

A FINANCIAL ANALYSIS OF THE BELL TELEPHONE REGIONAL HOLDING  
COMPANIES

BY

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I. INTRODUCTION

On December 29, 1989 the Federal Communications Commission (FCC) initiated a formal proceeding to represcribe the authorized rate of return for the interstate services of the Local Exchange Carriers (LECs). 1/ In the testimony filed by the seven Bell Regional Holding Companies (RHCs), among others, two dominant themes emerged. 2/ First, the RHCs had become less risky than the LEC's since divestiture due to the portfolio effect of diversification into non-regulated lines of business. This caused the investor required rate of return on common equity to be higher for the LECs than for the RHCs. Second, the LECs needed significant amounts of new investment to protect their competitiveness. This increased the risks of investment in RHCs and LECs to potential investors, thus requiring a higher ROE to induce such investments.

The submissions filed in response to the RHCs argued that these themes were undocumented assertions lacking in both analytical support and evidence. 3/ The FCC ultimately issued a rate of

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- 1/ In the matter of Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order, DA 90-5 (released January 5, 1990) ("Jan.5 Order").
- 2/ Initial Rate of Return Submissions, CC Docket No. 89-624, (February 16, 1990)
- 3/ Responsive Submissions, CC Docket No. 89-624, (March 27, 1990).

return order rejecting most of the RHC's positions. Nevertheless, the issues themselves remained unresolved, and became subject to further debate.

This study examines the RHC's claim that the diversification efforts of the RHCs made them less risky than their respective LECs. To the contrary, this study found that the diversification efforts of the RHCs were thinly capitalized, a characteristic closely associated with high risk. Moreover, it was the financial cross-subsidization from the LECs to the RHCs that allowed the RHCs to give the appearance that they were less, not more, risky than their respective LECs.

The non-regulated activities of the RHCs were highly unprofitable. The net income or earnings of the LECs was being used to support the highly unsuccessful diversification activities of the RHCs. In every instance the RHCs collected more in dollar amount from the LECs than they paid out in dividend payments to RHC shareholders. Finally, Net LEC investment expenditures have been flat in nominal dollars since divestiture. These findings support the claim that the RHCs have been made more risky, not less, by post-divestiture diversification activities.

This study is divided into six sections. Section I is introductory; Section II analyzes the capitalization of the non-regulated diversification activities of the RHCs; Section III analyzes the profitability of the RHCs non-regulated or diversified activities; Section IV analyzes the dividend payout ratios of the LECs and the RHCs, Section V examines the relative investment expenditures and depreciation expenses of the LECs; And, Section VI presents the conclusions of the study.

The data used to conduct the analysis were taken from the 10-K Reports filed with the Securities and Exchange Commission (SEC) by the RHCs and the LECs for the years 1985 through 1991.

## II. THE EFFECTS OF DIVERSIFICATION ON CAPITALIZATION

In this Section the capital structures of the RHCs are considered both with and without their respective LECs. This provides a proxy measure of the diversification efforts of the RHCs. Further, it demonstrates that the RHCs have relied upon the capitalizations of the LECs to support the creditworthiness of their non-LEC activities, e.g., financial cross-subsidization of the RHCs non-regulated activities by the capital structures of the LECs.

The common equity ratio is the percent of the shareholders claims to the total claims against the company, that is, the claims of both shareholders and debtors. A higher common equity ratio is matched by a lower debt ratio in the capitalization structure, and vice versa. Debt carries legal or contractual obligations not generally born by debt. All other factors equal, the higher the



percent of debt in the capital structure, the greater the financial risk of the company, and vice versa.

The common equity ratios for the RHCs, including annual means, were computed for the years 1985 through 1991. The common equity ratios for the RHCs demonstrated a stable pattern, peaking at near 60 percent in 1986, and declining to 52 percent in 1991. This masks a different pattern of capitalization for the separate parts of the capital structure.

The debt and equity for the individual LECs are removed from their respective Holding Company debt and equity. This residual is the capital associated with the non-regulated or diversified activities of the RHCs. In nominal terms, the non-LEC common equity of the RHCs plateaued in about 1987 and has remained flat, amounting to about \$7 billion at the end of 1991. This was matched by a debt level of about \$19 billion at the end of 1991. The mean common equity ratio for the RHCs diversified or non-regulated activities declined from a high of over 82 percent in 1987 to a low of about 26 percent in 1991.

