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RESPONSE TO *THE CASE FOR THE USE OF AN APPROPRIATE [HYPOTHETICAL] CAPITAL STRUCTURE IN UTILITY RATEMAKING*

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I. INTRODUCTION

Shortly before the March 1982 Public Utilities Symposium, a paper prepared by Bruce M. Louiselle and Jean M. Heilman, entitled *The Case for the Use of an Appropriate Capital Structure in Utility Ratemaking: The General Rule Versus Minnesota*,[1] was circulated to participants of the Symposium. In reality, the Louiselle-Heilman paper does not state the case for the use of an "appropriate" capital structure. It presents, rather, an argument that a capital structure hypothetically related to the capital circumstances of other companies in the industry, and not a capital structure based on the company's own financial circumstances, is the "appropriate" capital structure that should be used in ratemaking proceedings. The Louiselle-Heilman paper argues that a hypothetical structure may be as safe, and yet more economical, than the utility's actual capital structure, and should be used without regard to whether the company's actual capital is found to be unreasonable or imprudent.[2] The Louiselle-Heilman paper also suggests (what it calls "the General Rule Versus Minnesota") that the approach adopted on capital structure matters by the Minnesota Supreme Court and the Minnesota Public Utility Commission is out of step with the approach utilized in other jurisdictions.[3] As discussed below, both of these claims are of dubious validity.

1. Louiselle & Heilman, *The Case for the Use of an Appropriate Capital Structure in Utility Ratemaking: The General Rule Versus Minnesota*, 8 WM. MITCHELL L. REV. 423 (1982).
2. *Id.* at 434-36.
3. *Id.* at 427-28.

II. Discussion

Our initial paper for the Public Utilities Symposium reviewed the major Minnesota commission decisions on capital structure matters over the last decade in an attempt to discern the commission's approach.[4] Simply stated, the rule that has evolved in Minnesota is that the utility's capital structure, based upon its actual circumstances, should be used by the commission in a rate case unless it is found that such capital structure is imprudent and unreasonable.[5] This rule is based on the Minnesota Supreme Court's decision in *Northwestern Bell Telephone Co. v. State*,[6] in which the court stated the tenet that guides the commission in capital structure determinations:

> We have difficulty accepting the concept that in a rate case of this kind the state may collaterally attack the judgment of the company in maintaining its embedded debt at a low figure. We agree with the position of the Company that this is a discretionary matter of management which, in the light of soaring interest rates, seems to vindicate the company's decision to keep its debt obligations to a minimum.[7]

The rule is inferred from Minnesota Statutes, sections 216B.23 and 237.075(5). These statutes specifically provide that when the commission determines that rates charged by a utility, or the regulations, measurements, practices, acts or services of a utility, are unjust or unreasonable, the commission then shall determine the rates, regulations, measurements, practices, acts or services to be charged or applied.

At one point, Louiselle and Heilman accept the basic sense of the capital structure rule applied in Minnesota:

> This is not to say that actual capital structure cannot produce reasonable results; it can. *If it can be shown, however, that the actual*

4. Brehl & Gallagher, *Review of Minnesota Public Utility Commission Decisions Regarding Capital Structure Matters*, 8 WM. MITCHELL L. REV. 379 (1982).

5. North Cent. Pub. Serv. Co., Docket No. G-101/GR-77-221 (Minn. P.S.C. Dec. 30, 1977), at 15-16; Peoples Natural Gas Co., Docket No. G-011/GR-80-850 (Minn. P.U.C. Nov. 25, 1981), at 13-14. In North Cent. Pub. Serv. Co., Docket No. G-010/GR-81-780 (Minn. P.U.C. Dec. 30, 1982), the commission held that it would not depart from the actual capital structure of Donovan Companies, unconsolidated, when it was not shown to be unreasonable or imprudent. In Peoples Natural Gas Co., Docket No. G-011/GR-82-65 (Minn. P.U.C. Jan. 28, 1983), the commission found different circumstances than those present in the preceding *Peoples* rate case. The commission applied a hypothetical capital structure because it appeared that the capital structure of the multi-faceted parent, InterNorth, was not representative of a gas distribution company.

