's use of the constant growth DCF methodology and DRA's selection of the companies included in its barometer group. GTE-C also accuses DRA of manipulating the imput data in its risk premium analysis.

Clearly, the inconsistencies are not confined to the ROE showing any one party. For example, GTE-C's Brennan used the DCF and risk premium methodologies in the 1988 test-year proceeding, but eliminated risk premium in the 1989 attrition proceeding in favor of CAPM. DRA's Blunt eliminated CAPM, which he had used in 1988, in favor of risk premium.

Nor are we convinced by GTE-C's arguments that DRA has manipulated the selection of companies in its barometer group in order to obtain a predetermined outcome (i.e., a lower ROE). On cross examination by the City of San Diego, DRA's witness clarified that exclusion of three new telephone companies and one gas company (inclusion of which GTE-C objected to) resulted in a reduction in the discount rate of approximately 10 to 15 basis points; therefore, by including the companies DRA's witness concluded that

the result of the DCF analysis was actually increased (Tr. Vol. 3, p. 310).

We believe that the observation of a utility witness in an earlier Pacific Telephone general rate case (cited in Los Angeles' Brief, at p. 9) bears repeating:

> "To get empirical about it is almost impossible unless one could climb inside the mind of the common stock investor and know exactly what growth rate he is anticipating. That has always been impossible. No methodology I know of, including the widespread use of DCF, is able to climb inside the heads of all investors and come up with the right numbers, primarily because where one can use the mechanics of multiplying a retention rate times a projected rate of return on equity, that only gives you growth from plow-back, which is only one-thrid of the equation possibly. The other two ways for earnings to increase is if the investor is antcipating some improvement in the company's actual rate of return on equity, and then a third is the sale of stock above book value. ***." (A.83-01-022, RT. pp. 692-693.)

At bottom, the models are only helpful as rough gauges of the realm of reasonableness. In the final analysis we must rely on informed judgment rather than on any particular formula approach to establish the reasonable return on common equity. To do so, we assess the forecasts of overall economic conditions, the range of returns earned by comparable companies, and the relative risks faced by the particular utility under consideration (D.87-12-070, p. 20). In December 1987 when we last reviewed GTE-C's cost of equity, the prime interest rate was 8.7% to 9.00%, the discount rate was 6.00%, the Dow Jones Utility Bond Average stood at 85.90, and the Dow Jones Utility Stock Average at 178.05. At the time hearings were held in this matter, the prime rate was 10%, and other short-term interest rates had also increased since year-end 1987, although to a lesser extent. Long-term utility bond yields are now a full percentage point lower than at the time of

D.87-12-070 and stock yields are about 25 basis points lower. The Dow Jones Averages remain at about their former levels. In addition, GTE-C projects no new outside financing for the 1989 attrition year, whereas it had projected such a need in its last rate case; this militates against an incerase in ROE over currently authorized levels. We also consider the risk reduction implications of the fact that GTE-C's weighted total debt cost per D.87-12-070 and its common equity ratio then, compared with its lower debt cost and higher equity ratio today, are markedly different.

This underscores the great weight of the evidence in this proceeding that GTE-C's levels of business and/or financial risk for attrition year 1989 are no greater than they were at the time D.87-12-070 was issued. Indeed, the improved equity ratio adopted in this decision reduces GTE-C's risk further. While GTE-C has argued that it is entitled to an increase in its currently authorized 12.75% ROE because that figure was premised on a lower risk now eliminated with issuance of D.88-08-061, we believe this record demonstrates the existence of further reductions in risk, justifying retention of the 12.75% figure. Further, the underlying risk we reduced in D.87-12-070 by refraining from making GTE-C's revenues subject to refund, was permanently removed in D.88-08-061. It no longer exists as a risk confronting GTE-C in the 1989 attrition year. All things considered, we believe that a reasonable ROE for attrition year 1989 is the currently authorized 12.75%. This figure is well within the range of recommendations in the record, and falls at neither extreme.

Findings of Fact

1. In its 1989 financial attrition application, Pacific Bell sought to decrease its authorized intrastate rate of return from 12.12% to 11.56% premised on an average debt cost of 9.21%, a common equity return of 14.00%, and a capital structure composed of 42.5% debt and 57.5% equity.