The non-regulated common equity ratios showed even greater variation for individual RHCs. For the years 1990 and 1991, three out of seven of the RHCs had non-LEC common equity ratios in the single digits. Bell Atlantic's non-LEC common equity, in particular, bottomed out below 5 percent in 1990 from a peak level above 65 percent in 1986. This is in contrast to Bell Atlantic's RHC common equity which declined from 59 percent in 1985 to 44 percent in 1991.

A common equity ratio in the 44 percent range, as in the Bell Atlantic case, might be considered normal by industry standards for any of the three primary regulated industries, e.g., electricity, telecommunications, and/or natural gas distribution. However, a decrease from above 65 percent to 44 percent signals a shift in the relative risk associated with the corresponding debt leverage. And, under normal circumstances, a company with a 5 percent common equity ratio and 95 percent debt, e.g. Bell Atlantic's non-LEC activities, would probably not be considered a "going-concern." It might reasonably be expected to be into varying stages of financial reorganization and/or bankruptcy. Such declining common equity ratios do not support the financial profile of low-risk diversification activities which would be required to reduce the overall risk of the RHCs.

The financial markets are generally unwilling to lend monies when thin capitalization exists. This means that the RHCs, in effect, leveraged against the LEC common equity component in order to support or justify the leveraging of the non-LEC activities. Such financial cross-subsidization of the non-LEC activities by the LECs has the further effect of reducing the creditworthiness of the LECs, although to a lesser degree. This, in turn, increases the financing costs for the LECs.



Several factors have either been associated with the changing capitalizations, or are expected to have more effects on the capitalizations. First, what has been called Restructuring has resulted in significant balance sheet equity reductions. This generally involves either the downsizing of the LEC or the losses/write off of non-regulated activities. In 1991 the RHC 10-K reports identified about \$2 billion restructuring costs. Part, but not all of these costs were assigned to the LECs. The allocation of restructuring costs needs to be closely monitored by state regulators to be assured that restructuring costs associated with unprofitable non-LEC activities are not paid by regulated rate payers.

Second, every RHC has established a Leveraged Employee Stock Ownership Plan (LESOP). By December 31, 1989, the LESOPs accounted for about fifty percent of the increase in the non-LEC long term debt. The LESOP's debt is serviced by Company contributions and the dividends paid to the trusts for the shares of Company common stock held by the trusts. The Company guarantee of the LESOP Trust debt requires that the Company reflect this on their balance sheets. Bell Atlantic records the debt guarantee as an increase in long-term debt and an increase in deferred compensation (a decrease in common equity). There are at least two areas of impact for state regulators. First, since the LESOPs cover the regulated LEC employees, the increased debt and decreased common equity adjustments at the RHC level should be passed back to the LECs for adjustments to the LEC capital structures. Second, the tax savings due to the LESOPs are LEC employee based and should be passed back to the ratepayers by the state regulators.

Third, at least one RHC, Bell Atlantic, has already adopted FASB Statement No. 106, which is mandatory by January, 1993. This requires the accrual of all postretirement benefits other than pensions. The cost is expected to be in the \$2 billion to \$3 billion range for most of the RHCs. These postretirement plans entail a variety of economic, financial and demographic variables, which might be expected to change over the tenure of the plan. The State Regulators need to pay particular attention to these Plans to be sure that excessive cost recovery does not occur.

Fourth, FASB Statement No. 109 changes the accounting for deferred tax items. While there is uncertainty regarding the impacts of this Rule, enforcement and subsequent policy related decisions will eventually determine the magnitude of the effects.

Fifth, FASB Statement No. 107 requires companies to disclose the fair value of all financial instruments. Such requirements to revalue equity interest will impact upon how the RHCs carry the LECs equity on their books. The common equity value of the LECs, as recorded on their books, has been virtually unchanged since divestiture. Any revaluation, for whatever reason, changes the capitalization relationships and impacts on rates of return through changed capital structures.



### III. THE PROFITABILITY OF DIVERSIFICATION

Contrary to industry claims, the non-regulated activities of the RHCs have produced mixed results. The net income of the LECs was subtracted from the RHCs to determine the non-LEC net income of the RHCs. This residual net income as a percent of the non-LEC common equity was also used to compute the non-LEC return on equity (ROE).

