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SEP 26 1991

Decision 91-09-066 September 25, 1991

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

In the Matter of the Application of Contel of California, Inc., (U 1003 C) for Review of Its Cost of Capital and Capital Structure for 1991.	Application 90-10-006 (Filed October 1, 1990)
In the Matter of the Application of Roseville Telephone Company (U 1015 C) for Review of its Cost of Capital and Capital Structure.	Application 90-10-007 (Filed October 1, 1990)
In the Matter of the Application of Citizens Utilities Company of California (U 87 C), Constituting its Compliance Filing for Financial Attrition Review	Application 90-10-047 (Filed October 22, 1990)

Orrick, Herrington & Sutcliffe, by Robert J. Gloistein, Attorney at Law, for Contel of California, Inc.; Messrs. Cooper, White & Cooper, by E. Garth Black and Mark P. Schreiber, Attorneys at Law, for Roseville Telephone Company; Messrs. Beck, Young, French & Ackerman, by Jeffrey F. Beck, Sheila A. Brutoco, L. Russell Mitten, II, and A. J. Smithson, Attorneys at Law, for Citizens Utilities Company of California, applicants.

Thomas J. Ballo, Attorney at Law, for Pacific Bell, and Randolph W. Deutsch, Attorney at Law, for AT&T Communications of California, interested parties.

James Rood, Attorney at Law, Terry Mowrey, and William Thompson, for the Division of Ratepayer Advocates.

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OPINION

This decision authorizes an overall 1991 rate of return of 10.75% for Contel of California, Inc. (Contel), Roseville Telephone Company (Roseville), and Citizens Utilities Company of California (Citizens). We are neither convinced by qualitative assessments nor quantitative models that risk or economic conditions have sufficiently changed to justify a change in applicants' rates of return. Therefore, we continue the rates of return last found reasonable in Decision (D.) 90-06-015.

Just as we did in D.90-06-015, we here establish the overall rate of return, but do not establish return on equity or capital structure. This approach provides the utilities with an incentive to manage their capital structures efficiently.

1. Background

This is the third attrition year proceeding for these three utilities. First, D.89-05-059 approved settlements for the 1989 attrition year, with authorized overall rates of return of 10.74%, 12.02%, and 11.10% for Contel, Roseville and Citizens, respectively. The settlements provided that each utility file an application for review of capital structure and cost of capital for attrition year 1990.

Second, D.90-06-015 approved a 1990 attrition year rate of return of 10.75% for Contel, Roseville, and Citizens. Further, D.90-06-015 declined to establish authorized returns on equity or capital structure. Conclusion of Law 2 directed the utilities to file 1991 financial attrition applications on October 1, 1990.

Contel, Roseville, and Citizens filed their applications in October 1990 for the third--1991--attrition year. A prehearing conference was held December 14, 1990. Hearings were held on April 16, 17, and 18, 1991, with briefs filed on May 24, 1991.

The proposed decision of the ALJ was filed and served on August 21, 1991. Comments were timely filed by Contel, Roseville and DRA. No reply comments were filed. Contel points out three technical errors. Roseville identifies what it believes are several legal, technical and factual errors, and recommends the 10.75% rate of return proposed by the ALJ be increased to the 12.6% requested and supported by Roseville's showing. DRA supports the decision as written.

We have carefully considered the record, the proposed decision, and the comments. Comments which merely reargue positions taken in the briefs are accorded no weight, consistent with Rule 77.3 of our Rules of Practice and Procedure. We modify the ALJ's proposed decision where appropriate to reflect comments that have merit, or where further explanation of our intent is needed.

2. Summary of Requested and Recommended Rates Of Return

Applicants each request an increase in their authorized rates of return, but none requests an increase in rates. Each is willing to forego rate and revenue increases in these proceedings given that substantial rate and revenue impacts may occur soon with rate redesign in Phase III of Investigation (I.) 87-11-033 (our investigation into alternative regulatory frameworks for local exchange carriers (LECs)). Each is willing to avoid the "roller coaster" rates, customer confusion, and annoyance that further rate and revenue increases in these proceedings may cause. At least one direct impact of an increase in the authorized rate of return from these proceedings, however, would be the amount each utility may draw from the California High Cost Fund (CHCF).

The parties request or recommend the following rates of return compared to last authorized:

Party	Last Authorized	Request or Recommendation Original	Final	Increase over Last Authorized from Final Req.
	(%)	(%)	(%)	(basis points)
Contel	10.75	12.39	11.80, but no lower than 11.02	105 27
Roseville	10.75	12.6	12.6	185
Citizens	10.75	12.50	11.70	95
DRA	10.75	10.75	10.75	0

Contel originally requested an overall rate of return of 12.39%. In its brief, Contel lowered its request to 11.80% (reflecting a 13.93% return on equity), based on recent information, changed market conditions, and lower interest rate data raised at the hearings. Contel argues that in no event should the authorized rate of return be lower than 11.02% (reflecting a 12.50% return on equity), based on Contel's recalculation of the Commission's Division of Ratepayer Advocates' (DRA) analysis. Contel recommends a capital structure of 39.4% debt, 0.6% preferred equity, and 60.0% common equity.

Roseville requests an overall rate of return of 12.6%. Roseville does not agree with the approach of D.90-06-015 (to determine the overall rate of return without a determination of capital structure and cost of capital), but finds the approach acceptable for 1991 if the Commission adopts Roseville's recommended cost of capital of 12.6%. If the Commission adopts a capital structure, Roseville recommends 16% debt, 84% equity. Roseville recommends the Commission adopt Roseville's actual cost of debt and a cost of equity that reflects its low level of financial risk, for an overall return of 12.6%.

Citizens requests an overall rate of return of 12.50%, amended in late-filed exhibits and brief to a request of 11.70% based on more recent information. Citizens does not request a determination of cost of debt, return on equity, or capital structure.

DRA argues that circumstances have basically not changed since D.90-06-015, and recommends that the rates of return remain at 10.75%, without specific determinations of capital structure, cost of debt, and cost of equity.

As a factor common to each application, we will first discuss whether conditions have materially changed since we last established each utility's rate of return. Then we will turn to a review of each utility's showing.

3. Changes Since the Last Proceeding

Applicants generally argue that business and financial risks have increased since their rates of return were last authorized, thereby causing an increase in their cost of capital.[1] Further, applicants contend that increased interest rates and deteriorated general economic conditions have increased their cost of capital.

On the other hand, DRA argues that events have not increased business or financial risk since D.90-06-015. DRA agrees that reasonable rates of return tend to track interest rates and the economy in general. DRA asserts, however, that interest rates have fallen since the last rate of return decision and the economy has generally improved (although not sufficiently to support a

1 Both business and financial risks relate to the volatility of cash flows available for distribution to suppliers of a firm's capital (debt and equity). Business risk relates to the nature of the business in which the company is engaged, without regard to how the company is financed. Business risk includes the volatility of costs (due to such factors as the degree of fixed versus variable expenses faced by a firm based on the capital intensity of a business relative to other businesses, as well as the degree and nature of competition and regulation), and the volatility of revenues (due to such factors as the nature of demand, and the degree and nature of competition and regulation). Financial risk refers to the added volatility of cash flows due to the degree of fixed obligation financing in the capital structure (i.e., the amount of debt financing).

reduction in the authorized rate of return). DRA recommends that the rates of return remain at 10.75%.

