

SERVICE DATE

DEC 21 1994

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of)	
GTE NORTHWEST INCORPORATED)	DOCKET NO. UT-931591
for Review of its Authorized)	
Rate of Return)	THIRD SUPPLEMENTAL ORDER
.)	

SUMMARY

PROCEEDINGS: This is a filing by GTE Northwest Incorporated for review of its authorized rate of return.

HEARINGS: Hearings were held in Olympia, Washington, on April 27, June 20, and October 3, 1994. The hearings were held before Chairman Sharon L. Nelson, Commissioner Richard Hemstad, and Administrative Law Judges Heather Ballash and Lisa A. Anderl of the Office of Administrative Hearings. All parties filed briefs on November 14, 1994.

APPEARANCES: GTE Northwest Incorporated was represented by Thomas R. Parker, attorney, Irving, Texas, and Richard E. Potter, attorney, Everett. The Staff of the Washington Utilities and Transportation Commission (Commission Staff) was represented by Steven W. Smith, assistant attorney general, Olympia. The public was represented by Donald T. Trotter, assistant attorney general, Seattle (Public Counsel).

COMMISSION: The Commission authorizes the company to earn a return on equity of 11.25% and an overall rate of return of 9.76%. The Commission approves a capital structure of 55.521% common equity, 0.090% preferred equity, 37.224% long term debt, and 7.165% short term debt.

MEMORANDUM

I. Proceedings

On December 29, 1993, GTE Northwest Incorporated (GTE-NW or company) filed with the Commission a petition to establish its authorized rate of return. The filing is pursuant to a settlement agreement approved in the Second Supplemental Order in Docket No. UT-910499, which set an authorized rate of return range for the company of 9.75% to 10.75%. The agreement provided that if the company had not had its rate of return reviewed by the Commission by the end of 1993, the company would file a petition to establish a new rate of return.

The company, through its witness Frank Hanley, is requesting an overall rate of return of 11.581%, with a return on equity of 13.800%. Staff's witness, Kathleen Folsom, proposes an authorized return in the range of 9.57% to 9.91%, with a return on equity in the range 11.1% to 11.7%. Public Counsel, through witness Stephen Hill, proposes an authorized return of 9.45%, with a return on equity of 11.00%.

II. General Principles

In a rate of return case, the Commission first determines the appropriate capital structure, including the amount of common and preferred equity and the amount of short and long term debt. This analysis generally considers issues of economy and safety. The Commission then determines the appropriate cost rates for each component, balancing the considerations of a fair return for shareholders and protection of ratepayers' interests.

The Commission is guided by the often cited cases of Hope and Bluefield¹. In accordance with the principles set forth in those cases, the return to investors should be commensurate with returns on other investments having corresponding risks. The return should assure investors' confidence in the financial integrity of the utility, enable the company to operate successfully, and permit it to attract capital on reasonable terms.

The primary differences among the parties in this case concern the ratio of short term debt, the ratio of common equity, and the cost rate of common equity. On brief, Public Counsel concedes to the company on all cost rates excluding common equity. The parties' positions on capital structure and cost rates are summarized below.

¹ Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944) and Bluefield Water Works Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923).

III. Rate of Return Comparison

GTE-NW

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rates</u>	<u>Weighted Costs</u>
Long term debt	39.353%	8.505%	3.347%
Short term debt	1.411%	4.740%	0.067%
Preferred equity	0.143%	8.302%	0.012%
Common equity	<u>59.093%</u>	<u>13.800%</u>	<u>8.155%</u>
TOTAL	100.000%		<u>11.581%</u>

Commission Staff

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rates</u>	<u>Weighted Costs</u>
Long term debt	37.224%	8.240%	3.07%
Short term debt	7.165%	4.610%	0.33%
Preferred equity	0.090%	8.300%	0.01%
Common equity	<u>55.521%</u>	<u>11.1%-11.7%</u>	<u>6.16%-6.50%</u>
TOTAL	100.000%		<u>9.57%-9.91%</u>

Public Counsel

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rates</u>	<u>Weighted Costs</u>
Long term debt	41.850%	8.505%	3.559%
Short term debt	8.000%	4.740%	0.379%
Preferred equity	0.150%	8.302%	0.012%
Common equity	<u>50.000%</u>	<u>11.000%</u>	<u>5.500%</u>
TOTAL	100.000%		<u>9.450%</u>

IV. Capital Structure

The capital structure of the utility is the percentage of debt and equity in the total of investor supplied capital. The Commission will determine an appropriate capital structure based on considerations of economy and safety, noting that while a company with more debt is financially riskier, a company with more equity has a greater amount of invested capital in the most expensive type of capital.

