Southwestern Bell Telephone

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MISSOURI
PUBLIC SERVICE COMMISSION

September 10, 1993

**Alfred G. Richter, Jr.**
Vice President and
General Counsel
(Missouri)

Mr. David L. Rauch
Executive Secretary
Missouri Public Service Commission
301 West High Street, Floor 5A
Jefferson City, Missouri 65101

Re: Case No. TC-93-224, et al.

OFFICIAL CASE FILE

Dear Mr. Rauch:

Enclosed for filing with the Commission in the above-referenced case is an original and 14 copies of the Initial Brief of Southwestern Bell Telephone Company.

Please stamp "Filed" on the extra copy and return the copy to me in the enclosed self-addressed, stamped envelope.

Thank you for bringing this matter to the attention of the Commission.

Very truly yours,

Alfred G. Richter, Jr.

Enclosures

cc: Parties of record

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**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

| | |
|---|---|
| The Staff of the Missouri Public Service Commission, Complainant, v. Southwestern Bell Telephone Company, a Missouri corporation, Respondent. | Case No. TC-93-224 |
| In the matter of proposals to establish an alternate regulation plan for Southwestern Bell Telephone Company. | Case No. TO-93-192 |

OFFICIAL CASE FILE

**INITIAL BRIEF OF**
**SOUTHWESTERN BELL TELEPHONE COMPANY**

FILED

SEP 10 1993

MISSOURI
PUBLIC SERVICE COMMISSION

ALFRED G. RICHTER, JR.
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JOSEPH F. JEDLICKA, III
KATHERINE C. SWALLER

365.

September 10, 1993

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**(THIS ORDER FOLLOWS THE HEARING MEMO)**

## I. INTRODUCTION

With the adoption of Southwestern Bell Telephone Company's (SWB or Company) current incentive regulation plan, the Missouri Public Service Commission (Commission) initiated a regulatory policy appropriately focused on the changes and challenges presently facing the telecommunications industry and its customers. This case now places the Commission at a critical juncture. It can build on and continue the progress made as a result of the existing plan, or it can terminate incentive regulation in Missouri and retreat to a traditional regulatory environment. SWB believes the latter course would be a step backwards not only for the Company, but for its customers and the State of Missouri.

In evaluating proposals submitted in this case, the Commission should be guided by the success associated with incentive regulation over the last four years. SWB's rates have been reduced or remained stable; service has been good; investment in Missouri's infrastructure has been accelerated and substantial, even in the more rural areas of the state; customers have shared in a portion of the Company's earnings; and SWB has earned a fair return on its investment. Ex.48,p.5 The purpose of the plan and of incentive regulation is to give the Company the opportunity to grow its earnings and to encourage the Company to invest in the State while insuring basic service customers continue to receive quality service at reasonable prices. T.907-08 The plan did just what it was supposed to do. SWB has benefitted, customers have benefitted, and the State of Missouri has benefitted.

SWB's TeleFuture 2 (TF2) proposal would continue to build on this success. SWB has offered a plan that will ensure continued substantial incremental infrastructure development in Missouri (including for roughly half of the rural customers in the State that are served by SWB), lower or stable prices for services, the ongoing opportunity for customers to share a portion of SWB's earnings, and an ongoing opportunity for the Company to earn a fair return on its investment. T.778 TF2 offers a balance that has proven successful for both SWB and its customers for the past four years. Ex.50,p.4-5 As noted by G. Mitchell Wilk, former president of the California Public Utility Commission, the plan would allow the Commission to put its focus where it needs to be, on the price and quality of basic service. Ex.56,p.35

SWB's TF2 proposal is detailed in part III of this Brief. If the Commission chooses to continue with incentive regulation, SWB's proposal is the only viable choice. In fact, SWB's proposal is the only valid incentive regulation plan submitted to the Commission in this case. Although the Staff of the Missouri Public Service Commission (Staff) and the Office of the Public Counsel (OPC) contend that they are not opposed to an alternative regulatory plan for SWB (Ex.1,p.52,63), their proposals actually constitute a complete return to traditional regulation. Ex.57,p.11,15 In fact, if the Commission adopts Staff's or OPC's recommendations and penalizes SWB for its success in growing earnings without rate increases under the plan, "incentive" regulation would end up being far worse in its impact than traditional regulation. Ex.49,p.11 If under incentive regulation SWB's rates are going to be significantly reduced every 3 years, thus eliminating any real incentive to invest, increase earnings and reduce expenses during the plan, the Company would be better off under traditional regulation in which it is not required to share earnings and actually receives less regulatory oversight between proceedings.

There are really only two choices in this case: continue with incentive regulation or return to traditional regulation. Any attempts to craft a compromise between the two would simply not work. The current plan has been a success because of benefits realized by both the Company and its customers. Adopting rate reductions greater than those offered in SWB's TF2 proposal would send the message that the incentives under the plan are illusory. It would be evident that there is no financial advantage to becoming more efficient; there is no positive recognition for modernization; and no long term opportunity to become more profitable by growing revenues without increasing rates. The Commission is urged, therefore, to consider the many positive objectives that can be achieved under an extension of the incentive plan as proposed by SWB and to adopt the Company's TF2 proposal.

## II. REVENUE REQUIREMENT

As an initial matter, it is SWB's position that Staff lacked authority to file the Complaint which initiated Case No. TC-93-224, and that the only case properly before the Commission is Case No. TO-93-192, SWB's proposal for extending the current incentive regulation plan. Staff has acknowledged that it did not seek or receive any authority from the Commission to file the Complaint, even though Staff has sought such authority in other cases. Ex.99-

101;T.1289-91 The Complaint was thus not brought by the Commission on its own motion, nor has OPC or any other authorized party or parties filed a complaint. Staff is not authorized under §386.390 RSMo to file a complaint on its own behalf. The Commission itself, in recent complaint proceedings brought by AT&T against various local exchange companies (LECs), has ruled that the authority to file a complaint is limited to those entities listed in the statute.[1] Likewise, Rule 4 CSR 240-2.070 requires specific prior Commission authority for a Staff complaint regarding the reasonableness of rates, as opposed to other types of formal complaints which the rule does authorize Staff to bring without prior Commission approval.

Given that the Staff's Complaint was not authorized by law, it does not provide the Commission with jurisdiction to render a decision in Case No. TC-93-224. Therefore, the Commission should dismiss the Staff's Complaint and proceed to consider the merits of SWB's proposal to extend the current incentive regulation plan.

**1. TEST PERIOD ISSUES, ERRORS & ISOLATED ADJUSTMENTS**

Staff chose to use the "test year...1991, updated for known and measurable changes through September 30, 1992" for its Complaint case. Ex.2,p.2 In compliance with the Commission's Order concerning test year and to facilitate reconciliation with Staff's case, the Company agreed to this test period and prepared its rebuttal case on that basis beginning with 1991, updated to September 1992. Ex.7,p.5-6

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[1]<u>See</u>, <u>e.g.</u>, March 24, 1993 <u>Order Granting Motion to Dismiss</u> in Case No. TC-93-60,p.6-8.

As SWB witness Thompson explained, it is imperative to have the test year as close as possible to the rate year to be sure that future rates recover appropriate costs. Ex.5,p.7 Cost of service should be for a twelve-month period consistent with the rate base, investment, and capital structure that form the foundation for the test period. Ex.5,p.8,10 Staff indicated September 30, 1992 represented the last practical date through which the Staff could examine all relevant items necessary to maintain the rate base/revenue/expense relationship. Ex.2,p.3

Staff witness Meyer makes the point in his testimony that in order to determine a revenue requirement it is necessary to maintain an appropriate rate base/revenue/expense relationship. Ex.2,p.2-3;T.159-60,483 While Staff witnesses paid "lip service" to Mr. Meyer's "relationship" concept, it is clear that the various Staff witnesses never reconciled their adjustments to assure such an appropriate "relationship" existed in Staff's test year.

As testified by Mr. Meyer, Staff's case relied upon a mixture of test period dates. T.150,155,163-66 Therefore, the proper relationship among the revenue requirement items was not maintained and SWB's ability to earn its authorized return will be jeopardized. T.199-201

Staff indicated it updated all the telephone plant account balances to September 1992, principally to recognize the new St. Louis Data Center. T.152 All significant components of rate base including telephone plant in service accounts and the related depreciation reserve accounts were updated to September 1992. T.154-55 The "update" was nothing more than a comparison of end-of-period December 1991 account balances with end-of-period September 1992 balances. Staff also adjusted revenue accounts to a September 1992 level, to capture the growth in revenue during the period between December 1991 and September 1992. T.164,480-82,497-99 Staff also testified that wage and salary expense accounts were adjusted to a September 1992 level, to include the effect of the March 1992 management salary change, the August 1992 nonmanagement change and the reduced number of employees resulting from employee reduction plans. T.165

Although Staff used September 1992 data for most of rate base, revenues, salary and wage expense, and depreciation expense, in a few, but material and significant areas, such as nonwage expense, income tax adjustments and Southwestern Bell Yellow Pages (Yellow Pages or SWBYP) imputation, Staff failed to properly update revenue and expense accounts. Ex.7,p.12 Staff selectively adjusted virtually all rate base accounts to September 1992 balances, 95% of the revenues, 99% of depreciation and amortization expense, approximately 90% of the wage and salary expense, but only about 20% of the nonwage expenses. T.186-87 The difference between Staff and SWB revenue requirements related to test period is approximately $9M.[2] Ex.244

The most monetarily significant test period difference occurs in the nonwage expense category, which includes access expense, billing and collection expense, right-to-use fees, affiliated

[2]Reconciliation (in Thousands): Salaries & Wages - TEAM, $607; Salaries & Wages - Other, $32; Income Taxes - Pre-1981, Cost of Removal/Salvage, $1,372; Nonwage, $4,293; Access and Billing & Collection, $1,518; Deregulated Services, $1,274.

transactions, and other nonwage items. SWB witness Bauer discusses significant IRS implications with Staff's tax proposals. These are equally as significant. Ex.244 The amount of nonwage expense included in Staff's final revenue requirement calculation fails to reflect the annualized level as of September 30, 1992. T.656 In fact, it does not even represent the amount for the twelve months ended September 1992. Ex.43,p.55 In addition to nonwage, Staff brought all income tax adjustments to a 1992 level except the Cost of Removal and Salvage adjustment, which was inappropriately left at a 1991 level. Ex.37,p.82-83 As another example, even though Staff spent an exorbitant amount of time reviewing the current records of Yellow Pages, it rejected the use of test period results and instead utilized what will be nine-year-old 1985 data. Ex.49,p.27

Staff's haphazard combination of test period data negated the proper rate base/revenue/expense relationship Mr. Meyer was so adamant about maintaining. Staff identified rate base, capital structure, and return as of September 1992, but then did not bring all the other elements of revenue requirement to that same period. T.191 This relationship is important because telecommunications is a capital intensive industry and capital (or rate base) is the driver for revenues and expenses. Revenues are generated and expenses are incurred in the provision of services to customers based upon the plant and equipment in service. T.198-99 It is critical that a test year be used which reflects all components of revenue requirement on a consistent basis; operating income, revenues and expenses should be matched to the level of the September 1992 rate base and capital structure used. Ex.5,p.6

The Company's presentation of revenue requirement included normalization and annualization adjustments necessary to state all revenue categories including local, toll, access, other and uncollectible revenue, as well as wages and salaries, depreciation, access expense and other nonwage expenses as of September 30, 1992. The Company presentation also utilizes pro forma adjustments to establish a revenue requirement representative of ongoing operating conditions. Ex.7,p.20 The Company prepared an analysis of the trend in the relationship of investment/revenue/and expense over a period of years and compared the Company's case to this analysis. The Company's case is consistent with the trend in the relationship for the historical period, the current year, and into the future; the Staff's case is not. T.199-200 Staff's case overstates revenues compared to investment and understates expenses compared to investment, consequently overstating its proposed rate reduction and thus precluding SWB from earning its authorized return. T.201

**2. SENATE BILL 380, STATE TAX INCREASE**

Senate Bill 380 (SB380) became law in May 1993. It increases the Missouri State income tax rate and increases property taxes for SWB. Ex.8,p.2 SWB proposes that this post test year change be recognized in the cost of service. Staff opposes this addition because (1) it is beyond the test year, and (2) the property tax increase is not known and measurable.[3] T.204

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[3]Staff witness Schallenberg agrees the income tax change is known and measurable; the amount is only dependent upon the revenue requirement found in this case. T.204

Post test year changes are included when known and measurable. The degree of confidence in the measurability is "reasonable certainty." Ex.5,p.12 In the case of SB380, the change is certain -- it will occur during the rate year. The measurability is reasonably certain, and Staff has not contested the income tax increase.

SWB witness Toti presented the valuation of both changes. The proposal for property tax is logically consistent with the purpose of SB380 and easily calculated by Mr. Toti.[4] The property tax change requires <u>all</u> school districts to increase their tax levies to $2.75 to qualify for any additional state aid; absent the increase, school districts will be forced to operate on state aid funding levels from prior years. It is conservatively reasonable to assume that those school districts will increase their levies to qualify as Mr. Toti concluded. T.210 It is unreasonable to exclude it entirely.

## 3. RATE OF RETURN

### A. COST OF EQUITY

#### (i) OVERVIEW

In its testimony filed on February 1, 1993, Staff recommended a return on equity (ROE) for SWB in the range of 10.11% to 11.21%. This contrasts with Staff's higher recommended ranges of 10.7% to 12% for Orchard Farm Telephone Company (filed February, 1993 in Case No. TR-93-153), 10.96% to 11.55% for Citizens (filed June,

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[4]The proposal is conservative and will likely be higher than Mr. Toti has proposed since it does not include local assessments and is based upon 1992 assessments, rather than the higher 1994 assessments that SWB expects. Ex.8,p.5

1993 in Case No. TR-93-268) and 11.7% to 12.3% for United (filed in July, 1993 in Case No. TR-93-181), even though the latter three companies all face less competitive risk in their Missouri markets than SWB. T.277-78,397 Staff witness Moore, while acknowledging that a good deal of judgment rather than precision is involved in setting a return range, noted that Staff's return recommendation constitutes the largest single issue in the case, in excess of $53M. T.278;Ex.244,p.1

In re: Southwestern Bell Telephone Company, 29 Mo.P.S.C. (N.S.) 607 (1989) (herein Case No. TC-89-14), the Commission found SWB's ROE requirement to be 12.61%. But, in the agreement reached among the Commission, SWB and OPC, and ultimately approved by the Commission in Case No. TO-90-1, SWB was permitted under the current incentive regulation plan to earn up to 14.1% ROE before sharing earnings between 14.1% and a cap of 17.25% ROE. SWB has offered the testimony of Dr. William Avera in this case to support its position that SWB's current required ROE has not dropped below 12.61%, and is likely in excess of that amount. Dr. Avera estimated SWB's required ROE to be in the range of 12.77% to 13.77% under a properly conducted discounted cash flow (DCF) analysis, and in the range of 11.91% to 14.98% utilizing several forms of risk premium analyses. Ex.18,p.6,36,66-67

In contrast to both Staff and SWB, OPC has recommended a 10.5% ROE using a hypothetical capital structure of 50% equity, or 10.0% ROE using SBC's capital structure. Ex.16,p.3,62

If it elects to continue with incentive regulation, SWB has proposed that the Commission either continue to use the current sharing grid with its initial sharing point of 14.1% ROE, or that the initial sharing point be lowered to 10.7% ROE without using Yellow Pages earnings in calculating SWB's earnings under the plan. The 340 basis point difference between 14.1% and 10.7% represents the frozen level of adjusted 1985 Yellow Pages earnings included in the current plan and in existing rates. Ex.1,p.57-58 The resulting sharing point would be within Staff's proposed ROE range.

To the extent the Commission determines that the Company's ROE requirement is now below the 12.61% it found appropriate in Case No. TC-89-14, the Company's proposal to reduce rates by $22M in its TF2 plan adequately accounts for the approximately 140 basis point reduction suggested by the high end of Staff's recommended range (11.21%). One hundred basis points of return on equity equates to approximately $12M in revenue requirement in this case. T.406

If the Commission elects to end incentive regulation and return to traditional regulation, the record reflects ROE requirements ranging as low as 10% to as high as 14.98%. The Commission has a good deal of discretion in arriving at a number or a range within those numbers.[5] It will have to arrive at such a number or range by evaluating what it wants to accomplish in this case in terms of policy and future regulatory direction.

In his testimony, Mr. Moore cited a United States Supreme Court case in which it was held that regulatory bodies are not

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[5]<u>See</u> <u>State ex rel. Missouri Water Company v. Public Service Commission</u>, 308 S.W.2d 704 (Mo. 1957) at 718-19; <u>State ex rel. Missouri Public Service Commission v. Pierce</u>, 604 S.W.2d 623 (Mo. App. 1980) at 625-26; <u>State ex rel. Associated National Gas Company v. Public Service Commission</u>, 706 S.W.2d 870 (Mo. App. 1985) at 880; and <u>State ex rel. U.S. Water/Lexington v. Public Service Commission</u>, 795 S.W.2d 593 (Mo. App. 1980) at 597.

bound to any single formula or set of formulas in arriving at a reasonable return. See Federal Power Commission v. Natural Gas Pipeline of America, 315 U.S. 575 (1942) at 586. Mr. Moore agreed that the Commission has a good deal of discretion in arriving at its return finding in a case. T.316-17 While it is not completely clear if Mr. Moore in all cases equates a fair rate of return to the investor with a specific cost of capital, Staff witness Dr. Johnson and SWB witness Dr. Avera were both of the opinion that such a fair return may, for certain reasons, exceed the specific cost of capital. Ex.18,p.13,26-28;T.243,286-88,299-302

There is no legal requirement that the Commission establish a specific cost of capital figure in this case.[6] Both Staff and SWB have presented range of return analyses in this case. The Commission is not precluded from approving a range of return and permitting SWB to earn within such a range. The Commission has the discretion, if it decides to continue with alternative regulation, to establish a broad range of return in response to SWB's willingness to make discretionary investments, freeze rates and share a portion of its earnings within that range.[7] Likewise, if it elects to return to traditional regulation, the Commission may

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[6]In fact, in its recent Order in the Orchard Farm case, Case TR-93-153, the Commission approved an increase in revenue without establishing any ROE for the company. T.279-80 Furthermore, Mr. Moore acknowledged that most of the state's LECs operate under a form of price or forbearance regulation under which if they do not seek a rate increase, neither the Staff nor the Commission is likely to monitor their achieved ROE. T.280

[7]Sharing of revenues produced by approved rates would be precluded by the prohibition against retroactive ratemaking in the absence of SWB's agreement. Likewise, absent SWB's agreement, the Commission would have no authority to order SWB to make discretionary investment or freeze rates.

specify a fair return that exceeds the lowest reasonable cost of capital in order to encourage capital investment in the State or reward management efficiencies, as well as meet investor requirements as to a fair return on their investment.

The evidence presented in this case supports the extension of the current plan and a continuation of sharing at 14.1% ROE, or a reduction of the initial sharing point to 10.7% ROE if Yellow Pages earnings are not used in calculating SWB's earnings under the plan. In all other respects, it would be reasonable to continue with the current plan, which provides that SWB's earnings be adjusted utilizing the adjustments ordered by the Commission in Case No. TC-89-14. The Commission is not precluded from rejecting Staff's Complaint and adopting such a course in this case.

Even if the Commission elects to return to traditional regulation, it should adopt a return range higher than that recommended by Staff in order to encourage ongoing investment in SWB's Missouri network and to encourage Company management to continue with the efficiency and cost cutting efforts achieved under the current plan.[8]

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[8]The recent flooding, which Mr. Robertson estimated would impact SWB revenues and expenses by as much as $40 million (T.2087), and the significant federal tax increase just passed by Congress, neither of which are included in Staff's case or return analysis, are additional reasons for the Commission to adopt a higher range of return than recommended by Staff and to set rates on the basis of the high end of any range it adopts. The Omnibus Budget Reconciliation Act of 1993 increases the Federal corporate tax rate from 34% to 35% retroactive to January 1, 1993,and will increase SWB's annual intrastate Missouri revenue requirement in excess of $4M.

Four witnesses provided testimony on cost of equity: Dr. Avera on behalf of SWB, Mr. Moore and Dr. Johnson on behalf of Staff, and Mr. Hill on behalf of OPC.

(ii) DR. AVERA

Dr. Avera testified that leaving the 14.1% ROE intact, both from the perspective of determining the reasonableness of current rates and as an ongoing threshold for sharing under an extended incentive regulation plan, is consistent both with the goals of incentive regulation and current capital market conditions. Ex. 59,p.4 Although short term interest rates have declined significantly since the current plan was implemented, the decline in long term interest rates has not been as great. Id.,p.5 Furthermore, current capital market conditions continue to be distorted by government efforts to stimulate the economy. Ex.59,p.5 Additionally, the risk faced by SWB in its markets has continued to increase since the current plan was implemented, offsetting in part any general drop in investor required equity returns. Ex.59,p.5;Ex.65,66, 67

Long term interest rates (30 year treasury bonds) were yielding 7.89% in December of 1989, 7.43% in December of 1992, and 6.8% in June, 1993. Ex.59,p.20;Ex.14,p.8 During the course of the current plan, such rates have gone up as well as down. Ex.59,p.5;Ex.14,Sch.4;T.313 Value Line projects that long term interest rates will increase to 8.3% over the next three years. Ex.59,p.26 If the Commission decides to continue with incentive regulation, there is likely to be a period of at least 3 years during which SWB would not be able to seek rate increases to compensate for any increase in interest rates or equity costs. Thus, the return requirement established in this case must be flexible enough to allow the plan to work fairly over at least a three-year period. Neither Dr. Johnson nor Mr. Moore considered nor factored in the impact of implementing their return recommendations in the context of an extended incentive plan. T.250,310-315

Although investor required equity returns normally follow long term interest rates, they do not move in lock step and the evidence in this case suggests the risk premium between required returns on equity and long term interest rates widens as interest rates decline. Ex.59,p.21 In fact, Staff witness Dr. Johnson has testified that it would be unrealistic to assume a perfect correlation between bond yield and equity returns, and that fluctuations in the debt-equity spread will tend to cause variations in risk premiums between debt and equity. T.244 Staff witness Moore also appeared to agree that such an inverse relationship generally exists. T.351-52,355 Thus, there is good reason to believe investor return requirements have not declined as much as interest rates, if at all.

SWB faces more risk in its markets now than it did in 1989. Since that time, the Commission has classified several major SWB services as transitionally competitive in Case No. TO-93-116 (Order issued 12-21-92). Mr. Orozco detailed the ongoing growth in the level of competition faced by SWB in its Missouri markets.[9]

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[9]While Dr. Johnson, Mr. Moore and Mr. Hill all stated that they believed SWB was not experiencing sufficient competition to (continued...)

Ex.65,66,67 See Section III.2.A.(vi) infra of this Brief. This increased risk has contributed to declining bond ratings for SWB since 1989. SWB debt has been downgraded to single-A by all three major bond rating agencies,[10] making it the most risky and lowest rated of all the 18 Bell Operating Companies (BOCs), with the sole exception of New York Telephone Company. Ex.59,p.22-23

Under such circumstances, Dr. Avera concluded that it would be appropriate for the Commission to utilize the 14.1% ROE, both as the starting point for sharing under any extended plan and as a benchmark against which to gauge the reasonableness of SWB's current rates. Given the status of current capital markets, the growth of competition, the increase in investor perceived risk of SWB as an investment, and the likelihood that any extended plan will preclude any adjustments to the allowed return over an extended period, any significant reduction to the 14.1% ROE would have a negative impact on SWB's incentives to reduce costs, increase efficiencies, make discretionary investment, and grow earnings without rate increases.

As discussed in the next subsection, Dr. Avera testified that if the DCF presented by Mr. Moore had been properly conducted, it would have yielded an ROE range for SBC of at least 12.77% to 13.77%, not including any adjustment for flotation costs. Because

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[9](...continued) increase its required capital costs, all of them admitted that, unlike Mr. Orozco, they had done no Missouri specific study or analysis to support such views. Even Mr. Moore was generally unaware of Commission dockets, rulemakings and proceedings involving competitive issues. T.230-291,304-308,396

[10]Moody's, Standard & Poor's, and Duff and Phelps.

he believes that the DCF constant growth model does not accurately estimate SBC's cost of equity under present economic conditions, Dr. Avera also utilized several risk premium analyses to estimate a cost of equity for SWB.

In Case No. TC-89-14, the Commission declined to rely on a risk premium analysis. It found that the basic assumption of the risk premium approach is valid, but noted there was no consensus on how to measure risks and that required returns on stock are unobservable. R&O,p.64 But, a good deal of judgment is inherent in all methods of return analysis (T.338), and the Commission did state that it would prefer a SWB specific ROE analysis which did not require the use of a proxy. R&O,p.65 The risk premium analyses presented by Dr. Avera do focus on the specific ROE requirement of SWB. A risk premium analysis estimates the cost of equity directly by adding an equity risk premium to observable bond yields. Although SWB does not issue stock, it does issue bonds. Ex.59,p.22 The equity risk premium is the additional return that investors require to forego the safety of a bond and risk investing in a stock. Ex.18,p.40 The risk premium is added to the current yield on bonds to arrive at the cost of equity.

Dr. Avera used three different risk premium methodologies to present seven different risk premium analyses which focused on the cost of equity of SWB itself, as opposed to Southwestern Bell Corporation (SBC). Dr. Avera utilized as his starting point the leading studies of equity risk premiums for utilities in the academic and trade literature. The studies employed alternative methodologies, covered various time frames and different sample groups. Ex.18,p.47-67

In conducting his analyses, Dr. Avera took into account the fact that equity risk premiums tend to move inversely with interest rates; that is, when interest rates are lower, equity risk premiums are higher. This relationship is seen in virtually all the leading equity risk premium studies, including 5 of the 7 studies utilized by Dr. Avera in conducting his analyses. This inverse relationship becomes particularly important at times, such as now, when interest rates are at an extreme point. Currently, interest rates are at one of the lowest levels in the last twenty years, meaning equity risk premiums are approaching all time highs. Ignoring the demonstrated inverse relationship would thus substantially understate current equity risk premiums and, hence, cost of equity calculations as well. Id.,p.48-51

One of the risk premium methodologies utilized by Dr. Avera involved a mechanistic technique. Under a mechanistic approach, forward looking methods are used to estimate a cost of equity from which observable bond yields are subtracted to measure equity risk premiums. Using studies employing this technique, Dr. Avera presented five different risk premium analyses. Four of these analyses utilized studies in which the inverse relationship between equity risk premiums and interest rates was observed and quantified. The results of these studies indicated required ROEs for SWB of 12.74%, 11.62%, 11.91%, 14.98% and 14.31%. Ex.18,p.52-58

Another risk premium methodology involves conducting direct surveys of investors about their required risk premiums. Utilizing this technique and the leading available survey (which indicated an inverse relationship between equity risk premiums and interest rates) Dr. Avera estimated the cost of equity for SWB to be 12.91%. Ex.18,p.59-61

Finally, utilizing a technique that focuses on historical realized rates of return in determining historical risk premium levels, Dr. Avera estimated a cost of equity for SWB of 12.81%. Ex.18,p.61-62 No inverse relationship between equity risk premiums and interest rates was utilized in this analysis.

The average ROE indicated for SWB under Dr. Avera's seven risk premium analyses was 13.04%, which does not include any adjustment for flotation costs (see discussion of flotation costs, infra).

(iii) MR. MOORE

Mr. Moore utilized a DCF analysis to make a return recommendation for SBC. His suggested ROE range for SBC under that analysis was 10.62% to 11.72%. Although generally a proponent of the DCF model, Dr. Avera pointed out several reasons why the Commission should be hesitant to rely on the DCF analysis at this time, particularly as presented by Mr. Moore. Dr. Avera pointed out, and Mr. Moore concedes, that the DCF is based on several strict assumptions that are not currently true for SBC. DCF results track reality only when earnings, dividends and book value track closely. Dr. Johnson has testified that in conducting a DCF, one needs to avoid using a dividend yield and growth rate that are inconsistent. T.241-42 SBC has been experiencing disparate growth in earnings and dividends since divestiture, and analyst projections are that such disparate growth will continue in the future. Ex.18,p.18-19

Mr. Moore also used recent historical growth rates and near term growth projections as a guide to long run investor expectations. But he also pointed out past and future economic conditions that indicate his analysis was unduly influenced both by the recent weakness in the economy and his projections of a slow recovery. Ex.12,p.18-22 His analysis would thus tend to understate actual long run investor expectations which the DCF is intended to measure.[11] Id.,19-20 By focusing on past and near term projections, Mr. Moore's growth analysis focused principally on growth in SWB's regulated telephone business, while ignoring the long term expectations of investors regarding SBC's unregulated business ventures. This caused him to further understate long term investor expectations embodied in SBC's current stock price, and, in turn, to underestimate SBC's cost of equity. Id.,p.21

With ongoing fundamental changes occurring in the telecommunications industry, investors place less weight on historical experience in forming their expectations about SBC's growth.[12] Additionally, since dividend increases are likely to

[11]Dr. Johnson has testified on the importance of market data in conducting a DCF. He has also testified that conducting a DCF in a volatile market is difficult and that it is not always appropriate to automatically use historical dividend growth or book value in conducting a DCF. He has also acknowledged that speculation in a stock can cause a mechanical DCF application to understate the cost of capital. T.242-44

[12]While pointing out that SBC's 1991 ROE as reported by Value Line was 12.14%, which was above the reported national average of (continued...)

continue to trail the growth in earnings, investor long term expectations (what the DCF purports to measure) are better gauged by projected earnings.[13] Mr. Moore's testimony indicates analysts are projecting SBC earnings to grow between 7 and 9% over the next 3-5 years. Ex.12,Sch.20 Since near term forecasts likely understate investor long run expectations, utilizing a long term growth of 8-9% with a dividend yield of 4.77%, as used by Mr. Moore, produces a DCF estimate for SBC between 12.77% and 13.77%. Ex.18,p.21-22

In addition, Mr. Moore did not conduct an independent check on the reasonableness of his DCF estimate for SBC. Ex.18,p.22-23 Even OPC witness Hill agreed that Mr. Moore's market-to-book analysis did not constitute an independent check on Mr. Moore's DCF analysis. T.386 And, Dr. Avera pointed out that Mr. Moore's market-to-book analysis produced nonsensical results, suggesting a 7.5% cost of equity for SBC and a group of 13 other LECs based on 1991 data. Ex.19,p.24-25

Although Mr. Moore gave some recognition to flotation costs in calculating the Company's cost of debt, he ignored such costs in his cost of equity analysis. While Mr. Moore conceded that SBC has had flotation costs in the past, he took the position such costs should only be included in a utility's return requirement to the extent they are incurred in the test year. But, such a position is

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[12](...continued)
10.9%, Mr. Moore conceded that in the period 1988 to 1990, SBC's reported ROE was below the national average. T.289-290

[13]Value Line's projected industry average for 1992 was 15.5% ROE. SBC's 1992 figure was 13.99% ROE. Value Line's 1993 industry projected ROE is 15.17%. T.289-290

not consistent with how he treated debt flotation costs in this case. Mr. Moore took the position it was appropriate to include historical debt flotation costs in his return calculations, even though some occurred prior to the test year, because such costs were known, were on the Company's books, and were being amortized over time. T.334-336

Flotation costs include services such as legal, accounting, printing and broker fees incurred in issuing and selling stock. Ex.18,p.64 While debt flotation costs are recorded and amortized, no such accounting is made for equity flotation costs. Yet they are, as Mr. Moore concedes, a legitimately incurred and real cost associated with obtaining equity capital. Ex.18,p.64-65;T.334-36 Since there is no direct accounting mechanism to recover such costs, an upward adjustment to the cost of equity is necessary if they are to be recovered. Dr. Avera suggested an upward adjustment of 25 basis points. Without such an adjustment a utility is denied the opportunity to recover past flotation costs incurred to obtain a portion of its current equity. Ex.18,p.66 While disagreeing that a flotation cost adjustment was appropriate in this case, Mr. Moore acknowledged that if the Commission were to decide such an adjustment was proper, Dr. Avera's proposed adjustment of 25 basis points is within the range he would view as reasonable. T.337-38

(iv) DR. JOHNSON

Dr. Johnson took Mr. Moore's ROE analysis for SBC and factored it down to account for his view that SWB is less risky than SBC in total. He "concluded" that the risk difference between SWB and SBC's unregulated subsidiaries was equal to 270 basis points, and because he believed SBC unregulated activities represent 19% of total SBC equity, he suggested a return requirement for SWB that is 51 basis points lower than that determined by Mr. Moore as appropriate for SBC. Ex.10,p.61-62

The Commission rejected a similar adjustment proposed by Staff in Case No. TC-89-14. T.267-68 The Commission found that SBC was an appropriate proxy for SWB because the majority of SBC's revenues and assets were in SWB. It then rejected Staff's proposal to determine a specific ROE for SWB "based residually upon calculation of ROEs for SBC's unregulated subsidiaries." R&O,p.65

Dr. Johnson did not even follow the methodology typically used in a divisional cost of capital analysis, i.e., estimating a cost of equity for SWB and each other SBC subsidiary. Instead, he merely asserted that differences in bond yields can serve as a proxy for differences in equity costs associated with different levels of risk. Ex.10,p.55 Dr. Johnson then hypothesized that the difference in risk between SBC's unregulated activities and SWB equates to the difference between junk bonds and double A utility bonds "such as those of SWB" (Id.,57); even though SWB's senior debt carries only a single-A rating.[14] Ex.18,p.33-34 Additionally the testimony of OPC witness Mr. Hill regarding the yield differentials between A-rated and Baa-rated or junk bonds would indicate that Dr. Johnson has utilized yield differentials that fluctuate too significantly to be of any value in attempting to

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[14]In surrebuttal testimony Dr. Johnson acknowledged this error but argued the effect was unimportant. Ex.11,p.10

draw conclusions about the differential in equity requirements among the various SBC subsidiaries. Ex.17,p.8

Moreover, even though Staff's DCF analysis admittedly attempts to measure the return required by investors for SBC stock, and even though Dr. Johnson acknowledged that investor expectations rather than actual results are relevant to a DCF analysis, the information relied upon by Dr. Johnson for his analysis and adjustment (HC and P data) is not even available to investors. Ex.18,p.35; T.237,243 Instead of developing a cost of equity for SWB consistent with the current risk associated with providing telephone service, Dr. Johnson merely backed into his proposed adjustment to SBC's required return by subtracting what he presumed was the cost of equity for SBC unregulated activities.