In considering whether conditions have changed, we will first discuss changes in business and financial risks (including changes in competition and regulation), and then address interest rates and the economy in general.

3.1 Business and Financial Risks

Applicants argue that business risk has increased due to increases in competition, changes in regulation, and changes in technology (e.g., divestiture; deregulation of some previously regulated services; the new regulatory framework (NRF); probable ending of pooling and settlements; changes to the CHCF; accelerated technological change limiting useful lives of existing plant). Contel argues its financial risk has increased as a result of changes in its authorized capital structure (e.g., increases in the equity ratio) which are necessary due to increased business risk and competition. We find that conditions have not substantially changed since D.90-06-015 and no increase in the rate of return is justified.

3.1.1 Divestiture, NRF, and Competition

Applicants cite uncertainties and consequent risk due to divestiture and NRF in support of their requests for higher rates of return. Indeed, there have been significant changes in the telecommunications industry not only in recent years with NRF, but since 1984 with the breakup of AT&T. But we focus here on what events, if any, have changed investors' perception of risk for these three utilities since the adoption of the last authorized rate of return, and what, if anything, would change the risk premium already included in that rate of return.

Competition in the intraLATA toll market has been anticipated since at least 1987, when we issued our investigation into alternative regulatory frameworks for LECs (I.87-11-033), and has been factored into the capital cost of these utilities in the last several years. The order instituting investigation established an investigatory plan with three phases. Phase III of that investigation will consider further aspects of whether competition should be allowed in the intraLATA toll market. In D.90-08-066 we asked for comments on specific proposals that LATAs be opened to competition for most services, following rate rebalancing and the adoption of a more competitive rate structure. However, to date, intraLATA competition has not been authorized, and evidentiary hearings on that issue will be required during 1991. Moreover, while NRF (an incentive-based regulatory framework) has directly impacted Pacific Bell (Pacific) and GTE California Incorporated (GTEC), it will not be implemented for Contel, Roseville (if at all) and Citizens until after 1991. No actions will occur in 1991 to substantially change risk due to changes in regulation and competition which have not been generally known for some time.

Applicants argue that we must consider the impact on cash flows for all future years in determining the reasonable rate of return for 1991, since investors consider all future events in reaching the rate of return they must earn. The discounted cash flow (DCF) model is explicitly built on this premise, for example, wherein all future dividends (influenced by all future events) are discounted to the present in determining the return on equity.

Nonetheless, we focus on events expected to prevail in 1991 for the reason advanced in D.89-11-068, 33 CPUC 2d 525, 537. That is, while investors are concerned with the overall return over the entire period they hold the investment, investors are also aware that rates of return are regularly examined and adjusted (when appropriate) to reflect changes in risk and current economic conditions. The current trends in competition and changes in regulation have been known for some time and have been factored into previously authorized rates of return. No current events so materially increase risk as to now warrant an increase in rate of return. As future events unfold, future rates of return will be adjusted to compensate investors if risks increase beyond the risk premium already included in the current rate of return.

Applicants argue that as NRF becomes more concrete and its impacts more defined, investors' risk increases. To the contrary, to the extent uncertainties may have been introduced years ago by the contemplation of regulatory changes (and reflected in past rates of returns), those uncertainties are decreasing as those changes are being made concrete and being implemented. If anything, risk is now reduced.

3.1.2 Settlements

Applicants argue risk is increasing in 1991 due to changes in the settlements process.[2] A major source of applicants' revenue (as well as subsidy flow to support basic service) is from settlements. Contel asserts that the Commission's goals for the new settlements process include not only simplicity and funding stability, but also increased risk for LECs in order to encourage more efficient operations.

Our goal in changing the settlements process is to find a simpler approach for assuring rate stability for high cost telephone companies which is relatively insensitive to broader policy changes that may occur for the larger companies (D.90-08-066, mimeo. p. 169, re: Assigned Commissioner's Ruling dated November 22, 1989). We are obligated to always consider the extent to which our regulation encourages efficiency. Thus, applicants and their investors may be assured that we intend to make changes in settlements in ways that properly account for and balance risk while encouraging efficiency.

2 The settlements process is an accounting procedure to define how revenues of a single call are split among different companies involved in that connection.

Moreover, by D.91-07-044 we directed Contel and Citizens to negotiate with Pacific Bell a transition agreement to replace the current pooling and settlements arrangements, until they can participate in the new regulatory framework. Thus, Contel and Citizens are assured of receiving settlements revenues. Roseville will similarly receive settlements revenues, whether or not Roseville elects to continue in the settlements process thereafter, because we direct transition payments to remain at the current level for not only 1991 but also 1992 for all three utilities.

3.1.3 CHCF

Applicants also receive a significant portion of their revenues from the CHCF. Applicants argue their risk has increased since their receipts from the fund will decrease to 80% in 1991, 50% in 1992, and zero in 1993 unless they file a general rate case. Moreover, they indicate that proposed changes to the CHCF discussed in D.90-08-066 add further risk. Citizens, in fact, argues that the existence of the CHCF itself increases, not decreases, risk.

To the contrary, we find no increased risk for 1991 due to the administration or operations of the CHCF. First, the reduction in draw to 80%, 50%, and zero was known in 1988 (D.88-07-022). We have reflected whatever risk this causes in past authorized rates of return. Second, the changes we made in D.91-05-016 limit the draw from the CHCF so that the utility earns a rate of return no higher than last authorized. The only risk thus impacted is that investors will not earn more than we find reasonable. That investors will not be able to earn more than we find reasonable is not an increased risk, at least not one that is to be rewarded by an increase in the authorized rate of return.

Third, the CHCF is created to mitigate small and mid-sized LEC risk by providing relief to those LECs for losses due to regulatory changes. The CHCF does not itself increase risk. Nothing is expected to change in 1991 to increase investors' risk due to changes in our administration of the CHCF.

3.1.4 Technological Change and Financial Risk

While technological change may be rapid, there are no dramatic changes in the rate of technological change (which limits the useful life of existing plant) since the last proceeding. Thus, business risk from technological change is not materially different from that recognized in the last authorized rate of return.

Finally, we do not find any changes in conditions from D.90-06-015 that increase financial risk. The conditions that might cause a utility to increase its equity ratio (e.g., increased business risk) have not materially changed from the last proceeding. Thus, we find no changes in conditions from our last decision that would support an increase in the overall rate of return due to increased financial risk.

Moreover, we did not adopt specific capital structures last time in order to provide an incentive for each utility to manage its capital structure efficiently. Thus, Contel may adjust its capital structure if it wishes. But we again do not adopt specific capital structures and thus do not note any changes in financial risk by adoption of capital structures with a higher equity ratio.

