Source of flooding and location	#Depth in feet above ground. *Elevation in feet (NGVD)
Approximately 1.1 miles upstream of the Borough of Mount Holly Springs southern corporate limits.	*613
Maps available for inspection at the Township Building, 520 Park Drive, Boiling Springs, Pennsylvania.	
Speers (borough), Washington County (FEMA Docket No. 7116)	
Monongahela River:	
Approximately 0.70 mile downstream of CONRAIL bridge.	*764
Approximately 0.75 mile upstream of Interstate 70 ramp.	*765
Maps available for inspection at the Borough Building, 300 Phillips Street, Speers, Pennsylvania.	
Stockdale (borough), Washington County (FEMA Docket No. 7128)	
Monongahela River:	
Downstream corporate limits.	*767
Upstream corporate limits ...	*768
Maps available for inspection at the Borough Building, 438 Locust Street, Stockdale, Pennsylvania.	
Union (township), Washington County (FEMA Docket No. 7128)	
Monongahela River:	
At downstream corporate limits.	*752
At upstream corporate limits	*755
Maps available for inspection at the Municipal Building, Finleyville-Elrama Road, Union, Pennsylvania.	
WEST VIRGINIA	
Westover (city), Monongalia County (FEMA Docket No. 7128)	
Monongahela River:	
At confluence of Dents Run	*813
Approximately 560 feet upstream of U.S. Route 19 (Westover Bridge).	*814
Dents Run:	
At confluence with Monongahela River.	*813
Approximately 0.71 mile above confluence with Monongahela River.	*813
Maps available for inspection at the City Hall, 500 Dupont Road, Westover, West Virginia.	

(Catalog of Federal Domestic Assistance No. 83.100, ''Flood Insurance.'')

Dated: August 28, 1995.

Richard T. Moore,

Associate Director for Mitigation.

[FR Doc. 95–21916 Filed 9–1–95; 8:45 am]

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FEDERAL MARITIME COMMISSION

46 CFR Part 552

[Docket No. 94–07]

Financial Reporting Requirements and Rate of Return Methodology in the Domestic Offshore Trades

AGENCY: Federal Maritime Commission.

ACTION: Final rule.

SUMMARY: The Federal Maritime Commission is amending its regulations governing financial reporting requirements and rate of return methodology applicable to vessel-operating common carriers by water in the domestic offshore trades to discontinue use of the comparable earnings test in determining the reasonableness of a carrier's return on rate base. In its place, the Commission will use the weighted average cost of capital methodology. The Commission is modifying the calculation of the rate of return on rate base to a before-tax basis. In addition, the Commission is amending its rules pertaining to the computation of working capital. The rule addresses a number of shipper and carrier concerns regarding the Commission's current rate of return methodology and would align the Commission's ratemaking methodologies more closely with those used by numerous other regulatory agencies. The intent is to improve the Commission's methodology for evaluating the reasonableness of rates filed by carriers in the domestic offshore trades.

EFFECTIVE DATE: October 5, 1995.

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SUPPLEMENTARY INFORMATION: On April 7, 1994, the Federal Maritime Commission (''FMC'' or ''Commission'') published a Notice of Proposed Rulemaking (''NPR'' or ''proposed rule'') (59 FR 16592) which proposed to amend the regulations governing financial reporting requirements and rate of return methodology applicable to vessel-operating common carriers by water in the domestic offshore trades. The Commission proposed to change the method of determining the reasonableness of a carrier's return on rate base from the comparable earnings test (''CET'') to the weighted average cost of capital (''WACC'') methodology. At the request of Matson Navigation Company (''Matson''), the Commission extended the comment period for interested parties to file until July 20, 1994 (59 FR 27002). The following seven parties filed comments on the NPR: American President Lines (''APL''), Crowley Maritime Corporation (''Crowley''), Matson, Puerto Rico Maritime Shipping Authority (''PRMSA''), the Department of Transportation (''DOT''), Marsoft Incorporated (''Marsoft''), and the State of Hawaii (''Hawaii'').

By notice published November 4, 1994, 59 FR 55232 (''Request for Reply Comments''), the Commission invited reply comments on four specific issues—the calculation of the cost of capital, working capital, the selection of proxy groups, and the deletion of alternative methodologies. The Commission extended the time for reply comments until January 6, 1995, partially granting a request of NPR, Inc. (59 FR 62372). Reply comments were received from APL, Crowley, Matson, PRMSA, Hawaii, and Tobias E. Seaman (''Seaman''), president of the National Association of Shippers, Consignees, and Consumers for Maritime Affairs. With the exception of Seaman, all reply commenters had submitted initial comments on the proposed rule.

PRMSA and NPR filed a motion for an evidentiary hearing on December 2, 1994. The Commission does not believe that there is a need to hold an evidentiary hearing as suggested by PRMSA and NPR. There have been two rounds of comments which have given

all interested parties, including PRMSA and NPR, adequate opportunity to comment on the proposed rule.

The commenters raised concerns with many provisions of the proposed rule. The Commission has addressed all relevant comments. Any comment not specifically addressed has nevertheless been considered.

The Weighted Average Cost of Capital Approach

Comments: The commenters generally support the adoption of the WACC methodology for determining the allowable rate of return on rate base. Crowley does not support, however, the change to the WACC methodology for the following reasons. Crowley argues that the WACC methodology contained in the NPR does not correct the alleged shortcomings of the CET, because the WACC methodology will also rely on a proxy group to determine the regulated carrier's cost of capital. Crowley further urges caution in the Commission's deliberations because of the uncertainty over the Interstate Commerce Commission's (''ICC'') continued jurisdiction over intermodal services and the Government of Puerto Rico's continued attempts to sell PRMSA. Crowley also contends that the rule would raise the cost of regulatory compliance substantially. Crowley disputes, as being too low, the Commission's estimate of the additional regulatory burden of the proposed rule (*i.e.*, 1.5 weeks), because substantially more effort would be required in the first years as the carriers learn the new system. In his comments, Seaman echoes Crowley's opposition to the proposed rule.

In its initial comments, PRMSA urged the Commission to require carriers initially to provide parallel testimony and information which would permit analysis under both the CET and the WACC methodologies. In its reply comments, however, PRMSA states that no need exists for the parallel CET analysis should the FMC decide to be less restrictive in specifying the permissible evidence in rate-of-return proceedings, and instead, permit carriers to submit evidence as to their demonstrated risk and, hence, their required rate of return.

Both PRMSA and Matson argue that setting the maximum allowable rate of return on rate base equal to the carrier's weighted average cost of capital would not provide the regulated carriers with sufficient earnings to fund their operations and attract capital. PRMSA urges the Commission to adopt provisions which would allow an earnings ''cushion'' above the before-tax weighted average cost of capital (''BTWACC'').[1] PRMSA states that its required rate of return was less than that of the CET reference group, because it is 100 percent debt-financed and tax-exempt. Thus, it is said that PRMSA gained a tax advantage over the CET reference group. The earnings which the reference group devoted to tax payments was allegedly the ''cushion'' for PRMSA. The result, PRMSA states, is that the CET allows earnings levels which, when achieved, provide PRMSA with the ability to remain in business.

However, PRMSA maintains that the proposed BTWACC yields an untenable result for PRMSA, because it would strip away the earnings cushion which provides the ability to service debt which was acquired to finance past losses. PRMSA argues that this lack of an earnings ''cushion'' would be potentially harmful to any company with substantial debt in its capital structure. PRMSA contends that the allowable rate of return must provide a sufficient cushion above the cost of overall debt to permit the carrier to weather a downturn in its business.

Matson states that the Commission's definition of the cost of capital is the minimum rate of return necessary to attract capital to an investment. Matson also notes that in the proposed rule the maximum allowable return on rate base is the weighted average cost of capital. Matson claims that using the cost of capital to determine the allowable return on rate base sets the Commission's BTWACC as both the minimum and the maximum rate of return for the regulated carrier. Matson claims that for this to be correct, capital markets must be perfectly efficient. Matson claims that since it is recognized that capital markets are not perfectly efficient, by itself the BTWACC is not an adequate measure of the return on capital necessary to attract capital to the regulated carrier.

Matson claims that since the cost of capital is a minimum rate of return necessary to attract capital to the regulated firm, the Commission should allow carriers to earn returns equal to their cost of capital plus a specified margin in excess. Matson states that the extra earnings above the cost of capital that carriers in the domestic trades would be given the opportunity to earn would not be ''gouging'' the public. Matson states that the carriers in the domestic offshore trades face competitive market conditions, and thus the carrier's ability to meet customer needs will determine what return the carrier will earn from its operations. Matson claims that modifying the proposed rule to allow for a cushion above the BTWACC would permit Matson to attract capital to finance the assets necessary to continue and to enhance its operations.

Discussion: Crowley is correct that both the CET and BTWACC methodologies generally need to use some form of proxy group. However, for the following reasons, the Commission is convinced that the types of information used to calculate the BTWACC provide a better estimate than the CET of the allowable rate of return for each individual carrier. First, the BTWACC uses information specific to the regulated carrier's capital structure to calculate the carrier's required rate of return. Second, the BTWACC uses either the regulated carrier's cost of common-stock equity or a related proxy group's cost of common-stock equity to determine the required rate of return on equity, rather than the averages derived from all manufacturing firms that are used under the CET. Similarly, the BTWACC calculates the actual coupon payments for debt paid by the regulated carrier, rather than a proxy derived from a rolling average of Baa-rated corporate bonds. Therefore, the specificity that the BTWACC gives in determining the cost of capital of the individual regulated carrier is a vast improvement over the CET.

Crowley's claims of additional regulatory burden appear to be overstated. Under the proposed rule, if a carrier filed a general rate increase, the extra regulatory burden is estimated to be 24 staff-hours. An additional 41 staff-hours would have been required for the annual filing of the proxy group. Thus, the proposed rule estimated the increase in regulatory burden to be 41 to 65 staff-hours. The additional regulatory burden under the proposed rule, then, was quite modest. The Commission believes these estimates to be accurate approximations of the additional time necessary to comply with the final rule. Some firms may take more time while other firms may take less time, but on average the Commission believes that the estimates are accurate for the typical firm.

However, the Commission is concerned that any additional regulatory burden required under the final rule be minimized. Therefore, as will be discussed later, the requirement that carriers annually file a proxy group has been dropped in the final rule and the procedure for estimating the cost of equity has been changed. Under the final rule, a carrier that does not file a general rate increase will incur no extra regulatory burden because it need not

[1] The BTWACC is a before-tax version of the WACC.

file a proxy group. In addition, one of the three methods used to estimate the cost of equity, the Capital Asset Pricing Model, will no longer be required. These modifications to the proposed rule will result in a significant lessening of the regulatory burden. If the carrier does file a general rate increase, the extra regulatory burden remains 65 staff-hours. The Commission believes that the improvement in rate-of-return regulation which will occur under the BTWACC methodology more than compensates for the extra staff-hours of regulatory burden which will be incurred by those carriers which file a general rate increase. Therefore, the Commission rejects the suggestion by Crowley and Seaman that the Commission abandon its proposal to implement a BTWACC approach to determine the allowable rate of return in the domestic trades.

As will be discussed in the following sections, the Commission is modifying its proposed rule to allow for greater flexibility in the determination of the cost of common-stock equity. This modification should eliminate the need perceived by PRMSA in its initial comments that both the BTWACC and CET be utilized initially to determine an appropriate rate of return.

The NPR explained the legal and economic rationale for setting the allowable rate of return equal to the regulated carrier's cost of capital. Two landmark Supreme Court cases [2] established that investors in companies subject to rate regulation must be allowed an opportunity to earn returns sufficient to attract capital comparable to investments in other firms having the same amount of risk, and that revenues must not only cover operating expenses, but capital costs as well. The economic rationale for setting the allowable rate of return of a regulated company equal to its cost of capital is that in the long run the regulated firm's customers will pay the lowest cost for service while at the same time the company's earnings will be sufficient to attract capital so that the company is able to provide the customers' desired level of service. Based on the legal decisions and economic rationale, the Commission considers the BTWACC an appropriate measure of the allowable rate of return for regulated carriers. The Commission believes that the BTWACC methodology will allow carriers to attract adequate capital, thereby negating the concerns expressed by Matson. However, as PRMSA noted, a carrier with only debt financing would be allowed only to earn the cost of its long-term debt under the BTWACC.[3] It appears that such a capital structure is highly unusual and unlikely to occur without substantial government backing of the carrier (as has been the case with PRMSA).