2. Based on the testimony served prior to the scheduled commencement of hearings, the parties' 1989 attrition year recommendations varied greatly in such matters as the appropriate percentage of common equity to be reflected in the capital structure, the elimination of preferred stock, and the cost factor applicable to common equity.

3. On the day evidentiary hearings were scheduled to begin, Pacific Bell and DRA indicated they were close to settlement of all issues. The settlement proponents thereafter continued negotiations, which involved all parties in the proceeding.

4. The parties reached an agreement resolving all issues and presented a Settlement Agreement and Stipulation (Appendix B hereto) signed by all parties. Bay Area Teleport, Western Burglar and Fire Alarm Association, and TURN signed the agreement, indicating that they did not oppose its adoption; all other parties specifically requested that the Commission adopt the settlement.

5. The parties have agreed that for intrastate ratemaking purposes, Pacific Bell's 1989 attrition year rates shall be based on: (1) a 13.00% return on common equity; (2) a 9.21% average cost of debt; (3) a capital ratio composed of 43.75% debt and 56.25% equity; and (4) a 11.34% overall rate of return.

6. Although the settlement proponents did not comply with Rule 51.1(b) of the Commission's Rules of Practice and Procedure, which requires the convening of at least one conference with at least 7 days advance notice and opportunity to participate provided to all parties for the purpose of discussing stipulations and settlements in a given proceeding, the proponents' extensive and successful efforts to involve all parties in the process after October 17 were sufficient to justify granting a waiver from Rule 51.1(b).

7. Pursuant to Rule 51.1(e), an uncontested settlement, such as that presented by the parties in A.88-07-019, will not be approved unless it is reasonable in light of the whole record, consistent with law, and in the public interest.

8. There are legitimate concerns expressed in the text of this opinion about the return on equity and capital structure proposed in the settlement agreement. These concerns relate to the issues of cost-effectiveness; the impacts of the high equity component vis-a-vis Pacific Bell and its parent holding company; the reasonableness of a 13% cost factor for common equity given the improved equity ratio and resultant lowering of risk; and the elimination of the 6% voting preferred imputed by D.82-05-07 without consideration of a proposal designed to end the adjustment equitably from the ratepayer perspective.

9. Despite these specific concerns, we will adopt the uncontested settlement agreement as reasonable because, on the whole, it is within the range of recommendations presented to us in testimony served prior to settlement; further it is in the public interest to the extent that it will provide ratepayers the immediate benefits of a reduced revenue requirement, pending thorough review of these issues in I.87-11-033.

10. In its 1989 financial attrition application GTE-C sought to increase its authorized intrastate rate of return from 10.90% to 12.08%, premised on a long-term debt cost of 9.03%, short-term debt cost of 8.75%, preferred stock cost of 6.35%, and common equity return of 14.50%, and a capital structure composed of 38.2% long-term debt, 1.9% short-term debt, 2.7% preferred stock, and 57.2% common equity.

11. While capital structure was an issue in dispute for the 1989 attrition year, all witnesses supported some increase in the presently authorized 53.5% equity percentage (DRA recommended 55% and GTE-C 57.2%).

12. GTE-C asserted that its requested 57.2% equity percentage was key to maintaining its current AA bond rating, but evidence presented by DRA tended to demonstrate that GTE-C has additional flexibility prior to reaching the Standard & Poor's 42% guideline for the AA rating, and that the additional equity build-up may not be cost-effective from the ratepayer perspective. These cost-effectiveness concerns were validated by the calculations of Los Angeles' witness which challenged GTE-C's assertions that the total cost of service is lower for AA rated utilities than for A rated utilities.

13. GTE-C asserts that it has no plans to issue long-term debt during the 1989 attrition year.

14. There is no tangible evidence in the record indicating that GTE-C would be unable to maintain its current bond rating if its recommended capital structure were not approved.

15. Higher bond ratings may well reduce interest costs, but in the case of GTE-C's proposed capital structure, the benefits of this reduction may be outweighed by an increase in the equity cost component, which has a more significant impact on the overall cost of service.

16. DRA recommended capital structure, including its 55% equity percentage cap, which represents an increase over the presently authorized percentage, is reasonable in line with Value Line projections for 1988 and 1989, and is more responsive than GTE-C's proposal to the cost-effectiveness concerns discussed herein.

