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United States General Accounting Office

GAO

Report to the Honorable
Byron L. Dorgan, House of
Representatives

February 1988

PUBLIC UTILITIES

Information on the Cash Position of the Natural Gas and Telephone Industries

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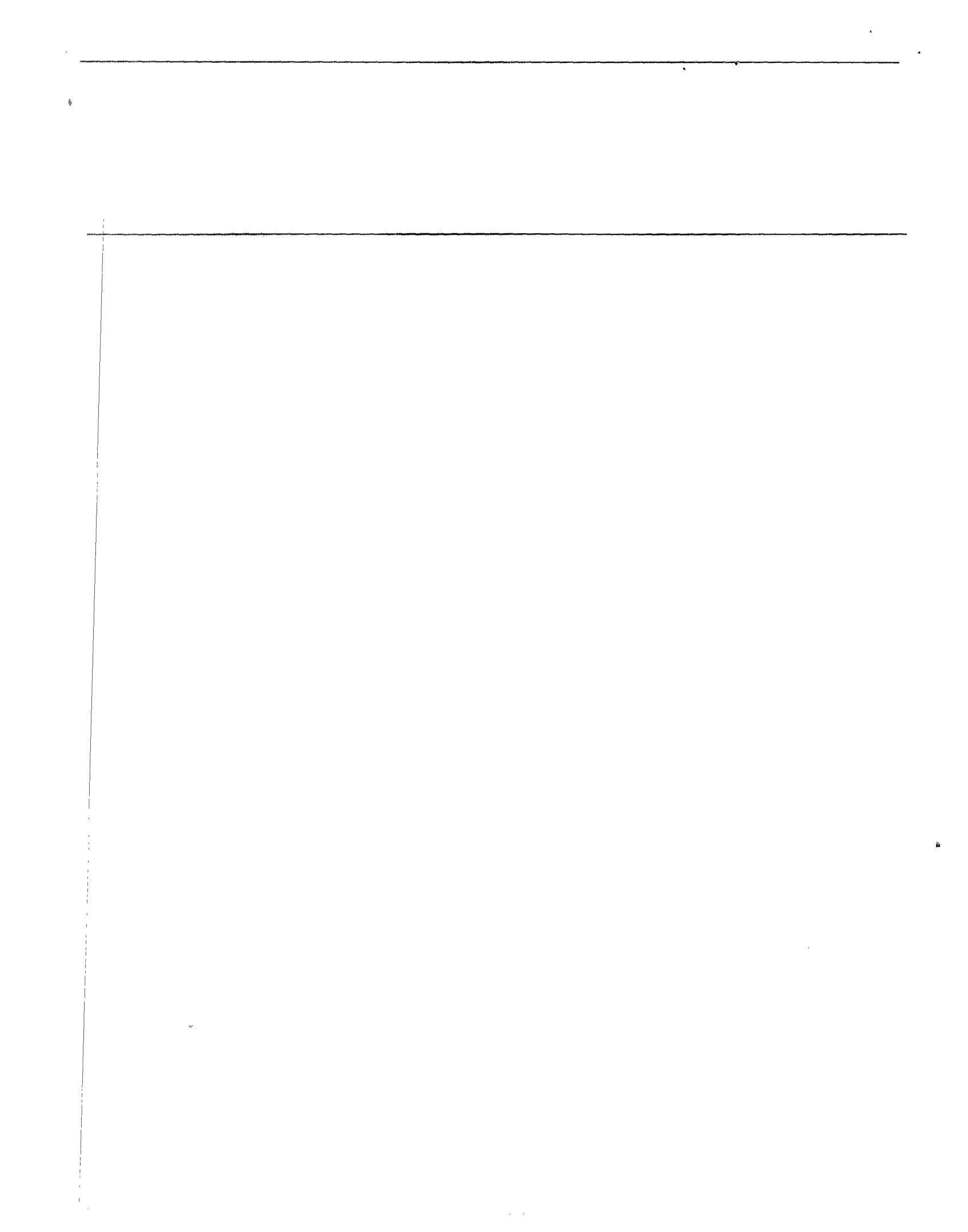
GAO/RCED-88-97



GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-229389

February 26, 1988

The Honorable Byron L. Dorgan
House of Representatives

Dear Mr. Dorgan:

In your letter of July 13, 1987, you asked that we examine the financial position of the public utility industries (electric, natural gas, and telephone). In particular, you expressed interest in the apparent improvement in the industries' level of available cash and whether this improved cash position would facilitate the ability of utilities to "return" to utility ratepayers excess deferred taxes resulting from the Tax Reform Act of 1986 in a time period shorter than that provided for in the act.[1] In subsequent meetings with your office, we agreed to develop historical trend information on the utility industries' cash availability and offer any comments or observations on these trends, as well as the potential impacts on the industry of returning excess deferred taxes in a shorter time period (referred to as flow-through).

On December 30, 1987, we reported the results of our analysis of cash availability in the electric utility industry for the 1976-85 period.[2] In the report, we provided our observations on the flow-through of excess deferred taxes. This report provides our analysis of the cash availability in the natural gas and telephone industries for the 1976-86 period.

