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Department of Commerce
Division of Public Utilities

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**MEMORANDUM**

**To:** Public Service Commission

**From:** Division of Public Utilities
Chris Parker, Director
Bill Duncan, Telecommunications-Water Manager
Casey J. Coleman, Utility Technical Consultant

**Date:** March 1, 2011

**Re:** In the Matter of the Application of South Central Utah Telephone Association, Inc. for USF Eligibility, Docket No. 10-052-01.

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## RECOMMENDATION:

In compliance with the Commission's directions, the Division is submitting its position statement on rate of return issues and patronage capital issues. These position statements are general in nature, and reflect current Division thoughts on these issues.

Because cost of capital and allowed rate of return issues are complex and the potential effect of any positions taken by the Division or decisions by the Commission likely would have broader applicability and import than just to South Central Utah Telephone Association, Inc, the Division recommends and requests that the Commission open a rulemaking proceeding that would allow all interested parties a venue to participate. By opening up a separate docket, the Division will be able to analyze patronage capital on a broader basis and evaluate methodologies pertaining to the appropriate evaluation of allowed rates of return. Additionally, opening up a separate rulemaking docket will encourage participation by all interested parties.

## BACKGROUND:

At a scheduling conference on December 15, 2010, the Commission requested that the Division file position statements on rate of return issues and patronage capital issues. In reviewing both of those issues the Division believes the following items are important:

- Rate of return is generally a measure of the opportunity cost or the cost of capital required by investors.
- The allowed rate of return should be sufficient to maintain the health of the company.

- Patronage capital may impact the cost of capital because it could be a different funding source than long-term debt or equity.
- Revenue requirement shortfalls for rural phone companies are paid by USF funds which use allowed rates of return to determine the revenue requirement. Because of this fact USF and cost of capital are intertwined.
- The affordable base rate regime established by the Commission as part of the USF could be circumvented with patronage capital refunds.

Each of these areas is expanded below to show the impacts and position of the Division.

**Rate of Return and Cost of Capital**

Rate of return or cost of capital is used in a variety of financing decisions. Because the rural phone companies are rate of return regulated, the weighted average cost of capital (WACC) and subsequent allowed rate of return is the lifeblood of the company, establishing the revenue requirement for the company. In rate cases the Division has the daunting task of determining the appropriate financial costs for the company and recommending that cost of capital to the Commission.

It is clear that setting the right rate of return is imperative to regulators, the regulated company, as well as consumers. The cost of capital is the instrument used by the Commission to simulate what would happen in the competitive marketplace, allow the company the ability to earn their allowed rate of return, and protects consumers from being "exploited". The cost of capital and the rates set by the Commission must allow the company to earn its cost of capital, "no more and no less".

The economic logic underlying the notion of a fair return is straightforward. There is an **opportunity cost** associated with the funds that capital suppliers provide a public utility. Dr. Morin has stated that, "[t]he concepts underlying the cost of capital are firmly anchored in the opportunity cost notion of economics".[1] The cost is the expected return foregone by not investing in other enterprises of corresponding risk. Thus, the expected rate of return on a public utility's debt and equity capital should equal the expected rate of return on the debt and equity of other firms having comparable risk. The allowed return should therefore be sufficient to assure confidence in its financial health so it is able to maintain its credit and continue to attract funds on reasonable terms.

**The Allowed Rate of Return[2]**

The heart of utility regulation is the setting of just and reasonable rates by way of a fair and reasonable return. Two landmark Supreme Court cases define the legal principles underlying the regulation of a public utility's rate of return and provide the foundations for the notion of fair return. In *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia.*, the Supreme Court stated:

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[1] Morin, Roger A., *Utilities' Cost of Capital*, Arlington, VA: Public Utilities Reports, Inc., (1989 ) pg. 20
[2] Morin, Roger A., *Utilities' Cost of Capital*, Arlington, VA: Public Utilities Reports, Inc., (1989 ) pages 10-12

> "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties…The return should be reasonable, sufficient to *assure confidence* in the financial soundness of the utility, and should be adequate, under efficient and economical management, to *maintain and support its credit and enable it to raise money* necessary for the proper discharge of its public duties."

