

COMMONWEALTH OF KENTUCKY  
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

NOTICE OF CONTINENTAL TELEPHONE	)	
COMPANY OF KENTUCKY OF AN ADJUST-	)	CASE NO.
MENT OF ITS INTRASTATE RATES AND	)	7790
CHARGES	)	

ORDER ON REMAND

The Public Service Commission ("Commission") issued an order on September 26, 1980, awarding Continental Telephone Company of Kentucky ("Company") \$2,178,921 of a requested \$4,509,146 revenue increase. A request for rehearing made by the Company was denied on November 5, 1980. That order was appealed to Franklin Circuit Court on November 17, 1980, by the Company. Two issues were raised in that appeal. The Company objected to the Commission's determination of toll settlement revenues from South Central Bell Telephone Company. It also challenged the cost of capital found reasonable by the Commission.

An order was issued by the circuit court on December 30, 1981, and amended January 21, 1982. The circuit court adopted the Company's positions, and directed the Commission to recompute the toll settlement revenues and imposed a surcharge on the existing rates of Continental's customers to allow the Company to recover \$241,000 the court found had been

unlawfully withheld from the Company. Since it is the Commission's opinion that this action by the circuit court represents an impermissible prescription of rates by the judiciary in violation of the Kentucky Constitution, 1/ the Commission has appealed this action of the circuit court to the Court of Appeals.

The circuit court further ordered the Commission to make specific findings of fact, determine the Company's cost of debt and equity and to delineate its position on double leverage. This Order on Remand is in response to that directive.

#### Cost Rates for Capital

In determining an appropriate rate of return on equity, the Commission evaluated the methods proposed by each witness. The Company's witness, Mr. Brennan, recommended a cost of common equity of 17 percent, although he said that 15 percent may be appropriate if the rate of inflation and money costs declined by the time the Commission reached a decision. He used earnings/price ratios, earnings/net proceeds ratios, discounted cash flow analysis, comparable earnings analysis, and risk premium analysis to estimate the Company's cost of equity.

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1/ Beshear v. South Central Bell Telephone Company, 38 K.L.S. 12, p. 9, September 23, 1981.

Mr. Johnson, the Attorney General's witness, recommended a cost of common equity range of 11.33 percent to 12.80 percent. He estimated the cost of equity to the parent corporation, Continental Telephone Corporation ("CTC"), to be 12 to 14 percent and adjusted this to account for double leverage in the parent-subsidiary relationship. Mr. Johnson used comparable earnings and market analysis to estimate the cost of equity to CTC.

In making its decision, the Commission chose not to use the risk premium approach of Mr. Brennan for two reasons. First, the testimony in this case on the cost of debt as a function of the cost of equity is sparse. Mr. Johnson did not use a risk premium analysis and Mr. Brennan used it only as a supplement to his principal testimony on the market and comparable earnings methods. Because there is not a substantial amount of evidence on the debt-equity relationship, the Commission is without adequate information to form a justifiable position on the cost of equity based on this type of analysis.

The second reason for discounting this testimony is the Commission's policy of not relying on debt cost at a particular point in time as the basis for establishing the cost of equity to a regulated company. The evidence shows that the Company's cost of debt fluctuated greatly from the end of the test period to the time of the issuance of the original

order. This is just one indication of the volatility of debt markets. Further, there is testimony indicating that the debt-equity markets are not conforming to historical patterns. Cost of debt is but one element to be considered in ratemaking, and is by no means the only measure of a fair rate of return. For these reasons, the Commission has chosen not to rely on debt cost at any particular time in determining a fair, just and reasonable cost of equity. Rather than predicate a rate of return on such an uncertain foundation, the Commission has determined that it is more reliable, accurate and fair to use the market and comparable earnings data to establish its equity finding.

Each witness used the DCF formula in establishing a market-based rate of return. This formula estimates the return an investor implicitly seeks on the money he invests in a company. Essentially, the dividend yield is combined with a company's growth expectation and applied to the book equity capital.

The range of equity return found by Mr. Johnson is 12-14 percent as opposed to a range of 15-17 percent advocated by Mr. Brennan. After evaluating the various components of the formulas used by the witnesses, the Commission has determined to use those of Mr. Johnson. The primary reason for accepting his analysis is his use of historical data, updated to reflect current trends and conditions. Mr.