6. 299 Minn. 1, 216 N.W.2d 841 (1974).

7. *Id.* at 14-15, 216 N.W.2d at 850.

> *capital structure* (or the one proposed by the company) *is imprudent and unreasonable*, the commission must reject it and must base the fair overall rate of return on a reasonable, albeit hypothetical, capital structure.[8]

Louiselle and Heilman, however, then depart from this concession and espouse the view that a hypothetical capital structure, not based on the actual capital structure, should be imposed without the necessity of establishing the actual capital structure is unreasonable and imprudent.

Although not always articulating the rule exactly as in Minnesota, the bulk of the jurisdictions that have considered the matter take essentially the same approach that has been adopted in Minnesota. In most cases, the actual capital structure is departed from only *after* there has been a determination that the actual capital structure is unreasonable and imprudent in some significant respect.[9] These cases recognize, as the Louiselle-Heilman paper ad-

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8. Louiselle & Heilman, *supra* note 1, at 426 (emphasis added).

9. For example, in Pacific Northwest Bell Tel. Co. v. Washington Util. & Trans. Comm'n, 98 P.U.R.3d 16 (King County Super. Ct. 1972), the court stated:

> Bearing in mind the respective functions of the commission and management and affirming the proposition that management has the right to determine what the debt equity should be but that it may not always make the ratepayer foot the bill resulting from its choice, it would appear to this Court that the proper rule of law to be set forth in guiding the commission be that the commission may disregard the existing capital structure of a regulated company when it finds from the evidence that the existing capital structure is unreasonable so as to impose an unfair burden on the consumer.

Id. at 26.

In New England Tel. & Tel. Co. v. Department of Pub. Util., 360 Mass. 443, 275 N.E.2d 493 (1971), the court stated:

> It would be unreasonable and an undue interference with reasonable Company judgment, for the . . . [Department] to insist that Company's rate of return conform with precision to what the . . . [Department] regards as an optimum 60% debt ratio. Within a substantial range this is a matter for Company's determination . . . . There is no evidence that . . . Company has adopted an unreasonable low debt ratio which may be regarded as a 'company luxury' imposing an undue burden on consumers.

Id. at 466-67, 275 N.E.2d at 508, *quoting* Boston Gas Co. v. Department of Pub. Util., 359 Mass. 292, 269 N.E.2d 28 (1970).

Similarly, in Boston Edison Co., 99 P.U.R.3d 417 (Mass. D.P.U. 1973), the commission stated, "Unless the company's actual capital structure is demonstrably unreasonable, determinations of a fair rate of return must be based on the applicable, as opposed to a hypothetical, capital structure." *Id.* at 419.

In Peoples Natural Gas Div. of Northern Natural Gas Co. v. Public Util. Comm'n, 193 Colo. 421, 576 P.2d 377 (1977), the court stated, "Unless it has been demonstrated by a substantial showing that ratepayers are materially prejudiced by the actual capital structure which finances utility operations, the PUC should use the actual capital structure in calculating rates." *Id.* at 425, 576 P.2d at 380.

In Mystic Valley Gas Co. v. Department of Pub. Util., 359 Mass. 420, 269 N.E.2d 233 (1971), the court stated, "[Our decisions] do not permit the D.P.U. to disregard (in fixing mits,[10] that each case must be resolved on its own facts when determining whether or not the actual capital structure of the utility is unreasonable or imprudent, and if so, what capital structure may be applied as reasonable and prudent under the circumstances.

Additionally, the term "hypothetical" has been used differently in different cases. As a result, a "numbers" game or count of cases, merely by reference to the term "hypothetical" without examining how the term is used in each case, inaccurately reflects the number of jurisdictions that adopt a truly hypothetical capital structure approach. For example, in some cases, "hypothetical" describes adjustments to the actual capital structure when the test period is incomplete at the time the record closes.[11] This certainly is not the type of "hypothetical" capital structure Louiselle and Heilman propose.