Later in *Federal Power Commission v. Hope Natural Gas Company* guidelines used to assess the reasonableness of the allowed return was expanded. The Court emphasized its statements in the *Bluefield* case and recognized that revenues must also cover "capital costs". The court stated:

> "From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock…By that standard the return to the equity owner should be *commensurate with returns on investments in other enterprises having corresponding risks*. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to *maintain its credit and attract capital*."

Two standards of fairness and reasonableness of the allowed rate of return ("ARoR") for a public utility emerge from the statements of the Court in these two cases: (1) A standard of capital attraction, and (2) A standard of comparable earnings

As regulators, the ARoR should be sufficient so that companies are financially healthy enough to attract the necessary debt and equity to continue to invest in the business, while providing earnings that would allow the return on risks to be comparable to similar investments.

It is important to note in this discussion about rate of return that the cost of capital for a company is not set by the Commission. The Commission only establishes the ARoR. Instead the cost of capital is set by the debt and equity markets and what investors determine is fair compensation for the cost of not investing that capital in another enterprise.

Thus, the Division seeks to recommend an ARoR that is sufficient to promote the financial health of the regulated telephone companies so that the companies are financially healthy enough to attract the necessary debt and equity to continue to invest in the business, while providing earnings that would allow the return on risks to be comparable to similar investment, and simultaneously protecting the consumers from unbridled monopolies.

**Patronage Capital and Allowed Rate of Return**

Because SCUTA is a cooperative telephone corporation there is an added element to the determination of ARoR and ensuring the correct costs are determined. The additional consideration is patronage capital.

One way patronage capital can be defined is as any revenue in excess of operating costs. This excess may be treated as equity capital contributed by the cooperative's members, which may be returned to the members in proportion to their purchase of telecommunications services. In effect, members are providing funds to their utility, akin to investors supplying funds to a utility by buying its stocks or bonds. At this time, the Division has no clear understanding how patronage capital is perceived by utility members and how it is treated by the utilities; however, the Division believes, at this time, that SCUTA pays patronage capital to its members on a sporadic basis. Many issues, including the relationship of patronage capital to ARoR and the effect of USF thereon, present themselves, and the Division believes that they may be worthy of further study.

**Affordable Base Rate and Patronage Capital**

Another area of concern for the Division when dealing with cooperatives is how patronage capital refunds seem to lower the affordable base rate paid by members. Generally, the Division believes refunding patronage capital appears to circumvent the affordable base rate regime established by the Commission when calculating revenue requirements. With the affordable base rate for residential customers at $16.50 a month, the Division believes members of the cooperative should be paying at least that amount for basic phone service. If the board of directors for a cooperative issues a refund to members, then that refund has lowered the total amount paid by consumers for the service. In the case of SCUTA though, this general belief does not seem to be relevant because SCUTA has not paid any patronage capital since 2007. For the Division to fully understand patronage capital and how it is intertwined with USF payments and revenue requirements, it would be beneficial to understand how each cooperative within the state determine the appropriate level of patronage capital to be retired.

**Conclusion Regarding the Allowed Rate of Return and Patronage Capital**

The Division’s general positions regarding rate of return and patronage capital have been presented above. These positions in any specific matter may be affected by factors unique to the individual case. The Division believes that the ARoR and how the appropriate costs of financing are addressed in the regulatory setting need to be evaluated further. As part of that analysis, the Division, Commission, SCUTA, and other parties need to look at the relationship between the WACC and the ARoR. Additionally, with regard to patronage capital the Division believes that patronage capital is another variable that could impact the WACC and the subsequent ARoR. Because of the import of these issues, and the fact that they are not limited only to SCUTA, the Division thus recommends and requests that a separate rulemaking docket be opened to address both rate of return and patronage capital issues in greater detail and with broader applicability.

cc: Felise Thorpe Moll, Assistant Attorney General
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