Date of Issuance
December 18, 2017

Decision 17-12-029 December 14, 2017

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Calaveras Telephone Company (U1004C), Cal-Ore Telephone Co. (U1006C), Ducor Telephone Company (U1007C), Foresthill Telephone Company (U1009C), Kerman Telephone Co. (U1012C), Pinnacles Telephone Co. (U1013C), The Ponderosa Telephone Co. (U1014C), Sierra Telephone Company, Inc. (U1016C), The Siskiyou Telephone Company (U1017C), Volcano Telephone Company (U1019C) ("INDEPENDENT SMALL LECS") for a Determination of Applicants" Cost of Capital for Ratemaking Purposes.	Application 15-09-005 (Filed September 1, 2015)

DECISION DENYING REHEARING OF DECISION 16-12-035

I. INTRODUCTION

Cal-Ore Telephone Co., Foresthill Telephone Company, Kerman Telephone Company, The Ponderosa Telephone Company, Sierra Telephone Company, Inc., and Volcano Telephone Company (hereinafter "rehearing applicants" or "small LECs") timely applied for rehearing of Decision (D.) 16-12-035.[1] D.16-12-035 implements the first step of the General Rate Case (GRC) plan approved in D.15-06-048, which adopted a GRC plan for California High Cost Fund-A (CHCF-A) recipients.[2]

[1] All citations to Commission decisions are to the official pdf versions which are available on the Commission's website at: http://docs.cpuc.ca.gov/DecisionsSearchForm.aspx.

[2] "In [D.15-06-048 at page 25 Finding of Fact Number 14] the Commission determined there should be a consolidated proceeding to examine the issue of cost of capital for each of the ten CHCF-A companies (Applicants). [Footnote omitted.] The Commission approved a schedule beginning with the filing of this application [i.e., A.15-09-005] to determine the Small LECs' cost of capital on September 1, 2015." (D.16-12-035 at p. 3.)

Rehearing applicants are a portion of the independent small local exchange carriers (LECs) who filed the underlying application and all are CHCF-A recipients. Pursuant to Public Utilities Code section 275.6, the CHCF-A provides supplemental funding to small independent telephone companies that continue to be regulated under a rate-of-return regulatory structure.[3]

Following the ten independent small LECs' filing of the underlying application (A.15-09-005), the Commission's Office of Ratepayer Advocates (ORA) filed a timely protest, and in April 2016 an evidentiary hearing was held. A proposed decision (PD) issued on November 1, 2016, both parties filed opening and reply comments and engaged in ex parte communications prior to issuance of D.16-12-035.

D.16-12-035 approved a LEC cost of capital to be applied in any of the ten independent small LECs pending and future GRC application cycles that are initiated before the year 2021. D.16-12-035 also established the LEC cost of capital for the recently concluded GRCs of three of the named utilities: Kerman Telephone Co., (by D.16-06-053), The Siskiyou Telephone Company (by D.16-09-047), and Volcano Telephone Company (by D.16-09-049) pursuant to the terms of those decisions.

D.16-12-035 adopted differing costs of capital for each of the small LECs ranging from between 8.44% (Ponderosa) to 9.22% (Sierra). We utilized the Capital Asset Pricing Model (CAPM) to determine a reasonable cost of equity for each of the companies.[4] The applicants sought modification of the CAPM, arguing that various additional risks should be included by seeking the addition of a "risk premia." The adopted cost of capital for each of the rehearing applicants is set forth in D.16-12-035 in Table 1 at pages 2-3. In arriving at the cost of capital for each small LEC, D.16-12-035 adopted a 10.80% cost of equity, and used the actual debt costs for the companies having debt, and a 4.53% debt cost for Cal-Ore, Pinnacles, and Siskiyou because those three utilities currently have no debt.

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[3] All statutory references are to the Public Utilities Code unless otherwise indicated.

[4] D.16-12-035 at p. 53 Finding of Fact No. 3.

Having reviewed each and every allegation of error, we are of the opinion that there is no good cause for rehearing of the challenged decision. Accordingly, the application for rehearing of D.16-12-035 is denied.

