Service Date: January 31, 1985

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 (Mountain Bell) for Authority to Change Rates and for Approval of Tariff Changes Due to Divestiture.	)))))	UTILITY DIVISION DOCKET NO. 83.11.81

IN THE MATTER of the Application of the Mountain States Telephone and Telegraph Company (Mountain Bell) for Authority to Increase Rates and for Approval of Tariff Changes for Telecommunications Service.	)))))	UTILITY DIVISION DOCKET NO. 84.4.19 ORDER NO. 5046d

* * * * * * * ** * *

RATE OF RETURN

* * * * * * * * *

APPEARANCES

REPRESENTING MOUNTAIN BELL:

Lawrence D. Huss and Dennis R. Lopach, Legal Counsel, Mountain Bell Legal Department, 560 North Park, Helena, Montana 59601

REPRESENTING AT&T COMMUNICATIONS:

Gary B. Witt, Attorney, AT&T Communications, Room 1537, 1872 Lawrence, Denver, Colorado 80202

Donald A. Garrity, Garrity, Keegan & Brown, 1313 11th Avenue, Helena, Montana 59601

REPRESENTING THE DEPARTMENT OF DEFENSE:

LeRoy L. DeNooyer, Senior Trial Attorney, Regulatory Law Office, U. S. Army Legal Service Agency, 5611 Columbia Pike, Falls Church, Virginia 22041-5013

REPRESENTING THE MONTANA CONSUMER COUNSEL:

James C. Paine, and John C. Allen, Montana Consumer Counsel, 34 West Sixth Avenue, Helena, Montana 59620

REPRESENTING THE COMMISSION:

Calvin K. Simshaw, Staff Attorney, 2701 Prospect Avenue, Helena, Montana 59620

BEFORE:

CLYDE JARVIS, Acting Chairman
JOHN B. DRISCOLL, Commissioner
HOWARD L. ELLIS, Commissioner
DANNY OBERG, Commissioner

FINDINGS OF FACT

1. On April 26, 1984 Mountain 'Bell filed an application for authority to increase rates to generate an additional $28,004,000 annually.

2. On October 18, 1984 Mountain Bell filed a Revised Motion to Amend the Procedural Order in this Docket.

3. On November 2, 1984 the Commission issued an Amended Procedural Order. The original Procedural Order would have resulted in all the testimony presented to the Commission in this docket utilizing budgeted data as opposed to actual historical data. The amended procedure bifurcated the hearings in this docket such that historical data would be used to determine revenue requirements in this case. The Amended Procedural Order set hearings on rate of return and rate design to begin on December 4, 1984. Hearings on remaining issues pending in the docket will begin on June 4, 1985.

4. This order is intended to address rate of return issues only. An order on rate design issues will be issued at a subsequent date. A final order determining revenue requirements will be issued subsequent to the June 4, 1985 hearings.

5. The following parties intervened in this Docket:

Montana Consumer Counsel (MCC)
Department of Defense (DOD)
AT&T Communications
Montana People's Action

COST OF CAPITAL

6. The cost of debt to Mountain Bell was not a contested issue in this case. All parties used 9.28 percent as the cost of debt to Mountain Bell. The Commission accepts 9.28 percent as the proper cost of debt in this case.

7. Four witnesses testified on the cost of equity to Mountain Bell. Martha Paine and Robert Morris testified on behalf of the Applicant. John Wilson testified on behalf of Montana Consumer Counsel. Mark Langsam testified on behalf of the Department of Defense. The following findings summarize each witnesses[1] testimony on cost of equity and present the Commission's decision on the appropriate cost of equity.

Summaries

8. Mr. Morris bases his recommendation of the cost of equity to Mountain Bell on a discounted cash-flow analysis and on a risk premium analysis. Mountain Bell is a wholly-owned subsidiary of US West and as such does not have publicly traded stock. For this reason, Mr. Morris constructed a proxy of telephone utilities for use in his DCF. Mr. Morris also calculates a DCF return for US West. However, Mr. Morris states that he does not rely upon the results for US West because of the limited information available for US West at the time of filing (Applicant's Exh. 1, p. 6). Mr. Morris' risk premium analysis is based upon a review of the

difference between the realized rate of return on the common stock of a group of companies and the realized rate of return on a group of bonds. Based on the DCF analysis and on the risk premium analysis, Mr. Morris recommends a return on equity of 16.50 percent within a range of 16.12 percent to 17.70 percent.