Dr. Johnson also erred in his calculations by excluding the portion of SBC's equity associated with Telmex in his estimate of the percent of SBC equity associated with its regulated businesses.[15] Ex.18,p.35-36

While Dr. Johnson apparently disagrees with this Commission's finding in Case No. TC-89-14 that SBC is the appropriate proxy for determining SWB's required return, he did concede that SWB is the source of the majority of SBC income and the source of most of its assets. Ex.10,p.58 Additionally, Mr. Moore testified that in his opinion SBC's current stock price is driven by investors who see SBC itself as a low risk alternative to money market funds, and

[15]Dr. Johnson also appeared to concede this error, but again concluded it did not amount to much. Ex.11,p.10-11

that he considers SBC a low risk utility stock.[16] If Mr. Moore's analysis started with such assumptions in regard to SBC, it is not clear why he thought Dr. Johnson's adjustment was needed at all. T.332-33 Dr. Johnson himself has testified on rate of return in three other cases involving BOCs, and in each case he used the Regional Holding Company (RHC) return requirement as a proxy for the telephone company and made no adjustment such as he is presenting in this case. T.224-25

Despite offering the opinion that SWB faces little competitive risk in Missouri, Dr. Johnson knew nothing about who has been certified to provide competitive services in Missouri (T.230-32), was not familiar with the Commission's recent order classifying certain SWB services as transitionally competitive (T.232-33), did not know what might be causing the decline in SWB's profitability which he acknowledged was occurring and thought would continue to occur (T.233-35)[17], was not familiar with the collocation rule then being considered by the Commission (T.236), and conducted no studies on competition or market demand specific to Missouri (T.238-39). In fact, Dr. Johnson's testimony that "there's a lot of this happening nationwide, and I suspect may be happening with

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[16]Interestingly, Dr. Johnson, Mr. Moore and Mr. Hill all stated they had made no attempt to analyze who holds SBC stock or to get a profile of the average SBC investor. T.228,302-03,389 Mr. Moore did acknowledge that it might be helpful to have information about the persons or entities whose expectations everyone is attempting to measure. T.303-04

[17]Staff witness Rucker conceded that decreases in Company revenues in certain service categories were likely due to competition. T.505

SWB as well" (T.235), is just the sort of testimony that caused the Michigan Public Service Commission to conclude that:

> As to Dr. Johnson's testimony, the Commission finds that it lacks sufficient foundation. On cross-examination Dr. Johnson admitted that he did not rely on any specific studies or analyses related to Michigan Bell but, rather, drew upon his general knowledge, including studies from market share and power in other jurisdictions.
>
> In particular, Dr. Johnson acknowledged that he did not rely on any formal studies or reports relative to several areas in which he offered testimony, specifically, Michigan Bell's service mix and service territory, the risk of telephone utilities versus the risk of energy utilities, the risk of utilities versus the risk of industrial companies, the advantages he claims Michigan Bell enjoys in the marketplace, the demand for Michigan Bell's primary services, opportunities or incentives for customers to bypass the local network, the regulatory process in Michigan, et cetera.
>
> In short, Dr. Johnson's testimony could have applied to any telephone company in the country.

T.240;Case No. U89-87,111 P.U.R 4th 1 (March 1990)

(v) MR. HILL

OPC's witness Hill recommends that the Commission adopt a hypothetical capital structure with 50% equity and an ROE of 10.5%. In arriving at his 10.5% recommendation, Mr. Hill utilized a DCF applied to the other RHCs and to a group of nine natural gas companies. Mr. Hill utilized gas companies because he believes it is generally accepted that telephone utilities incur greater risk than electric utilities. Ex.16,p.11 This contrasts with Dr. Johnson's opinion that telephone companies face less risk than electric utilities. Ex.13,p.14 In fact, the beta figures applied by Value Line to the telephone, gas and electric industries indicate investors feel telephone utilities are considerably more risky than either gas or electric utilities. Ex.19,p.6-7;T.378-80

Additionally, regulatory agencies have in recent years been granting higher return requirements to telephone utilities, further indicating a higher risk recognized by investors. T.341-42

In Case No. TC-89-14, the Commission determined that it was more reasonable to utilize SBC as a proxy for SWB to determine SWB's ROE than to use comparable companies, as Mr. Hill has done. The Commission noted that it has not in the past accepted comparable company analyses because companies are rarely sufficiently comparable, and that, when available, an appropriate proxy is preferable. R&O,p.65

Mr. Hill takes the position that capital costs must be down significantly from 1989 levels because interest rates are down. But even he seemed to recognize that the fact short term interest rates are currently so much lower than long term rates is a clear indication investors do not expect current economic and capital market conditions to continue prospectively. In applying the capital asset pricing model (CAPM) in his own testimony, Mr. Hill normalized his risk-free interest rate because the use of the current and future T-bill rates "does not yield particularly meaningful results in the current interest rate environment." Ex.16,p.58

In performing his DCF analysis, Mr. Hill appeared to give recognition to the need to measure what investors expect (Ex.16,p.34), but he then discounted such expectations. He took the position that certain actual growth rates cannot "grow continuously" within the DCF theory and concluded that the proper growth rate to use is the theoretical "sustainable growth rate."

Ex.18,p.37-39 But the only appropriate growth rate to use in the DCF is the long term rate which investors actually incorporate into the stock price, even if Mr. Hill considers such a growth rate to be "ridiculous." Mr. Hill thus substituted his judgment for that of actual investor expectations in conducting his DCF. Ex.19,p.17-18

In using a "sustainable growth rate," Mr. Hill contradicted his own recognition of the need to gauge investor expectations by accurately assessing the economic environment in which those expectations are formed. Ex.16,p.4-5 Mr. Hill's "sustainable growth rates" are merely mathematical derivations that take no consideration of the fact that the U.S. economy has been in a recession, that investors expect a sluggish recovery in the short-run followed by a return to normal growth, and clear capital market evidence (the steep yield curve) that current low interest rates are expected to be temporary. In short, he calculated his growth rate not on long term investor expectations, but on historical data and short term forecasts of the economy. Ex.19,p.18-19

Mr. Hill's misapplication of DCF theory is best seen in his conclusion that investors expect utility market-price-to-book ratios to range between current levels and 1.0, and his use of that assumption to gauge future investor expectations. Ex.16,p.44 Since such market-price-to-book ratios for the RHCs and the gas companies which he looked at are well above 1.0, Mr. Hill must believe investors expect share prices to fall. Such a fall would mean negative growth. If that truly is the expectation of investors, then such negative growth, not Mr. Hill's theoretical sustainable growth rate, should be used in his analysis. But negative growth would mean a cost of equity below current dividend yields, which would be nonsensical. Ex.19,p.19-21

In performing his CAPM analysis, Mr. Hill utilized an adjusted yield on short term treasury bills instead of long term treasury bonds, and he used a geometric as opposed to the arithmetic means. Both of these steps are contrary to the accepted method of utilizing a CAPM for deriving a cost of capital or required return. Ex.19,p.23-24 Utilizing the appropriate arithmetic means in Mr. Hill's CAPM calculation takes his result from 10.85% to 12.74%. T.387-88 Applying his acknowledged arithmetic mean to long term interest rates results in a cost of equity of 13.2% for the RHC group which he analyzed. Ex.19,p.24-25

Finally, while not denying the existence of flotation costs, Mr. Hill takes the position they should be ignored. Ex.16,p.63-65 His first reason for ignoring them is that SBC's current share price is above book value. But, flotation costs reduce net proceeds and increase the cost of equity regardless of the share price of new stock. His second reason is that such fees are usually in the form of a discount, rather than out of pocket expense. However, this does not make flotation costs any less of a cost. His third reason is that his growth rate already recognizes the sale of stock above book value. But, the growth investors may expect from the sale of new stock has nothing to do with past or future flotation costs paid to third parties. His fourth reason is that such costs are offset by brokerage fees. He incorrectly attempts to equate investor transaction costs with utility flotation costs. Finally, Mr. Hill states the empirical evidence of market pressure associated with the sale of new stock is "unconvincing." But, the flotation adjustment proposed by Dr. Avera in this case has nothing to do with the existence or magnitude of "market pressure." Ex.19,p.26-27

### B. COST OF DEBT

The Staff takes the position that SWB's cost of short term and long term debt should be calculated on the basis of SBC's overall cost of debt on a consolidated basis as of September 30, 1992. This results in a cost of debt of 7.33%. Ex.1,p.5;Ex.12,Sch.14,15 Based upon Mr. Hill's proposed hypothetical capital structure, OPC suggests the Commission use a weighted average cost of debt of 7.44%. Ex.1,p.5;Ex.16,Sch.14 SWB takes the position the Commission should utilize SWB's actual September 30, 1992 cost of debt of 7.66%. Ex.37,p.52;Ex.1,p.6

Both the OPC and Staff proposals would result in SWB being unable to recover its actual cost of debt. Furthermore, while Staff's proposed cost of debt provides customers with all the savings which resulted from SWB debt refinancing through the end of the test period, it fails to provide the Company any recovery for the costs associated with such refinancing. Ex.70,p.19 Mr. Moore stated that he was willing to make an adjustment to allow SWB to recover the costs associated with debt refinancing which occurred during the test year, but such an adjustment was never made.[18]

[18]Under Part 32, debt refinancing costs are booked as an extraordinary, below-the-line charge in the year the debt is refinanced. This differs from prior Part 31 treatment which included such costs in the cost of debt, which in turn was included (continued...)

Ex.13,p.16;T.346-47,360-61 Staff's Complaint involves a review of SWB's revenue requirement. Debt costs are a part of that requirement. The actual level of SWB's debt costs are known, not in dispute, and should be used rather than the debt costs of SBC or a hypothetical entity.

### C. CAPITAL STRUCTURE

Staff is recommending that the Commission use SBC's September 30, 1992 consolidated capital structure (55.65% equity and 44.35% debt) to establish SWB's revenue requirement in this case. OPC recommends the use of a completely hypothetical capital structure of 50% debt and 50% equity. SWB recommends that the Commission use the actual September 30, 1992 capital structure of SWB (57.42% equity and 42.58% debt). Ex.1,p.6

Staff offered no support for its position in its direct testimony. In his rebuttal testimony, Mr. Moore merely took the position that use of SBC's capital structure would be consistent with the Commission's findings in Case No. TC-89-14. Ex.13,p.2-3 Taking the mid-point of Staff's ROE range, use of SBC's capital structure, rather than the capital structure of SWB, reduces SWB's revenue requirement by approximately $4.9M. Ex.37,p.54 SWB's actual debt percentage is not in dispute. Nor is the cost of that debt in dispute. Staff simply recommends that SWB not be allowed to recover its actual cost of debt. T.343-44

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[18](...continued)
in the revenue requirement. Ex.70,pp.16-17 Staff's failure to adjust its cost of debt for this recognized additional cost is another reason the Commission should authorize a range of return higher than that suggested by Staff.

On the one hand, Staff is recommending the use of the capital structure and cost of debt of SBC as a surrogate for SWB in determining the latter's return requirement. On the other hand, Staff is recommending that SBC's cost of equity be adjusted downward to arrive at what Staff believes is a more appropriate return for SWB. Thus, Staff's proposal is internally inconsistent in seeking to use SBC's actual capital structure and cost of debt as a proxy for SWB, but then rejecting the use of SBC's equity cost as a proxy for SWB. Staff's approach appears designed merely to achieve the lowest possible revenue requirement. Ex.37,p.52-56; T.291-295

Nor was Mr. Moore accurate when he stated that the Staff is merely proposing that the Commission carry forward with what it found appropriate in Case No. TC-89-14. In that case, the Commission determined that because it had found SBC to be an appropriate proxy for SWB in setting SWB's ROE, it was consistent to use SBC's capital structure as well. R&O,p.66-68 In that case, the Commission specifically rejected Staff's proposal, similar to the proposal made in this case, to adjust SBC's required return level to arrive at a different return for SWB. Thus, Staff's proposal is not consistent either internally or with the Commission's decision in Case No. TC-89-14.

Since a DCF analysis cannot be conducted for SWB itself (because it does not have publicly traded stock) (Ex.12,p.21), and because Mr. Moore and Dr. Johnson apparently agree that SWB's ROE requirement cannot be determined from a review of comparable telephone companies as Mr. Hill attempted to do (see R&O, Case No.

TC-89-14,p.61;T.241,269-70), it is appropriate to use SBC as a proxy for SWB's ROE requirement, just as the Commission did in Case No. TC-89-14. However, it is not appropriate or consistent to ignore SWB's directly observable and undisputed debt and capital structure, and to set rates on a basis that will knowingly cause SWB to underrecover its actual costs.

In regard to Mr. Hill's recommendation that the Commission adopt a hypothetical 50% equity ratio, Standard and Poor's (S&P) financial ratio guidelines for telephone companies suggest that such a ratio would barely maintain SWB's current single-A bond rating. S&P looks for an equity ratio greater than 58% to support a double-A rating, and between 48 and 60% to support a single-A rating. A ratio of 50% or less is typically associated with the lowest investment grade, triple-B, or below. Ex.19,p.12-13 Mr. Hill's recommendation is thus inconsistent with SWB's need to attract capital on reasonable terms, especially in light of the fact that SWB's bond rating is already the lowest of any BOC, with the exception of New York Telephone. Ex.59,p.22-24

Further, in his "operating risk" analysis, Mr. Hill addresses the historical earnings of LECs based on the aggregate experience of some 600 such companies. When confronted with the inconsistency that such companies have had their average equity ratio increase from 42-43% in 1981 to "about 60%" in 1989 (Ex.16,p.25;T.382-83), Mr. Hill simply declares that such a shift was unwarranted. This presumptive disregard for the financing decision of some 600 companies is the only way Mr. Hill can circumvent the fact his own data contradicts his conclusions.

## 4. DEPRECIATION

Depreciation policy must keep pace with the dynamic nature of the telecommunications environment in Missouri and throughout the nation. T.420 It is more important now than ever before that the rates be accurately set, rather than rely upon successive represcription meetings and after-the-fact amortizations to obtain capital recovery. T.422,425,442,447

The parameters[19] are at issue in only two accounts, the Digital Switching and Digital Circuit-Other accounts, because the parameters for all other accounts were agreed upon at the 1992 Three-way meeting. T.414 Nevertheless, the depreciation issue is significant because those two accounts comprise nearly 20% of the Company's total investment in depreciable property.[20] Additionally, although the parameters for 34 of 36 accounts are not in dispute, the rates for those accounts are at issue because the Company has proposed to restore parity between interstate and intrastate reserve percentages resulting in identical rates. Ex.24,p.11-15 An amortization of less than 0.4% of the depreciation expense incurred during the period when dual rates were in effect, will eliminate this jurisdictional reserve difference and return parity in depreciation rates to all accounts. SWB's proposal is for this amortization to be completed over a

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[19]The three main parameters used in the equation to calculate depreciation rates are the life, future net salvage and shape curve. Only the life parameter is at issue on the two disputed accounts.

[20]The number discussed at the hearing was 16%, but a calculation of numbers on Ex.215,Sch.3, Adjusted Total State Column, more accurately reflects a 19.96% composition.

three year period. In this Complaint case environment, the proposal will not increase customers' rates. Ex.24,p.22-23

SWB's proposed rates for the two digital accounts should be adopted because they accurately reflect the consumption of assets and they are consistent with the interstate rates and the rates in place for the majority of the industry. Ex.26,p.3-4;T.419,434 Similarly, SWB's parity proposal makes sense because it acknowledges the reality that property used in both jurisdictions has only one life. Ex.24,p.21-22;T.417-18

Digital Switching

The Digital Switching account contains the "brains" of the Company's network. It is the equipment that actually routes telephone calls and contains all of the hardware and software necessary to support that function. In the switching arena, the only constant is change, brought about by technical obsolescence, customer demand, new minimum service requirements (to standardize urban and rural service) and competition. T.415-16 The change that has occurred has been not only in switches, like replacement of Step-by-Step and Cross-Bar with digital, but also in the processor area where both regulatory requirements such as CCS7, CIC and interchangeable NPA codes, as well as competition to bring new features to customers, cause more rapid retirements. See 4 CSR 240-32.100

SWB proposes a rate of 6.6%, down very slightly from the current rate of 6.7% retained in 1989; whereas, Staff proposes a continuation of the parameters from 1986, without performing a study, which produces a 5.5% rate. T.442 The Company's and

Staff's rates are quite different because the two parties disagree on how long the equipment in the switching account will last. SWB projects an average life of 17.5 years; whereas Staff bases its rate on the same 20 year projection life that it proposed at the 1986 Three-way meeting - more than eight years ago. T.422,442

Significant changes have occurred since 1986. Take for example Case No. TR-90-98 where the Commission sets the depreciation policy for SWB. In the R&O issued in that case, this Commission rejected SWB's proposal to adopt the lower depreciation rates supported by Staff at the 1989 Three-way meeting with the FCC:

> [U]nder current conditions technological advances and modernization of Southwestern Bell's network indicate that depreciation rates should increase or remain constant not decrease. The Commission cannot approve of rates which are contrary to these conditions.

R&O,p.7 SWB's proposal in this case is consistent with that policy. The rates are also well in line with the rates in effect for other telecommunications companies using the same equipment. See T.432;Ex.26,Sch.3 The average rate in the Digital Switching Account for the other 22 companies, whose depreciation rates were set at the 1992 Three-way meeting, was 7.2% -- resulting in much more rapid recovery than SWB's proposal in this case. Ex.26,p.3 A review of the individual rates for the 22 companies reveals that Staff's proposed rate of 5.5% for SWB to be the lowest by more than a full percentage point than any of those companies whose rates were represcribed in 1992. Ex.26,Sch.3 Staff's proposal cannot be considered even remotely consistent with this Commission's position in Case No. TR-90-98.

The Commission's views on the pace of depreciation were echoed by its Project Team on Network Modernization and Incentive Regulation, which stressed the link between network modernization and forward looking depreciation rates, where it provided:

> Although past history is an important part of the service life determination for an asset, a method which places greater weight on the estimated date of future retirement and technological obsolescence would be more compatible with network modernization. As future technologies emerge to meet customer demands, a sound capital recovery policy needs to be in place which better matches projected lives of equipment with current consumption.

Ex.23,p.10 SWB's rate is the most appropriate rate because it is based upon the most recent information and a reasonable judgment as to future retirements, as opposed to Staff's reliance upon outdated vintages in a dead account. See T.444-46

SWB prepared a study using the same method Staff prefers and derived a projected life of 16 years for the Digital Switching Account versus Staff's 20 year projected life. T.443 The FCC used a life span method, previously used for other switching equipment, and derived a 17.5 year life. SWB compromised during the Three-way negotiations and accepted the FCC's proposal. Staff did not prepare a study, nor accept the results of the two independent studies prepared for the meetings. The FCC's life span method, although not necessary to the setting of the rate SWB has proposed, is well suited to deriving the life parameter in this account. Ex.26,p.11-12 This method, unlike the one used by Staff and SWB, recognizes and accounts for the modularity of digital switches. Id. Although an individual base switch may last for a period of time in excess of 17.5 or 20 years, the account is comprised of numerous switches and many other items of equipment used to support the switch or its functions. By the time a digital switch retires, a majority of its original modular components will have been replaced. Id. It is the interim retirements of the support equipment which drives the life of the account down and necessitates a faster pace of capital recovery. Ex.26,p.11-13 As new services, such as E-911 and custom calling features, are made available to customers depreciation rates must keep pace and not ignore known future events. T.438-39

A final cross check on SWB's proposed 6.6% rate is a review of retirements to determine whether they have proceeded at the pace projected in the 1992 study. Retirements from 1992 to the present were 863.8% of the original forecast indicating that an even shorter life and thus a higher rate would be appropriate in the Digital Switching Account. Ex.26,p.5

Digital Circuit-Other

The dispute on the proposed rate in the Digital Circuit-Other account derives from the same philosophical difference as the dispute on the Digital Switching Account. Staff has again proposed rates based upon information from the 1986 Three-way meeting; whereas the Company's proposal originates from the 1992 Three-way meeting and the study the Company prepared for that meeting. T.422,450

The Staff's 8.4% rate is again among the very lowest of the 22 companies whose rates were prescribed in 1992, whereas the Company's proposed 10.9% rate is quite close to the average rate of those same companies. Ex.26,Sch.3 Again SWB's proposal is the only one before the Commission which is consistent with the policy enunciated in Case No. TR-90-98 and the recommendation of the Project Team.

The disagreement between Staff and SWB on this account can be traced to the split that occurred in the Circuit Equipment Account in 1988. T.447 Before 1988, the account was a circuit equipment account which contained both analog and digital equipment. When the FCC mandated the split, the account was 56% digital, and 43% analog. T.449 The Company's proposed 10.9% rate is based upon the history of the entire account, as well as factors expected to affect future retirements. Ex.26,p.17-19 Staff's proposed 8.4% rate looks at the pre-1986 history alone and relies upon data from the 1986 Three-way meeting. At the same time, Staff has ignored the more recent post-1986 history for the digital portion of the account because in Staff's view the data period is too short. T.448-49

Staff's rejection of the more telling recent history on the Digital Circuit-Other account is inconsistent with its use of the same post-1986 data to determine the agreed upon rate in the Analog Circuit-Other account. T.448;<u>see</u> Ex.21,Sch.6-1,6-2 When Staff witness Richey graphed the post-1988 data for digital circuit equipment, the projected life for the account was 12.8 years[21] -- nearly the same as the Company's 12.5 year projected life. <u>See</u> Ex.26,Sch.5;T.453-54

[21]Although Mr. Richey claims the 12.8 year average service life (ASLs) is not comparable to the Company's 12.5 projection life, he compared ASLs to projected lives in the Digital switching account. <u>See</u> Ex.21,Sch.2-1,2-2,2-3

A comparison of actual, more recent retirements in the Digital-Circuit Other Account versus the projected retirements forecasted in the 1992 study validates the Company's proposal. Actual retirements were 127.5% of projected retirements indicating a shorter life which means that a higher rate would be appropriate. Ex.26,p.22

Amortization

The last element of the Company's proposal is to restore parity to interstate and intrastate depreciation rates by amortizing the reserve difference in all 36 accounts. The Company believes uniform rates make sense because property used in both jurisdictions has only one life. Ex.24,p.21-22;T.417 Additionally, parity reduces the number of reports and confusion that can and does result from multiple reports.[22] Ex.24,p.18-22 Although the Company's proposal would increase the depreciation accrual by $1.04M, that is only slightly higher than 0.5% of the total current accrual. Ex.24,p.12

The Project Team Report urged equal rates of depreciation in the interstate and intrastate jurisdictions. Ex.23,p.11 The Company's amortization proposal echoes that recommendation at a time when the $3.121M reserve increase, which the Company recommends be amortized over three years, can be accomplished without a corresponding increase in customer rates under either the TF2 proposal or Staff's Complaint.

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[22]Staff's testimony on the data center had to be corrected on the stand because Staff relied upon the wrong report to calculate the reserve percentage.

## A. COMPENSABLE PROPERTY DEPRECIATION RESERVE

SWB has property located in each state which is used to provide service to customers in one or more of the other SWB operating states. SWB performs an annual study ("the compensation study") to determine how much each state must remit to other states for service provided.[23] Missouri is a "net" receiver -- that is, it provides more service to other states than it receives. Ex.38,p.7-8 At issue is the amount of depreciation reserves and accumulated deferred taxes associated with this investment to be removed from Missouri's revenue requirement to recognize the "net" compensable property used for other states.[24] T.594;Ex.38,p.9; Ex.24,p.31-33

Staff is proposing a new method for the calculation of depreciation reserves on compensable property. Ex.38,p.11 Because this new method is fraught with internal errors, Staff witness Doerr had to revise his proposal several times during the course of the hearings, producing very divergent results.[25] T.598;Ex.188, Sch.2 Staff continued to make alterations on the stand. T.589

Historically, the compensation study is based upon account averages. Staff now proposes to use specific asset/reserve account balances for some accounts -- principally the newer St. Louis Data Center and One Bell Center (OBC) facilities -- but averages for

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[23]The study is of maintenance, depreciation, and property tax expenses, as well as investment and return on investment.

[24]The related new St. Louis Data center issue is addressed in Section II.6 of the Brief.

[25]The adjustments proposed by Staff for compensable investment were (in thousands) $119,328, $127,117, $126,904, $121,289.

other accounts. Ex.24,p.40-42;Ex.38,p.11-12;Ex.25,p.2-6 There are a number of problems and errors in this selective account proposal.

First, it violates specific depreciation group accounting techniques. Ex.25,Sch.1,2 Staff does not contest this point. Further, it has not been uniformally applied by Staff -- and it should be since the asset/reserves for all accounts would have to be calculated and charged to expense on the same asset specific basis, not just a select few contained within the compensation study which constitutes only a small portion of the total plant assets for Missouri. T.596;Ex.25,p.3-4 Finally, the asset specific method does not comply with Internal Revenue Code (IRC) Section 167 -- normalization provisions -- concerning "consistent estimate" techniques -- nor was Staff even aware of this tax requirement.[26] T.613-14;Ex.227,Sch.2

Second, Staff's method has not been consistently applied. For instance, Mr. Doerr mixes investment on an FCC (MR) basis with reserves on a state basis (FR Intrastate) for some of the investment. T.601-02,608 Other MR investment is calculated by Mr. Doerr using reserves at the combined state and FCC (FR Total) basis.[27] T.604-05,610. Staff concedes that its proposal "cannot

[26]Inconsistent estimates and projections of tax expense, depreciation expense or reserves for deferred taxes are a violation of the normalization rules of IRC §167. This violation results in the Company being ineligible to utilize the accelerated depreciation provision of the code section. The result of the loss of accelerated tax depreciation would be a significant increase in the rate base and revenue requirement to the Company and its customers, as is discussed in more detail in Ex.227,Sch.2.

[27]SWBT witness Barfield noted that non-uniform FCC and State depreciation rates and reserves caused confusion by others in the selection of the proper depreciation report to be used. Ex.24,
(continued...)

be used consistently" to develop reserves but blames this problem on an alleged failure of SWB to maintain adequate records. Ex.39,p.10 SWB's records are maintained in complete accord with Commission accounting rules and industry requirements. Ex.25,p.2-4 The problem is in Staff's "new" and inconsistent proposal.

Third, despite Staff witness Meyer's statement that the test period should have the proper matching of rate base, expense, and revenues (Ex.2,p.3-5), Mr. Doerr claims matching is not necessary at all. T.603 The investment used by Mr. Doerr was for June 1992 while the reserve level was at the September 1992 levels.[28] T.602 Other aspects of Mr. Doerr's proposal did, however, properly match September 1992 investments and reserves. T.626; Ex.215,Sch.4, e.g.,P-1-B,Sch.6,e.g.,R-1-A Staff also used Mr. Richey's estimated 1991 OBC investment, produced for use at the April 1992 Three-way Depreciation Meetings, believing it was actual December 1991 results. T.621 That error yielded a different number than the result of its audit of the books and records which was updated to September 1992. T.623-24

Fourth, as of the hearings, Staff's case still had a number of inaccuracies in postings, assumptions, adjustments, etc. despite the repeated revisions to correct past errors.[29] See Ex.24,p.43-44,55-7;Ex.25,p.6-9;T.590-93 For instance, Staff confused the

[27](...continued)
p.18-21 Mr. Doerr's testimony Ex.39,p.34 is an example of this problem in Staff's analysis.