II. DISCUSSION

A. Rehearing Applicants have shown policy differences, but not legal error.

1. A difference of opinion regarding policy, does not amount to a constitutional or other violation of law.

The point of this proceeding is to determine the cost of capital for each of the ten CHCF-A recipient carriers. (D.16-12-035 at p. 7.) Arguing against adoption of a specific capital structure, applicants sought for the Commission to either leave the determination of capital structure to individual rate cases or, in the alternative, adopt a single cost of capital for all of the small LECs at a rate of 14.6%. (D.16-12-035 at pp. 4, 8-9.) According to D.16-12-035, by their application, the ten independent small LECs "proposed that if a single cost of capital is adopted for all companies, it should be 14.6% based on a 70% equity to 30% debt capital structure with a 5.5% cost of debt and an 18.5% cost of equity (applicants proposed an 18.5% return on equity for each company). (D.16-12-035 at p. 4.) Rehearing applicants contend the cost of capital adopted for each small LEC is the result of an abuse of discretion.

Applicants argued for adoption of a single cost of capital based on an 18.5% cost of equity. ORA, however, argued that an 18.5% cost of equity was a much higher rate than any previously approved by the Commission.[5] Rehearing applicants' arguments challenge the costs of capital adopted based on a 10.8% equity cost and a weighted cost of debt adopted for each company. They argue that their constitutional rights have been violated because the cost of capital percentages adopted "were

[5] "ORA disputed the Applicants' claims of risk with respect to ongoing operations, and opposed the use of a hypothetical capital structure . . ." arguing that applicants' actual equity structures ranged from a low of 42.36% to a high of 65.76% or an average of 56.80%. (D.16-12-035 at p. 4.)

calculated using a hypothetical 70% equity and 30% capital structure, a 10.8% cost of equity, and weighted cost of debt information for each company in 2014," and will result in a lower cost of capital (following the GRC decision for each company) than the transitional cost of capital reduction instituted by the Federal Communications Commission (FCC). (Reh.app. at pp. 6, 12-13; and see, D.16-12-035 at p. 38.) The allegation is speculative at best.

As they did in comments on the PD, rehearing applicants contend the cost of capital ultimately adopted for each of the small LECs lacks evidentiary support and fails to acknowledge the regulatory and commercial risks affecting independent small LECs. (Reh.app. at pp. 9-12.) Citing the same seminal United States Supreme Court cases discussed in D.16-12-035 (at page 7),[6] rehearing applicants contend that the Commission is required "to adopt a cost of capital that reflects the returns demanded by investors in companies facing similar risks." (Reh.app. at p. 8.) Acknowledging that D.16-12-035 utilizes the constitutional standards at issue, rehearing applicants contend the decision failed to correctly apply those standards to their application, and the outcome amounts to an unconstitutional taking.

To constitute an unconstitutional taking, rehearing applicants must show that D.16-12-035 has substantially devalued their property. Any future subsidies rehearing applicants may receive from the CHCF-A are not ownership interests by these small LECs—and the Commission is not required to adopt a cost of capital demanded by the small LECs. Rather, among other things, section 275.6 requires that CHCF-A subsidies must not be excessive, and are sufficient to make up a portion of any revenue requirement that cannot reasonably be provided by the small LECs' customers. (§ 275.6(c)(4) and (7).) Rehearing applicants have failed to show that the challenged decision fails either of these statutory requirements. Further, as in any rate setting, the

[6] *Duquesne Light Company v. Barasch* (1989) 488 U.S. 299, 314-315; *Federal Power Commission v. Hope Natural Gas Company* (1944) 320 U.S. 591, 593; *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia* (1923) 262 U.S. 679, 693.

Commission is required to ensure that rates established for the small LECs are just and reasonable, and non-discriminatory. (§§ 275.6(c)(1) and (3), 451, 454, 455, 728.) The small LECs were not persuasive in arguing that the challenged decision would cause them, or any one of them, to not recover reasonable rates or subsidies to which they may be entitled. "A rate providing for the recovery of fully allocated cost, including the cost of capital, is not confiscatory." (*FCC v. Fla. Power Corp.* (1987) 480 U.S. 245, 254.) D.16-12-035 considered the evidence presented by the parties and did not find the applicants' evidence persuasive. Rehearing applicants have not prevailed in showing that the cost of capital determination will cause the small LECs to lack the ability to meet the requirements of section 275.6.