In other cases, a "hypothetical" capital structure describes adjustments to an actual capital structure to eliminate non-utility ac-

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rates) existing capital structures of regulated companies unless they so unreasonably and substantially vary from usual practice as to impose an unfair burden on the consumer." *Id.* at 429, 269 N.E.2d at 239.

In Tampa Elec. Co., 92 P.U.R.3d 398 (Fla. P.S.C. 1971), the commission stated:

> In the absence of evidence to the contrary, it must be presumed that management, with full knowledge of the company's particular circumstances and its relationship to the growth and development of its service area, has by deliberate design developed such a capital structure as will keep within reasonable bounds the financial risk of the company and enable it to obtain necessary capital at reasonable cost.

Id. at 416.

Likewise, in General Tel. Co. of California, 80 P.U.R.3d 2 (Cal. P.U.C. 1969), the California Public Utilities Commission stated, "In our opinion, it is preferable to use the actual capital structure, or as close an approximation as possible, unless it is entirely inconsistent with good regulatory practice." *Id.* at 23.

In Florida Power & Light Co., 67 P.U.R.3d 113 (Fla. P.S.C. 1966), it was well reasoned that:

> Management lives from day to day with intricate and complex problems of corporate finance, and has the responsibility of seeing that the utility has the financial ability to meet its public duties. The 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.

Id. at 162 (emphasis added).

In Pennsylvania Pub. Util. Comm'n v. Bell Tel. Co. of Pennsylvania, 93 P.U.R.3d 13 (Penn. P.U.C. 1971), the commission stated, "However, capital structure is management's prerogative and we do not attempt to transgress this prerogative *unless wide margins of acceptability* are exceeded to points of unreasonableness." *Id.* at 39 (emphasis added).

10. Louiselle & Heilman, *supra* note 1, at 426-34.

11. Laclede Gas Co., 27 P.U.R.4th 241 (Mo. P.S.C. 1978); Central Main Power Co. v. Public Util. Comm'n, 405 A.2d 153 (Me.), *cert. denied*, 447 U.S. 911 (1979); South Cent. Bell Tel. Co. v. Louisiana Pub. Serv. Comm'n, 373 So. 2d 478 (La. 1979).

tivities. In the 1977 and 1980 North Central Public Service Company cases before the Minnesota Public Utilities Commission, the utility made such an adjustment without any objection or challenge by the intervenors. Those adjustments presented both the North Central operating division and Donovan Companies, Inc., unconsolidated as a "gas distribution utility," in conformity with the rate of return testimony presented by the Department of Public Service (Department). In *El Paso Natural Gas Co.*,[12] the Federal Power Commission approved such adjustments, stating:

> In our opinion a fair rate of return should be based upon a capitalization that is associated with the utility business where a separation is feasible, as it is here. When the capitalization reflects investment in properties not related to the jurisdictional business which we are regulating, a distortion of the rate of return determination may result unless capitalization is adjusted to exclude these investments.[13]

Certainly, this is not the type of "hypothetical" capital structure that Louiselle and Heilman propose.

In other cases, particularly telephone cases, the term "hypothetical" describes recognition of the parent-subsidiary relationship and adjustments made to reflect the effects of that relationship upon the capital structure of the subsidiary. At least to the extent that these cases involve the use of "double leverage," even Louiselle and Heilman acknowledge that they do not involve a "hypothetical" capital structure of the sort they sponsor.

Finally, there are cases that involve adjustments to the actual capital structure of a utility for specific reasons found by the regulatory authority. These cases, however, usually do not entail substantial debt/equity percentage differences between the actual structure and the structure ultimately utilized. Again, this is not the type of "hypothetical" capital structure advanced by Louiselle and Heilman.

It simply is inaccurate to suggest, as Louiselle and Heilman do, that most jurisdictions approach the determination of the capital structure applicable in a rate case without beginning with the actual capital structure or the capital structure proposed by the utility based upon the actual circumstances of the utility. Similarly, it is inaccurate to suggest that any more than a small minority of the jurisdictions favor or would adopt a capital structure determined

12. 44 F.P.C. 73, 85 P.U.R.3d 309 (1970), *aff'd*, 449 F.2d 1245 (5th Cir. 1971).
13. *Id.* at 77, 85 P.U.R.3d at 313.

by matters aside from the actual circumstances of the utility, without first determining that the actual capital structure of the utility is unreasonable and imprudent in some substantial respect.