[28]Indeed, Mr. Doerr later stated "I don't know what should be matched up on the same basis." T.610

[29]In some cases, Staff just chose to ignore errors. T.606-607

computer account with the capital lease account (Ex.25,p.7), and assumed that all computers in the new Data Center were "new," (Ex.25,p.6,31,)[30] -- later, Staff sponsored an exhibit and conceded all of the computers were not new but were transferred from the old Data Center. T.630-31 SWB confirmed this point in testimony. T.645

SWB's compensation study proposal is consistent with past regulatory practice and is a more reasonable and tested approach, because it is updated yearly to account, on a uniform basis, for all net compensable plant. Staff's so called "simplified" method (Ex.39,p.4), fails to consistently, much less accurately, measure the net compensable plant.

**6. ST. LOUIS DATA CENTER**

Both SWB and Staff agree that the impact of only one St. Louis Data Center should be included in cost of service and that it should be the new St. Louis Data Center.[31] Ex.38,p.15;Ex.24,p.58-59 Both agree with the rate base impact; and, thus, the only remaining issue is the recognition of the $7.1M annual operating expense.

Mr. Meyer maintains the $7.1M (total state) expense is already recognized in Staff witness Doerr's compensable property allocation. Ex.4,p.25 Mr. Doerr does not agree (T.627); and in

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[30]By assuming all were "new," Mr. Doerr understates the depreciation reserve for computers. T.618-19

[31]There was some mild confusion at the hearing concerning whether the old Data Center, the 14 S. 4th Street facility, remained in the rate base. It is not, nor are any of the old Data Center expenses being claimed by the Company in its case. T.642-649; Ex.24,p.58-59

fact, Mr. Meyer is incorrect. Mr. Doerr acknowledges that his compensable property adjustment removes, from SWB-Missouri results, compensable property used for other states. T.594-95 The Order in Case No. TC-89-14 acknowledges this result:

> Net compensable property is property which is located in Missouri but is used to provide service to customers in other states. This property is removed from SWB-MO's rate base for purposes of calculating SWB-MO's revenue requirement. (emphasis added.)

R&O,p.16. Mr. Doerr also acknowledges that the beginning balance for Staff's operating test period expenses does not include any expense recognition of the new Data Center. T.627 Since his compensable property adjustment is a reduction to test period expenses, and since the beginning test period expenses do not include the new Data Center, there can be no "duplicate recognition" as Mr. Meyer has suggested. Staff does recognize the test period rate base and depreciation expense, but not the operating expense for heat, power, etc.[32]

These expenses are known and measurable and Mr. Edmundson has presented the detailed basis for the inclusion of the operating expenses.[33] Ex.42,p.2-5 Staff witness Meyer does not refute these

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[32]Staff had to "add" the Data Center investment to its September 1992 test period account balances. Ex.38,p.7-8;Ex.24, p.62-63;T.626 Staff has to "add" the operating expense also -- but has not.

[33]Company witness Edmundson was cross-examined on the construction of the new Data Center and explained its necessity, and Staff's prefiled testimony does not challenge the need for the new Data Center. SWB reserves the right to brief this issue if Staff raises it in its Brief. See T.637-639

calculations other than to generically claim such are not known or measurable.[34] Ex.4,p.27

7. INTEREST DURING CONSTRUCTION (IDC)

Under the Uniform System of Accounts (Part 32) approved by the Commission in Case No. TC-89-14, telephone plant under construction (TPUC) is not placed into the rate base but is assigned "interest during construction" which is capitalized and added to the rate base when the plant is placed into service.[35] Staff witness Riley proposes to alter the historical Commission approved IDC methodology. SWB witness Toti recommends following the historical IDC methodology. Ex.37,p.57-58

The Staff's principal deviations from past Commission decisions are in the area of (1) the "interest" cost to assign IDC and (2) the treatment of "excess" depreciation as a carry over to the next period's construction requirements. Ex.37,p.57-58

A. INTEREST COST

Rather than the overall cost of capital (which is used in Part 32 and by SWB),[36] Staff proposes to use the "lowest cost of debt" for IDC. Ex.35,p.26,29;Ex.37,p.57 Staff bases this proposal upon

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[34]This is an inconsistency in Staff's position -- at one point Mr. Meyer claims he already has sufficient expense recognition and only a $540,000 additive is not needed. Ex.4,p.25 Then Mr. Meyer next claims that the expense is not known or measurable. Ex.4,p.27 How then could Mr. Meyer, at p.25 of Ex.4, know what amount was not included in Staff's original presentation?

[35]Long term TPUC is treated this way in Part 32. Short term TPUC is placed directly into the rate base. Staff's IDC proposal deviates from Part 32 in this aspect as well. SWB's alternative response to this "short term" IDC is a suggestion that short term be placed into the rate base as Part 32 requires in lieu of applying IDC. Brief, Section II, No.8.

[36]47 CFR 32.2000(c)(2)(x);Ex.37,p.66

several assertions; (1) that there is a "double recovery" in SWB's IDC method, and (2) that depreciation represents a "cost free" source of funds for construction.

The "double recovery" argument is based upon Mr. Riley's contention that the payment for service by customers results in the return of the depreciation component in cost of service which, in turn, reduces rate base through the increase in accumulated depreciation reserve. Ex.35,p.25-28;T.543,547,575 However, since the "rates" are not "rebased" to recognize the reduced rate base, Mr. Riley argues that customers will continue to pay rates in excess of the return now required for the reduced rate base. Further, Mr. Riley argues that since the same depreciation is used to now fund TPUC and since an IDC rate is applied to TPUC this results in the customer paying "double." Ex.35,p.27;Ex.37,p.62-64

SWB witness Toti proved that no "double recovery" occurs. First, Mr. Toti confirmed that recognition of the "depreciation reserve" increase does occur through standard accounting procedures -- a point Mr. Riley also confirmed during his cross-examination. T.548 Second, rather than SWB's rate base decreasing (a key component to Mr. Riley's contention) it has actually increased by over $200 million.[37] Ex.37,p.65 Third, Mr. Toti provided an

[37]Since rates are not "rebased", rather than a double recovery, SWB's investors are not provided any return on the increase through rates until the "rebase" occurs. Ex. 37,p.65 Mr. Riley agreed that no "double recovery" will result in a plant growth situation such as in SWB's case. T.557-58 Indeed, Staff's own case reflects an increase in rate base. T. 577 Mr. Riley's argument is internally inconsistent with other parts of Staff's case and Mr. Meyer's intent to maintain an appropriate relationship in cost of service.

example which confirmed that SWB does not "double recover" as Mr. Riley claimed.[38] Ex.37,p.66-68,Sch.6

Mr. Riley also contends that depreciation is a "cost free" source of funds provided by ratepayers and used by SWB to fund construction.[39] During cross-examination, Mr. Riley agreed that customers merely pay for service and that depreciation represents funds that indeed have an associated cost. T.546,549-51 Depreciation is not a "cost free" source of funds. Ex.37,p.62,70; T.550 The return of "depreciation" expense in cost of service is the return of investor supplied capital and, if used for construction, should receive the overall cost of capital for IDC, as Part 32 requires. Ex.37,p.65-66

Historically, the overall cost of capital is used for IDC; Mr. Riley recommends SWB's lowest cost of debt be used; why, is not clear. Neither of Staff's cost of capital witnesses, Mr. Moore nor Dr. Johnson, recommend a different rate of return for TPUC projects, such as Mr. Riley proposes. When asked during cross-examination, Mr. Riley could not justify why his IDC proposal should distinguish investor capital in TPUC from other investor provided capital. T.536-37 Indeed he could not demonstrate any understanding of the composition of TPUC at all. T.556 The

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[38]Mr. Riley responded with a counter exhibit -- but under cross-examination, admitted that his exhibit incorrectly treated deferred taxes as a source of income in his income statement. This overstated the results he presented. Ex.36,Sch.2;T.565-67

[39]If "cost free," as Mr. Riley argues, one would have to ask why assign any cost at all to "IDC" -- Mr. Riley himself assigned a cost of debt to TPUC, contradicting his own "cost free" argument.

historical Commission practice, is to use the overall cost of capital for IDC and it should continue to be used. Ex.37,p.65-66

### B. EXCESS DEPRECIATION

A second argument is Mr. Riley's contention that since depreciation expense exceeds construction requirements in some months, the "excess" should be carried over to the next month. Ex.35,p.27 The major difficulty with his proposal is, as Mr. Riley admits, the carry over of the "excess" results in the assignment of no interest during the "carry over period." T.560

Further, Mr. Riley's "excess" argument is based upon his contention that depreciation, an internally generated source of funds, is "only" used for TPUC, therefore this "excess" is available to be carried over month to month.[40] Mr. Riley later conceded that these internally generated funds are used for other needs -- for various operating requirements, such as other operating expenses. T.554 Therefore there is no unused "excess" for "carry over" to TPUC. Since rate base actually increased, it is clear that additional capital was needed -- in excess of depreciation -- to fund construction, exactly opposite of Mr. Riley's contention.

### 8. SHORT TERM - TELEPHONE PLANT UNDER CONSTRUCTION (ST-TPUC)

In lieu of the IDC process being applied to ST-TPUC, SWB proposed to include ST-TPUC in cost of service. Ex.37,p.71 This inclusion is justified for several reasons.

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[40]If Mr. Riley's theory was correct, SWB's financials should have reflected a "large cash" reserve for the excess funds he says are available to carry over. However in Mr. Riley's analysis of SWB's cash flow for the years 1988-1992, he concluded that SWB's cash flow was adequate and not excessive. Ex.36,p.10

First, the ST-TPUC balance is relatively small in relation to the entire rate base ($27 million v. $1.56 billion). Second, Part 32 directs the inclusion of ST-TPUC. Third, the test period TPUC balance is already in service, providing benefits to customers. Fourth, the test period TPUC balance is principally composed of replacement facilities or central office upgrades which would not result in additional net revenues.[41] Fifth, the rate base includes other items, such as materials and supplies, which have similar characteristics to ST-TPUC. Ex.37,p.71-76

SWB witness Crossley stated that SWB must have a continuous program of ST-TPUC to satisfy the Commission's service requirements.[42] Ex.76,p.28-29 The undertaking of the construction to satisfy this Commission imposed obligation requires that full recognition be granted in the rate base.[43]

### 9. CASH WORKING CAPITAL (CWC)

All investor supplied capital, including working capital, must be recognized in the cost of service. CWC is a component of working capital over and above other specifically identified investments in plant and service. Ex.43,p.24 CWC is needed to bridge the gap between the time expenditures are required to provide service and the time collections are received from customers for service provided. Ex.43,p.24 Staff defines CWC as

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[41]The projected revenues are expected to be offset by the additional depreciation expense that will be recorded after the plant is placed in service -- thus the revenue/expense/rate base relationship is not distorted. Ex.37,p.74

[42]Staff did not rebut Mr. Crossley's facts.

[43]Commission Rules 4 CSR 240-32.060,.070, and .080

the amount of cash necessary to pay the day-to-day expenses incurred in providing service. Ex.186,p.2 The only CWC issue in question is the proper time period to assign to the "collection lag" component of the revenue lag.[44] SWB uses its actual collection lag of 28.46 days while Staff uses an arbitrary 21 days.

SWB based its 28.46 day lag proposal upon an average accounts receivable turnover study. Ex.43,p.27-29 Staff performed its own studies and reviewed a number of different studies, all of which were consistent with SWB's 28 day results. T.1776,1779 However, Staff rejected its own factual analyses and relied instead upon "21 days" -- which Staff witness Boczkiewicz stated was the maximum "due date established by 4 CSR 240-33.40."[45] Ex.43,p.27;Ex.186,p.7

Staff conceded that indeed, the average time for SWB customers to pay their bill is around 28 days -- all the factual studies Staff performed/reviewed conclude this is accurate.[46] Indeed, Staff stated that the best means to determine the collection lag is by a "sample of accounts" method that it performed. Ex.43,p.36;T.1780-81 This "sample" resulted in a lag of 29.52 days (range 23.33 to 31.53 days) (T.1776-78); Staff, however, rejected the results of its own "best" method. T.1780-81

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[44]Collection lag is the number of days from the time the bill is generated until the utility receives payment from the customer. Ex.43,p.27

[45]Staff implies that 21 days is the <u>maximum</u> allowable by Commission rule -- it is not a payment practice but a billing practice which limits the waiting period before which SWB cannot demand payment. That is, customers do not have to pay the bill until a minimum of 21 days have expired. Ex.194,p.3

[46]The results of the different studies were 25.84 days, 29.52 days, and 32.67 days. T.1776-80;Ex.43,p.35

While eventually agreeing that SWB's customers payment habits are in the 28-day range, Staff concludes this 28 day "lag" is nevertheless "excessive" or "unreasonable" because, Staff contends, it is "so different" from other utility's results (T.1780-81) (e.g., SWB collection policies must therefore be at fault). Ex.186,p.9;Ex.187,p.2-6 Staff's comparison of SWB results with "other utilities" results could not support Staff's conclusion.[47] Staff was not even familiar with other utility practices. T.1790-1806

SWB witness Bollinger testified that SWB's collection practices are a balance of various competing factors -- such as risk, credit history, bill disputes, preferential bill dates, customer complaints, etc. Ex.194,p.2-12 She testified that SWB's uncollectible results are very low and support the practices now used by SWB. Ex.194,p.12-13 She also testified that Staff's recommendation (i.e., to "threaten" disconnection and increase disconnection notices) was not cost effective.[48]

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[47]Staff guidelines state comparisons should be between utilities of the same type and of like size. T.1785 The comparison Staff used did not follow this guideline. Based upon Staff's comparison, there is no factual basis to presume any payment practices can be compared between various different types of utilities. For instance, in the St. Louis area, customers payment habits for gas, electric and telephone utility service are not comparable as Staff.

[48]The value of this issue is $1.5 million. Ex.43,p.24 The cost to SWB to follow Mr. Boczkiewicz's suggestion would be approximately $11 million annually. T.1813

## 10. POST EMPLOYMENT BENEFITS

### A. PENSIONS (SFAS 87)

#### 1. THE ADOPTION OF FAS 87 IN CASE NO. TC-89-14 SHOULD NOT BE REVERSED.

SWB seeks a continuation of the Commission's present ratemaking policy for the Company's pension expense which requires that test year pension expense be calculated based upon Financial Accounting Standard (FAS) 87 methodology. Staff proposes a new method of calculating the Company's pension expense based upon the minimum allowed contribution to the Company's ERISA guaranteed pension fund. A continuation of the present policy for SWB is merited by the rationale originally relied upon to adopt FAS 87 for ratemaking, by the accounting theory underlying FAS 87 and by the ratemaking advantages inherent in that method of accounting. Additionally, FAS 87 should be retained for ratemaking, rather than adopting Staff's new ERISA minimum method, because such a radical change in methodology will not add any certainty to the ratemaking process and would cause financial harm to the Company.

##### a. THE PRIOR ADOPTION OF FAS 87 MUST BE CONSIDERED AS A FACTOR.

In its Order in Case No. TC-89-14, the Commission adopted FAS 87 for ratemaking purposes in the context of its adoption of Part 32 of the Uniform System of Accounts (USOA). At that time SWB's pension related revenue requirement was negative as a result of the funded status of its pension plan and the favorable earnings on that fund.[49] Ex.37,p.7,10-11;<u>see</u> T.1545 Although Staff initially

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[49]As the Section on FAS 106 will explain, OPEB expenses on FAS 106 will also produce a negative revenue requirement after (continued...)

opposed the adoption of FAS 87 in its pre-filed testimony in Case No. TC-89-14, it withdrew its opposition prior to the hearings. Ex.37,p.13;T.1545 The effect of adopting FAS 87 in that case was a reduction in customer rates of approximately $19M, driven in large part by the transition asset which was to be amortized over 18 years. Ex.37,p.7;T.1621

**b. THE COMMISSION'S PRIOR RATIONALE ADOPTING FAS 87 IS MORE COMPELLING NOW.**

In its 1989 decision adopting Part 32 of the USOA, including FAS 87, the Commission explained:

> The Commission has determined that based upon the review of the evidence in this record and the changes occurring in the telecommunications industry in Missouri, that it is more reasonable to adopt Part 32 procedures for ratemaking treatment in this case.
>
> Part 32 brings SWB's accounting procedures more in line with competitive companies, thus making SWB better able to meet the requirements of a more competitive industry. In Case No. TO-89-56 SWB has requested that most of its services other than basic local service be declared transitionally competitive, with the potential of relaxing regulation on certain of SWB's services. **If this occurs, Part 32 is a more appropriate costing procedure** than a surrogate or side record.

Case No. TC-89-14, R&O, at p.13-14 (emphasis added). In fact the classification of certain SWB services as transitionally competitive **did occur** in January of this year in Case No. TO-93-116.[50] See T.1542-43 Further, as Company witness Gilbert Orozco explained in his testimony, the telecommunications environment has only become more competitive in the intervening four years with

[49](...continued) approximately 8 to 10 years when earnings on the OPEB fund exceed expenses. T.1665

[50]In a separate docket concluded earlier this year, SWB's speed calling service was classified as competitive.

more than 74 new competitors authorized to compete with SWB since 1989. Ex.65,p.5;see also,Ex.37,p.9 Accordingly, the Company's real costs, those reflected on its financial books and records as determined by Generally Accepted Accounting Principals (GAAP) accounting (including FAS 87), should form the basis for the Company's rates and its pricing decisions in order to be fair to the Company and its customers.

### 2. FAS 87 IS MORE APPROPRIATE FOR RATEMAKING THAN AN ERISA MINIMUM APPROACH.

FAS 87 and ERISA are both actuarial determinations of employers' pension expense. Ex.37;T.1645 Both methods recognize that pensions are a form of deferred compensation earned by employees over their respective service lives. FAS 87 is, however, a superior method of determining actual pension expense for ratemaking purposes because: it is the same method used to determine pension expense reflected on the financial books of the Company, it permits only one actuarial method, it mitigates volatility in annual pension expense, and it allows a negative revenue requirement when the transition asset amortization and earnings on plan assets exceed expenses.

#### a. PENSION EXPENSE SHOULD BE CALCULATED BASED UPON SWB'S ACTUAL COSTS.

The Company is required by the Securities and Exchange Commission (SEC) to keep its books and records in accordance with GAAP. Ex.37,p.4;Ex.167,p.9 FAS 87 was adopted in 1985 by the Financial Accounting Standards Board (FASB) and was required for fiscal years after December 15, 1986. Id. SWB adopted FAS 87 in 1986 and began to use it for ratemaking purposes in 1989 after the

Commission recognized that it made sense for the Company to use the same accounting methods used by its competitors. Id.,p.5.

The financial books and records of the Company, which reflect pension expense pursuant to FAS 87, better match the Company's costs of providing the underlying benefits to the period in which those benefits are earned by employees. Ex.37,p.6 FAS 87 focuses on the benefits earned in each individual accounting period as determined by the actuarial study, rather than upon the separate business decision to fund that obligation. Id. Accordingly, rates based upon FAS 87 will properly match the expenses to the periods in which services are provided to customers. Id.

**b. FUNDING DOES NOT CORRESPOND TO EXPENSES.**

Much of Staff's rationale for its ERISA minimum approach seems to be that utilities have intentionally overfunded their pension plans and that through delayed recognition of actuarial gains and losses coupled with inappropriate interest rates on gains, utility's have failed to pass expense savings on to customers. T.1661-63 Neither of those concerns is a reality in SWB's case. Excessive contributions have not been made, and the gains and losses which SWB currently amortizes over the average remaining service life of its employees have produced almost the same level of earnings that an immediate recognition of gains and losses would have produced. Id.

An analysis of why the ERISA minimum method will not work requires an understanding of ERISA and how the funding levels are determined. The Employers Retirement Income Security Act (ERISA) was passed into law by Congress in 1974 to insure that pension rights, once earned (or "vested"), would be backed by cash when the retirees needed that income. The statutory scheme when viewed together with tax provisions, is the classic carrot/stick combination. Employers are required to deliver the promised level of benefits and in return employers are permitted a tax deduction for contributions to a qualified pension plan up to a certain level. ERISA imposes significant fiduciary duties on the employer/trustee, including the requirement that the funds be prudently invested. 29 USC §402(b) The investments produce earnings for the fund, as has been the case with SWB's pension fund since its inception. Favorable earnings, rather than excessive pension fund contributions, have been the precise and only reason that SWB has not been required to make a pension fund contribution since 1987. Ex.37,p.10-12.Ex.166,p.23

Because of the statutory duty to prudently invest its pension funds, the Company's ERISA contributions in any given year are a function of how the fund has earned and do not bear direct relationship to the Company's actual pension liability. Id. Instead, the pension liability corresponds directly to the deferred compensation earned by SWB employees in a particular year. Ex.37,p.4-5,11-12 Accordingly, ERISA minimum would be an arbitrary basis for setting customer rates.

**c. ERISA FUNDING LEVELS MAY FLUCTUATE AND CANNOT LOWER RATES.**

In addition to the fact that the ERISA minimum method is an arbitrary method of determining pension expense, it is also inappropriate for ratemaking because it can produce wild swings in expense levels from year to year and it is also incapable of producing a negative revenue requirement to the advantage of customers. Ex.37,p.10;Ex.166,p.23

Earnings on the pension fund, which by their nature can be volatile, are a primary factor in whether contributions will be possible or required in a particular year. Id. As a result, a large contribution may be required, or tax advantaged, in one year, with no contribution being possible in the next. Id. Unregulated companies generally maintain a funding level well above the bare minimum pension obligation in order to even out funding requirements from year to year and to guarantee that poor earnings years will not adversely affect a company's ability to meet its pension benefit obligation. SWB's actuary, Joseph Vogl, explained in his prefiled testimony that it is not unusual for pension assets to exceed a company's Anticipated Benefit Obligation (ABO) or even its Projected Benefit Obligation (PBO). Ex.166,p.23 Logically, unregulated companies which compete primarily on price would want to state expenses as low as possible and maintain good cash flow. Accordingly such companies would have no incentive to "overfund."[51] SWB's funding performance compares well to unregulated firms and confirms that the Company's pension funding policy and practices have been sound. Id. It makes no sense, therefore, to use Staff's arbitrary and volatile funding standard to determine pension expense for ratemaking as it bears little relationship to true pension expense.

[51]This is particularly true because ERISA funds cannot be used to pay expenses other than pensions and OPEBs where a 401(h) transfer has been made.

The practice of funding above the bare ERISA minimum has had a positive effect on customer rates under FAS 87. FAS 87, unlike ERISA, allows pension expense to be recorded as a negative number when assets exceed liabilities and earnings on assets exceed expenses. Ex.161,p.7;T.1551-52 When that occurs, the utility has a negative revenue requirement which can produce lower customer rates. T.1552 That is precisely what happened with SWB in 1989 when FAS 87 was first adopted and for sharing purposes in Incentive Regulation Plan years 1990 and 1991. Id.

#### d. FAS 87 ACTUARIAL LIMITATIONS PROVIDE RATEMAKING SAFEGUARDS.

FAS 87, unlike ERISA, allows for only one actuarial method. T.1543-44 Thus, the potential for manipulation is minimized, and results from company to company, regulated and unregulated are more comparable. Id. The New York Public Utility Commission found the limitation on actuarial methods a persuasive factor earlier this year when it adopted FAS 87 for ratemaking purposes for all New York public utilities. In its Order the Commission explained:

> [F]ollowing GAAP makes the comparison with both regulated and non-regulated companies' pension expense more meaningful. Prior to SFAS No. 87, GAAP permitted a variety of actuarial methods for determining pension expense. Since pension expense between companies was often based on different actuarial methods, a strict comparison of dollars charged to expense did not necessarily inform the financial user of the actual differences between the plans. SFAS No. 87 reduces the variance resulting from different methods and, this, makes the comparison between companies more meaningful....

A fourth consideration is that there are many acceptable methods for calculating pension costs under current PSC accounting rules. Each method, the results of which can vary widely, requires the selection and use of numerous assumptions. SFAS No. 87 requires the use of one standard method. Narrowing the manner in which pension costs must be calculated improves staff's monitoring of pension costs by reducing the number of methods with which staff must become familiar.

Case No. 91-M-0890, In the Matter of the Development of a Statement of Policy Concerning The Accounting and Ratemaking Treatment for Pensions and Post-Retirement Benefits Other Than Pensions, (hereafter "New York"), Appendix A, p.9-10.[52] The limitation on actuarial methods, coupled with the relationship between FAS 87 accruals and actual pension expense makes FAS 87 the most appropriate method for ratemaking.

3. ERISA MINIMUM SHOULD BE REJECTED BECAUSE IT WILL FORCE THE COMPANY TO CHANGE TO A NEW METHOD WITH POTENTIAL FINANCIAL HARM RESULTING.

SWB was using a funding type method prior to Case No. TC-89-14 in the pre-FAS 87 time period. FAS 87 was found to be a more appropriate measure of the Company's pension expense in that case and the Company switched to that method in 1989. Now with no change in circumstances to justify it, Staff proposes that the Company be forced to switch back to a pre-FAS 87 type funding method; not because of any real concerns about the utility of FAS 87, which has worked well over the past four years, but because it fears the Commission will use FAS 87 as a reason to adopt FAS 106. Although SWB strongly encourages the Commission to allow the

[52]The New York opinion, which is one of the most detailed examinations of the cash versus accrual accounting issue. It has not been published in the PUR series and is attached hereto in Appendix A.

Company to use FAS 106 for ratemaking, it believes the two issues can be treated individually and that FAS 87 should not be reversed simply because of alleged consistency concerns about the treatment of OPEBs.

### a. REVERSING THE FAS 87 DECISION WOULD CAUSE FINANCIAL HARM TO SWB.

The adoption of FAS 87 resulted in lower rates of over $19M per year beginning in 1989. T.1621-22 That was $19M dollars in annual rates customers have saved over the past four years. That rate reduction was made possible because of the amortized return of the pension asset (the transition asset is similar to the transition obligation, the TBO, on the FAS 106 side) and the favorable earnings on that asset which resulted in negative pension expense and the reduced revenue requirement. Id. Now after customers have benefitted for the past four and one-half years under FAS 87 and pension expense has turned positive, thus increases revenue requirement, Staff is reverting to a funding approach for "a heads I win, tails you lose" approach.

A utility may not have a constitutional right to a particular ratemaking methodology, but the Constitution does implicitly guarantee that the regulatory process cannot be used to harm a utility and in this case that is what Staff's proposal would do. Although it is difficult to put the actual numbers into a chart because pre-1989 the Company was using a funding method which was different from Staff's ERISA minimum approach, it is easy to see with a simple illustration how switching from one accounting method to another can lead to underrecovery of expenses in the long run.

| | PENSION EXPENSE | |
|---|---|---|
| YEAR | FAS 87 | FUNDING |
| 1 | 20 | 15 |
| 2 | 15 | 20 |
| 3 | 15 | 25 |
| 4 | 20 | 20 |
| 5 | 30 | 20 |
| TOTAL | 100 | 100 |

The example shows that staying with one method will, in the long run (and in theory), assure full recovery of pension expenses. However, if we assume a switching back and forth between methods such that in years one and two a funding method, like Staff's ERISA minimum method was in place and then in years three and four FAS 87 was used for ratemaking, until in year five funding was required again, the grand total is less than overall expense:

| YEAR | RATEMAKING METHOD | PENSION EXPENSE FOR RATEMAKING |
|---|---|---|
| 1 | Funding | 15 |
| 2 | Funding | 20 |
| 3 | FAS 87 | 15 |
| 4 | FAS 87 | 20 |
| 5 | Funding | 20 |
| TOTAL | | 90 |

Much like the simple illustration suggests, SWB is at risk of underecovering its full pension expense as a result of vacillating between funding and FAS 87 methods for determining pension expense.

The New York PUC was concerned about the idea of flip flopping when it adopted FAS 87 earlier this year. That Commission explained:

> A fifth reason for adopting SFAS No. 87 is that by now almost all companies have adopted SFAS No. 87 for reporting purposes, but they are still deferring the difference between rate allowances under the old formula and financial accounting amounts under SFAS No. 87. Requiring companies to switch back to the previous method would be costly, cumbersome, and confusing. Also, switching back and forth between methods might lead the more sophisticated investor and rating agencies to question the integrity of the financial statements.

New York Opinion, Id. at Appendix A, p.10. With no good reason to revert to funding, other than alleged concerns about consistency with FAS 106, it makes no sense to require SWB, which must operate in an environment more competitive than when the Order in Case No. TC-89-14 was issued, to use an out-of-date funding method with the great potential that such a switch could cause the Company to underrecover pension expenses.

**b. A REVERSION TO A FUNDING METHOD REQUIRES RATEMAKING TREATMENT FOR THE REMAINING PENSION ASSET.**

On January 1, 1994 when new rates will go into effect, SWB will still have a pension asset of approximately $26M (intrastate) on its Missouri books.[53] See Ex.164 That pension asset, which would not exist under the funding method, will have to be reversed (i.e., charged to expense) and ratemaking treatment afforded if Staff's proposal is adopted. Ex.37,p.14-16 Now that Staff recognizes that the pension asset will still exist into the first quarter of 1995, it is willing to increase rate base, but only if the Commission returns SWB to traditional regulation and then only by $21M intrastate, rather than the full $26M. The $21M, is based upon Staff's mistaken assumption that customer rates were rebased in each year of the current Incentive Regulation Plan using actual pension expense in each of those years. See T.1551 In reality customer rates were established in 1989 based upon the 1987 test year and were reduced by $19M. In every year after 1989 customers

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[53]That dollar level, which on a corporation-wide basis is $220M, may be substantially understated because it presumes 401(h) transfers in 1993, 1994 and 1995 to offset OPEB expenses, which may or may not occur.

continued to pay the same lower rates based upon the pension expense underlying that original $19M annual reduction. Staff's proposed rate base treatment would not be sufficient. SWB should also receive expense recognition of the full amount because of the required write down. Such treatment would be consistent with recognition of the transition asset in expenses which occurred when FAS 87 was adopted. Accounting methods cannot be switched in mid-stream without transition, otherwise SWB will be harmed.

**B. FAS 106 EXPENSES SHOULD BE INCLUDED IN RATES.**

The Commission may have grown understandably weary of hearing about the FAS 106 problem because it has looked at the issue throughout the year in many cases, some of which are still pending and some which have been resolved, but the issue will not go away without forward thinking Commission action. What is new about the issue in this case is evidence that FAS 106 will affect telecommunications companies differently than other utilities, a new perspective on the way that other regulators have implemented 106 and perhaps most importantly, the fact that FAS 106 can be adopted in this case without a rate increase. Many of the 38 jurisdictions which have adopted FAS 106 throughout the nation have exercised their full regulatory authority by adopting 106 while imprinting their own unique policies upon the statement to insure that its use in their individual states would be fair and reasonable to all affected parties. That is what SWB is seeking in this case: an adoption of FAS 106 which protects the Company from financial harm and puts it on an even footing with unregulated competitors, while still providing any reasonable safeguards the

Commission may feel would be appropriate. There will never be a time when an accounting change this significant can be adopted so easily. SWB encourages the Commission to seize this opportunity.

