

Exhibit No.:

Issues:

*Right-to-Use Fees,
Deregulated Services,
St. Louis and Kansas City
Data Centers, SFAS 112,
Non-Wage Expense, Income
Taxes, Salaries & Wages,
SBC, Separations*

Witness:

Robert E. Schallenberg

Sponsoring Party:

MoPSC Staff

Type of Exhibit:

Surrebuttal Testimony

Case Nos.:

TC-93-224 & TO-93-192

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SOUTHWESTERN BELL TELEPHONE COMPANY

CASE NOS. TC-93-224 & TO-93-192

SURREBUTTAL TESTIMONY

OF

ROBERT E. SCHALLENGER

*Jefferson City, Missouri
June, 1993*

REVISED

Exhibit No. 31
Date 7-15-93 **Case No.** TC-93-224
Reporter lund

SURREBUTTAL TESTIMONY

OF

ROBERT E. SCHALLENGER

SOUTHWESTERN BELL TELEPHONE COMPANY

CASE NOS. TC-93-224 & TO-93-192

Q. Please state your name and business address.

A. Robert E. Schallenberg, P.O. Box 360, Jefferson City, Missouri 65102.

Q. By whom are you employed and in what capacity?

A. I am a Regulatory Auditor with the Missouri Public Service Commission (Commission).

Q. Are you the same Robert E. Schallenberg who has previously filed direct and rebuttal testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony in this case?

A. There are numerous issues between the Commission Staff (Staff) and Southwestern Bell Telephone Company (SWBT or Company). I will address the rebuttal testimony of the following Company witnesses and their corresponding issues:

Company Witness

Issues

**Delbert L. Duncan, Marla S. Martin,
Connie J. Wepfer**

Right to Use/License to Use Fees

Marla S. Martin, Patrick R. Doherty

Deregulated Services

Marla S. Martin, Patrick R. Doherty

Kansas City Data Center - Deregulation

**David W. Toti, Joseph M. Vogl,
David L. Foster**

FAS 112

**Surrebuttal Testimony of
Robert E. Schallenberg**

Company Witness

Issues

Michael J. Bauer, David W. Toti	Income Taxes-Vacation Pay
William E. Barfield, Jr.	St. Louis Data Center
Connie J. Wepfer	Salaries and Wages - March 93 Management Increase
Connie J. Wepfer	Non-Wage Adjustments
Connie J. Wepfer, Judy L. Smith	EMP & EP Adjustments
Kathleen Larkin, Connie J. Wepfer	SBC Adjustments
Michael J. Bauer, Marla S. Martin	Separations - March 93 Factors
Connie J. Wepfer, Judy L. Smith	Salaries & Wage / SIPP

RIGHT-TO-USE FEES

Q. What is the issue related to Right-to-Use Fees?

A. There are actually two components to this issue. Ms. Martin describes the two components in the following excerpts of rebuttal testimony regarding the Company's position on this issue:

The Company's position is that RTU and LTU fees are normal and prudently incurred operating expenses which are as necessary in the provision of customer service as the equipment itself. The Company proposes to include RTU/LTU fees for the twelve month period ending September 1992 and the remaining RTU fees for the AT&T contract change and the FCC 800 database order booked in the fourth quarter of 1992. This amounts to \$40.8 million on an intrastate basis.
(Martin rebuttal, p. 47)

. . . .

Surrebuttal Testimony of Robert E. Schallenberg

The Company has included \$18.6 million of this total, representative of the ongoing level of RTU/LTU fees, in the non-wage adjustment (refer to Company witness Wepfer's testimony-Section III). The Company also proposes to amortize the remaining \$22.2 million over a three-year period. The amortization increases the revenue requirement for SWBT by \$7.4 million and is quantified in this section of my testimony. (Martin rebuttal, p. 48)

The two components of this issue, as described in the above testimony, are the Right-to-Use/License to Use fee (RTU/LTU) amortization (\$7.4 million) and the non-wage Right-to-Use fee adjustment (\$2.6 million).

Ms. Martin describes the RTU/LTU amortization as follows:

The accelerated expenses incurred in 1992 should be allowed in cost of service. However, SWBT realizes that a 1992 level of RTU/LTU fees is not indicative of an ongoing level of expenses. Therefore, SWBT has adjusted its case to include an ongoing level of RTU fees as part of the non-wage adjustment (refer to Company witness Wepfer's testimony-Section III) and to amortize the fees above the ongoing level over a three-year period.
(Martin rebuttal, p. 50)

• • • •

The difference between the total RTU/LTU expense of \$40.8 million and the ongoing level of \$18.6 million is \$22.2 million. This additional expense is amortized over three years, \$7.4 million per year.
(Martin rebuttal, p. 50)

The RTU fees that SWBT is proposing to amortize relate to CCS7-CCO, Network Interconnect and 800 database. Significant costs were required to offer CCO and 800 database. The necessary hardware (i.e., switches) and initial operating system software were capitalized,

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 however any subsequent RTU fees are expensed when
2 incurred per Part 32. *Rather than recognizing them in*
3 *one period, SWBT is proposing to amortize these costs*
4 *to better match the costs with the revenues generated*
5 *from offering these services.*

6 (Emphasis added)

7 (Martin rebuttal, pp. 53-54)

8
9

10
11 These RTU fees represent costs incurred to comply with
12 FCC Docket 86-10 and changes in the recognition of
13 expenses for the CCS7-CCO contract. The revenues
14 generated from these services were realized starting in
15 1992 and should be matched with the expenses.
16 Therefore, I propose that the extraordinary level of
17 expenses incurred in 1992, which would have been
18 incurred in future years absent the FCC mandate and the
19 change in the AT&T contract, be amortized to match the
20 ratepayer benefit from the services as a result of the
21 upgrade to the network.