The imaginary or "hypothetical" capital structure sponsored by Louiselle and Heilman, which disregards the actual circumstances of the utility involved, is typified by the Department's "hypothetical" proposals in the 1977 and 1980 North Central Public Service Company rate cases.[14] In both North Central cases, the Department disregarded the actual capital structure of the North Central Public Service Company division and Donovan Companies, Inc., unconsolidated. Instead, it proposed the use of an average of the common equity ratios of a number of "comparison" gas distribution companies, thirteen in 1977 and sixteen in 1980.

The Department also disregarded the equity character of the comparison companies' preferred stock and the costs associated with preferred stock. It averaged only the common equity ratios of the comparison companies, which, in effect, combined preferred stock and debt for the purposes of constructing a "hypothetical" capital structure for North Central Public Service Company. Donovan Companies, Inc. (North Central) has no preferred stock.

The Department made no study of the prudence and reasonableness of the actual capital structure of North Central Public Service Company and Donovan Companies, Inc. The Department neither asserted nor presented any evidence that the actual capital structures were unreasonable or imprudent, but merely asserted that since their actual equity ratio exceeded the average common equity ratio of the so-called "comparison" companies, they should be replaced by a hypothetical capital structure containing a common equity ratio equal to the average of the comparison companies.

In the 1980 North Central case,[15] the Department witness acknowledged that the capital structure used by the utility was "appropriate in that it is real in some sense." He further conceded that there was no ideal capital structure for the company. The Department witness also conceded that he had "perhaps simplified things here too much" when he testified that the actual capital

14. North Cent. Pub. Serv. Co., Docket No. G-010/GR-80-422 (Minn. P.U.C. June 19, 1981); North Cent. Pub. Serv. Co., Docket No. G-101/GR-77-221 (Minn. P.S.C. Dec. 30, 1977).

15. North Cent. Pub. Serv. Co., Docket No. G-101/GR-80-422 (Minn. P.U.C. June 19, 1981).

structure of the company "is simply the product of management decisions and policy." He recognized on cross-examination that there "absolutely are" external factors that influence capital structure.[16]

Nevertheless, the Department in both cases urged that the average equity ratio of the comparison companies was the appropriate capital structure for North Central Public Service. Obviously, if the average equity ratio of the comparison companies was appropriate for North Central, then it follows that it is appropriate for each of the comparison companies, and, for that matter, any other gas distribution company arguably comparable to the comparison companies or North Central. In other words, the Department advanced the average as an "ideal" or "per se" gas distribution company capital structure, the very thing the Department witness conceded did not exist.

Ironically, although espousing the average as *the* appropriate capital structure for North Central and other gas distribution companies, the Department did so without studying the capital structures of the comparison companies, their bond indentures, their bond ratings, the terms of their preferred stock or common stock, the existence or absence of non-utility operations, their size or risk relative to North Central or the other companies, the existence of subsidiary operations, the acknowledged trend in recent years and currently to heavier common equity ratios, the timeliness of the ratios used, or the many other factors individual to each of the companies that might affect the reasonableness or prudency of its capital structure or the appropriateness of its comparison to North Central or any other gas distribution company.

The unavoidable reaction to the Department proposal was stated by the commission in its order in the 1980 North Central case:

> The Commission finds Dr. Rettenmayer's testimony singularly unpersuasive. Although he acknowledged a trend towards higher common equity ratios for gas distribution utilities, he was content to establish an appropriate equity ratio for the Company in the test year ending September 30, 1981 on the basis of 1979 data. Although he acknowledged that preferred stock was equity, and had tax consequences similar to common stock, and a cost higher than that of debt, in his capital structure recommendation he simply treated the 7.7% preferred

16. *Id.* (Hearings Transcript, Vol. III, at 120-21).