PRMSA is unique among ocean carriers in the domestic offshore trades in that, until its recent sale to NPR in January 1995, it was government owned and 100 percent debt-financed. PRMSA contends that it lost money year after year and part of its debt was used to finance past losses.[4] While a regulatory commission should minimize regulatory risk by ensuring that regulated firms are given the opportunity to earn a reasonable return on capital, it is the responsibility of the firm to achieve a viable capital structure and operate the business efficiently. The BTWACC is an appropriate measure of the cost of capital for carriers having a broad range of capital structures. The Commission cannot prevent a carrier from departing from the broad range of capital structures that are generally used. However, the Commission must assure that ratepayers do not pay a premium for such a decision by the carrier. Therefore, the Commission believes that ratepayers should not be required to pay for an additional ''cushion'' due to PRMSA's unique capital structure.

Lastly, as a further clarification the Commission will state in its rule that the BTWACC is the ''allowable'' rate of return rather than the ''maximum allowable'' rate of return.

Accessibility of Carrier Financial Data

Hawaii argues that the adoption of the BTWACC methodology will require that all parties have access to information regarding the carrier's financing and capitalization. Such information is company specific and can be obtained only through the carriers' annual financial reports filed with the Commission. Hawaii recommends that the Commission reverse its present policy of not requiring the carriers' annual reports to be made available to all parties.[5] However, the issue was not raised in the NPR and there has been no opportunity for the other parties to comment on Hawaii's recommendation. Accordingly, it would not be proper for the Commission to rule on the merits of Hawaii's recommendation here.

Hawaii also requests the right of discovery by all parties, so that any questions which may arise concerning the carrier's financial situation may be pursued. Rule 67 of the Commission's rules of practice and procedure (46 CFR 502.67) currently provides for discovery in proceedings under section 3(a) of the Intercoastal Shipping Act, 1933 (''1933 Act'') 46 U.S.C. app. 845 (a). Hawaii's request fails to explain why Rule 67 is deficient. In any event, an amendment to Rule 67 is outside the scope of this proceeding and cannot be properly addressed here.

Deletion of Alternative Methodologies

The proposed rule revised paragraph (b) of § 552.1 by deleting the provision that the methodology employed in each case will depend on the nature of the relevant carrier's operations and financial structure. Also, the proposed rule added language to the paragraph that specifies the extent of possible alternative methodologies. Paragraph (b) reads:

> (b) In evaluating the reasonableness of a VOCC's overall level of rates, the Commission will use return on rate base as its primary standard. A carrier's allowable rate of return on rate base will be set equal to its before-tax weighted average cost of capital. However, the Commission may also employ the other financial methodologies set forth in § 552.6(f) in order to achieve a fair and reasonable result.

Paragraph (d) of the same section has been deleted. That paragraph provided that the Commission may use some other basis for allocation and calculation and may consider other operational factors in any instance where it is deemed necessary to achieve a fair and reasonable result.

APL advised, in its initial comments, that these provisions are at the heart of a major dispute in FMC Docket No. 89–26, The Government of the Territory of Guam, et al. v. Sea-Land Service, Inc. and American President Lines, Ltd. It pointed out that the NPR does not give any reasons for the proposed changes to § 552.1 and argued that the changes cannot be legally adopted unless and until the FMC identifies its reasons for such a change and allows opportunity for comment. Further, APL pointed out that the proposed changes could have no effect on a pending complaint docket focused on a prior time period.

In the Request for Reply Comments, the Commission explained that the Guam trade is unique in that the trade is a very small portion of the carriers' overall service. Whether the current

[2] *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923) and Federal Power Commission v. Hope Natural Gas Company,* 320 U.S. 391 (1944).

[3] If a carrier is 100% debt-financed, the equity portion of the BTWACC equation equals 0.

[4] Similar to Crowley, PRMSA has filed many of its rates in ICC-regulated or exempt tariffs since 1981, the last year in which that carrier's rates were subject to an FMC investigation.

[5] Section 552.4(c) of the Commission's regulations protects the carrier's annual reports from public disclosure and treats them as confidential information in the files of the Commission.

method of allocation is appropriate in such a case need not be decided in this proceeding because the two carriers serving Guam, APL and Sea-Land Service, Inc., currently file most of their rates with the ICC. Neither carrier files full financial reports under 46 CFR part 552. If in the future a carrier serves Guam under FMC regulation, the Commission could address the need for any change in 46 CFR part 552 in a separate rulemaking proceeding. Paragraph (d) of § 552.1 was eliminated because the Commission did not want such determinations to be made on an ad hoc basis during a rate investigation. It is essential that significant issues relating to the underlying methodology to be employed in determining the reasonableness of rates be settled prior to any rate investigation. The 180-day limit specified by section 3 of the 1933 Act cannot be met if parties are permitted to change methodologies during the course of a rate investigation. Moreover, the Commission stated in its Request for Reply Comments that parties to a rate proceeding are entitled to rely on the Commission's rules. They should not have to respond to ever-changing methodologies proposed by other parties. The Commission also explained that any changes that may be made to part 552 as a result of this proceeding will only be applied prospectively and will have no application in pending cases such as Docket No. 89–26.

Both APL and Matson support the proposed changes to § 552.1. APL urges the FMC, in discussing the reply comments in this proceeding, to ''avoid overbroad statements that might be argued to have application to pre-existing complaint dockets as opposed to GRI proceedings.'' (APL Reply at 3.) Matson concurs with the Commission that it is essential that significant issues relating to the underlying methodology to be used in determining the reasonableness of rates be settled prior to any investigation.

Crowley argues that it is not clear that the Commission has adequately preserved its option of using other rate-of-return methodologies ''in order to achieve a fair and reasonable result.'' The carrier suggests that, while certainty in predicting the Commission's reaction to a proposed rate increase is important, it should not be achieved at the expense of the Commission's flexibility to consider legitimate alternatives for measuring a carrier's rate of return.

Seaman does not comment on the merits of the proposed changes to this section, but rather repeats his opinion that the alternative methodologies should be applied to Matson's operations in the Hawaii trade. He further claims, as APL did in its initial comments, that because the NPR did not give any explanation for the proposed changes, the due process rights of those affected are violated.

Crowley's and Seaman's concerns that methodologies other than rate of return on rate base be available appear to be overstated. The Commission believes that the proposed methodology should be appropriate for almost any conceivable situation. Moreover, neither Crowley nor Seaman provide sufficient reasons for altering the proposed changes to § 552.1. The flexibility they appear to seek simply cannot be accommodated within the 180-day limit specified by section 3 of the 1933 Act. Further, neither Crowley nor Seaman have addressed the fact that it is not fair to require parties to respond to ever-changing methodologies proposed by other parties. Therefore, unless the Commission prescribes an alternative methodology in its order commencing a rate investigation, all parties will be limited to the use of rate of return on rate base throughout the proceeding. The changes to § 552.1 will be adopted as proposed.

Capital Structure

The Proposed Rule

The proposed rule provided that a regulated domestic offshore carrier's expected capital structure is to be used in calculating that carrier's BTWACC. In the case of a regulated carrier that is a subsidiary of a larger parent company, the proposed rule provided that a subsidiary carrier's capital structure be used in computing the BTWACC unless, after notice and opportunity for comment, the Commission determines that the carrier may use the capital structure of the parent company (i.e., the consolidated system). Such a determination would require that: (1) The subsidiary carrier's parent company issues publicly traded common stock equity; (2) no substantial minority interest in the subsidiary exists;[6] and (3) the risks are similar between the subsidiary carrier and the parent company.[7] The NPR also proposed that the capitalization ratios (i.e., the weights) used in calculating the BTWACC be based on the test-year average book value.

Comments: Hawaii agrees that the expected capital structure should be used when a company is an independent company. In the case of wholly owned subsidiaries,[8] however, Hawaii recommends that the FMC allow greater flexibility in adopting the appropriate capital structure. Hawaii suggests that the Commission not declare a preference for either the subsidiary or consolidated financial data but avail itself of the option to decide, on a case-by-case basis, whether to use the subsidiary, consolidated system,[9] or a hypothetical capital structure. By deciding on a case-by-case basis, Hawaii contends that the FMC will avoid prejudging which method will allow the most accurate estimation of the carrier's cost of capital.

Hawaii points out two potential drawbacks of using subsidiary data. The first drawback would be the need for a portfolio of comparable companies. Hawaii contends that finding a comparable group may be problematic or impossible within the framework of the proposed rule.

The second drawback would be the possible artificiality of the capital structure of a subsidiary. Hawaii points out a situation it has encountered in which the capital structure of a subsidiary is reported to consist of all equity. The parent company holds and sells all debt, but the proceeds of the debt are used by the subsidiary. Hawaii states that it has

> no *a priori* reason to believe that data from a portfolio of comparable companies is a better base from which to estimate a carrier's cost of capital than data from the consolidated system of which a carrier is a part. There are necessarily pros and cons in a choice between the characteristics of a consolidated company, within which the characteristics of the relevant company are hidden, and a portfolio of proxy companies which may bear little resemblance to the relevant company.

(Hawaii at 7). Hawaii suggests that the choice between two inappropriate

[6] Under the proposed rule, no substantial minority interest in a subsidiary carrier would exist when a parent company owns 90 percent or more of the subsidiary's voting shares of stock.

[7] In considering the similarity of both business and financial risks facing the parent and subsidiary, the following will be considered: Financial risk measures, such as total capitalization and debt/equity ratios, investment quality ratings on short and long term debt instruments; and coverage ratios, such as times interest earned and fixed charges coverage ratios, and the degree to which the regulated subsidiary comprises the parents' holding.

[8] Hawaii couched its comments on a wholly owned subsidiary in terms of Matson Navigation Co., Inc., which is a subsidiary of Alexander & Baldwin, Inc.

[9] Hawaii requested clarification on the issue of whether all parties have the option to apply for the use of the consolidated system. The Commission anticipates that only the regulated carrier will be able to apply for use of the consolidated system's capital structure. In addition, the Commission's staff may also recommend the use of the consolidated system. Such application or recommendation will be subject, however, to notice and comment prior to Commission approval. It appears that interested parties will be provided with ample opportunity to comment on this issue.

capital structures could be avoided by using a hypothetical capital structure.

Hawaii also points out the interrelationship between the capital structure and the required rate of return on equity. As the share of equity increases in the capital structure, financial risk and total risk are lessened. Thus, the required rate of return on equity declines as the proportion of equity increases, all other things being equal.

With respect to the NPR's provision for basing the capitalization ratios and amounts on average book values, PRMSA asserts that the capital structure using historic book valuation may differ significantly from a capital structure computed using market valuation.[10] Depending on how the book value of equity deviates from its market value, the Commission may be allowing a rate of return that is either too high or too low.

Discussion: The Commission is not persuaded by Hawaii's argument to decide the capital structure on a case-by-case basis. The Commission believes the capital structure of the subsidiary will generally be the most direct measure of the regulated carrier's capital structure. However, where the regulated carrier can show that the business and financial risk of the parent company and the subsidiary are similar, the Commission may allow the use of the consolidated system's capital structure because its cost of capital will likely be the same as the subsidiary's cost of capital. Moreover, the calculation of the consolidated system's cost of capital will be more direct because there will be no need to select a proxy group to estimate the cost of common-stock equity. Thus, in some cases, the use of the consolidated system's capital structure will likely give the best measure of the regulated carrier's capital structure.