In summary, our work showed that the natural gas industry's level of cash availability in the aggregate was varied but generally favorable for the 1976-84 period. During this period, the industry's current ratios remained above 1.0, its cash flow was positive, and, except for 1981, cash from internal sources contributed more than half of its total cash available. However, for the 1984-86 period, its cash availability had

[1]One provision of the Tax Reform Act of 1986 was to reduce the corporate tax rate. One effect of this change was to create an excess amount of taxes that had been collected from utility ratepayers but had been deferred for future payment to the Treasury. Under the act, the excess, referred to as excess deferred taxes, is to be returned to utility ratepayers through a normalization approach. The time period for accomplishing the return is associated with the remaining life of utility assets, which, in the case of coal and nuclear power plants, can be up to 30 years.

[2]Public Utilities: Information on the Cash Position of the Electric Utility Industry (GAO/RCED-88-76, Dec. 30, 1987).

declined. We found that in 1986 the industry's current and quick ratios[3] had declined to their lowest level in the 11-year period, the industry's cash availability after major obligations had been met had decreased, and the percentage of total cash provided from internal operations had decreased relative to cash obtained through long-term borrowing and stock sales. Our review of changes in the industry's use of cash for the 11-year period showed that, on a relative basis, cash devoted to construction had decreased while cash used to retire long-term debt and pay dividends had increased. (Details on the natural gas industry are contained in app. I.)

With respect to the telephone industry, our work showed that between 1976 and 1979, its cash availability from internally generated funds had declined but then improved between 1979 and 1983. For example, the industry's current ratio reached a level above 1.0 in 1983, indicating that the industry's current assets exceeded its current liabilities for the first time during the period. Further, we found that in 1983, its cash flow based on internally generated funds was positive, indicating that the industry was able both to fund the construction budget and to pay dividends from its operations. However, since 1983, the industry's cash situation has declined somewhat: its current ratio dropped below 1.0, and it again experienced a negative cash flow. (Details on the telephone industry are contained in app. II.)

As with the electric utilities, our review of the financial data for selected natural gas and telephone utilities showed that the industry aggregate cash flow position would not necessarily be indicative of each individual company's cash flow position. Most of the companies we reviewed followed the general trend within their respective industry as a whole. However, we noted that wide variances existed among these companies and that significant changes occurred in the cash flow position for each company between 1985 and 1986.

Scope and Methodology

For the natural gas utilities, our work was based on an examination of financial data reported to the Federal Energy Regulatory Commission for the 1976-86 period and compiled by the Energy Information Administration. For the telephone utilities, our work was based on an examination of financial data reported to the Federal Communications

[3]The current ratio and quick ratio have been traditional measures of a company's ability to meet its short-term obligations. The current ratio represents a company's current assets divided by current liabilities. The quick ratio represents a company's liquid assets (cash, current receivables, short-term investments, etc.) divided by its current liabilities.

Commission for the 1976-86 period. We did not verify the accuracy of the data reviewed. As agreed with your office, we did not obtain comments from interested parties. Our work was conducted between November 1987 and January 1988.

We plan no further distribution of this report but will make copies available to interested parties on request.

Major contributors to this report are listed in appendix III.

Sincerely yours,

Keith O. Fultz

Keith O. Fultz
Senior Associate Director

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Abbreviations

EIA	Energy Information Administration
FCC	Federal Communications Commission
FERC	Federal Energy Regulatory Commission
GAO	General Accounting Office
RCED	Resources, Community, and Economic Development Division

Cash Position of the Natural Gas Industry

All major interstate natural gas pipeline companies that operate in the United States provide financial and operating information annually to the Federal Energy Regulatory Commission (FERC). The Energy Information Administration (EIA) compiles and consolidates these financial data for its annual publication, Statistics of Interstate Natural Gas Pipeline Companies. Aggregated data for 1986 were the most recent data readily available. Figures I.1 through I.4 are based on the data EIA compiled for the balance sheet statistics and for the statements of changes in financial position.

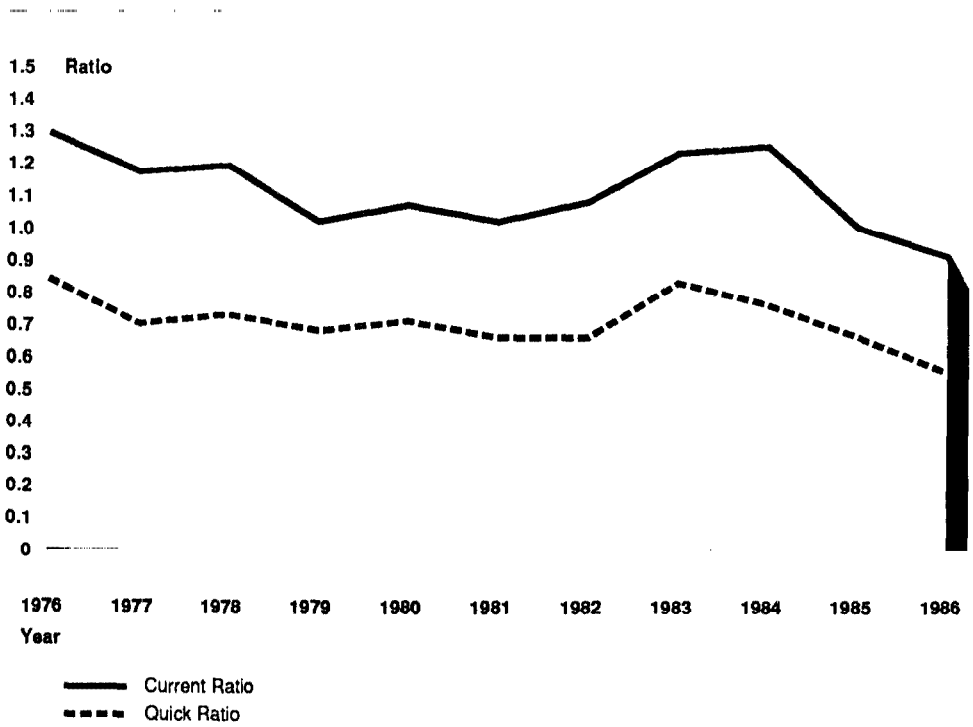
Cash Availability in the Natural Gas Industry