9. Ms. Paine, in analyzing the cost of equity, uses a discounted cash flow analysis, a comparable risk study, and a risk premium analysis. Ms. Paine's DCF analysis utilizes combined market information for the seven regional holding companies. Ms. Paine's comparable risk study looks at the required returns of 23 high quality industrials and 12 utilities. Ms. Paine used the returns for these companies as calculated using a DCF approach rather than actual achieved returns (Applicant's Exh. 3, p. 23). Ms. Paine's risk premium analysis is based on a comparison between earned returns of Standard & Poor's 49 utilities' common stocks versus long-term bonds. Using these three methodologies, Ms. Paine recommends a return on equity of 16.0 cent. Ms. Paine then makes an adjustment of ½ percent to prevent dilution of shareholders' equity when new stock is sold.

10. Dr. Wilson's recommendation on the cost of equity to Mountain Bell is based on a discounted cash flow analysis. Dr. Wilson uses information for US West and other telephone utilities as the basis for his study. Given the limited data currently available for estimating the future growth of US West, Dr. Wilson uses the growth history of AT&T and the other US West operating affiliates as well as the recent earnings and payout data for US West and the other Bell holding companies. Dr. Wilson also presents DCF studies for the electric utility industry, DCF studies for the telephone utility industry, and earned rates of return for telephone utilities, electric utilities, and unregulated firms and industries. After his analysis, Dr. Wilson testified that the best estimate of the current cost of equity capital for Mountain Bell is 13 to 14 percent.

11. Mr. Langsam bases his recommendations for a return on equity on a relative risk and earnings analysis, a market value analysis (DCF), and a risk premium analysis. Mr. Langsam' s relative risk analysis shows that using Moody's 24 Utilities as a benchmark for required return on equity the Company would require between 13.5 percent and 14.0 percent return. Mr. Langsam's DCF approach shows a current dividend yield in the 8.5-9.5 percent range

and growth of 5.0-5.5 percent. These numbers combine to form a required return on equity of 13.5 percent - 14.5 percent. Mr. Langsam's risk premium study is based on his analysis of the long-term historical relationship between the yield on outstanding public utility bonds and an estimate of the cost of equity capital for Moody's 24 Utilities. Using this relationship Mr. Langsam estimated a cost of equity between 14.1 percent and 14.5 percent.

Discussion

12. Mr. Morris presents a DCF for US West and for a "market proxy." Mr. Morris explains:

> Because Mountain Bell does not have publicly traded stock its market-required rate of return on equity cannot be directly determined, necessitating the use of an equity market proxy. I have developed a composite of telephone utilities serving market segments similar to Mountain Bell to arrive at its market-required rate of return on equity. In addition to my determination of the market-required rate of return for this proxy, I determined the market-required rate of return for USW. (Applicant's Exh. 1, p. 6)

Mr. Morris' market proxy consists of three companies: Cincinnati Bell, Inc, Rochester Telephone Corp., and Southern New England Telephone. These companies were chosen based on the Standard Industrial Classification System, inclusion in COMPUSTAT and Value Line, and the source of revenues for the company. (Applicant's Exh. 1, pp. 15-16.)

13. Mr. Morris was asked why he believed that a composite should be constructed of companies serving market segments similar to Mountain Bell. Mr. Morris responded:

> I believe it is necessary to construct a composite of companies serving market segments similar to Mountain Bell because these markets are experiencing increased market share competition. This competition is based upon technological advances which have created product substitutes with lower prices and/or costs than the telephone utilities. This increased competition should reduce the stability of revenues, earnings and dividend growth of the local telephone utilities which in turn should increase the risk of an investment in them. (Applicant's Exh. 1, p. 8.)

However, Mr. Morris does not discuss the similarity between the three companies serving as his proxy and Mountain Bell in the area of market share competition. Certainly the companies are impacted by the risks competition brings by a much greater extent than Mountain Bell's Montana operations. None of these companies are restricted by the MFJ line of business restrictions[1] and so are free to enter into competitive ventures to a much

(1) Judge Harold H. Green ruled that the Court will not grant line of business waivers for activities the total estimated net revenues of which exceed ten percent of a Regional Holding Company's total estimated net revenues. See Applicant's Exhibit 12.

greater extent than US West. Therefore, the Commission will not place any emphasis on Mr. Morris' return recommendations derived from the market proxy.

14. Ms. Paine uses information for all seven regional holding companies in formulating her recommendations on cost of equity. While the Commission views the regional holding companies as more similar to US West than Mr. Morris' market proxy, the Company has taken great pains to point out that it is not a "telephone company" but rather a unique diversified entity[2]. The Commission will place more weight on information for US West than the other regional holding companies.