Although ORA argued that use of the 70/30% hypothetical rate structure would lead to a windfall for shareholders, the challenged decision found that the "actual five-year capital structure of the ten Applicants is very close to the 70/30 hypothetical structure recommended by Applicants." (D.16-12-035 at p. 54 Finding of Fact No. 21.) As discussed in D.16-12-035, ORA argued that each of the small LECs should receive authorization for its own cost of capital in the ranges of 6.24% to 7.67%:

> To calculate those costs of capital, ORA used the actual capital structure for seven companies and the average of those seven (56.82% equity to 43.18% debt) for the three companies that currently have a 100% equity structure. ORA proposed the Commission use the actual cost of existing debt for the seven companies with debt (ranging from 2.93% to 5.53%) and an average debt cost from those seven companies, 4.53%, for the three companies without any current long-term debt. Finally, ORA proposed the Commission use the same cost of equity, 8.79%, for all the companies.

(D.16-12-035 at pp. 4-5; and see, ORA 5/13/16 opening brief at p. 21.)

The small LECs proposed using "a wide range of risk factors including, fiscal, size, liquidity, competitive, and regulatory risks as the basis for modifying the CAPM." (D.16-12-035 at p. 18; and see, Small LECs' 5/13/16 opening brief at p. 28.)

They argued in the underlying proceeding that ORA did not consider these risk factors in presenting its argument. (D.16-12-035 at p. 19.)

The challenged decision discusses in detail the argument made by the small LECs including the rehearing applicants' disagreements with ORA's arguments concerning the risk factors claimed by the small LECs. (*Id*. at pp. 19-24.) It also discusses the arguments presented by ORA (at pages 24-28). Having reviewed the parties' arguments and the supporting evidence, the challenged decision determined:

> We agree with ORA that Applicants have failed to show that more than two components are justified in this case to calculate a reasonable cost of equity. The Commission has traditionally used two inputs to the CAPM, the equity risk premium and the risk-free rate, to calculate the cost of equity for a regulated utility. We have traditionally held there should be no adjustments to the financial modeling results for other financial, business or other regulatory risks because the financial modeling results already include those risks. We have not been convinced that we should deviate from this method in this case.

(D.16-12-035 at p. 28.)

At pages 50-51 of the challenged decision is a discussion of constitutional allegations and other challenges raised by the applicants in comments on the PD; all quite similar to those raised again in the rehearing application. The application for rehearing does not present issues not already considered and addressed. The rehearing applicants' allegations of error in the decision are really nothing more than criticisms, and as the Commission noted some years ago concerning Ducor Telephone Company:

> This criticism is no more than a request for the Commission to reweigh the evidence, and thus, constitutes an attempt to relitigate the issue. Such a request does not constitute an allegation of legal error. (See Pub. Util. Code, §1732, requiring rehearing applicants to set forth grounds on which the decision is unlawful; see also, Commission Rules of Practice and Procedure, Code of Regs., tit. 20, §16.1, subd. (c).)

(D.10-05-022 at p. 6.)[7]

The record does not support rehearing applicants' allegations that the cost of capital determination for each rehearing applicant is the result of arbitrary and capricious decision-making and is not based on the evidentiary record. Rehearing applicants have not shown that their constitutional rights were violated.

2. No showing of a violation of Public Utilities Code section 275.6

Rehearing applicants contend the challenged decision conflicts with the statute.[8] (Reh.app. at p. 11.) They contend the average 8.89% cost of capital fails to account for the specific risks facing the small LECs and thus will discourage investors and lower their incentive to deploy broadband-capable facilities in rural areas. (Reh.app. at p. 12.) This argument is speculative at best. Their claim that the Commission has failed to rely on any evidence in support of its determination is flatly erroneous; the challenged decision is replete with discussion of our consideration of the evidence and of the parties' arguments. There is ample basis to support the decision's reasoning. Rehearing applicants have not established that the challenged decision violates section 275.6, or that it failed to make a reasonable policy determination, or that the individual cost of capital determinations for each of the small LECs was the product of legal error.

B. No showing that the challenged decision erred in determining equity costs for purposes of the cost of capital determination.