22 (Martin Rebuttal, pp. 54-55)

23
24 Ms. Wepfer's rebuttal testimony adds the following description to the

25 Company's non-wage adjustment for RTU/LTU:

26 The Company uses a calendar year 1991 updated
27 through September 1992 level of non-wage expense to
28 develop its revenue requirement. The September 1992
29 level of non-wage expense included \$28,200,000 in
30 right-to-use fee expense. Since this amount included a
31 larger than normal right-to-use level, an adjustment was
32 made to reduce the amount by \$9,700,000 to the
33 expected 1993 level of \$18,600,000. Company witness
34 Martin discusses right-to-use fee expense further.

35 (Wepfer rebuttal, p. 58)

36
37 Q. Why are you opposed to the RTU adjustments proposed by the
38 Company?

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 A. First, the RTU amortization represents an inappropriate attempt on the
2 part of SWBT to recover these costs twice from SWBT's customers. The entire 1992
3 level of RTU/LTU fees was considered as an expense by the Company in its
4 development of the 1992 level of customer credits under the Southwestern Bell
5 Incentive Regulation Experiment (SBIRE). This item was the primary reason for the
6 fact that the Company's credit calculation resulted in zero credits. Therefore, the 1992
7 RTU/LTU fees have already been recovered from the Company's ratepayers. In fact,
8 the Company's credit calculation shows that in 1992 SWBT earned 12.92% on equity,
9 a level above its authorized return of equity (12.61%) established in Case Nos.
10 TC-89-14, et al., (TC-89-14), even after giving consideration to the full expensing of
11 the 1992 RTU fees the Company now proposes to amortize.

12 Since these RTU fees have already been recovered from the Company's
13 Missouri ratepayers, the RTU fee amortization reflects an attempt on the part of the
14 Company to overcharge its customers.

15 Q. Why are you opposed to the non-wage RTU adjustment?

16 A. The non-wage RTU adjustment is an isolated adjustment beyond the test
17 year and update period ordered by the Commission. The adjustment is not known and
18 measurable and violates an appropriate revenue-expense-investment relationship. The
19 non-wage RTU adjustment represents an attempt to adjust the 1991 test year RTU/LTU
20 fees to reflect the Company's 1993 budget. In fact, the RTU fees do not support the
21 expense increase reflected in the Company's non-wage RTU fee adjustment.

**Surrebuttal Testimony of
Robert E. Schallenberg**

The Company's response to Staff Data Request No. 770, Supplement No. 1 shows the following levels of RTU fees for the 1991, 1992 and 1993 budgets:

	<u>RTU Fees</u>
1991	\$10,108,600
1992	42,282,400
1993	9,332,900

The above response indicates that the 1991 test year level of RTU fees represented an ongoing level of RTU fees, if not slightly higher than normal. The Staff could see no basis for an adjustment to the test year amount in light of this information. The Company's workpapers now indicate the 1993 budget for RTU fees is \$10.5 million and the 1991 actual amount was \$10.3 million. This information still shows the test year actual amount was reasonable for ratemaking purposes given the variability in the Company's budget.

Q. Why are you opposed to the Company's non-wage LTU adjustment?

A. The Company's workpapers indicate that the 1991 level of LTU which the Staff used was \$11.2 million, and the 1993 budgeted LTU is \$14.5 million. Therefore, the issue is actually related to the 1993 budgeted level of LTU fees. Most of the 1993 budgeted LTU fees (\$13.4 million) are related to the new "Services" organization formed within SWBT and then allocated to SWBT-MO. The 1993 budget material contains the following footnote:

This view contains the most recent change file activity for midwest. As mentioned on my previous response there is a lot of activity in the engineering organization

**Surrebuttal Testimony of
Robert E. Schallenberg**

and budget levels can be expected to fluctuate between
states. (Staff Data Request No. 1139)

Therefore, the amount of the 1993 LTU fees is not known and measurable.

**ENHANCED MANAGEMENT PENSION (EMP), ENHANCED PENSION (EP), AND
SUPPLEMENTAL INCOME PROTECTION PROGRAM (SIPP)**

Q. What is the issue related to EMP, EP and SIPP?

A. Ms. Wepfer describes EMP and EP as follows:

The Enhanced Management Pension (EMP) plan was made available to SWBT managers during the 4th quarter of 1991. It was a management force reduction program designed to provide incentive for managers to retire or resign earlier than they might otherwise have done so that the Company could streamline its operations. Participants were required to leave the payroll by December 30, 1991.

On March 21, 1992, SWBT and the Communication Workers of American (CWA) reached an agreement on a voluntary Enhanced Pension (EP) plan for non-management employees of SWBT. This voluntary force reduction program expanded pension eligibility and provided enhanced pension payments to eligible non-management employees authorized for participation in EP. Those that elected to participate had to remain on the payroll through June 6, 1992, but had to retire no later than December 31, 1992.

(Wepfer rebuttal, p. 73)

Regarding EMP and EP, Ms. Wepfer states:

The Company believes that these costs are necessary and reasonable for efficiently operating the business. Recent history shows that the Company has implemented numerous force reduction plans and has incurred the associated costs on a fairly regular basis. More importantly, since these costs provide identifiable

**Surrebuttal Testimony of
Robert E. Schallenberg**

benefits for customers through lower ongoing wage and salary levels, the Company recommends that the entire amount of the EMP and EP plan costs be amortized and recovered through the revenue requirement over a 3-year period in an effort to match the expenses with the savings realized from these plans.
(Wepfer rebuttal, p. 74)

Ms. Wepfer describes SIPP and the Company's position as follows:

The Company does agree that future SIPP recipients are included in the wage and salary annualization. However, SIPP expense (computed for the September 1992 test year) was incurred for non-management employees that have already terminated employment. The salaries associated with these employees are excluded from both the Staff's and the Company's wage and salary annualization. Including the SIPP expense in the computation of total wage and salary 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 current lower wage and salary expense produced by the SIPP expenses; these SIPP expenses represent a legitimate cost of doing business and should be included in the cost of service. Company witness Smith addresses the benefits of SIPP further in her testimony.
(Wepfer rebuttal, p. 15)

Q. What is the basis for the Staff disagreement with the Company's position on this issue?

A. The issues related to these three items (EMP, EP and SIPP) share a conceptual difference between the Staff and the Company. The conceptual difference was tried before the Commission in Case No. TC-89-14 in the issues of the Management Transitional Program (MTP) and SIPP. The portion of the Commission's Order addressing those issues is as follows:

Management Transitional Program (MTP)

The Commission Staff proposes to reduce test year expenses by approximately \$1,273,000 representing MTP payments which are nonrecurring in nature. MTP was a program aimed at reducing the work force by encouraging managers to resign their employment. A formalized plan was offered from August 1, 1986 to June 30, 1987, offering as much as a year's salary in addition to other retirement benefits.