The company proposes to use the actual capital structure of GTE-NW as of June 1994, except that it would include an amount for short term debt which is based on an adjusted five quarter average. This results in a short term debt component of 1.4%, or \$23 million. The company calculates this amount by adjusting the average to remove "unusual and extraordinary" uses of short term debt. The company proposes a common equity ratio of 59.1% and a total debt component of 40.7%. The company argues that these actual ratios are consistent with other firms in the telecommunications industry and are consistent with the requirements for the company to maintain its bond rating.

The company wishes to maintain its Standard & Poor's "A+" rating (recently downgraded from "AA-") in order to keep its cost of debt down and facilitate the sale of its bonds. No party contended that it is inappropriate for the company to maintain an "A+" bond rating. Standard & Poor's considers a company's debt ratio, and various other factors specific to a particular company's operations, when it establishes bond ratings.

Staff would also use an actual capital structure as of June 30, 1994. Staff would include an amount of short term debt which is based on a 37 month average, for a total of 7.16% short term debt, or \$127 million. Staff believes that GTE-NW's equity ratio is high when compared to those of other telephone companies. However, Staff indicates that while a hypothetical capital structure can be appropriate, a capital structure with a higher equity ratio theoretically has a lower risk. Staff notes that its analysis of the cost of equity adjusts for various risk factors, including the lower risk of the high equity ratio. Staff argues that the capital structure it uses appropriately balances the economic risks and costs of shareholder funding with those of debt funding.

Public Counsel proposes a hypothetical capital structure of 50% common equity and 50% preferred equity and debt. The short term debt component is 8%, or \$125 million. Mr. Hill supports his determination of a 50% equity ratio with a check of the safety of such a capital structure. He claims the results of his analysis show the company will have more than sufficient earnings to cover interest, even with a 60% debt ratio.

In further support of a hypothetical capital structure, Public Counsel argues that GTE-NW is cross-subsidizing the unregulated operations of GTE Corporation. Public Counsel points out that GTE Corporation has more unregulated assets than GTE-NW, that non-telephone operations have a higher risk, and that a firm with more operational risk should not be capitalized with a lower equity ratio. GTE Corporation has a much lower equity ratio (42%) than GTE-NW. Public Counsel argues that its hypothetical capital structure will help rectify the cross-subsidization problem between the regulated and unregulated companies.

Public Counsel concludes that its position is consistent with Commission policy to set a capital structure with both safety and economy.

The Commission believes that in general, an actual capital structure is preferable to a hypothetical one. Where an actual capital structure is available and appropriately balances the risks and costs of shareholder and debt funding, the Commission will use that structure in the rate of return determination. In this case, the Commission adopts Staff's recommendation with regard to capital structure.² The actual capital structure of the company, including the realistic and prudent use of short term debt, will allow the company to maintain its bond rating and reflects an appropriate apportionment of capital between debt and equity. We adopt a capital structure of 55.521% common equity, 0.090% preferred equity, 7.165% short term debt, and 37.224%, long term debt.

The appropriate short term debt ratio is 7.165%. The analysis presented by Staff and Public Counsel on this issue is persuasive. GTE-NW's short term debt ratio during the past five quarters averaged \$129 million. GTE-NW has consistently used similar amounts of short term debt during the past five years. Furthermore, the telecommunications industry as a whole uses approximately 7-8% short term debt.

The company's adjustments to the amount of short term debt are not appropriate. Even if the Commission accepted that the past uses were extraordinary and unusual, the fact is that the existence of short term debt within the company's capital structure has been neither, and at a cost of less than 5%, that is as it should be. It is not economic or prudent to use the 1.4% ratio proposed by the company.

Long term debt is the remainder of the capital structure, at 37.224%. This, combined with the short term debt, produces a total debt ratio of 44.389%. To the extent that this ratio is of concern for the company's bond rating, it is firmly within the most recent guidelines set by Standard & Poor's for an "A" rated local exchange company, 40-52% total debt.

² In rejecting Public Counsel's hypothetical capital structure, the Commission nonetheless wishes to note that Public Counsel raises a valid concern about cross-subsidization. It is intuitive that cross-subsidization may exist under the current capitalization structure and it is obvious that there is an incentive to cross-subsidize unregulated operations. As the threat of competition becomes a reality, that incentive increases. However, having said that, the slightly richer equity mix adopted in this case is supported by the increased business risk faced by the company. The Commission will monitor this issue in future proceedings with this company.