To measure trends in the natural gas industry's cash availability, we examined aggregate industry year-end financial data for the period 1976-86. More specifically, we computed (1) the industry's current and quick ratio for each of these years,[1] (2) the industry's cash flow, and (3) the percentage of total cash provided from internal operations relative to cash obtained from primary external sources, i.e. long-term borrowing and stock sales. We computed the current and quick ratios because these measures have often been used to examine changes in financial position. We examined cash flow because this measure of change in financial position had been recently supported by the Financial Accounting Standards Board. We examined the relative levels of internal and external sources of cash to determine the extent to which the natural gas industry had supported its operations through externally raised cash.

The natural gas industry's current and quick ratios for the period 1976-86 are shown in figure I.1. As figure I.1 shows, in 1976 the industry's current ratio was 1.29; it declined to 1.02 in 1981, then gradually increased to 1.25 in 1984, but declined to 0.91 in 1986. Similarly, the quick ratio was 0.84 in 1976; it declined to 0.66 in 1981, increased to 0.83 in 1983, and then declined to 0.55 in 1986. These overall trends indicate that the industry's ability to meet its short-term obligations generally declined between 1976-81, improved between 1982-84, but then declined to its lowest point by 1986.

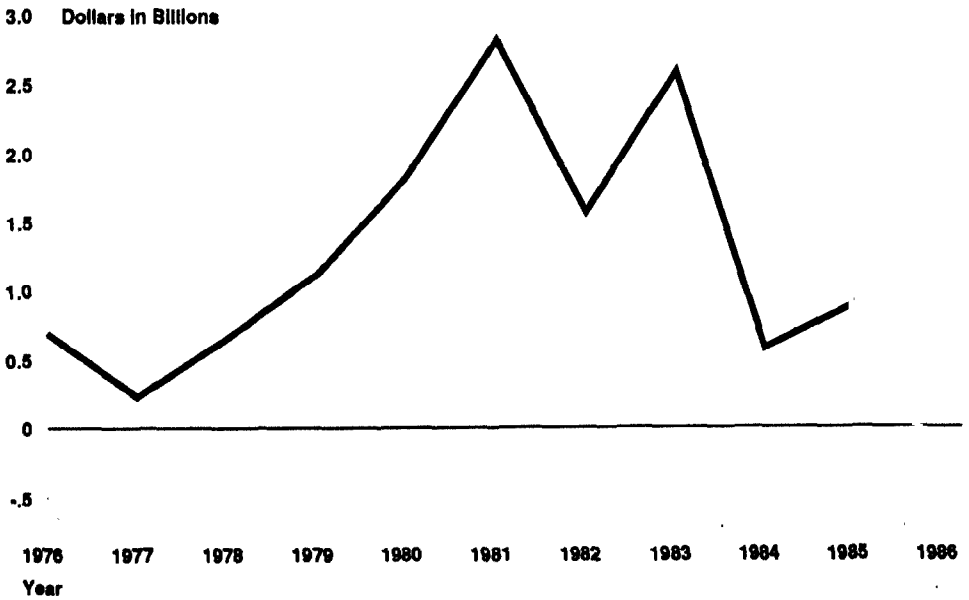
[1]The current ratio and quick ratio have been traditional measures of a company's ability to meet its short-term obligations. The current ratio represents a company's current assets divided by current liabilities. The quick ratio represents a company's liquid assets (cash, current receivables, short-term investments, etc.) divided by its current liabilities.

Figure I.1: Current and Quick Ratios for the Natural Gas Industry, 1976-86



The natural gas industry's cash flow (major sources of cash less cash payments for major uses)[2] is shown in figure I.2. As shown, the industry's cash flow improved significantly between 1977 and 1981, but then decreased significantly (with the exception of 1983 and 1985), reaching a negative cash flow of about $0.35 billion in 1986.

