Service Date: August 24 1979

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * * *

IN THE MATTER of the Application of the MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY for authority to establish increased rates for telephone service.	)))))	DOCKET NO. 6496 ORDER NO. 4389g

ERRATA SHEET

Page 1:

Please substitute "March 14, 1977" for "March 14, 1979" in paragraph 1.

Please insert the word "and" following "increased rates" in line 3 of paragraph 1.

Page 6, Commissioner Schneider's Specially Concurring and Partially Dissenting Opinion:

Please insert the word "company" following "operating telephone" in line 8 of the concluding paragraph.

Service Date: August 23, 1979

DEPARTMENT OF PUBLIC SERVICE REGULATION
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* * * * *

IN THE MATTER of the Application of the MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY for authority to establish increased rates for telephone service.	)))))	DOCKET NO. 6496 ORDER NO. 4389g

HISTORY OF PROCEEDINGS

1. By application filed March 14, 1979, the Mountain States Telephone and Telegraph Company (Mountain Bell or Applicant) sought authority from this Commission to increase rates for the approval of tariff changes for telecommunication services provided its customers in the state of Montana. The proposed permanent rate changes would generate $11.83 million of additional yearly revenues.

2. Following legal notice, hearing on Phase I of Docket No. 6496 commenced on November 1, 1977 and concluded November 8, 1977. On April 4, 1978, Phase II hearings began and continued through April 12, 1978.

3. Contained in its application to the Commission was Mountain Bell's request for interim relief. This request was renewed at both the November and April hearings.

4. Interim rate Orders 4389a, 4389b, and 4389c issued in March and May, 1978 granted the utility interim revenue increases totaling $2,326,000.

5. Through Order No. 4389d, served on October 2, 1978, Mountain Bell was authorized to submit rate schedules designed to increase annual revenues by $3,087,000; this increase was in lieu of rather than in addition to those granted on an interim basis .

6. On October 12, 1978, Applicant and the Montana Consumer Counsel (MCC) filed Motions and Briefs for Reconsideration of Order No. 4389d.

7. After reviewing the Motions, Briefs and Answers dealing with reconsideration of its Order No. 4389d as well as the record in Docket No. 6496, the Commission issued its Amended Final Order, Order No. 4389e, on November 22, 1978. The Amended Order raised the allowed revenue increase to $3,097,000 and modified the rate structure.

8. On December 1, 1978, Mountain Bell filed an Amended Motion for Reconsideration, for Rehearing and for Stay of Orders. The utility therein petitioned the Commission to order re-hearings on the intrastate toll charges authorized by Order No. 4389 and on the independent company toll settlements.

9. On January 5, 1979, pursuant to understandings reached at a pre-hearing conference, the Commission issued its Second Amended Final Order, Order No. 4389f, substituting the intrastate toll schedule then in effect for that required by Order No. 4389d.

10. On December 21, 1978, Mountain Bell filed its Petition for Judicial Review of the Commission's final decision in Docket No. 6496. The petition was filed in the First Judicial District Court of Montana in and for the County of Lewis and Clark as Cause No. 43291.

11. Pursuant to Mountain Bell's Motion to Limit Issues on Appeal, dated April 17, 1979, and the District Court's Pretrial Order, dated May 15, 1979, the issues on judicial review were narrowed to include only the Commission's application of "double leverage" and its "NARUC" tax adjustment, each of which is set out in Order No. 4389d.

12. On July 16 and 17, 1979, in the trial of Cause No. 43291 the District Court received evidence in the form of testimony and exhibits concerning the “double leverage” and “NARUC” tax adjustment issues.

13. On July 25, 1979, the District Court ordered that the Commission receive a copy of the record of evidence taken at the trial and that the Commission consider such record of evidence and report to the District Court its action in rescinding, amending, modifying or affirming its Order No. 4389d.

14. On August 7, 1979, the District Court ordered that the Commission have until August 23, 1979 in which to report its action to the Court.

