

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

CASE NO. TA-87-91

In the matter of the application of
United Telephone Long Distance Company
of the Midwest for a certificate of
public convenience and necessity to
provide intrastate interLATA
telecommunications services in
Missouri.

APPEARANCES: Joseph P. Cowin, General Counsel and Secretary,
6666 West 110th Street, Overland Park, Kansas 66211,
for United Telephone Long Distance Company of the
Midwest and United Telephone Company of Missouri.

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Southwestern Bell Telephone Company.

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Public Counsel and the Public.

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the Staff of the Missouri Public Service Commission.

REPORT AND ORDER

On February 18, 1987, United Telephone Long Distance Company of the Midwest (UTLD) filed an application for a certificate of public convenience and necessity to provide intrastate interLATA telecommunications services within the State of Missouri.

On February 27, 1987, the Commission issued its order providing notice of the application to interested parties and scheduling an intervention deadline for March 30, 1987.

On April 10, 1987, the Commission granted UTLD's request to schedule an early prehearing conference to address the issues raised by certain entities who had filed applications to intervene. Pursuant to the Commission's order the prehearing conference was held on April 22, 1987. The parties were unable to settle any of the issues raised.

On May 1, 1987, the Commission issued its order adopting a schedule of proceedings which set filing dates, a prehearing conference and a hearing to be held on June 17 and 18, 1987. The order expanded the scope of the proceedings, made United Telephone Company of Missouri (UTM) a party and granted the applications to intervene filed by the following parties: Southwestern Bell Telephone Company, AT&T Communications of the Southwest, Inc., and MCI Telecommunications Corporation.

On May 29, 1987, the Commission issued its order making US Sprint a party to the proceeding and modifying the filing dates and prehearing conference date.

On June 5, 1987, the Commission issued its order granting the application to intervene out of time filed by Competitive Telecommunications Associations of Missouri.

The Commission held hearings in this matter on June 17, 18 and 19, 1987. At the close of the hearing the parties presented oral argument.

Findings of Fact

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact:

Introduction

This case involves the request of an affiliate of a local exchange company for a certificate of public convenience and necessity to provide interexchange service in the interLATA market. In Case No. TX-85-10 (1985) the Commission enunciated a policy that creates a presumption that additional competition in the interLATA market is in the public interest and upon a showing of financial fitness, a certificate of public convenience and necessity will be granted.

As the Commission recognized in its order scheduling proceedings issued in this matter on May 1, 1987, Case No. GX-85-10 did not address an affiliated relationship between an interexchange carrier and a local exchange company as is contemplated in this application. In that order, the Commission recognized the potential for the subsidization of UTLD's services by UTM local service rates and the potential that UTLD might have an unfair advantage over its interexchange competitors because of its affiliation with UTM. Because of these potential abuses, the Commission expanded the scope of these proceedings beyond the question of financial fitness and directed the parties to address safeguards against these potential abuses.

Having delineated the issues to be tried in this matter, the Commission determines that prior to the grant of an application such as herein involved, the Commission must be persuaded that adequate safeguards exist to protect against the subsidization of UTLD operations by the UTM local exchange operation and adequate safeguards exist to protect against any unfair advantage that UTLD may have by reason of its affiliation with UTM that may hamper the development of competition in the interLATA market.

UTLD Proposal

UTLD is a wholly-owned subsidiary of United Telephone Company of Kansas (UTK). United Telecommunications, Inc. (UTI) is the parent company of UTK and UTM. UTM and UTK are telephone companies providing local exchange service in the States of Missouri and Kansas respectively. UTI is a fifty percent owner of US Sprint, an interexchange carrier which is authorized to provide intrastate interexchange service within the State of Missouri. United Telephone System-Midwest Group (Midwest Group) includes UTK and UTM as well as other United Telephone local exchange operating companies. Six jurisdictions are involved in the Midwest Group.

Although UTLD is a subsidiary of UTK, it is not structurally separate. UTLD has no employees, assets or facilities of its own. All UTLD functions will be performed by UTK or UTM employees. Initially two employees will be assigned full time to UTLD operations, a supervisor and a customer service representative. These are UTK employees who will be located in Gardner, Kansas. This building is occupied by North Supply (another UTI subsidiary), the Western Region Data Center and several Midwest Group employees, including Mr. Logan who devotes full time to coordinating the implementation of equal access for the Midwest Group.