V. Cost of Capital

A. Cost of debt and preferred equity

The cost of short term debt is agreed by the company and Public Counsel to be 4.74%. Staff recommends a rate of 4.61%. The Commission adopts the company's rate for short term debt. The rate was supported by the company on rebuttal and is a more recent figure than Staff's. This cost rate is appropriate and is adopted. The cost of long term debt is also not greatly disputed. Staff recommends 8.24%, while the company and Public Counsel agree on 8.505%. The Commission adopts the company's proposed cost rate of 8.505% for its long term debt. The Commission also adopts the company's proposed cost rate for its preferred stock, 8.302%.

B. Cost of common equity

The remaining issue for the Commission to determine is the company's cost of common equity. As noted above, the Commission does not set the cost of equity, but rather determines what the market requires as a return on this type of investment. To this end, the rate of return must be competitive with what investors could earn by placing their money in other enterprises with corresponding risks. The parties propose various methods for measuring the risk and required return for GTE-NW.

The company requests an equity return of 13.8%. The company proposal is based on the averaging of three models, Discounted Cash Flow (DCF), Risk Premium, and the Capital Asset Pricing Model (CAPM). Staff proposes an equity return in the range 11.1% to 11.7%. Staff based this recommendation on the DCF model and the use of a unique regression analysis to compare GTE-NW and the proxy companies. Public Counsel proposes a maximum rate of return of 11.0%, based on the DCF model. Mr. Hill checked his DCF results with several other models, including Earnings/Price Ratio, Market to Book Ratio, and CAPM.

C. Discounted cash flow

The DCF method requires information about market price and dividend yield and growth rates. However, because GTE-NW is not publicly traded, that information is not directly available. Thus, each party in this proceeding has chosen a proxy group or groups which it believes to be comparable to GTE-NW in order to measure the cost of common equity.

The Company's proxy group contains eleven telecommunications companies, including four local exchange companies (LECs) and seven regional Bell holding companies (RBHCs). However, Mr. Hanley only relies on the four independent LECs. He believes that the seven RBHCs are not comparable in size to GTE-NW, and that small companies tend to require a greater return than large companies.

Mr. Hanley's DCF results range from 10.8% to 15.4%, with a recommended average of 13% for the proxy group of LECs. His DCF results for the RBHCs range from 10.0% to 13.5%, with an average of 11.3%. However, these results were not used by Mr. Hanley in measuring the overall return requirement of the RBHCs, even as a check.

Ms. Folsom's proxy group contains the same eleven companies. However, Staff does not favor the independent LECs over the RBHCs. Instead, Staff notes that the companies within the proxy group are not exactly uniform, or representative of GTE-NW, and that each has different business and financial risks. Staff attempted to compare the indicators of comparable risk of proxy companies with their equity return. The resulting comparisons were measured in a multiple regression. Using the results of the regression and GTE-NW values for the indicators, Ms. Folsom calculates her proposed return of 11.4%, and then establishes a range of 11.1% to 11.7%.

The company disagrees with the statistical analysis used to derive GTE-NW's return. The company argues that Staff's analysis was improperly founded, that the independent variables are chosen by the use of "data mining", and that the independent variables are not independent. Staff replies that each of the variables were chosen based on sound financial theory and that as indicated by the results of Ms. Folsom's tests, they are independent and have a high degree of correlation with the dependent variable.

Mr. Hill does not include the four independent LECs in his proxy groups. He identifies the revenue breakdown of these companies to be highly unregulated and thus inappropriate for comparison. He does rely on the seven RBHCs, but considers them to be of slightly greater risk than a LEC such as GTE-NW. He also measures the rate of return requirement of a group of gas distribution companies which he believes to have similar business risk to as LECs.

Public Counsel recommends a return on equity lower than that of the RBHCs, which have a return requirement of between 11.25% and 12.25%, and higher than the gas distribution companies, which have a return on equity of between 10.25% and 10.50%. Public Counsel also takes issue with GTE-NW's suggestion that it is a small company. Public Counsel argues that no evidence was provided as to the distinction between small and large companies and that such a conclusion fails to recognize that GTE-NW is part of GTE Corporation, the largest LEC holding company in the country.

D. Other Methodologies

The company used two other models to calculate return requirements. The Risk Premium model produced a return requirement of 13.9%. The CAPM approach produced a return requirement of 14.6%. The company argues that DCF should not be used as the primary method to measure common equity rate of return, and that averaging the results helps offset the defects contained in the DCF model. Both Public Counsel and Staff criticize the use of other models, except as a check. In addition, Public Counsel criticizes the company's application of the other methods.

