- BEFORE THE PUBLIC SERVICE COMMISSION OF UTAH -

In the Matter of the Consideration of the Role of Patronage when Determining Rate of Return, Affordable Base Rate, and Support from the Utah Universal Public Telecommunications Service Support Fund for Certain Telephone Corporations	)))))))	DOCKET NO. 11-2528-01 Position Statement of the Division of Public Utilities

The Division of Public Utilities hereby files the following Position Statement as directed by the Public Service Commission of Utah (the "Commission") in response to the issues the Commission has set forth in its Notice of Agency Action in the above-reference docket:

RESPONSES TO ISSUES RAISED BY THE COMMISSION

1. Clarifying the definition of patronage

Patronage capital can be defined as any revenue in excess of operating costs. This excess is treated as equity capital contributed by the cooperative's members, which eventually must be returned to the members in proportion to their purchase of telecommunications services. The general premise in a cooperative is that equity can only come from the members.[1] When determining the revenue requirement for a cooperative, the Division believes that the associated "costs" incurred by the Cooperative when using patronage capital for financing of capital projects would be significantly less than the equity costs of the cooperative. The premise goes back to the basic underlying economic principle dealing with the cost of capital, i.e. the opportunity cost of investors.

When investors supply funds to a utility by buying its stocks or bonds, not only are they postponing consumption, giving up the alternative of spending their dollars in some other way, but they are also exposing their funds to risk. Investors are willing to incur this double penalty only if they are adequately compensated. In a cooperative members are pooling capital to provide a desired and vital public service. The Division doubts most customers of the

[1] Traditionally in Utah, cooperatives were considered associations, classified as nonprofit corporations with their primary objective to provide telephone services in rural areas to support agriculture; not to pay dividends on invested capital.

cooperative even believe they are “investing” capital and forgoing consumption with the membership fees or the price they pay for telecommunications services.

Additionally, in a traditional equity scenario, where investors have invested capital taking an ownership position in a company, if they are not satisfied with the way management is “investing” retained earnings, those investors have the option to sell their equity portion or stock and find another investment. In a cooperative, members can leave the cooperative, but the equity of the members is not tradable in an open marketplace. In essence, a shareholder elects to buy stock in a company, whereas a cooperative member is a captive investor. Because of this glaring reality, the Division finds it difficult to classify members of a cooperative as investors who are experiencing opportunity costs that need to be compensated, creating an equity cost for their capital.

2. **Should a telephone corporation’s support from the State USF fund be reduced proportionate to the amount of patronage paid**

As discussed by the Division below in question number 4, the Division believes that it appears members of a cooperative are paying less than the affordable base rate when patronage capital is refunded to members.

Because the amount of revenues received is intertwined with the affordable base rate, the Division believes it is difficult to look at the USF fund without considering the Affordable Base Rate. The Division recognizes that the companies do not agree that patronage capital refunds are impacting the rate paid by members. If the Commission agrees with that premise, then it creates a scenario where cooperative members could be paying the affordable base rate, the cooperative receives USF funds, and pays patronage capital to its members.

A first impression of the Division is that USF funds should not be used to pay patronage capital to members. USF funds are provided for a specific purpose as outlined by the Federal Communication Commission and the Commission. If a company was using USF funds for patronage capital then it would seem to fall outside of the allowed uses of USF funds. As a result lowering the payments from the USF would seem like the appropriate course of action.

To quantify the exact impact to cooperatives, the Division would need to verify where the USF money had been spent and ensure that the affordable rates paid by members were not being refunded back to members in the form of patronage capital.

3. **Should a telephone corporation's support from the State USF fund be eliminated if patronage paid exceeds support from the State USF fund**

   See the response to question 2 above.

4. **The role of patronage when determining rates of return**

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

> "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.

Intuitively, because cooperatives may not be required to pay dividends as regularly as investor owned companies, and the members of a cooperative are a captive investor, the Division believes the risk premium required by members of the cooperative should be less than a risk premium for a company like Rocky Mountain Power. Because there is scant public information available on rural telephone cooperatives, it is extremely difficult for the Division to quantify how significant the difference of the risk premium between a cooperative and a company similar to Rocky Mountain Power.

The dissimilarity of the cooperative associations as compared to a for-profit entity is that same nuance addressed above within the proposed definition of patronage. The cooperative members essentially "buy into the cooperative" as a captive member and do not pay into the cooperative as an investment opportunity to earn dividends. Yet, the patronage capital can significantly sway the setting of rates.

5. The role of patronage when determining affordable base rates

Generally, the Division believes refunding patronage capital appears to circumvent the affordable base rate regime established by the Commission when calculating revenue requirements. Typically, patronage capital refunds seem to effectively lower the affordable base rate paid by members. 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. 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 determines the appropriate level of patronage capital to be retired.

Usually, the role of patronage capital when determining the affordable base rate and the amount paid by customers will depend on the specific bylaws of each cooperative. While the Division believes that it appears that the affordable base rate is being circumvented by the rural cooperatives, a more specific understanding of each company and how they treat patronage capital payments is required by the Division to altogether conclude the role of patronage capital when evaluating affordable base rates.

CONCLUSION

For the reasons cited above, the Division submits that patronage capital, ARoR, disbursements from the USF, and the affordable base rate are all intertwined. The Commission must consider the appropriate "cost" for a rural telecommunications cooperative when dealing with patronage capital and determine if the allowed costs should be different than the equity costs.