Having fully considered the record of evidence taken by the District Court in its trial of Cause No. 43291, the Commission makes the following Findings of Fact, Conclusions of Law, and Order :

FINDINGS OF FACT

1. In reviewing the record of evidence submitted by the District Court, the Commission found that little new evidence was presented by the three witnesses sponsored by Mountain Bell. None of the three had testified at the November, 1977 Commission hearings; and each seemed to lack familiarity with evidence taken at that time. The Commission did, however, find additional evidence to support its Order No. 4389d in the testimony of the two witnesses sponsored by the Montana Consumer Counsel. The Commission found the testimony of Mr. Ralph Miller to be particularly revealing and persuasive.

"Double Leverage"

2. The Commission remains persuaded that the "double leverage" approach which it employed in Order No. 4389d is the proper method to determine the fair return for Mountain Bell. Because AT&T, a company with debt in its capital structure, holds the majority interest in Mountain Bell, the subsidiaries' book capitalization underestimates the amount of debt which actually finances its operations. "The double leverage" approach recognizes the two layers of debt and the associated costs.

3. Mr. Ralph Miller's testimony revealed how Mountain Bell's proposed 9.47 percent overall rate of return would result in an unreasonably high rate of return (14.26%) being earned by the parent AT&T's common shareholders at the expense of Mountain Bell ratepayers.

4. Among the infirmities Mr. Bruce Wilson found in Order No. 4389d was the discrepancy between the average rate of return on equity of 10.01 percent which results from the Order and the 11.25 percent determined to be a fair rate in Finding of Fact No. 22. By Commission order Mountain Bell has been granted revenues sufficient for a return of 11.25 percent to the ultimate owners, that is, the minority interest of Mountain Bell and AT&T's shareholders. The 10.01 percent average return on equity is a consequence of Mountain Bell and AT&T's capitalizations and has little relevance to a determination of whether the Commission has failed to grant a fair dollar return. Court examination of Mr. Ralph Miller on this point is revealing:

> THE COURT: Are you saying that the Commission has allowed 11.25 percent for the minority stockholders in Mountain Bell, and it's up to the company and the company's problem whether they want to pay it to them?
>
> THE WITNESS: Basically, I'm saying that that's one of the points that should be made in considering whether the return ordered by the Commission is appropriate; that the Commission has provided the money for the minority shareholders, and at the moment, -- The Commission might not have done so, and that would not be completely unreasonable, but the Commission did provide the money. The problem that Bell System is telling us, they can't give the money to the minority shareholders; they have to keep most of it for themselves, and in order to give to the minority shareholders all that is appropriate for them, we have to increase the size of the pie by a factor of approximately eight so when the minority shareholders get only the proportionate share of all that Mountain Bell gets, that would be enough.
>
> THE COURT: You' re saying that's not the Commission's problem; that's Mountain Bell's problem.
>
> THE WITNESS: Yes, I'm saying that that is a management problem. (Trans., Vol. II, pp. 68-9).

5. The allowed return is fair because it provides the dollar earnings to cover Mountain Bell's debt and equity costs as determined by the Commission. If minority shareholders are shortchanged, the deficiency is caused by management, not this

Commission's order. Just as the Commission would reject a capital structure shown to be imprudent, it must refuse to grant excess returns in order that minority shareholders enjoy 11.25 percent returns despite Mountain Bell's present institutional arrangements and capital structure which disadvantage the minority interest.

NARUC Tax Adjustment

6. The Bell System files a consolidated federal income tax return where the tax liability of each participant is allocated primarily on a source-of-taxable income basis. During direct examination, Mr. George Hess gave a concise explanation of why the resulting allocation is not a fair distribution for rate-making purposes:

> A. The source of taxable income method, using that method, each company tax deductibility of the debt of AT&T. AT&T's tax liability is separated between the Long Lines Department and the General Department. And in that separation, a portion of AT&T's debt is assigned to the Long Lines Department; but, for the most part, AT&T's General Department retains the interest deductibility of its own debt.
>
> As a result, AT&T General Department records on its books a substantial negative income tax. For the year 1976, this amounted to about $189 million.
>
> It follows that if, for rate-making purposes, the operating companies are allowed to charge ratepayers the allocated share of the consolidated tax without reflecting any part of AT&T's debt interest deductions, and the Long Lines Department is regulated on that basis, the sum of the taxes that would be allowed for rate-making purposes will exceed the amount that has to be paid. (Trans., Vol. II, p. 82).