The Commission will continue to rely on the discounted cash flow analysis as the most satisfactory method of measuring investor expectation. The various other methods employed by the parties, including CAPM, Risk Premium, Earnings/Price Ratio, and Market to Book Ratio, are useful as a check. The results of all of the other methods are interesting for the Commission to see as points of comparison. However, those methods are not relied upon in this order to reach a decision on a rate of return. The Commission thus continues to discourage the approach of averaging DCF with other methods.

The Commission believes that Public Counsel's analysis of the cost of equity is particularly persuasive. Mr. Hill's testimony recognizes, as does this Commission, that GTE-NW is not comparable to the four small LECs in the other proxy groups. In fact, it is difficult to find a comparable company. In part because of GTE-NW's unique position as a subsidiary of GTE Corporation, it is simply unlike other LECs. It is more similar to the RBHCs, both in the nature and the scope of its operations. Mr. Hill's analysis and approach in the use of the DCF is based on a reasoned, well founded analysis of the company's circumstances and of similarly situated companies in comparable risk groups. As such, the Commission has given greater weight to the DCF results of those companies.

The Commission has looked with interest at Staff's regression analysis. The Commission applauds Ms. Folsom's efforts and her creative approach to the DCF analysis. However, the regression analysis may in fact suffer from statistical bias as alleged by the company, and is therefore subject to question as a means of defending the cost of equity calculation. That being said however, the Commission encourages parties to continue to develop and present innovative approaches.

The Commission concludes that GTE-NW's cost of equity is 11.25%. It is significant to note that all of the parties reach similar results in the application of the discounted cash flow method to the proxy group of RBHCs. In addition, the similarity of the results serves as a check on reasonableness.

This authorized rate of return will continue to allow the company to attract capital at a reasonable cost. It provides the company with an opportunity to earn on its overall capital at a rate of 9.76%, a level which fairly compensates investors and is consistent with expected returns in current economic markets. The Commission's determinations on capital structure and cost of capital for GTE-NW are shown in the following table.

<u>Type of Capital</u>	<u>Ratios</u>	<u>Cost Rates</u>	<u>Weighted Costs</u>
Long term debt	37.224%	8.505%	3.166%
Short term debt	7.165%	4.740%	0.340%
Preferred equity	0.090%	8.302%	0.007%
Common equity	<u>55.521%</u>	<u>11.250%</u>	<u>6.246%</u>
TOTAL	100.000%		<u>9.759%</u>

FINDINGS OF FACT

Having discussed the oral and documentary evidence concerning all material matters, and having stated findings and conclusions, the Commission now makes the following summary of those facts. Those portions of the preceding detailed findings pertaining to the ultimate findings are incorporated herein by this reference.

1. The Washington Utilities and Transportation Commission is an agency of the state of Washington vested by statute with authority to regulate rates, services, facilities, practices, rules, accounts, securities, and transfers of public service companies, including telecommunications companies.

2. Petitioner GTE Northwest Incorporated is engaged in the business of providing telecommunications services to customers in the state of Washington as a public service company.

3. The appropriate capital structure of GTE Northwest Incorporated is 55.521% common equity, 0.090% preferred equity, 37.224% long term debt and 7.165% short term debt.

4. The company's cost of common equity is 11.25%. An overall rate of return of 9.76% on the approved capital structure is a fair and reasonable rate of return which will allow the company to attract capital on reasonable terms and will maintain the company's financial integrity.

CONCLUSIONS OF LAW

1. The Washington Utilities and Transportation Commission has jurisdiction over the subject matter of and the parties to this proceeding.

2. The rate of return for GTE Northwest Incorporated should be set at 9.76%, with a return on common equity of 11.25%. These rates are consistent with the principles set forth in Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944) and Bluefield Water Works Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923).

ORDER

THE COMMISSION ORDERS That GTE Northwest Incorporated is authorized to earn an overall rate of return of 9.76% on the capital structure set forth in this order. The authorized return on common equity is 11.25%.

DATED at Olympia, Washington, and effective this 21st day of December 1994.

WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

Sharon L. Nelson

SHARON L. NELSON, Chairman

Richard Hemstad

RICHARD HEMSTAD, Commissioner

Wm. R. Gillis

WILLIAM R. GILLIS, Commissioner

NOTICE TO PARTIES:

This is a final order of the Commission. In addition to judicial review, administrative relief may be available through a petition for reconsideration, filed within 10 days of the service of this order pursuant to RCW 34.05.470 and WAC 480-09-810, or a petition for rehearing pursuant to RCW 80.04.200 or RCW 81.04.200 and WAC 480-09-820(1).