With respect to hypothetical capital structures, some regulatory commissions do use a hypothetical capital structure. However, the Commission believes that good reasons exist for using the actual capital structure rather than a hypothetical capital structure. First, capital structures are the products of decisions, which may be assumed to be logical and efficient at the time they are made, although a different capitalization might be consistent with a lower BTWACC at the time of investigation and hearing. Second, the hypothetical capital structure substitutes the judgment of the regulator for the judgment of those operating the business as to the best mix of debt and equity for the company. The initial decision as to the best debt/equity mix should be left to the company management, with regulatory oversight by the Commission.

A review of regulatory commission practice indicates that, in general, the actual capital structure is used, unless that structure is wasteful or not otherwise in the long-term public interest. In cases where the Commission might find evidence of wasteful or imprudent investment, it is permitted to deduct such investment from the carrier's rate base.[11] Therefore, the Commission believes that it has ample authority to deal with imprudent or wasteful investment without employing a hypothetical capital structure.

In situations in which the Commission determines that the capital structure of a subsidiary does not represent the true capitalization of a carrier (e.g., debt ''hidden'' in a parent company's capital structure), the Commission believes that it has adequate options for ensuring that the subsidiary's capital structure reflects its financing. First, the Commission can order that the capital structure of the consolidated system be used. If the consolidated system consists of a number of subsidiaries or its capital structure is very complex, the Commission can fashion an appropriate proceeding to determine the appropriate capital structure. At the conclusion of the proceeding, the Commission would weigh all the information it had collected to determine the most realistic and meaningful capital structure possible for the regulated carrier. The Commission does not believe, however, that such proceedings will be necessary in most cases.

The NPR recognized that valid theoretical reasons exist for measuring the capital structure on the basis of the market value of its components. However, the common practice of regulatory commissions is to compute capitalization ratios on the basis of book values for a number of practical considerations. First, a regulated firm is believed to raise capital in such a fashion that a target capitalization ratio expressed on the basis of book values is maintained by the company over time. Consequently, regulators must compute the firm's overall cost of capital on the same basis to ensure that the company's capital costs are adequately covered. Second, effective regulation is said to result in book and market values approaching equality. Last, and most importantly, book-value capitalization ratios are stable, removing the problems that volatile market prices can present when determining the appropriate capitalization ratio. The Commission remains convinced that the practical considerations outweigh the theoretical issues involved in using book-value capitalization ratios. Therefore, the process of determining the regulated carrier's capital structure is adopted without change from the proposed rule.

Calculation of the Before-Tax Weighted Average Cost of Capital

In its initial comments, PRMSA pointed out that the formula for the BTWACC [12] is inconsistent with the Commission's formula for the rate of return on rate base.[13] This inconsistency resulted from computing the cost of capital on a before-tax basis while the rate of return on rate base is computed on an after-tax basis. PRMSA further commented that the after-tax rate of return formula currently used by the Commission and retained in the proposed rule is technically deficient; because, in the numerator, it adds the full amount of interest expense to income. PRMSA noted that more modern financial analysis recognizes that only the after-tax cost of interest should be added back to the numerator in computing after-tax rate of return. PRMSA suggested either changing the cost of capital to an after-tax basis so it can be compared to the after-tax return on rate base, or retaining the BTWACC

[10] PRMSA's initial comments on this issue continued its characterization of the Commission's reasons for proposing a change from the CET to the BTWACC as resulting from a desire to eschew the use of accounting data in favor of the use of market data. PRMSA contends that because the proposed rule relies extensively on historic accounting data, the shortcomings of the CET are perpetuated in the proposed rule.

[11] Likewise, the Commission may disallow questionable expense items for a carrier's income statement.

[12] The proposed rule states the before-tax weighted average cost of capital will be calculated using the following equation.

$$BTWACC=(D/D+P+E)K_d+(P/D+P+E)K_p(1/1-T)+(E/D+P+E)K_e\,(1/1-T)$$

where:

K_d is the regulated firm's cost of long-term debt capital;

K_p is the regulated firm's cost of preferred stock capital;

K_e is the regulated firm's cost of common-stock equity capital;

D is the value of the regulated firm's long-term debt outstanding;

P is the value of the regulated firm's preferred stock outstanding;

E is the value of the regulated firm's common-stock equity outstanding;

T is the corporate income tax rate

[13] Current FMC regulations (46 CFR 552.6 (d)(2)) provide that return on rate base is computed by dividing Trade net income plus interest expense by Trade rate base.

and changing the rate of return on rate base to a before-tax basis.

In the Request for Reply Comments, the Commission proposed retaining the BTWACC contained in the NPR and changing the calculation of the rate of return on rate base to a before-tax basis. Comments were sought on the following change to § 552.6(d)(2):

(2) Return on Rate Base. The return on rate base will be computed by dividing Trade net income plus interest expense plus provision for income taxes by Trade rate base.

In its reply comments, Hawaii recognizes the basis for PRMSA's concern that the proposed BTWACC and the rate of return on rate base are not directly comparable. However, Hawaii prefers that the proposed rule be changed so the weighted average cost of capital is computed on an after-tax basis and the rate of return on rate base remain as it is currently defined in the Commission's rule. According to Hawaii, the Commission's current definition of return on rate base embodies the conventional idea of payment (or return) to lenders and equity holders who have advanced the money for capital purchases. Payments to governments in taxes on revenue and earnings from the employment of the purchased capital are not strictly ''returns'' and it would distort the concept to include tax payments in the definition.

Crowley and Matson comment favorably on the proposed change to the rate of return on rate base. Although Seaman opposes the proposed methodology for calculating the allowable rate of return, he acknowledges the comparability problem.

All parties have recognized that a change must be made to either the calculation of the BTWACC or the calculation of the rate of return on rate base to make the two terms compatible. The Commission believes that putting the BTWACC and the rate of return on rate base on a before-tax basis will result in the appropriate determination of the allowable rate of return. The Commission's research indicates that most regulatory agencies determine the allowable rate of return on a before-tax basis. While Hawaii expresses a preference for using the after-tax calculation, it agreed that putting the weighted average cost of capital and the rate of return on rate base either on a before-tax basis or after-tax basis is correct as long as the two terms are compatible. Therefore, the Commission will adopt a BTWACC and modify the calculation of the return on rate base as indicated in the Request for Reply Comments.

Cost of Equity Estimation

The NPR specified that three methods of determining the cost of common-stock equity—the discounted cash flow (''DCF''), capital asset pricing model (''CAPM''), and risk premium (''RP'') methods—would be used to produce separate estimates in arriving at a final estimate of a regulated carrier's cost of common-stock equity capital. The Commission would thereby avoid any inappropriate judgments that could be embodied in any one of the individual estimates.

Both Matson and PRMSA contend that the DCF is unsuitable for FMC-regulated carriers, because most of those carriers are either subsidiaries of larger entities or privately owned firms. PRMSA avers that choosing a proxy group for the regulated carriers is impossible, therefore, the DCF and also the CAPM methods are not valid methods for the FMC to use in estimating the cost of equity.

In both sets of comments, PRMSA criticizes the derivation of the expected annual growth in dividends per share, or ''g'', as specified in the NPR. The NPR provides that in the DCF model three methods of estimating ''g'' would be used: (a) The average of the historical growth rate of dividends per share, earnings per share, and book value per share; (b) the average of (1) the five-year dividend, earnings and book value forecasts published by Value Line Investment Survey (''Value Line''), and (2) the five-year earnings forecast published by the Institutional Brokers Estimation Service (''IBES''); and (c) the use of the sustainable growth rate method, which relies on forecasted values of the earnings retention rate. To derive a final estimate of ''g'' the separate estimates of ''g'' would be averaged.

PRMSA states that there is no certain method to ascertain ''g'' directly. To the extent that ''g'' is wrong, the cost of capital is incorrectly estimated. Further, PRMSA states that the proposed averaging of the estimates has no theoretical or practical basis and might be ''contra-indicated'' when the disparities between the estimates are large. In its comments, PRMSA used data from one carrier, Overseas Shipping Group, to derive an estimate of ''g'' based on the methodology prescribed in the proposed rule. PRMSA showed that the historic growth rate method resulted in an estimate for ''g'' of 20.4 percent, while the sustainable growth rate estimate of ''g'' was 11.2 percent. According to PRMSA, the results of its study demonstrate that the methodology used in the proposed rule will likely result in widely divergent results among the three estimation procedures. PRMSA asserts that averaging these numbers results in a meaningless estimate. It argues that since many of the numbers are derived from historical book value, the proposed methodology offers no advantage over the CET, which involves looking directly at history and basing judgments directly thereon. PRMSA contends that the frailties of the methodology cannot be remedied by averaging.

Several commenters point out deficiencies in the CAPM model. Hawaii does not oppose its use, but notes that many regulatory analysts are moving away from using the CAPM as a cost of equity model. Hawaii suggests that the use of the CAPM in a regulatory rate setting removes it from its intended purposes.[14] Hawaii also states that the most salient criticisms of CAPM lie with its central element, beta.[15] Hawaii states that these criticisms include the following: (1) Beta is a measure of variability not risk; (2) beta is not forward looking (in keeping with a future test year); (3) betas typically have very low correlation coefficients; and (4) recently it has been shown that there is no statistical relationship between beta and return. PRMSA also notes that the CAPM literature has begun to question the model's empirical underpinnings. Matson advises that it is widely acknowledged that the CAPM does not adequately account for firm size in determining expected return.

Matson concurs with the NPR which stated that the DCF, CAPM, and RP each have strengths and weaknesses. However, according to Matson, the RP has an advantage that compels its use. The RP can be adjusted to reflect the fact that the cost of common stock equity is a function of firm size. Matson argues that the NPR's use of the RP[16] is deficient because the risk of investment in a small company, such as Matson, is not the same as that of a Standard & Poor's 500 Stock Index (''S&P 500'') firm.

[14] Hawaii states that the CAPM was developed for, and is widely used in, the estimation of the return probabilities of a diversified stock portfolio relative to the return of the theoretical market.

[15] Beta is the coefficient of regression of a stock's price variability relative to the variability of the whole stock market. It gauges the degree to which an individual stock price moves relative to the overall stock market.

[16] The NPR proposed that the RP method was to be used in its generic form without any adjustments for any possible differences in the risks of the firms contained in the Standard & Poor's 500 Stock Index and that of the regulated carrier.

In both its initial and reply comments, Matson advocates the Commission's adoption of one method to calculate the cost of common-stock equity and urges the adoption of the RP model adjusted for firm size. Matson comments that neither the explanatory text nor the rule language in the NPR indicates how the three estimation methods are to be ''blended'' to arrive at a final cost of common-stock equity estimate. It believes there is inefficiency and unfairness in any system that determines a regulated company's allowable earnings by taking the results of three separate calculations and then, using some unexplained process, arrives at a single result. According to Matson, this unexplained process cannot be understood by the regulated carriers and financial markets. Further, effective judicial review would be problematic.

The RP model advocated by Matson is the arithmetic average return differential between rates of return actually earned on investments in firms of the same size as the carrier, and the five-year Treasury Note. Matson states that the risk premium in such a model should be based on the historical data series ''Decile Portfolios of the NYSE'' published annually in Stocks, Bonds, Bills and Inflation (''Ibbotson Yearbook''), and should directly correspond to that decile that matches the carrier's own size.

Likewise, in its reply comments, PRMSA urges the Commission to use only the RP method to estimate the cost of common-stock equity. PRMSA recommends that the proposed RP method be modified to allow for several adjustments for risk. One such adjustment would be for firm size, similar to that suggested by Matson. It also recommends adjustments for illiquidity (in the case of privately-owned carriers), industry risk, and individual carrier risk (as compared to the industry average for publicly traded firms).

Marsoft comments that the RP model is designed to reflect the return on equity of the large, diverse range of companies included in the S&P 500. Marsoft, therefore, contends that the NPR puts a heavy weight on the assumption that all regulated companies are identical and are no more or less risky than companies included in the S&P 500. In contrast to the suggestions of Matson and PRMSA, Marsoft recommends that the Commission give lower weight to non-specific standards such as the RP model.

In addition to commenting on the specific provisions of the cost of equity estimation models, several commenters contend that the process of estimating the cost of equity is too rigidly prescribed in the NPR. Most commenters point out the importance of allowing judgment to enter into the estimation process.