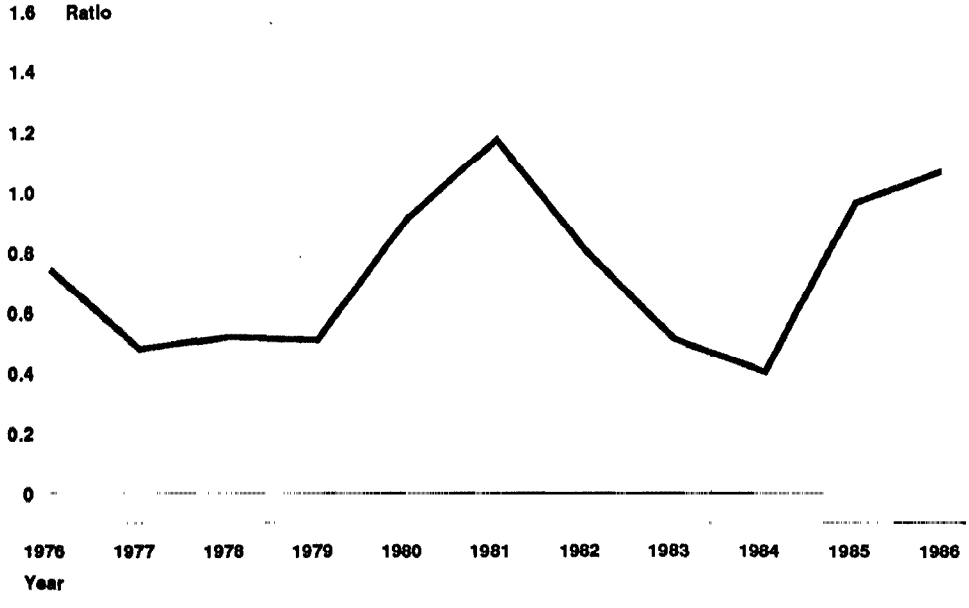
Figure I.2: Cash Flow of the Natural Gas Industry, 1976-86



[2]Major sources of cash include cash from operations, long-term borrowing, increases in short-term debt, and stock sales. Major uses of cash include construction, retirement of long-term debt, decreases in short-term debt, and dividends.

The trend in the natural gas industry's net cash from operations relative to cash obtained through borrowing and stock sales is shown in figure I.3. In 1976, the ratio of external sources of cash to internal sources was 0.74. It declined during the 1977-79 period, then increased to 1.17 in 1981, the highest point during the 11-year period. This ratio then fell to its lowest level (0.40) in 1984, but then increased to 1.07 in 1986. As shown by this trend, cash from internal sources contributed more than half, except in the years 1981 and 1986, of the gas industry's total cash available.

Figure I.3: External to Internal Cash for the Natural Gas Industry, 1976-86



Taken together, these cash availability measures indicate that between 1976 and 1984, the natural gas industry's cash situation varied but was generally favorable. However, since 1984, and particularly in 1986, the industry's level of cash availability had declined. By 1986, the industry overall was less able than in previous years to meet its short-term obligations, experienced a negative cash flow, and needed to obtain more than half of its total cash needs from external sources, primarily from long-term debt.

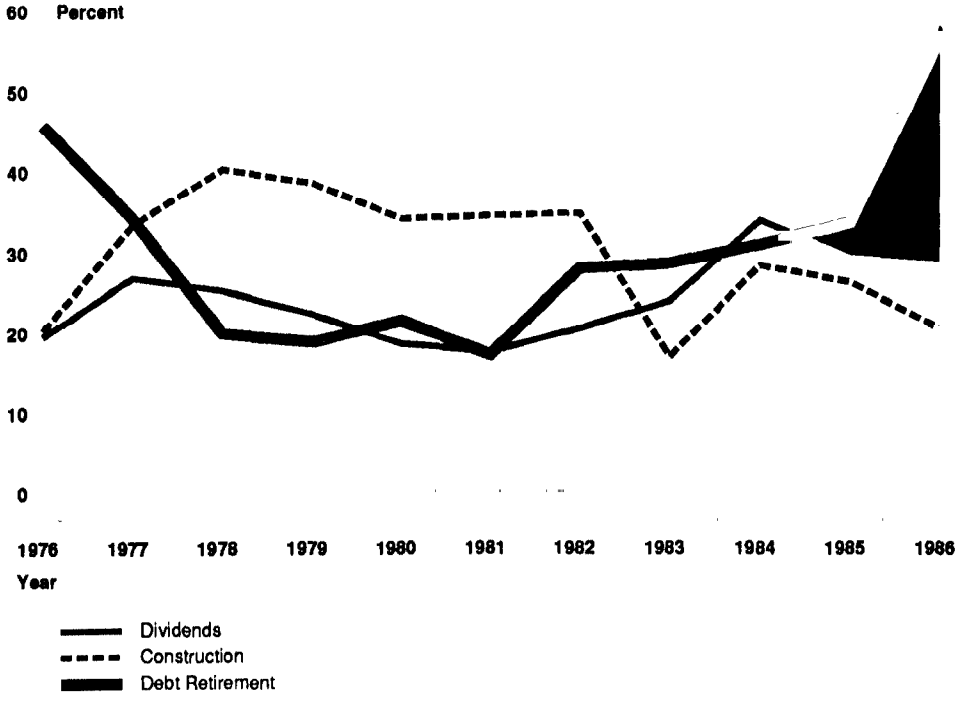
Use of Cash in the Natural Gas Industry

To supplement our examination of cash availability, we also examined selected financial data that would indicate whether and how the natural gas industry's use of available cash from major sources had changed during the 1976-86 period.

Specific data we examined included expenditures for construction, long- and short-term debt retirement, and dividends. According to the industry's aggregate statements on the sources and uses of funds, these four uses of cash represented between 69 percent and 105 percent of total cash from major sources during the period.