During its first two years of operation, UTLD's capital will be provided by UTK through a combination of debt through advances and paid in capital. Repayment will be at a variable rate based on UTK's average monthly commercial paper rate.

UTLD proposes to resell US Sprint services to UTM customers in exchanges where equal access is available. UTLD is currently negotiating a contract with US Sprint which at the time of the hearing was not executed. Special access between UTM's office and Sprint's point of presence (POP) will be leased by Sprint for UTLD. US Sprint will route calls over its network to the termination point.

UTM will provide billing and collection services, operator services and repair services for UTLD at tariffed rates or upon comparable terms as are available to other interexchange carriers.

The UTK employees in Gardner, Kansas, will provide service connection and disconnection, pricing and sales management functions. Initially, UTLD intends to mirror AT&T rates.

UTLD's strategy is to market its services to UTM customers at the time of equal access conversion. Equal access provides customers with the capability of making interLATA calls by dialing one plus the number to be called using the participating long distance company of their choice on a rotary or touch telephone. Without equal access this capability is only available to AT&T. Without equal access customers generally must use a touch telephone and may have to dial up to 25 extra digits to place an interLATA call using a long-distance company other than AT&T.

The Federal Communications Commission (FCC) has promulgated guidelines and requirements which govern the equal access process. Under the guidelines UTM's equal access conversion involves six steps: (1) Long-distance companies are notified of the equal access conversion 190 days prior to the scheduled conversion date. The long-distance companies are advised that they must order service into the converting exchange by no later than 120 days prior to the conversion date in order to appear on the equal access ballot; (2) proof ballots are produced and forwarded to each long-distance company for their review; (3) once approved equal access ballots are mailed to customers 90 days prior to the conversion date along with an explanation of equal access; (4) customers who have not responded by the deadline as printed on the ballot are assigned, at random, in proportion to the first ballot result, to one of the participating long-distance companies listed on the ballot; (5) second ballots are mailed to customers who fail to respond to the first ballot advising them of the identification of the long-distance company to whom they have been tentatively assigned; (6) if the customer does not respond to the second ballot, the tentatively assigned long-distance company actually becomes the customer's interLATA long-distance carrier. UTLD contends that the Midwest Group strictly complies with

FCC requirements and, thus, fairness of the balloting and allocation process is assured.

UTLD's marketing strategy capitalizes on the belief that United local exchange customers desire an alternative to having two or more relationships with a telephone company. UTLD's advertising campaign encourages the customer to: "stay United with the people you know"; "avoid dealing with a stranger"; and states that "our long-distance service will also unite all your phone calls on one bill"; and that "United Telephone long-distance will cost you no more than you are now paying". However, UTLD is not the only interexchange company whose bills are included in the local exchange company's billing. In addition, other interexchange carriers charge lower rates than UTLD will propose. Therefore, UTLD advertisements are misleading.

All expenses and revenues associated with UTLD operations are proposed to be treated below the line. In order to ensure that all UTLD revenues and expenses are being separately identified, Nonregulated Accounting Procedures (NAP) are being used. The NAP guidelines are issued by UTI and are designed to fully distribute costs for services provided to UTLD by the Midwest Group. Under these guidelines, expenses are divided into three categories: direct attributable costs; general business costs; and joint use asset costs.

Direct attributable costs are expenses having characteristics which can be directly linked or related to UTLD. These costs are directly reported to below-the-line business unit operations wherever possible.

General business costs are those expenses which have characteristics common to all companies within the Midwest Group. No direct relationship to a specific segment exists for general business costs. Consequently, these costs cannot be directly reported but must be allocated to UTLD based on the ratio of direct and indirect labor reported to UTLD to total company labor within the Midwest Group.

Joint use asset costs are those costs applicable to assets common to both regulated and below-the-line business unit operations which are recorded in regulated

accounts. Rather than transferring a portion of shared asset costs to below-the-line business unit operations, a capital carrying charge assessment is made to UTLD for the use of assets which have been included in the ratemaking process. Depreciation expenses and property tax expenses on joint use assets are allocated to UTLD based on the ratio of the asset value applicable to UTLD to total asset value.

UTLD contends that its accounting methods are adequate to ensure that cross subsidization does not take place since in its opinion the NAP guidelines do not allow for cross subsidization.

Positions of the Parties

UTLD takes the position that it meets the criteria set forth in TX-85-10 and therefore the granting of the certificate is in the public interest. UTLD contends that issues of cross subsidization and other issues raised in this matter should be investigated subsequent to the granting of the certificate.