Marsoft states that the proposed cost of equity methodology is excessively restrictive and is likely to result in biased estimates of the appropriate rate of return on equity. Under the BTWACC methodology, it believes that the Commission will need to exercise considerable judgment in determining the appropriate estimate for the cost of common-stock equity. Marsoft suggests the Commission use information from security analysts, management reports, and other industry-based sources in determining the appropriate rate of return on equity.

Hawaii points out that the NPR's specification of using a six-month average stock price as a base for calculating dividend yield may limit appropriate subjective judgments and preclude Commission consideration of valid information.[17] It suggests that in addition to prescribing that the average stock prices be used in the DCF (and interest rates in the CAPM and RP models), the Commission should also allow parties to use the most recent stock price in calculating the DCF model. Hawaii contends that some financial analysts argue that the use of average stock prices and interest rates may lead to greater forecast error in determining the test year stock price and interest rate than will occur when the most recent stock price and interest rate are used. According to Hawaii, allowing parties to calculate these models using both a six-month average stock price and interest rate, as well as the most recent stock price and interest rate, would add flexibility to the proposed rule and increase the information upon which the Commission could base its judgment.

Hawaii also states in its initial comments that access to several data sources is required to determine the cost of common-stock equity under the proposed rule. One of the required data sources used to compute the DCF model is published by IBES. In addition, data from Ibbotson Associates must be used to compute the CAPM and RP models. Hawaii requests that, depending on the cost of acquiring the necessary data, the Commission consider making both the IBES and Ibbotson Associates data available to non-subscribing parties.

[17] Hawaii commented similarly on the CAPM and RP models. In those models, the NPR specified the use of a six-month average of five-year Treasury note yields.

In drafting the proposed rule, the Commission attempted to specify in detail the calculation of the cost of common-stock equity in order to prevent prolonged debate that would accompany more subjective and flexible methodologies. Under section 3 of the 1933 Act not only must the FMC rule within 180 days, but also carriers and protestants have similar time limits in that hearings must be completed within 60 days.

The commenters have taken issue with the NPR's specification of the estimation methods and have suggested that the proposed rule would unduly limit the amount of information that the Commission could consider in the course of a proceeding, to the detriment of obtaining a just and reasonable result. The Commission believes that these comments have merit. If a party to a proceeding follows a predetermined formula in preparing testimony, the resultant testimony may not contain the necessary judgment required in using these estimating techniques. There are many different applications of these methodologies, and an important part of the estimating procedure is the skill with which the practitioner implements the methodology. As a consequence, the Commission, as decision maker, would not be making the fullest use of the expertise that the testimony could provide in arriving at an appropriate determination of the cost of common-stock equity for the regulated carrier.

The Commission has decided, therefore, to modify the cost of equity estimation procedures contained in § 552.6 of the proposed rule. Carriers will still be required to use the DCF and RP methods to determine the cost of common-stock equity. However, they will not be required to follow the proposed rule's detailed specifications in implementing the techniques.

The Commission has decided to strike the requirement to use the CAPM method. As the NPR explained, the CAPM is actually the company-specific form of the general RP model. The central feature of the CAPM model, beta, has been commented upon disparagingly not only by the instant commenters, but also by an increasing number of academicians. The major criticisms of Beta are that: beta measures variability not risk; beta is not forward looking; and no statistical relationship exists between a firm's beta and its return. Given that the merits of beta and, therefore, the CAPM are increasingly suspect, the Commission does not believe that this deletion will negatively impact upon the FMC's responsibilities under the 1933 Act.

The Commission is not persuaded that the selection of the proxy group is so problematic that the requirement to use the DCF model should be eliminated. The DCF method remains a standard tool used by regulatory agencies to determine cost of common-stock equity in rate cases. The Commission acknowledges that selecting a proxy group may be an extremely controversial matter, given that no two companies have exactly the same risk characteristics. Nevertheless, any alleged arbitrariness should be able to be overcome by a judicious determination of the business and financial risk factors of the regulated carrier. Further, with the requirement to use the CAPM being eliminated, the Commission does not believe that it should limit itself to only one method of estimating the cost of common-stock equity.

The proposed rule provided that the estimate produced by the RP method was to be used as a check on, and in combination with, the company-specific estimates produced using the DCF and CAPM models. With the CAPM being deleted, however, the RP will become more prominent in the determination of the cost of equity. In order to produce a more representative estimate of the risk premium required by investors for a particular carrier, the final rule will permit, but not require, carriers to argue for a risk adjustment for firm size. The final rule also allows for an RP model in its generic form.

In contrast to most commenters, Matson states that the Commission's process of determining the cost of capital is not spelled out clearly enough. The Commission does not agree with Matson on this point. The Commission requires the flexibility to consider all issues relevant to estimating the regulated carrier's cost of capital. The Commission recognizes that each of the methodologies are estimates only and that reasoned judgment is necessary in the process of determining the final estimate of the regulated company's cost of capital. Therefore, the process of combining the estimates of the cost of equity in the final rule will remain as it is in the proposed rule, though only the DCF and RP estimates of the cost of equity will be used to reach a final determination.

If a proceeding is initiated, the Commission will evaluate the testimony of the carrier, the FMC staff, and all protesters in arriving at its decision on the allowable rate of return. The Commission will then issue a ruling that spells out its reasoning so that the parties can see how the Commission arrived at its decision. Therefore, the Commission does not accept Matson's assertion that the process of combining the two estimates of common-stock equity is unfair. The combining process will be arrived at openly and will take into account the vagaries of cost of capital estimation.

With regard to the use of average prices, the Commission stated in the proposed rule that regulatory agencies often use average prices over time rather than a price on a particular day to remove aberrations in stock price movements. Such aberrations could be the result of events internal to the company (e.g., the stock may go ex-dividend) or due to factors external to the company (e.g., political events that affect the price of a firm's stock). The Commission continues to believe that the use of an average will be appropriate in most instances to filter out potential aberrations in stock prices and interest rates. However, to avoid the possibility that use of an average may serve to blind the Commission to significant changes or trends, the rule will permit, but not require, parties to calculate these models using both a six month average stock price and interest rate as well as the most recent stock price and interest rate as suggested by Hawaii.

With respect to the suggestion that the FMC consider providing access to the required data, the Commission has considered this, but has decided that the costs of such information are not prohibitive. Under the final rule no particular data source is required for the DCF analysis. IBES data can be obtained inexpensively from Compuserve, an on-line information provider. The Ibbotson Yearbook and Value Line are available at many libraries or through subscription at nominal cost.

Proxy Group

If a carrier is an independent company which issues no publicly-traded common-stock equity or is a subsidiary that obtains its common-stock equity capital through a parent company, a proxy group of companies must be selected to impute the carrier's cost of common-stock equity. Under the proposed rule, the proxy group is selected from companies listed in Value Line that operate and derive a major portion of their gross revenues primarily as common carriers in the business of freight transportation, and own and operate transportation vehicles or vessels. Further, under the proposed rule, carriers relying on proxy companies are to use the prescribed risk criteria in selecting proxy companies and are to submit their selection of proxy companies, along with their annual report of financial and operating data, as required in § 552.2.

In its initial comments, Hawaii was concerned that the companies in Value Line which satisfy the Commission's criteria for the proxy group do not have business risks similar to those of Matson. Hawaii claimed that these companies are generally consolidated companies; are not dominant in their markets; and do not operate in industries with statutory barriers to entry.

Marsoft stated that according to its research only three marine transportation companies and four trucking companies meet the proposed guidelines for the proxy group. Marsoft did not believe that airlines, railroads, or full-load trucking companies should be included in the proxy group, because they do not provide comparable services. Marsoft also stated that in many cases large, geographically and operationally diverse companies will be compared to small, highly specialized private carriers. Marsoft contends that the comparison may not be credible in some cases. Further, Marsoft urged the Commission to allow non-U.S. based firms to be included in the proxy group.

PRMSA commented that the proxy group should not be restricted to the freight transportation business. PRMSA asserted that equity capital in the regulated carrier competes against the broad spectrum of companies in the economy, not just against companies involved in freight transportation. PRMSA stated that the nature of a company's business is only one ingredient of business risk, not the sole determinant. PRMSA noted that as of June 1994, there were a total of 39 companies listed in Value Line involved in transport by air, truck, water, and railroad. Allegedly, not all of these companies were involved in freight transportation as required by the proposed rule. PRMSA concluded from this that the potential list of comparable companies is highly limited.

In its Request for Reply Comments, the Commission sought specific suggestions on industries other than freight transportation to be added to the current proxy group criteria. In its reply comments, Hawaii concurs with the parties who have suggested that dependence on data for proxy groups reported in Value Line and IBES imposes a limitation on finding appropriate proxy group members. Hawaii is unable to suggest other sources from which the required financial data would be available. However, Hawaii urges the Commission not to unduly limit the data that may be used to present evidence, especially

with respect to the proxy group. Hawaii also points out that undue limitation of the companies that may be used as proxies might introduce the statistical problems inherent in small samples.

Hawaii states that the Commission should not expect to be able to apply the results of estimations based on proxy groups directly to the regulated carrier. It urges the Commission to allow the introduction of information which relates to the comparability of the proxy group and the applicant company. In addition, Hawaii states that if each expert witness is allowed to provide estimates based on different proxy groups, the Commission would gain valuable insight into the impact of various risk characteristics on the cost of common-stock equity.

Matson argues that the Commission should retain the proxy group identified in the NPR and not add other industries. According to Matson, business risk is dependent on the diversification of a business, the cyclicality of its operations, and the operating leverage employed in its business. It suggests that transportation companies generally have similar levels of cyclicality and degrees of operating leverage. Matson claims that it would be extremely difficult to identify companies outside of the transportation industry that have the same amount of cyclicality and degree of leverage as transportation companies.

In its reply comments, PRMSA notes that the most serious deficiency of the proposed rule is the use of the proxy groups to compensate for the lack of market data for non-publicly traded companies. PRMSA points out that most domestic offshore carriers are either privately owned or subsidiaries of larger consolidated systems for which no market data exists. PRMSA asserts that the Commission has embarked on an impossible task in attempting to enumerate specific companies and/or industries to serve as a proxy for the regulated company. PRMSA says that the selection of proxy companies will necessarily be arbitrary, negating the mathematical exactitude that can be achieved under the DCF model.

With respect to the annual submission of proxy groups, PRMSA contends that this proposal would actually require a greater use of agency resources than are currently devoted to rate-of-return analysis in the domestic offshore trades. PRMSA argues that the proposed selection process raises serious due process issues, because it attempts to bar members of the public from challenge at a time when their interests are at stake, because of their failure to have made a challenge when no injury could be alleged.

Crowley advocates opening up the proxy group to companies outside the freight transportation business because, it contends, the key comparison is not the line of business. Crowley notes that companies within the same industry may have different business characteristics, and different attractions to investors. Crowley would, however, restrict the selection to any company listed in Value Line. Crowley also states that other suitable industries would be those characterized by large initial capital investments, seasonal markets, and common carrier operations. Crowley proposes that passenger transportation and certain telecommunications industries might be possible sources of proxy groups.

In Seaman's comments, he notes that the commenting parties have given ample reason why the selection of a proxy group is flawed. Seaman contends that without a comparable portfolio of companies, estimates of the cost of common-stock equity are meaningless. He concludes, therefore, that the Commission will not be able to determine a fair rate of return under the BTWACC methodology.

The Commission does not agree with the contention that the proxy group selection is unworkable. The use of proxy groups is a common regulatory practice, especially in conjunction with the DCF model in estimating cost of common-stock equity. Selecting a proxy group will require, however, an assessment of the regulated carrier's operations and financial status in order to determine the appropriate business and financial risk. The results of this assessment will be used to select companies to be included in the proxy group. Because no two companies will be identical in all aspects of risk, the proposed rule specified a number of risk indicators that might be used in selecting a proxy group.

After carefully reviewing all of the comments on comparable risk companies, the Commission has determined to drop three proposals. First, the Commission has decided that requiring the annual submission of a proxy group of companies which would be subject to notice and approval would expend considerable resources. Little benefit would be gained from the exercise if the regulated carrier were not to file any rate increases during its fiscal year. Thus, the final rule allows for the submission of the proxy group of companies at the same time as the submission of direct testimony in support of a proposed general rate increase.

