

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI

CASE NO. TR-82-223

In the matter of the filing by  
Continental Telephone Company of  
Missouri of new intrastate rates,  
tolls and charges applicable to  
intrastate telecommunication  
services furnished within the  
State of Missouri.

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APPEARANCES: W. R. England, III, Attorney at Law, Hawkins, Brydon &  
Swearengen, P. O. Box 456, Jefferson City, Missouri 65102,  
for Continental Telephone Company of Missouri.

A. Scott Cauger, Assistant General Counsel, P. O. Box 360,  
Jefferson City, Missouri 65102, for the Staff of the Missouri  
Public Service Commission.

REPORT AND ORDER UPON REHEARING

On January 26, 1983, the Commission issued its Report and Order in the above-styled matter, the same to become effective February 7, 1983. Said Report and Order authorized the Company to file revised tariffs designed to increase gross annual revenues by \$5,385,640, exclusive of gross receipts and franchise taxes.

On February 3, 1983, the Company filed its Application For Rehearing alleging, inter alia, that the Commission erred in recognizing that financial leverage exists between Company and its parent corporation and that the Commission further erred in finding Staff's method of calculating double leverage is appropriate.

By Order issued April 19, 1983, the Commission granted the Company's Motion For Rehearing on the issue of the use and proper method of calculating double leverage and set the matter for hearing.

The hearing was convened on June 21, 1983, for the presentation of evidence. Counsel for the Company and the Staff appeared. No other parties who had

previously participated in the hearing of this matter appeared. At the close of the hearing the parties indicated no desire to file briefs or orally argue the matter and waived Section 536.080, RSMo 1978. On July 20, 1983, the Commission convened an on-the-record conference for the purpose of receiving a reconciliation with respect to the revenue requirement which would result from the Commission's findings in this matter. Counsel for Company and counsel for Staff appeared for this purpose.

#### Findings of Fact

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact:

The proceedings in this matter involved the filing of revised tariffs by Continental Telephone Company of Missouri (hereinafter CTM). CTM is a wholly owned subsidiary of Continental Telecom, Inc. (hereinafter CTI).

The Commission in its Report and Order found as reasonable a return on equity for CTM of 13.6 percent resulting in a weighted cost of capital of 10.80 percent. In reaching this conclusion, the Commission adopted Staff's double leverage adjustment. Staff's double leverage adjustment involved a series of calculations which resulted in a composite subsidiary return which would produce the desired consolidated return.

The issue upon rehearing is twofold: (1) whether double leverage should be utilized in calculating the appropriate return on equity for CTM and (2) if double leverage is found to be appropriate, then the proper method for calculating double leverage to arrive at a return on equity for CTM.

#### The Use of Double Leverage

Double leverage is a term which refers to the presence of debt capital at two levels, the parent level and the subsidiary level. An adjustment for double leverage ordinarily involves the use of the weighted average cost of capital of the

parent company of the subsidiary as a measure of the cost of equity of the subsidiary.

Company opposes the use of double leverage because it assumes (1) that a subsidiary's cost of equity is determined by ownership rather than risk; (2) that the equity of all subsidiaries is equal in risk; and (3) that the equity of all subsidiaries is financed in the same proportion as the components contained in the parent's capital structure. The Company maintains that the parent is entitled to the same return on equity from its subsidiaries that the investors of the parent equity capital expect and thus the parent's cost of equity is the same as the subsidiary's cost of equity.

In a case where a subsidiary is wholly owned by a parent, the Commission determines the subsidiary's cost of equity by reference to the parent's cost of equity. In this case, the Commission determined the parent's cost of equity by analyzing the investor expected return, or the market required return for CTI common equity stock. The return on equity found reasonable by the Commission for CTI is 15.70 percent.

The record reflects that the total dollars of consolidated common equity are less than the total dollars of the composite common equity of the subsidiary. The record also reflects that the return on equity of the consolidated entity has historically been greater than the return on equity of the composite subsidiaries. Therefore, if the subsidiaries' required return on equity were equal to CTI's required return on equity, the result would produce a return on the parent's equity which is greater than that which has been found reasonable. Thus, there is no reason to assume that the market required return on equity for the parent must be extended to the unmarketed common equity of the subsidiary. The application of double leverage is not a question of ownership as asserted by the Company, rather it is a concept designed to produce the appropriate return which will meet investor expectations at the parent level where the stock is traded.

The Commission finds the assumption implicit in the double leverage

concept, that the equity of the subsidiary is financed in the same proportion as the various capital components contained in the parent's capital structure, is reasonable even though further refinement of the concept might be appropriate in order to take into account the difference in risk of the various subsidiaries. Based on the foregoing, the Commission concludes that it is appropriate to apply the concept of double leverage in order to determine the appropriate return on equity for CTM.