SWB resists the adjustment on the grounds that, while MTP did expire, other termination allowance policies continue. It is alleged by SWB that it has the continuing ability to reduce managers from the payroll with the termination payment. In spite of that contention there are no planned MTP expenditures for 1988 or 1989 and there appear to be no firm plans in place for any substitute plan. In the Commission's opinion any potential termination plans are too speculative to be the basis for maintaining in current rates the cost of the MTP Plan which has been terminated.

Supplemental Income Protection Plan (SIPP)

SIPP is a collectively bargained feature of SWB's labor contract under which eligible non-management employees are given additional income when terminated as a result of surplus force conditions. The Staff proposes a reduction to test year expense in the approximate amount of \$2,512,000 representing the amount which will not be paid in wages if the test year SIPP expenses are paid to affect employee termination. Staff concedes that, unlike MTP payments, SIPP-related expenses are continuing in nature and new employees become eligible every month.

In the Commission's opinion the adjustment is appropriate since it considers only base salary reductions as a result of force reduction. Employees who would receive SIPP payments will also not receive a full year's wages although the wages have been accounted for in the salary annualization adjustment.

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 SWB resists the adjustment, contending that it assumes
2 net reduction in employees whenever SIPP is paid, while
3 in reality employees in one location may be declared
4 surplus even though SWB adds similar jobs in another
5 location. If this condition is true, it appears that the
6 entire SIPP program is a failure if the additional
7 payments do not result in the intended purpose of a net
8 reduction in work force. Test year SIPP payments are
9 the highest level since 1984 and in the Commission's
10 opinion the Staff's proposed disallowance should be
11 approved. Re: Southwestern Bell, 29 Mo. P.S.C. (N.S.)
12 607, 624-25 (1989).
13

14 The primary conceptual difference for the Staff's disagreement with SWBT for
15 these three items in this case is that these amounts represent costs paid in lieu of
16 salaries and wages, similar to the MTP and SIPP issues in Case No. TC-89-14. Any
17 future payments of these costs beyond September 1992 will be made in place of
18 salaries and wages included in both the Staff's and Company's case. The Staff's
19 position is that any future EMP/EP type costs and/or SIPP costs will be offset by
20 reductions of salaries and wages currently included in the Staff's cost of service.
21 SWBT proposes to include in its case both the wages and salaries of current employees
22 as well as additional costs to reduce these wage and salaries. SWBT's position
23 overstates its cost of service and thereby attempts to over-collect its costs from its
24 ratepayers.

25 Q. Are there any additional reasons the Staff opposes the Company's
26 treatment of EMP, EP and SIPP costs?

27 A. Yes. EMP and EP costs are not known and measurable. These costs
28 are speculative at this time since there is no current force reduction program being

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 offered. Any such future program will be well beyond the September 1992 update
2 period. There are currently no firm plans to offer EP/EMP-type programs in the near
3 future. This unknown force reduction program would be an isolated adjustment that
4 would violate an appropriate revenue-expense-rate base relationship.

5 Also, the Company's EMP/EP position represents an attempt to collect these
6 costs twice from ratepayers. The entire EMP/EP level of expense was considered by
7 SWBT in its development of the 1992 level of customer credits under SBIRE. These
8 items, along with the 1992 level of RTU fees, were used by SWBT to derive a zero
9 level of customer credits. Therefore, the EMP/EP costs have already been recovered
10 from the Company's ratepayers. This fact is further illustrated by the fact that the
11 Company still earned above its authorized return on equity as set in Case No.
12 TC-89-14 after full consideration of EMP, EP and the 1992 level of RTU fees. The
13 Company's attempt to amortize its EMP/EP costs after including the full level in its
14 1992 customer credit calculation reflects an attempt on the Company's part to
15 overcharge its customers by seeking to recover these costs twice.

16
17 **INCOME TAXES - VACATION PAY**

18 Q. What is the issue related to vacation pay?

19 A. The issue of vacation pay is raised in the testimony of Messrs. Bauer
20 and Toti. The issue consists of two components. Mr. Bauer's rebuttal testimony refers
21 to these two components as "Vacation Pay - Timing Difference" and "Vacation Pay -

Surrebuttal Testimony of
Robert E. Schallenberg

Rate Base Adjustment." Mr. Bauer, on page 3 of his rebuttal testimony, describes this issue as follows:

VACATION PAY - TIMING DIFFERENCE - Staff's income tax calculation must be adjusted to reflect the reversal of vacation pay book-tax timing differences which previously received flow-through accounting treatment. *In Order No. TR-79-213, the Missouri Public Service Commission ordered the company to use flow-through accounting treatment for all book-tax timing differences related to vacation pay. The company consistently followed this treatment until the Commission ordered normalization accounting in Case No. TC-89-14. Prior to the issuance of the order in TC-89-14, the company flowed through the benefit of the tax deduction for 1988 vacation pay. This 1988 vacation pay is being recognized as a book expense over a 10-year period in accordance with FCC Part 32. Since the tax deduction for this vacation pay was given flow-through treatment, the corresponding book expense must also be given flow-through treatment. Unless adjusted for this item, Staff's income tax calculation does not include the addition to taxable income necessary to reflect the previous flow-through accounting treatment.*

VACATION PAY - RATE BASE ADJUSTMENT - Staff's rate base calculation must be adjusted to include the off-book deferred income tax reserve related to vacation pay. This off-book balance represents *tax benefits which were previously flowed through to customers pursuant to Missouri PSC Order No. TR-79-213. Unless adjusted for this off-book amount, Staff's rate base calculation is inconsistent with the Commission Order.* (emphasis added).