With respect to the use of the CAPM framework to estimate the cost of equity, the challenged decision provides:

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[7] Furthermore, the instant rehearing application is an attempt to ask the Commission to reweigh the evidence and to permit the rehearing applicants to relitigate their position. An application for rehearing is not a vehicle for such relitigation. Any attempts to relitigate shall be denied. (Cal. Code of Regs., tit. 20, § 16.1, subd. (c); and see, *OIR re California Renewables Portfolio Standard Program* [D.13-02-037] at pp. 3-4; see also, *Application of Exposition Metro Line Construction Authority for an order authorizing the construction of a two-track at-grade crossing for the Exposition Boulevard Corridor Light Rail Transit line* [D.11-10-022] at pp. 5-6.)

[8] Section 275.6 authorizes the CHCF-A.

> Applicants rely on the CAPM framework, which involves identifying the rate of return on a "riskless" investment and then adding specific "risk premia" to account for the added risks of the subject investment relative to the "riskless" investment. Applicants cite to prior Commission decisions for telecommunications and other utilities that have used the CAPM method in some capacity to justify its use here. Applicants propose a variant of CAPM that builds-up elements to reach a recommended cost of equity. This "build-up" CAPM method breaks out the risk factors into specific premia that, taken together, generate the proposed cost of equity.

(D.16-12-035 at pp. 18-19; Small LECs' 5/13/16 opening brief at p. 28.)

Reasoning that the adopted rates of return on equity have been falling for the past two decades, ORA proposed an equity cost of 8.79%. (ORA 5/13/16 opening brief at p. 6; D.16-12-035 at p. 24.) In reviewing the parties' arguments concerning cost of equity calculations, D.16-12-035 rejected the applicants' proposal, choosing to follow a traditional process, providing at page 28:

> The Commission has traditionally used two inputs to the CAPM, the equity risk premium and the risk-free rate, to calculate the cost of equity for a regulated utility. We have traditionally held there should be no adjustments to the financial modeling results for other financial, business or other regulatory risks because the financial modeling results already include those risks. We have not been convinced that we should deviate from this method in this case.

Rehearing applicants contend that the challenged decision deviates from record evidence in adopting a cost equity rate, yet have failed to show that the decision is not based on the record. Rehearing applicants have not established that the challenged decision contains an erroneous interpretation of the CAPM. They have not established more than a difference of opinion; and contrary to their allegation, the record does not compel a different conclusion.

C. Rehearing applicants have not shown that our not adopting the risk premia proposal constitutes arbitrary, capricious or otherwise unreasonable decision-making.

Rehearing applicants' arguments allege, but do not establish, that the decision not to adopt the proposed risk premia was the result of arbitrary and capricious decision-making. Much of this general argument compares the Commission's treatment of water companies with the decision's determination regarding the risk allocation for the independent small LECs. We have previously considered comments along this line and responded to them in the decision. (D.16-12-035 at pp. 50-51.) Like their arguments in the underlying proceeding and comments on the PD, much of the arguments presented in the application for rehearing are policy arguments, which the challenged decision thoroughly addressed, and not allegations of legal error.[9]

In the rehearing application, as in the independent small LECs' comments on the PD, they contend D.16-12-035 errs by not adopting their expert's testimony regarding risk factors. D.16-12-035 notes: "The Small LECs state that a fundamental flaw with the proposed decision is its failure to provide them with additional profit because of the risk factors identified in their expert's testimony." (D.16-12-035 at p. 50.) The decision finds that the evidence the independent small LECs presented simply was not persuasive. (D.16-12-035 at pp. 53-54 Finding of Facts Nos. 11-16.) Applicants take issue with those findings, as well as a few others, in addition to contesting Conclusions of Law Numbers 11 and 12. They allege those findings and conclusions are unsupported by the record; but again, the allegation is based on a difference of opinion and the rehearing applicants have not shown the decision was reached in an unreasonable manner and have not shown that the determinations made are without evidentiary support. Rehearing

[9] Pursuant to section 1732: "The application for a rehearing shall set forth specifically the ground or grounds on which the applicant considers the decision or order to be unlawful. No corporation or person shall in any court urge or rely on any ground not so set forth in the application." And "[t]he purpose of an application for rehearing is to alert the Commission to a legal error, so that the Commission may correct it expeditiously." (Commission Rules of Practice and Procedure, rule 16.1(c).)

applicants may not appreciate ORA's evidence (deriding it as "simplistic"), but their criticisms do not amount to proof of legal error; and rehearing applicants have not established that the decision is not based on record evidence, or shown that it violates their constitutional rights, or is the product of arbitrary and capricious decision-making. The allegation is without merit.