15. All witnesses present some version of a discounted cash flow analysis. The discounted cash flow method of determining the cost of equity assumes that the price investors pay for stock is dependent upon an expectation of future revenues which is discounted given the investors perception of the relative risk of the investment. The model equates these future revenues, expressed as a percentage return to the investor, to the dividend yield plus the expected dividend growth rate.

16. Mr. Morris and Ms. Paine both use the expected dividend yield in the first half of the DCF formula. These yields include an assumption that the regional holding companies will increase their dividends by 6-7 percent in 1985. Ms. Paine shows a dividend yield for US West of 9.1 percent to 9.4 percent (Applicant's Exh. 3, Sch. 2). Mr. Morris shows a dividend yield for US West of 10.03 percent (Applicant's Exh. 1, Sch. 3).

(2) See Value Line discussion in Exhibit MCC-2.

17. Dr. Wilson and Mr. Langsam both use the current dividend yield in the DCF formula. This dividend yield is calculated by dividing the current market price by the currently declared dividend. Using recent market prices for US West, Mr. Langsam computes a dividend yield of 8.5 to 9.5 percent (DOD Exh. 1, p. 33). Dr. Wilson calculates a dividend yield of 9.0 percent based on the average price of US West stock February through July of 1984.

18. The Commission finds that using the current dividend yield is preferrable to using an expected yield. As Mr. Langsam explains:

> When computing the dividend yield, it is vital that the numerator of the ratio be the currently indicated yearly dividend (dividend for the current quarter times four) and the denominator be the current price. This is the figure which is published in the financial community and used by investors. (DOD Exh. 1, p. 30.)

The Commission finds 9.0 percent to be a reasonable dividend yield for use in the DCF formula. Nine point zero percent seems especially reasonable in light of Ms. Paine's statement that her most recent calculation would indicate a dividend yield of 8.8 percent (Trans. p. 147) and the New York Times article used by Ms. Paine in which Donna M. Jaegers of Paine Webber, Inc. quotes a current yield around 8.5 percent. . ." (Applicant's Exh. 20).

19. The growth component of the DCF formula is typically highly contested. In this case we have growth estimates for US West ranging from 3 .0 percent to 9.0 percent with the

majority in the 3 percent to 7 percent range. Part of the discrepancy centers around a continuing controversy over whether or not and to what extent investors rely on analysts forecasts.

(3) For further discussion see Applicant's Exhibit 3, page 21.

The Company quotes a Cragg and Malkiel study which concluded that analysts are the best explanation of stock prices.(3) MCC quotes a Wall Street Journal article and a New York Times article that question the independence of investment analysts and indicate that their projections are far to enthusiastic (4). Dr. Wilson also points out that the Cragg and Malkiel study referenced by Mountain Bell found that analysts projections for electric utilities were among the worst with respect to accuracy and that "prediction performances were uniformly mediocre across industries" (MCC Exh. 4, p. 55).

20. Further controversy exists concerning the use of growth in book value as a benchmark for growth in dividends. Mountain Bell discounts book value growth when estimating growth rates. MCC and DOD both put substantial emphasis on growth in book value. Mr. Langsam explains:

> The appropriate growth rate. . . is the growth rate in the utilities dividends and book value. Regulatory Commissions establish the earnings level as a percentage return on rate base or book value. Thus, for a regulated utility, earnings and dividend growth are a function of the underlying growth in book value. (DOD Exh. 1, p. 34.)

21. In reality investors probably incorporate all of this information, along with personal biases into decisions on buying and selling utility stocks. For instance, Value Line reports earnings, dividends, and book value growth rates for the past ten years, past five years and the next three to five years. This Commission has placed substantial reliance on historical growth information in prior orders based on the opinion that investors do not really expect the overly enthusiastic projections of analysts to materialize. As Dr. Wilson points out, there is often a large disparity between the growth that utility industries have been able to achieve in the past

and the higher growth projections published by analysts. The Commission fails to envision a future for the basic operating companies (versus the holding companies) especially in rural areas like Montana radically different from the past in terms of growth possibilities.

22. US West has been in operation since January 1, 1984. Therefore, no historical data exists for US West. Mr. Langsam used historical information for Moody's Utilities and current information for US West as an indication of typical utility growth and estimated a growth rate of 5.0 percent to 5.5 percent (DOD Exh. 1, p. 37). Dr. Wilson uses historical information for AT&T and for AT&T's subsidiaries (including Mountain Bell) during times when portions of their stocks were publicly traded. Fifteen years growth for the six partially-owned AT&T subsidiaries ranged from 2.35 to 4.75 percent. Ten year growth averaged 4.5 percent. Ten year growth for an average of earnings, dividends and book value of Mountain Bell was 4.8 percent. (MCC Exhs. 4 and 4a, p. 49 and Exh. J.W. 7.)