7. Without the NARUC tax adjustment, subsidiaries such as Mountain Bell do not benefit from the tax deductibility of AT&T's debt although the parent is a major source of their financing. In a rate-making context, the adjustment results in a more equitable distribution of tax liabilities than would reliance on Mountain Bell's booked tax expense.

CONCLUSIONS OF LAW

1. The Commission's application of the "double leverage" approach in Order No. 4389d has provided Mountain Bell with a rate of return that meets the constitutional requirement of being

"commensurate with the returns on investments in other enterprises having corresponding risks and sufficient to insure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591, 603 (1944).

2. The NARUC tax adjustment made by the Commission in Order No. 4389d is proper in order to adjust an operating subsidiary's federal tax expense to reflect an allocation of the parent's debt upon which the subsidiary's ratepayers are ultimately paying interest. Re Mountain States Teleph. & Teleg. Co. (Colo. 1975) 11 PUR 4th 1, 21-24; South Central Bell Teleph. Co. v. Tennessee Public Service Commission (Tenn Ch Ct 1973) 100 PUR 3rd 45, 53-55.

ORDER

THE MONTANA PUBLIC SERVICE COMMISSION ORDERS THAT:

1. Having fully considered the record of evidence taken by the First Judicial District Court of Montana in and for the County of Lewis and' Clark, in Cause No. 43291, the Montana Public Service Commission does hereby AFFIRM its Order No. 4389d as that order is amended by Order Nos. 4389e and 4389f, all in Docket No. 6496.

2. A copy of this Order No. 4389g be filed in First Judicial District Court, Cause No. 43291, together with a letter to the Court as this Commission's report of its action in this matter. Said report being required by Section 69-3-404, MCA, and the District Court's order of July 25, 1979.

DONE IN OPEN SESSION at a meeting of the Montana Public Service Commission held on the 20th day of August, 1979, by a vote of 4 to 1.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

GORDON E. BOLLINGER, Chairman

CLYDE JARVIS, Commissioner

JAMES R. SHEA, Commissioner

GEORGE TURMAN, Commissioner

THOMAS J. SCHNEIDER, Commissioner
(Specially Concurring and Partially Dissenting)

ATTEST:

Madeline L. Cottrill
Secretary

(SEAL)

SPECIALLY CONCURRING AND PARTIALLY DISSENTING OPINION

BY COMMISSIONER SCHNEIDER

I concur with the majority on the NARUC tax adjustment advocated by Consumer Counsel witness Hess.

The remaining issue before the Commission on remand is the appropriate cost of capital or the overall fair rate of return. The Commission's responsibility is to establish just and reasonable rates which recognize legitimate and prudent utility costs, including a fair return.

The evidence presented to the Court by Mountain Bell on appeal is at best "marginally new" but unpersuasive on the basic issue of the appropriate cost of capital. To accept the position of Mountain Bell is to ignore the realities of the holding company system as they impact upon the legitimate capital cost of Mountain Bell. Consumer Counsel witness Miller exposed the results of accepting Mountain Bell's position demonstrating that AT&T shareholders would earn 14.26 percent on its equity investment in Mountain Bell, which is far in excess of the 11.25 percent fair return determined by the Commission. Adoption of the Mountain Bell approach by each state jurisdiction in which Mountain Bell operates would result in a $35 million excess to the parent AT&T. To accede to this pyramid effect would be to abdicate our regulatory responsibility. I reject as entirely inappropriate the position of Mountain Bell that the fair cost of capital is 9.47 percent. It is well settled that "the underlying capital structure of the system must be considered in any parent subsidiary situation." Priest, "Principles of Public Utility Regulation," 210-215 (1969); Potomac Edison Company v. Maryland Public Service Commission (1977) 279 Md 573, 369 A2d 1035, 1040.

Mr. Miller has provided substantive new evidence on the issue of establishing a fair cost of capital to be borne by the ratepayer. Witness Miller provided two alternatives which recognize the holding company system: (1) the double leverage method (adopted by the Commission); and (2) a hypothetical capital structure using the Bell System consolidated structure and cost as a proxy for an efficient -- least cost financing mechanism.