SWBT's position on this issue is based on the following points:

**Surrebuttal Testimony of
Robert E. Schallenberg**

1. The Missouri Public Service Commission ordered SWBT to use flow-through accounting treatment for all book-tax timing differences related to vacation pay.
2. The Company flowed through the benefit of the tax deduction for 1988 vacation pay in 1988.
3. The 1988 vacation pay is being recognized as a book expense over a ten-year period in accordance with FCC Part 32.
4. The benefit of this 1988 vacation pay deduction has been previously flowed through to customers.

The Company's assertions for items 2 and 4 are based on its interpretation of the Commission's Order in Case No. TR-79-213. This interpretation is wrong. The Commission's Order in Case No. TR-79-213 did not order SWBT to apply flow-through accounting treatment to all book-tax timing differences related to vacation pay. This can be shown in the following relevant language in the Commission's Report and Order from Case No. TR-79-213:

D. Normalization Versus Flow-through. As a part of its case, Company seeks full normalization of the results of tax timing differences. The Staff, supported by PC, recommends flow-through treatment concerning three items. The Staff proposes flow-through of \$6,975,000 relating to capitalized construction overheads consisting of relief and pensions and social security taxes. Those costs were capitalized during construction but allowed to be deducted currently for income tax purposes.

Another item, vacation costs, representing \$550,000, has been deferred under a provision of the IRS which

**Surrebuttal Testimony of
Robert E. Schallenberg**

allows the deduction in the current year of the expected costs of vacations during the following year. Staff has proposed flow-through of both of these items in prior cases.

In addition, Staff proposes to flow through \$3,216,000 resulting from the difference in book and tax treatment of salvage and removal costs. Salvage and removal costs are included in depreciation rates for book purposes, but as yet have not been incurred as a tax liability.

The Commission has frequently ruled that complete normalization should only be permitted when a company's cash flow is insufficient or when its internally generated funds or interest coverage is at an inadequate level. In the instant case, the Company's indentures contain no interest coverage restrictions; however, the after-tax interest coverage has increased from 2.75 in 1974 to 3.06 in 1978. For the twelve months ending August 31, 1979, the coverage was 2.76. For the test period, the Company generated 54.6 percent of its construction funds internally. From 1974 to 1978 the percentage of internally generated funds has been approximately 50 percent.

The Commission is of the opinion that since the Company's cash flow, interest coverage and internally generated funds appear to be a generally acceptable level, there is no justification for departing from its customary position of favoring flow-through for the involved items. The Company should flow through the benefits of the tax timing difference relating to relief and pensions, social security taxes, cost of removal and salvage, and vacation pay accrual. The Company's net operating income, for the purposes of this case, should be increased in the amount of \$10,741,000.

(emphasis added). (Re: Southwestern Bell, 23 Mo. P.S.C. (N.S.) 374, 381 (1980).

The above language does not refer to "all book-tax timing differences related to vacation pay." The Case No. TR-79-213 Report and Order only refers to an "item,

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 vacation costs." The item was the difference caused by SWBT booking as expense
2 only the vacations it paid in the test year while the IRS allowed SWBT to deduct on
3 its tax return "the expected costs of vacations during the following year" (i.e., accrual
4 accounting). The book and tax treatment of vacation pay changed subsequent to the
5 Commission's decision in Case No. TR-79-213.

6 Q. How did the book and tax treatment of vacation pay change subsequent
7 to Case No. TR-79-213?

8 A. In 1988, the book treatment for vacation pay changed from a basic "pay-
9 as-you-go" (cash) method to an accrual method. In 1986, vacation pay was treated for
10 tax purposes on a "pay-as-you-go" method with the passage of the Tax Reform Act of
11 1986 (TRA). Both of these changes are discussed by Mr. Bauer on page 18 of his
12 rebuttal testimony.

13 The TRA changed the tax treatment of vacation pay to what was basically the
14 book treatment of vacation pay *prior to* the implementation of the FCC Part 32 in
15 1988. In fact, if not for Part 32, the book-tax timing difference for vacation pay would
16 have been eliminated for all practical purposes after TRA. Therefore, the book-tax
17 timing difference that was flowed through in Case No. TR-79-213 was eliminated with
18 the passage of the TRA. The vacation pay book-tax timing difference was only
19 revived by the Commission by its adoption of Part 32 in Case No. TC-89-14. Below
20 is a brief chronological history of the book and tax treatment of vacation pay:
21

**Surrebuttal Testimony of
Robert E. Schallenberg**

Event	Treatment
Case No. TR-79-213	Tax - accrual Book - pay as you go Ratemaking - flow through difference between book and tax
TRA (1986)	Tax - pay as you go Book - pay as you go Ratemaking - concept still flow through but no difference exists between book and tax
Part 32 / Case No. TC-89-14	Tax - pay as you go Book - accrual Ratemaking - not explicitly addressed

As shown above, TRA eliminated the difference between book and tax treatment of vacation pay that existed at the time of Case No. TR-79-213. Part 32 reversed the difference between book and tax treatment that existed at the time of Case No. TR-79-213. Therefore, the Company citations regarding the Commission's tax treatment in Case No. TR-79-213 are irrelevant to this issue. The adoption of Part 32 by the Commission in Case No. TC-89-14 and the tax treatment explicitly and/or implicitly adopted in that decision for vacation pay should be the deciding factor to this issue.