3.2 Economic Conditions

Rates of return tend to vary in the same direction as changes in interest rates, and reflect economic conditions in general. Applicants point to the federal budget deficit, U.S. foreign trade imbalance, the Middle East crisis, and inflationary pressures to support their requests for higher rates of return.

Applicants specifically cite increases in interest rates as one reason to support increases in their rates of return. For example, Contel argues that Treasury bond yields have increased over the period of October 1989 to August 1990 from 7.88% to 8.98% (a 13.96% increase), and AA utility bond yields over the same period have increased from 9.22% to 9.85% (an increase of 6.83%). Contel testifies that projected yields for 1991 are slightly less than the August levels, but that low levels of economic growth, higher unemployment, and high inflation will persist, preventing capital markets from returning to their levels prior to the Iraqi invasion of Kuwait.

DRA, on the other hand, provides evidence that while interest rates were increasing at the time the applications were filed (due to the war in the Middle East, for example), later events have resulted in interest rates falling below the levels in place at the time of D.90-06-015.

We find that interest rates in general are at the same or slightly lower levels than when we last authorized these utilities' rates of return, and are not forecast to increase significantly. For example, utility bond yields for a bond rated Aa have fallen from 9.57% in February 1990 to 9.23% in March 1991. Similarly, short-term interest rates measured by 3-month Treasury bills have fallen from 7.76% to 5.91%, and are forecast by Data Resources, Inc. (DRI) to be 6.05% over the full year 1991. Long-term interest rates measured by 30-year Treasury bonds have fallen from 8.50% to 8.29% over the same period, and are forecast by DRI to be 8.45% over 1991. We agree with DRA that interest rates have fallen since our last attrition proceeding and will not materially increase in 1991. Indeed, applicants generally acknowledged this at hearing, with some reducing their requests.

Moreover, applicants generally argued that the invasion of Kuwait by Iraq and the resultant war in the Middle East along with increases in the rate of inflation justify an increase in their rates of return. The war has concluded and we do not see a material increase in the rate of inflation. In general, economic conditions do not support an increase in applicants' rates of return.

3.3 Conclusions

Thus, we do not find justification to change our rate of return determination for these utilities from that last found reasonable due to changes in business and financial risks, interest rate movements, or changes in the economy. Indeed, Citizens' witness Shine testified on cross-examination that he does not believe that Citizens' business, financial, and regulatory risks have changed appreciably since the last attrition proceeding, only that the Commission did not properly recognize those risks when it last set the rate of return at 10.75%. (Tr. pp. 62-63.) Public Utilities Code Section 1709 provides that:

> "In all collateral actions or proceedings, the orders and decisions of the Commission which have become final shall be conclusive."

D.90-06-015 is final. Citizens' argument is an untimely attempt to challenge the legality and reasonableness of our last decision, and its attempt fails. Citizens' witness Shine argues that risk is about to increase (Tr. p. 63), but we find no evidence of that based on changes in business or financial risks, increases in interest rates, or changes to the economy in general.

Having discussed this common factor of the proceeding, we will now turn to a more detailed examination of each utility's request.

4. Contel's Financial Attrition Request

Contel develops its request by first recommending a capital structure and then applying requested costs of debt, preferred equity, and common equity. Contel adjusts its results by flotation costs to develop its final request.

4.1 Capital Structure

Contel recommends a capital structure of 39.4% long-term debt, 0.6% preferred equity, and 60.0% common equity. This is a reduction from the last authorized percentages for long-term debt and preferred equity (from 44.0% and 3.0%, respectively), and an increase for common equity (from 53%). (D.89-05-059, 1989 attrition year.) DRA does not recommend the adoption of a specific capital structure, based on our approach in D.90-06-015.

4.2 Cost of Debt

Contel recommends a 1991 debt cost of 9.032% (including a forecast financing in late 1990). This is an increase from the 8.86% Contel requested for 1990. DRA recommends an effective cost of debt of 9.19%, or 15.8 basis points higher than Contel. DRA's calculation uses net proceeds as the denominator, where Contel uses face value. DRA argues that net proceeds is used for the other applicants and, even though it produces more costly results, it is consistent and fair to use net proceeds for Contel.

4.3 Cost of Preferred Stock

Contel develops a 1991 cost of 5.59% for its preferred stock. DRA agrees.

4.4 Return on Equity

4.4.1 Contel

Required return on equity is estimated by Contel using discounted cash flow (DCF), capital asset pricing model (CAPM), and risk premium (RP) analyses. Contel then performs a comparable earnings analysis for a comparison of its rate of return recommendation with other results.

4.4.1.1 Discounted Cash Flow

Just as it did in the past two proceedings, Contel performs its DCF analysis on a sample of telephone companies rather than on the parent company (Contel Corporation). Contel does this to provide consistency with Supreme Court decisions on fair rates of return,[3] to mitigate distortions in historic dividend or earnings growth that might occur, and to eliminate odd or abnormal conditions particular to any one utility that could distort results.

3 Bluefield Water Works and Improvement Company v. West Virginia Public Service Commission (1923), 262 US 679, and Federal Power Commission v. Hope Natural Gas Company (1944) 320 US 591.

The DCF model sums the dividend growth rate and the dividend yield to determine the investors' expected return on equity. Contel estimates the dividend growth rate by averaging both historic (1976 - 1989) and forecast growth rates for both dividends and earnings, resulting in a rate of 8.38%. Dividend yield is estimated by adding the last four quarterly dividends (adjusted for stock splits and dividend growth) and dividing by the month-end stock price, for the average of 12-, 6-, and 3-month periods. This produces a dividend growth result of 4.41%, for a DCF result of 12.79%. To this, Contel adds a premium of 46 basis points based on the difference between utility bonds rated AA and A, to reflect the difference between Contel's bond rating (A+) and the sample companies' bond rating (AA-). Thus, Contel estimates an adjusted DCF result of 13.25%, before further adjustment for flotation costs.

4.4.1.2 Capital Asset Pricing Model

CAPM assumes that an equity investor's market return equates to the return an investor could expect to receive on a risk-free investment plus an expected premium that is proportional to the level of risk the investor is assuming. CAPM measures market risk by reviewing the degree an individual equity security has moved historically with changes in the equity market. The measure of this risk is called the beta coefficient.

Contel conducted its CAPM analysis by averaging the CAPM results for each of several sample telephone companies applying 3-month Treasury Bill and 30-year government bond yield projections as a proxy for the expected risk-free return component of the analysis. Using a DRI estimate, Contel projected Treasury bill returns to be 7.16% in 1991 and projected 30-year government bond yields to be 8.44% in 1991.

Contel derived the risk premium component of the analysis by using historic equity risk premiums between common stock returns and both Treasury bill and long-term government bond yields from 1926 to 1989. The premiums are respectively 8.7% and 7.5%. Calculating the CAPM for the 15 sample telephone companies, Contel estimates a range of 14.12% to 15.94% return on equity, with an overall average of 15.39%. To this Contel adds the 46 basis points also used in the DCF model to account for Contel's A+ bond rating, producing a final result of 15.85%.