Second, the Commission has decided not to limit the selection of the proxy group only to companies followed by Value Line. The proposed rule required Value Line to be used because it contains all the data necessary to complete the cost of equity calculations specified in the proposed rule. Since the final rule will not be as specific as the proposed rule in delineating the methods and data sources to be used in estimating the cost of common-stock equity, the Commission believes the need to use only Value Line data is lessened. Therefore, in addition to Value Line, other data sources will be permitted for proxy group selection.

Nevertheless, the Commission believes that Value Line provides the best overall data available for determining a proxy group. It provides analysis of many factors necessary for the selection of comparable risk companies. While Value Line does not cover every company that issues stock, the Commission expects that most proxy group companies will be found in it. The Commission does not want to proscribe the use of companies not followed by Value Line that would make good proxy group members. However, if a party selects proxy group members based on data from sources other than Value Line, the burden is on that party to prove that the data source is reliable and the data are sufficiently detailed to calculate the BTWACC.

Finally, the Commission has decided not to limit the allowable proxy group members only to companies which operate in the transportation industry. The final rule will require that the majority of the proxy companies be companies which operate in the transportation industry. This will allow those giving testimony some latitude in selecting proxy group members from outside the transportation industry.

Crowley is the only commenter suggesting other industries that might be included as candidates for the proxy group. Crowley suggests that proxy group members could be selected from the passenger transportation and telecommunications industries. Crowley offered very little analysis as to why these industries should be included. A thorough analysis would be required to persuade the Commission that companies in these industries would make acceptable proxy group members.

The Commission is concerned that the difficulty commenters had in suggesting alternative industries from which proxy group members might be selected is illustrative of the difficulties that may be found in attempting to find proxy group members outside the transportation industry. Most

commenters, however, were quite concerned that in some cases it may be difficult to select an adequate list of proxy group members within the confines of the transportation industry. To balance these two concerns, some of the proxy group members will be permitted to come from outside the transportation industry. However, a majority of the proxy group members will be required to come from the transportation industry. Those seeking to include companies outside the transportation industry in the proxy group shall have the burden of establishing that the firms selected have business risks comparable to the regulated carrier.

The final rule will continue to require that the proxy group be limited to U.S. companies. In many instances foreign accounting procedures are different from U.S. accounting practices. In order to ensure that accurate estimates of the cost of common-stock equity can be made from the proxy group, the exclusion of foreign companies will continue. Lastly, based on the prior discussion of the concerns regarding the use of beta, two of the risk indicators specified in the proposed rule to be used in selecting the proxy group will be eliminated, the volatility of a company's common-stock price changes as measured by both beta and standard deviation.

Deferred Taxes and the Capital Construction Fund

The proposed rule provided for two amendments to allow for the treatment of deferred taxes in the calculation of rate base. First, the cost of an asset included in the rate base would be reduced by the amount of funds withdrawn from the ordinary income and capital gains components of the Capital Construction Fund (''CCF'').[18] Second, the rate base would be reduced by the amount of deferred taxes, except that portion resulting from the CCF or the expired Investment Tax Credit.

Capital Construction Fund

Matson, Crowley and DOT oppose the Commission's proposal to exclude CCF withdrawals from the rate base. Hawaii's comments appear to support the proposal, although most of its comments address deferred taxes.

The opposition to the proposed treatment of the CCF falls into two main areas. First, several commenters contend that the proposed changes are contrary to the Congressional intent behind the Merchant Marine Act, 1936, 46 U.S.C. app. section 1100, et seq., as amended, which governs the CCF. Matson points out that the Commission recognized the Congressional intent in Docket No. 78–46, Part 512. Financial Reports of Common Carriers by Water in the Domestic Offshore Trades. In that proceeding, Matson states that the Commission gave the reasons for its complete rejection of methodologies which penalized the carrier for using the financing benefits provided by the Merchant Marine Act, 1970. That legislation amended the 1936 Act and, inter alia, extended the CCF provisions to include the domestic offshore carriers. Matson points out that, in Docket No. 78–46, the Commission stated that:

> The Commission is persuaded that the Congress, in enacting the Merchant Marine Act, 1970 sought to provide carriers with tax incentives in order to encourage investment aimed at modernizing and expanding the fleet serving the domestic offshore trades. As MARAD indicated [in its comments], the adoption of the flow-through methodology would not be in accordance with the Congressional intent. Docket No. 78–46, 19 SRR at 1305. (Matson at 8).

Crowley adds that it ''makes no sense for the FMC to take away the benefit of the CCF program, or to steer CCF funds away from the domestic trades, when the program is a part of the basic U.S. government policy to support the U.S. Merchant Marine.'' (Crowley at 8). DOT asserts that the proposed rule would frustrate Congress' intent in establishing the CCF program by directly penalizing companies that participate in the program, which would in turn impede DOT's efforts to maintain and expand the U.S.-flag fleet.

Second, the carriers and DOT contend that the proposed changes in the accounting treatment of the CCF and accumulated deferred taxes are based on a misunderstanding of the actual financial and tax consequences of the CCF and deferred taxes. Crowley argues that the Commission has misconstrued the character of the contributions to the three components of the CCF. In its comments, DOT explained that under the CCF program both deposits from taxable income and any subsequent investment earnings are temporarily sheltered from federal income taxes. These tax benefits are assured only if the deposits and earnings thereon are withdrawn to meet the company's CCF program objectives, principally vessel construction or reconstruction. Any unauthorized withdrawals are fully taxable. The recovery of the tax benefit of CCF deposits is accomplished by reducing the income tax basis of a vessel built with CCF monies. The reduction of the taxable basis of the CCF vessel reduces otherwise allowable depreciation over time which, in turn, increases taxable income, thereby recovering the initial benefits of the CCF deposit. DOT points out that this tax deferral has no connection to the cost of a vessel and therefore, should have no impact on the FMC's determination of a carrier's rate base for setting an allowable rate of return.

Matson contends that the Commission has grossly overstated the benefit of the CCF investment. According to Matson, the sole economic benefit which flows from the use of a CCF is the interest-free use of the deferred tax monies until the taxes are paid through the loss of tax-depreciation on the CCF investment. Matson points out that the tax repayment period is 10 years for vessels, and 5 years for containers. According to Matson, not only has the FMC overstated the benefit but also, the duration of the benefit because its proposal would ''exclude forever 100% of the CCF investment.''

Based on the comments received, the Commission is abandoning the proposed treatment of the CCF. The NPR indicated that of the three accounts comprising the CCF (capital account, capital gains account, and ordinary income account) the capital account is the only account containing carrier contributions to the CCF. The NPR likewise indicated that the capital gains and ordinary income accounts were comprised solely of the carriers' earnings on money contributed to the CCF. Several commenters clarified that the capital gains account consists of capital gains from the sale of CCF vessels as well as earnings from that account, and the ordinary income account consists of CCF vessel income plus earnings from that account. Only the capital gains and ordinary income accounts are tax deferred. Given the commenters' clarifications that the capital gains and ordinary income accounts are comprised of carrier contributions along with earnings, it appears that to require carriers to reduce the cost of the vessel by the amount of funds withdrawn from these two components of the CCF would indeed penalize CCF carriers and serve as a disincentive to carrier participation in the CCF. Such disincentive would appear to be contrary to the Congressional intent in establishing the CCF program.

Deferred Taxes

Hawaii supports the changes to the treatment of deferred taxes in the proposed rule. The State points out that

[18] The Capital Construction Fund is comprised of three components: the capital account, the capital gains account, and the ordinary income account.

the Commission appropriately decided in Docket No. 78–46 to require carriers to calculate their income tax expense at the applicable statutory rate. Before issuing the final rule in Docket No. 78–46, the Commission had ordered deferred income taxes deducted from rate base in two rate investigations.[19] However, in Docket No. 78–46, the Commission reversed its prior rulings and decided not to require carriers to deduct accumulated deferred income taxes from rate base. Hawaii also notes that the proposed treatment of deferred taxes conforms with the policy of a majority of state regulatory commissions, as well as the Federal Communications Commission and the Federal Energy Regulatory Commission.

In its initial comments, Matson asserts that the deferred taxes account arises only due to the different treatment of depreciation for tax purposes than for expense purposes. According to Matson, when an asset is allowed to depreciate faster for tax accounting purposes than for book accounting purposes, a timing difference occurs and is reflected in deferred taxes. The differences in taxes booked versus taxes paid is recorded as a ''book'' liability. Matson claims that this is not a real liability but only the recognition that more taxes have been expensed than have yet to be paid. If the generally accepted accounting principles (''GAAP'') allowed for recording as an expense only the amount of taxes paid, no book liability for deferred taxes would occur. Matson argues that the value of deferred taxes is only in the time value of money, and this value reverses over a relatively few years. Matson claims that the benefit that the Commission refers to in the proposed rule does not exist. It is merely a philosophical difference between GAAP and the Internal Revenue Service code.

In its reply comments, Matson addresses Hawaii's statement that the majority of regulatory agencies surveyed by the National Association of Regulatory Utility Commissioners treat deferred taxes similarly to the Commission's proposed treatment. Matson argues that such treatment of deferred taxes by state regulatory agencies resulted from the requirements of the Tax Reform Act of 1969 that required utilities to deduct deferred taxes from the rate base, if the utilities planned to use accelerated depreciation.

PRMSA argues that the proposed rule would negate the stimulating effect on investment that was intended by public policy. It further argues that prohibiting returns on shipping assets financed by funds generated through the tax treatment of accelerated depreciation creates a disincentive to investment in the regulated shipping trades. PRMSA suggests that it is clear that a firm's decision to invest funds provided by deferred taxes is a decision that puts its investor-provided equity at risk. Therefore, PRMSA contends that the FMC should focus on providing a rate of return on deferred taxes more akin to that provided by equity. Nevertheless, PRMSA suggests that the return could be adjusted downward to recognize the fact that the initial funds are not investor provided, although once the firm uses those funds its own equity is at risk and some reward is required.

DOT avers that the proposed treatment of deferred taxes is unfair to CCF companies. DOT states that a consequence of participation in the CCF program is that companies tend to have large deferred tax liabilities. Therefore, the Commission's proposal would penalize CCF vessels, which are all U.S. flag, by reducing the rate base by the amount of the tax benefit, which would directly devalue the CCF incentive conferred by Congress. DOT takes issue with the statement in the NPR that accumulated deferred taxes should be eliminated from the rate base, because ''unlike debt, preferred stock, and common-stock equity, deferred taxes cost the carrier nothing.'' (NPR at 52). In its discussion of the CCF, DOT argues that deferred taxes are not cost free to the carrier, because over the life of a vessel, CCF companies will tend to pay higher taxes in later years than those carriers not participating in the CCF program.

The Commission views the issue of deducting deferred taxes arising from accelerated depreciation from the rate base as being similar to that of deducting CCF withdrawals from the cost of a vessel or equipment. The Commission believes that carriers should not be penalized for using accelerated depreciation by deducting accumulated deferred taxes from the rate base and that such a deduction would likely serve to reduce the incentive of carriers to invest in the industry. Congress clearly intended companies to benefit from the use of accelerated depreciation and the Commission does not believe it should take any action which would minimize that benefit. Therefore, the Commission will not require carriers to deduct accumulated deferred taxes arising from accelerated depreciation from the rate base as was proposed. This is in conformance with current Commission policy determined in Docket 78–46, Financial Reports of Common Carriers by Water in the Domestic Offshore Trades.

Working Capital

In the NPR, the Commission proposed to amend its regulations governing the computation of working capital to remove the extraordinary treatment of insurance expense. Only Hawaii commented on the proposed change. In addition to supporting the proposed change, Hawaii proposed two additional changes. First, Hawaii suggested that, in determining the amount of working capital to be included in rate base, the Commission adopt what it termed a ''modified lead-lag approach''. Hawaii's second proposal is to exclude interest expense from the calculation of working capital.