The non-LEC RHC ROE for the period 1985 through 1991 was widely divergent for the industry as well as the individual companies. The mean ROE across the seven RHCs was negative in four out of seven years, including both 1990 and 1991. The mean RHC non-LEC ROE was -9.4% and -13.6% for the years 1990 and 1991, respectively. Only Bell South and Southwestern Bell showed positive returns in every year. However, these numbers showed wide fluctuations and were based on thin capitalizations.

### IV. DIVIDEND PAYOUT RATIOS

The RHCs maintained a stable dividend payout ratio at the expense of the LECs. The RHCs demonstrated a stable but increasing pattern of dividend payments over the post-divestiture period. This ratio of dividends paid out to the shareholders, as a percent of net income, stabilized around 60 percent from 1985 to 1988, and increased to 75 percent in 1990. The 1991 statistic exceeded the 100 percent level because of some payouts in the face of writeoffs. The RHC dividend payout ratio serves more as a facade for the pattern of dividends collected by the RHCs from their respective LECs.

The dividend payout ratio was computed for each LEC for each year from 1985 through 1990. The mean ratio for the LECs averaged 89 percent over the post-divestiture period, peaking at 98 percent in 1989. It was not unusual for RHCs to remove more in a dividend payment from a LEC than the respective LEC earned in a particular year. This, in effect, constituted a downsizing of the LEC, a practice totally inconsistent with the alleged need for significant net investment to keep the LEC's competitive. For example, in both 1987 and 1988 Bell Atlantic removed in excess of 100 percent of C&P's net income in the form of dividend payments, 127 percent and 134 percent, respectively. Bell Atlantic removed 97 percent of C&P's net income in 1991, in spite of a loss passed back to C&P from Bell Atlantic of about \$33 million. NYNEX removed 140 percent of N.Y. Telephones' net income in 1989. PACTEL removed 104 percent of Pacific Bells net income in 1999.

The dollar amount of dividend payments made by Bell Atlantic to Bell Atlantic shareholders was deducted from the total dividend collections of the RHCs from their respective LECs for each year 1985 through 1991. Without a single exception, the RHCs collected more in dividend payments from the LECs than they paid out in dividends to their shareholders. Such a cash drain from the LECs by the RHCs decreases the ability of the LECs to make investments. Instead, the excess collections from the LECs are going to fund the



non-LEC activities and cover their respective losses. This suggests that the RHCs have become more risky, not less risky, because of post-divestiture diversification and non-regulated activities.

#### V. DEPRECIATION AND INVESTMENT SPENDING

This Section compares the annual capital investment expenditures of the LECs with their annual depreciation expenses. The capital investment expenditures have been adjusted for gains and/or losses associated with salvage, removal and disposition for the respective year in which they were made. The depreciation expenses are at book value or nominal amounts. No adjustment has been made for the time value of money related to the underlying costs of the plant and/or equipment being expensed as depreciation. Again, the data was analyzed for each RHC by individual LEC.

The annual depreciation expenses as a percent of total annual investment expenditures were computed. They tend to hover about 80 percent. However, in some years, the ratio was above 100 percent for some participants.

While this 80 percent depreciation to investment (D/I) ratio may appear to present a strong positive growth scenario, it does not, in fact, do so. The depreciation expenses are based on historical book value, while net capital expenditures are in real or current terms. Because of this discrepancy of real and historical dollars, anything above 80 percent might be considered a posture of net-disinvestment or downsizing of the company.

Bell Atlantic's 80 percent D/I ratio suggests that Bell Atlantic is basically in a maintenance posture with respect to the LECs. However, on an individual LEC basis, the situation is different. For two of Bell Atlantic's LECs, namely, C&P of D.C. and C&P of W. Va., significant amounts of downsizing, or net disinvestment actually occurred in the years 1987 and 1989. This is typified by D/I ratios reaching as high as 120.17 percent.

#### VI. CONCLUSIONS

Three conclusions can be drawn from the above analyses. First, diversification has resulted in significantly increasing the riskiness of the regional holding companies to their shareholders and prospective investors. This increased risk is associated with what appears to be speculative and relatively unprofitable non-local exchange carrier investments. Second, the regional holding companies have actively downsized or disinvested in their local exchange carriers to support their speculative and relatively unprofitable non-local exchange carrier investments. Finally, the regional holding companies have been less than open and forthright in their failure to pass the financial impacts of the LESOP's back to their respective local exchange carriers. For this reason, state regulators need to pay particular attention to the cost recovery associated with FASB Statement No.s 106, 107 and 109 as well as the volume of restructuring charges being written off.