Brennan's emphasis on current conditions without tempering his forecasts with historical input distorts his conclusions. His projections both as to dividend yield and growth rate are too unstable to provide a reliable basis for computing an equity rate.

Mr. Johnson's growth rate of 3.0-3.5 percent is a more realistic assessment of the Company's projected performance. This rate takes into account the near saturation of the Company's service area, modified population growth and the impact of competitive firms.

In evaluating the comparable earnings analysis of the witnesses, it is apparent that Mr. Johnson's is more comprehensive. Mr. Johnson used a longer historical perspective in his analysis -- 18 years compared to 9 years for Mr. Brennan. Additionally, he used a broader spectrum of comparables, including industrials, electric and telephone companies. Mr. Brennan used only Standard & Poor's 400 Industrials.

Both the Attorney General and the Company presented testimony about double leverage. Mr. Johnson proposed a double leverage approach in determining his return on equity. The basis for his position is that the Company benefits from the use of capital of its parent at a lower cost than the return it receives on the use of that capital. The Company disputes the validity of double leverage both in application and theory.

In this case, it is unnecessary to apply double leverage to determine a fair, reasonable rate of return for the Company. The Commission understands that double leverage is a valid method to be used in appropriate circumstances. Just as other financial and market approaches to a determination of a rate of return are used in various circumstances, based on the supporting data, company characteristics, witness credibility and Commission judgment, double leverage can be a useful tool in the ratemaking process.

Because the range found by Mr. Johnson of 12-14 percent does not require the application of the double leverage principle, the Commission need not utilize that concept in this case to arrive at a fair, reasonable rate of return on equity.

After reviewing the testimony of the two cost of capital witnesses, the Commission has determined that a reasonable rate of return on equity is within a range of 12-14 percent. This range was determined by using the financial and market data provided by Mr. Johnson. When faced with experts presenting conflicting conclusions based on essentially similar data, the Commission must rely on its sound discretion to evaluate the credibility of each witness. Even if the testimony of each witness is equally plausible, which here it is not, a judgment must be made to accept one opinion over the other. The judgment to use Mr. Johnson's

recommendation is based on the reliability of his methods, the credibility of his data and the reasonableness of his conclusions.

As a result of a review of the evidence in this record, the Commission has assigned a cost of long-term debt of 7.30 percent, and preferred debt of 9.36 percent. In computing the cost of debt, 14.64 percent short-term debt cost has been used as an adjustment to the end of test period embedded debt cost, rather than allowing a return on the end of test period balance of short-term debt.

The Commission's conclusion is that a fair, reasonable rate of return is within a range of 12-14 percent. Within this range, the best estimate of the Company's cost of equity is 12.75 percent and its overall cost of capital is 9.55 percent.

These figures are the result of consideration of the Company's capital structure, its historical capital costs, and the cost of each component of capital and their relative weights. This estimate will best achieve the needs of the Company in attracting capital and maintaining its financial integrity. It will also help balance the interests of consumers by maintaining equitable rates.

The following table shows the capital structure ratios and the total Company capital that the Commission finds reasonable for the Company's Kentucky intrastate operations:

	<u>Total Company</u>	<u>Allocation Factor</u>	<u>Intrastate</u>	<u>Capital Structure</u>
Long-Term Debt	\$34,239,540	80.94%	\$27,713,483	56.85
Preferred Stock	1,698,426	80.94	1,374,706	2.82
Common Equity	<u>24,289,897</u>	80.94	<u>19,660,243</u>	<u>40.33</u>
Total Capital	<u>\$60,227,863</u> 2/		<u>\$48,748,432</u>	<u>100.00</u>

Based upon the above-stated findings of fact, the Commission hereby ORDERS that the rates found fair, just and reasonable for Continental Telephone Company as set forth in Appendix A of the Commission's September 26, 1980, order are hereby affirmed.

IT IS FURTHER ORDERED that all other provisions of the Commission's September 26, 1980, order not modified herein, shall remain in full force and effect.

Done at Frankfort, Kentucky, this 22nd day of April, 1982.

PUBLIC SERVICE COMMISSION

Marlin M. Vohy  
Chairman

Katherine Randall  
Vice Chairman

Don Canger  
Commissioner

ATTEST:

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Secretary

2/ Item 25-C Page 1 of 3, Total Capitalization \$57,379,575  
Item 3-I Unamortized Investment Cr. Rev. Act 71 2,848,288  
\$60,227,863