In Docket No. 78–46, and Docket No. 91–51, Financial Reports of Common Carriers by Water in the Domestic Offshore Trades, Hawaii recommended the use of a ''lead-lag study'' in calculating the amount of working capital to be included in rate base. Taking into account the complexities inherent in adopting such an approach, the Commission declined to abandon average voyage expense as the basis for calculating working capital.[20]

Hawaii stated that ''the modified lead-lag approach compares the lag in paying for major operating expenses (excluding depreciation and amortization, and interest expense) with the lag in receiving the revenues to pay for these expenses.'' (Hawaii at 19) Although Hawaii downplays the complexity of this method, its very description of the process belies this conclusion. The Commission can envision carriers spending inordinate amounts of time analyzing various accounts to develop the working capital component of rate base. On the other hand, the Commission believes that the average voyage expense calculation is straightforward and uniquely suited for the maritime industry.

Hawaii also proposed removing interest expense from the calculation of working capital. In its initial comments, Hawaii stated:

Interest expenses should also be excluded from the working capital computation because they represent a *source* of working

[19] See FMC Docket No. 75–57, *Matson Navigation Co.—Proposed Rate Increase in the United States Pacific Coast/Hawaii Domestic Offshore Trade* and FMC Docket No. 76–43, *Matson Navigation Company—Proposed Rate Increase in the United States Pacific Coast/Hawaii Domestic Offshore Trade.*

[20] In Docket No. 78–46, the Commission wrote, ''There is no persuasive evidence in this proceeding or otherwise available which would indicate that average voyage expense incurred by a carrier utilizing self-propelled vessels is not a fair measure of that carrier's working capital requirements.''

capital funds. Interest is not paid to bondholders until after the related revenue is received by the carrier. Thus, interest expense does not create a need for working capital.

(Hawaii at 20).

Crowley and Seaman comment on this proposal. Crowley opposes Hawaii's suggested treatment of interest. Crowley argues that interest expense is a cost of doing business not unlike any other liability for which working capital is required, such as employee costs, equipment acquisition and maintenance and repair, and similarly accrues on the carrier's books. Seaman merely endorses Hawaii's position.

The Commission agrees with Crowley that interest expense is no different from a carrier's other liabilities for which working capital is required. The Commission believes that the working capital component of the rate base is intended to provide for a return on the cash required for the carrier's day-to-day operations and that interest expense meets this criteria. Therefore, the final rule eliminates only the extraordinary treatment of insurance expense from the calculation of the working capital component of rate base.

The Federal Maritime Commission certifies pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(n), that this rule will not have a significant economic impact on a substantial number of small entities, including small businesses, small organizational units and small government jurisdictions. The Commission grants a waiver of the detailed reporting requirements to carriers which earn gross revenues of $25 million or less in a particular trade in accordance with 46 CFR 552.2(e).

The collection of information requirements contained in this rule have been approved by the Office of Management and Budget under the provisions of the Paperwork Reduction Act of 1980, as amended, and have been assigned OMB control number 3072–0008. Under the proposed rule the incremental public reporting burden for this collection of information was estimated to range from an average of 41 hours to 65 hours per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. The annual filing of a proxy group was estimated to require 41 man-hours while Schedule F was estimated to require 24 man-hours to complete. Since the final rule no longer requires that a proxy group of companies be filed annually, carriers which do not file a general rate increase as described in 46 CFR 552.2(f) will incur no additional regulatory burden. To be conservative, the estimated regulatory burden for carriers which file a general rate increase is still estimated to be 65 man-hours. However, the cost of equity estimation has been simplified by eliminating the requirement that a capital asset pricing model be used in deriving the final estimate of the cost of equity. Thus, an extra cushion of time within the 65 man-hours has been created for carriers which file a general rate increase. Send comments regarding this burden estimate, including suggestions for reducing this burden, to Bruce Dombrowski, Deputy Managing Director, Federal Maritime Commission, Washington, DC 20573 and to the Office of Information and Regulatory Affairs, Office of Management and Budget, Washington, DC 20503.

List of Subjects in 46 CFR Part 552

Maritime carriers, Reporting and recordkeeping requirements, Uniform system of accounts.

Therefore, pursuant to 5 U.S.C. 553, sections 18 and 43 of the Shipping Act, 1916, 46 U.S.C. app. 817 and 841a, and sections 2 and 3 of the Intercoastal Shipping Act, 1933, 46 U.S.C. app. 844 and 845, part 552 of Title 46, Code of Federal Regulations, is to be amended as follows:

PART 552—FINANCIAL REPORTS OF VESSEL OPERATING COMMON CARRIERS BY WATER IN THE DOMESTIC OFFSHORE TRADES

1. The authority citation for part 552 continues to read as follows:

Authority: 5 U.S.C. 553; 46 U.S.C. app. 817(a), 820, 841a, 843, 844, 845, 845a and 847.

2. In § 552.1, paragraph (b) is revised to read as follows and paragraph (d) is removed:

§ 552.1 Purpose.

* * * * *

(b) In evaluating the reasonableness of a VOCC's overall level of rates, the Commission will use return on rate base as its primary standard. A carrier's allowable rate of return on rate base will be set equal to its before-tax weighted average cost of capital. However, the Commission may also employ the other financial methodologies set forth in § 552.6(f) in order to achieve a fair and reasonable result.

* * * * *

3. In § 552.2, paragraph (a) is amended by revising the filing address contained therein, paragraph (b) is revised, paragraph (f)(1)(iv) is amended by removing ''and,'' from the end thereof, paragraph (f)(1)(v) is amended by changing the period at the end thereof to a semicolon and adding ''and,'' to the end of the paragraph, and a new paragraph (f)(1)(vi) is added reading as follows:

§ 552.2 General requirements.

(a) * * *

Federal Maritime Commission, Bureau of Economics and Agreement Analysis, 800 North Capitol Street, NW, Washington, DC 20573–0001

(b) Annual statements under this part shall consist of Exhibits A, B, and C, as described in § 552.6, and shall be filed within 150 days after the close of the carrier's fiscal year and be accompanied by a company-wide balance sheet and income statement having a time period coinciding with that of the annual statements. A specific format is not prescribed for the company-wide statements.

* * * * *

(f) * * *

(1) * * *

(vi) Projected schedules for capitalization amounts and ratios (Schedule F–I); cost of long-term debt capital calculation (Schedules F–II and F–III); cost of preferred (and preference) stock capital calculation (Schedules F–IV and F–V); corporate income tax rate (Schedule F–VI); and flotation costs (Schedule F–VII) for the 12-month period used to compute projected midyear rate base in paragraph (f)(1)(ii) of this section.

* * * * *

4. In § 552.5, paragraphs (b) and (c) are revised, and paragraphs (v), (w), (x), (y), (z), (aa), and (bb) are added to read as follows:

§ 552.5 Definitions.

* * * * *

(b) *The service* means those voyages and/or terminal facilities in which cargo subject to the Commission's regulation under 46 CFR 514.1(c)(2) is either carried or handled.

(c) *The trade* means that part of the Service subject to the Commission's regulation under 46 CFR 514.1(c)(2), more extensively defined below under Domestic Offshore Trade.

* * * * *

(v) *Book value* means the value at which an asset is carried on a balance sheet.

(w) *Capital structure* means a company's financial framework, which is composed of long-term debt, preferred (and preference) stock, and common-stock equity capital (par value plus earned and capital surplus).

(x) *Capitalization ratio* means the percentage of a company's capital structure that is long-term debt, preferred (and preference) stock, and common stock-equity capital.

(y) *Consolidated system* means a parent company and all of its subsidiaries.

(z) *Subsidiary company* means a company of which more than 50 percent of the voting shares of stock are owned by another corporation, called the parent company.

(aa) *Long-term debt* means a liability due in a year or more.

(bb) *Times-interest-earned ratio* means the measure of the extent to which operating income can decline before a firm is unable to meet its annual interest costs. It is computed by dividing a firm's earnings before interest and taxes by the firm's annual interest expense.

5. In § 552.6, paragraph (a)(1), the first sentence of paragraph (a)(2), (b)(5), and the heading of paragraph (b)(9) are revised; paragraphs (c)(5) and (c)(10) are revised; paragraphs (d)(1) and (d)(2) are revised; paragraphs (e) and (f) are redesignated (g) and (h); a new paragraph (e) is added and paragraphs (d)(3) and (d)(4) are redesignated (f)(1) and (f)(2) and the paragraph headings thereof revised reading as follows:

§ 552.6 Forms

(a) *General.* (1) The submission required by this part shall be submitted in the prescribed format and shall include General Information regarding the carrier, as well as the following schedules as applicable:

Exhibit A—Rate Base and supporting schedules;
Exhibit B—Income Account and supporting schedules;
Exhibit C—Rate of Return and supporting schedules;
Exhibit D—Application for Waiver;
Exhibit E—Initial Tariff Filing Supporting Data; and
Exhibit F—Allowable Rate of Return schedules.

(2) Statements containing the required exhibits and schedules are described in paragraphs (b), (c), (d), (e), (g), and (h) of this section and are available upon request from the Commission. * * *

(b) * * *

(5) *Working Capital (Schedule A–V).* Working capital for vessel operators shall be determined as average voyage expense. Average voyage expense shall be calculated on the basis of the actual expenses of operating and maintaining the vessel(s) employed in the Service (excluding lay-up expenses) for a period represented by the average length of time of all voyages (excluding lay-up periods) during the period in which any cargo was carried in the Trade. Expenses for operating and maintaining vessels employed in the Trade shall include: Vessel Operating Expense, Vessel Port Call Expense, Cargo Handling Expense, Administrative and General Expense, and Interest Expense allocated to the Trade as provided in paragraphs (c) (2), (4) and (5) of this section.

* * * * *

(9) *Capitalization of leases (Schedules A–VII and A–VII(A)).* * * *

(c) * * *

* * * * *

(5) *Interest expense and debt payments (Schedules B–IV and B–IV(A)).* This schedule shall set forth the total interest and debt payments, apportioned between principal and interest, short and long-term, on debt and lease obligations. Payments on long-term debt are to be calculated consistent with the method set forth in § 552.6(e)(7) for computing the cost of long-term debt capital. Principal and interest shall be allocated to the Trade in the ratio that Trade rate base less working capital bears to company-wide assets less current assets. Where related company assets are employed by the filing company, the balance sheet figures on the related company's books for such assets shall be added to the company-wide total in computing the ratio. In those instances where interest expenses are capitalized in accordance with paragraph (b)(9) of this section, a deduction shall be made for the amount so capitalized.

* * * * *

(10) *Provision for income tax.* Federal, State, and other income taxes shall be listed separately. If the company is organized outside the United States, it shall indicate the entity to which it pays income taxes and the rate of tax applicable to its taxable income for the subject year. Federal, State and other income taxes shall be calculated at the statutory rate. Such tax rates are to be identical to those set forth in Schedules F–VI or F–VI(A) used in determining the carrier's allowable rate of return.

* * * * *

(d) *Rate of Return (Exhibits C and C(A))*—(1) *General.* All carriers are required to calculate rate of return on rate base. However, the Commission or individual carriers, at the Commission's discretion, may also employ fixed charges coverage and/or operating ratios as provided for in paragraph (f) of this section.

(2) *Return on rate base.* The return on rate base will be computed by dividing Trade net income plus interest expense plus provision for income taxes by Trade rate base.

(e) *Allowable rate of return on rate base (Exhibits F and F(A))*—(1) *General.* A carrier's allowable rate of return on rate base shall be set equal to the carrier's weighted average cost of capital calculated on a before-tax basis (''BTWACC''). The BTWACC is defined mathematically by the following expression:

$$BTWACC = \left(\frac{D}{D+P+E}\right)K_d + \left(\frac{P}{D+P+E}\right)K_p\left(\frac{1}{1-T}\right) + \left(\frac{E}{D+P+E}\right)K_e\left(\frac{1}{1-T}\right)$$

where:

K_d is the carrier's cost of long-term debt capital;
K_p is the carrier's cost of preferred (and preference) stock capital;
K_e is the carrier's cost of common-stock equity capital;
D is the average book value of the carrier's long-term debt capital outstanding;
P is the average book value of the carrier's preferred (and preference) stock capital outstanding;
E is the average book value of the carrier's common-stock equity capital (par value plus earned and capital surplus) outstanding; and
T is the carrier's composite statutory corporate income tax rate.