Figure I.4 shows trends in the natural gas industry's use of cash as a percent of major cash sources between 1976 and 1986.

Figure I.4: Uses of Cash by the Natural Gas Industry, 1976-86



As shown in figure I.4, in 1976 cash used by the industry for construction represented about 20 percent of total available cash from major sources. This percentage increased to about 40 percent in 1978 and then gradually decreased to about 20 percent by 1986.

With respect to the retirement of long-term debt and decreases in short-term debt, in 1976 over 45 percent of cash was used to retire such debt. Between 1976 and 1981, this percentage declined to 17 percent, then increased to 56 percent in 1986.

During the period, the industry used between 17 percent and 34 percent of its cash from major sources to pay dividends. For the last 3 years, these percentages were the highest for the period.

These trends in the natural gas industry's major uses of cash show that for the years 1978-82, most of the industry's cash was devoted to construction, but these expenditures have decreased in recent years. The percentage of cash used to retire debt more than tripled between 1981 and 1986, and the percentages of cash used to pay dividends were at their highest level for the 1984-86 period.

Cash Availability for Selected Gas Utilities

We also performed a limited review of 1985 and 1986 financial data for selected natural gas utilities to compute their cash flow positions. Our review was performed to determine whether aggregated industry cash flow trends generally reflected the cash flow position of individual utilities within the industry. Financial data we reviewed were from the five utilities that had an excess deferred tax amount of $75 million or greater. We used this selection criteria because of the overall interest in evaluating whether utilities' cash position would facilitate the return of excess deferred taxes to ratepayers in a time period shorter than that provided for in the Tax Reform Act of 1986. Table I.1 shows the results of that analysis.

Table I.1: Selected Financial Data for Five Natural Gas Utilities

Dollars in millions

Company	Amount of excess deferred taxes	Cash flow position, 1985	Cash flow position, 1986
A	$121.1	$40.3	$(142.2)
B	92.5	(235.1)	296.8
C	82.2	(260.0)	(1,118.6)
D	86.1	39.5	(209.4)
E	128.2	417.8	302.5
Industry	$1,283.3	$890.5	$(350.7)

Source: GAO analysis based on information compiled by the National Association of Regulatory Utility Commissioners, the Energy Information Administration, and the Federal Energy Regulatory Commission.

As the table shows, the cash situations of individual utilities, using the measure we applied, varied widely relative to one another. In addition, the cash flow position for individual utilities generally changed significantly from 1985 to 1986. In comparison, the aggregate industry data reflect a positive cash flow level of $890.5 million in 1985, decreasing to a negative cash flow of about $350.7 million in 1986. The data from four of the five utilities we examined also showed a decrease in their cash flow between 1985 and 1986.

Cash Position of the Telephone Industry

All major telecommunication common carriers (i.e. telephone and telegraph companies) that operate in the United States provide financial and operating information annually to the Federal Communications Commission (FCC). The FCC compiles and consolidates these financial data for its annual publication, Statistics of Communications Common Carriers. Aggregated industry data for 1986 were the most recent data readily available. Figures II.1 through II.5 are based on the data FCC compiled for the balance sheet statistics and for the income and retained earnings statements.

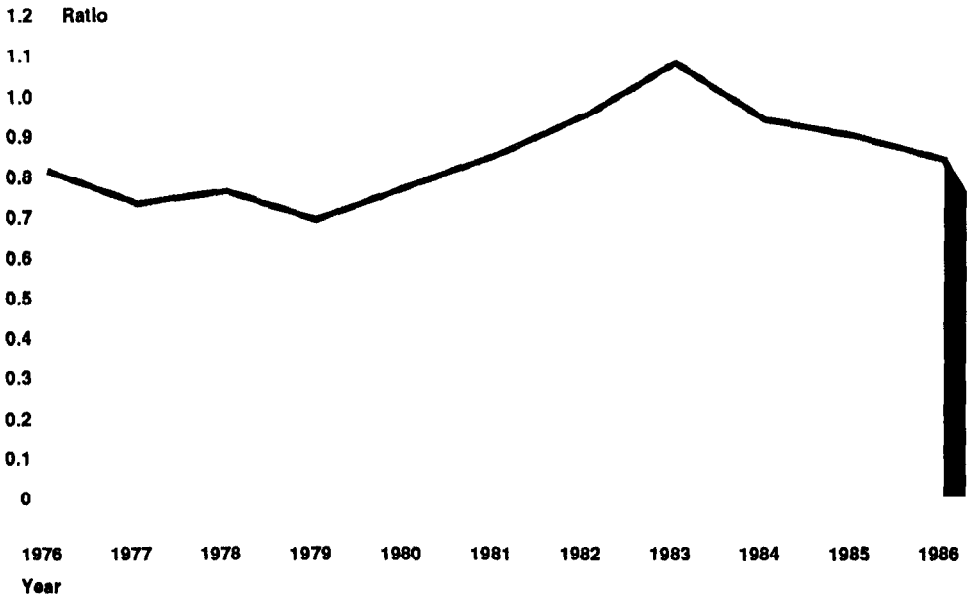
Cash Availability in the Telephone Industry

To measure trends in the telephone utility industry's cash availability, we examined aggregate industry year-end financial data for the 1976-86 period. More specifically, we computed (1) the industry's current ratio for each year and (2) a measure of the industry's cash flow based on its funds from operations. We also analyzed the changes in the composition of the equity and liabilities accounts in the balance sheet.