FAS 106 requires for OPEBs what FAS 87 required for pensions: that the deferred compensation nature of the benefits be recognized by accruing for the expenses as employees earn their benefits. Starting with fiscal years after December 1992, all employers have been required to record FAS 106 expenses on their financial books. Ex.37,p.21 SWB made that transition in the first quarter of 1993. Id. Subsequently the Company has received ratemaking treatment or a promise of treatment for such expenses in all of its jurisdictions, except Missouri.[54] Id.,Sch.4. The issue in this case is whether Missouri will afford like treatment.

### 1. THE UNIQUE CIRCUMSTANCES AFFECTING SWB ARE A SIGNIFICANT FACTOR.

The Commission rejected the Company's application to consider the FAS 106 issue in a separate docket earlier in the year. A part of the Company's reason for seeking an earlier hearing in Case No. TO-90-1 was a concern that the policy aspects of the issue might, for practical purpose, be decided before the Company had an opportunity to even present evidence because rate proceedings involving St. Joseph Light and Power (St. Joseph) and Missouri Public Service Company (MoPub) were on a much faster track. However, the circumstances affecting the telecommunications industry generally are very different from those affecting the energy utilities. T.1495-1509 Because of those unique factors, as

[54] Oklahoma has not addressed the issue yet for SWB, but the Commission Staff has expressed support for FAS 106 methodology.

well as the underlying soundness of the FAS 106 principles and methodology, the Commission should approve FAS 106 for SWB.

**a. APPROVAL OF FAS 87 ARGUES IN FAVOR OF FAS 106 ADOPTION.**

One of the unique factors distinguishing SWB's case from MoPub and St. Joseph is how the Company records its pension expense. T.1498 SWB has been using FAS 87 to record its pension expense since authorized to do so in Case No. TC-89-14. Id. Neither St. Joseph, nor MoPub were using FAS 87 for ratemaking when they were ordered to continue to account for OPEBs on a cash basis. Id. Although the Company believes the FAS 87 and FAS 106 issues can be separately judged and decided upon their own merits, the rationale underlying the Commission's original decision adopting FAS 87 for SWB and many of the principles of FAS 87 are equally applicable to FAS 106.

The R&O in Case No. TC-89-14 adopted Part 32 as the new USOA, including FAS 87, primarily because,

> Part 32 brings SWB's accounting procedures more in line with competitive companies, thus making SWB better able to meet the requirements of a more competitive industry.

R&O,p.14 The same can be said of FAS 106. Ex.37,p.30;Ex.167,p.34 As of this year, all companies subject to SEC standards have been required to convert to FAS 106 accounting on their financial books and records. Ex.167,p.4 Regulated and unregulated companies in the telecommunications industry are using FAS 106 on their financial records, and with the exception of 4 states, on their regulated books, as well. Ex.37,Sch.4 That is the environment in which SWB must compete. It only makes sense that the Company compete on equal footing and that its financial statements be meaningful and comparable to investors. The same competitive pressures that led the Commission to conclude that GAAP accounting made more sense for SWB in 1989 should lead it to adopt FAS 106 in 1993.

In addition to the pressures that resulted in the original adoption of FAS 87, some of the principles underlying FAS 87 are present with FAS 106 and make it equally appropriate for ratemaking. Mr. Toti identified some of those similarities in his Rebuttal testimony.[55] Ex.37,p.31 Each of the similarities point to the superiority of accrual accounting because it measures the periodic liability as accurately as possible and matches that liability to the period of incurrence using the best actuarial and accounting tools available. Further, the FAS 106 transition mechanism allows the change from one accounting method to another to be accomplished without rate instability or financial compromise to the utility. The list noted above and the other items in Appendix B to Statement 105 demonstrate that the similarities among the two statements far outweigh any differences.[56] Id.

**b. THE COMPETITIVE PRESSURES FACING SWB MAKE ADOPTION OF FAS 106 MORE IMPORTANT.**

As mentioned earlier, competition is another unique factor affecting the telecommunications industry differently from the

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[55]Mr. Toti explained that: both require an actuarial valuation to determine net periodic costs; both include the same cost components; have a transition asset/obligation which represents the impact of changing from one accounting method to another; and both allow for the amortization of the transition asset/obligation.

[56]The differences most often cited are the lack of a legal obligation and the actuarial uncertainty of estimating OPEBs. Such differences do not withstand close analysis as Section 2.c below demonstrates.

energy utilities. A person would not have to look at this case in depth to note that the Company placed a special emphasis on competition. The discussion of that evidence in Section III of this Brief will not be repeated here, although it is as important to the FAS issues as it is to any other issue in the case. The Company's emphasis on competition does not come from a belief that the Commission is unaware of the true extent of competition in the Missouri telecommunications environment, but stems instead from the fact that competition must be factored into more than just rate design and incentive regulation, but also into the accounting arena where the cost base for rate design and all other decisions originate.

Staff witness Traxler admitted that competition was not considered, even in passing, as Staff presented the identical pay-as-you-go position in SWB's case as it had in the earlier energy utility cases. T.1502 Nevertheless, Mr. Traxler acknowledged at the hearing that SWB faces competition. T.1500-09 SWB believes that competition, once factored in, will merit a different answer to the FAS 106 debate than was reached in prior cases.

The relevance of competition to the issue of FAS 106 is inherent in three arguments concerning how OPEBs should be calculated. First competition raises an intergenerational equity concern, second it raises an issue concerning the proper basis for pricing decisions, and finally it is a factor in considering how the investment community may react to the ratemaking treatment afforded to OPEBs.[57]

Competition reduces the overall customer base to the extent that competitors take away customers of the incumbent provider. Ex.167,p.27-29;T.1506-09 That is a given when a monopoly market is opened up to new competitors as has been the case in the toll and related long distance services markets in Missouri. In its December 21, 1992 order in Case No. TR-93-116, this Commission noted that competition in those markets had reduced the Company's market share and revenues during the past few years. R&O,p.12,18

SWB's total OPEB obligation, as measured by the TBO, is currently $333M. Ex.37,p.27 No one has questioned the legitimacy of these expenses which relate to prudently incurred health care related expenses deferred under the pay-as-you-go method. The difficult issue is who is going to pay those expenses. FAS 106 requires current customers to pay for the expenses of current employees, by matching the accounting period to the period in which the employee earns future retirement benefits. Ex.167,p.23-24 There is no question that those expenses will be less if paid today than if paid years down the road after inflation has been factored in. Id. On the cash basis advocated by Staff, the next generation of customers will be required to pay for this generation of employee's retirement benefits. Ex.167,p.24 That concept is unfair even if the base of customers were to stay fairly stable, but it is truly unfair when competition is already shrinking the

[57]See Subsection 3 infra for discussion of investment community factor.

customer base and can be expected to continue to affect the customer base in the future. Id.

The New York PUC was concerned about competition when it required the adoption of FAS 106 by utilities subject to its jurisdiction and explained why:

> OPEB[s], like pensions, are a form of deferred compensation. In exchange for the employee's current services, the employer promises a deferred benefit in the form of OPEB[s]. Since today's customers receive the employees' services, it is only fair that they pay the full cost of the employees, including the cost of benefits which will be paid out at a later date. The alternative is to allow the companies to build a liability beyond $3.4 billion owed by ratepayers to date. This is of particular concern to industries where competition inroads are likely to reduce the number of customers from which the OPEB liabilities might be recovered. There is also a question of fairness to future generations which weighs on the side of current recovery. (footnote omitted).

Case No. 91-M-0890.

Adoption of 106 will invariably affect the prices SWB charges for its competitive services. Pay-as-you-go understates liabilities and thus allows prices to be set lower than actual cost. The potential for below-cost pricing of competitive services is unfair to the Company and its competitors. Given this Commission's recognition of the effects of competition on SWB's customer base, that issue must be a factor in the decision in the FAS 106 issue.

### c. FAS 106 CAN BE ADOPTED WITHOUT A RATE INCREASE.

In Case No. TC-89-14, this Commission recognized that rate reduction cases can provide a useful vehicle to adopt accounting changes which may have significant rate impacts. In that case the capital to expense shifts associated with the adoption of Part 32 had a significant revenue requirement. In its Order the Commission reasoned:

> Although not the primary determining factor, the Commission considered the fact that the shift of costs resulting from the adoption of Part 32 for ratemaking purposes occurs within the context of a case to reduce SWB's rates. Since the Commission in this decision will be reducing SWB's rates, it can allow the implementation of Part 32 for ratemaking treatment without a concurrent rate increase....

R&O, at p.14 Just as with Part 32 in 1989, FAS 106 has a significant revenue requirement, but it can be adopted in this case without a concurrent rate increase. Ex.37,p.41;T.1496-97 Therefore, this case poses a unique opportunity to adopt a necessary and forward looking accounting change without a concurrent rate increase. _See_ T.1539 Additionally, after approximately 8 to 10 years, the revenue requirement for OPEB is expected to turn negative as earnings of the funded liability are expected to exceed expenses in that time frame. T.1665 So in the long run, customers will benefit from the adoption of FAS 106.

#### d. SWB'S EFFORTS TO CONTAIN OPEB EXPENSES SHOULD BE A FACTOR.

The testimony of James Zishka detailed the Company's extraordinary efforts to manage its OPEB expenses through creative and tenacious planning. Ex.169 Every change, starting with the Custom Care managed network system through to the most recent and aggressive program, an expense cap on retiree benefits, has been a hard fought improvement obtained through negotiations with the Communications Workers of America (CWA). _Id._,p.3 Although none of the changes to the benefit plan have resulted in an overall _reduction_ in benefit expense levels, they have minimized the

Company's responsibility for the future growth in expenses through discounts and efficiencies negotiated from the health care delivery system and by the sharing of the responsibility for increased expenses with employees. T.1655 As a result, the Company's future expenses are more predictable. T.1666-68;Ex.173

Neither Staff nor OPC challenged the level of OPEB expenses included in the Company's case. T.1509-10,1536-37 In fact Mr. Traxler acknowledged the significant steps taken by the Company to insure that customers are paying the lowest rates necessary to cover these reasonable and necessary expenses. T.1537

Some of the concerns expressed in other states regarding FAS 106 have centered around the level of OPEBs, which under the pay-as-you-go accounting method had grown much larger than many companies and regulators realized. See e.g., New York, Appendix A Many states have required companies to address their level of OPEB expenses in their FAS 106 filings and one state, Pennsylvania, made an aggressive cost containment program a prerequisite for FAS 106 recovery. PUC v. West Penn Power Co., PAPUC Docket R-000922378, Order at p.60 The level of SWB's OPEB expense is reasonable and will remain so in the future due to the Company's efforts and more specifically the retiree benefit cap. T.1666-67;Ex.173 Accordingly, this unique feature of SWB's case should be viewed as a positive factor qualifying the Company for FAS 106 recovery.

e. SWB'S COMMITMENT TO FULLY FUND IS A POSITIVE FACTOR.

The Company has funded approximately 80% of its current annual OPEB liability and has committed to fully fund its obligation if this Commission makes funding a FAS 106 prerequisite.[58] T.1654; Ex.170,p.5 Tax advantaged funding is permitted up to the unfunded liability attributable to nonmanagement employees/retirees. T.1636-39 Nonmanagement employees comprise approximately 2/3 of SWB's work force and the total OPEB obligation level attributable to those employees is well over $1 billion.[59] T.1637 The Company's current overall annual OPEB obligation attributable to Missouri is at $28M, thus a tax advantaged vehicle is currently available to fully fund the annual expense level for several years. T.1636-39 SWB has fully funded in three of its jurisdictions and is expecting tax deductions for the full amount of funding. T.1639 The Company's commitment to fully fund in a tax advantaged manner is another positive factor on this issue.

### 2. FAS 106 IS MORE APPROPRIATE FOR RATEMAKING THAN PAY-AS-YOU-GO ACCOUNTING.

Many regulators throughout the nation have had concerns about the propriety of FAS 106 expenses for ratemaking. Some Commissions, like Georgia and Iowa, initially ruled against FAS 106 and then in later dockets reversed their first opinions because of the mounting evidence that FAS 106 could work and that a failure to adopt it would financially harm the affected utilities. <u>See e.g.</u>, <u>Re: Other Post-Retirement Benefits (SFAS 106)</u>, 141 PUR4th 283 (Georgia) <u>Re: Rate-making Treatment For Post-Employment Benefits</u>

[58]Mr. Toti explained that funding provides two significant benefits. It provides employees and retirees with some security, knowing that funds will be there to pay for earned benefits. Additionally, funds are invested and earn tax-free returns which reduce future OPEB expenses charged to customers. T.1664-65

[59]Missouri's portion is $175 million.

Other Than Pensions, 140 PUR4th 240 (Iowa). Many states which have adopted FAS 106 examined their individual concerns and tailored the adoption of the statement in their jurisdiction to address those concerns.[60] T.1663-64,1615-16 Practical approaches to ratemaking have allowed regulators to make the transition to the new accounting method while still protecting utility customers. Missouri can take a similar approach and adopt FAS 106 while requiring any safeguards this Commission may believe are necessary to satisfy concerns. T.1664

a. FAS 106 PROVIDES BETTER MATCHING.

FAS 106 requires OPEBs to be accounted for on an accrual basis, rather than booking expenses only as retiree claims are actually paid out. As a result, FAS 106 matches the recording of the benefit/expense to the period in which it is earned by employees. Ex.167,p.23-26 This concept of matching is what has been termed "intergenerational equity." The concept recognizes that OPEBs are not a gratuity conferred by the employer after the employee retires, but rather that they are earned by the employees as they provide service to the company and its customers. Accordingly, FAS 106 attempts to quantify the employer's current obligations and recover that obligation in current rates. Mr.

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[60]For example, the Rhode Island Commission was concerned about the potential to manipulate the actuarial study and alleviated that concern by requiring utilities to use standard actuarial assumptions in their calculation of OPEB expenses. Ex.37,Sch.4 Many Commission's, such as Texas and Kansas, were concerned about whether the revenues collected to cover the OPEB obligations would be there when the obligations came due and therefore have required funding as a prerequisite to 106 recovery in rates. T.1668-69

Foster explained the benefits of matching in his Rebuttal testimony. Ex.167,p.3-4

Staff and OPC believe intergenerational equity will not be available under either method. Although that may be true during the transition period when the change in accounting methods must be accomplished through a catch-up mechanism called the Transition Benefit Obligation or TBO, once the TBO is amortized, FAS 106 provides perfect matching. Ex.167,p.26 SWB is recommending amortizing the TBO over 16 years (average service life of employees) rather than immediate recognition in order to prevent adverse rate consequences. Ex.37,p.27 Although the amortization of the TBO will require current customers to pay for benefits to retirees rather than current employees, it is the first step towards a complete match, unlike pay-as-you-go which perpetuates the inequity. Ex.167,p.23-7;Ex.37,p.33 The Maine Public Utility Commission in a July 12, 1993 Order found that FAS 106, even with the TBO improves intergenerational equity.[61] Re: Compliance with the GAAP Requirements of SFAS No. 106 (Chapter 720) Docket No. 93-050, Order at p.4, (hereafter "Maine"). Simply put, although FAS 106 does involve some actuarial based estimation of OPEB expenses, the estimation is much more accurate than pay-as-you-go which by estimating nothing erroneously implies that the obligation to provide OPEBs does not exist. Ex.37,p.25

[61]The Order provides "Thus, by moving to the accrual basis under SFAS 106, today's ratepayers will be required to pay for the cost of the benefits being earned today (current service costs), thereby improving intergenerational equity. We find this to be true even when the amortization of the transition obligation is considered." Maine, at p.4

**b. FAS 106 IS ACTUARIALLY SOUND AND RATEMAKING SAFEGUARDS ARE AVAILABLE.**

Much of Staff and OPC's concerns about FAS 106 are related to a fundamental suspicion of the actuarial process. T.1522 The only actuary who testified in the case was Joseph Vogl of Towers Perrin. T.1520-23 He testified on behalf of SWB and explained that the actuarial study of SWB's OPEB expenses provides a sound estimation of the net periodic expense. Ex.166,p.1-18 Staff's witness, who is not an actuary and has had no actuarial training or education, criticized the Company's study, but admitted that he would not have accepted any actuarial study for purposes of determining OPEB expenses for ratemaking purposes because he simply does not believe the estimation can be accurately done. T.1520-22 At the same time however, he did not take the time to sit down and meet with Mr. Vogl to ask questions about the actuarial study or Mr. Vogl's methodology to determine if a better understanding of actuarial methods could satisfy his concerns about the process, nor did Staff retain its own actuary to study SWB's OPEB expenses. T.1521 Such vague, unsubstantiated criticisms are very difficult to dispel. Staff's concerns are unfounded and cannot form the basis for a valid denial of FAS 106 recovery because there is no competent evidentiary support for Staff's position on the actuarial study. Additionally, even if the concerns had a basis in fact, any legitimate concerns can be addressed without the wholesale rejection of FAS 106.

SWB's study has been scrutinized many times and found sound for ratemaking purposes. The basic study performed by Towers Perrin and underlying SWB's request for FAS 106 recovery in this case has been submitted, examined and formed the basis for the adoption of FAS 106 in all of the Company's other five (including interstate) jurisdictions.[62] T.1523 Similar studies have or will be used to determine OPEB expenses for ratemaking in the 38 of 42 jurisdictions which have adopted FAS 106. Ex.37,Sch.4;T.1523

SWB's study took into consideration all of the benefits the Company has realized from its aggressive management of its health care expenses by reducing the base dollars,[63] including the effect of the cap on retiree expenses which has the effect of making Company OPEB expenses relatively flat and very predictable going well into the future. T.1666-67;Ex.166,p.17;Ex.173 Additionally, the key assumptions used in the study, the health care trend rate and the discount rate compare favorably with assumptions used by unregulated Fortune 500 companies which would have no incentive,

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[62]Actual adoption has not yet occurred in Oklahoma, however a commitment to adopt has been made by Staff.

[63]Staff witness Traxler questioned the initial 12% health care trend rate used in the actuarial study because the Company's actual experience has been better than the trend. Although it is true that the Company's aggressive management of its health care expenses have reduced its growth rate, Staff's criticism reflects a misunderstanding of the actuarial process. First, the 4.77% growth rate addressed in Company witness Zishka's testimony and noted by Mr. Traxler in his Surrebuttal, was the overall rate for active and retirees for a single year, whereas the trend rate used in the actuarial study of OPEBs is for <u>retirees</u> only and was over a 20 year time frame. More importantly, the study took SWBT's favorable experiences into account in a different way by reducing the base level of expenses at the outset of the study, rather than trying to guess how management's efforts would allow it to beat inflation in future years. Such a technique is actuarially sound and recognizes that expense reduction programs which may lessen the effect of inflation on the Company in the year when such programs are adopted by sharing cost increases with retirees, but will not allow the Company to control the overall inflation rate which is influenced primarily by what doctors and hospitals charge. Ex.170,p.6-8;T.1666-67

real or perceived, to inflate their OPEB liabilities. Ex.166,p.10-15

The FASB recognized that actual experience could differ over time when compared to actuarial expectations. To insure that discrepancies, if any, would not impair the validity of financial statements the FASB requires an annual true-up to track such changes and insure that they are folded into expense calculations. Ex.167,p.40-41 FAS 106 allows the recognition of such gains and losses immediately or on a deferred basis. The deferral method takes into account that gains in one period may be offset by a loss in a subsequent period, and therefore recognizes differences between actual experience over expected in a way that avoids potentially large swings in expense levels from year to year. T.1655-56 Mr. Toti described this "neat" feature of FAS 106 at the hearing. T.1655-58

Some state Commissions have found comfort in the stabilizing effect of the deferral approach, whereas others have expressed concern that a long term amortization may prevent customers from realizing the benefits of actuarial gains in a timely manner. FAS 106 is not a package deal dictated by "the accounting powers that be" to regulators or the regulated. Although it sets forth standards that all companies must abide by for financial reporting purposes, Schedule 4 to Ex.37 illustrates that regulators in many of the 38 jurisdictions that have adopted FAS 106 have required their own safeguards to insure that the new method of accounting for OPEBs made sound ratemaking policy in their individual states.

These safeguards have taken various forms such as funding or standard actuarial assumptions.[64] Ex.37,Sch.4 For SWB, the incentive plan, if continued, would provide a unique safeguard in that actuarial gains and losses could be folded into the sharing mechanism to insure immediate accountability for the actuarial study, if this Commission were to deem that necessary. SWB encourages the Commission to satisfy its concerns through the various ratemaking safeguards which are available, rather than a wholesale rejection of FAS 106.

### c. OPEBS DO NOT DIFFER MATERIALLY FROM OTHER ESTIMATED ELEMENTS OF COST OF SERVICE.

One of the most frequently mentioned concerns about FAS 106 rate recovery is the perceived lack of a legal obligation to provide and maintain such benefits. Although OPEB obligations, unlike pensions and nuclear decommissioning requirements, are not neatly derived from a single piece of federal legislation, the legal and practical restrictions are equally binding. In SWB's case those restrictions are found in the labor and tax areas.

SWB's retirement benefits, including health care, are an integral part of employee total compensation which cannot be withdrawn nor reduced without prior union approval and in all likelihood a corresponding increase in a different element of the compensation package. T.1514-18,1641 The Commission recognized that reality in the area of concession service in its order in Case No. TC-89-14 wherein it stated:

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[64]Many states have required funding, and Rhode Island recently required standard actuarial assumptions, while New York adopted a ten year deferral period (rather than the average remaining service life) for the recognition of gains and losses.

> The Commission still agrees with SWB's contention that the longstanding telephone concessions are reasonable and that a disallowance of those concessions would result in demands for higher wages to replace those lost benefits.

R&O, at p.28 Although Company management has taken the position that it does not bargain for retirees, the reality of that equation is that there are two equally strong parties to the collective bargaining process and the other party, the union, which represents approximately 2/3 of SWB's employees, insists on negotiating for retiree benefits.[65] As Mr. Toti explained during cross-examination, the contract with the Union is replete with references to retirees which lends credence to the Union's perspective on the scope of bargaining. T.1641-43,1652

The issue becomes one of semantics, but the bottom line is the Company could not restrict nor eliminate retiree benefits without swift and serious consequences to its employee relations and customer service, including the potential for strikes, similar to the 100 day strike the CWA organized against NYNEX when that RBOC sought to reduce retiree health care benefits in 1989, or law suits similar to the one McDonnell Douglas is embroiled in right now. *See T.1650,1641,1514-17* *Whether the Company would win or lose such* fights -- and the case law goes both ways[66] -- is not so much the point as the fact that the mere potential for such an expensive, protracted struggle and the *ensuing damage it would have on*

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[65]In the CWA's bargaining position statement for 1992, one of its stated missions was to strengthen retiree health care benefits. See T.1514-17

[66]See e.g., United Auto Worker v. Yark-Man, Inc., 716 F.2d 1476 (6th Cir. 1984); Bower v. The Bunker Hill Co., 725 F.2d 1221 (9th Cir. 1984).

employee relations and customer service acts as a strong deterrent to any consideration of benefit reductions.[67] T.1642

Beyond the employee relations side of the OPEB legal liability issue are the less emotional tax related issues. SWB has elected to make a 401(h) transfer of pension funds to be used for the payment of OPEB expenses. T.1518,1647 Having done so, the Company is required by the tax laws to maintain the same level of benefits during a "cost maintenance period" of five years. T.1519 A new five year period starts with each 401(h) transfer and effectively restricts the Company's ability to reduce its benefit levels for the next five years and subsequent five year periods as long as the 401(h) tool is used. See 16 USCA 5215 §420(c);T.1571-73,1613-14

The Company has also established a Voluntary Employee Benefit Account or VEBA to fund its OPEB liabilities. The same ERISA regulations which restrict the way in which pension funds are handled apply equally to "employee welfare benefit plans," which are defined to include funds established "for the purpose of . . . medical, surgical or hospital care or benefits in the event of sickness, accident, disability [or] death . . . ." 29 USC 1001 §2; T.1611-13

It is clear that restrictions exist which leave little doubt that the OPEB expenses the Company seeks recovery for in rates will be there down the road. The assumption that OPEBS will be there after rates anticipating those expense levels have been set is no

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[67]Additionally, FAS 106 at ¶¶90-99 has specific provisions to handle plan reductions or curtailments. Those provisions require that expense savings be applied first to reduce the TBO, rather than be realized by the employer.

different than the same assumptions which are inherent in the ratemaking process in other areas. See T.1512-14 The Commission sets rates based upon a test year level of employee compensation on the assumption that the Company will continue to pay its employees based upon that salary history. Id. The Commission also sets depreciation rates based upon existing plant levels and presumes the Company will not immediately salvage property and try to recover the expense dollars more rapidly than necessary before new depreciation rates can be set.[68] Id.

A certain level of trust, balanced by ongoing oversight, is a reality in the regulatory arena and insures that rates based upon projected expenses, including OPEB expenses and depreciation expenses, will be reasonable and not overly compensatory in the period during which rates will be in effect.

### 3. FAILURE TO ADOPT FAS 106 WILL FINANCIALLY HARM SWB.

When this Commission was originally faced with the issue of whether to adopt FAS 106 for ratemaking purposes it appeared that there were a couple of ways to handle the issue without serious risk of financial harm to the utilities unaffected by competition. In fact, the first time the Commission was required to address this issue one utility, Union Electric (UE), came in seeking a

[68] The self-healing aspects of FAS 106 process are similar to the depreciation represcription process where rates are readjusted every three years based upon the most current information, which always includes an estimate of how long the property will last and what the Company will receive in the way of net salvage when property is retired. The estimation of OPEBs like estimating depreciation parameters includes some educated guesses which are trued-up as new information is received and like depreciation a presumption must exist that the need for the rates will continue into the future.

regulatory asset instead of FAS 106 recognition; a much different posture than the most recent applicants. At the time UE approached this Commission in 1992, it appeared that FAS 106 could be adopted, or that a FAS 71 regulatory asset could be established to guarantee long term recovery of the OPEB expenses. See T.1524-25,1558-59

Even in its most recent cases the Commission has stated a belief that a regulatory asset may be established to allow long term recovery for OPEBs. Staff witness Traxler disagrees. He explained that the regulatory asset alternative is simply no longer available unless the rather restrictive guidelines[69] established by the Emerging Issues Task Force (EITF) of the FASB are satisfied. He candidly informed the Commission that the orders in the St Joseph and MoPub cases were not sufficient to establish a regulatory asset.[70] T.1558-59 That being the case, failure to allow for recovery of FAS 106 expenses in rates will result in financial harm to the Company as a result of the impact on net income of the charge of FAS 106 expenses to current earnings and the fact that the unrecovered liability of the Company must be disclosed to the investment and debt communities. T.1525-26

[69]Among other requirements, the EITF guidelines permit a regulatory asset to be recorded only when full FAS 106 recovery will occur within 5 years, but not when the regulator continues to include OPEBs in rates on a pay-as-you-go basis. Ex.167;p.43-47

[70]Mr. Traxler advised Commissioner Kincheloe that the language in the MoPub and St. Joseph opinions will not result in recognition of a regulatory asset. T.1558-59

All companies subject to SEC regulations were required to transition to FAS 106 accounting no later than 1993.[71] Beginning this year the Company's annual (10K) and quarterly (10Q) reports have reflected FAS 106 expenses. Failure to recover full 106 expenses is an event the Company will be required to disclose to investors and financial institutions in the body of its financial statement, rather than buried in a footnote.[72] T.1579,1606

The investment community, even before the EITF guidelines became final in January of this year, expressed concerns about how the failure to obtain concurrent rate recovery for OPEB expenses might adversely affect regulated utilities. Standard and Poors CreditWeek, "Utilities and FAS 106" June 15, 1992 cautioned that:

> S&P's comfort with the creation of a regulatory asset for utilities which are not permitted cash recovery will be assessed within the context of individual regulatory environment and competitive position....Under a worse case scenario unresponsive regulatory treatment which leads to a reduction in cash flow may result in immediate, negative ratings actions.

*See* Ex.163 The creation of a phantom regulatory asset would certainly qualify as nonresponsive because it fails to address the issue at all. Dr. Avera, the only rate of return expert in the case who addressed the impact of FAS 106 on the Company's treatment in the equity and capital areas explained:

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[71]Mr. Foster explained that FASB pronouncements are recognized as authoritative by the SEC and referenced Financial Reporting Release No. 1, Section 10. Ex.167,p.9

[72]The Empire District Electric Company which obtained an Accounting Authority Order requiring continued pay-as-you-go recovery of OPEBs has issued its 10Q addressing the issue. That statement was marked as Ex.162. It was admitted for illustrative purposes only, but it exemplifies the type of language investors and banks will consider when dealing with companies which have failed to obtain full rate recovery of FAS 106 expenses.

[I]f regulators no longer honor this "regulatory compact" and exclude or substantially reduce reasonable and necessary expenses in setting a utility's rates, then the risks perceived by investors would rise significantly. To compensate for these additional risks, investors would correspondingly increase their required rate of return....

Ex.18,p.39;T.1554-55

The Georgia Commission which originally rejected FAS 106 and then reconsidered the issue in March of this year noted:

The Commission [by continuing pay-as-you-go] would be running the risk that the utility would not be allowed to recognize the regulatory asset and be required to recognize a current loss of the difference between pay-as-you-go and accrual. It is the opinion of the Commission that this latter event would be the most likely to occur if the Commission attempted to adopt a pure pay-as-you-go approach for rate recovery. This could significantly impact the financial condition of the utility and could significantly raise cost of capital and have other adverse financial impacts.

141 PUR4th 285.

The Iowa Utilities Board in an order issued on January 4 of this year expressed similar concerns:

If the accrual method is not adopted for rate-making purposes, the Board has concerns that the utilities may be unable to meet the standards for the establishment of a regulatory asset. As a result, those costs could be charged against current earnings which could cause a substantial hardship to the utilities.

Order at p.3;see also, Maine Order, supra at p.4-5

Staff in its testimony confused the impact of continued pay-as-you-go treatment with the Company's decision to write-off the Transition Benefit Obligation (TBO) and incorrectly concluded, on the basis of stock prices alone, that SWB would not be harmed by a failure to adopt FAS 106. OPC, without any apparent concern for the Company's financial condition, recommended disallowing the prudently incurred TBO expenses if FAS 106 is adopted. Neither Staff's nor OPC's positions on the TBO withstand scrutiny.

**4. ADOPTION OF FAS 106 WITHOUT THE TBO IS NOT AN EQUITABLE COMPROMISE.**

The Company's decision to write-off the TBO, which represents only the already incurred OPEB expenses, and has nothing to do with expenses going forward, should not be confused with the issue of recovery. The write-off is a recording issue, not a recovery issue. T.1677,1680-83 In the year of implementing FAS 106 the accounting rules allow a one-time expense write-off, which if done as an industry in unison, as it was in this case,[73] cancels out any investor fall-out assuming ultimate recovery is equally uniform. In theory, such a move gets the problem over with. The difficulty in SWB's case is that all of those assumptions are not yet true. If recovery is not allowed in Missouri, the expenses will not have simply gone away and no accounting or regulatory magic will make the payment of those expenses any easier nor make the investment community and lending institutions forget that they exist. Id. The Company's financial statements will continue to reflect whether the expenses are being recovered and the balance sheet will reflect the impact of the TBO costs for all future years. Ex.170,p.9-10 Thus investors and bankers will still compare SWB's position to the regulated utilities in over 90% of the other states that have received recovery and rate the Company accordingly. Id.