A carrier's BTWACC shall be calculated in precise accordance with the rules set forth in this section.

(2) *Subsidiary carrier's capital structure.* Where a carrier is a subsidiary that obtains its common-stock equity capital through a parent company, the capital structure of the subsidiary shall be used in computing the BTWACC unless the carrier has received prior approval by the Commission to use the consolidated capital structure. The subsidiary carrier's cost of common-stock equity capital, the subsidiary carrier's cost of long-term debt capital, the subsidiary carrier's cost of preferred stock capital, and the subsidiary carrier's composite statutory corporate

income tax rate shall also be used in computing the BTWACC. The subsidiary carrier's cost of common-stock equity capital shall be inferred as the cost of common-stock equity capital estimated for a sample of firms having business and financial risk comparable to the subsidiary carrier when the subsidiary carrier's capital structure is used in calculating the BTWACC.

(3) *Comparable risk companies.* (i) A proxy group of companies shall be selected to impute the carrier's cost of common-stock equity capital where:

(A) The carrier is an independent company (i.e., it has no corporate parent) which issues no publicly-traded common-stock equity, or

(B) The carrier is a subsidiary that obtains its common-stock equity capital through a parent company.

(ii) The selection of the proxy group of companies shall be based on the following criteria:

(A) The proxy companies shall be based in the United States.

(B) The proxy companies shall be listed in The Value Line Investment Survey or equivalent data source. If a party uses data from sources other than The Value Line Investment Survey, the burden is on that party to prove that the data source is reliable and the data are sufficiently detailed to calculate the BTWACC.

(C) A majority of the proxy companies shall operate and derive a major portion of their gross revenues primarily as common carriers in the business of freight transportation, and shall own or operate transportation vehicles or vessels. Companies with gross annual revenues equal to or less than $25,000,000 shall be excluded from the proxy group. Proxy group companies whose businesses are not in the transportation industry must clearly be demonstrated to have business risk equivalent to the regulated carrier's business risk.

(D) In addition, comparable risk companies shall be selected by examining some, but not necessarily all, of the following risk indicators:

(1) A company's total capitalization ratio and/or debt-to-equity ratio;

(2) The investment quality ratings of a company's long-term debt instruments;

(3) The investment safety ranking of a company's common-stock equity;

(4) The rating of a company's financial strength;

(5) Other such valid indicators deemed appropriate by the Commission.

(4) *Consolidated capital structure.* (i) Upon application, after notice and opportunity for comment, the Commission may authorize use of the capital structure of the consolidated system (i.e., the parent company and all of its subsidiaries) in computing the BTWACC. The application must show that:

(A) The subsidiary carrier's parent company issues publicly traded common-stock equity;

(B) The subsidiary carrier's parent company owns 90 percent or more of the subsidiary's voting shares of stock; and

(C) The business and the financial risks of the subsidiary carrier and the parent company are similar.

(ii) The similarity of the parent company's and subsidiary carrier's business risk shall be evaluated by examining the degree to which the consolidated system's profits, revenues, and expenses are composed of those of the subsidiary carrier, and the extent to which the parent's holdings are diversified into lines of business unrelated to those of the subsidiary carrier, and/or other indicators of business risk deemed appropriate by the Commission. The similarity of the parent company's and subsidiary carrier's financial risk shall be evaluated by examining the consolidated system's and the subsidiary's total capitalization ratios, debt-to-equity ratios, investment quality rankings on short- and long-term debt instruments, times-interest-earned ratios, fixed charges coverage ratios (calculated to include both FMC and non-FMC regulated operations), and/or other measures of financial risk deemed appropriate by the Commission.

(iii) When the consolidated capital structure is used, the consolidated system's cost of common-stock equity capital (issued by the parent company), the consolidated system's cost of long-term debt capital, the consolidated system's cost of preferred (and preference) stock capital, and the consolidated system's composite statutory corporate income tax rate shall also be used in estimating the subsidiary's BTWACC.

(iv) Where the Commission has approved the use of a consolidated capital structure, such use will not be subject to challenge in a subsequent rate investigation brought under section (3) of the Intercoastal Shipping Act, 1933.

(5) *Book-value, average capitalization ratios.* Capitalization ratios representing the capital structure used in deriving a carrier's BTWACC shall be computed on the basis of average projected book value outstanding over the 12-month period used to calculate projected midyear rate base in § 552.2(b)(1)(ii). The average amount of any class of capital outstanding used in determining the capitalization ratios is computed by adding the amount of a particular type of capital expected to be outstanding as of the beginning of the 12-month period to the amount of that same type of capital expected to be outstanding as of the end of the 12-month period, and dividing the sum by two.

(6) *Capitalization amounts and ratios (Schedules F–I and F–I(A)).* A carrier shall show its long-term debt, preferred stock, and common-stock equity capitalization amounts outstanding, stated in book value terms, as of the beginning and as of the end of the 12-month period used to calculate projected midyear rate base, and the average amounts and average ratios for that 12-month period. Where a carrier is a subsidiary of a parent company, the carrier shall show its own capitalization amounts and ratios unless the carrier has applied for and has been granted permission from the Commission to use a consolidated capital structure in computing the BTWACC. Where such permission has been granted, the carrier shall show instead the consolidated system's capitalization amounts and ratios.

(7) *Cost of long-term debt capital (Schedules F–II, F–II(A), F–III, and F–III(A)).* (i) The cost of long-term debt capital [1] shall be calculated by the carrier for the 12-month period used to compute projected mid-year rate base on the basis of:

(A) Embedded cost for existing long-term debt; and

(B) Current cost for any new long-term debt expected to be issued on or before the final day of the 12-month period.

(ii) The arithmetic average annual percentage rate cost of long-term debt capital calculated on the basis of all issues of long-term debt expected to be outstanding as of the beginning and as of the end of the 12-month period used to compute projected mid-year rate base shall be the cost of long-term debt capital used in computing the BTWACC.

(iii) The annual percentage rate cost of long-term debt capital for all issues of long-term debt expected to be outstanding as of the beginning and as of the end of the 12-month period used to compute projected mid-year rate base shall be calculated separately for the two dates by:

(A) Multiplying the cost of money for each issue under paragraph (e)(7)(v)(A)(*10*) of this section by the principal amount outstanding for each issue, which yields the annual dollar cost for each issue; and

[1] The cost of sinking fund preferred stock shall be computed in accordance with the regulations for calculating the cost of long-term debt.

(B) Adding the annual dollar cost of each issue to obtain the total dollar cost for all issues, which is divided by the total principal amount outstanding for all issues to obtain the annual percentage rate cost of long-term debt capital for all issues.

(iv) The arithmetic average annual percentage rate cost of long-term debt capital for all issues to be used as the cost of long-term debt capital in computing the BTWACC shall be calculated by:

(A) Adding the total annual dollar cost for all issues of long-term debt capital expected to be outstanding as of the beginning of the 12-month period used to compute projected mid-year rate base to the total annual dollar cost for all issues of long-term debt capital expected to be outstanding as of the end of the 12-month period, and dividing the resulting sum by two, which yields the average total annual dollar cost of long-term debt for all issues for the 12-month period;

(B) Adding the total principal amount outstanding for all long-term debt issues expected to be outstanding as of the beginning of the 12-month period used to compute projected mid-year rate base to the total principal amount outstanding for all long-term debt issues expected to be outstanding as of the end of the 12-month period, and dividing the resulting sum by two, which yields the average total principal amount expected to be outstanding for all issues for the 12-month period; and

(C) Dividing the average total annual dollar cost of long term debt for all issues for the 12-month period by the average total principal amount expected to be outstanding for all issues for the 12-month period, which yields the average annual percentage rate cost of long-term debt capital for all issues to be used in computing the BTWACC.

(v)(A) *Cost of long-term debt capital calculation (Schedules F–II, F–II(A), F–III and F–III(A)).* The carrier shall calculate the annual percentage rate cost of long-term debt capital for all issues of long-term debt expected to be outstanding as of the beginning and as of the end of the 12-month period used to compute projected mid-year rate base separately for the two dates, and shall also calculate the average annual percentage rate cost of long-term debt for all issues for the 12-month period. The carrier shall support these calculations by showing in tabular form the following for each class and series of long-term debt expected to be outstanding as of the beginning and as of the end of the 12-month period separately for the two dates:

(*1*) Title;

(*2*) Date of issuance;

(*3*) Date of maturity;

(*4*) Coupon rate (%);

(*5*) Principal amount issued ($);

(*6*) Discount or premium ($);

(*7*) Issuance expense ($);

(*8*) Net proceeds to the carrier ($);

(*9*) Net proceeds ratio (%), which is the net proceeds to the carrier divided by the principal amount issued;

(*10*) Cost of money (%), which, for existing long-term debt issues, shall be the yield-to-maturity at issuance based on the coupon rate, term of issue, and net proceeds ratio determined by reference to any generally accepted table of bond yields; and, for long-term debt issues to be newly issued on or before the final day of the 12-month period, shall be based on the average current yield (published in such a publication as Moody's Bond Survey) on long-term debt instruments similar in maturity and investment quality as the long-term debt security that is to be issued;

(*11*) Principal amount outstanding (%);

(*12*) Annual cost ($); and

(*13*) Name and relationship of issuer to carrier.

(B) Where a carrier is a subsidiary of a parent company, the carrier shall show the cost of long-term debt calculations and information required in this paragraph for its own cost of long-term debt unless the carrier has applied for and received prior permission from the Commission to use a consolidated capital structure in computing the BTWACC. Where such permission has been granted, the subsidiary carrier shall show the required cost of long-term debt calculations and information for the consolidated system's long-term debt.

(vi) In the event that new long-term debt is to be issued on or before the final day of the 12-month period used to compute projected mid-year rate base, the carrier shall submit a statement explaining the methods used to estimate information required under paragraph (e)(7)(v)(A) (*1*) through (*13*) of this section.

(8) *Cost of preferred (and preference) stock capital (Schedules F–IV, F–IV(A), F–V, and F–V(A)).* (i) The cost of preferred (and preference) stock capital shall be calculated by the carrier for the 12-month period used to compute projected mid-year rate base on the basis of:

(A) Embedded cost for existing preferred (and preference stock); and

(B) Current cost for any new preferred (and preference) stock to be issued on or before the final day of the 12-month period.

(ii) The arithmetic average annual percentage rate cost of preferred (and preference) stock capital calculated on the basis of all issues of preferred (and preference) stock expected to be outstanding as of the beginning and as of the end of the 12-month period used to calculate projected mid-year rate base shall be the cost of preferred (and preference) stock capital used in computing the BTWACC.

(iii) The annual percentage rate cost of preferred (and preference) stock capital for all issues of preferred (and preference) stock expected to be outstanding as of the beginning and as of the end of the 12-month period used to compute projected mid-year rate base shall be calculated separately for the two dates by:

(A) Multiplying the cost of money for each issue under paragraph (e)(8)(v)(A)(*9*) of this section by the par or stated amount outstanding for each issue, which yields the annual dollar cost for each issue; and

(B) Adding the annual dollar cost of each issue to obtain the total for all issues, which is divided by the total par or stated amount outstanding for all issues to obtain the annual percentage rate cost of preferred (and preference) stock capital for all issues.