Q. Did the Commission authorize flow-through of vacation pay in Case No. TC-89-14?

A. No. In fact, Mr. Bauer states on page 5 of his rebuttal testimony that "the Commission ordered normalization accounting in Case No. TC-89-14". Therefore,

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 **Mr. Bauer's statement that the 1988 vacation pay was flowed through to customers is**
2 **inaccurate.**

3 **Q. Mr. Toti, on page 85 of his rebuttal testimony, discusses his Schedules**
4 **8 and 9 in relation to these issues. Do you have any comments in regard to these**
5 **issues?**

6 **A. Yes. Mr. Toti's testimony is not clear as to what Schedules 8 and 9 are**
7 **meant to show. However, these schedules are related to Staff audit work regarding the**
8 **1990 sharing credits under SBIRE. They have no relevance to deciding this issue**
9 **other than providing a description of some of the basics to this issue. I can show this**
10 **in three points.**

11 **First, the Staff's receipt of this response and subsequent actions had no bearing**
12 **on SWBT's rationale for the booking of vacation pay in 1988 since the Staff did not**
13 **receive this information until 1991. Therefore, the Staff's reaction to the material in**
14 **Mr. Toti's Schedules 8 and 9 could not form any basis for the Company's booking**
15 **decisions in 1988.**

16 **Second, the information provided in Schedule 8 is contradictory to the**
17 **information contained in Messrs. Bauer and Toti's testimony. As previously discussed,**
18 **the Company cites that the Commission's decision in Case No. TC-79-213 forms the**
19 **basis for its vacation pay booking decision in 1988. However, Mr. Toti's Schedule 8-3**
20 **stated that, "Flow-through treatment was explicitly ordered in TC-89-14." This**
21 **statement is directly in conflict with Mr. Bauer's rebuttal testimony on page 5 that**
22 **states "the Commission ordered normalization accounting in Case No. TC-89-14".**

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 Messrs. Toti and Bauer's testimony makes no similar statements regarding flow
2 through treatment for vacation pay in Case No. TC-89-14. Therefore, in this regard,
3 either the information provided to the Staff on Mr. Toti's schedule or Messrs. Toti's
4 and Bauer's rebuttal testimony is inaccurate.

5 Third, the letter resolving any 1990 SBIRE credit issues among the parties
6 states that methods, principles, allocations underlying the 1990 sharing credit
7 agreements were the result of a negotiated settlement. Mr. Toti's testimony implies
8 that he used the material underlying the 1990 credit settlement against the Staff's
9 current complaint case. If I have correctly understood Mr. Toti's implication, then his
10 testimony would appear to be in violation of the following paragraph of the agreement
11 related to the 1990 credit settlement.

12 7. Staff, OPC and Southwestern Bell shall not be
13 deemed to have approved or acquiesced in any
14 ratemaking principle, valuation methodology, method of
15 cost of service determination, or cost allocation
16 underlying any of the provisions contained in this
17 Statement of Agreement. Additionally, the methods
18 agreed to herein shall not be used against any party in
19 any proceeding before the Commission or courts.

20 Q. How can you be sure that the Commission did not flow through
21 vacation pay to Missouri ratepayers in Case No. TC-89-14?

22 A. Flow through treatment is not indicated on Mr. Toti's Schedules 7-1
23 through Schedule 7-3. Schedules 7-1 and 7-2 are SWBT workpapers relating to its
24 rebuttal case in Case No. TC-89-14. Schedule 7-3 is page 82 from the Commission's
25 Report and Order from that case. Below is a portion of Schedule 7-2:

**Surrebuttal Testimony of
Robert E. Schallenberg**

<u>Item</u>	<u>Description</u>	<u>Amount (\$000)</u>
1	1988 payments deductible in 1988	(27,081)
2	1988 book expense (accrual)	27,192
3	Section 481 adjustment on 1987 reserve	4,463
4	Section 481 adjustment on 1974 suspense account	(1,771)
5	PART 32 10-YEAR CATCH-UP ADJUSTMENT	<u>2,708</u>
	Net annual book/tax addition (deduction)	5,511

Items 1 and 2 together represent minor adjustments to the book level of expense. Items 3 and 4 are related to the vacation pay issue that was decided in Case No. TC-89-14. These items are shown as item 8.C and highlighted by the arrow on Mr. Toti's Schedule 7-3. Items 3 and 4 are related to the true-up and amortization of prior years' vacation pay deductions converted to a pay-as-you-go basis. This was a result of the passage of TRA. Item 5 removes any tax deduction related to the ten year book amortization of the vacation pay (i.e., compensated absences) component of Part 32. If the 1988 vacation pay timing difference was flowed through, then there would need to be a sixth item valued at approximately \$27 million as a further reduction to taxable income. No such item existed for consideration in the Commission's determination of Case No. TC-89-14. Further, as shown below, while ratepayers provided 110% of annual vacation pay through rates set in Case No. TC-89-14, customers have not received the benefit of the tax deductibility of that additional 10% in their rates. The following is a chart showing the annual treatment of the \$27

**Surrebuttal Testimony of
Robert E. Schallenberg**

million amount of vacation pay on the Company's books after adoption of Part 32 in
Case No. TC-89-14 for book and tax purposes:

	Expense	Income Tax Deduction
1988	\$27 million accrual 2.7 million amortization	\$27 million (related to ten year amortization)
1989	\$27 million accrual 2.7 amortization	\$27 million (1988 accrual)
1990	\$27 million accrual 2.7 amortization	\$27 million (1989 accrual)
1991	\$27 million accrual 2.7 million amortization	\$27 million (1990 accrual)
1992	\$27 million accrual 2.7 million amortization	\$27 million (1991 accrual)
1993	\$27 million accrual 2.7 amortization	\$27 million (1992 accrual)
1994	\$27 million accrual 2.7 amortization	\$27 million (1993 accrual)
1995	\$27 million accrual 2.7 amortization	\$27 million (1994 accrual)
1996	\$27 million accrual 2.7 amortization	\$27 million (1995 accrual)
1997	\$27 million accrual 2.7 amortization	\$27 million (1996 accrual)
1998	\$27 million accrual -0- amortization	\$27 million (1997 accrual)