stock of his average 1979 capital structure as debt, and at the cost of debt. He made no response to the Company's contention that his recommendations would render the Company unable to issue debt under the terms of its bond indenture. Finally, Dr. Rettenmayer made no determination that his proposed hypothetical capital structure was desirable, and no study of the reasonableness or desirability of the capital structures of his 16 companies. This is a significant shortcoming in view of the Commission's discussion of its rejection of a proposed hypothetical capital structure in the previous case:

> [The witness] has shown no reason why it should be assumed that the average capital structure of this group of companies should be assumed to be a desirable capital structure. Since there has been no analysis of the companies' individual capital structures to determine if they are desirable, there is no structure to determine if they are desirable, there is no reason to believe the composite capital structure is desirable. *North Central*, G-010/GR-77-221, at 15, 16.

The commission finds that equity ratios of natural gas distribution companies have been increasing recently; that because the Company has no preferred stock its common equity ratio can be higher than that of a gas distribution company which has preferred stock; that the Company's equity ratio is not out of line with the equity ratios of comparison companies, and that no testimony has shown the Company's proposed capital structure to be unreasonable.[17]

The premise of Louiselle and Heilman, and that of the Department in the two North Central cases, appears to be that even if the capital structure proposed by the utility, based on its actual circumstances, is reasonable and prudent, that capital structure should be disregarded and any hypothetical structure that appears in the short term to be more "economical" should be imposed, unless the utility demonstrates that the hypothetical is unsafe. They argue that a challenge by an intervenor that more debt would be cheaper should trigger imposition of a hypothetical capital structure. Since they claim that debt is always cheaper than equity, a hypothetical capital structure could be adopted in every case. In effect, Louiselle and Heilman refuse to consider the factors that influence the development of a utility's capital structure, which they characterize as totally within "management discretion." To

17. *Id.* at 8.

Louiselle and Heilman, any capital structure with a higher debt ratio than the actual is appropriate.

Professor Phillips, in *The Economics of Regulation*, states:

> [T]here is no ideal capital structure, and even expert opinion can differ. The existing capitalization may well have resulted from sound and economical decisions when made, although a different structure might attract capital at a lower cost at the time of a rate case. While hindsight is often superior to foresight, financial decisions must be made on the basis of a judgment of present and future conditions. "It seems, then, that it is economically sound to leave with management the decision as to proper debt ratio, at least within that area where the directors are not usurping or defaulting on their duties as directors."[18]

In an initial brief filed in *Midwestern Gas Transmission Co.*,[19] testimony of Mr. William R. Field, an economic analyst with H. Zinder and Associates, recounted on behalf of Midwestern some of the different elements and judgments affecting management discretion and evolution of the financial structure of a utility:

> [N]ot only differing facts and circumstances underlying the development of each company and its capitalization but also differing opinions expressed in making honest and good faith business decisions based on those facts and circumstances. Such reasons include: differing perceptions of risks facing the industry as well as the particular entity; differences in age groups and backgrounds (e.g., those who "remember the depression"); different timing as to building the basic system and the different impacts of sinking fund mechanics; differing financial conditions relative to the timing of capital requirements; different perceptions as to where the industry and company stands in its 'life cycle' relative to gas supply and growth opportunities; different opportunities and requirements (sometimes quite fortuitous) as to major expansions, gas storage projects, additional compression, supplemental gas projects, gathering facilities, advance payments, etc.; honest differences of opinions as to the appropriate dividend payout policy; differences in views as to permanency in tax laws as to the deductibility of interest or the treatment of dividends; differences in views of debt and preferred capital as 'obligations' to a similar

18. C. PHILLIPS, THE ECONOMICS OF REGULATION 283 (1969) (footnotes omitted); *see also* J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 243-44 (1962); Foster, *Fair Return Criteria and Estimation*, 28 BAYLOR L. REV. 883, 890-92 (1976).

19. Docket Nos. RP81-17, RP81-57 (F.E.R.C. Mar. 15, 1982) (copy on file in William Mitchell Law Review office).

nature; etc.[20]

Other factors also affect the evolution of the capital structure of each particular utility involved in a rate case proceeding and each utility used as a comparison company in the derivation of an "imaginary" capital structure as was proposed in the North Central cases. In addition, market forces affect the financial structure of each company, as the Department's witnesses acknowledged in the North Central cases. Management discretion obviously does not control all these factors.