4.4.1.3 Risk Premium

Contel also employed a risk premium analysis. This methodology determines the historic spread between debt and expected equity returns. It adds the spread to the current debt yield to arrive at the required return on equity. Utility AA debt was compared to historic returns on S&P utility stocks from 1940 to 1989, deriving an average from 40-, 30-, 20- and 10-year averages. AA debt was also compared to historic expected returns on equity for sample telephone companies from 1984 to 1990. Contel estimates an average spread of 449 and 325 basis points, respectively, which Contel averages to 387 basis points. Adding this spread to the average 1991 projected AA utility debt rate (9.82%), plus the 46 basis point premium for A rated debt, Contel projects the cost of equity capital to be 14.15% before flotation costs.

4.4.1.4 Contel Results

Averaging the results of its three methodologies (DCF of 13.25%, CAPM of 15.85%, and RP of 14.15%), Contel recommends a 14.42% required return on equity before flotation costs. Flotation costs are those associated with underwriting a stock issuance. Contel estimates flotation costs to be 4.32%. Contel multiplies the portion of equity capital not derived from retained earnings by a flotation cost adjustment factor of 1.0432 to arrive at a final average book requirement of 14.66% on common equity. Contel weights its recommended costs of debt, preferred equity, and common equity by its recommended capital structure to arrive at its recommended rate of return of 12.39%.

Finally, Contel conducted a comparable earnings analysis on historic and projected equity and total returns for 1988 through 1991 for the sample telephone companies. Contel finds that its recommendation is within the range of historic and projected equity and total returns.

4.4.2 DRA

DRA's recommendation is based on both qualitative assessments (that conditions have not materially changed since the last determination of rate of return, discussed above) and the results of financial models. DRA, like Contel, used DCF, CAPM, and RP methodologies for its financial model analysis. DRA performed this analysis on a sample of comparable telecommunications companies to estimate a return on equity.

DRA's comparable group of telecommunications companies all have a Value Line financial strength of at least B, a Value Line beta of between 0.7 and 1.0, and a Value Line safety rating of 1, 2, or 3. DRA eliminated firms from the group that provide primarily interstate long distance telecommunications services, have suspended dividends without indication of reinstatement, or show abnormal historical and forecast growth due to acquisition of cellular operations.

Further, DRA did not use Contel Corporation data in its models since the pending merger of Contel Corporation with GTE Corporation has materially influenced the market data for Contel Corporation. This makes difficult an isolation of the impact of the expected merger with the results of Contel. DRA did not include Roseville data because DRA considers Roseville basically a privately owned public utility (since its stock is traded publicly on only a very limited basis, primarily to its customers) and market data is not readily available. Finally, DRA did not use Citizens data. Citizens is a diversified company with slightly over 40% of its revenues derived from telecommunications services, according to DRA. DRA believes that the market price for Citizens represents investors' perception of the total company, and it is therefore reasonable to use a comparable group as a surrogate to determine the required equity return on Citizens' telecommunications operation.

4.4.2.1 DCF

DRA estimated the dividend growth component by examining both historic and forecast growth rates for both dividend and earnings. DRA also considered sustainable dividend growth rates. Due to the breakup of AT&T in 1984 and the changing business environment, DRA used five years of historic data to focus on a more recent observation period. Eliminating the lowest and highest results as unreasonable, DRA estimates the dividend growth rate to be between 6.75% and 7.25%. DRA estimates the dividend yield component to be between 5.24% and 5.26%, for a final range of returns on equity of 11.99% to 12.51%.

4.4.2.2 CAPM

DRA estimates the market risk premium to be the same as that estimated by Contel (8.7% for Treasury bills and 7.5% for long-term government bonds). DRA estimates the beta for the group to be 0.91. Added to the forecast 1991 risk-free return (6.02% for 3-month Treasury bills, and 8.20% for 30-year Treasury bonds), DRA estimates the return on equity to be between 13.94% and 15.03%. DRA cautions against the use of the CAPM because of theoretical and practical frailties (e.g., the need to forecast the "riskless" return).

4.4.2.3 Risk Premium

DRA estimates the risk premium for the sample companies compared to 30-year Treasury bonds and AA utility bonds over the last five years to be 4.29% and 3.07%, respectively. Adding the forecast bond rates for 1991 to the risk premiums yields a range of return on equity of 12.44% to 12.49%. DRA warns that observed premiums have not been stable in the last five years, however, and that it uses this model in conjunction with DCF and CAPM, not by itself, in arriving at DRA's final recommendation.

4.4.2.4 DRA's Recommendation

DRA concludes that the reasonable equity return for all three applicants (based on the sample of companies used for all three applicants) is from 11.99% to 12.51%. DRA recommends using the mid-point of the range, or a 12.25% return on equity. To calculate overall rate of return, DRA applies its estimated cost of debt, preferred equity and common equity for Contel to the capital structure of its sample group (since the estimated cost of equity from the sample is impacted by the financial risk of the sample group). The result is an overall return for Contel of 10.88%. Considering its qualitative analysis (i.e., that conditions have basically not changed from the last proceeding), DRA recommends a continuation of the last rate of return of 10.75%.

4.4.3 Contel's Revised Request

In its brief, Contel revises its request to a rate of return of 11.80% after "...taking into account the market changes since this application was filed." (Brief, p. 8.) Further, Contel argues in its brief that DRA failed to properly account for the difference in risk between the companies in the sample group and Contel (represented by the difference in cost between utility bonds rated AA and A). Contel adjusts DRA's analysis and recommends that the Commission adopt a rate of return no lower than 11.02%.

4.4.4 Discussion

We stated our view in D.89-10-031 (Phase I of NRF) that adopting a rate of return without reference to an adopted capital structure for Pacific and GTEC provides these utilities with an incentive to manage their capital structures efficiently. This principle applies equally well to Contel, Roseville, and Citizens. We declined to adopt capital ratios or returns on equity for these three companies in D.90-06-015 for that reason, but instead focused on an appropriate overall rate of return. We decline again to set capital ratios or returns on equity for the same reason and again will instead focus on the appropriate rate of return.

Using similar resources, Contel and DRA arrive at different conclusions about investor expectations of returns. Without venturing into a detailed comparison, we observe that Contel's analysis produces high results by taking averages of averages (e.g., dividend yield averaging 12- , 6- , and 3-month averages; risk premium analysis averaging 40-, 30-, 20-, and 10-year averages). This technique weights the later data more heavily, which in nearly all cases produces higher results. Different results for DRA and Contel are also attributable to differing growth rates, comparable company groups, risk-free rates, and time periods for the analysis, among other things.