Staff argues in its testimony that SWB's favorable stock prices earlier this year are an indication that the Company will

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[73]Most companies adopting FAS 106 took a write-off in the year of adoption. Ex.170,p.9

suffer no financial harm if FAS 106 recovery is denied. SWB's stock prices during the spring of this year when the TBO write-off was taken are no indication of how a failure to obtain rate recovery will affect the Company's financial health. Ex.170,p.9-10 As Mr. Traxler agreed at the hearing, any number of other factors may have been affecting stock prices at that time, such as interest rates and the fact that investors would have been aware that the majority of regulators were allowing recovery of FAS 106 costs, including Texas and Arkansas at that time. T.1530-32;Ex.170,p.9-10 The credible evidence is instead that rate recovery is key to maintaining the Company's position in the investment and lending communities.

OPC has recommended disallowing the TBO if FAS 106 is adopted. Staff has not endorsed that recommendation. Ex.161,p.34 OPC's position, which on the surface looks like an appealing compromise, is grossly unfair to the Company. The TBO represents expenses prudently incurred by the Company in providing benefits to retirees and existing employees for past service. OPC does not claim that the expenses were imprudently incurred and no such evidence exists. See e.g.,T.1537 Accordingly, a disallowance would penalize the company unfairly for an accounting dilemma it had no hand in creating.

OPC's main concern seems to be based upon intergenerational equity arguments: that current customers should not pay for past service. But that is exactly what pay-as-you-go does and it is pay-as-you-go which created the TBO in the first place. In fact, pay-as-you-go essentially represents the TBO. Further, the TBO is not comprised of retiree expenses alone. Thirty-three percent of the TBO is for services rendered by employees who are still actively providing service to SWB customers.[74] T.1609

The TBO may be a difficult transition, but it is the flip side of the very welcome Transition Asset which was amortized[75] and resulted in reduced rates when FAS 87 was adopted in 1989. T.1545 Now when a transition asset is instead an obligation, the treatment should not be any different, particularly in an earnings reduction mode where an increase to customer rates is simply not a factor. Forty-two states have faced the FAS 106 issue. The vast majority have taken creative approaches to make adoption of the new accounting method suitable for ratemaking in their individual states. Although many were encouraged by the consumer advocates to disallow the TBO, none of those states adopted that patently unfair position and neither should this Commission. T.1615;Ex.37,Sch.4

FAS 106 is probably one of the most difficult revenue requirement issues facing this Commission since the Callaway nuclear power plant came on line back in 1985. In that case the Commission recognized, after intense debate, that fairness requires that legitimately incurred utility expenses, even when extraordinarily high, must be included in the cost of service and recovered from customers. See EO-85-17,p.202-203 SWB's FAS 106

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[74]A disallowance of the TBO would create the awkward accounting problem concerning how to book OPEBs for those employees who comprise the 33% of the TBO. When those employees retire and begin to submit doctor bills, will those bills be for the years of service disallowed or for the remaining service years incurred after this case is decided? See T.1607-08

[75]The amortization period was 18 years.

expenses are substantial, but can be included in rates without a corresponding rate increase and more importantly they are the true expenses of the Company and should form the basis for rates.

## C. POST EMPLOYMENT BENEFITS (SFAS 112)

### 1. THE COMMISSION SHOULD ADOPT FAS 112.

FAS 112 requires employers to accrue other post employment benefits expense on their books, rather than record such expenses when cash is disbursed. FAS 112 is the third in the series of three employee compensation statements (FAS 87 and FAS 106 are the other two) issued by the Board which were designed to require companies to consistently, accurately and timely reflect their employee compensation related liabilities. FAS 112 does for pre-retirement, post-employment benefits (i.e., employees on long term disability) what FAS 87 and FAS 106 do for post-retirement benefits.

If the Commission adopts FAS 106 or retains FAS 87, FAS 112 should be adopted also. Like the other two employee compensation statements, accruing for post-employment benefits more accurately reflects the fact that employees earn such benefits over their service life, rather than receive them as a gratuity. FAS 112 is relatively easy to transition to because expenses under both methods are approximately the same. Ex.37,p.43. Further, the entire TBO, at $11.3, which the Company recommends amortizing over 3 years at $3.8M per year, is manageable in the context of this case. Perhaps the best part of FAS 112 is that it represents the last of the three major employee compensation statements. T.1579-1581. If the Commission adopts the FAS package in this case, it will be permitting SWB to clear a very significant hurdle on its way to even footing with its competition.

11. **DEREGULATED SERVICES**

SWB and Staff both agree that an adjustment should be made to the regulated accounts to remove non-regulated service results from cost of service. Ex.29,p.23-24;Ex.7,p.56 Both also agree that CAM should be used to value the adjustment.[76] The only issue is a test year question; Staff has used 1991 results while SWB recommends results for the twelve months ended September 1992, consistent -- as Staff witness Meyer proposes -- with other parts of the rate base and expense Staff proposes. Ex.7,p.60

Staff opposes updating to September 1992 because of "unexplained cost shifts."[77] Ex.31,p.23 SWB witness Doherty testified about his review of the CAM process and detailed the changes (and the basis for those changes) in response to Staff's original assertions and explained why the CAM process is a continuing review process, not static. Ex.32,p.23-26 Mr. Doherty testified that all CAM changes improved the costing techniques for non-regulated services. Further, as Mr. Schallenberg acknowledges, these costing processes are also subject to SWB external auditor review which was provided to Staff. Ex.31,p.23

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[76]Staff witness Schallenberg's direct testimony stated that his adjustment was based upon "CAM" but, in fact, it was not. Ex.29,p.24;Ex.7,p.57-58 In his surrebuttal testimony, Mr. Schallenberg corrects for this error and uses CAM. Ex.7,p.56-60

[77]This is similar to but different from Mr. Schallenberg's original vague assertions concerning 1991 CAM which he agrees to follow anyway in this proposal. Ex.29,p.25

Staff's response is basically one of claiming "ignorance." It claims it has insufficient explanation and has not had the opportunity to review the external audit workpapers. Ex.31,p.23 The inability of Staff to be fully "informed" -- after over one year of audit time -- is suspect. Further, since SWB is using the very process -- CAM -- that Mr. Schallenberg recommends, there can be little room to complain about the results.

**12. SEPARATIONS**

Staff's initial testimony contained significant deviations from SWB's separation proposals. Ex.7,p.21 Staff later altered its proposal and by the end of the hearings, only one difference remained. T.1753;Ex.185 That disagreement deals with the proper treatment of Billing and Collection (B&C) charges billed by LECs to SWB for Primary Toll Carrier (PTC) settlement plans. SWB pays a fee to the LECs for their service in billing and collecting SWB toll charges and the issue is whether this should be classified 100% intrastate, as SWB proposes, or apportioned to interstate as Staff proposes. T.1740-41,1753;Ex.185,p.30-31

Prior to September 1991, SWB assigned 100% of these B&C costs directly to intrastate (Ex.185,p.31) in accordance with 47 CFR 36.2(e):

> Costs associated with services . . . billed to another company . . . and are thus identifiable as entirely . . . intrastate in nature, shall be directly assigned to the appropriate . . . jurisdiction."[78]

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[78]Staff witness Meyer agrees that intraLATA PTC B&C charges are 100% intrastate. T.1747

In August 1991, the FCC's Common Carrier Bureau issued an interpretation which more narrowly applied 47 CFR 36.2(e).[79] Ex.184;Ex.185,p.29-30 SWB then began to apportion those B&C costs to interstate, but immediately sought clarification of the Bureau's interpretation from the FCC. Ex.185,p.30-31 In March 1993, the FCC finally issued an Opinion, reconsidering the Bureau's interpretation, and clarified and confirmed that B&C costs (i.e., 47 CFR 36.2(e)) should be directly assigned to the jurisdiction, not apportioned.[80] SWB (Ex.184,p.3,fn.15) altered its assignment back to the pre-September 1991 100% direct assignment. Ex.185,p.32 SWB's proposal is to reflect that direct assignment in its separations factor. Ex.7,p.22,Sch.10-2

Staff opposes this direct assignment because Staff considers it to be a "change" in March, 1993 after the end of the adjusted test year. Staff does not contest the fact that this proposal is "known and measurable," but opposes it on pro-forma principles. Ex.4,p.7-8;T.1748-50

While SWB disagrees that it is a "change" in the separation process as Mr. Meyer claims (i.e., it is merely a restatement -- a correction -- to conform to the existing test year direct assignment rules), even if it is a post test year occurrence, it is a known and measurable change, which best reflects the operations in the rate year 1994. Indeed, it correctly reflects the appropriate intrastate test year expense with the underlying

[79]Letter of Interpretation, 6 FCC RCD 5058 (Comm. Car. Br. 1991).

[80]Memorandum Opinion and Order, FCC 93-95 (March 3, 1993).

account balances as of September, 1992. See also Case No. TC-89-14, at p.12.

13. RIGHT-TO-USE/LICENSE FEE AMORTIZATION

SWB incurred a higher level of Right-To-Use (RTU) fees in 1992 compared to either those incurred in the past or those projected in the future. The increase was primarily due to an FCC order, CC Docket No. 86-10 that mandated LECs to provide 800 database access to the IXCs by May 1, 1993 and due to a change in the terms of a contract with AT&T regarding Common Channel Signaling System 7 Call Control Options (CCS7-CCO). Ex.7,p.47 Although it was appropriate for these amounts to be included as part of the 1992 revenue sharing calculation, indications were that Staff and/or OPC would oppose the inclusion of the fees in the 1992 calculation. The determination of revenue sharing credits is typically not finalized until around May (in this case 1993). Therefore, in order for SWB to assure recovery of the legitimate expenses it incurred, the Company included the higher level of RTU fees in its revenue requirement filed in this case. Recognizing that a portion of the fees were not recurring in nature, SWB adjusted its case to include an ongoing level of fees and to amortize the fees above the ongoing level over a three-year period. Ex.7,p.50 The amortization provided a better matching of the costs with the revenues generated from offering these services. Ex.7,p.54

Neither Staff nor OPC ultimately opposed the inclusion of the incurred level of RTU fees in the 1992 revenue sharing calculation. On May 14, 1993, OPC filed a letter with the Commission with comments on SWB's 1992 revenue sharing report. OPC stated that they "considered a different accounting method for these one time costs, but after careful consideration, will not raise this issue with the Commission." They also stated that "an adjustment to the 1992 earnings report would have a negative effect on both rate reductions in the Complaint case and potential 1993 sharing levels under the incentive regulation experiment." Apparently, SWB's inclusion of the amortization of these RTU fees in its case caused a reconsideration of the issue. Because SWB's purpose for including the adjustment in its case was to insure recovery of these normal and prudently incurred expenses, and due to the decision by Staff and OPC to allow these expenses in the 1992 revenue sharing calculation, SWB appropriately withdrew this adjustment from its case.

## 14. EMPLOYEE COMPENSATION

### A. SENIOR MANAGEMENT INCENTIVES

Staff proposes to disallow the following expenses for senior manager incentive plans:

1) Long Term Incentive award expenses for SWB-Missouri and General Headquarters Senior Managers; and

2) Short Term and Long Term Incentive award expenses for SBC Senior Managers.

Staff's rationale for these disallowances is that the plans are not focused solely on Missouri results. This disallowance, however, ignores the key benefits and purposes of these plans. By using "at risk" incentive plans, the Company has structured a total compensation package for its senior managers which is simple and encourages plan participants to focus on important performance objectives. As discussed below, the design characteristics of these two plans complement each other and foster a team-based approach to conducting business. Ex.181,p.5

Mr. H. Richard Troy, Jr., a principal and Compensation Analyst in the Human Resources advisory group of Coopers & Lybrand, testified in support of SWB's senior management incentive plans. Mr. Troy is a member of the American Compensation Association and the main focus of his work is toward assisting corporate boards of directors, senior executives and human resource managers in the design and implementation of compensation plans and performance evaluation systems. Ex.181,p.1-2 Mr. Troy's review of SWB's senior manager incentive plans found that each of the plans meet the criteria of a well designed incentive compensation program -- the plans are cost effective and contingent upon the achievement of a manageable number of performance measures. Ex.181,p.24

It is important to note that under SWB's plans, a significant portion of senior managers' total cash compensation is placed "at risk". To receive market competitive total cash compensation, participants must not only earn base salary and formula driven incentives, they must also demonstrate exceptional performance -- either as a team member or individually -- in order to generate additional incentives. Ex.181,p.15-16 Senior manager incentive plans similar to SWB's plans are prevalent throughout the industry today.[31]

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[31]As noted by Mr. Troy, leading professional organizations, like the Conference Board and American Compensation Association, and nationally recognized compensation consulting firms, like Sibson, Wyatt and Hewitt, regularly study compensation trends among their clients and survey participants. These firms reported annual management incentive programs in place in over 90% of survey respondents. Ex.181,p.16

In In Re: GTE North Incorporated, 30 Mo. P.S.C. (N. S.) 88 (1990), Staff similarly sought to disallow executive incentive plan payments asserting in part that the plans were based on non-Missouri results and emphasized net income as a high priority. As here, however, there was no contention that the resultant salaries were too high or that any person was being overpaid. T.1695 Citing Staff v. Union Electric Company, 29 Mo. P.S.C. (N. S.) 605 (1989), the Commission found that an acceptable management performance plan should contain goals that improve performance and the benefits of the plan should be ascertainable and reasonably related to the incentive plan. The Commission found that GTE's plans met the Union Electric conditions and therefore allowed the expenses.

A similar result is called for in this case. SWB's senior manager incentive plans clearly meet the Union Electric conditions and therefore the Company's costs associated with these plans are appropriately included in its cost of service.

(i) Short Term Incentive Plan

The Senior Manager Short Term Incentive Plan is an effective annual incentive plan which accomplishes two fundamental goals:

1) calls attention to performance standards which are responsive to the needs of customers and shareholders, and

2) places an increasing portion of annual cash compensation "at risk".

"At risk" compensation is paid to participants only if SBC (or its division or subsidiary) meets specific performance goals, established by SBC's Human Resources Committee at the beginning of each fiscal year. At each organizational level, SBC or its business entity, e.g., SWB-Missouri, must achieve its customer service goal and financial objective. Ex.181,p.9-11

A notable plan design feature of the Short Term Incentive Plan is its discretionary pool provision. These discretionary incentives may only be earned after customer service and net income objectives have been met and are awarded for the accomplishment of specific performance results, such as extraordinary year-over-year improvement in customer service, performance against business plan objectives or achieving a breakthrough in technology. The awards must be paid within the limits of funds established and approved by the Board of Directors. Ex.181,p.10 SWB's Short Term Incentive Plan effectively focuses on the important business of customer service and fiscal responsibility while providing an upside incentive opportunity for deserving plan participants.

(ii) Long Term Incentive Plan

The Long Term Incentive Plan is also a performance based plan that determines the value of the distributable award according to results attained during a three year performance measurement.[82] A

[82]Under the plan, performance units are assigned to participants at the beginning of each new three year cycle. Each performance unit represents the value of one share of SBC common stock at the then current price. The total number of units to be distributed to the senior managers at the end of the three year performance measurement period depends on 1) the three year average attainment of established financial performance goals for SBC during the measurement period, 2) the attainment of optional performance categories determined by the SBC Human Resources Committee, and 3) in part upon the award of optional units for individual exceptional performance. Ex.181,p.16-17 In 1991, SWB restructured its long term plan which resulted in an even greater emphasis placed on optional performance categories. Under the revised plan provisions, approximately 50% of the total maximum award value may be earned through the achievement of goals other than meeting or exceeding corporate net income objectives. Ex.181,p.20

long term incentive plan is a critical part of any executive compensation package because it causes senior managers, who can effect long term results, to focus and plan strategically for the long term future of the Company. Such a plan creates incentives for participants to concentrate on the future and to smooth volatile short term results by making a substantial portion of their total compensation contingent upon performance over a long period. To provide this balance, a long term plan is an essential element in any well-conceived senior management compensation program. Ex.181,p.17-18 As detailed in Mr. Troy's testimony, numerous studies confirm that long term incentive plans are regularly utilized in U.S. industry and are becoming more widely used each year. Ex.181,p.20-24

(iii) **Effectiveness of Senior Management Plans**

Despite Staff's vague and conclusory criticisms of SWB's senior management incentive plans, the plans work. Considering the complexities related to operating in this rapidly evolving industry, SWB must develop its incentive compensation arrangements to focus attention on objectives of primary importance and reinforce the behavior which allows those objectives to be met. The constant reminders to SWB senior managers are: (1) serve your customers well, and (2) keep your eye on the financial health of the Company. Ex.181,p.27 The Company's incentive plans ensure that SWB's senior managers are focused on the business and have the incentive to make the difficult decisions when such decisions are in the best interests of customers and shareholders.

As recognized by the Staff, SWB has implemented a number of significant force reduction plans over the last several years. If senior management had not been thinking about the long term needs of the business in Missouri and elsewhere, they could have ignored the signs which called for these force reductions and postponed action indefinitely. Staff witness Tunks noted further organizational changes within SWB. Ex.176,p.3;T.1687 These ongoing changes provide additional evidence that SWB's management is continuing to aggressively manage this business and implement the changes necessary to effectively compete in this industry.

Staff's conclusion that "achieving the goals of SBC and unregulated subsidiaries is too remote to be a justifiable cost of service for Missouri ratepayers" fails to consider important realities about how to design executive compensation programs so as to align management's objectives with those of the Company's stakeholders. Ex.181,p.38 As a publicly traded, for-profit entity, SBC provides services to the public in the five state SWB region, throughout the U.S., and on a global basis. Acknowledging SBC's profit motive, these incentive plans reward participants according to their ability to increase net income over the long term and, as a result of that income generation, influence the appreciation of the per share value of SBC's common stock. Linking compensation to profit objectives is the only sensible way to structure executive compensation.[83] The incentive to maximize

[83]Staff's conclusion that the profit performance of SBC is too remote to Missouri's customers ignores the reality that the market plays. Like customer service standards and other relevant performance indicators, the Company's profit objectives are essential elements in overall plan design.

profit is essential to corporate viability and benefits both shareholders and customers. Ex.181,p.38-39

To avoid Staff's disallowance, SWB would have to structure a compensation plan with larger base salaries and no incentive payments. Under Staff's rationale, base salaries for senior managers are an appropriate element of cost of service. If SWB were to pursue this alternative, it would likely: 1) increase its fixed costs -- base salaries would inevitably increase significantly to more closely match the total annual compensation paid by other employers; 2) increase salary driven benefit costs; while 3) losing the desirable motivating influences of incentive compensation. SWB, therefore, would be saddled with a compensation program wholly inconsistent with its compensation philosophy.

It would also appear that a state specific plan may be acceptable to the Staff, however, such a plan would forfeit the valuable benefits derived from the Company's publicly-traded stock. The stock price captures the effect of long term decisions on a present value basis and hence is particularly appropriate to include in a compensation plan. Further, the stock price and changes in the stock price are valuable indicators of how the capital market evaluates SWB's senior managers, including the senior management of Missouri. If the compensation of Missouri senior managers ignores this barometer, an important, independent evaluation of management performance will be lost. Ex.181,p.45

In conclusion, SWB's senior manager incentive plans, designed to encourage teamwork and place a relatively greater number of dollars "at risk," are beneficial to customers and in step with incentive compensation practices in leading companies today. A plan designed consistent with Staff's analysis -- where incentives were driven exclusively by Missouri-specific results -- would be impractical, narrowly focused, costly to administer and not in the best interests of Missouri customers. Ex.181,p.44-47

### B. TEAM EFFECTIVENESS AWARD FOR MANAGER'S (TEAM) PROGRAM

As with senior management incentive compensation plans, Staff's disallowance of the TEAM award expenses for the General Headquarters' (GHQ) employees makes no sense and is inconsistent with Staff's own testimony recognizing the benefit of the GHQ job function to Missouri customers. As explained by Mr. Darrel Barbour, SWB's District Manager-Management Compensation/ Administration, the TEAM award is a key element of the total cash compensation package for SWB management employees.[84] Ex.182,p.4 TEAM's emphasis on customer service and financial performance sends a strong message to employees in terms of the priorities SWB places on customer service and financial responsibility. A group incentive program such as the TEAM program provides considerable cost efficiency because TEAM dollars are "non-embedded." It is a one-time annual award which must be re-earned every year. Ex.182,p.7 Recognizing these benefits and citing the <u>Staff v. Union Electric</u> case, the Commission in Case No. TC-89-14 allowed

[84]TEAM was implemented in 1986 as an "at risk" group program designed to recognize and reward management employees on the basis of group achievement related to customer service and financial objectives. The six SWB teams consisted of each of the five state organizations and GHQ. When earned, these "at risk" awards vary, depending upon the degree to which each team meets defined customer service and financial objectives. Ex.182,p.4

all costs associated with TEAM, including the GHQ TEAM awards, finding the awards were reasonably calculated to encourage companywide performance.

Staff's disallowance of the TEAM for GHQ employees is predicated on the notion that the award is based upon objectives which are not Missouri-specific. Rather, the TEAM is based upon the net income and service results of each of the entities which the GHQ employees support, of which Missouri is one. Despite its disallowance of the TEAM award, Staff clearly and specifically recognizes the benefit to Missouri customers of the job function performed by GHQ employees. Staff witness Tunks states:

> [t]he payroll expenses for the GHQ employees should be included in the cost of service calculation because the benefit to Missouri is apparent. GHQ employees perform centralized functions for Missouri, Arkansas, Kansas, Oklahoma and Texas. It is theoretically more efficient to have one GHQ person perform certain functions for five states than to have one person at each state performing these functions.

Ex.182,p.12

Staff's proposed disallowance of the GHQ TEAM award is inconsistent with its allowance of the GHQ base salary dollars specifically recognizing the efficiencies and benefits of centralization. As the Commission recognized in Case No. TC-89-14, TEAM is part of a total compensation package. It, therefore, makes no sense to sever this one part of the GHQ prorate from the total GHQ prorate for compensation. Staff has recognized the efficiencies of the centralized job function, so too should Staff allow the GHQ TEAM expense which awards GHQ for and encourages these efficiencies. Both base salary and TEAM are part of the total compensation for an employee whose objective is to support its state entities on a more efficient centralized basis. Staff admits that there has been no finding or no allegation that SWB's total compensation package is excessive. T.1693 In fact, for Missouri employees, Staff's case has allowed both the base salary and the TEAM award. Given the fact that Staff has specifically found the GHQ centralized job function to benefit Missouri, its exclusion of the TEAM award, an incentive to perform the centralized function well, has no basis whatsoever.

In addition to its disallowance for GHQ TEAM expenses, Staff has failed to update TEAM awards and senior manager incentive awards to the 1992 level. As with other test year elements, Staff selectively chooses elements within wage and salary to update to a September 1992 level while leaving others at calendar year 1991 levels. In this instance, employee levels and corresponding base salaries and wages are reflected at the end of period September 1992 level. Ex.43,p.8-9 Staff, however, fails to use the 1992 performance year awards and instead uses the awards earned by employees during the 1991 performance year and paid in 1992. The use of the 1991 TEAM award, rather than the award earned by employees during 1992, reduces SWB's revenue requirement by more than $600,000.[85] Ex.43,p.12;Ex.176,p.12;T.1699 TEAM payments have been and are a normal component of wage and salary expense and are recorded as such. Ex.43,p.12 Staff's utilization of the 1992 payment, rather than the annualized 1992 TEAM accrual level as

[85]The TEAM and senior manager incentive adjustments are the only compensation adjustments Staff makes on a cash basis, adjusting to the 1992 payment for the 1991 performance year. All other wage and salary adjustments are made on an accrual basis. Ex.43,p.12

proposed by SWB, is inconsistent with the Commission's acceptance of GAAP and accrual accounting in Case No. TC-89-14 and is not reflective of ongoing operations. Ex.43,p.9,12

### C. EXPENSE PERCENTAGE

Payroll costs can be charged to either expense or capital. Payroll costs charged to construction are capitalized as plant in service and expensed over the life of the plant. Payroll costs related to operating and maintenance activities are recorded as expense in the cost of service. Ex.176,p.20-21 The Company and Staff disagree over the development of the expense percent. This is the ratio applied to annualized payroll costs to compute the portion of total payroll charged to expense in the cost of service. Ex.176,p.20 Specifically, the disagreement centers around the treatment of payroll costs charged to the custom work order (CWO) clearing account.

Staff witness Tunks removes the CWO activity from his computation of the expense percent because Mr. Tunks incorrectly assumes the CWO clearing account clears to zero on a calendar year basis. Ex.176,p.21-22 Costs are continually charged to and cleared from this account as projects are undertaken. For any given twelve month period, there will always be a balance in the account. T.1702 Since this is a continuing activity, no adjustment is necessary to compute the expense percent. The Company's expense percent reflects the ongoing nature of the CWO activity.

Further, the level of CWO activity removed from total payroll costs by Staff is not reflective of ongoing levels. The charges for CWOs have decreased from $3.7M for 1991, to $1M for the twelve months ended September 1992, to $0.5M for calendar year 1992, to $0.1M for the first five months of 1993. T.1703-04 As the level of CWO activity decreases, the impact of both its inclusion or exclusion on the expense percent diminishes. Therefore, Staff's use of 1991 data rather than data closer to the time rates will be implemented understates SWB's expense percent thus lowering SWB's revenue requirement.

### D. SEVERANCE PAYMENT PLANS

Staff excludes expenses for collectively bargained workforce reduction plans -- supplemental income protection plan (SIPP), reassignment pay protection plan, and the Severance Payment Plan. Significantly, these plans resulted from negotiations between SWB and the collective bargaining agent for the nonmanagement employees of the Company, the CWA,[36] and represent appropriate expenses for ongoing adjustments of workforce levels necessary due to changes in technology and increasing competition. Ex.183,p.4;Ex.127,p.5-6 These expenses achieve long term efficiencies with the resultant benefits going to customers. Without the ability to properly size SWB's force, when and where needed, the Company's cost of service would necessarily be higher. The short term costs of the force reduction programs result in ongoing savings that far outweigh the initial costs.

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[36]The SIPP article was initially negotiated by AT&T with the CWA in August 1977 in response to CWA's bargaining demands regarding employment security. SIPP provided financial protection for a specific period of time to employees who were declared surplus due to a technological change and changes in the Company's operations. Ex.183,p.3-4;Ex.127,p.5

As explained by SWB witness Smith, Division Manager-Labor Relations and Employee Development, the SIPP article was replaced in June 1992 with a new Severance Payment Plan. Although the SIPP plan no longer exists, the new Severance Payment Plan provides payment to surplus employees similar in concept to that of SIPP. Further, the SIPP level of expenses represents a good surrogate for the new severance plan expenses. Ex.183,p.3-4

Staff removed the expenses for SIPP payments because it concluded that the wages associated with future SIPP recipients are included in Staff's wage annualization. The SIPP expense, however, as noted in Company witness Wepfer's testimony, was incurred for nonmanagement employees that have already terminated employment. The wages associated with those employees are excluded from both the Staff's and the Company's wage and salary annualization.[87] Ex.43,p.15 Including the SIPP expense in the computation of total wage expense properly matches it with the savings embedded in the annualization and also recognizes the recurring nature of this expense. Both current and future customers benefit from the ongoing lower wage expense produced by the SIPP expenses. Ex.43,p.15

[87]Staff's proposed disallowance of 1991 SIPP is also inconsistent with Staff's position that "it would be inappropriate to include costs to eliminate employees in the future when the wages and salaries for those employees are also included in the payroll annualization." Staff's use of September 1992 employee levels in its payroll annualization includes the future wage savings associated with employees receiving SIPP payments between January and September 1992. Ex.183,p.5 The wages for these employees are not included in the Staff's payroll annualization. To be consistent with Staff's position, either the 1991 SIPP costs or the wages associated with the 1992 SIPP participants should be included in the cost of service.

### E. ENHANCED MANAGEMENT PENSION (EMP) AND ENHANCED PENSION (EP)

The EMP and EP plans have become recurring expenses as ongoing adjustments of workforce levels prove necessary due to changes in technology and increasing competition. EMP was a voluntary force reduction program offered to management employees in late 1991. Ex.182,p.18-19 The EMP offer made immediate and enhanced pension payment options to eligible SWB managers. Ex.182,p.18-19 The EP was negotiated in March 1992 with the CWA. It was the outcome of the CWA's bargaining request to address the then current nonmanagement surplus situation. The EP offer gave more nonmanagement employees the opportunity to retire, by expanding pension eligibility and providing enhanced pension payments to nonmanagement employees. Ex.183,p.3

Staff's contention that force reduction costs are nonrecurring is completely inconsistent with SWB's record of downsizing for the past six years. Although the Company's specific force reduction plans were unrelated to each other and conceived at different times for different reasons, the fact remains that a number of force reduction programs have been implemented by SWB since 1986, as illustrated below:

| Program | Years | SWB Participants |
|---|---|---|
| MTP | 1986-87 | 1,953 |
| MFAP | 1990 | 1,081 |
| EMP | 1991 | 3,537 |
| EP | 1992 | 1,232 |
| SIPP | 1986-92 | 2,261 |
| MFRP | 1992 | 35 |

Ex.182,p.20 Staff's case assumption further ignores the overwhelming industry-wide evidence that downsizing is an accepted, widely-used and ongoing practice in corporate America. Ex.182,p.19;Sch.2 Despite Staff's rejection of the related costs, the common practice of downsizing in corporate America was recognized by Staff witness Schallenberg. Ex.30,p.22

Finally and most importantly, Staff ignores the fact that as a direct result of SWB's force reduction programs, the corresponding employee force levels and the accompanying salary and wage expenses associated with such levels are now significantly lower. Staff has proposed an annualization adjustment, based upon the lower September 1992 base wage and employee levels, to take advantage of SWB's force reduction plans. However, by disallowing the costs associated with the force reduction plans, Staff fails to allow SWB to recover its reasonable costs which directly resulted in the decreased employee force levels and associated expenses. As SWB witness Wepfer explains, SWB does not seek to recover the costs associated with these programs on a yearly ongoing basis, it simply seeks to amortize those costs and reasonably recover expenses directly associated with the reduced salary and wage levels that Staff includes in this case.[88] Ex.43,p.78

Staff is incorrect when it contends that the Company's proposal to amortize the EP and EMP costs "reflects an attempt on the Company's part to overcharge its customers by seeking to recover these costs twice." Ex.31,p.11 Staff bases this

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[88]Both the EMP and EP programs were implemented during Staff's test period. The Company's three year amortization of the costs associated with both plans simply normalizes the activity to be included in the cost of service. The Company includes a level of EP/EMP costs representative of the average cost of all force reduction plans between 1986 and 1992. Ex.43,p.77-78

contention on the fact that the 1992 level of expense for the 1992 monitoring period, which included EP and EMP expenses, caused earnings to fall below 14.1%, which resulted in no customer credits. T.1713 However, the primary reason for this level of expense was the booking of Right-to-Use fees. T.1713 Consequently, 1992 sharing was not impacted by EP and EMP costs.