23. The Commission finds that 5.0 percent is a reasonable long-term growth rate for use in this case. While relying more heavily on historical growth, 5 percent does not seem unreasonable given current analyst forecasts. Applicant's Exhibit 3, Schedule 3 shows analysts growth forecasts from 3.0 to 9.3 percent with the majority falling in the 5 to 6 percent range. These forecasts are for US West as a whole, recognizing that US West will be entering into new business ventures and operates in much more populous areas than Montana. As Dr. Wilson explains:

> ……since most telephone utilities operate in businesses other than intrastate telephone utility service, it is important to identify the capital costs which properly apply to those jurisdictional services that are subject to tariff determination in this proceeding. The aspect of telephone utility business applicable to MB in this case is the Company's intrastate telephone utility operating business in Montana. . . (MCC Exh. 4, p. 44.)

Given the facts that competition is evolving at a slower pace in Montana than in the areas with large cities and that Montana customers should not have to assume the additional risks of US West's new ventures, adopting the lower end of analysts forecasts seems very logical.

24. A 9 percent dividend yield combined with a 5 percent growth factor leads to a 14 percent cost of equity. A 14 percent cost of equity is supported by the comparative risk studies of both Dr. Wilson and Mr. Langsam. It is also supported by Mr. Langsam' s risk premium study.

25. Ms. Paine recommends an additional 50 basis points be added to the return on equity for flotation costs and market pressure. This Commission has consistently denied adjustments of this type, absent some showing that these costs will actually be incurred and are properly charged to Montana ratepayers. Dr. Wilson supports this position in his testimony:

> Although my return recommendation does not include an explicit allowance for issuance expense, to the extent that investors anticipate future public offerings, that anticipation is reflected in the price of common stock and therefore is included in the dividend yield portion of the DCF results.
>
> Moreover, MB's common equity ratio is more than adequate for utility service purposes and further common equity capital would not be the most economical source of additional funds. This means that no allowance for issuing common stock is needed since it is neither necessary nor reasonable to provide revenues to cover any hypothetical cost which is not attributable to serving the needs of intrastate customers.

The Commission agrees with Dr. Wilson and once again denies this adjustment.

CAPITAL STRUCTURE

26. Ms. Paine recommends using Mountain Bell's projected average 1984 capital structure of 44.05 percent debt and 55.95 percent common equity. Both Dr. Wilson and Mr. Langsam reject this capital structure and recommend the Commission adopt a hypothetical capital structure. Dr. Wilson testifies that an equity ratio of more than 45 percent is excessive. Mr. Langsam favors a capital structure of 50 percent debt and 50 percent equity.

27. Mr. Langsam and Dr. Wilson explain why the Company's capital structure is an important issue:

> When a utility, through inadvertence or corporate purpose moves to a capital structure that contains too much equity capital, it will not be using the most efficient capital structure, i.e., the least cost capital structure. A commission that encourages this by setting rates based on a cost of capital containing more equity than the actual capital structure, or allows it by setting rates based on an actual capital structure containing more equity than necessary, will be violating the goal of regulation. (DOD Exh. 1, p. 66)
>
> Today it is more widely recognized that when excessive common equity ratios are used for ratemaking purposes, utility customers are forced to bear an unwarranted capital cost and tax burden. That is one reason why most electric utilities target their equity ratios in the 40 percent range. (MCC Exh. 4, p. 89)

28. Both Dr. Wilson and Mr. Langsam testify that using a 55 percent equity ratio would cause Mountain Bell's utility ratepayers to subsidize US West activities.

> US West is a company which offers both tariffed services through the Company and non-tariffed services such as equipment sales and rental, Advanced Mobile Phone Services, etc. These non-tariffed services may require higher equity ratios and may have higher overall costs of capital than the Company's tariffed services.
>
> The capital structure used by the Company may be appropriate for US West but is not appropriate for the Company. Using the Company's capital structure for rate making purposes would overcharge the Company 's rate payers and subsidize the other activities of US West. (DOD Exh. 1, p. 68)
>
> US West has formed a number of equity-financed nonregulated subsidiaries. The Company refused to respond to data and information requests pertaining to the financing of these subsidiaries. Obviously, if US West is using its consolidated financial posture to support equity-funded non-regulated subsidiaries, it should be recognized for ratemaking purposes that these entities have an impact on overall corporate capital costs. This is especially true with respect to equity costs since all equity capital is raised by US West on a consolidated basis. As reported by Value Line on July 27, 1979, US West's nonutility operations, which are expected to be exceptionally large for an RBOC, have (except for yellow pages) apparently lost money so far……
>
> Thus, it is critical for this commission to hold a careful regulatory rein on MB so as to assure that the Company and its parent, US West, are not permitted to use the regulated telephone utility enterprise as a ''cash cow'' to support speculative adventures in new competitive markets. Most importantly, in this case this means setting an allowed return on the basis of a telephone utility capital structure (i . e., no more than 45 percent common equity capital). (MCC Exh. 4, p. 91)