(iv) The arithmetic average annual percentage rate cost of preferred (and preference) stock capital for all issues to be used as the cost of preferred (and preference) stock capital in computing the BTWACC shall be calculated by:

(A) Adding the total annual dollar cost for all issues of preferred (and preference) stock capital expected to be outstanding as of the beginning of the 12-month period used to compute projected mid-year rate base to the total annual dollar cost for all issues of preferred (and preference) stock capital expected to be outstanding as of the end of the 12-month period, and dividing the resulting sum by two, which yields the average total annual dollar cost of preferred (and preference) stock for all issues for the 12-month period;

(B) Adding the total par or stated amount outstanding for all preferred (and preference) stock issues expected to be outstanding as of the beginning of the 12-month period used to compute projected mid-year rate base to the total par or stated amount outstanding for all issues expected to be outstanding as of the end of the 12-month period, and dividing the resulting sum by two, which yields the average total par or stated amount expected to be outstanding for all issues for the 12-month period;

(C) Dividing the average total annual dollar cost of preferred (and preference) stock for all issues for the 12-month period by the average total par or stated

amount expected to be outstanding for all issues for the 12-month period, which yields the average annual percentage rate cost of preferred (and preference) stock capital for all issues to be used in computing the BTWACC.

(v)(A) *Cost of preferred (and preference) stock capital calculation (Schedules F–IV, F–IV(A), F–V and F–V(A)).* The carrier shall calculate the annual percentage rate cost of preferred (and preference) stock capital for all issues of preferred (and preference) stock expected to be outstanding as of the beginning and as of the end of the 12-month period used to compute projected mid-year rate base separately for the two dates, and shall also calculate the average annual percentage rate cost of preferred (and preference) stock for all issues for the 12-month period. The carrier shall support these calculations by showing in tabular form the following for each issue of preferred (and preference) stock as of the beginning and as of the end of the 12-month period separately for the two dates:

(*1*) Title;

(*2*) Date of issuance;

(*3*) Dividend rate (%);

(*4*) Par or stated amount of issue ($);

(*5*) Discount or premium ($);

(*6*) Issuance expense ($);

(*7*) Net proceeds to the carrier ($);

(*8*) Net proceeds ratio (%), which is the net proceeds to the carrier divided by the par or stated amount issued;

(*9*) Cost of money (%), which, for existing preferred (and preference) stock issues, shall be the dividend rate divided by the net proceeds ratio; and, for preferred (and preference) stock issues to be newly issued on or before the final day of the 12-month period, shall be the estimated dividend rate divided by the estimated net proceeds ratio;

(*10*) Par or stated amount outstanding ($);

(*11*) Annual cost ($); and

(*12*) If issue is owned by an affiliate, name and relationship of owner.

(B) Where a carrier is a subsidiary of a parent company, the carrier shall show the cost of preferred (and preference) stock calculations and information required in this paragraph for its own preferred (and preference) stock unless the carrier has applied for and been granted permission from the Commission to use a consolidated capital structure in computing the BTWACC. Where such permission has been granted, the subsidiary carrier shall show the required cost of preferred (and preference) stock calculations and information for the consolidated system's preferred (and preference) stock.

(vi) In the event that new preferred (and preference) stock is to be issued on or before the final day of the 12-month period used to compute projected mid-year rate base, the carrier shall submit a statement explaining the methods used to estimate information required under paragraph (e)(8)(v)(A) (*1*) through (*12*) of this section.

(9) *Cost of common-stock equity capital.* A carrier's cost of common-stock equity capital shall be calculated using the Discounted Cash Flow (''DCF'') and the Risk Premium (''RP'') methods. A final estimate of that cost shall be derived from the separate estimates obtained using each of the methods.

(10) *DCF method.* (i) The DCF model that shall be used in calculating a carrier's cost of common-stock equity is defined algebraically as follows:

$$K_e = \frac{D_o}{P_o}(1+.5g) + g$$

where:

K_e is the carrier's cost of common-stock equity capital;

D_o is the carrier's current annualized dividend (defined as four times the current quarterly installment) per share;

P_o is the current market price per share of the carrier's common stock; and

g is the constant expected annual rate of growth in the carrier's dividends per share.

(ii) *Current market price per share of common stock.* A DCF analysis in which the current market price per share of the carrier's common stock is an average of the monthly high and low market prices during a six-month period commencing not more than nine months prior to the date on which the proposed rates are filed is required. Supplemental DCF analysis using the most recent stock price as a basis for the current market price per share of common stock may also be used.

(iii) *Additional Studies.* Other analysis or forms of the DCF model may be included in the computation and determination of the DCF estimate of the cost of common-stock equity.

(11) *RP method.* (i) The RP model that shall be used in calculating a carrier's cost of common-stock equity is defined mathematically as follows:

$$K_e = K_d + RP$$

where:

K_e is the regulated carrier's cost of common-stock equity capital;

K_d is the incremental cost of debt; and

RP is the risk premium.

(ii) *Risk Premium.* The risk premium used in the RP model shall be the historical arithmetic average return differential between rates of return actually earned on investments in the Standard and Poor's 500 Stock Index and the five-year Treasury note. A risk adjustment specific to the carrier for firm size may be included in the computation and determination of the risk premium. The risk premium shall be based on the complete historical data series published annually in the Stocks, Bonds, Bills and Inflation Yearbook, for the period 1926 through the most recent date for which the specified data are available.

(iii) *Incremental cost of debt.* A six-month average of five-year Treasury Note yields computed over a period commencing not more than nine months prior to the date on which the proposed rates are filed shall be the estimate of the incremental cost of debt in the RP model. Supplemental RP analysis using the most recent five-year Treasury Note yield as a basis for the incremental cost of debt may also be used.

(12) *Corporate income tax rate (Schedules F–VI and F–VI(A)).* The corporate income tax rate used in computing the BTWACC shall be the carrier's composite statutory corporate income tax rate for the 12-month period used to compute projected midyear rate base. Such rate shall be a composite of the carrier's Federal and State income tax rates, and of any other income tax rate to be applied to the carrier's income by any other entity to which the carrier is to pay income taxes. The carrier shall calculate and show its composite statutory corporate income tax rate as well as its Federal, State, and any other applicable statutory income tax rates separately for the 12-month period used to compute projected midyear rate base. The carrier shall also state the name of any entity other than the Federal and State governments to which it is to pay taxes. Where a carrier is a subsidiary of a parent company, the carrier shall show its own statutory corporate income tax rates unless the carrier has applied for and been granted permission from the Commission to use a consolidated capital structure in computing the BTWACC. Where such permission has been granted, the carrier shall show instead the consolidated system's statutory corporate income tax rates.

(13) *Flotation costs (Schedules F–VII and F–VII(A)).* (i) A carrier's cost of common-stock equity capital shall be adjusted to reflect those costs of floating new issues that are actually incurred, but only in the event that new common stock is to be issued to the general

public during the 12-month period used to compute projected midyear rate base. Those flotation costs for which an allowance shall be made must be identifiable, and must be directly attributable to underwriting fees, and printing, legal, accounting, and/or other administrative expenses. No allowance shall be made for any hypothetical costs such as those associated with market pressure and market break effects. The allowance shall be applied solely to the new common-stock equity and shall not be applied to the existing common-stock equity balance. The formula that shall be used to compute such an allowance is as follows:

$k = Fs/(1+s)$

where:

k is the required increment to the cost of the carrier's common stock equity capital that will allow the company to recover its flotation costs;

F is the flotation costs expressed as a decimal fraction of the dollar value of new common-stock equity sales; and

s is the new common-stock equity sales expressed as a decimal fraction of the dollar value of existing common-stock equity capital.

(ii) *Flotation costs data (Schedules F–VII and F–VII(A)).* (A) In the event that new common-stock equity is to be issued during the 12-month period used to compute projected midyear rate base, the carrier shall show separately by category the estimated costs of floating the new issues to the extent that such costs are identifiable and are directly attributable to actual underwriting fees, and to printing, legal, accounting, and/or other administrative expenses that must be paid by the carrier. The carrier shall submit a statement explaining the method used in estimating the flotation costs. The carrier shall also show estimates of the date of issuance; number of shares to be issued; gross proceeds at issuance price; and net proceeds to the carrier.

(B) Where a carrier is a subsidiary that obtains its common-stock equity capital through a parent company, and the parent company intends to issue new common-stock equity during the 12-month period, the carrier shall show separately by category the estimated costs to the parent company of floating the new issues, and estimates of the above items relative to the parent company's issuance of new common-stock equity, provided that such carrier has applied for and been granted permission from the Commission to use a consolidated capital structure in computing the BTWACC.

(f) *Financial ratio methods*—(1) *Fixed charges coverage ratio.* * * *

(2) *Operating ratio.* * * *

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By the Commission.

Joseph C. Polking,

Secretary.

[FR Doc. 95–21845 Filed 9–1–95; 8:45 am]

BILLING CODE 6730–01–W

FEDERAL COMMUNICATIONS COMMISSION

47 CFR Part 73

[MM Docket No. 95–66; RM–8625]

Radio Broadcasting Services; Dayton, WA

AGENCY: Federal Communications Commission.

ACTION: Final rule.

SUMMARY: The Commission, at the request of Steven C. Hoffman, allots Channel 272A at Dayton, Washington, as the community's second local FM transmission service. *See* 60 FR 26712, May 18, 1995. Channel 272A can be allotted at Dayton in compliance with the Commission's minimum distance separation requirements with a site restriction of 3.0 kilometers (1.9 miles) southwest to avoid short-spacings to the construction permit site for Station KRAO(FM), Channel 273C3, Colfax, Washington, and the licensed site for Station KORD(FM), Channel 274C, Richland, Washington. The coordinates for Channel 272A at Dayton are North Latitude 46–17–57 and West Longitude 117–59–52. Since Dayton is located within 320 kilometers (200 miles) of the U.S.-Canadian border, concurrence of the Canadian government has been received.

DATES: Effective October 16, 1995. The window period for filing applications will open on October 16, 1995 and close on November 16, 1995.

FOR FURTHER INFORMATION CONTACT: Sharon P. McDonald, Mass Media Bureau, (202) 418–2180.

SUPPLEMENTARY INFORMATION: This is a synopsis of the Commission's *Report and Order,* MM Docket No. 95–66, adopted August 24, 1995, and released August 30, 1995. The full text of this Commission decision is available for inspection and copying during normal business hours in the FCC Reference Center (Room 239), 1919 M Street, NW., Washington, DC. The complete text of this decision may also be purchased from the Commission's copy contractors, International Transcription Service, Inc., (202) 857–3800, 2100 M Street, NW., Suite 140, Washington, DC 20037.

List of Subjects in 47 CFR Part 73

Radio broadcasting.

Part 73 of title 47 of the Code of Federal Regulations is amended as follows:

PART 73—[AMENDED]

1. The authority citation for part 73 continues to read as follows:

Authority: Sections 303, 48 Stat., as amended, 1082; 47 U.S.C. 154, as amended.

§ 73.202 [Amended]

2. Section 73.202(b), the Table of FM Allotments under Washington, is amended by adding Channel 272A at Dayton.

Federal Communications Commission.

John A. Karousos,

Chief, Allocations Branch, Policy and Rules Division, Mass Media Bureau.

[FR Doc. 95–21908 Filed 9–1–95; 8:45 am]

BILLING CODE 6712–01–F

47 CFR Part 73

[MM Docket No. 95–48; RM–8590]

Television Broadcasting Services; Weaverville, CA

AGENCY: Federal Communications Commission.

ACTION: Final rule.

SUMMARY: This document allots UHF television Channel 32 to Weaverville, California, as that community's first local television broadcast service, in response to a petition for rule making filed by Mark C. Allen. *See* 60 FR 20950, April 28, 1995. Coordinates used for Channel 32 at Weaverville are 40–54–45 and 122–52–15. *See* Supplementary Information, *infra.* With this action the proceeding is terminated.

EFFECTIVE DATE: October 16, 1995.

FOR FURTHER INFORMATION CONTACT: Nancy Joyner, Mass Media Bureau, (202) 418–2180.

SUPPLEMENTARY INFORMATION: This is a synopsis of the Commission's *Report and Order,* MM Docket No. 95–48, adopted August 23, 1995, and released August 30, 1995. The full text of this Commission decision is available for inspection and copying during normal business hours in the FCC's Reference Center (Room 239), 1919 M Street, NW., Washington, DC. The complete text of this decision may also be purchased from the Commission's copy contractors, International Transcription Service, Inc., (202) 857–3800, located at 1919 M Street, NW., Room 246, or 2100 M Street, NW., Suite 140, Washington, DC 20037.