Louiselle and Heilman erroneously argue that, since all rates must be "just and reasonable," the actual capital structure of the utility cannot be deemed to be prima facie reasonable and prudent. They insist that the utility must carry the initial burden of proving that its capital structure is reasonable and prudent. To the contrary, substantial authority holds that a utility's expenses are presumed prudently incurred, with the burden upon intervenors to show unreasonableness or imprudence.[21]

By emphasizing the "just and reasonable" requirements of *Bluefield* and *Hope*, and the indication in *Permian Basin* that the regulatory process includes an assessment of the broad public interest, Louiselle and Heilman have neglected the standard established by *Hope*, *Bluefield*, and applicable Minnesota law. A utility is entitled to a fair and reasonable return upon *its investment* for the period during which the rates are collected.

The utility is at all times answerable to the utilities commission, not only for the maintenance of rates which are "just and reasonable," but associated therewith, for the preservation of a capital structure that is reasonable and prudent. Of that there is no argument. Therefore, if the intervenor presents creditable and material evidence of the unreasonable and imprudent nature of the actual capital structure of the utility, the burden shifts to the utility to persuade the commission that its capital structure is actually reasonable and prudent. This ultimate burden of persuasion, however, does not conflict with the sensible rule of Minnesota and other jurisdictions that the actual capital structure, adjusted as may be feasible in the rate case to remove the effect of non-utility

20. *Id.* at 22.

21. *See* West Ohio Gas Co. v. Public Util. Comm'n, 294 U.S. 63 (1935); Anaheim v. Federal Energy Regulatory Comm'n, 669 F.2d 799, 809 (D.C. Cir. 1981), *citing* Missouri *ex rel.* Southwestern Bell Tel. Co. v. Missouri Pub. Serv. Comm'n, 262 U.S. 276, 289 n.1 (1923).

activities and to fit the test period, shall not be departed from unless it has been first established to be unreasonable and imprudent.

The suggestion of Louiselle and Heilman that the commission abandons its regulatory authority over the capital structure of the utility by the rule indicated above is unfounded. Instead, that rule establishes the most reasonable approach to the capital structure issue and assures that the rate of return allowed is based upon *the utility's* investment *at the time the rates are being collected*.

The imposition of a capital structure divorced from the actual circumstances of the utility, while at the same time establishing a rate of return based on a market cost analysis, reduces the effective allowed rate of return and aborts the market cost rate of return determination. The market based rate of return becomes only a pretense because the allowed overall rate of return will be at the lower effective rate after the effects of the hypothetical capital structure are felt.

Theoretically, one of the purposes for imposing a hypothetical capital structure is to cause the utility to reduce the amount of equity and to increase the amount of debt in its actual capital structure. Since the utility must go to the market for its debt and equity capital based upon its actual capital structure, the imposition of a hypothetical capital structure may make it difficult, if not impossible, for the utility to effect the regulator's desired change in its capital structure. That is, the lowering of the effective rate of return by imposition of the hypothetical capital structure may make it impossible for the utility to increase its debt ratio while at the same time meeting its capital needs. That is clearly the case if the hypothetical structure, being based upon factors other than the actual circumstances of the company, prevents the utility from meeting its bond indenture requirements for the placement of additional debt. If additional debt actually cannot be placed, the capital needs of the utility will then have to be satisfied out of further equity investments. Instead of accomplishing a reduction of the common equity ratio, the effect of the hypothetical structure may be that a heavier equity ratio will actually be necessary. Further, even if some debt can still be placed, the actual circumstances of the utility probably will worsen because the additional debt will either be short term debt at high rates or long term debt at greater rates than would have been demanded by lenders had a higher effective rate of return been allowed on the actual capital structure.