Public Counsel, MCI and Comptel contend that the issuance of a certificate of public convenience to UTLD is not in the public interest because the local exchange ratepayers will probably subsidize UTLD and the entrance of UTLD in the interLATA market will not promote competition.

Staff believes there are issues of cross subsidization, potential for anti-competitive behavior and royalty payments that should be addressed prior to the issuance of a certificate. Staff does not believe it has sufficient information on these issues for it to recommend the granting or denial of the certificate.

AT&T contends that the issues raised by Public Counsel and Staff should be considered in determining whether a certificate should be granted.

UTM takes no position. US Sprint does not oppose the application. Southwestern Bell does not oppose the application.

Cross-Subsidization

A great deal of the hearing time was devoted to the adequacy of the NAP procedures to ensure against cross subsidization. If costs are underallocated to

UTLD, they will be overallocated to the Midwest Group and therefore UTM. This would result in an inappropriate subsidy flowing from local exchange ratepayers to the UTLD long distance operation.

Since the allocation of common costs (general business costs) are based on the ratio of direct reported labor costs to total Midwest Group labor costs, the amount of common costs allocated to UTLD will be a function of the amount of directly reported labor costs. Thus, the more labor costs which are contained in the direct reported category, the more common costs will be allocated to the UTLD operation.

Only one of the witnesses who appeared on behalf of the Applicant directly reported his time and, thus, his salary and expenses are directly reported to UTLD. The remainder of the witnesses and the Company's legal counsel do not directly report their time and thus their salaries are placed in a general cost pool and allocated based upon the above-described ratio.

Mr. Goulet, Network Development Manager of the Midwest Group and General Manager of UTLD, directly reports his time. His salary and associated costs are directly assigned to deregulated activities and the remainder of his salary is allocated to the jurisdictions within the Midwest Group.

The two UTK employees who will work full time for UTLD keep positive time reports and, thus, their salaries are directly assigned to UTLD. Mr. Goulet testified that various employees within the Midwest Group work on UTLD but less than a dozen report their time directly.

Mr. Sichter, Director of Policy Research for UTI, who testified on behalf of the Applicant, submits quarterly time reports but does not keep a daily record of his time. Approximately ten percent of his time is allocated to nonregulated activities which under the Company's procedures would include UTLD.

Mr. Logan, Customer Service Director, Midwest Group, devotes full time to coordinating equal access conversion in the six jurisdictions. Although he had spent approximately 100 hours on the UTLD certificate proceeding, he does not direct report

his time and, thus, his salary is treated as a general business cost and allocated according to the factor described above.

Mr. Walker testified in support of accounting safeguards to ensure UTLD transactions are separately identified. Mr. Walker, UTLD's treasurer, manages all accounting activities and issues financial statements for the Midwest Group and UTLD. Mr. Walker's salary goes into the general cost pool and is allocated based upon the general business cost allocation factor. Mr. Walker testified that approximately 42 percent of his salary is allocated to UTM.

Legal counsel which represented UTLD in this proceeding and who also represents UTM and other Midwest Group companies does not report his time directly. His salary and the rest of the legal departments' salaries are placed in the general business cost pool and allocated to the various operating companies and nonregulated services.

Along with the application submitted in this proceeding, UTLD provided pro forma statements for UTLD operations for 1987 and 1988. The pro formas are broken down into four-state operations and a combined total. The pro formas represent budgets for 1987 and 1988 and follow the NAP guidelines described above. The budgets include approximately 19 categories of direct costs and eight categories of allocated costs (general business costs).

For the year 1987, the Missouri pro forma shows no costs allotted to the following direct categories: start-up; billing and collection program development; software and miscellaneous. Interest is a direct expense but does not appear on the pro forma. Upon further cross-examination Mr. Walker stated that start-up costs appear under the miscellaneous category of the Kansas pro forma schedule and in the sales and payroll category of the Missouri pro forma schedule. Mr. Walker also stated that advertising is reflected under the sales category.

The pro forma contains no expenses allocated to the depreciation category and no joint use asset costs. Furniture lease, rent and utilities, appear as categories on the pro forma and represent a capital carrying charge assessment.