#### The Method of Calculating Double Leverage

Staff's double leverage adjustment involved a series of calculations whereby Staff determined its recommended return on equity for CTI. Staff then divided the consolidated net income of CTI by its consolidated common equity to arrive at a return on consolidated equity actually earned by CTI. Staff computed the additional income that would allow the consolidated entity to earn a return comparable to Staff's recommended level. The additional income was then added to the subsidiary's combined income and divided by a restated common equity amount for the combined subsidiaries. The quotient produced a required return on equity for the subsidiaries which would generate the required return on equity which Staff recommended for CTI. These calculations were made using data for the years ending June 30, 1982, December 31, 1981, 1980 and 1979. Staff averaged the results for the four periods to arrive at its recommended return on equity for Company of 13.10 to 14.00 percent. The Commission relied on Staff's presentation in arriving at the 13.6 percent return on equity found reasonable for CTM.

The Company takes the position that if double leverage is imposed, the traditional method should be used. Company defines the traditional method as a method whereby the parent's cost of capital using the capital structure of the parent only is applied to the subsidiary's book common equity. The Company takes issue with the Staff's method because in its view using the consolidated income as a starting point, is replete with assumptions and jurisdictional problems in that AFUDC income, below the line income, JDIC income, interstate toll income, nonregulated income and losses are considered in Staff's calculation.

Company asserts that since Staff's method penalizes its rate of return by including nonjurisdictional sources of income, the traditional method is preferable and more indicative of the Company's cost of capital. The Company submits that either of its alternative approaches as shown on Company's Exhibit 48, Schedule RAR-3 (as revised in Exhibit 52) or RAR-4 is preferable to Staff's calculation. Exhibit 52 and Schedule RAR-4 are set forth below. Company characterizes Exhibit 52 as the traditional method of calculating double leverage and RAR-4 as a variation of the traditional double leverage calculation.

Staff asserts that it used its method because it had been unable to get the Company's capital structure to a cost basis. This is because the Company keeps its books on an equity basis rather than on a cost basis. Under the equity basis of accounting, the undistributed earnings of the subsidiaries since the date of acquisition are reflected in the parent's retained earnings account. In addition, the majority of the subsidiaries were acquired on a "pooling of interest" as opposed to a "purchase of assets" basis. For a pooling of interest acquisition, only the original book equity of the acquired subsidiaries is reflected on the parent's books. Therefore, the original cost of investment is not necessarily reflected in the parent's equity accounts. For the above reasons, the data is unavailable to get the parent's equity account to a cost basis and for this reason Staff was unable to perform a cost based double leverage calculation. A cost based double leverage calculation would utilize a parent's capital structure which reflects the actual cost the parent has invested in its subsidiary.

The Company offered Schedule RAR-4 which it characterizes as a proxy for cost based double leverage. Schedule RAR-4 which is reproduced below removes the parent's retained earnings from the parent's capitalization, assigns the parents weighted cost of capital to the subsidiary's common stock and capital surplus and assigns the parent's cost of equity to the subsidiary's retained earnings.

CONTINENTAL TELEPHONE COMPANY OF MISSOURI

COST OF CAPITAL UNDER ALTERNATIVE  
DOUBLE LEVERAGE

	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
<u>CONTINENTAL TELECOM, INC. - PARENT</u>			
Debt	41.62%	13.46	5.60%
Preferred Stock	6.98%	8.58%	.60%
Common Equity (Excluding Retained Earnings)	<u>51.40%</u>	15.70%	<u>8.07%</u>
Total	<u>100.00%</u>	-	<u>14.27%</u>

CTC OF MISSOURI

Long-Term Debt	44.86%	7.835%	3.514%
Interim Loans	1.59%	15.318%	.243%
Preferred Stock	4.60%	8.560%	.394%
Common Stock and Capital Surplus	29.75%	14.270%	4.245%
Retained Earnings	<u>19.20%</u>	15.700%	<u>3.014%</u>
Total	<u>100.00%</u>	-	<u>11.410%</u>

The Company also calculated a double leverage calculation contained in Schedule RAR-3 (as revised Exhibit in 52) which simply applies the parent's weighted cost of capital to the common equity component of the subsidiary. Exhibit 52 is reproduced below:

CONTINENTAL TELEPHONE COMPANY OF MISSOURI

CALCULATION OF COST OF CAPITAL USING  
TRADITIONAL DOUBLE LEVERAGE

6/30/82

		<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
<u>CONTINENTAL TELECOM, INC. - PARENT</u>				
Debt	420,981	28.05%	13.46%	3.78%
Preferred Stock	70,652	4.70%	8.58%	.40%
Common Equity	<u>1,009,605</u>	<u>67.25%</u>	15.70%	<u>10.56%</u>
Total	<u>1,501,238</u>	<u>100.00%</u>		<u>14.74%</u>

CTC OF MISSOURI

Long-term Debt		44.86%	7.835%	3.514%
Interim Loans		1.59%	15.318%	.243%
Preferred Stock		4.60%	8.560%	.394%
Common Equity, CTCM				
CTI Debt		13.73%	13.46%	1.848%
CTI Preferred		2.30%	8.58%	.197%
CTI Common		<u>32.92%</u>	15.70%	<u>5.168%</u>
Total		<u>100.00%</u>		<u>11.364%</u>

During the course of the hearing, Staff conceded that the calculation contained in Exhibit 52 is an appropriate method for calculating double leverage for CTM. Staff's witness acknowledged that Exhibit 52 is essentially the same approach and format that Staff used in the most current United Telephone case which Staff

submitted in its prefiled evidence in May of 1983. Staff noted that the parent Company of United Telephone Company also accounts for its investment in its subsidiaries based on the equity method of accounting.

Since it is apparent that a cost based capital structure is not attainable for the parent Company, the Commission determines that the double leverage calculation contained in Schedule RAR-4 is inappropriate for this Company. Exhibit RAR-4 is appropriate for a company which keeps its books on a cost basis. Under the cost method the retained earnings of the subsidiary are not included in the parent's common equity and, therefore, the market required return on equity is assigned to the retained earnings of the subsidiary. A cost based double leverage calculation has been utilized by this Commission in determining the return on equity for Southwestern Bell Telephone Company, whose parent uses the cost based accounting method. The removal of retained earnings from the parent's common equity in this case does not accomplish the same result since the parent's retained earnings account contains items other than the retained earnings of the subsidiaries. Therefore, since the capital structure is not cost based, the application of a cost based leverage calculation is inappropriate.

The Commission determines that the method contained in Exhibit 52 is a reasonable and appropriate method of calculating double leverage for Continental. It operates on the assumption implicit in the double leverage concept that the subsidiary's equity is financed in the same proportion as the capital components contained in the parent's capital structure. The Commission further finds that this approach is preferable to Staff's method which used consolidated income as a starting point and thereby ignores the cost of capital approach. The Commission has also taken into consideration the fact that Staff has conceded that the Company's approach contained in Exhibit 52 is appropriate.

Based on the foregoing, the Commission determines upon rehearing that the appropriate return on equity for Continental Telephone Company of Missouri is 14.74 percent, resulting in a weighted cost of capital 11.36 percent. Therefore, the Company should be authorized to file tariffs designed to increase gross annual

revenues by \$654,849.00, exclusive of gross receipts and franchise taxes.

### Conclusions

The Missouri Public Service Commission has arrived at the following conclusions:

Continental Telephone Company of Missouri is a public utility subject to the jurisdiction of this Commission pursuant to Chapters 386 and 392, RSMo 1978.

When a public utility's existing rates and charges for telephone service are found to be insufficient to yield reasonable compensation for the service rendered, the Commission shall authorize revisions to the Company's applicable tariffs which will yield an appropriate fair return on the Company's property. The resulting rate shall be fair, just and reasonable and sufficient and shall not be unduly discriminatory or unduly preferential.

Based upon the Commission's findings herein, the Commission's Report and Order issued January 26, 1983, should be modified and the Company should be authorized to file revised tariffs in conformance with the findings of this Report and Order.

It is, therefore,

ORDERED: 1. That the Commission's Report and Order in this matter issued January 26, 1983, be, and it is, hereby modified and the Company is authorized to file, for approval by this Commission, revised tariffs designed to increase gross annual revenues by \$654,849.00, exclusive of gross receipts and franchise taxes and said revised tariffs shall be in conformance with the rate design and other findings contained in the Commission's Report and Order in this case issued on January 26, 1983.

ORDERED: 2. That the rates to be established through revised tariffs conforming to the Commission's findings and conclusions in this Report and Order may become effective for service rendered on and after the date the Commission approves the revised tariffs authorized herein.

ORDERED: 3. That this Report and Order shall become effective on the date

hereof.

BY THE COMMISSION

*Harvey G. Hubbs*

Harvey G. Hubbs  
Secretary

(S E A L)

Shapleigh, Chm., Dority and  
Musgrave, CC., Concur.  
Mueller and Hendren, CC., Not Participating.

Dated at Jefferson City, Missouri,  
this 20th day of July, 1983.