I am persuaded that the new hypothetical capital structure alternative is the most appropriate method for determining the fair return or cost of capital on this record. As the Maine Supreme Judicial Court stated there are two well-recognized circumstances in which a utility commission might disregard a utility's "actual" capital structure and adopt a hypothetical capital structure for rate-making purposes. First, when it is determined that the utility's actual capital structure may be inefficient and unreasonable, thereby necessitating an inflated return. Second, when a utility is part of a holding company system wherein "the utility's book capital structure and capital costs may not be a true reflection of the system's capital costs with respect to the particular operating company." New England Teleph. _ Teleg. Co. v. Maine P.U.C. 27 PUR 4th at 34 - 35. In the case of Mountain Bell both circumstances apply.

The record testimony of Miller is persuasive that the existing Mountain Bell capital structure is not efficient or least cost. Miller demonstrates that Mountain Bell is substantially under-leveraged on its nominal capital structure in comparison with the consolidated Bell System structure. The result of this inefficient structure is a significantly higher nominal cost of capital. The Bell System consolidated cost of capital was 8.96 percent as compared to Mountain Bell's nominal cost of 9.47 percent, which they advocate before the Court. (Tr., Vol. II, pp. 43-47). Miller concluded that is indeed possible and prudent to finance telephone assets at a cost below 9 percent as demonstrated by the actual experience of the Bell System consolidated. (Tr. pp. 44, 46 & 47).

Miller, then, presented the Bell System consolidated capital structure and associated costs as an appropriate proxy for an efficient and prudent hypothetical financial structure. Neither the consolidated structure nor its various cost components, as presented on Exhibit "D," were rebutted by Mountain Bell. The Commission determined the cost of equity at 11.25 percent on the basis of a comprehensive record which included a DCF and comparative earnings analysis for a wide range of utilities and other companies. That cost of equity of 11.25 percent is undisputed before the Court. Because of its broad based determination on this equity cost, I find it must necessarily be applied as the cost of equity in the hypothetical capital structure. I find that the consolidated structure and associated costs contained in Exhibit "D" constitute the best evidence of record on the fair cost of capital to be borne by the ratepayer:

Type of Capital	Percent of Capitalization	Cost	Weighted Cost
Debt	49.07	6.86	3.37
Preferred Stock	4.01	7.82	.31
Common Stock	46.92	11.25	5.28
			8.96

The existence of minority interest equity in the nominal Mountain Bell Capital structure was the focus of considerable testimony and examination on this record. The existence of debt in the parent company's equity holding in a subsidiary will in all cases result in higher earnings by investors in the parent than by the minority equity in the subsidiary. However, the unreasonable and unfair result of accepting Mountain Bell's position "for the minority stockholders" was previously described. Miller throughout his testimony correctly advocated that the Commission adopt a fair return based upon the legitimate, efficient, and prudent requirements of the financing of telephone assets of Mountain Bell. In that context Miller directly addresses the minority interest question.

> The consequence of it (the under-leveraged Mountain Bell structure) is, however, that the management of the Bell System is making less than fully efficient use of the equity capital furnished by or obtained from the minority shareholders in Mountain Bell, because the management of the Bell System has chosen to provide less than the most efficient amount of leveraging on the common equity capital that these minority shareowners in Mountain Bell provide...
>
> ...However, if the management of Mountain Bell chooses to operate in this fashion, that does not, in my view, provide a proper excuse for charging the rate payers additional revenues so as to compensate the minority shareholders whose capital is being used less than maximally efficiently by the management of the company at a higher rate in order to give them the full benefits that would be obtained if their capital were being used fully efficiently. (Trans., Vol. II, pp. 63-64).

Miller suggests that the management of Mountain Bell could in large part resolve the minority interest problem by aligning its nominal structure with the hypothetical structure, based on that of the consolidated Bell System. In that fashion minority investors would receive the full benefits of the leverage which their investment provides.

Mountain Bell and other Bell System companies have generally conceded that the consolidated capital structure technique is appropriate for wholly owned subsidiaries. On the other hand Mountain Bell's position is that because a minority stock interest exists in its nominal structure all common stock should receive the equity return of 11.25 percent.