During the course of the hearing, much attention was devoted to the allocated legal costs contained in the pro forma. Counsel for UTLD participated in three days of hearing, three other appearances in Jefferson City, time spent participating in discovery, preparing pleadings and preparing for the hearing. The Missouri pro forma reflects a total of \$412 in legal costs for 1987. Mr. Walker testified that based upon the NAP accounting procedures, the amount actually allocated to the legal category through May 31, 1987, is \$342.

It is apparent that the allocated costs under the NAP procedures at least with respect to legal costs, do not result in a reasonable allocation. Legal costs incurred that are not reflected in UTLD operations remain with the Midwest Group and, therefore, a portion is allocated to UTM. This is true for all allocated costs to the extent that the allocation is not representative of what is actually occurring.

Since only a small number of employees prepare direct time reports, the direct hours reported to UTLD is so small compared to total Midwest Group hours that the percentage allocation will always be a very small percentage of the cost pool. For example, if Mr. Walker were spending 80 percent of his time on UTLD, under the allocation factor a very small percentage would be allocated to UTLD. However, 42 percent of his time would be charged to UTM and the remainder would be allocated among the other five jurisdictions.

Mr. Walker admitted that, in the short term, the NAP procedures may result in an under allocation of UTLD expenses. He contends, however, that the method will reasonably allocate costs over time. He believes that as equal access sites continue to be added direct charges will increase, thereby increasing UTLD's percentage allocation for common costs.

In the Commission's opinion, UTLD has not shown the NAP procedures to be a reasonable method to allocate costs. Under the NAP guidelines, general business costs are those common costs which have no direct relationship to a specific segment and cannot be direct reported. The criteria for determining why so many costs are allocated rather than direct charged was not explained. A group within the Midwest Group decides which costs are direct charge and which are allocated. No record of the decision is kept and no written procedures exist. A group on Mr. Walker's staff routinely monitors nonregulated activities to be sure the NAP process is appropriate. They review time sheets, sale agreements and work orders. It is not at all apparent how such a review would affect the question of which costs should be direct reported and which should not. In the Commission's opinion, no justification has been advanced to explain why executives, accountants, lawyers, and perhaps other Midwest Group employees should not keep positive time reports.

Based on the foregoing, the Commission determines that UTLD has not shown that adequate safeguards exists to protect against the subsidization of UTLD operations by the local exchange operations. It does not appear that NAP procedures are always followed as is shown by the lack of certain direct costs on the pro forma statements. In addition, it appears that many costs which could be direct reported are being treated as common costs and therefore not being allocated to UTLD operations. Such improper allocations would be difficult to correct during the course of a rate case audit because no time records are being kept for costs which are being placed in the general business cost pool.

Fair Competition

UTLD has the ability and incentive to engage in anticompetitive conduct because of its affiliation with UTM which controls the "local bottleneck". AT&T's control of local exchange facilities was one reason why the Bell system was divested into an interexchange company and seven regional Bell operating companies. AT&T's substantial domination of the telecommunications industry was the other reason for

divestiture. United States v. American Telephone and Telegraph Company, 552 F. Supp. 131, 162-163 (1982). Thus, control of the local exchange network was not the sole basis for divestiture.

However, the incentive of those who control the local network to discriminate against competitors was one of the reasons for prohibiting the Bell operating companies from providing interexchange services. 552 F. Supp., supra, at 188. These restrictions may not last indefinitely as divestiture and the realization of equal access are designed to promote fair competition in the interexchange market; but it is doubtful that the restrictions will be lifted until it is shown that adequate safeguards exists to insure against anticompetitive conduct.

Because of its affiliation with UTK, UTLD's debt is at a more favorable rate than could be had under an arms-length transaction with an independent financial institution. UTLD is also in a position to trade on UTM's goodwill at no cost. Although the securing of financing through the United Telephone System and the use of the United's nine square logo provide UTLD with an advantage over its competitors, the Commission does not believe such an advantage must necessarily be "unfair". Safeguards could be instituted that ensure UTLD's financing is at the market rate and that UTLD pay a royalty fee for the use of the local exchange company's goodwill.

UTLD, by use of its affiliation with UTM and Sprint, might be able to secure more favorable treatment from both UTM and Sprint than other resellers may be able to obtain. However, safeguards can be established to ensure that such arrangements be on the same terms and conditions as are offered to other resellers or OCC's.