We have consistently found in recent years that the models used by the parties offer guidance in our determination of appropriate rates of return, but, because of the variations in their results, do not provide absolute answers to questions regarding appropriate capital costs. We reaffirmed this view in several recent decisions (e.g., D.89-10-031, which established rates of return for Pacific and GTEC; D.90-06-015, the last rate of return decision for these three utilities; and D.90-11-057, which established the 1991 cost of capital for seven energy utilities). In these decisions we have also indicated our continued considerable skepticism of these models. Not surprisingly, the discussion in D.90-11-057 (mimeo. pp. 5-7) is equally applicable here:

> "Our consideration of these models has always been accompanied with considerable reservation."
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> * * *

> "In reviewing the results of the various model trials this year we see a familiar pattern of relatively low results from the DCF and results some 100-200 basis points higher from the RP and CAPM."
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> "A further criticism of the use of models comes from our observation that each was developed and intended to be used for purposes other than ratemaking. They cannot reflect the interests of ratepayers in avoiding having to pay more in rates than is actually warranted."
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> * * *
>
> "With these criticisms in mind we will give some weight to the model analysis, but we think it would not be worthwhile to attempt to resolve every criticism of every model run."

And just as we concluded there for the 1991 cost of capital for seven energy companies, we similarly conclude here:

> "Due to the inherent limitation of the models, no particular model analysis convinces us that an increase or decrease in the returns on equity is warranted."

We will address, however, one element of the quantitative analysis because of Contel's focus on this issue: the adjustment of model results for the difference in riskiness between the sample companies and Contel. We have adjusted model results for the difference in riskiness between sample companies and a particular utility in other proceedings (e.g., D.89-11-068, D.90-11-057, where we applied the difference in cost between AA and A rated bonds in our determinations of energy utility cost of capital). Contel argued in its last attrition proceeding that the rate of return should be adjusted by 49 basis points as a measure of the difference in risk represented by the bond rating of its sample companies (AA-) and its own bond rating (A+), where the 49 basis points measure the difference in cost between AA and A rated bonds. We considered that factor in establishing the 10.75% rate of return in the last proceeding. We consider that again in this proceeding, but note that nothing has changed in Contel's argument or its application that would produce a different result than was produced last time. We find the same result applies again.

In this proceeding Contel recommends a 46 basis point adjustment, based on a 10-year average in differences between AA and A rated bonds. We note, however, as we did in D.89-11-068, that the spread between AA and A has narrowed considerably in recent years. Contel's witness presents evidence that the spread (measured annually) has declined six out of the last eight years since 1982, with the rate for available 1990 data being 18 basis points (down from the high of 107 basis points in 1982). The average AA/A difference over the last 3 years is 20 basis points. We further note that the average rating of Contel's sample companies is AA-, not AA, and Contel's rating is A+, not A. Not only is nothing new in Contel's argument or data to cause us to account for this effect any differently than we did in the 1990 attrition year, but an adjustment of 46 basis points would be excessive. In fact, even a simple adjustment of 18 to 20 basis points based on the more recent data would be excessive because the difference in yields between AA- and A+ is less than the difference between AA and A.

We reject a specific adjustment of some part of the 18 to 20 basis point difference because we remain considerably skeptical of this level of precision of the models. Rather, we apply our judgment in deciding to continue the last reasonable rate as the reasonable rate of return for the 1991 attrition year. Similarly, we reject establishing a rate of return lower than 10.75% (based on reduced interest rates since the application, a generally stabilized economy and the use of the low end of DRA's recommended return on equity (11.99%) rather than the DRA recommended 12.25% average).

Regarding flotation costs, we note that we rejected their inclusion for rate of return determination in D.89-11-068 and D.90-06-015, and we do so again here.

With these observations in mind, we believe a reasonable rate of return for Contel is 10.75%. Using Contel's requested capital structure and cost of debt and preferred equity, the resulting return on common equity is 11.93% (nearly the same as the 12.05% calculated in D.90-06-015 on a slightly different Contel requested capital structure):

	Capital Ratios	Cost Factor	Weighted Cost
Long-Term Debt	39.4%	9.03%	3.56%
Preferred Equity	0.6	5.59	0.03
Equity	60.0	11.93	7.16
Total	100.0		10.75%

This is slightly below DRA's recommended rate of return of 12.25% based on 55% equity. We note that the average equity ratio for the sample groups of both Contel and DRA is about 55%, while Contel's estimated actual and requested equity ratio for 1991 is 60%. A lower return on equity than that recommended by DRA based on the sample is consistent with Contel's reduced financial risk relative to the sample, and is reasonable.

Applying the 1989 adopted capital structure to Contel's requested cost of debt and preferred equity, the resulting return on equity is 12.47%:

	Capital Ratios	Cost Factor	Weighted Cost
Long-Term Debt	44.0%	9.03%	3.97%
Preferred Equity	3.0	5.59%	0.17
Equity	53.0	12.47	6.61
Total	100.0%		10.75%

This is slightly above DRA's recommended rate of return of 12.25% based on 45% debt, and is reasonable.

This return on equity and rate of return are adequate to allow Contel to maintain its creditworthiness and to attract capital at a reasonable cost. In not adopting a specific return on equity or capital structure, we allow Contel to manage its capital structure to produce the most efficiency. An overall rate of return of 10.75% is reasonable. No change in rates is necessary or authorized.

5. Roseville's Financial Attrition Request

Roseville requests an increase in its rate of return to 12.6%.

5.1 Capital Structure

Roseville uses ranges of capital structures in developing its rate of return request, with debt ranging from 5% to 30% of its total capitalization. Roseville's actual capitalization on December 31, 1989 was 5% debt and 95% equity. Actual capitalization at the time of hearing was 16% debt and 84% equity. The Commission's last authorized capitalization was 30% debt and 70% equity (D.89-05-059). Neither Roseville nor DRA necessarily recommends the adoption of any one capital structure in this proceeding, consistent with our not adopting a capital structure in the last proceeding.

5.2 Cost of Debt

Roseville uses various costs of debt imputed based on the amount of debt in the capital structure, ranging in cost from 8.9% to 9.7%. DRA recommends using Roseville's embedded cost of debt of 8.9%. Roseville objects, arguing this ignores a planned and partially executed offering of debt in 1991, as well as the impact on debt cost of various levels of debt.

5.3 Return on Equity

5.3.1 Roseville

Roseville primarily relies on the DCF methodology in estimating its required return on equity, with supplemental consideration of other methods and factors. Roseville does not use a group of investments with risks comparable to its own for estimating its cost of equity. Rather, it uses a sample of companies that are not exactly comparable to Roseville to draw statistical relationships from known factors, which are then related to Roseville.

To do this, Roseville first uses a quarterly dividend form of the DCF model on its sample companies to estimate their required returns on equity. Second, Roseville accounts for the difference in business and financial risk between itself and the sample companies. This is done by using CAPM to measure relative risk (beta) for Roseville's equity. Because Roseville's beta is not observable, Roseville develops an equation by regressing the betas of each of the sample companies against four variables. Substituting Roseville's values for the four variables, Roseville estimates its beta to be 0.80.

Third, Roseville develops another equation by regressing the calculated returns on equity for each of the sample companies to that company's own risk (beta), thus stating equity return as a function of beta. Finally, Roseville's estimated beta is used in the equation to estimate Roseville's required equity return. The results are then "relevered" to account for different levels of debt, resulting in a range of equity returns from 13.1% to 13.9%.