29. Dr. Wilson points out that most electric utilities have equity ratios around 40 percent. Mr. Langsam testified that Moody's 24 utilities are comparable to the Company. These utilities have an average equity ratio of 41 percent which is estimated to go to 44 percent in 1987-89.

30. Ms. Paine testifies that Mountain Bell's capital structure is necessary because of the increased risks that the Company is facing. Mr. Simshaw asked about these risks in cross-examination of Ms. Paine:

> Q. But it's a risk that what will happen, that revenues will go down?
>
> A. That Mountain Bell would experience a revenue loss because we are not competing, we are not meeting market demands or not able to tailor what we have to offer to the market. . . (Tr., p. 158)

31. In past orders the Commission has attempted to compare the risks of electric utilities with telephone utilities. In the recent past electric utilities have experienced significant problems with excess capacity and abandoned or delayed construction projects. These problems have certainly existed in some of the companies this Commission regulates. Some of these companies have been forced to absorb significant amounts of investment in abandoned projects and have experienced delayed or no revenue relief in excess capacity situations. When Mr. Simshaw asked Ms. Paine if she knew of any situations that created risks of similar magnitude in the telephone industry she responded that she knew of no similar situations. When asked if these companies had increased their equity ratios by significant amounts she responded that she did not know (Tr., pp. 162-163). None of the utilities that this Commission regulates have attempted to increase equity ratios by large percentages. The Commission realizes that the problems electrics are experiencing from an excess capacity standpoint are probably not long-term in nature. Competition and rapid technological changes in the telecommunications industry are permanent changes. Therefore, the Commission finds that Mountain Bell may be somewhat more risky than electric utilities. However, the difference in risk between Mountain Bell's Montana operations and those of an electric utility certainly do not justify the difference between a 40 percent equity ratio and a 55 percent equity ratio.

32. The Commission finds that Mr. Langsam's recommended capital structure containing 50 percent debt and 50 percent equity is appropriate for Montana intrastate operations. It does not contain as much equity as Mountain Bell recommended nor as little as MCC recommended. This capital structure reflects the additional risks that Mountain Bell faces today in Montana that a strict monopoly would not face. This Commission does not intend to allow Montana ratepayers to subsidize US West's unregulated competitive operations. To adopt a 55 percent equity ratio would be allowing Montana ratepayers to pick up an unreasonable expense.

RATE OF RETURN

33. Based on the findings in this order, the Commission authorizes Mountain Bell an overall rate of return of 11.64 percent determined as follows:

Component	Percent of Total	Cost Rate	Weighted Cost
Debt	50%	9.28	4.64
Equity	50%	14.00	7.00
	100%		11.64%

CONCLUSIONS OF LAW

1. Applicant, Mountain States Telephone and Telegraph Company is a corporation providing telephone and other communication services within the state of Montana and as such is a "public utility" within the meaning of §69-3-101, MCA.

2. The Montana Public Service Commission properly exercises jurisdiction over the Applicant's Montana operations pursuant to Title 69, Chapter 3, MCA.

3. The Commission has the authority to inquire into the management of the business of Mountain Bell and is required to keep itself informed as to the manner and method in which the same is conducted 69-3-106 (1), MCA.

ORDER

1. NOW THEREFORE IT IS ORDERED that the authorized overall return in Docket No. 84.4.19 is 11.64 percent.

Done and Dated this 28th day of January, 1985 by a vote of 5 – 0.

BY THE MONTANA PUBLIC SERVICE COMMISISON

CLYDE JARVIS, Chairman

JOHN B. DRISCOLL, Commissioner

TOM MONAHAN, Commissioner

DANNY OBERG, Commissioner

ATTEST:

Trenna Scoffield
Secretary

(SEAL)

Note: You may be entitled to judicial review in this matter. Judicial review may be obtained by filing a petition for review within thirty (30) days of the service of this order. Section 2-4-702, MCA.