Because UTLD and the Midwest Group have common employees, executives, facilities, and offices, UTLD has access to UTM's equal access conversion plans, billing information, marketing information and other customer specific information which is proprietary and is not available to other interexchange carriers. If UTLD can secure this kind of information it will have an unfair competitive advantage over

its other interexchange competitors which could threaten the development of competition in the interLATA market at least where UTM exchanges are involved. Absent a structurally separate subsidiary and a prohibition from disclosing such information to the subsidiary or provision of access to this kind of information to all competitors, the Commission is unaware of safeguards which adequately protect against this unfair advantage. No evidence was presented to the Commission which suggests safeguards in this area exist other than the Midwest Group's generalized assertions that such information is not provided to UTLD.

As a result of the equal access balloting that occurred in six Missouri exchanges, UTLD's market share ranged from 18.2 percent to 26.8 percent of the total access lines within the markets. It is reasonable to conclude that UTLD's ability to capture such a large market share is partly because of its ability to trade on the United name. It is unknown if a portion of the market share is dependent upon UTLD's attempt to capitalize on customer confusion through its misleading advertising campaign and access to proprietary information.

Nevertheless, UTI through its ownership interests in UTLD and US Sprint has the ability to capture such a large share of the market that UTI and AT&T (the established carrier) could conceivably control the market. This could cause a regression from the competitive market structure which MCI, US Sprint and various resellers have been creating in the interLATA market place and could create a barrier to the entry of new competitors.

Competition is desirable if it encourages the introduction of new services and results in lower prices. Neither of these results is contemplated by the creation of UTLD. "One stop" shopping is not new. It is currently available from AT&T, since UTM includes AT&T's bill in the customer's monthly phone bill. Thus, UTLD's service provides an alternative to AT&T's service. However, UTLD does not intend to compete with AT&T as to price. Therefore, UTLD's proposed interLATA service offers neither a price nor service advantage. UTLD is offering Sprint

service at AT&T's price, the highest price in the industry. If AT&T and UTI can capture the market, no market pressure will exist to force rates down. Consideration of market share, alone, is not determinative of whether additional competition should be allowed in the interLATA market. This discussion merely illustrates that UTLD's proposed service may not encourage competition.

Decision

Having carefully reviewed the evidence, the Commission finds that Applicant has not shown that adequate safeguards exists to ensure UTLD operations are not subsidized by UTM. Specifically, Applicant has not shown that the NAP procedures provide a reasonable allocation of common and joint costs.

The Commission further finds that Applicant has not shown a grant of the application would promote competition in the interLATA market nor that a grant of the application would not hamper the development of competition in the interLATA market. Specifically, the evidence shows that an absence of safeguards to prevent UTLD's access to sensitive and proprietary information (which is not available to other interexchange carriers) constitutes a threat to the development of full and fair competition in the interLATA market.

Based on the foregoing, the Commission finds that the Applicant has not shown that a grant of the application is in the public interest. Accordingly, the Commission determines that the application should be denied.

Since the Commission is denying the instant application, it need not determine whether an interLATA long distance enterprise of a local exchange telephone company should be treated as a "below the line" operation. The Commission believes, however, that future LEC applicants for interLATA toll authority must be prepared to meet their burden of proving with competent and substantial evidence that "below the line" treatment, (which would be a change from traditional regulatory treatment for LEC toll revenues and expenses), would be in the public interest.

Conclusions

The Missouri Public Service Commission has arrived at the following conclusions:

United Telephone Long Distance Company is a telephone corporation pursuant to 386.020 and as such is subject to the jurisdiction of this Commission pursuant to 386.250.

United Telephone Long Distance Company proposes to provide service to the public under a certificate of public convenience and necessity pursuant to Section 392.260, RSMo 1986.

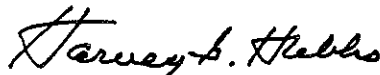
After due notice and hearing, the Commission has found that the application should be denied since the Applicant has not shown that a grant of the application in the public interest.

It is, therefore,

ORDERED: 1. That the application filed in this matter on February 18, 1987, by United Telephone Long Distance Company be, and it is, hereby denied.

ORDERED: 2. That this Report and Order shall become effective on the 27th day of August, 1987.

BY THE COMMISSION



Harvey G. Hubbs
Secretary

(S E A L)

Steinmeier, Chm., Mueller, Hendren
and Fischer, CC., Concur and certify
compliance with the provisions of
Section 536.080, RSMo 1986.
Musgrave, C., Not Participating.

Dated at Jefferson City, Missouri,
this 28th day of July, 1987.