The above chart not only shows that ratepayers have not received the full flow-through benefit of the vacation pay deduction, customers have yet to receive the tax deduction related to the ten year amortization (\$2.7 million) established in Case No. TC-89-14. The normalization treatment afforded to ratepayers in the Staff's case will

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 correct that error made in Case No. TC-89-14, by allowing a vacation pay tax
2 deduction of \$29.7 million (\$27 million plus \$2.7 million). However, the Company
3 proposes not only to continue the error in Case No. TC-89-14 and deny customers the
4 tax deduction related to the ten year amortization, but to overcharge customers by
5 denying them tax deductions they have never previously received by adding back the
6 \$2.7 million to taxable income, on the premise it had been previously flowed-through
7 to customers.

8 The above schedule also shows that SWBT will never pay, unless it
9 discontinues its operations, the additional expense added to the Company's cost of
10 service in Case No. TC-89-14 for vacation pay. The Staff's current case does not
11 reflect in operating expense any additional vacation pay over the amount of vacation
12 expense related to ongoing operations.

13
14 **ISOLATED ADJUSTMENTS**

15 Q. Has SWBT included in its case other isolated adjustments beyond the
16 September, 1992 update besides the RTU/LTU fee and EP/EMP adjustments?

17 A. Yes. SWBT has included a March 1, 1993 management salary increase
18 (\$3.4 million); a March 1993 separation factor change (\$1.8 million), an April 1993
19 Stock Value payment to management employees (\$.4 million), and a September 1993
20 Success Sharing estimate (\$1.2 million). The September 1993 Success Sharing amount
21 is not known and measurable at this time. All four adjustments would violate an
22 appropriate revenue-expense-investment relationship. It is curious that all four

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 adjustments are not only contrary to the Commission's test year decision in this case
2 but contrary to the prior Commission Order that Ms. Thompson referenced in her
3 rebuttal testimony on the test year. Her testimony stated:

4 In Case No. 17,322 for SWBT, the Commission's order
5 in Section F, Operating Expenses Item 2(6) stated:
6

7 In light of the facts in this case, the most
8 accurate matching of revenues and expenses with
9 investment during the test year precludes the use
10 of out-of-period adjustments that occur in the
11 normal course of business. To hold otherwise
12 would be to abandon the test-year concept unless
13 other out-of-period adjustments are made to *all*
14 *of the other items* which enter into the rate-
15 making process including *revenues, expenses,*
16 *taxes, and utility plant. If this be done an*
17 *entirely new test year would be created*
18 (emphasis added). 96 PUR 3d p. 156
19 (Thompson rebuttal, p. 10)

20 Therefore, even the Order cited by the Company would show the Company's
21 isolated adjustments of approximately \$7 million are inappropriate and would only be
22 proper if all other items were likewise considered.
23

24 **DEREGULATED SERVICES**

25 Q. What is the issue related to Deregulated Services?

26 A. The Company proposes to use the level of deregulated costs for the year
27 ending September 30, 1992 instead of the test year level of deregulated costs.

28 Q. Why does the Staff oppose this adjustment?

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 A. The Company's proposed level of expense reflects unexplained cost
2 shifts from deregulated operations to regulated operations in 1992. The Company's
3 testimony and underlying support do not identify the specific changes that cause the
4 shift of deregulated costs to regulated operations. Further, the Company does not
5 support why the Cost Allocation Manual (CAM) changes were appropriate or are
6 expected to continue into the future. The Staff has not been able to review the
7 external audit workpapers to see if the auditors reviewed and accepted these CAM
8 changes.

9
10 **KANSAS CITY DATA CENTER - DEREGULATION**

11 Q. What is the issue related to the Kansas City Data Center?

12 A. The Company is proposing to move a portion of the Kansas City Data
13 Center from its regulated operations to its non-regulated operations.

14 Q. Why is the Staff opposed to the Company's adjustment?

15 A. There are several reasons for the Staff's opposition to the Company's
16 adjustment. First, the adjustment is an isolated adjustment beyond the 1991 test year
17 updated through September 30, 1992. Company testimony (Martin rebuttal, page 26)
18 indicates that SWBT will shift the Kansas City Data Center from regulated operations
19 to deregulated operations "effective January, 1993." Second, the Company has not
20 removed all the costs related to the Kansas City Data Center from its regulated
21 operations. The level of expenses for the Kansas City Data Center included in the
22 Company's rebuttal case would result in the Company's regulated operations

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 subsidizing its alleged deregulated Kansas City Data Center operations. For example,
2 the Company's calculation of the deregulated portion of its Financial Accounting
3 Standard (FAS) 106 expense is based on 1991 data. In 1991, the Kansas City Data
4 Center was not a deregulated operation. Therefore, the Company's allocation of FAS
5 106 expense retains the portion of these proposed deregulated expenses in its regulated
6 operations.

7 Third, the Company's proposal is not known and measurable. The FCC Cost
8 Allocation Manual (CAM) determines the Company's deregulated expenses. Once the
9 Company begins recording the Kansas City Data Center as a deregulated operation, the
10 Kansas City Data Center will increase the directly assigned deregulated expenses.
11 Directly assigned deregulated expenses would then have a direct impact on the
12 allocation of various cost pools. Also, the St. Louis Data Center provides back-up
13 capability to the Kansas City Data Center. Therefore, if more of the Kansas City Data
14 Center is considered deregulated, the St. Louis Data Center will need to have a portion
15 of its cost assigned to deregulated operations. The impact of the Kansas City Data
16 Center shift to deregulated operations will not be known until a full year of its
17 operations has been reflected in the Company's CAM. The Kansas City Data Center
18 impact will only be known then if it is separately identified in the Company's CAM
19 process.