Staff goes further to say that since the EP/EMP costs are "one-time" expenses, they will not be recovered twice unless they are built into the rates. T.1713 These costs, however, are not "one-time" costs, as suggested by actual history they represent a normal cost of doing business and as such should be included in the cost of service.

When more technologically advanced equipment is used to replace older, less efficient equipment, both the costs associated with the old and new equipment are included in the cost of service over the lives of the respective investment and matched with the ongoing savings resulting from the replacement. This very scenario recently occurred with the amortization of step and crossbar equipment which was replaced under the current modernization plan. T.1723 The Company's case utilizes the same concept in its amortization of EP/EMP costs. The EP/EMP costs needed to produce the efficiencies are amortized and included in the cost of service and matched with the resulting ongoing wage and salary savings. This results in a fair association of costs and cost savings in the test period. Without this association, all the savings are reaped by the customer in the lower cost of service and all the costs are borne by the shareholder.

## F. STOCK PLANS

During Staff's "1991 test year updated through September 1992," SWB established two stock compensation plans and the costs associated with those plans were accrued in accordance with this Commission's acceptance of GAAP and Part 32. Ex.43,p.17-18 Staff's exclusion of both SWB's Success Sharing Plan and its Stock Value Appreciation (SVA) Plan ignores accepted accrual accounting methods.

SWB's SVA Plan provides an award to eligible first and second level management employees based on established thresholds in the average price per share of SBC stock. This plan directly encourages and recognizes employee contributions toward increasing the Company's value and building a financially sound organization in which customers benefit. Ex.182,p.15-16 The Success Sharing Plan, a plan for nonmanagement employees, was an outcome of the collective bargaining process and is part of the nonmanagement total compensation package. Ex.183,p.7-8;Ex.127,p.8-9 This plan provides incentive payments to nonmanagement employees based on the appreciation of SBC stock price within an established range. Ex.183,p.8-9 The incentive for SWB's employees to work together to improve Company performance is essential to SWB's success and clearly beneficial to Missouri customers.

These plans were implemented in July and August 1992, during the Staff's updated test year period for wage and salary issues. Ex.43,p.17-18 Staff acknowledges that these plans are part of the total compensation package offered to employees yet excludes them from its wage and salary expense calculation. Ex.175,p.6 However, in order to properly quantify the wage and salary expense for the same time period used by Staff for other wage and salary adjustments, the costs of these plans should be annualized and included in the cost of service along with other wage and salary expenses at September 1992. Ex.43,p.17-18 The accrual of these costs is a normal accounting practice consistent with Part 32.[89] The Commission has accepted accrual accounting methods and Part 32 for ratemaking purposes and therefore inclusion of both the SVA and Success Sharing accrued expenses for the test period is proper.

### G. OTHER PAYROLL ISSUES

Issues concerning appropriately updating TEAM awards and senior manager incentive awards for 1992 performance are discussed in Section II.14.B. Treatment of the March 1, 1993 management salary increases is discussed below in Part J of this Section.

### H. YELLOW PAGES PAYROLL ADJUSTMENT

Incentive compensation and individual awards are a necessary component of Yellow Pages' compensation program and represent reasonable and necessary business expenses. Ex.213,p.17

### I. DOUBLE COUNTING OF SBC INCENTIVES

This issue has been resolved.

### J. MARCH 1, 1993 MANAGEMENT SALARY INCREASE

On March 1, 1993, management salaries increased. The Company, therefore, proposes a pro forma adjustment to update the test period for this known and measurable change, reflective of future operating conditions. Ex.43,p.19 In the Commission's March 9,

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[89]In the Company's case, it included an accrual for one third of the SVA which better reflects in ongoing operations the costs of a periodic award program.

1993 Order regarding the test year, such an adjustment was anticipated. The Commission noted that "isolated adjustments can be proposed for items beyond the updated period. These are items which a party contends are known and measurable and for which the adjusted numbers should be used to calculate the Company's revenue requirement". Order Adopting Procedural Schedule and Granting and Denying Interventions, Case No. TC-93-224, p.3-4. The March 1, 1993 salary increase has occurred. It therefore is "known and measurable" and is much more accurate and reflective of ongoing operations than Staff's 1992 level. The rationale used by the Commission in In Re: St. Louis County Water Company, 29 Mo. P.S.C. (N.S.) 425, 434-5 (1988) is similarly applicable here.

In St. Louis County Water, the Commission found that a postage increase occurring in April, 1988 should be included in the cost of service even though Staff's test year ended September 30, 1987. The Commission determined that the increase was appropriately included because "the increase is an expense that the Company will actually be experiencing at the time the rates established herein go into effect". Id.,p.435 The same analysis was applied in In Re: Citizens Electric Corporation, 24 Mo. P.S.C. (N.S.) 450, 457 (1981) regarding a known and measurable wage increase outside the test year. The Commission included the wage increase because again it "constitutes an expense that the Company will actually be experiencing at the time the rates determined to be just and reasonable herein will go into effect". Id.

The facts here compel a similar result. The March 1 increase has occurred and therefore is known and measurable. It is an expense the Company is experiencing today and will be experiencing when the rates approved by this Commission go into effect. The nature of this change is one of a change in salary rates. No additional revenue will be generated from this change and investment will not need to be increased to accommodate this change.

## K. COMPENSATED ABSENCES

In Case No. TC-89-14, the Commission approved Part 32 and the accrual accounting for compensated absences as a reasonable method for ratemaking.[90] Staff of Missouri P.S.C. v. SWBT, 104 PUR 4th, 3981, 400 (1989) Part 32 required SWB to recognize a deferred charge on its balance sheet in 1988 for the amount of compensated absences that would be recorded that year and to amortize that deferred charge over 10 years. 47 CFR 32.24(b) SWB's proposal recognizes the deferred charge and amortization expense (one-tenth).

Staff refuses to recognize both the one-tenth expense amortization during the test period as well as the remaining unamortized deferred charge. Ex.43,p.16-17 Staff's direct testimony does not mention the "omission;" only in Staff's surrebuttal is any "reason" first explained for deviating from

[90]Such as vacation pay, etc.

SWB's books of account.[91] Staff's terse explanation is found at the end of its income tax analysis:[92]

> Staff's current case does not reflect in operating expense any additional vacation pay over the amount of vacation expense related to ongoing operations.

Ex.31,p.21 Staff's position seems confusing and it appears that there had been no prior discussion between Staff members of any intent to omit the inclusion of this expense in its direct case. T.1727-30[93] Staff finally agreed in its surrebuttal testimony that it was purposely not including the expense. T.1729

Staff also acknowledged that failure to allow recovery would, under FASB 71, obligate SWB to "write down" the remaining deferred charge to cost of service. T.1730 The financial impact of this write down is not included in Staff's cost of service proposal. T.1730 Since the deferred charge was created on SWB's books of account in response to the Commission's approval of Part 32, alteration of the recovery of this deferred charge by any Commission action will necessitate recognition of the $11M deferred charge in cost of service. Ex.44,p.5-6 The more reasonable approach is to continue with the Part 32 process as already

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[91]Commission Rule 4 CSR 240-2.130(12) requires that the Staff explain all adjustments to SWB's books of account in its direct testimony. Staff argued that it did not "alter SWB's books of account". T.1727-30 This is perhaps an unintentional misstatement since Part 32.24 clearly sets up the books of account and Staff omitted those accounts in its schedules.

[92]The income tax aspects of compensated absences are discussed in Section II.18.A of this Brief.

[93]Mr. Schallenberg, Staff's surrebuttal witness on this point, was not even aware of what Staff had proposed in its Direct case. T.1728-29

approved in Case No. TC-89-14. Staff has provided no compelling basis to change from Part 32.

15. SBC ALLOCATIONS AND EXPENSES

A. Business Unit Adjustment

Staff proposes to change the method of allocating the parent company costs from SBC to SWB in order to reduce SWB's share of the allocated costs. Staff's alternative methodology is identified as the "business unit approach." Ex.29,p.16

Staff's business unit approach does not have support in either industry practice or in accounting theory because it has no cost causative basis. Ex.219,p.34-35;Ex.220,p.IV-1 through IV-23 Staff's approach utilizes a set of arbitrary and inconsistent groupings of companies organized into non-homogeneous categories that are not identical or even in remotely similar businesses. T.2230-33 For example, Staff includes in one group a provider of cellular services, an advertising publisher, and a real estate and relocation management subsidiary. T.2231-32 In another separate group, it includes a provider of telephone services, another advertising publisher, and a printing company. T.2230-31 Although Staff claims that Bellcore uses a similar approach, the evidence established that all the Bellcore clients are involved in the same line of business, and that, in any event, Bellcore uses a different methodology for allocating the majority of its project costs. T.2229-30,2234-37

However, the most fatal flaw in the business unit approach is that it produces absurd results. The approach assigns 25% of the SBC employee-related costs to SWB International (SBIH) even though

SBIH has less than five-tenths of 1% of the total SBC employees. Ex.217HC;T.2237,2239-40 SWB, on the other hand, has approximately 86% of the employees, but under Staff's approach receives less than 25% of the SBC employee-related costs. Ex.217HC;T.2240-41 Similarly, while SWB has approximately 77% of the SBC investment, under Staff's approach, it receives less than 25% of the SBC investment-related costs. Ex.217HC;T.2241-42

In contrast to Staff's method, SBC's investment and employee factors provide a rational basis for assigning costs based upon accepted cost causative methods of allocating common costs. Ex.219,p.5-11 Use of assets and employees as cost causative allocators is a common method that has been accepted by the FCC. Ex.219,p.9-10;T.2221-24 Conversely, Staff's business unit approach has never been adopted by anyone, and provides neither a rational nor a cost causative basis for assigning parent company costs. Ex.219,p.34-35. Staff's business unit approach should be rejected.

### B. SBC GENERAL FACTOR ADJUSTMENT AND INCLUSION OF SBC IN THE GENERAL FACTOR

Staff proposes to treat SBC as a business unit and to include its retained expenses in the calculation of the general allocation factor. Again, the purpose of Staff's proposal is to reduce the amount of SBC costs allocated to SWB. Ex.29,p.17-18;Ex.35HC,p.18; Ex.35,p.19-21

The initial fallacy in Staff's analysis on this issue is that it assumes SBC is a business unit, when in fact SBC sells no services to the public, produces no revenues, and exists as a parent company which performs functions solely on behalf of and for the benefit of its operating subsidiaries. Ex.219,p.36 Were it not for the existence of the subsidiaries, the SBC costs would not exist. Ex.219,p.29 Also, because SBC is a cost center, its costs should be allocated to the subsidiaries causing its costs. Although Staff contends that SBC should receive a direct assignment of costs, industry practice and standards demonstrate no support for such a theory. Ex.219,p.24,36;Ex.220,p.IV-1 through IV-6

Moreover, Staff's proposed treatment of SBC as a business unit suffers from the same cost causative deficiencies inherent in the Staff's general business unit approach. For example, SBC has less than 1% of the total SWB employees, but under Staff's approach would receive 25% of the employee-related costs. Also, while SBC has zero percent of the equity investment (because all such investment is in the operating subsidiaries), under Staff's approach, it would receive 25% of the investment-allocated costs.[94]

Staff's proposal that the SBC retained expenses be included in the calculation of the general allocator is also inappropriate. The very reason why certain SBC expenses are retained is because of the determination that those expenses should not be assigned and/or allocated. Thus, to include them in the calculation of the general allocator defeats the very purpose of retaining the expenses and, if adopted, would introduce an inconsistency into the cost assignment process by including the expenses for one purpose, but excluding them for another. T.2254-60 There is simply no logical

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[94]Staff's assertion that the FCC pronouncements indicate direct assignment should be the basis for calculating the general allocator is contradicted by the express language of the FCC. Nor did the FCC indicate in either its rules or in its Docket No. 86-111 orders that generally allocated costs should in any case be assigned to the parent company. T.2260-62,2272-73

basis for including retained expenses or expenses withheld from allocation in the calculation of the general factor.

If the SBC allocation process is changed to include SBC retained expenses in the calculation of the general allocator, SBC may well decide that it should cease the practice of retaining certain costs. SBC has no requirement to retain any portion of its costs. T.2272-73 Furthermore, in the event that SBC decided not to retain costs, the evidence shows that SWB would receive a significantly larger cost assignment than would be purportedly saved by including the SBC retained expenses in the calculation of the general allocator. T.2257-60

Finally, the evidence shows that, if the allocation process is changed or varied among particular jurisdictions, as it would be under Staff's proposals, a potential is created for the over- or under-recovery of costs between the jurisdictions. The Staff warned the FCC about the dangers of that potential in Case No. 86-111, yet it proposes that very result in this case. T.2224-27 For each of these reasons, the Commission should reject Staff's proposals to change or alter the SBC cost assignment methods.

### C. SBC EXPENSE DISALLOWANCES

#### (i) EXECUTIVE AND BOARD OF DIRECTORS

Staff proposes to disallow certain SBC expenses based upon claims of duplication, lack of benefit to SWB, and alleged improper coding. While Staff claims to have conducted an audit of SBC expenses, it has offered little documentation, and in many cases no documentation, to support its claims or to show that the challenged SBC expenses were duplicative, unnecessary, or unreasonable. Staff is merely speculating, and it is well settled in Missouri that speculation and conjecture do not qualify as competent or substantial evidence.[95]

Staff contends that the SBC and SWB executive as well as the SBC and SWB Board of Director costs are duplicative. This claim ignores the difference in functions performed by the two groups of executives and Boards. The SBC executives and Board set the strategy and policy for the entire Corporation, including SWB, while the SWB executives and Board have responsibility for assimilating and implementing those policies as well as running the day-to-day operations of the telephone business. Ex.219,p.42-48[96]

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[95]State ex rel. Oliver v. PSC, 542 S.W.2d 595,602 (Mo. App. 1976); State ex rel. Eldon Miller, Inc. v. PSC, 471 S.W.2d 483,488 (Mo. App. 1971); State ex rel. National Trailer Convoy, Inc. v. PSC, 488 S.W.2d 942,948 (Mo. App. 1972). It also bears noting that Staff has the burden of proof in this case since the Staff is seeking to change Commission-approved rates which were set without any SBC expense or allocation adjustments. §386.430 RSMo. 1986 As shown, Staff has not met that burden.

[96]As an example of alleged duplication, Staff attaches documents which supposedly indicate that both the SBC and SWB Boards perform similar functions relating to the SBC Foundation. Mr. Schallenberg states that Mr. Flaherty ignores this fact, and claims that it shows duplication. Ex.218HC,p.25 Actually, all the funding of the Foundation comes from the SBC subsidiaries (including SWB) in the form of direct payments. The SBC Board simply approves the ultimate or total level of such funding. That is not duplication. The Deloitte & Touche study also shows that, while the subsidiaries do the Foundation funding, SBC performs additional activities such as development of the contribution policy, management of funding requests, maintenance of accounting records, interfacing with charitable organizations, processing of contribution payments, and management of the Foundation's assets. Ex.220,p.V-71 Another example which Mr. Schallenberg uses to allege duplication is the approval process for the Form 10Ks filed with the SEC by SBC and SWB. Ex.218,p.26 He ignores that SBC participates in the drafting and review of all 10K filings with the SEC and that SBC has the primary legal and accounting expertise relating to such filings. Ex.221,p.IV-26 It is purely a formality, and not a matter of duplication, that the filings are (continued...)

Having SBC set the general strategy and policy benefits ratepayers by allowing the SWB executives to spend more time on the operational side of the telephone business. It is clear that, with such pervasive and important issues as special and switched access collocation, 800 data base and CCS7 implementation, etc., the SWB executives have had no time to engage in or devote to the broader policy setting activities of the SBC executives and SBC Board. Ex.219,p.43-48

There is also a significant difference in the makeup of the SBC and SWB Boards. The SBC Board includes outside directors, while the SWB Board is composed entirely of SWB senior managers serving as internal directors. Ex.219,p.45 The inclusion of outside directors is a requirement of publicly-held companies that are listed and traded on the New York Stock Exchange. If SBC did not exist, SWB would have to include outside directors on its Board and would have to bear 100% of the related costs. With SBC including outside directors on its Board, SWB does not have to bear all of the outside director expenses, but shares those expenses with other operating subsidiaries. Ex.219,p.7,13,45[97] Staff recognizes that outside director expenses represent necessary costs. Ex.218,p.27

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[96](...continued)
approved by each Board. Moreover, Staff makes no attempt to quantify the amount of time spent by each Board on Foundation or SEC activities, which would be a more reasonable approach than proposing to disallow all of the SBC Board costs on this basis.

[97]The inclusion of internal directors on each Board has no monetary significance because the internal directors are all officers of their respective companies and receive no compensation for Board service beyond their normal salaries. Ex.219,p.45-46

Also, as in the case of executives, the SBC and SWB Boards perform different functions and activities. For example, the SBC Board and its Human Resources Committee set and approve compensation and benefit standards for the entire corporation, while the SWB Board implements SWB compensation and benefits within the parameters set by the SBC Board. Ex.221,p.IV-53,IV-54,IV-55,V-10 Clearly, SBC and SWB function differently in these areas, and SWB benefits from SBC's performance of these functions because of the savings that result from SBC's centralized performance of such activities. Ex.221,p.III-14,III-15[96]

Staff also criticizes the SBC executives and Board for working on non-SWB activities and, on that basis, proposes to disallow all of the SBC executive and Board of Directors costs. The SBC executives and Board members work on multiple projects involving a wide variety of issues common to a number of subsidiaries. Because the SBC executives and Board work on so many activities and the areas of their responsibilities are so broad, their costs are properly allocated to SWB and the other operating subsidiaries using the general allocator. Use of the general allocator in this context is entirely appropriate and assigns costs in recognition of the general nature of the SBC executive and Board activities. Ex.229,p.V-65,V-66 To break those costs down further would serve no purpose, except to make the allocation process more cumbersome

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[96]Staff suggests that SWB could benefit if some of the SBC functions were performed by SWB. Ex.218,p.55 However, the Deloitte & Touche value study demonstrates that it would cost SWB-Missouri $31M more to perform the SBC functions on its own and that it would cost $66.2M more for SBC to outsource many of its functions. Ex.219,p.13-15

and potentially less reliable. Indeed, it would be similar to having Commissioners keep time sheets on each item discussed at an agenda meeting. Such a degree of specificity is neither reasonable nor required. Ex.219,p.26-27;T.2274-77,2245-47

Although Staff's testimony appeared to be suggesting that the SBC executives and Board members keep time sheets in order to directly assign all of the time spent on non-SWB activities, Mr. Schallenberg admitted on cross-examination that there is no such requirement in the FCC rules, and even stated that he did not favor the use of time sheets because of concerns about subjectivity and potential reporting errors. T.2272-74

(ii) OTHER SBC EXPENSE DISALLOWANCES

Staff contends that the SBC employee information cost center contains costs that are duplicative of the costs incurred at SWB. The evidence shows the SBC employee information function relates to and has relevance to all SBC subsidiaries, including SWB. It provides information related to SBC financial results, competitive issues facing all SBC subsidiaries, subsidiary products and services, and coverage of human resource issues of interest to all subsidiaries. Conversely, the SWB employee information cost center function generally provides information that is specifically related to issues and concerns of telephone company employees. Ex.219,p.48-49;Ex.221,p.V-4

Mr. Schallenberg claims that his supplemental surrebuttal Schedule 4 shows that the SBC and SWB employee publications are duplicative. Ex.218HC,p.31;Ex.218,p.32 This claim is based upon the inclusion of some SBC and non-telco news items in the SWB publication "This Week." What Mr. Schallenberg fails to mention is that the "This Week" articles concerning non-SWB activities are actually taken from SBC publications such as SBC FAX that have been prepared by SBC employees and are simply included in "This Week." SWB does not actually work on or write such articles and, thus, there is no duplication of effort. Moreover, a review of the "This Week" indices provided in Mr. Schallenberg's supplemental surrebuttal Schedule 4-4 and 5-4 clearly indicates that the vast majority of "This Week" articles are specific to SWB. Finally, by focusing solely on publications, Mr. Schallenberg ignores the other necessary functions and expenses in this cost center, such as research. Ex.220,p.V-65;Ex.221,p.V-4

The Staff contends that the SBC news and public information cost center is duplicative of costs incurred at SWB. Staff offers one sentence to support this view: "Costs are unnecessary and duplicative of SWB functions." Ex.29,Sch.4-36 This allegation ignores that news and public relations activities at SBC typically involve providing information on the corporation and its subsidiaries, including SWB, to national financial news media such as The Wall Street Journal, Forbes and Financial World. In contrast, SWB's news and public relations group is engaged in providing telephone company-specific information and they work more closely with the news media in the five SWB States. Similarly, the evidence shows that the news and public information activities of the SBC and SWB Staffs are coordinated for the very purpose of avoiding duplication and ensuring that appropriate coverage is afforded to the SBC and/or SWB messages. Ex.219,p.49;Ex.221,p.V-

3,V-4 This evidence shows that the activities are different and not duplicative.

Staff further claims that the costs in the SBC trademarks, patents and graphic service cost center are unnecessary and duplicative. Staff offers no support or explanation for this claim. Ex.29,p.22 The evidence shows that the expenses in this cost center relate to the development and maintenance of corporate graphics and identity guidelines as well as actions concerning the use of the Southwestern Bell name, all Bell trademarks, and patents. The evidence shows that SWB does not perform these activities, and that activities such as policy development and administration of the identity guidelines are exclusively performed by SBC. Ex.219,p.50

Staff's proposed disallowance of these costs appears to be more related to its belief that SWB should either receive a royalty from the non-SWB subsidiaries for the use of the SBC name or should not have to pay any of the costs associated with protecting that name and the related trademarks. The first argument ignores the fact that SBC, not SWB, owns the Southwestern Bell name and logo and has the sole right to license their use. Ex.50,p.16-17 The second argument ignores the fact that SWB benefits from SBC's protection of the Southwestern Bell name and trademarks because SWB uses them and does so extensively. Staff also ignores that this cost center includes other necessary functions and costs. Ex.220,p.V-69;Ex.221,p.IV-26

Staff next contends that the costs of the SBC tax group are duplicative of costs incurred at SWB. Ex.218,p.27-28 The evidence shows that duplication is avoided through the Managing Director of SBC Taxes who supervises and directs the activities of each subsidiary tax director. In addition, the evidence shows that the SBC tax group performs more intensive tax research and planning activities than the tax group at SWB, including detailed investigation of alternative tax approaches. The evidence further shows that, without SBC tax assistance, SWB could have paid well over $50M more in taxes in 1992. Ex.219,p.50-51 Mr. Schallenberg acknowledges the creation of those savings in his supplemental surrebuttal testimony. Ex.218,p.27 The functions performed by the SBC tax group are necessary, beneficial, and nonduplicative of the functions performed at SWB. Ex.221,p.IV-7 through IV-11

Staff also claims that the cash management cost center is duplicative of costs incurred at SWB. Ex.29,p.22;Ex.218,p.27 To the contrary, the evidence shows that SBC performs certain cash management functions that are not performed by SWB, and further, as part of this cost center, SBC provides SWB with a free line of credit. Ex.219,p.51-52 Mr. Schallenberg acknowledges in his supplemental surrebuttal testimony that the free line of credit has a specific value to SWB. Ex.218,p.27 Nevertheless, he refuses to acknowledge any SWB responsibility for any of the SBC cash management costs. His approach to this issue is arbitrary and inconsistent.

Another method which Staff employs in an attempt to discredit the SBC allocation process is to reference allocated projects and imply they have nothing to do with SWB or say that SWB is bearing more than its fair share of such costs. It appears Staff is employing this tactic simply for effect because the record does not reflect that Staff is proposing any specific disallowances related to the ten or so items. Ex.218,p.32,38-39;Ex.218HC,p.33-37

Whatever the reasoning, the evidence shows that, even if one were to assume Staff were right that SWB should not receive an allocation of any of the costs associated with these specific projects, the intrastate Missouri amount involved would be immaterial (less than $160,000 out of $12.5M in test year expenses) as shown on Appendix C.[99] The Commission should reject all of Staff's proposed SBC expense disallowances.

16. AFFILIATE TRANSACTIONS

As set forth in the reconciliation, Staff is proposing a $2.72M adjustment to SWB's revenue requirement based upon a review of SWB's affiliate transactions performed by Technical Associates, Inc. (TAI). To support its recommended adjustment, TAI filed a multi-volume report consisting of several hundred pages. Unfortunately, the report is confusingly written and difficult to follow or understand. Moreover, the report is replete with misunderstandings, anecdotal evidence, and erroneous as well as unsubstantiated and misleading conclusions.

Notwithstanding the multitude of issues raised by TAI, the entire $2.72M adjustment is based upon the belief that SWB's fully

[99]Except as noted on Appendix C hereto, SWB does not believe or admit that the allocations identified by Staff were unreasonable or improper. In any event, the evidence shows that Staff did not go behind the paper or interview SBC employees to determine whether the projects were or were not properly assigned and/or allocated. Thus, there is nothing more than conclusory and unsubstantiated allegations to support Staff's claims on these points, and such allegations are not sufficient. See State ex rel. Oliver, supra. T.2287-88.

distributed cost (FDC) studies for non-tariffed services provided to affiliates are significantly flawed and understate the FDCs for those services.[100] As demonstrated by SWB witness Dale Lundy, TAI's claim of SWB errors for the most part do not exist, and certainly do not support either TAI's inflated FDC re-computations or the corresponding assumptions regarding increased revenues from sales to affiliates. Ex.241,241P Accordingly, the Commission should reject the proposed adjustment and TAI's other recommendations as being neither appropriate nor warranted.[101]

(i) TAI'S REVIEW

Before directly addressing the proposed adjustment, the Commission should be aware of the review that gave rise to that proposal. It is axiomatic that transactions between a utility and its nonregulated affiliates continue to be the subject of scrutiny by regulators due to concerns about potential revenue/expense shifting generally termed "cross-subsidization." As demonstrated by its witnesses, SWB has taken all necessary and appropriate steps and then a few more to meet that heightened scrutiny.

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[100]Due to page limitations, this section of SWB's initial brief will focus on Staff's proposed adjustment. Failure to address any general or specific TAI assertion does not indicate any acquiescence or agreement by SWB with any such assertion. SWB instead stands on the totality of its affiliate witnesses' testimony, which prove the inaccuracy of those assertions.

[101]Implementing TAI's recommendations for just a few services could result in a loss of $1.3M in annual revenues, even before accounting for the cost of those changes. Ex.242,p.15,21,23,30,36

Notwithstanding the adoption of specific affiliate transaction rules and the strong disincentives against cross-subsidization,[102] there is inevitably a presumption that there must be something amiss with a utility's affiliate transactions. As a result, regulatory auditors seem to begin with the belief that there is "something" to find. And, when "something" is found that fits that belief, they too often jump to the erroneous conclusion that cross-subsidization is actually occurring without first investigating further. SWB submits that TAI followed just this pattern.

In attempting to find "something," TAI generated data requests (DRs) usually covering 1988 through 1992 which resulted in SWB producing thousands of pages of material. From those responses, TAI believed that it had found several "problems." Due to an overly adversarial approach seeking "gotchas" instead of understanding, TAI chose to assert matters in testimony before this Commission without first following up to ensure that the "problems" did truly exist or that they were material. To take a single example, TAI asserted that SWB's overall affiliate purchases had increased substantially on the basis of the rise in a single SWB Part 32 account. Ex.229,p.11-12 Remarkably, Staff witness Schallenberg filing testimony at the <u>same time</u> correctly stated

[102]SWB witness Larkin sets forth just some of those disincentives. Ex.222,p.17-18 If regulators disallow expenses associated with affiliate transactions, then the ultimate owner actually comes out <u>far worse</u> than if its utility subsidiary had dealt with a non-affiliate. For example, disallowing a utility's expense associated with equipment purchased from an affiliate means the ultimate owner does not get to recoup the actual cost of that equipment, much less any profit. In a sense, the owner will be "cross-subsidizing" ratepayers in that its utility will be wholly uncompensated for the cost of that equipment being used to provide utility service - a tremendous disincentive to the ultimate owner.

that affiliate purchases had actually decreased, which SWB witness Larkin confirmed. Ex.29,p.7;Ex.222,p.9-10 The increase in that single account was simply due to an FCC accounting classification change for certain expenses. In fact, only 1.3% of the expenses for affiliate transactions are recorded in that account. Ex.222,p.11-13[103] As a result of TAI's approach, Staff, SWB, other parties, and the Commission have expended resources on matters that could have easily been resolved more quickly and efficiently with an attempt to understand rather than to denounce. SWB submits that TAI's time would have been better spent examining and understanding SWB's practices rather than preparing a multitude of speculative spreadsheets based on tenuous, if not wholly absent, foundations.

Another fundamental problem with TAI's review was caused by its own flawed methodology and the fact that TAI was overwhelmed by the very avalanche of paper it requested. In response to Staff and TAI DRs, SWB supplied tens of thousands of pages of affiliate transaction documentation. Ex.229,p.3 Confusing volume with complexity, TAI asserts that there was no audit trail, and that SWB did not provide TAI with the information it had sought. SWB submits that an audit trail exists, but TAI chose not to recognize the clear trail, or else just failed to follow it. See, e.g., Ex.222,p.24-34,Sch.4;Ex.242,p.10

Nowhere is this more clearly epitomized than with the testimony surrounding the "Seven Basic Habits of Highly Effective

[103]TAI's response to this explanation is equally disappointing. Dr. Ileo shifted his insinuations to focus on other accounts and the lack of information regarding 1988, three years before the test year. Ex.237,p.30

People" workshop taught by SBC Administrative Services, Inc. (ASI) to Southwestern Bell personnel, including Company employees.[104] Ex.222,p.45-47;Ex.243,p.27-30 SWB witness Taylor expressed her personal frustration at TAI's failure to seek an explanation for the manner in which the price to SWB was set, instead of just assuming that something was amiss. Ex.243,p.27-30 In retort, TAI witness Ileo asserted that:

> [d]espite TAI's repeated requests for 'back-up' materials, none of the information provided by SWB contained references to the Covey Leadership Center. This oversight demonstrates once again the 'audit trail' problems within SWB.

Ex.237,p.35 (emphasis added) Turning, however, to pages 307-10 of Appendix B.3 of Volume VI of TAI's report, TAI included one-sided copies of two-sided vouchers that SWB provided in response to TAI-generated DR 5372. Ex.235,p.307-10 (SWB does not know why a complete copy was not submitted by TAI.) As is clear from even those incomplete pages in TAI's very own report, SWB provided information concerning its purchases from Covey which TAI found probative enough of some point to include in its massive filing with the Commission. Indeed, as stated by TAI witness Yontz, DR 5372 was "specifically related to ASI training classes;" SWB supplied the requested information. Ex.240,p.6 TAI is obviously not aware that the information was actually supplied, and of course did not follow up on this information. This did not stop TAI from criticizing SWB for an alleged lack of an audit trail, or an alleged paucity of information provided.