III. SPECIFIC SUPPORT FOR THE MINNESOTA RULE

The reasons supporting the rule established by statute, case authority, and actions of the commission in Minnesota, that the actual capital structure of the utility will not be disturbed unless it is first shown that the actual capital structure is unreasonable and imprudent, are numerous:

a. Each gas and electric utility is required to obtain approval of changes in its actual capital structure and to provide capital structure information regarding both the utility and any parent or subsidiary corporation. Capital structure is defined by statute[22] and discussed by commission rule:

> A rate of return/cost of capital summary schedule showing the calculation of the weighted cost of capital using the proposed capital structure and the average capital structure for the most recent fiscal year and the projected fiscal year. This information shall be provided for the unconsolidated parent and subsidiary corporations. These statutes and rules provide constant scrutiny over the capital structures of utilities.[23]

b. Although the commission may reserve in financial dockets that its approval of the capital structure in those proceedings does not preclude its reconsideration of capital structure in rate proceedings, nevertheless, the capital structure of the utility stands approved by order of the commission in its financial dockets as being in the best interests of both the utility and its customers. Furthermore, if the capital structure of the utility has been considered and approved by the commission in a prior rate proceeding, the capital structure, subject to changes since that time, stands approved and should be regarded as prima facie reasonable and prudent.

c. A presumption, although rebuttable, that the actions of the utility in the regular course of business are legal and proper is appropriate.

d. The *Bluefield* and *Hope* requirement that a fair return be allowed on the investment of the utility at the time the rates are in effect necessarily directs itself to acceptance of the actual capital structure of the utility, at least in the first instance.

e. Presuming that market cost methodology is used for determination of the allowable rate of return, the actual capital structure is that which the market reflects; not a hypothetical. To use a hypothetical aborts the market cost rate of return analysis.

22. MINN. STAT. § 216B.49(2) (1982).
23. 13 MINN. CODE AGENCY R. PSC 405(D)(1) (1982).

f. The actual capital structure determines the utility's ability to compete for capital. It should not be hamstrung in competing for capital by disregard of the actual capital structure in the rate proceeding, absent a determination that the actual capital structure is unreasonable and imprudent.

g. Utility management carries the day to day responsibility for the financial structure of the utility and is accountable to the regulatory authorities, its investors, and customers. Absent a determination that their actions have been unreasonable and imprudent, it is inappropriate to displace their judgment in favor of that of consultants who have no significant on-going accountability and do not share in the consequences of errors of judgment. This is particularly true when the consultants have no actual experience in the placement of debt and equity capital on behalf of utilities, lenders or underwriters.

h. Louiselle and Heilman assert that it is "an established principle of law that the party asserting or denying the existence of facts has the burden of proof as to those facts."[24] That principle should place the burden upon the party challenging the actual capital structure, the basic factual setting in the case, to establish that the actual capital structure is unreasonable and imprudent. The actual capital structure of the utility is fact, not speculation. Any contrary facts alleged should be the burden of the challenger.

i. No single ideal capital structure exists. Accordingly, the first step of any consideration should be the actual capital structure itself, until it is shown to be unreasonable and imprudent.

j. To maintain economic and efficient rate regulation proceedings, intervenors opposing the use of an actual capital structure should be required to show by material, creditable evidence that the actual capital structure is unreasonable and imprudent.

k. Louiselle and Heilman in effect assert that there exists an impropriety on the part of management in allowing a capital structure to evolve which does not produce the lowest immediate possible cost. Their insinuation, that the application of "management discretion" is improper, should place the burden of proving such a claim of impropriety upon the challenger.

l. Basic fairness dictates that after-the-fact criticism and "Monday morning quarterbacking" not be allowed to upset management judgments exercised in good faith and with reasonable-

24. Louiselle & Heilman, *supra* note 1, at 436.

ness and prudence. Management, investors, and lenders act on a daily basis in reliance upon the actual capital structure of the utility, a capital structure that the commission has approved or permitted to exist or occur. It would be both unfair and unwise to prejudice them by adopting a hypothetical capital structure prior to it being established that management actions have departed from the range of reasonableness and prudence.