17. Cost factors of 9.03% for long-term debt, 8.2% for short-term debt, and 6.34% for preferred stock are virtually undisputed and, on that basis, reasonable for adoption for attrition year 1989.

18. Since December 1987, when we last reviewed GTE-C's cost of equity, short-term interest rates have risen modestly, but no other significant changes have occurred which would markedly

increase GTE-C's current business or financial risks. Indeed the improved equity ratio adopted in this decision reduces GTE-C's risk further.

19. Based on our analysis of overall economic conditions, the range of returns earned by comparable companies illustrated in the various models used in this proceeding, and the relative risks faced by GTE-C, a reasonable ROE for attrition year 1989 is the currently authorized 12.75%; this results in an overall rate of return of 10.99%.

Conclusions of Law

1. The parties' request for waiver of Rule 51.1(b) of the Rules of Practice and Procedure should be granted because the due process protections embodied in these provision were effectively, albeit belatedly, extended to all parties by the settlement proponents.

2. The terms and conditions of the Settlement Agreement and Stipulation (Appendix B hereto), embodying a complete, total, and uncontested settlement of A.88-07-019 should be adopted in furtherance of the ratepayer interest in immediate recognition of Pacific Bell's reduced revenue requirement for attrition year 1989.

3. GTE-C has not carried its burden of proof justifying an increase in its common equity ratio from the 53.50% adopted in December 1987, to 57.2%.

4. DRA's recommended capital structure for GTE-C, including its 55% equity percentage cap, should be adopted for the 1989 attrition year.

5. Cost factors of 9.03% for long-term debt, 8.2% for short-term debt, and 6.34% for preferred stock should be adopted for the 1989 attrition year.

6. A return on common equity of 12.75% should be adopted for GTE-C for attrition year 1989, resulting in an overall rate of return of 10.99%.

O R D E R

IT IS ORDERED that:

1. The following cost of capital is adopted for Pacific Bell for attrition year 1989 in accordance with the terms of the Settlement Agreement and Stipulation hereby adopted in its entirety:

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	43.75%	9.21%	4.029%
Preferred Stock	-	-	-
Common Equity	56.25	13.00	7.312
Total	100.00%		11.34%

2. The terms of the Settlement Agreement and Stipulation attached hereto as Appendix B are incorporated herein.

3. On or before December 28, 1988, Pacific Bell shall have filed advice letters and/or supplemental advice letters pursuant to General Order 96-A to implement its 1989 attrition allowance effective January 1, 1989, based on (1) our resolution issued today in connection with its 1989 operational attrition advice letter filing, and (2) its financial attrition showing, as adjusted to reflect the rate of return adopted herein. Such advice letter shall also reflect the bill and keep surcharge/surcredit mechanism developed in response to the directives of D.88-08-024, and designed to coordinate the reflection of current memoranda account balances in rates with 1989 attrition, and interLATA and intraLATA SPF-to-SLU changes, using an estimated 1989 billing base.

4. The following cost of capital is adopted for GTE California Incorporated (GTE-C) for attrition year 1989:

Adopted Cost of Capital

Component	Capital Ratio	Cost Factor	Weighted Cost
Long-term Debt	40.50%	9.03%	3.66%
Short-term Debt	2.00	8.20	0.16
Preferred Stock	2.50	6.34	0.16
Common Equity	55.00	12.75	7.01
Total	100.00%		10.99%

5. On or before December 28, 1988 GTE-C shall have filed advice letters and/or supplemental advice letters pursuant to General Order 96-A to implement its 1989 attrition allowance effective January 1, 1989, based on (1) our resolution issued today in connection with its 1989 operational attrition advice letter filing, and(2) its financial attrition showing, as adjusted to reflect the rate of return adopted herein. Such advice letter shall also reflect the bill and keep surcharge/surcredit mechanism developed in response to the directives of D.88-08-024, and designed to coordinate the reflection of current memoranda account balances in rates with 1989 attrition, and interLATA and intraLATA SPF-to-SLU changes, using an estimated 1989 billing base.

This order is effective today.

Dated DEC 19 1988, at San Francisco, California.

I will file a written concurring opinion.

/s/ STANLEY W. HULETT
President

I will file a written concurring opinion.

/s/ FREDERICK R. DUDA
Commissioner

I will file a written concurring opinion.

/s/ G. MITCHELL WILK
Commissioner

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
JOHN B. OHANIAN
Commissioners