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[104]Notwithstanding SWB's explanation in testimony, TAI apparently still believes that Covey Leadership Center actually teaches the course to Southwestern Bell personnel. Ex.237,p.35

In an attempt to refute the fact that TAI's problems stemmed from its burdensome, overly broad method of review, Ms. Yontz tried to demonstrate that SWB had been unresponsive, and that TAI thus had no choice but to do its analysis as it was performed. All TAI does is demonstrate the legitimacy of SWB's claims. On page 6 of her surrebuttal testimony, Ms. Yontz quotes only limited parts of three DRs. Ex.240,p.6 In the first two DRs, a "progression" of DRs that were asked on the same day, TAI asked for information regarding "prevailing market price." As indicated by TAI's own capitalization of that phrase in DR 5321, "prevailing market price" is defined by affiliate transaction rules to mean the price established by a substantial number of transactions with non-affiliates. Ex.240,p.6;Ex.229,p.29 (TAI's discussion of the meaning of "prevailing market price") In accordance with TAI's requests, information regarding "prevailing market price" was provided. Then in DR 5372, the third DR listed, TAI asked for the determinations of FDCs. As indicated above, SWB supplied the information regarding the ASI training in response to DR 5372 as the training was priced at FDC because it had no "prevailing market price." Ex.222,p.45-46 In essence, TAI failed to ask for the information it apparently wanted in either of the first two DRs. SWB endeavors to answer the question asked. SWB cannot read the mind of the DR writer, and certainly cannot be blamed for answering the questions actually asked.

From this alleged lack of responsiveness, TAI draws the conclusion that some 'vast conspiracy' exists to cross-subsidize SWB's affiliates. Given the manner and sloppiness with which TAI conducted its review -- it cannot truly be called an audit -- that claim is simply not credible. While SWB admits that some DR responses were late, that delay was often caused by the considerable amount of time and effort required to answer the overexpansive, burdensome DRs issued by TAI. Ex.222,p.37 For TAI to make unrealistic, unreasonable demands and then claim 'conspiracy' when those demands have not been met is wholly unjustifiable and untenable.[105] Nowhere has TAI cited one shred of direct evidence that supports its claim. As more than one SWB witness has testified, there is no cause for alarm. Ms. Larkin, Ex.222,p.4; Mr. Powers, Ex.242,p.2,3; Ms. Taylor, Ex.243,p.4; Mr. Lundy, Ex.241,p.2,3 Instead, as has been demonstrated, SWB scrupulously attempts to comply with applicable standards to assure itself that it can recover those costs attributable to affiliate transactions, and in order to generate substantial contribution from sales to affiliates which inures to the benefit of SWB's customers.

(ii) PROPOSED ADJUSTMENT

Staff's recommended $2.72M adjustment to SWB's revenue requirement comes solely in the area of sales to affiliates of non-tariffed services provided by SWB. In essence, Staff wants the Commission to act as if SWB charged and collected $2.72M more in revenue from its affiliates than it actually did. In selling goods

[105]In a very few instances, SWB was admittedly unable to provide TAI with documentation that would normally be available. Those few instances were not very significant, and truly were aberrations. Ex.241,p.30-32

and services to affiliates, SWB complies with the following hierarchy established by the FCC in 1987:

(1) if a tariff rate exists, then the sale is recorded at that rate;

(2) if a tariff rate does not exist, then the sale is recorded at the prevailing price, which is the market price established through arms length sales to non-affiliates;

(3) if a prevailing price does not exist for a product (asset), then SWB must record the <u>higher</u> of the product's fair market or net book value; and

(4) if a prevailing price has not been established for a service, then SWB must record <u>no lower</u> than SWB's FDC to provide the service.

Ex.222,p.13-15;47 CFR 32.27 As SWB witness Larkin explains, these Part 32 rules were developed by the FCC after a lengthy rulemaking process that involved the entire industry and federal as well as state regulators. Ex.222,p.20,21 Part 32 was adopted by the Commission in Case No. TC-89-14.

The TAI-supported adjustment is based on TAI's claim that SWB undercharged its affiliates in certain transactions that fell within categories (2) and (4). Category (2) services are referred to by the FCC and SWB as "incidental;" TAI also refers to them as "non-contractual." SWB refers to those services in category (4) as "affiliate services;" TAI chose instead to refer to them as "contractual services" and "affiliate billing." Ex.242,p.3,4 The breakdown[106] of that adjustment is as follows:

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[106]TAI's breakdown is a little different in that TAI lumps together incidental services and affiliate services for which no FDC study was performed, labeling them "SWBT revenues reported with no costs." This classification is unnecessarily confusing. As explained, affiliate services for which no FDC studies were performed are appropriately handled in accordance with applicable (continued...)

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|---|---|
| Affiliate Services (Category (4)) | $1,388,000[107] |
| Incidental Services (Category (2)) | $1,332,000[108] |

These numbers are rounded to the nearest $1,000 consistent with the rounding of the Staff's proposed adjustment.

(iii) AFFILIATE SERVICES - CATEGORY (4)

Under FCC Part 32 accounting rule, SWB is required to book no less than FDC for affiliate services. Thus, before providing an affiliate service, its FDC is determined. If SWB stopped there and booked FDC, the FCC would be content that the transaction was recorded properly and that no cross-subsidization was occurring.

However, SWB takes that extra step "to prevent even the appearance of cross-subsidization. Whenever possible, SWB sets prices for affiliate services at prices which reflect market-like conditions, but never less than fully distributed cost." Ex.242,p.3[109] Using this process, SWB witness Powers was able to generate for SWB $2,089,858 in revenues above FDC during 1991 and,

[106](...continued) regulatory standards. With incidental services, no cost studies are performed because they simply aren't necessary to set price, and to conduct such a study would merely waste resources. The market sets the prices for those services.

[107]This figure is the aggregation of line (4) with the product of line (6) and TAI's 24.46% inflation factor (set forth on line (5)) in Ex.230,Table IV-C.

[108]This figure is the product of line (7) and TAI's 24.46% inflation factor in Ex.230,Table IV-C.

[109]In its report, TAI continually fails to distinguish for the Commission the difference between that "market-like" price and the FCC's "prevailing price" standard. The two are not the same and any attempt by TAI to imply otherwise is wrong and misleading.

from 1988 to 1991, approximately $10.1M in contribution above direct costs. Ex.242,p.3,4

The $1,388,000 revenue adjustment related solely to affiliate services (Category (4)) is based upon two alleged deficiencies of SWB's FDC studies - that the FDC studies fail to properly include certain costs ($1,341,606) (Ex.229,p.45-52;Ex.230,Table IV-C,line (4)), and that no FDC study was performed for certain affiliate services that had no identifiable direct costs ($46,128). Ex.229,p.54-55;Ex.230,Table IV-C,product of line (6) and 24.46%

a. ALLEGED COST STUDY ERRORS

The first alleged deficiencies involved at least 14 separate claims of errors in SWB's cost studies. As SWB witness Lundy amply demonstrated with his testimony, nearly all of the criticisms made by TAI are invalid. Ex.241,241P For example, TAI was critical of the manner in which supervision costs were excluded in certain studies. In determining the FDC for an affiliate service, supervision costs were not included in some labor rates for lower level employees, but were included in those of higher level employees. Ex.229,p.45 As Mr. Lundy explained, since the lower level employees report to the higher level employees and those higher level employees were included in the cost study, supervision costs are already being included. To do as TAI suggests would be to double count those costs. Ex.241,p.6 Similarly, TAI criticized the absence of supervision costs for loaned employees. Again, Mr. Lundy explained that factually those employees were not being supervised by SWB management and thus to include SWB supervision costs would be in error. Ex.241,p.6,9-11 As Mr. Lundy made clear, in this and other areas, SWB takes a conservative approach with its FDC studies that sometimes results in a higher than actual FDC. Ex.241,p.9-10

Most of TAI's criticisms lacked the same sort of conceptual and factual bases. However, in reviewing TAI's report, Mr. Lundy concluded that two criticisms were valid, and accordingly acknowledged that he agreed even though the effects were immaterial.[110] Dr. Ileo seeks to exploit those two acknowledgements in his surrebuttal testimony to unconvincingly argue with Mr. Lundy's testimony on other alleged errors. Again, TAI makes the same claims about supervision costs regarding two other services. Ex.237,p.17 SWB stands by Mr. Lundy's testimony on these supervision cost issues. Even after making the necessary changes to respond to those two errors which Mr. Lundy acknowledged, not one affiliate service price charged by SWB was below the restated FDC results. Ex.242,p.38 This further demonstrates SWB compliance with FCC affiliate rules. In sum, Dr. Ileo's criticisms are simply incorrect, invalid, or immaterial, and TAI's attempt to inflate FDCs is completely insupportable.

Even assuming for the sake of argument that all of the TAI FDC criticisms were valid and material, the adjustment proposed by TAI for SWB-Missouri's revenue requirement is wildly speculative. After creating unfounded and completely hypothetical FDCs that are

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[110]Steps have already been taken to correct these minor matters, that will change relevant costs by only 1.5%. Ex.241,p.17-19

inflated by 123.29% to 214.6% above actual FDCs,[111] TAI compounds its error by assuming that the revenues from the sale of affiliate services would have actually increased after tremendous price increases. In doing so, TAI makes the unstated and unsupported assumption that each affiliate would have purchased the <u>exact</u> same services in the <u>exact</u> same quantity from SWB despite those huge price increases. Elementary economics tell us that when prices go up, the number of units sold go down. Faced with increased prices, the affiliate could simply perform the services itself, buy them elsewhere, or buy less. Ex.242,p.6 With a real-life example of lost sales due to SWB's price, SWB witness Powers clearly demonstrated that this economic principal works with affiliate services. Ex.242,p.21 Staff and TAI clearly fail to understand how markets behave, not to mention how those operating in competitive markets and with real budgets react. Indeed, neither Staff nor TAI provide any support or evidence whatsoever that what they assume would actually occur.[112] In sum, Staff would have the Commission set SWB's revenue requirement based on totally

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[111]Even ignoring the validity of the TAI's criticisms, the insubstantial nature of these inflation figures are revealed by their derivation. The 123.29% figure is based upon a ratio of dollar amounts; 214.60% is the unweighted average of 22 separate percentages; and a third inflation figure, 163.90%, is derived from the application of the first two inflation figures. TAI completely ignores the need to maintain mathematic consistency throughout its calculation. With each step, TAI's reasoning and its foundation becomes more and more attenuated.

[112]With the inevitable reduction in purchases of these non-tariffed services, TAI's adjustment would have the effect of reducing the contribution generated by these affiliate services that help cover joint and common costs. Therefore, TAI's recommendations would actually negatively affect SWB's customers.

speculative, phantom transactions resulting from its form of "voodoo economics."

Even if SWB's affiliates would have continued to make the exact same purchase decisions with the inflated FDCs as TAI assumes, the adjustment would still be largely improper from an accounting perspective. Of this $1,341,606 adjustment, a total of $61,169 is attributable to sales to Metromedia Paging Services, Inc. ($1007), an affiliate that has been sold, and Southwestern Redevelopment Corporation II ($60,162), a company whose activity has ceased with the completion and transfer of the St. Louis Data Center. Ex.229,Table IV-A,p.4,17;Ex.243,p.27;Ex.222,p.11 These constitute known and measurable changes, and cannot form the basis of the proposed adjustment. A full $765,934 is attributable to SWB sales to Southwestern Bell Audit Services, Inc. ($24,615), SBC ($735,175), SBC-Washington, Inc. ($2597), Southwestern Bell Technology Resources, Inc. ($3547), four companies whose charges to SWB are based upon FDC. Ex.229,Table IV-A,p.8-10,14;Ex.220,p.III-2,III-3 Thus, to the extent that Staff is proposing that those companies' costs increase through increased prices for services purchased from SWB, the FDC-based charges to SWB also would have risen for services purchased from those affiliates, and SWB's cost of service increased accordingly. Yet neither TAI nor Staff, who have the burden of proof in this complaint case issue, have reduced the proposed adjustment to account for any corresponding increase in SWB expense. Finally, $133,467 is attributable to sales to Yellow Pages. Ex.229,Table IV-A,p.16 If the Commission continues to impute and act as if SWB and Yellow Pages were one company, making this adjustment would simply "wash out" of the process. In sum, $960,570 (71.6%) of the proposed $1,341,606 adjustment either fully or partially fails to recognize known and measurable changes, or would not be made in accordance with proper regulatory accounting practices. The Commission must reject at least this amount of the proposed FDC adjustment.

b. "NO STUDY" SERVICES

The second adjustment for affiliate services proposed by TAI involves services for which no FDC study was prepared.[113] In this area, TAI recommends an imputation of $46,128 in revenues not actually generated by these services. Affiliates were, of course, charged an appropriate market-like price for these services; there simply was no material direct cost upon which an FDC could be calculated. Ex.242,p.33-35 The testimony explaining these circumstances and the appropriateness of not performing an FDC study, as well as the basis for the actual prices charged are clearly explained in the testimony of SWB witnesses Lundy, Doherty, and Powers and will not be restated here. Ex.241,241P,32,242 The Commission should also reject this $46,128 adjustment.

Nevertheless, assuming for the sake of argument that TAI's position has any validity, the Commission should note the basis for this adjustment. TAI added up the revenues associated with the "no study" affiliate services and applied a "gross up" factor of 24.46% to derive this proposed adjustment. That factor is based on a

[113]In order to avoid causing any more confusion with TAI's use of "services with no costs" in Ex.229,Table IV-A to describe these services and incidental services, SWB will adopt "no study" to refer to affiliate services for which no FDC study was performed.

ratio, in which the numerator is the total TAI-supported revenue adjustments associated with the alleged FDC study errors, and the denominator is the total SWB revenues in 1991 for affiliate services. Since TAI used its own FDC study adjustments, shown by Mr. Lundy to be incorrect, there is no basis for this 24.46% factor. Unless the Commission finds for TAI on <u>each and every one</u> of its alleged FDC study errors and <u>completely agrees</u> with TAI on the effect of those alleged errors on the calculation of the actual FDC, the 24.46% factor derived from those alleged errors has <u>absolutely no validity</u>.[114] Any change to the re-computed FDC numerator would change the calculation of TAI's proposed adjustment.

Again, TAI's adjustment is based on the assumption that affiliates would be willing to purchase the exact same quantity at these inflated prices, an assumption that has been proven to be demonstrably false. Additionally, more than 77.5% of the adjustment ($35,749) is attributable to services sold to Yellow Pages. Ex.229,Table IV-A,p.16 If the Commission continues to impute in this case, this adjustment would result in the same form of "double accounting" discussed above. Another 6.7% of the adjustment ($3073) is attributable to SBC. Inasmuch as SBC has moved to San Antonio and these services consisted of the use of conference rooms in St. Louis, making an adjustment on the basis of

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[114]Even if TAI's FDC adjustments were appropriate, SWB does not concede that this 24.46% factor has any validity whatsoever in that this factor assumes an identical relationship between the revenues and costs for all the services to which TAI applies the factor. Indeed, adjusting revenues based upon costs, as TAI proposes, is more than a little inconsistent with TAI's criticism that SWB's FDC studies allegedly allocated costs based upon revenues.

continued SBC usage of these conference rooms would ignore an obvious known and measurable change to the Company's operations.

In sum, TAI has not carried its burden that these affiliate services require any form of adjustment, much less the $1,388,000 imputation of phantom revenue sought by Staff. The Commission should decline to make this adjustment.

### (iv) INCIDENTAL SERVICES - CATEGORY (2)

The TAI-proposed adjustment for incidental services (Category (2)) is approximately $1,332,000. As set forth earlier, the prices for incidental services are based upon a substantial number of actual, real transactions with non-affiliates. Ex.242,p.16 As SWB witness Doherty testified, "incidental services" are non-tariffed services that do not arise to a line of business due to their relative size and level of marketing activity, but are treated as regulated for accounting purposes. Ex.32,p.9 In other words, the market sets the price for these services, and affiliate and non-affiliate alike actually buy at that price. All of the revenues inure to the benefit of the Company and its customers.

Notwithstanding SWB's compliance with the FCC "prevailing price" standard for these incidental services, TAI essentially proposes a price increase for these services. In other words, TAI would have the Commission make an adjustment based upon TAI's derivation of a "below market prevailing price." The market apparently has not set a price high enough for TAI's tastes. SWB believes doing cost studies or market research in areas where the market has already set a price would be a waste of resources that the Commission would not and should not sanction.

In deriving this $1,332,000 revenue adjustment for incidental services, TAI proposes to use the same 24.46% used with "no study" affiliate services to "gross-up" actual revenues to derive its hypothetical increased revenue stream. Ex.229,Table IV-A,p.2-20 Using the 24.46% "gross-up" factor is equally inappropriate here, as the factor remains based on TAI's incorrect FDC criticisms.

Note, however, that the real prices were high enough for TAI's tastes when the service was provided to non-affiliates. TAI is not proposing to inflate the incidental revenues associated with sales to non-affiliates. TAI must believe the prevailing market price paid by non-affiliates is appropriate but, inconsistently, the same price is suddenly inappropriate when an affiliate purchases the same service. To say the least, this is a novel approach to segmenting a market and certainly belies any claim that TAI is merely judging SWB by the applicable FCC accounting standards. TAI's proposed pricing for these incidental services is unique, for which neither TAI nor Staff cites any precedent whatsoever.[115]

As with affiliate services, this adjustment also depends upon TAI's absurd assumption that elementary market forces would not affect affiliate purchases of services whose prices have seen a 24.46% increase. Finally, when one examines the actual transactions on which TAI bases its "incidental service gross up,"

[115]Nor does Staff or TAI explain why SWB would want to "cross-subsidize" non-affiliate companies. If the price of an incidental service is too low, a non-affiliate pays less than it should, leaving SWB all the poorer. (In fact, if SWB consistently priced at less than a market rate, SWB could expect to have that "incidental service" turn into a line of business as the market rushed to SWB's lower price.) If the price was set too high, SWB would be unable to sell to anyone, including its affiliates, leaving SWB again the poorer.

the complete inappropriateness of making the proposed adjustment is revealed. Nearly 77% ($1,023,330) of this "gross up" is attributable to Bellcore, of which SWB is only a one-seventh owner. Ex.229,Table IV-A,p.18 None of SWB's Bellcore purchases have been challenged by Staff and, as a result of this case, SWB's investment in Bellcore and its Bellcore dividends will be included in the calculation of SWB's revenue requirement and earnings. Under these circumstances, SWB has absolutely no incentive to cross-subsidize Bellcore, as any benefit would accrue solely to third parties.[116] Another 19.8% of this "gross up" ($263,722) is attributable to transactions with Yellow Pages. Ex.229,Table IV-A,p.16 If the Commission continues to impute, making this adjustment without an opposite and equal decrease to Yellow Pages' imputation would be "double accounting." In all, more than 98% of the "incidental services gross up" is simply inapplicable to one degree or another, after taking into account the other affiliates as set forth above.[117] The Commission should decline to make this adjustment as well.

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[116]This adjustment is also inexorably tied to the Commission's decision on the Kansas City Data Center (KCDC) issue. SWB is proposing that the revenues, expenses, and investment associated with KCDC be treated as nonregulated. <u>See</u> Section 17 Inasmuch as $1,022,107 of this adjustment is related to billing performed for Bellcore through the KCDC, declaring KCDC nonregulated would moot this amount. Ex.32,p.4-14;Ex.229,Table IV-A,p.18;Ex.232, p.203

[117]TAI's recommendation includes the following adjustments attributable to the listed companies: Metromedia - $2936; Audit Services - $979; SBC - $12,966; SBC-Washington - $489; and Technology Resources -$1223. Ex.229,Table IV-A,p.4,8,9,10,14

### (v) OTHER AFFILIATE ISSUES RAISED BY TAI

TAI has raised several other affiliate issues, but no specific dollar adjustment is being proposed by Staff. Nevertheless, due to TAI's recommendation that the Commission mandate several operational and management actions by SWB, those matters must be addressed albeit briefly.

#### a. PURCHASES FROM AFFILIATES

In purchasing products (assets) and services from affiliates, SWB follows applicable FCC rules, which are as follows:

- SWB records the affiliate's prevailing price, which is the market price for the same product or service purchased as established and documented through arms length sales to non-affiliates;

- if a prevailing price has not been established for a product, the purchase must be recorded at the <u>lower</u> of the product's net book or fair market value;

- if a prevailing price has not been established for a service, the purchase must be recorded at <u>no greater</u> than the affiliate's FDC for providing the service.

Ex.222,p.14,15 Adopted in the same proceeding as the rules for sales to affiliates, these rules resulted from a lengthy FCC proceeding. Note that the rules are tilted to ensure that cross-subsidization does not occur and that the customer always wins. There is no disagreement about the applicability of these rules; TAI questions whether SWB has complied with them. As Ms. Taylor and Ms. Larkin testified, SWB does comply with these rules to the particular benefit of SWB and its customers. In fact, Ms. Taylor demonstrated that SWB has gone beyond the FCC rules in negotiating a pricing arrangement with Southwestern Bell Telecom which benefitted SWB in 1991 to the tune of $690,177, including being able to purchase through Telecom at lower prices than SWB could have obtained on its own. Ex.243,243P,p.21-25

b. DETERMINING MARKET-LIKE PRICES

TAI spends a great deal of effort questioning and criticizing how SWB goes about determining a market-like price for affiliate services. Mr. Powers demonstrated that SWB has dedicated a prudent amount of Company resources to establishing these prices and that affiliate prices clearly fall within available market price ranges. Ex.242 A more elaborate method of setting prices would raise SWB's costs (and hence prices quoted to the affiliates) without any assurance that SWB would be able to recover those increased costs or continue to generate the substantial revenues that affiliate services currently contribute. Ex.242,p.20-22 Implementing TAI's recommendations in this area could result in the loss of $1.3M in revenues, plus increased incremental costs if SWB priced itself out of the market. Ex.242,p.15,21,23,30,36 As the experience with Yellow Pages illustrated, affiliates can and will go elsewhere if affiliate services are overpriced. Ex.242,p.29 This practice is in full accordance with the Commission's statement in Case No. TC-89-14 that SWB set prices on services provided to affiliates in order to maximize contribution, to the effect that $10.1M in contribution was generated from 1988 to 1991. Ex.242,p.3,4,22,23 SWB has addressed the concerns and suggestions made by Staff during that case. Nevertheless, TAI now seeks an unjustified, retroactive change in the ground rules.

(vi) CONCLUSION

The Commission should reject the Staff's proposed $2.72M revenue adjustment because it is based upon inaccurate criticisms and erroneous assumptions, and violates FCC standards and regulatory accounting principles. Staff has clearly not carried its burden that this adjustment is appropriate or warranted. Similarly, the operational and management changes that TAI recommends that the Commission mandate simply have not been shown to be necessary, and are based more on difficulties caused by TAI and its approach than real problems needing corrective action. In light of the pending joint Federal/State affiliate audit of SWB, any such change also would be premature. At the very least, the Commission should wait for that comprehensive, on-site audit to be completed rather than relying on TAI's sloppy and fundamentally flawed conclusions to mandate unnecessary and costly changes.

17. KANSAS CITY DATA CENTER

SWB performs certain data processing functions for non-Missouri clients from its Kansas City Data Center (KCDC). Ex.32,p.4,12 SWB proposes that these operations be treated as "nonregulated" and removed from inclusion in cost of service. Staff, on the other hand, proposes to include these nonregulated revenues and expenses at September 30, 1992 levels. Ex.7,p.26

In determining the value of its proposal, Staff initially made several errors in (1) recognition of revenues, (2) use of the appropriate separations factor, and (3) recognition of the correct expense amounts. Ex.7,p.29-32 Before the hearings were completed, Staff corrected the revenue and separations adjustments; and thus only the expense disagreement remains. Ex.7,p.27A;Ex.28,p.1-2

Staff never contested the "expense" adjustment errors noted by SWB witness Martin. Ex.7,p.30-32 Rather, Staff witness Rucker's surrebuttal testimony stated that she would "examine" these expenses and make any corrections. Ex.28,p.2 No further statements were received in the record to rebut SWB witness Martin's testimony. If the KCDC is included in cost of service, it must be at the correct expense level Ms. Martin proposes, to assure, as Mr. Meyer states, that the appropriate relationship exists. Staff's proposal understates revenue requirement by almost $2M. Ex.7,Sch.15

SWB, however, proposes to treat the KCDC functions described above as nonregulated because they are not Missouri utility services[118] and, under nonregulated guidelines, must be removed from the regulated accounts. Ex.32,p.8;Ex.31,p.23-25[119] The adjustment is based upon test period results, is known and measurable, and therefore, consistent with Staff's other nonregulated adjustments (e.g., Ex.29,p.23-24;Ex.7,p.56), should be removed as SWB proposes.

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[118]Staff did not contest the fact that these KCDC services were no longer "public utility communications services".

[119]Mr. Schallenberg could only state that he was "not sure at this time" whether the services are nonregulated. He did offer some vague assertions that not "all the costs" were accounted for in the removal. Ex.31,p.23-24 This assertion is ironic given that Staff itself could not properly account for either the revenues or expenses in its case. Mr. Doherty testified that the non-regulated procedures used to identify costs are reasonable, appropriate and in line with guidelines. Ex.32,p.13-14,23-26

## 18. INCOME TAX

### A. VACATION PAY

This is a question related to a book/tax timing difference and how to account for the Commission's past decisions that "flowed through" the tax benefit in past cases.[120] Besides adjusting SWB's expense accounts to remove compensated absence expense, Staff also proposes an income tax adjustment to exclude the SWB "addition to taxable income" for the 10 year amortization (Part 32.24(b)) of vacation pay required by Case No. TC-89-14. Ex.37,p.83-84

The "addition to taxable income" tax expense is required because SWB was ordered to use "flow through" accounting by the Commission in Case No. TR-79-213:

> The Company should flow through the benefits of the tax timing difference relating to ... vacation pay accrual. 23 Mo. P.S.C. (N.S.) at 381. T.2309

SWB thereafter "flowed through" the tax timing difference between expense and accrual accounting for vacation pay until the 1989 Commission Order approved tax normalization in Case No. TC-89-14. Ex.227,p.18-20;Ex.37,p.83-85

Staff opposes SWB's adjustment to recognize the flow through impact <u>principally</u> because the Tax Reform Act of 1986 "eliminated the difference between book and tax treatment that existed" in Case No. TR-79-213. Ex.29,p.16 This, Mr. Schallenberg concludes,

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[120]See also the discussion on COR/SAL in Section II.18.D of this Brief.

eliminated any "book/tax timing difference" required in Case No. TR-79-213. Ex.29,p.15[121]

However, as Mr. Schallenberg had to admit on cross-examination, the Tax Reform Act of 1986 did not alter the book/tax timing difference. T.2352 It was the Revenue Act of 1987, Sec. 10210, that altered the book/tax timing difference for all tax liability after 1987. This 1987 tax change coincided with the adoption of Part 32, and continued the book/tax timing difference.

It was not until the Commission's adoption of tax normalization in Case No. TC-89-14 that the going forward tax timing differences were normalized and no longer flowed through. Ex.37,p.83-84 By then, the vacation pay book/tax timing difference "flow through" had already occurred.[122] SWB recognized this regulatory accounting "flow through" impact in the subsequent sharing years. Ex.37,p.85-86,Sch.8,9 The add back to expense is required to assure past recognition is not again applied to reduce current rates.

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[121]Unlike Mr. Meyer's contention with COR/SAL, Mr. Schallenberg does not really contest that the Commission did order flow-through accounting for vacation pay book/tax timing difference in Case No. TR-79-213; another example of Staff's internal inconsistency. The same order required SWB to "flow through" the tax timing difference for COR/SAL and vacation pay. 23 MoPSC (N.S.) 374, 381 (1980)

[122]Implicit in Mr. Schallenberg's argument is a suggestion that for some reason SWB should have discontinued following and complying with the Commission Order in Case No. TR-79-213 prior to the Order in Case No. TC-89-14.

## B&C. AMORTIZATION OF INVESTMENT TAX CREDIT (ITC) AND EXCESS DEFERRED INCOME TAX AMORTIZATION (EDITA)

As was true in Case No. TC-89-14, Staff fails to properly recognize the appropriate ITC and EDITA associated with its deregulated adjustment and net compensable property adjustment.[123] Staff made three attempts at properly recognizing ITC and EDITA but has failed each time.

Originally, Staff used a December 31, 1991 level of ITC and EDITA -- but used September 30, 1992 rate base and depreciation expense levels. This, SWB witness Bauer stated, would violate the IRS normalization rules. Ex.227,p.2 Staff implicitly acknowledged this error by altering its proposal and adjusting ITC and EDITA to September 30, 1992. But, in doing so, Staff did not adjust for the removal of <u>any</u> net compensable property or deregulated property.[124] Staff's second adjustment also was in violation of the IRS normalization rules. Ex.227,p.2

Two days before the end of the hearings, Staff provided its third proposal. This time, it "arbitrarily" included $50,000 for deregulated and compensable property related ITC and EDITA. T.2326 Mr. Meyer stated that this amount was not based upon any Staff analysis, or workpaper, but was just arrived at by "talking with Mr. Schallenberg." T.2326-28,2338 Mr. Meyer concedes he does not

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[123] The Commission agreed with SWB in that case that consistent treatment of net compensable property requires that the amounts of EDITA and ITC should also be removed in calculating SWB income tax. 104 PUR 4th at 401-402.

[124] Staff's December 31, 1991 proposal did recognize net compensable property but had a zero recognition in its second adjustment. T.2328-31 In neither case did Staff account for its deregulation adjustment. Ex.227,p.10-12

know if his adjustment is even now in compliance with the IRS code. T.2340

SWB witness Bauer explained that the Internal Revenue Code requires consistent estimates; if rate base is adjusted (as Staff did for nonregulated and net compensable property) then Staff must also use consistent estimates for the related ITC and EDITA as well. Ex.227,p.2,7-12,Sch.2 Mr. Meyer agrees that his "$50,000" is not based upon any consistent estimates with Staff's other rate base adjustments.[125] T.2337

As a stop gap tactic, Mr. Meyer argues that SWB is at fault because "the company has provided no information or data" and that Staff -- after over a year of audit activity -- does "not have the information to verify the deduction." Ex.4,p.19-20 SWB proposes the same method used in Case No. TC-89-14. Staff Witness Doerr was able to calculate deferred tax in his net compensable property adjustment -- yet Mr. Meyer was unable to state why a similar method could not be used for ITC and EDITA. T.2334-35 In short, Mr. Meyer agrees that recognition is required, but he cannot accurately determine the amount. He does admit that his $50,000 adjustment is "not the right number." T.2339

[125]Mr. Meyer says that his review of this matter indicates the ITC difference is "immaterial". Ex.4,p.18-19 This "immateriality" is because he fails to recognize net compensable property in the second adjustment and compares it with his first adjustment which had a December 31, 1991 balance which does include the compensable property. He then later asserts that his December 31, 1991 proposal should not have had net compensation recognition anyway! T.2331-32 His arguments are both circular and illogical. But even if it is "immaterial", it does not account for EDITA differences -- only ITC.

As was true in Case No. TC-89-14, Staff's proposal must be rejected.