We computed the current ratios because this measure has often been used to examine changes in financial position. Since the current ratios were less than 1.0 for all but one year in the period, indicating that the industry's current assets were insufficient to meet its current liabilities, we did not compute the quick ratios. We computed a cash flow measure to determine the extent to which the industry's funds from operations were able to support construction outlays and the payment of dividends, the two major uses of cash. We analyzed the changes in equity and liability accounts to assess the extent to which the industry relied on the sale of stock or long-term debt for its external source of funds.

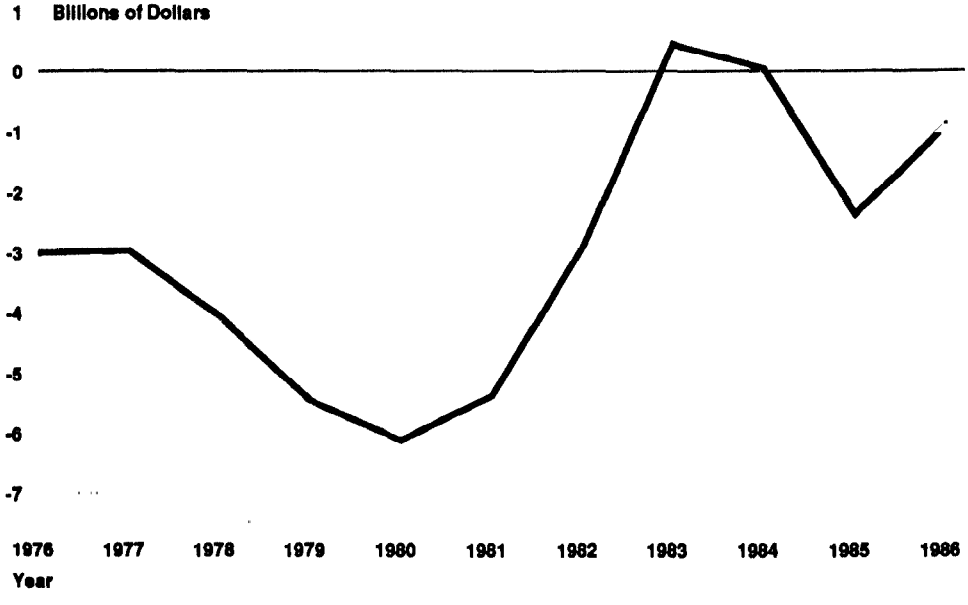
The telephone industry's current ratios for the 1976-86 period are shown in figure II.1. In 1976, the industry's current ratio was 0.81; it declined to 0.69 in 1979, then increased to 1.08 in 1983, but then declined to 0.84 in 1986. This overall trend indicates that since 1976 the industry's current assets were not at a level sufficient to cover its current liabilities in any single year, except for 1983.

Figure II.1: Current Ratios for the Telephone Industry, 1976-86



The FCC statistical data did not include statements of sources and uses of funds. Consequently, we could not compute cash flows for the telephone industry in the same manner as we did for the natural gas industry. For the major sources of funds, we were able to approximate the amount of funds from internal sources on the basis of income statements, i.e., the sum of the net income, the depreciation expense, and the deferred federal income taxes. As for the major uses of funds, we were able to obtain the annual amounts used for construction and the amounts used to pay dividends. Our computation of the telephone industry's cash flow from its internally generated funds is shown in figure II.2.

Figure II.2: Cash Flow of the Telephone Industry, 1976-86



As shown in figure II.2, the industry was able to fund its construction budget and pay dividends from internally generated funds in 2 years (1983-84) of the 11-year period. In the remaining 9 years, the industry would have had to seek funds from outside sources (for example, either through stock sales or long-term borrowing). Since we could not readily determine the extent to which the industry relied on each of these sources from the FCC data, we compared the amount and percent of change in these balance sheet accounts between 1976 and 1986. This comparison is shown in table II.1.

Table II.1: Comparison of the Telephone Industry's Equity and Liabilities Accounts Between 1976 and 1986

