The Regulation of Public Utilities

Theory and Practice

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1993
PUBLIC UTILITIES REPORTS, INC.
Arlington, Virginia

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First Printing, May 1984
Second Edition, June, 1988
Third Edition, July 1993

Library of Congress Catalog Card No. 93-085285

ISBN 0-910325-45-6

Printed in the United States of America

And the District of Columbia commission rejected a telephone company's actual capital structure of 15 percent debt and 85 percent equity as being unrealistic, adopting for rate-making purposes a hypothetical capital structure of 40 percent debt and 60 percent equity. "In our judgment," said the commission, "this capital structure, when applied to the cost of debt and equity, will amply afford sufficient earnings to pay a reasonable dividend and allow an increment for surplus."[76]

During this same period, other commissions adopted the actual capitalization. The New York commission declared that to disregard the "actual historic structure" created with the commission's approval "would unsettle investors" and remove from management control over the capital structure. It added that "having approved a company's capital structure . . . the company and the public have the right to rely upon our using the capital structure which we have approved as the basis for determining its rate of return."[77] The commission later indicated, however, that it would disregard the actual capital structure when it was "wasteful."[78] The Colorado commission said that it "could adopt a hypothetical structure for rate making in the event that applicants' actual financial structure is not in the long run public interest. . .keeping in mind that responsibility for financial decisions rests with management."[79] The Arizona commission rejected the use of hypothetical capital structures on the grounds that they involve "pure speculation," while actual capitalizations are "more realistic."[80] The Florida commission held that capital structures "fall within the prerogatives of management" and that "invasion of the field of management in such a sensitive area is justified only when the public interest requires the exercise of extreme measures for its protection and benefit."[81] Finally, the FCC rejected the adoption of a hypothetical capital structure for AT&T in a 1967 decision, but noted that in fixing the allowable rate of return it would take into account the "extraordinary amount of risk insurance respondents have given its stockholders by its low debt ratio policy."[82]

Debt ratios began to rise during the late 1960s and early 1970s, and the financial condition of the public utility sector began to deteriorate. It became the common practice to use actual or expected capitalizations; actual where a historic test year is used, expected when a projected or future test year is used.[83] The objective, in short, shifted from minimization of the short-term cost of capital to protection of a utility's ability "to raise capital at all times. This objective requires that a public utility make every effort to keep indebtedness at a prudent and conservative level."[84] A hypothetical capital structure is used only where a utility's actual capitalization is clearly out of line with those of other utilities in its industry or where a utility is diversified.[85]

Consolidated Capital Structure and Double Leverage. Where a utility is a wholly owned subsidiary that obtains its equity capital through its parent corporation, commissions commonly use the capital structure of the consolidated system.[86] When (1) no substantial minority interest exists and (2) risks