### D. COST OF REMOVAL/SALVAGE FOR PRE-1981 PROPERTY

This is a book/tax timing issue that arises because cost of removal (COR) and salvage (SAL) is recognized for book purposes in the depreciation rate but not recognized for tax purposes on the SWB tax return until the end of the service life. Ex.37,p.89;T.2296 Prior to 1981, the Commission ordered that this book/tax timing difference should be "flowed through" to reduce rates.[126] T.2311 Effective 1982, the tax code was changed and thereafter, COR/SAL was normalized for book purposes and could not be "flowed through". T.2299

SWB proposes to recognize the previous "flow through" of this book/tax difference to avoid passing through to customers for a second time the same tax benefit already passed through prior to 1981. Ex.37,p.90 Staff fails to make this adjustment and thereby understates revenue requirement. Ex.37,p.90

#### (i) RATE BASE

Staff refuses to adjust rate base for pre-1981 COR/SAL because it claims that the real issue is "whether in fact deferred taxes are created" with pre-1981 COR/SAL. Ex.4,p.22-23 Staff witness Meyer argues that "deferred taxes could not be generated." Ex.4,p.23

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[126]Flow through means that the tax benefit is recognized for book purposes prior to the time it occurs, thus lowering customer rates. This is contrary to normalized accounting that was used by the FCC, both under Part 31 and Part 32 accounting. Tr.2299-2301,Ex.37,p.89 Mr. Meyer admitted that the COR/SAL adjustment made on Staff Accounting Schedule 12 was to recognize the flow-through. T.2305-06

Mr. Meyer's claims are inconsistent with Staff's prior claims in Case Nos. TR-77-214 and TR-79-213:

> In addition, Staff proposes to flow through $3,216,000 resulting from the difference in book and tax treatment of salvage and removal cost. Salvage and removal costs are included in depreciation rates for book purposes, but as yet have not been incurred as a tax liability. 23 MoPSC (N.S.) 374, 381 (1980). T.2309-2311;Ex.223

Mr. Meyer could not explain this contradiction in Staff positions.[127] T.2310

Mr. Meyer next argues that the adjustment is proper only if book salvage is higher than book COR -- this argument is not relevant. Ex.4,p.21-22 The tax timing difference, as the Commission noted in Case No. TR-79-213, is in reference to a book and tax difference (Ex. 227); Mr. Meyer's comparison of only the book difference in his COR/SAL analysis does not concern the book/tax timing difference. Ex.227,p.17 Moreover, his argument is based upon his study of 1988-1992 book COR/SAL (and his review of the results from a Staff study for 1984-1987). T.2312 This, obviously, is the wrong period -- the issue is COR/SAL for pre-1981 property, which Mr. Meyer concedes he did not study. T.2313

(ii) INCOME TAX CALCULATION

Contrary to his rate base arguments, Mr. Meyer does include in his income tax calculation, the December 31, 1991 income tax effect of COR/SAL "flow through" for pre-1981 property.[128] SWB included

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[127]The Commission adopted the Staff recommendation in Case No. TR-79-213 and ordered the Company to "flow through" the benefits of the tax timing difference. 23 Mo. P.S.C. (N.S.) 381 There cannot be any serious argument that this benefit has already lowered rates and should not be used again.

[128]It is inconsistent to recognize COR/SAL in the income tax calculation but not in rate base.

the September 30, 1992 balance to match other aspects of the rate base.[129] Ex.37,p.83 Mr. Meyer states that he did not choose the September 30, 1992 level because he believes that, while the December 31, 1991 "positive" balance is representative, the September 30, 1992 "negative" balance is not and, historically, negative balances "could not have been generated".[130] T.2321

Again, however, Staff contradicts itself with its own past presentations. In Case No. TC-89-14, Staff itself argued for a "negative" income tax balance for COR/SAL: a "negative balance" Mr. Meyer now says could not have occurred. T.2314-15;Ex.224 The Commission's Order in Case No. TC-89-14 likewise refers to a negative balance. Staff of Missouri P.S.C. v. SWBT, 104 PUR 4th at 435 (1990) Likewise, sharing reports also confirm "negative" balances. T.2322 Mr. Meyer's December 31, 1991 "positive" balance is out of line with historical trends and the September 30, 1992 balance. He fails to follow his own recommendation to have an "appropriate" relationship of test period revenues, expenses, and rate base.

### E. NON-PROPERTY RELATED DEFERRED TAXES

Staff's deferred income tax balances failed to include all deferred taxes in its rate base. Specifically, Staff failed to include all "nonproperty related" accumulated deferred income tax

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[129]All other aspects of the income tax calculation, in both SWB's and Staff's cases, are at September 30, 1992 levels. Ex.227;Ex.37,p.79-83;T.2305

[130]The positive balance increases Staff's case; a negative balance would reduce Staff's case. Staff performed no verifications that either number was correct.

reserves in Accounts 4340.29 and 4100.29.[131] These must be included to comply with the Commission's requirement in Case No. TC-89-14. Ex.37,p.87-89 Staff gives no indication of why it failed to include these balances -- nor does Staff rebut SWB witness Toti's testimony that the accounts were not included and must be included.

19. **BUSINESS MEALS**

Staff witness Meyer proposes to remove all (100%) business meal expenses based upon his belief that the Company "had not corrected the problems" that the Commission discussed in Case No. TC-89-14. Ex.2,p.17 The sole basis for Mr. Meyer's statement was his review of summary reports from four Internal Audit Reports performed by SWB. Ex.4,p.15;T.673 Mr. Meyer <u>did not</u> audit the meal expense vouchers himself and <u>did not</u> review the specific items covered in the Audit Reports. Ex.7,p.78-79;T.671 In fact, he <u>did not</u> personally (a) audit SWB's internal controls, (b) review the SWB Operating Practice 56 - Bill Payment Practice,[132] (c) review external/internal audit controls, or (d) review IRS section 1.274-5(C)(4) pertaining to meal expenses documentation. Ex.7,p.78;T.671-77

[131] Staff did include some nonproperty balances in other accounts but the inconsistency with these accounts is not explained. Ex.37,p.89

[132] Provided to Staff in DR 171. This practice establishes the parameters of business meal expense reporting. Exhibit 47 is the meal expense reporting form used which requires detailed data to explain and justify the expense.

During cross-examination, Mr. Meyer conceded that improvement in SWB's business meal expense reporting had indeed occurred since Case No. TC-89-14. T.679

SWB witness Martin also concurred that Missouri results were much improved -- only a 1.7% error rate -- over similar data relating to other operating states referred to in Case No. TC-89-14.[133] Ex.7,p.79-80 But Ms. Martin also noted that a deficiency revealed by the Internal Audit Report does not mean that the expense was inappropriate -- merely that some detail on the voucher was insufficient, such as failing to attach original receipts, mathematical accuracy, etc.[134] Ex.7,p.75-78

Even Mr. Meyer's cursory examination of the four summaries fails to support his 100% adjustment. Those summaries, as he admits, indicate that no improprieties were found, no significant negative trends were noted, no inappropriate expenses were found, and that employee meal reimbursements were in accordance with Management Expenses Guidelines.[135] Ex.4P,p.16-17;T.676-80[136]

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[133]This 1.7% error rate means only $24,000 of meal expenses were affected by the errors. Ex.7,p.82

[134]In the event of insufficient documentation, the IRS Code allows for substantiation by other means. IRS Reg. 1.274-5(C)(4). The Internal Audit Reports all confirmed that the employee vouchers had documentation, but that in some cases it was insufficient. The Reports, after review of those cases, found the vouchers to be "in compliance."

[135]Management Employee Expense Guidelines. Ex.7,Sch.13

[136]One report dealt with an isolated case of employee fraud. The investigation pointed out that controls are in place to identify suspicious circumstances and take corrective action. That situation was remedied, restitution obtained and corrective action taken. Ex.7,p.81

SWB has controls in place and detailed reporting requirements and various audit functions are used to assure compliance. Ex.7,p.72,80-82;Ex.47 Business meal and entertainment expenses for employees participating as Company representatives in external/public affairs and community/civic activities are booked "below the line" and not included in cost of service. T.689-90 While SWB does not suggest any process will assure 100% accuracy or that a process which guarantees 100% is cost effective, the Company's standard and the results in this case are more than reasonable. Rejection of all meal expense (100%) is unreasonable.

Mr. Meyer recommends that SWB resort to a "per diem" process. T.681 However, SWB does have a "per diem" process, and yet Mr. Meyer's proposal results in a recommended disallowance for those "per diem" expenses as well.[137] Mr. Meyer seemed surprised to find out that SWB's procedures included a per diem process. T.682-83 This is, perhaps, just another indication of the lack of understanding Mr. Meyer has about this entire process.

## 20. YELLOW PAGES IMPUTATION

### (i) SWB'S PROPOSALS

In the divestiture proceedings Judge Greene initially considered transferring the Yellow Pages operations to AT&T, but ultimately left those operations with the RHCs to protect against a loss of subsidy that might have caused local exchange rates to increase. Ex.200,p.37;T.1918-19 That was prior to 1984. However, since 1984 SWB's local exchange rates have not increased at all in Missouri, and in fact have decreased. T.1915;Ex.50,p.13-14

[137]The per diem rate ranges around $23 to $25 per day. T.687

SWB's proposal in this case is that local exchange rates be frozen for at least three more years, and for the duration of any extended incentive plan. Ex.50,p.14 But, even if the Commission determines not to continue with incentive regulation and determines that SWB's revenues should be reduced as a result of Staff's Complaint, under the rate design stipulation agreed to by SWB, Staff, OPC and most other parties, it is highly unlikely there would be any reductions to local exchange rates in this case. Under the stipulation, there would be no reductions to local exchange rates at all unless SWB is ordered to reduce its revenues in excess of $132M, and no reductions to residential local exchange rates unless the Company is ordered to reduce revenues by approximately $140M. Ex.159;T.1919

Thus, under the recommendation made by the Staff itself, imputation would not be utilized in this case to support local exchange service, but merely to drive down the Company's earnings and the rates for other telephone services, based on profitability of an advertising line of business.

SWB asks that the Commission consider adopting a policy that it will not impute Yellow Pages earnings in a proceeding such as this in which the Company is not proposing to either increase its revenues in general or local exchange rates specifically. In this proceeding, SWB is proposing to reduce its revenues and continue to hold local exchange rates at current levels. Given these facts, it would be reasonable for the Commission to forgo imputation in this case, while reserving its ability to impute in future or other cases involving different circumstances. Yellow Page earnings constitute the single largest subsidy in SWB's current price/cost structure. Competition in the telecommunications industry will eventually require the reduction and eventual elimination of such subsidies. In this case, the Commission can take a step in that direction without an adverse impact on telephone rates.

Under SWB's proposal for extending the incentive regulation plan, the 1985 adjusted level of Yellow Pages earnings actually would continue to be embedded in the Company's rates and in the calculation of customers' credits under the sharing grid. The Company has proposed that if the sharing grid is left at 14.1% ROE, that the 1985 adjusted level of Yellow Pages earnings continue to be imputed under the plan. If the Commission would agree to exclude Yellow Pages earnings from its calculation of SWB's earnings under the plan, the Company has proposed to lower the initial sharing point to 10.7% ROE, a reduction of 340 basis points, which is equivalent to the 1985 adjusted level of Yellow Pages earnings that Staff has recommended be used in its case. Ex.48,p.13-16,22-26;Ex.49,p.15-17,19-22;Ex.1,p.57-58

In its Complaint proceeding, Staff has issued over 490 data requests with multiple subparts (T.1924-25;Ex.206), requiring the production of over 50,000 pages of material covering over 10 years of time (T.1926-1927), and spent well over 5,000 hours (Ex.102) compiling over 600 pages of testimony and exhibits (T.1927;Ex.195,196,200-203) to develop a recommendation that the Commission do what it already had stated it was going to do anyway in its Order in Case No. TC-89-14 (Tr. 1927-28); that is, continue to impute the 1985 adjusted level of Yellow Pages earnings unless and until SWB demonstrated that some other level was appropriate. R&O,p.50-51

If the Commission elects to return to traditional regulation, SWB's proposal is that the Commission exercise its discretion not to impute, or, if it does elect to impute, that it use Yellow Page results from the twelve month period ending September 1992 (Ex.7,p.62-63,70;Ex.49,p.22); and these results are actually better than the 1985 adjusted level proposed by Staff. Ex.49,p.26-27;T.1933-34 Thus, the focus could have been limited to what, if any, adjustments could or should be made to such results. Instead, tremendous amounts of Staff and Company resources were spent in order for Staff to develop numerous alternatives based on data from several different years.

First, Staff recommended the Commission utilize 1985 Yellow Pages earnings as adjusted by the Commission in Case No. TC-89-14, which would result in an imputation amount of $42.2M. Ex.7,p.63;T.1899 Alternatively, Staff recommended the Commission consider reversing an adjustment made in that case, based on uncollectible data from 1986, on the theory that reversal of that adjustment would make the 1985 results more representative of SWBYP ongoing operations, not as they actually exist, but as Staff thinks they should be.[138] T.1847-48,1900 Reversal of the adjustment would result in imputation of approximately $49M. T.1900 The

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[138]Ms. Levins acknowledged that Staff was not seeking a number that reflects actual results, but rather a number reflective of "ongoing levels for ratemaking purposes." T.1847 Ms. Levins took the position that customers are entitled to some guaranteed level of imputation regardless of actual earnings from Yellow Pages operations. T.1882 None of Staff's proposals reflect an ongoing or representative level of actual SWBYP results. Ex.213,p.10-11

Staff also suggested the Commission could use actual 1991 test year earnings levels, which would result in an imputation of $41.8M (T.1900), but recommended such levels be adjusted in one of two ways. Under one proposal, the Commission would apply various adjustments which Staff has suggested be made to SWB's results.[139] This would result in an imputed amount of $43.3M. Ex.7,p.63;T.1901 Another approach would be to treat Gulf Printing and Times Journal as if they were part of SWBYP. This approach would result in an imputed amount of $43.7M. Ex.7,p.63;T.1901-02

Staff takes the position that the Commission can pick any of these numbers, that it can impute 50% of such numbers, or even 125% of such numbers. T.1903-05 In fact, Staff's position seems to be that the Commission is not limited to actual results in any way, but can, in effect, pick any number it chooses. Surely this is not what the legislature intended when it gave the Commission the option to impute.[140] But, if the Commission can truly pick any

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[139]The SWBYP expenses which Staff seeks to adjust were all demonstrated to be reasonable. The prices paid by SWBYP for printing and paper to Gulf and Times Journal are comparable to prices charged by unaffiliated firms in the same line of business, Ex.213,p.19,21-23;Ex.213,p.21,Sch.3; Ex.200HC,p.82; dues and donations are designed to facilitate advertising sales, Ex.213,p.15-16; management compensation is designed to achieve improved financial objectives for SWBYP, Ex.213,p.16-17; and SBC allocations allow SWBYP to share costs it would otherwise have to incur on a standalone basis, Ex.213,p.16. Proposed Staff adjustments to these areas would not result in a "representative level" of expenses associated with actually running SWBYP. Ex.213,p.11-12,16,24-25

[140]While Section 386.330.4 RSMo. Supp. 1992 gives the Commission authority to impute Yellow Pages earnings, it does not give any explicit or implied authority to treat SWBYP as a regulated entity, or adjust its revenues and expenses on that basis. A Texas Appeals Court has recently rejected a proposal to disallow a portion of SWBYP's operational expenses as part of an imputation adjustment on (continued...)

number, why was it necessary to spend 5000 hours of Staff time and so much SWB and SWBYP time in reviewing data from 1983 to 1993 for purposes of making a recommendation on a 1991 test year, updated through September of 1992? The process has become unduly complicated, arbitrary and burdensome. T.831-32,2050,2063-64

If the Commission decides to impute, it should use results for the twelve month period ended September 1992. Ex.7,p.62,70 SWB has suggested two adjustments to that data. One of these adjustments, the business development adjustment, merely removes expenses associated with non-traditional SWBYP products and services, such as directory delivered inserts and direct mail. Staff concurs with that adjustment. T.1933 A second adjustment of $178,000 is necessary to remove certain white pages revenues and expenses from SWBYP results because they are already reflected in SWB's Missouri financials. Ex.7,p.65-66

Finally, the Company has proposed that, if the Commission is going to continue to impute, it should allow a return on the assets that produce Yellow Pages earnings, just as the Commission allows SWB a return on its investment and assets utilized to provide telephone service.[141] If it is going to treat Yellow Pages earnings as part of the regulatory equation, the Commission should

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[140](...continued) the basis that the Texas affiliate statute is not applicable to such expenses. Abilene, et al v. PUC of Texas, 854 S.W.2d 932,946-47 (Tex. App., Austin 1993). A copy of that decision is included in the appendix to this brief.

[141]This proposal is consistent with Staff's Bellcore adjustment in which both investment and dividend income were included by Staff in SWB's cost of service. Ex.7,p.69

allow a return on the assets and investment that produce such earnings.

Such a return allowance is worth approximately $7.5M when applied to September 1992 SWBYP results (Ex.7,p.63), but because such actual results are better than the adjusted 1985 results (Staff's first recommendation), the resulting imputed amount of approximately $39.6M would only be $2.6M below Staff's own recommended imputation amount of $42.2M. Ex.7,p.63

With the exception of prepayments, Staff's various imputation proposals make no allowance for a return on the majority of SWBYP's investment, which includes property, plant, equipment, accounts receivable and deferred directory charges.[142] Ex.7,p.67 If the Commission continues to impute in this case, a cost of equity allowance should be made regardless of whether the Commission utilizes 1985, 1991 or 1992 data. Applied to 1985 results, the adjustment would be $5.1M, and applied to 1991 results it would be $6.8M. Id.,p.69

In calculating her proposed equity allowance, Ms. Martin took total SWBYP Missouri receivables and prepayments, which constitute the largest portion of SWBYP investment, and compared the Missouri totals for such assets with those for SWBYP in total. The resulting percentage, the percent of SWBYP assets in those categories specific to Missouri, was then multiplied by the total amount of SWBYP equity as reflected on its books to arrive at a

[142]The revenue requirement effect of Staff's prepayment adjustment is $1M based on adjusted 1985 results. Ex.7,p.63 SWB's proposal would result in an adjustment of $5.1M if a return is allowed on all SWBYP Missouri equity based on adjusted 1985 results. Ex.7,p.69

percent of such equity to be allocated to Missouri. That number was then multiplied by SWB's recommended ROE of 14.1% to arrive at a cost of equity for SWBYP's Missouri investment.[143] Ex.202HC,Sch.5

(ii) OTHER YELLOW PAGES ISSUES

In the testimony and during the hearings there was a discussion about whether and to what extent competition exists in regard to the sale of directory advertising by SWBYP. SWBYP does encounter significant competition in seeking to maintain or increase its advertising revenues in Missouri. The greatest competition for such revenues comes from <u>other advertising media</u> such as newspapers, TV, cable TV, radio, magazines and direct mail advertisements. Ex.196P,Sch.5-3,5-4,7-7,7-8,7-23,7-24;Ex.209, p.3,13-14,Sch.2 The Kansas City and St. Louis Yellow Pages contain over 1000 listings under various advertising headings. Ex.197,198 Yellow Pages revenues overall account for only 7% of the advertising revenues spent on a nationwide basis among all advertising media. Ex.209,p.3-4;Ex.196,Sch.7-12;T.2134,2166 Only about 30% of the businesses with free listings in the Yellow Pages actually buy any advertising in such books.[144] Ex.209,p.5;T.2150,

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[143]If a different ROE is finally approved by the Commission in this case, such a return can be utilized to calculate the value of Ms. Martin's adjustment by dividing the approved ROE by 12 and inserting the result into the calculations included by Mr. Featherstone in Exhibit 202HC, Sch. 5. That schedule reflects 1991 SWBYP results.

[144]SWBYP pays SWB for the use of SWB customer listings and also pays the expenses of going out to sell advertising to such customers. T.2124-30,2146-52;Ex.209,p.2,16

2166 Thus, the majority of businesses listed in the Yellow Pages, to the extent they advertise, do so in other media.

SWBYP also faces competition from alternative publishers of Yellow Pages directories. Approximately 43 of SWBYP's 50 Missouri Yellow Page directories face competition from 52 different directories put out by alternative publishers.[145] However, SWBYP does not view alternative directory publishers as its most significant or chief source of competition. T.1848-58,1865,2134,2166;Ex.196P,Sch.7-18,7-23,7-24

In recent years, other media have recognized that the level of money being spent on advertising has failed to grow significantly, and even declined in 1991. T.2133,2165,2170-71 To increase their share of available revenues, these other media have increased efforts to get businesses to advertise more with them and less in the Yellow Pages. Ex.209,Sch.2;Ex.196P, Sch.5,7;T.2129,2167,2169-70 SWBYP, in turn, has employed a similar strategy to attract the advertising revenues being spent in other media. Ex.169P,Sch.7; T.2172-73 This competition is real, and Ms. Vann's testimony, and even that of Ms. Levins, shows that such competition has in recent

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[145]Some questions indicated surprise that SWBYP would claim that it faces effective competition from alternative directories in light of its studies showing low usage by consumers of most alternative directories. But, usage studies measure usage of directories by consumers, not ad sales or revenues generated by alternative publishers from those who purchase Yellow Pages advertising. Certain publishers have remained profitable and have successfully sold Yellow Pages advertising for many years despite having, in many but not all cases, low consumer usage. Ex.209,p.13-14;T.1948-49,1952-53,2128-29,2137,2138,2155-56,2160,2162 Ms. Vann testified that even some SWBYP directories with customer usage rates as low as 2% have generated a significant profits. T.2155-56

years become a bigger factor affecting SWBYP operations and pricing strategies.[146]

But, as Mr. Robertson points out, SWB is not asking that the Commission exercise its discretion not to impute in this case simply because SWBYP faces competition. Ex.50,p.12-14 Testimony in this case indicated SWBYP is a well-run, successful company.[147] Ex.213,p.16-17;T.1881 Imputation should not be utilized to artificially adjust upward actual operating results impacted adversely by competition and economic conditions. T.1881-82 Telephone customers do not pay for Yellow Pages advertising, advertisers do. Ex.209,p.15-16.Ex.213,p.15;T.2129 Sometimes those advertisers are SWB customers, sometimes not.[148] Ex.209,p.15; T.2166 Even if the Commission decides to impute, telephone customers should not have what is already a pure subsidy further enhanced by ignoring actual results in favor of someone's version of "ideal ones."[149]

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[146]SWBYP currently loses approximately 17% of its sales each year and must aggressively seek to offset such losses through innovative sales efforts. T.2131-32,2134,2172-73 Competition has also resulted in SWBYP's limiting its price increases since 1983 to roughly the increases in Consumer Price Index. Ex.209,p.5-6;T.1878-81 Even so, Staff continues to recommend imputing more than SWBYP actually earns anyway.

[147]The compensation of SWBYP's management team is tied to its financial results, not those of SWB or SBC. Ex.213,p.4-5;T.2053

[148]SWBYP publishes over 360,000 listings of non-SWB customers, and its directories and sales extend to both non-SWB customers and service areas. Ex.209,p.3,15;T.1953-55

[149]Any notion that customers of telephone service have, by paying rates for their services, somehow obtained an ownership interest in SWBYP earnings is contrary to both fact and law. SWB customers pay for telephone service and SWBYP customers pay for advertising. T.744,885,2040-43 Neither acquires an interest in (continued...)

Issue was also taken with whether Yellow Page directories are "essential" to telephone service. The publication of Yellow Pages directories are not included in the statutory definition of either "telecommunications service" or "basic local telecommunications service" and the Commission has no jurisdiction over Yellow Page prices or complaints.[150] The Commission's own rules and its recent decision in Case No. TO-92-306, involving expanded local calling, would indicate that Yellow Page directories are not as important to telephone service as the White Pages.[151] Certainly Mr. Featherstone stretches credibility to suggest Yellow Pages are more indispensable to telephone service than inside wire or customer premises equipment (T.1907-10), revenues from which are not

[149](...continued)
the business of such companies as a result of such purchases. Board of Public Utility Commissioners v. New York Telephone Company, 271 U.S. 23,32 (1926)

[150]See §386.020(3),(32) and (44) and §386.330(4), RSMo. Supp. 1992.

[151]The Commission's rules require publication of a White Pages directory, but not a Yellow Pages. Ex.200,p.25;4 CSR 240-32.040(4);T.1912 In its December 23, 1992 and July 23, 1993 orders in Case TO-92-306, the Commission required LECs to address certain White Pages issues associated with expanded calling scopes, but no such requirement was addressed for Yellow Page directories. T.1912-1915 While it would make no sense to stop publishing Yellow Page directories, such action could be taken without regulatory approval. Ex.49,p.21

imputed[152], but without which no calls could be made even if one had a thousand Yellow Page directories.[153]

In any event customers already receive such Yellow Page directories free of charge. It is advertisers, who are SWBYP's actual customers and who pay for the production and distribution of such books. T.2129 These advertisers are not billed by SWB, but separately by SWBYP. Ex.209,p.16 It is simply not reasonable that SWB's consumers should not only receive the Yellow Page directories for no charge, but then also get a hypothetical imputation amount that is more than the actual earnings realized from Yellow Pages operations.

Finally, it was suggested by Staff that if the Commission decides not to impute it should require SWB to enter into a contract with SWBYP under which SWB would "retain" a portion of Yellow Page revenues. The GTE, United and Mast contracts in which LECs have the right to retain such revenue were given as examples. All of the referenced retention contracts involved co-bound directories in which the White and Yellow Pages are combined in one directory. T.1958-60,2187-89 However, over 70% of SWBYP's directory revenues come from the St. Louis and Kansas City Yellow Page books which are not co-bound. Ex.209,p.18;Ex.196HC,p.56

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[152]Neither are sales of such things as electrical or gas appliances imputed in those industries. T.1910-11 While the law clearly gives the Commission authority to impute Yellow Pages earnings, consistent treatment should be a reason to consider not exercising such discretion under the facts of this proceeding.

[153]There are other sources for obtaining telephone numbers, such as other directories, White Pages, directory assistance, classified newspaper ads, radio, TV, direct mail and magazines. Ex.209,p.20-22

Applying a retention rate, including even the high retention rate of 48% suggested by Staff, to 30% or less of SWBYP's revenues would not result in the level of imputation suggested by Staff. T.2208-11 In any event, it makes no sense to substitute one form of imputation for another (T.2086-87), particularly when the proposed substitution would involve the Commission exceeding its jurisdiction by ordering SWB management to enter into a particular contractual relationship to obtain services from SWBYP.[154]

## 21. ANNUALIZATION/YEAR ENDING

### A. REVENUES

Both SWB and Staff adjusted 1991 revenues to September 30, 1992 levels based upon the same SWB marketing report. SWB increased revenues $26.9M while Staff increased the same revenues by $36.3M. Ex.7,p.34 The difference in the amount of the adjustment is the methodology used to annualize the revenue. Staff's revenue annualization methodology failed to take into consideration the nature of the different categories of revenue, thereby overstating the annualized level of revenues. Ex.7,p.34-36 The differences are in four categories:

1. Toll and access revenues,
2. Nonrecurring local and end user revenues,
3. Full 12 months of data when no trend was recognizable, and
4. Uncollectible revenues.

[154]The Commission has no authority to become the financial manager of a utility and cannot substitute its judgment for that of company management. State ex rel. Southwestern Bell Telephone Company v. Public Service Commission, 262 U.S. 276, 289, (1923)

### (i) TOLL/ACCESS REVENUES -- SEASONALITY

The principal difference concerns the impact of seasonality. Staff, by using only September, failed to consider the seasonality of the test period data for both Toll and Access. Ex.7,p.36-38 Ms. Rucker initially testified she could not discern a "trend" or seasonal pattern in the data she examined. T.490,506 During cross-examination, she later agreed that the same data series did exhibit trends.[155] The toll/access data confirms that using only the one month of September (rather than the average revenue per access line times the number of access lines at the end-of-period as Ms. Martin proposes), results in overstating the toll/access revenues.[156] In Case No. TC-89-14, the Commission agreed (with Staff) that such seasonal patterns of the type Ms. Martin discusses should be recognized. Staff of the Missouri P.S.C. v. SWBT, 104 PUR 4th 381, 389 (1989).

Staff witness Rucker dismisses Ms. Martin's seasonality critique (a) by claiming that "overall" Staff's revenues are

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[155]Ms. Rucker's initial opinion was based upon her visual review of the numerical data series column of numbers. T. 506 When these same numbers were graphed, as SWB witness Martin did (Ex.7,Sch.11), the seasonal pattern became clear to Ms. Rucker. Toll had a distinct pattern, year to year, in which September was one of the higher months in the series. Further, due to competition, the trend was uniformly downward for business toll and flat for residence toll. T.490-92 September access revenues used by Ms. Rucker were the highest ever in the series. T.505-06

[156]The end result is that Ms. Rucker's proposal exceeds the actual 1992 results by a considerable amount and it will not be until late 1993 or early 1994 that these amounts can be expected to be achieved. Ex.28HC,Sch.1 The Commission, in Case No. TC-89-14, when evaluating the same question, looked to the actual results to determine the reasonableness of Staff's proposal. Staff of Missouri P.S.C. v. SWB, 104 PUR 4th 381, 398 (1989). In this case, SWB's proposal is a better fit to actual 1992 revenues. Ex.28HC,Sch.1

reasonable, and (b) by erroneously comparing total annualized test period revenue to SWB's budgeted revenue for the following three years.[157] Ex.28,p.5-8 These two comparisons are <u>not</u> appropriate.

First, annualization does not purport to "predict" the future but is used as a year-ending technique. Ex.7,p.17-18 Second, looking <u>only</u> at future revenue growth fails to recognize that greater investment would be needed and higher expense would result. What Ms. Rucker should have asked is whether those "future" revenues will maintain the same relationship to the rate base and expense levels that Mr. Meyer is proposing for the test period. Ex.7,p.46 Of course, she did not and could not -- nor did Mr. Meyer -- make such an analysis. T.159-60 To the contrary, Ms. Rucker agreed that her projection of toll/access revenues, using September times twelve, reflects revenues at one of the highest points of the test period and <u>captures more than the actual growth for the period</u>, thus resulting in a mismatch of those revenues with Mr. Meyer's test period expense and rate base. T.497,499,505-06[158] Staff's proposal overstates the relationship and clearly will not provide SWB a fair opportunity to achieve its authorized return. Ex.7,p.46

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[157]Ms. Rucker also argues that her reliance upon future "budget" data is reasonable since SWB also uses and relies upon such data. Ex.28,p.8 What Ms. Rucker failed to understand is SWB used -- not revenues -- but earnings and overall results, that is, the net of revenues and expenses related to a specific rate base. T.512 Again, as Ms. Rucker concedes, it is the revenues/expenses/rate base relationship that is at issue, not the revenue level per se. T.483

[158]It seems undisputed by Staff that Ms. Rucker's revenues were never compared to Mr. Meyer's rate base or expense for any determination of an "appropriate relationship." T.513 Ms. Martin did make that comparison. T.197-201