Consider, then, the illogical and unreasonable result of applying those positions to a situation in which the parent owns 99 percent of the subsidiaries common stock while one percent is owned by minority stockholders. In this instance an 11.25 percent equity cost is "required" on all stock to assure the minority interest cost. The 99 percent holding of the parent would earn the nominal rate of 11.25 percent, but its common stockholders would earn 14.26 percent. The overall return would be 9.47 percent from the ratepayer. If, however, the parent owned 100 percent of the subsidiary common stock, the consolidated system capital cost would appropriately be applied with the resulting capital cost of 8.96 percent. It is obvious from the example that the mere presence of a minority interest under the Bell approach extracts unwarranted revenues from ratepayers if such potential abuse is not addressed squarely by the regulator.

Conclusion

The hypothetical or consolidated capital structure approach is in my opinion the most appropriate method on this record for determining the fair cost of capital in a holding company system. It realistically avoids the untenable intersystem transactions and vagaries of minority interest participation in order to focus on the reality of Bell System financing by the public. Such approach is a reasonable vehicle for allowing the legitimate cost of financing telephone assets for an operating telephone thereby fairly balancing the investor and ratepayer interests.

Thomas J. Schneider Commissioner
Commissioner

August 23, 1979

PUBLIC SERVICE COMMISSION
1227 11th Avenue

Helena Montana 59601
Telephone: (406) 449-3007 or 449-3008

Gordon Bollinger, Chairman
Clyde Jarvis
Thomas J. Schneider
James R. Shea
George Turman

The Honorable Peter G. Meloy
District Judge
Lewis and Clark County Courthouse
Helena. MT 59601

RE: MOUNTAIN STATES TELEPHONE AND TELEGRAPH COMPANY, a Colorado corporation v. THE DEPARTMENT OF PUBLIC SERVICE REGULATION, MONTANA PUBLIC SERVICE COMMISSION, and GEOFFREY L. BRAZIER, MONTANA CONSUMER COUNSEL, Cause No. 43291

Dear Judge Meloy:

Pursuant to Section 69-3-404, MCA, and this Court's Order of July 25, 1979, the Montana Public Service Commission has considered the record of evidence taken by this Court on the 16th and 17th days of July, 1979, in the trial of Cause No. 43291. This Court's Order. of August 7, 1979, granted the Public Service Commission until August 23, 1979, in which to report its action on this matter. Upon having fully considered the record of evidence submitted by the Court, the Commission has issued its Order No. 43899 which affirms that action taken in Order No. 4389d concerning the "double leverage" approach and the NARUC tax adjustment.

The members of the Commission were unanimous in their decision to uphold the NARUC tax adjustment. They are also unanimous in their rejection of Mountain Bell's proposed 9.47 percent overall rate of return.

Mr. Ralph Miller in his testimony described how Mountain Bells proposal would result in an unreasonably high rate of return being earned by the parent AT&T's common shareholders at the expense of Mountain Bell ratepayers. Mr. Miller presented two methods the Commission could employ to overcome this inflated return. it is evident from Mr. Miller's testimony that either a "double leverage" approach or a "Bell System consolidated" approach would provide enough revenue to allow both the Mountain Bell minority shareholders and the AT&T shareholders to earn a fair rate of return but no more. Four of the Commissioners voted to uphold the "double leverage" approach already employed in Order No. 4389d. Commissioner Schneider stated his preference for a "Bell System consolidated" approach.

This letter together with Order No. 4389g constitutes this Commission's report to the Court in compliance with the Court's Order of July 25, 1979, and Section 69-3-404, MCA.

I have attached hereto, a copy of this Commission's Order No. 4389g. I am also returning herewith, the certified copy of the record of evidence that was transmitted to the Commission on August 3, 1979.

Sincerely,

Gordon E. Bollinger
Chairman

dc

cc: Coleman M. Connolly, Esq.
J. Walter Hyer, 111 Esq.
George T. Bennett, Esq.
Geoffrey L. Brazier, Esq.
James C. Paine, Esq.
John C. Doubek, Esq.