State of Utah
Department of Commerce
Division of Public Utilities

FRANCINE GIANI
Executive Director

THAD LEVAR
Deputy Director

PHILIP J. POWLICK
Director, Division of Public Utilities

JON HUNTSMAN Jr.
Governor

GARY HERBERT
Lieutenant Governor

September 15, 2008

TO: **PUBLIC SERVICE COMMISSION**

FROM: **DIVISION OF PUBLIC UTILITIES**
Philip J. Powlick, Director
Bill Duncan, Manager, Telecommunications
Casey J. Coleman, Technical Consultant

Re: In the Matter of Utah Rural Telecom Association's Petition for a Rule on Capital Structure Docket No. 07-999-09

RECOMMENDATION:

Publish the attached rule R746-361 Proposed Rule on Capital Structure for Telephone Cooperatives and Telephone Corporations Regulated on Rate of Return Basis.

ISSUES:

On December 20, 2007 Utah Rural Telecom Association ("URTA") filed a proposed rule change with the Public Service Commission ("Commission") proposing a new method for calculating capital structure in telecommunications corporations rate cases. As a result of that petition, and some concerns that parties had with the rule, the Commission issued an order establishing a taskforce that would discuss capital structure for rate of return regulated phone companies.

In the order the Commission specified objectives that were to guide the goals and meetings of the taskforce:

- Suggesting a rule for capital structures for cooperative and non-cooperative rural ILECs.
- Recommending to the Commission whether there is a necessity for the capital structure rule to be different for cooperatives and non-cooperatives.
- Recommending as to whether a uniform rule is needed or whether the issue of the appropriate capital structure should be determined in individual rate reviews.

The Division of Public Utilities ("DPU") or ("Division") was asked to be the chair for the taskforce and to manage the meetings. On April 9, 2008 the taskforce had its first meeting. Participants included representatives from URTA, URTA member companies, Citizens Telecommunications, Committee of Consumer Services ("CCS"), DPU, and other interested parties.

Over the course of the next few months the taskforce met in a bi-weekly schedule to discuss issues, provide potential solutions, and review the proposed rule. The Division saw involvement from almost all the rural companies, CCS, and representatives from the different companies. The result of the meetings is the attached rule.

From the beginning all participants agreed that one of the major purposes of the taskforce was to provide a framework that allowed some certainty as to what hypothetical capital structure or actual capital structure would be applied in a rate case. The general feeling of many rural companies recent requirements to use a hypothetical capital structure or an actual capital structure were arbitrary. Having a specific rule would mitigate this potential obstacle.

Historically, the Division had used a hypothetical capital structure of 50 percent debt and 50 percent equity to determine capital structure. This hypothetical capital structure worked when a company was close to a 50/50 capital structure, but if a company was either highly leveraged with little equity, or had almost no debt or was close to 100 percent equity, the hypothetical capital structure presented problems. From the Division's perspective a highly leveraged company was getting a higher equity portion when calculating the allowed return than what their actual capital structure would allow. From some URTA member companies, who had little debt, their allowed rate of return was reduced by adding a hypothetical debt component to their capital calculation.

Another concern that surfaced from the taskforce dealt with companies that were highly leveraged with little equity. In some rate cases it seemed that the Division was only allowing companies to earn the minimum amount needed to pay the debt portion. Because there was not additional capital above interest payments being received from companies, this created a situation where it became extremely difficult to change the capital structure to a higher equity position and reduce the amount of debt used by companies. Many companies discussed the need for the capital structure to allow them some additional revenues above interest payments as a way to increase their equity.

The method developed by the taskforce to provide this level or certainty and avoid some of the above-stated challenges was to use a "blended" approach. The blended approach uses an actual capital structure when companies fall within a specific range. The agreed upon range was a ceiling of 65 percent equity and a floor of 35 percent debt. If a company falls within that band of capital structure, then the rule states that the actual capital structure will be used.

For those companies whose actual capital structure is outside the floor or ceiling, the Division would use a hypothetical capital structure. For a highly leveraged company, the hypothetical capital structure would be computed at 65 percent debt and equity of 35 percent. The understanding of the Division was that the additional equity above the actual capital structure of the company would be used to provide additional revenues to help the highly leveraged company lower their debt in the company. In the inverse a company that was financed primarily with equity would use a hypothetical capital structure of 65 percent equity and 35 percent debt. The general consensus of participants was that this would allow companies some flexibility to determine what capital structure would be best for their individual situation, while still balancing the needs of companies, customers and the public.

Another element of the proposed rule is the requirement for highly leveraged companies or cooperatives to file an additional report with the Division. The rule states that a telephone corporation or telephone cooperative whose equity capital is less then 20 percent will file up to a one page report with the Division one year after a triggering event (a rate case). These reports will need to be filed with the Division until the corporation or cooperative has increased their capital structure above the 20 percent equity. If a company's capital structure stays basically flat or decrease for four consecutive years, the rule also contemplates that the Division could recommend, and the Commission could order, some different capital structure other then the 65/35 equity to debt hypothetical ratio.

The taskforce also believes that this rule is applicable to both Cooperative and Regulated Telephone companies and the blended capital structure can be applied in either instance.

cc: Kira Slawson, Blackburn-Stoll
Stephen Mecham, URTA
Curt Huttsell, Citizens Telecommunications Company of Utah
Michael Ginsberg, Assistant Attorney General