20 Q. Do you agree that a portion of the Kansas City Data Center should be
21 treated as a deregulated operation?

Surrebuttal Testimony of
Robert E. Schallenberg

1 A. I am not sure at this time. However, another concern is the fact that the
2 Kansas City Data Center will bill Bellcore for its activities. Bellcore will then bill a
3 portion of those costs back to SWBT, which it will reflect as a regulated expense.
4 Under the test year treatment of the Kansas City Data Center (as a regulated operation)
5 reflected by SWBT until 1993, any Data Center revenues received over related
6 expenses would offset the corresponding Bellcore expenses. This would no longer be
7 possible under the Company's proposal.

8
9 **STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 112**
10 **"EMPLOYEES' ACCOUNTING FOR POST-EMPLOYMENT BENEFITS"**
11 **(FAS 112)**

12 Q. What is FAS 112?

13 A. FAS 112 is the recent pronouncement by the Financial Accounting
14 Standards Board requiring companies to accrue currently on their financial statements
15 estimated future post-employment benefits that will be payable to current employees
16 *after* employment but *before* retirement. In concept, FAS 112 is similar to FAS 106,
17 which dealt with accrual accounting for post-retirement benefits. FAS 112 will be
18 effective for most entities on January 1, 1994.

19 Q. What is the issue related to FAS 112?

20 A. The Company proposes that its cost of service be increased to reflect
21 its estimate of the cost related to adoption of FAS 112. The Company's adjustment
22 reflects a three year amortization of a one-time cost related to the adoption of this
23 accounting change.

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 **Q. Why is the Staff opposed to this Company adjustment?**

2 **A. There are several reasons for the Staff's opposition to this adjustment.**

3 First, it is an isolated adjustment beyond the 1991 test year updated through
4 September 30, 1992. The Company reflected the entire amount of one-time costs
5 associated with FAS 112 on its books in 1993. This is a year earlier than the required
6 date to reflect the impact of FAS 112 on its books. Second, the Company's data
7 would indicate that this item is similar to vacation pay. That is, it is an expense that
8 would not be paid unless the company goes out of business. Third, the actual cash
9 expense is much more accurate than this estimated accrual. For this reason, the Staff
10 is opposed to the use of FAS 112 for ratemaking purposes for the same reasons it is
11 opposed to FAS 106 for ratemaking purposes.

12 **Q. Does the Staff have an alternative to including the Company's**
13 **adjustment in its cost of service?**

14 **A. Yes. If the impact of FAS 112 is treated for ratemaking purposes, then**
15 **the one-time cost should be treated entirely in the calculation of the 1993 customer**
16 **credits of SBIRE. Under this scenario, the rate impact of FAS 112 adoption would be**
17 **"gotten over" as quickly as possible, and also allow the 1993 SBIRE credit audit to**
18 **true-up the amount associated with adoption of FAS 112.**

ST. LOUIS DATA CENTER

Q. What is the issue related to the St. Louis Data Center?

A. The Company proposes to increase its expenses to reflect an ongoing level of expenses related to the St. Louis Data Center.

Q. Why does the Staff oppose this adjustment?

A. This adjustment is duplicative of the compensation study adjustment proposed by the Company. This will be addressed in the Staff witness Stephen F. Doerr's surrebuttal testimony regarding this issue.

NON-WAGE

Q. What is the issue related to Non-Wage?

A. The Company is proposing to increase its expenses through a series of non-wage adjustments. The RTU non-wage adjustments has already been discussed in another portion of this testimony. The additional non-wage adjustments include an end-of-period non-wage adjustment, affiliate transaction non-wage adjustments, and "other" non-wage adjustments. The end-of-period non-wage adjustment is the product of applying the Gross National Product - Implicit Price Deflator (GNP-IPD) to a September 30, 1992 base of a portion of non-wage expenses. The remaining adjustments are the product of substituting the year ending September 30, 1992 non-wage components for test year non-wage expenses.

Q. Why does the Staff oppose these adjustments?

Surrebuttal Testimony of
Robert E. Schallenberg

1 A. The Staff opposes the end-of-period non-wage adjustment because it is
2 not a known and measurable charge. This adjustment merely applies a factor derived
3 from the GNP-IPD to a non-wage base. This adjustment assumes the GNP-IPD
4 inflation factor is actually experienced by the specific SWBT non-wage expenses to
5 which it applies. This assumption is unsupported and unverifiable. Ms. Wepfer's
6 workpapers show no evidence of the GNP-IPD inflation factor being actually
7 experienced by SWBT. Therefore, the adjustment is not known and not measurable.
8 The adjustment does not consider the possible non-wage offset of productivity resulting
9 from reductions in the use of non-wage items. For example, Ms. Martin notes a
10 reduction in non-wage expenses related to force reductions in the following excerpt of
11 her direct testimony in this case:

12 Q. Does this schedule include all of the cost
13 savings SWBT-MO has achieved during the plan period?

14 A. No. These savings represent the direct
15 cost savings identified with each plan, such as salaries
16 and wages, benefits, payroll taxes and pensions. *The*
17 *indirect cost savings related to force reductions, such as*
18 *decreases to travel, training, equipment, etc., could not*
19 *be readily quantified.* In addition, as I mentioned
20 previously, many of the cost saving efforts occur on a
21 much smaller scale than the plans displayed on Schedule
22 No. 10. These smaller efforts, although not quantifiable
23 on an individual basis, produce substantial savings when
24 taken in the aggregate. The savings quantified on
25 Schedule No. 10 reflect the most significant cost saving
26 measures implemented during the Plan period.
27 [Emphasis added.]
28 (Martin direct, p. 27)
29

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 The end-of-period adjustment ignores the reduction in non-wage expense related
2 to force reductions. Further, this adjustment, as well as the other non-wage
3 adjustments, ignores the impact of Company programs to reduce non-wage costs. For
4 example, the Company's "Explanation of 1993 Budget vs. 1992 Actuals" notes a \$2.7
5 million reduction in Missouri's material expense related to the Quest Project. A
6 further point is that the Commission has not accepted these types of adjustments to
7 historical test years in the past.