Roseville calculates a CAPM estimate for comparison. Roseville uses 0.80 for beta on a market-based risk premium of 8.6%, plus a risk-free rate (estimate by the June 1, 1990 90-day Treasury bill rate of 7.7%), for a result of 14.6%.

Finally, Roseville considers several risk factors. First, Roseville's actual equity ratio is higher than that of the sample group. This tends to reduce Roseville's financial risk and its required return on equity relative to that required for the companies in its sample. Further, Roseville considers changes in technology, Roseville's markets, and regulatory framework, all of which increase its business risk, according to Roseville. In its final assessment, however, Roseville maintains that its lower leverage is at least somewhat offset by the increased business risk. However, Roseville argues that since the Commission last set its rate of return at 10.75%, the Middle East situation has made financial markets more volatile, and regulatory events have occurred that increase overall risk.

5.3.2 DRA

DRA's analysis on equity return is based on its sample group (which is representative of all three utilities), and therefore is the same for Roseville as Contel. DRA applies its estimate for Roseville's cost of debt and its recommended equity return of 12.25% to the capital structure of the sample group (45% debt, 55% equity) to calculate a required overall rate of return for Roseville of 10.75%. According to DRA, the qualitative and quantitative factors both support retaining Roseville's rate of return at 10.75%.

5.4 Roseville Rebuttal

Roseville presented three rebuttal witnesses. Roseville's first rebuttal witness argues that DRA did not properly assess its own data, and shows the impact of different analyses on DRA's data. Roseville argues that DRA did not increase the cost of debt when using higher debt ratios in the capital structure. Further, Roseville argues that the after-tax equity rate of return is only 9.6% using DRA data (a rate that is below yields on A-rated utility bonds), and the implied beta using DRA data is only 0.19 (a value that is unreasonably low).

Roseville's second rebuttal witness points out Roseville did issue debt in 1990 and 1991 not accounted for by DRA. Roseville's last rebuttal witness argues that pending regulatory changes are not already included in Roseville's rate of return.

At Roseville's request at hearing, notice was taken of Feist Publications v. Rural Telephone Service, 499 U.S. ___, 111 S. Ct. 1282 (1991). In its brief, Roseville argues that this decision jeopardizes Roseville's revenues from directory advertising, and that the Commission must consider its impact in assessing risk.

5.5 Discussion

As we said above, while we use financial models as a guide, we are considerably skeptical of the models and their results. We note that the adjusted R-squared is 0.43 for Roseville's regression of four variables to estimate beta. This means that 43% of the explanation of the equity beta is captured by the equation, but 57% is not. Roseville did not report the degree of confidence in its second regression (cost of equity as a function of beta). Using not only one but two regressions, with their inherent errors, means the degree of confidence may be low, and the confidence interval around the final results can be quite wide. As Roseville's witness pointed out, other techniques have similar problems but the errors are not measurable, as they are with regressions. Thus, these regressions have some weaknesses in their ability to measure final results with a great degree of precision, and all models have some weaknesses, whether measurable or not.

Moreover, regarding Roseville's qualitative arguments, we do not find any increases in the rate of technological change or changes in regulation since our last assessment of Roseville's rate of return that support an adjustment, as we have addressed above. Similarly, we do not see any significant changes in Roseville's markets that justify an increased rate of return.

Roseville argues that the Feist decision must be considered in addressing Roseville's risk. We note, however, that this action dates back to alleged copying of white pages from a 1982 to 1983 directory, a United States District Court decision dated January 5, 1987, and a United States Court of Appeals decision dated March 8, 1990. The issue did not just arise since our last rate of return determination, and the risk has already been reflectd in prior authorized rates of return. The Supreme Court decision on its own does not increase Roseville's risk in any way not already included in the risk premium portion of our last rate of return determination.

In its comments on the proposed decision of the ALJ, Roseville argues that the Feist decision was a whololy unexpected 1991 event. To the contrary, outcomes are uncertain when matters are litigated. To the extent uncertain outcomes increase risk, that impact has been felt since the original action began several years ago. Nothing has changed since we last authorized Roseville's rate of return, nor is risk increased for 1991.

Moreover, Roseville asserts its directory revenues are $3.6 million per year, and are now at risk. However, even if true, Roseville provides neither a link between the $3.6 million and the rate of return, nor a link between any portion of the $3.6 million and the rate of return. As we say above, this impact has already been reflected in establishing the rate of return.

With these observations in mind, we believe a reasonable rate of return for Roseville is 10.75%. Using Roseville's suggested capital structure and cost of debt, the resulting return on common equity is 10.96% (a slight increase from the 10.83% similarly calculated in D.90-06-015):

	Capital Ratios	Cost Factor	Weighted Cost
Debt	16.0%	9.6%	1.54%
Equity	84.0%	10.96	9.21
Total	100.0%		10.75%

Applying the 1989 adopted capital structure to Roseville's recommended debt cost at 30% debt, the resulting return on equity is 11.20% (a slight increase from the 10.98% similarly calculated in D.90-06-015):

	Capital Ratios	Cost Factor	Weighted Cost
Debt	30.0%	9.7%	2.91%
Equity	70.0%	11.20	7.84
Total	100.0%		10.75%

Just as was the result in D.90-06-015, these returns on equity are below those recommended by DRA. But we again find, as we did in D.90-06-015, that this is reasonable in light of the high equity ratio in Roseville's capital structure. Roseville's percent equity in its capital structure (84%) is much more than the percent equity of Contel (60%), Citizens (60%), or DRA's sample group (55%), and therefore Roseville has less financial risk relative to Contel, Citizens and the sample group. Because of its high equity ratio, Roseville's investors face correspondingly less risk than investors of other telephone utilities.

Roseville's cost of debt was high in the 1990 attrition proceeding, and we note it is still above that of Contel and Citizens. Roseville's estimated returns on equity are lower than they would be if Roseville's cost of debt were lower. For example, if Roseville's cost of debt were 8% (slightly lower than Citizens', see below), its return would be 11.93% using its 1989 authorized capital structure, or very nearly the low end of that now recommended by DRA (based on companies with more financial risk than Roseville). But here again, as we did in D.90-06-015, by establishing an overall rate of return without reference to authorized capital structure or cost of equity, Roseville's shareholders, not its ratepayers, will be at risk for Roseville's capital structure and its costs.

Our adopted rate of return for Roseville is the same as we apply to Citizens and Contel, which are similarly situated companies in terms of the regulatory and business risks they face. We see no reason to apply a different rate of return to Roseville and thereby impose on its ratepayers capital costs which are higher than what would be expected for Roseville, and which are within the control of the utility. Moreover, if we were to adopt a higher return for Roseville than for Citizens and Contel, we would be sending a message to Citizens and Contel that we do not recognize their efforts to keep capital costs low.

Our decision today provides a reasonable return to shareholders, considering Roseville's capital structure, and the appropriate incentive to develop a capital structure which will be most beneficial to its shareholders and more efficient. The rate of return adopted in this decision will permit Roseville to realize a fair return on equity in 1991. No change in rates is necessary or authorized.