IV. NON-MINNESOTA JURISDICTIONS

In all but a very few cases, the regulatory authorities have held that the actual capital structure will be determined unreasonable and imprudent and a "hypothetical" structure imposed only if there is a marked departure from that which might be considered normal. For example, in *Carrabasset Light & Power Co.*,[25] the Maine commission followed a two step process. First, it found that the existing capital structure was unreasonable when it contained only 11.3% debt, all short term, and 88.7% equity. Only then did it impose a hypothetical structure of 50% debt, 15% preferred, and 35% common.[26]

Similarly, in *Communications Satellite Corp. (COMSAT) v. Federal Communications Commission*,[27] a zero debt structure was adjusted to reflect 45% debt only after the federal commission first determined that COMSAT could have leveraged with debt, but unreasonably did not do so.[28] In *Southern Bell Telephone & Telegraph Co. v. Louisiana Public Service Commission*,[29] the court affirmed the commission after the commission had first examined the particular circumstances of the actual capital structure, which contained a debt ratio of 24.7%, and only after finding it unreasonable, applied the so-called "45% debt rule" and imposed a "hypothetical" capital structure.[30]

V. CONCLUSION

Louiselle and Heilman, in proposing their test of reasonableness of a capital structure, defeat their principle argument that a hypo-

25. 17 P.U.R.4th 246 (Me. P.U.C. 1976).
26. *Id.* at 247-48.
27. 611 F.2d 883 (D.C. Cir. 1977).
28. *Id.* at 902-06.
29. 239 La. 175, 118 So. 2d 372 (1960).
30. *Id.* at 195-203, 18 So. 2d at 380-82. For additional cases from other jurisdictions, see *supra* note 9.

thetical structure should be imposed without regard to the actual capital structure and without any preliminary showing that the actual capital structure is unreasonable or imprudent. Their "reasonableness test" requires that the beginning point be the actual capital structure of the utility. They further concede that "while such analyses cannot produce the optimum capital structure, they can answer the question of whether a particular capital structure is safe."[31] In other words, they concede that no single ideal capital structure exists. They then make the extreme statement that if a capital structure contains x% debt and is safe, one containing more than x% debt would be even safer. Their rationale is most suspect if it is based upon that conclusion.

Their "test of reasonableness" further acknowledges the difficulty in appraising the reasonableness and prudence of a capital structure and the lack of sense in looking to a hypothetical capital structure divorced from the actual circumstances of the particular utility. They state various factors that must be considered in determining whether the hypothetical is safe, all of which must relate to the particular utility. This conflicts with the use of a hypothetical derived from the data of other companies.

The Louiselle and Heilman argument as to safety of a capital structure is flawed when they suggest that a decline in the bond rating of a utility is acceptable and "not determinative" so long as the bonds remain of investment grade. The safety of a capital structure bearing the affect of a reduction of its bond rating from "AAA" to "Baa" must be suspect in the real world of placement of debt or equity capital, if not in the utopian world of economic theory.

The Louiselle and Heilman discussion of the economy gained through increasing the debt ratio is also flawed because it fails to recognize that the cost of equity will increase as the debt structure and the risk confronted by investors rises. Louiselle and Heilman also fail to recognize an increment of additional debt cost by reason of the fact that the additional debt should be installed at the cost of placement of debt today, rather than at the embedded debt cost.[32]

In conclusion, it appears the basic error of Louiselle and Heilman is their assumption that the sensible rule adopted in Minnesota requires the commission to defer entirely to management with

31. Louiselle & Heilman, *supra* note 1, at 446.
32. *See* Citizens Util. Co., 34 P.U.R.4th 606, 617 (Idaho P.U.C. 1980).

respect to the capital structure of the utility. This is simply incorrect. The commission is not required to withdraw, nor has it withdrawn, from its responsibility to make utilities answerable for reasonable and prudent capital structures. The rule in Minnesota is, and should remain, consistent with that in most jurisdictions. There will not be a departure from the utility's actual capital structure unless it is first established by material, creditable evidence that the actual capital structure is unreasonable and imprudent. This rule provides a sound and practical approach to the resolution of capital structure issues and is fair to both utilities and customers.