8 The non-wage affiliated transactions and non-wage other merely reflects the
9 September 30, 1992 book amount in lieu of the test year amount. The Company offers
10 no support as to the reason for the increase above test year levels and why the increase
11 should be considered ongoing. SWBT's expenses vary over time. In fact, the non-
12 wage affiliated transaction is primarily caused by an unexplained \$900,000 expense
13 increase to SWBT from Southwestern Bell Asset Management charged to Account
14 6711, Executive Costs. The problem with the non-wage "other" adjustment is that its
15 cause cannot even be isolated to the degree of the non-wage affiliated transaction
16 adjustment.

17
18 **SOUTHWESTERN BELL CORPORATION (SBC)**

19 Q. What is the issue as it relates to SBC?

20 A. The issue has not been completely examined at this time due to certain
21 problems in acquiring the support workpapers related to this issue. The Company has
22 disagreed with the treatment of SBC costs in the Staff's direct case. The rebuttal

**Surrebuttal Testimony of
Robert E. Schallenberg**

testimony of Ms. Wepfer provides the Company's areas of contention related to the
SBC issue:

INTRASTATE REVENUE REQUIREMENT CALCULATIONS (\$000's)	
	Staff/SWBT Difference
Annualization Adjustment	\$ (406)
Investment Factor Adjustment	(56)
Inclusion of SBC in General Factor	(1,367)
SBC Business Unit Adjustment	(1,864)
SBC General Factor Adjustment	(1,586)
SBC Expense Disallowance	(1,954)
TOTAL REVENUE REQUIREMENT EFFECT	\$(7,233)
*The quantification of the test period difference is included in the Non-Wage section of Ms. Wepfer's testimony.	

Staff witness Kelly J. Riley will address the Annualization Adjustment and
Investment Factor Adjustment.

Ms. Wepfer states in her testimony that:

It is the Company's position that the methodology employed by SBC for cost allocation is reasonable and results in an equitable and acceptable assignment of cost responsibility. The allocation factors represent reasonable methods for use in cost assignment. Please refer to Company witness Flaherty for the Company's position.
(Wepfer rebuttal, p. 66)

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 Mr. Flaherty's rebuttal testimony contains the support for the Company's
2 assertions that the SBC method is reasonable and results in an equitable and acceptable
3 assignment of cost responsibility.

4 Ms. Larkin's rebuttal testimony provides the following description of Mr.
5 Flaherty's role in this issue:

6 Finally, the accounting firm of Deloitte & Touche, was
7 asked by Southwestern Bell Corporation (SBC) to
8 perform a comprehensive analysis of the allocation
9 methodology utilized by SBC and its administrative
10 subsidiaries for the distribution of costs to SWBT and
11 the other corporate affiliates. The conclusion of that
12 analysis, as presented in the testimony of SWBT witness,
13 Thomas J. Flaherty, is that the SBC direct assignment
14 and allocation process is in compliance with the FCC
15 safeguards, and is consistent with the parent company
16 allocation process performed by the preponderance of
17 American corporations, and is a fair and reasonable
18 method for the distribution of costs related to SBC
19 activities.

20
21 At the request of Southwestern Bell Telephone
22 Company, Deloitte & Touche has also performed a
23 *Value Study* of the services SWBT receives from SBC
24 and its administrative subsidiaries. The conclusions of
25 the *Value Study*, also presented in Mr. Flaherty's
26 testimony, are:

27
28 1. The services provided by SBC are
29 necessary, and sometimes legally mandated, corporate
30 functions and appropriately located in a centralized
31 corporate organization.

32
33 2. The services provided by SBC are
34 distinctly defined and not duplicative of activities
35 performed within SWBT.

36
37 3. The value achieved through the provision
38 of these services on a centralized basis is *very*

**Surrebuttal Testimony of
Robert E. Schallenberg**

1 significant. The stand-alone cost to provide these
2 services to Missouri customers would be approximately
3 \$30.9 million *higher* than SWBT's current allocated
4 costs for these services. If SBC were to purchase certain
5 services SBC currently performs from outside vendors,
6 it would result in an approximate \$4.8 million *increase*
7 in costs to Missouri customers for these services.

8
9 The weight of this evidence overwhelmingly supports the
10 conclusion that SWBT does not improperly subsidize
11 affiliates with regulated profits. On the contrary, SWBT
12 has well established processes and procedures to assure
13 compliance with the FCC safeguards, as well as a
14 properly focused management making the appropriate
15 business decisions for the sale to or purchase from
16 affiliates by SWBT.

17 (Larkin rebuttal, pp. 6-8)

18 I disagree with the above conclusions that Ms. Larkin stated as they relate to
19 SBC. Mr. Flaherty is the source of the Wepfer and Larkin conclusions. Mr.
20 Flaherty's rebuttal testimony will be addressed in a supplemental surrebuttal filing.

21 Q. Does this conclude your surrebuttal testimony at this time?

22 A. Yes, it does.

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.)
and)
In the matter of Proposal to Establish an)
Alternate Regulation Plan for)
Southwestern Bell Telephone Company)

Case No. TC-93-224

FILED

JUN 14 1993

PUBLIC SERVICE COMMISSION

Case No. TO-93-192

AFFIDAVIT OF ROBERT E. SCHALLENGER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Robert E. Schallenberg, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 32 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Robert E. Schallenberg
ROBERT E. SCHALLENGER

Subscribed and sworn to before me this 11th day of June, 1993.

Wanda J. King
Notary Public

My Commission Expires: 9/4/95