D. Rehearing applicants have not established that the adopted costs of debt are based on arbitrary and capricious decision-making.

Findings of Fact Numbers 26-32 pertain to the cost of debt. (D.16-12-035 at pp. 54-55.) In arriving at our decision, D.16-12-035 reviews the arguments presented by the independent small LECs regarding the individual costs of debt for each company:

> Applicants advocate for using the actual, weighted, embedded cost of debt at the time of a company's rate case. Applicants argue that waiting until the rate case to determine the cost of debt will produce a more accurate figure and shield the Applicants from anticipated rises in costs of debt. Applicants also state that it is easy to compute the cost of debt at the time the rate case is filed. For companies that do not currently have any debt, Applicants urge the Commission to adopt a hypothetical debt rate of 5.5%.

(*Id*. at p. 39.)

"ORA . . . disputed the use of a single cost of debt and its impact on the weighted average cost of capital and resulting revenue requirement." (D.16-12-035 at p. 4.) The decision notes that ORA proposed a different approach and suggested use of a 4.53% weighted average cost of debt for the three carriers that are without debt; and ORA argued that the actual 2014 embedded, weighted cost of debt[10] for each company with debt (see Table 3 on page 41 of D.16-12-035) should be used because such costs can be

[10] The 2014 actual costs of existing debt was the most available information in the record for the proceeding. (D.16-12-035 at p. 41.)

easily calculated at the time of each carrier's rate case. ORA argued against estimating future debt costs. (*Id*. at p. 40.)

Not convinced by the applicants' testimony, the challenged decision agreed with ORA that if the Commission did not forecast a number for debt cost for those seven carriers carrying debt, it cannot calculate the cost of capital for each carrier, and that a debt cost of 4.53% should apply to the three carriers without debt. (*Id*. at p. 42.) Based on the evidentiary record, D.16-12-03 determined an average 4.53% cost of debt was reasonable, explaining as follows:

> We find that the current average of 4.53% of the Small LECs better approximates the rate that might be expected in the future for any of these carriers. [Footnote omitted.] After consideration, evaluation, and weighing of Applicants' and ORA's weighted cost of debt analysis we find that a reasonable weighted cost of debt for the three companies that do not currently have debt (Cal-Ore, Pinnacles, and Siskiyou) is 4.53%.

(*Id*. at p. 43.)[11]

Applicants disagree with the outcome, but they fail to show anything other than a difference of opinion; they have not established that the cost of debt determination was not based on record evidence. In addition, there is no merit to rehearing applicants' argument that the correction of a technical error in the PD establishes legal error in the challenged decision.[12] Their challenge to the costs of debt issue is without merit.

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[11] Table 4 on page 43 of D.16-12-035 provides the weighted cost of debt for each utility.

[12] "The proposed decision said that the median debt cost was 5.2%, but the median, or the value in the middle, of the seven companies with debt is 4.77%, and falling between 3.66% and 4.5% if we consider all ten companies in the application. It is clear from the analysis that we intended to adopt the average of the seven companies with debt for the three companies that have no debt. That figure is 4.53%. We have made changes to the proposed decision accordingly." (D.16-12-035 at p. 52.)

III. CONCLUSION

Having reviewed each and every allegation raised by the rehearing applicants, we find that they have not established legal or factual error in D.16-12-035. Accordingly, the application for rehearing is hereby denied.

THEREFORE, IT IS ORDERED that:

1. The application for rehearing of Decision 16-12-035 filed by Cal-Ore Telephone Co., Foresthill Telephone Company, Kerman Telephone Company, The Ponderosa Telephone Company, Sierra Telephone Company, Inc., and Volcano Telephone Company is denied.

2. The proceeding, Application 15-09-005, is hereby closed.

This order is effective today.

Dated December 14, 2017, at San Francisco, California.

MICHAEL PICKER
President
CARLA J. PETERMAN
LIANE M. RANDOLPH
MARTHA GUZMAN ACEVES
CLIFFORD RECHTSCHAFFEN
Commissioners