Dollars in billions

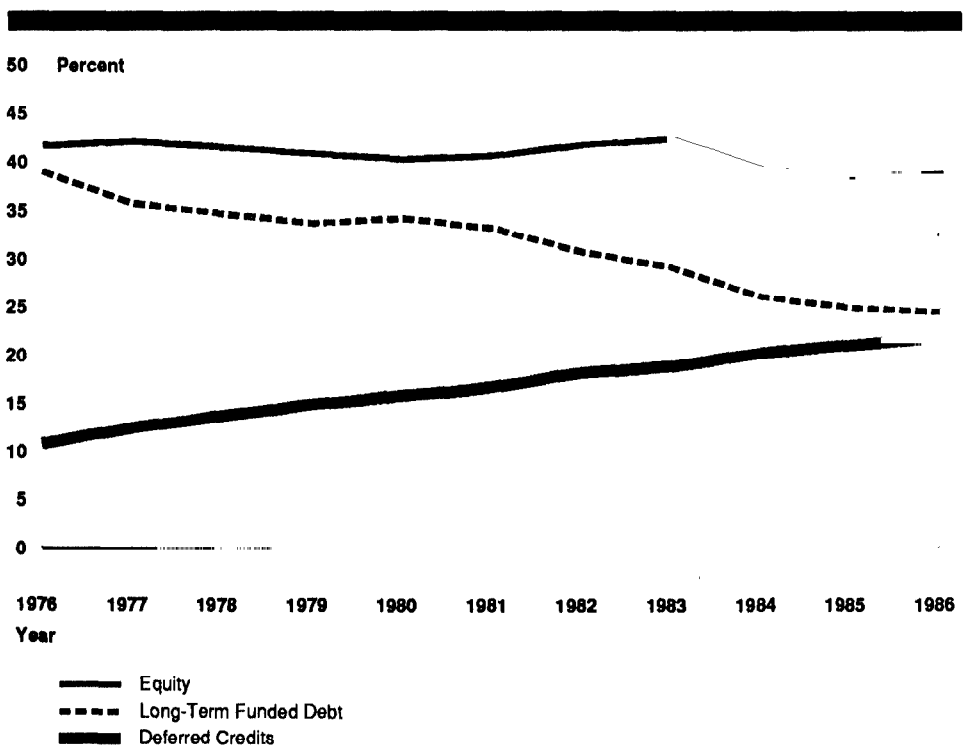
Balance sheet item	1976	1986	Percent change
Capital stock and surplus	$38.683	$66.947	73.07
Long-term debt	36.247	45.426	25.32
Current liabilities	8.303	23.358	181.31
Deferred credits	9.943	37.637	278.53
Total	**$93.176**	**$173.368**	**86.06**

Source: Federal Communications Commission data for the years indicated. Percentages were calculated by GAO.

Table II.1 shows that while the industry aggregate for its balance sheet total increased by 86 percent, its equity (capital stock and surplus) increased by 73 percent, and its long-term debt increased by only 25 percent. The largest increase was in deferred credits, which increased by 278 percent.

We developed the trends in the percentage of the total balance sheet represented by the equity and major liabilities accounts for each year of the 11-year period as shown in figure II.3. While the equity percentage remained fairly level, the funded portion of the long-term debt decreased from about 38 percent to about 24 percent, whereas the deferred credits doubled from about 10 percent to over 21 percent. These changes indicate that the industry relied more on the sale of capital stock for its outside source of funds than on borrowing on a long-term basis. Furthermore, it appears that the industry has substituted cash generated internally from deferred credits for cash generated externally from long-term borrowing.

Figure II.3: Equity, Long-Term Funded Debt, and Deferred Credits as Percentage of Total Balance Sheet for the Telephone Industry, 1976-86



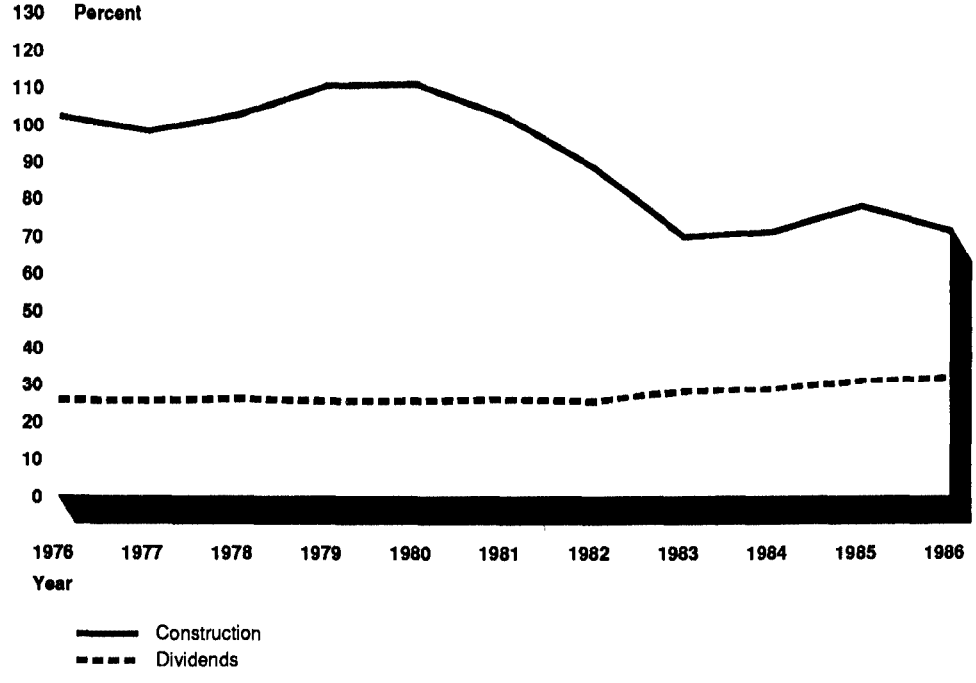
Taken together, these cash availability measures indicate that between 1976 and 1979, the telephone industry's cash situation with respect to its internally generated funds had declined but improved significantly in the 1979-83 period. In 1983, the industry's current ratio reached 1.08, indicating that for the first time during the period, it could meet short-term obligations. Also, in 1981, the industry's cash flow was positive, indicating that it could both fund its construction budget and pay dividends from internal sources. Between 1983 and 1986, the industry's cash position declined somewhat, with the current ratio dropping to 0.84, and its cash flow dropping to a negative position.