6. Citizens' Financial Attrition Request

6.1 Citizens

Citizens does not use DCF, CAPM, or RP models to support its request. Rather, Citizens updates the last authorized overall rate of return for present financial conditions, and assesses the risk faced by Citizens compared to other utilities.

Citizens asserts that the Commission established its rate of return at 10.75%, or 75 basis points less than that established for Pacific and GTEC, because Citizens faces less risk than larger companies due to the CHCF. Citizens argues that the CHCF increases rather than decreases Citizens' risk in comparison to Pacific.

Citizens argues that the differential below Pacific's rate of return should be 25, not 75, basis points. The remaining 50 basis points must be for additional Pacific/GTEC business risk, according to Citizens. Citizens, however, argues that it has more business risk than Pacific and GTEC due to the rural nature of its service, lower subscriber density, less diversity, higher dependency on toll and access charge revenues, and greater exposure from the uncertain state of the settlement and CHCF issues. Therefore, the differential should be no more than 25 basis points, according to Citizens.

Citizens estimates that Pacific's rate of return should be increased from 11.50% to 12.95% (a 12.64% increase) to reflect higher interest rates on 30-year Treasury bonds since the last proceeding. (This is based on Citizens' use of the Commission's "trigger" methodology for Pacific and GTEC in D.89-10-031, mimeo. p. 282.) Subtracting its recommended 25 basis point differential, Citizens arrives at a required 12.70%. Citizens compares this to the increases allowed by the Federal Energy Regulatory Commission in its quarterly benchmark rate of return cases, Citizens' requests in other states, and the requests of Contel and Roseville in their last and current proceedings. Based on these comparisons, Citizens reduces its request to 12.50%.

Citizens recommends the use of a capital structure of 40% debt and 60% equity. Citizens asserts its current cost of debt of 8.09% will increase to 8.75% after completion of a merger with Louisiana General Services Inc., and as a result of higher interest rates driving up the cost of Citizens' variable cost debt. With this capital structure and cost of debt, Citizens estimates its resultant return on equity would be 15%.

<u>6.2 DRA</u>

DRA estimates Citizens' 1991 cost of debt to be 8.16%, not 8.75%, based on DRA's lower forecast of interest rates and the resultant impact on Citizens' variable cost debt. DRA's assessment of Citizens' cost of equity is based on the same sample group DRA uses for Contel and Roseville, which was drawn to reflect the conditions of all three companies. Applying its estimated cost of debt and required equity return (12.25%) to the capital structure of the sample group, DRA estimates Citizens' rate of return should be 10.42%. Considering that conditions have not really changed since D.90-06-015, DRA recommends continuing the last rate of return of 10.75%.

6.3 Citizens' Late-Filed Exhibits

Citizens filed late exhibits that update its showing for data raised at the hearing. In its update, Citizens estimates its required return to be 11.70% (down from 12.50%). Citizens testifies that it will submit a general rate case before April 1, 1992, at which time the Commission can conduct a full-scale review of Citizens' costs and rate of return.

6.4 Discussion

We addressed the risk faced by Citizens in our discussion above of whether conditions have changed since the last rate of return proceeding. We find no changes in the risk faced by Citizens. Moreover, Public Utilities Code Section 1709 forecloses Citizens' attempt to relitigate D.90-06-015 in this proceeding.

Citizens' model to update its rate of return is based on a literal, exact application of the Pacific/GTEC trigger mechanism. The trigger mechanism, however, is designed for a different purpose and to operate in a different way. The trigger mechanism is designed for the purpose of initiating an investigation of the reasonable rate of return when the 30-year Treasury bond yield increases by over 250 basis points, not for the purpose of a straight application of the change in yield to Pacific's or GTEC's rate of return. Moreover, Citizens' evidence is that the yield has increased only about 100 basis points. Therefore, not only would the trigger not yet be invoked, but if invoked, the result would be an investigation into the reasonable rate of return, where the impact on the overall rate of return would not necessarily be the exact change in the bond rate.

We find DRA's estimate of Citizens' debt cost more reasonable since interest rates are lower, and are forecast to be lower in 1991, than at the time Citizens filed its application.

With these observations in mind, we believe a reasonable rate of return for Citizens is 10.75%. Using Citizens' recommended capital structure and DRA's recommended embedded debt cost, the resulting return on equity is 12.48% (up slightly from 12.40% similarly calculated in the last proceeding):

	Capital Ratios	Cost Factor	Weighted Cost
Debt	40.0%	8.16%	3.26%
Equity	60.0%	12.48	7.49
Total	100.0%		10.75%

Applying the results to the 1989 adopted capital structure produces a return on equity of 12.34% (down slightly from the 12.44% similarly calculated in the last proceeding):

	Capital Ratios	Cost Factor	Weighted Cost
Long-Term Debt	38.0%	8.16%	3.10%
Equity	62.0	12.34	7.65
Total	100.0%		10.75%

These returns on equity are within DRA's recommended range of 11.99% to 12.51% and are reasonable.

Citizens' existing revenue requirement allowed it to realize an 18.1% return on equity in 1989. Citizens testifies that it is currently earning in excess of its authorized rate of return (which we also recognized in D.90-08-066). The 10.75% adopted rate of return will allow Citizens to attract reasonably priced capital and to provide its shareholders with a fair return on equity, and is reasonable. The operation of the CHCF under D.91-05-016 will help limit Citizens' rate of return to 10.75%. In not adopting a specific return on equity or capital structure, we allow Citizens to manage its capital structure to produce the most efficiency. No change in rates is necessary or authorized.

7. No Need for Another Attrition Review

In past decisions we have directed the three utilities to file subsequent financial attrition applications so that we could conduct an annual rate of return review. We decline to order them to do so again.

As we indicated in D.90-08-066, we are aware that most small and mid-size LECs' earned rates of return were in excess of their authorized levels in 1989, and many have not had rate reviews since the early 1980's. We have made changes to the CHCF, for example, to address this problem. Significant rate restructuring will be underway soon in Phase III of I.87-11-033. But as we reluctantly indicated there, commencement of their rate cases before the rate restructuring is effected is probably impractical. However, under the terms of our current administration of the CHCF, a utility's draw from the CHCF will reduce to 80% in 1991, 50% in 1992, and zero in 1993, unless the utility files a rate case. That is a powerful incentive for the utility to file if there is truly a need for rate relief. Roseville and Citizens currently draw from the CHCF and will therefore have this incentive to file a general rate case.

Moreover, we indicated in D.91-07-044 that we will require Contel and Citizens to accept NRF on or before January 1, 1994. Acceptance of NRF will mean Contel and Citizens must file for review by the end of 1992. That will be soon enough for further assessment, unless the utility determines a need to file sooner, or we issue our own investigation. Citizens, in fact, has indicated its intention to file a general rate case by April 1, 1992.

Roseville is not required to accept NRF, but only NRF companies may participate in any adopted transitional surcharge to make up for reduced settlement revenues or phased transitional contract payments from Pacific after exiting the settlements pools. Roseville will be left with the option of seeking assistance from the CHCF after the one-time contract payment usually offered by Pacific, and to do so it must satisfy the requirements for participation in that fund.