Use of Cash in the Telephone Industry

To supplement our examination of cash availability, we also examined selected financial data that would indicate whether and how the telephone industry's use of available cash from internally generated sources had changed during the 1976-86 period.

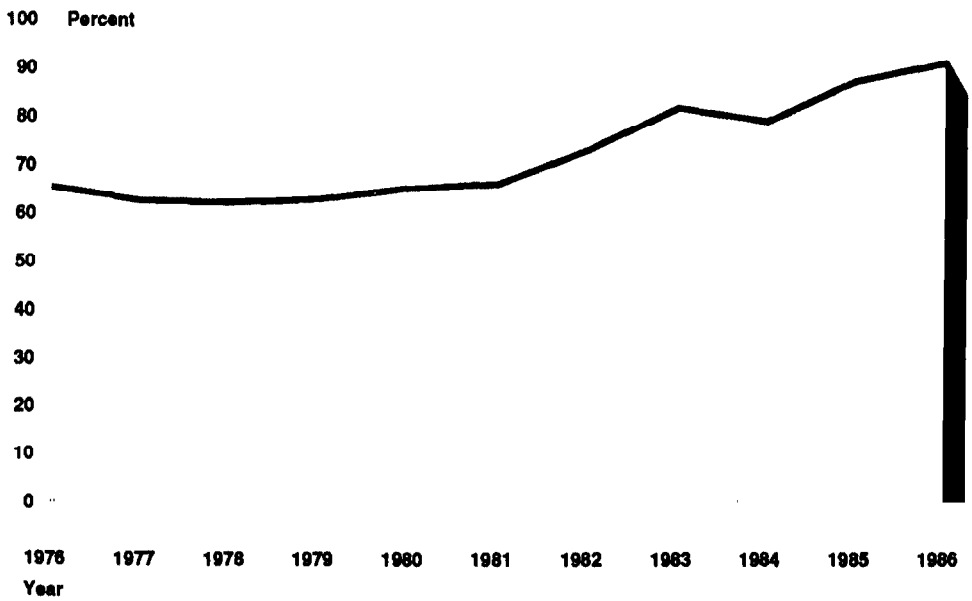
Figure II.4 shows the extent to which the industry's internally generated funds were sufficient to cover the construction costs and pay dividends. These funds were generally insufficient to cover the construction costs for the 1976-81 period but were more than sufficient to cover these costs for the 1982-86 period. Since 1981, the industry's construction budgets have grown only modestly, increasing from $19.5 billion in 1981 to $21.4 billion in 1986; but the internal funds have grown rapidly, increasing from $19.0 billion in 1981 to $29.9 billion in 1986. On the other hand, the percent of the internally generated funds used to pay dividends remained fairly constant at around 25 percent through 1982, but since then it has steadily increased to over 31 percent.

Figure II.4: Uses of Internally Generated Cash by the Telephone Industry, 1976-86



The trends in the telephone industry's percentage of net income paid out in dividends is shown in figure II.5. Between 1976 and 1981, the percentage was between 60 and 65 percent, but it increased significantly through 1986, reaching more than 90 percent.

Figure II.5: Percent of Net Income Paid in Dividends by the Telephone Industry, 1976-86



These trends indicate that the telephone industry is generating more funds internally and is using a larger share of these funds to pay dividends.

Cash Availability for Selected Telephone Utilities

We also performed a limited review of 1985 and 1986 financial data for selected telephone utilities to compute their cash flow positions relative to the industry as a whole. Our review was performed to determine whether aggregated industry cash flow trends generally reflected the cash flow position of individual utilities within the industry. Financial data we reviewed were from the five utilities that had an excess deferred tax amount of $500 million or greater. We used this selection criteria because of the overall interest in evaluating whether individual utilities' cash position would facilitate the return of excess deferred taxes to ratepayers in a time period shorter than that provided for in the Tax Reform Act of 1986.

Table II.2 shows the results of that analysis. It should be noted that the quantitative dollar amounts for the individual utilities are not directly equivalent to the industry aggregate data because the FCC data base did

not include specific construction cost data for each company. In order to obtain an amount for this item, we considered that the net change in the gross book cost of the communications plant from the previous year would be a good approximation of the company's construction expenditures. However, this approximation overstates the cash flow position for these companies somewhat. The net change in the gross book value consists of the amount of "new communications plant added" minus the amount of "communications plant retired."

Table II.2: Selected Financial Data for Five Telephone Utilities

Dollars in millions

Company	Amount of excess deferred taxes	Cash flow position, 1985	Cash flow position, 1986
A	$768.3	$516.8	$(345.8)
B	816.1	289.5	1,123.5
C	779.9	93.8	408.1
D	587.2	356.4	870.8
E	556.9	344.9	510.2
Industry	$7,726.6	$(2,356.6)	$(911.9)

Source: GAO analysis based on information compiled by the National Association of Regulatory Utility Commissioners and the Federal Communications Commission.

As the table shows, the cash positions in 1985 of individual utilities, using the measure we applied, were positive, although the industry in the aggregate experienced a negative cash flow of about $2.4 billion. The data from four of the five utilities we examined showed significant increases in the cash flow between 1985 and 1986, a change also experienced by the industry in aggregate.

Major Contributors to This Report

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