Thus, there is sufficient incentive for all three utilities to come before us for full rate review reasonably soon. We need not order another financial attrition filing. Rather, the next rate of return review for Contel, Roseville and Citizens will take place beginning no later than January 1, 1993 in the context of either a full general rate case or a general rate review pursuant to the utility entering NRF, consistent with our intent expressed in ordering paragraphs 12 and 13 of D.91-07-044.

Ordering Paragraph 12 states, in relevant part:

> "These mid-size LECs are expected to file general rate proceedings for a test-year no later than 1994 and, as appropriate, their requests for NRF flexibility effective on January 1, 1994." (mimeo, p. 74.)

That is, we expect the mid-size LECs to file general rate proceedings for a specific test-year. That test-year could be 1992 or 1993, but is to be no later than 1994, with test year 1994 rates effective on January 1, 1994. Recognizing the time it will take to process a general rate case, that means we expect the utilities to file for a general rate proceeding no later than January 1, 1993. This is similarly true for NRF to be effective by January 1, 1994.

Findings of Fact

1. Contel requests a change in its authorized capital structure, an increase in its authorized costs of debt, preferred equity and common equity, and an increase in its authorized rate of return, but does not request an increase in rates.

2. Roseville and Citizens request an increase in their authorized rates of return, but do not request changes in their authorized capital structures, costs of debt and equity, or an increase in rates.

3. Competition in the intraLATA toll market has been under consideration since at least 1987 and, to the extent relevant, has been factored into the capital costs of Contel, Roseville, and Citizens in the last several years.

4. IntraLATA competition has not been authorized to date, and evidentiary hearings on that issue will be required during 1991.

5. NRF will not be implemented for Contel, Roseville, and Citizens in 1991.

6. No actions will occur in 1991 to substantially change risks due to changes in competition or regulation which have not been generally known for some time.

7. Rates of return are regularly examined and adjusted (when appropriate) to reflect changes in risk and current economic conditions.

8. Current trends in competition and regulation have been known for some time and have been factored into previously authorized rates of return.

9. Settlement transition payments will remain at the current levels for 1991 and 1992 for all three utilities.

10. The scheduled reduction in draw from the CHCF has been known since 1988 and any resultant impact on risk has been reflected in previously authorized rates of return.

11. That investors may not be able to earn more than we find reasonable (as a result of the changes made to the CHCF in D.91-05-016) is not an increased risk, at least not one that is to be rewarded by an increase in the authorized rate of return.

12. The CHCF mitigates risk to small and mid-size LECs by providing relief for losses due to regulatory changes.

13. The evidence did not show that competition or regulatory uncertainty will be greater in 1991 than it has been in recent years.

14. The evidence did not show that technological change during 1991 will impose greater risks than it has in recent years.

15. The evidence did not show that financial risk during 1991 will be greater than it has been in recent years.

16. Interest rates are at the same or slightly lower levels than when we last authorized these utilities' rates of return, and are not forecast to increase significantly in 1991.

17. The Middle East conflict in Kuwait has concluded.

18. No material increase is foreseen in the rate of inflation for 1991.

19. There is no justification to change our rate of return determination for these utilities from that last found reasonable due to changes in business and financial risks, interest rate movements, or changes in the economy.

20. D.89-11-031 and D.90-06-015 found that adopting a rate of return rather than a return on equity and capital structure provides the utilities with an incentive to efficiently manage their capital costs and capital structure.

21. Financial models offer guidance in our determination of appropriate rates of return, but do not provide absolute answers to questions regarding appropriate capital costs.

22. Nothing in Contel's argument or its application of adjusting rate of return for the difference in yield between AA and A rated utilities (for the difference between the average rating of a sample of utilities and Contel) produces a different result than was produced last time.

23. A rate of return for applicant utilities of 10.75% will provide utility shareholders with a reasonable return on investment and permit the utilities to attract capital.

24. Applying a 10.75% rate of return to Contel's last authorized capital structure produces an equity return of 12.47%.

25. Applying a 10.75% rate of return to Roseville's last authorized capital structure produces an equity return of 11.20%.

26. Roseville's percent equity in its capital structure (84%) is much higher than the percent equity of Contel (60%), Citizens (60%), or DRA's sample group (55%), and therefore Roseville has less financial risk relative to Contel, Citizens, and the industry sample.

27. The more equity in an utility's capital structure, the lower the required equity return because risk to shareholders decreases as the proportion of equity increases.

28. Roseville's estimated equity return would increase if Roseville reduces its equity ratio or secures less expensive debt.

29. The issue raised in the Supreme Court's Feist decision did not just arise since our last authorized rate of return, and the risk--as part of business risk--has already been reflected in prior authorized rates of return.

30. The adopted rate of return for Roseville is the same as that adopted for Contel and Citizens, which are similarly situated utilities.

31. If the Commission adopts a higher rate of return for Roseville than for Contel or Citizens, the Commission would not properly recognize the efforts of Contel and Citizens to keep their capital costs low.

32. The trigger mechanism established in D.89-10-031 is designed for the purpose of initiating an investigation of the reasonable rate of return when the 30-year Treasury bond yield increases by over 250 basis points, not for the purpose of a straight application of the change in yield to Pacific's or GTEC's rate of return.

33. DRA's estimate of Citizens' cost of debt is based on lower estimates of interest rates in 1991 than those forecast by Citizens.

34. Applying a 10.75% rate of return to Citizens' last authorized capital structure produces an equity return of 12.34%.

35. There is sufficient incentive for all three utilities to come before us for full rate review (between the operation of the CHCF and the implementation of NRF), and thus there is no need to order another financial attrition review.

Conclusions of Law

1. The rate of return for Contel, Roseville, and Citizens should not be changed from that last found reasonable.

2. A rate of return of 10.75% for Contel, Roseville, and Citizens is reasonable because it appropriately recognizes risk and provides a fair return on shareholder investment.

3. It is reasonable to set a rate of return rather than a new capital structure and return on equity because the utilities may determine appropriate returns on equity by establishing the capital structures which will be most beneficial to their shareholders.

4. The Commission should not authorize any changes to Contel's, Roseville's, or Citizens' rates.

5. Applicants should not be ordered to file another financial attrition request at this time, since we will review their rates of return beginning no later than January 1, 1993, in the context of either a full general rate case or a general rate review pursuant to the utility entering NRF, consistent with the intent of ordering paragraphs 12 and 13 of D.91-07-044.

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

NEAL J. SHULMAN, Executive Director

O R D E R

IT IS ORDERED that the applications of Contel of California, Inc., Roseville Telephone Company, and Citizens Utilities Company of California to increase their rates of return are denied. These proceedings are closed.

This order is effective today.

Dated September 25, 1991, at San Francisco, California.

PATRICIA M. ECKERT
President
JOHN B. OHANIAN
DANIEL Wm. FESSLER
NORMAN D. SHUMWAY
Commissioners

I abstain.

/s/ G. Mitchell Wilk
Commissioner

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

NEAL J. SHULMAN, Executive Director